SSRO

Single Source
Regulations Office

The 2020 review of the procurement framework for single source defence contracts

Consultation

December 2019

Contents

1. Introduction

1.1 This document sets out the SSRO's understanding and views on matters related to the statutory framework of regulation of single source defence contracts by the Ministry of Defence (MOD). The SSRO is seeking views and evidence in relation to these matters to help it decide whether, in respect to each matter, it should:

a) make any specific recommendations to the Secretary of State for Defence for changes to the regulatory framework, to inform the review he is expected to complete by December 2020;

b) make any changes to the guidance it provides to the MOD and contractors in relation to the matters considered;

c) make any changes to the reporting system which it maintains to enable contractors to meet their transparency obligations under the framework;[1] or

d) undertake any further work or engagement on these matters.

1.2 In a number of areas, the SSRO is not yet persuaded of the need for change. Stakeholder input is sought on the benefits and impacts of any potential changes to ensure these are fully considered before any firm proposals are developed.

Structure of the paper

1.3 The paper is divided into the following sections:

- Section 2: Summarises the key features of the regulatory framework, the SSRO's statutory duties and the background to the current review.
- Section 3: Describes the engagement and review activity the SSRO has undertaken to help inform its consideration of the matters set out in this paper.
- Section 4: Provides an overview of the matters discussed in Sections 5 to 10 on which views, evidence and proposals are sought.
- Section 5: Discusses matters related to the cost risk adjustment in determining the contract profit rate for a regulated contract.
- Section 6: Discusses matters related to the profit on cost once adjustment in determining the price of a regulated contract.
- Section 7: Discusses matters related to the defined pricing structure which is used by contractors to provide a breakdown of contract costs in statutory reports.
- Section 8: Discusses matters related to the reporting of contract amendments and variances.
- Section 9: Discusses matters related to the overheads reports which contractors may be required to submit if certain conditions are met.
- Section 10: Discusses other matters related to the pricing or reporting of contracts.

1 The Defence Contract Analysis and Reporting System (DefCARS).

How to provide input

1.4 This consultation is open for a ten-week period until 28 February 2020. The SSRO welcomes the opportunity to discuss the matters highlighted in the paper with stakeholders during this period, or to discuss other matters relevant to the operation of the regulatory framework that are of concern to stakeholders.

1.5 The SSRO intends to hold a workshop with stakeholders to discuss the proposals. Should you wish to attend, please contact us at consultations@ssro.gov.uk.

1.6 We invite written responses to the consultation, which should be received no later than 5pm on 28 February 2020. These should be sent:

a) by email to consultations@ssro.gov.uk (preferred); or

b) by post to SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.

1.7 In the interests of transparency for all stakeholders, the SSRO's normal practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm whether they consent to the attribution of comments made. Where consent is not provided, comments will only be published in an anonymised summary form.[2]

2 The SSRO has published policy statements on its website, 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.

2. The single source regulatory framework

The regulatory framework

2.1 The regulatory framework for single source defence contracts was introduced by Part 2 of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations) and came fully into effect in December 2014. In 2018 and 2019, the Regulations were amended by three statutory instruments:

- The Single Source Contract (Amendment) Regulations 2018;
- The Single Source Contract (Amendment) (No. 2) Regulations 2018; and
- The Single Source Contract (Amendment) Regulations 2019.

2.2 The framework established a scheme of regulation that:

- controls the prices of qualifying contracts (qualifying defence contracts and qualifying sub-contracts); and
- requires transparency on the part of defence contractors regarding their prices and strategic matters such as their capacity to continue to meet the government's requirements.

2.3 These measures are imposed on contracts that have not been the subject of competition. The intention of the regulatory measures is to ensure that, in the absence of competition:

a) good value for money is obtained in government expenditure on qualifying defence contracts, and

b) persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.

The SSRO

2.4 The SSRO was established to be the custodian of the regulatory framework and its functions extend throughout operative provisions of the framework, including:

a) assessing and recommending the appropriate rates for use in pricing contracts;

b) issuing statutory guidance on pricing contracts, reporting and penalties;

c) providing opinions and determinations on the functioning of the framework;

d) analysing matters relevant to the operation of the framework;

e) monitoring the extent to which reporting requirements are complied with; and

f) keeping the operation of the framework under review and making recommendations for change to the Secretary of State.

2.5 In carrying out its functions the SSRO is expressly required to seek to achieve the twin aims described in paragraph 2.3.[3]

3 Section 13(2) of the Act

Review by the Secretary of State

2.6 The Secretary of State is required to complete periodic reviews of the framework.[4] The first review was completed by December 2017. It led to changes being made to the Regulations by the three statutory instruments listed in paragraph 2.1.

2.7 The Act requires that subsequent reviews are undertaken at least every five-years. The Secretary of State intends to complete the next periodic review in December 2020, well in advance of the end of the review period (17 December 2022).

2.8 In carrying out a review, the Secretary of State must have regard to any recommendations made by the SSRO, provided these are submitted six months before the date on which the review is to be completed.

2.9 The SSRO committed to the following procedure in its framework document with the MOD:

- formulate recommended changes to the Regulations (and potentially the Act) and consult with the primary users;
- publish the draft recommendations in a publicly available document to form the basis of a public consultation. The consultation period should be a minimum of two months to ensure an appropriate level of engagement and enable any interested party to contribute (in line with the government's 'Code of Practice on Consultation'); and
- publish recommendations to the Secretary of State for Defence. This must happen at least six months in advance of the Secretary of State's duty to review the legislation.

2.10 After considering responses to the matters discussed in this paper, the SSRO intends to make any recommendations to the Secretary of State by 17 June 2020.

4 Section 39(3) of the Act

3. The SSRO's engagement and background

3.1 We describe below the SSRO's general engagement with stakeholders on matters relevant to the regulatory framework for single source defence procurement and the specific review work undertaken during 2019 to inform the SSRO's consideration of matters discussed in this paper.

General engagement with stakeholders

3.2 The SSRO actively engages with relevant stakeholders to inform its priorities and discharge of its functions. This broad programme of engagement has enabled it to develop its understanding of how the provisions of the legislation are being applied to shape that application in appropriate ways. The SSRO's approach has included:

- extensive engagement with the MOD, including a range of planned meetings related to implementation of the regulatory framework;
- regular meetings with individual contractors to promote compliance, on-boarding training workshops with new contractors to the regime and responding to contractor queries through a help desk function;
- site visits to contractor premises and facilities and industry forums;
- facilitating the SSRO's regular Operational Working Group meetings;
- consulting with stakeholders to develop the SSRO's guidance, its assessment of the baseline profit and capital servicing rates and its compliance methodology; and
- attending workshops with the MOD and defence industry in relation to the proposed changes resulting from the 2017 review.

Review of contract profit rates

3.3 During 2019, as signalled in its corporate plan,[5] the SSRO undertook a review of contract profit rates expected or earned by contractors in qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs); the non-competed contracts which are subject to the Regulations. The review of contract profit rates (review of CPR) aimed to help the SSRO:

a) better understand contract profits in QDCs and QSCs;

b) understand factors that have influenced these contract profits; and

c) consider whether and what changes may be needed to legislation or the SSRO's monitoring, methodologies or guidance to better achieve the intent of the legislation.

3.4 In undertaking the review, the SSRO was mindful that the requirements introduced by the Regulations are still relatively new, with very few contracts priced under the Regulations having completed. Given the limited evidence base available to inform any proposals for change and stakeholders' expressed desire for stability in the regime, our starting position was that changes should only be proposed where these would better enable the efficient agreement of QDCs and QSCs and contribute to the achievement of value for money and fair and reasonable contract prices.

5 SSRO (2019) *SSRO Corporate Plan 2019-2022*.

3.5 The SSRO's review of CPR was undertaken in two phases. The first phase looked broadly at the contract profit rates agreed to date and the second involved a more-detailed consideration of some specific issues. The objectives for Phase 1 of the review were to:

a) examine the operation of the six steps used to calculate the contract profit rate for a QDC or QSC;

b) analyse the estimated, expected or actual profits earned in QDCs/QSCs;

c) explore the ability of existing data to identify factors associated with variance; and

d) identify and prioritise issues for further examination, in consultation with stakeholders.

3.6 Extensive analysis was undertaken of contract pricing data reported for 159 contracts agreed from 1 April 2015 to 30 September 2018. This was supplemented by analysis of financial data for QDC/QSC contractors and their global ultimate owners, and for comparator group companies. We also considered feedback provided by the MOD and industry stakeholders in response to previous consultations and engagement on matters related to cost risk and incentives[6] and on the SSRO's approach to monitoring and evaluating contract profit.[7]

3.7 The findings from analysis were shared in presentation format with members of the SSRO's Operational Working Group (OWG) in April 2019. The material shared was subject to discussion at a meeting of the OWG in April and two follow-up teleconferences with OWG members.

3.8 Drawing on the findings from the analysis, a number of potential areas where further work might be desirable were identified and the priority of these was discussed with stakeholders. Stakeholders agreed that the main priorities for Phase 2 of the review of CPR were:

a) codifying a set of principles which could inform the determination and monitoring of contract profit rates that support value for money and fair and reasonable prices;

b) clarifying and refining the SSRO's baseline profit rate (BPR) methodology, to include a review of the company size and data quality criteria for entry to the comparator groups; and

c) developing the approach to the consideration of risk in the determination of contract profit rates.

3.9 We summarise below the work undertaken in 2019 in each of the three priority areas.

Profit principles

3.10 The SSRO considers that a lack of common understanding among stakeholders on the principles which underpin the payment of profit in QDCs and QSCs has hindered debate on whether the current arrangements for pricing these contracts result in prices and, in particular, profits that are fair and reasonable. In an effort to overcome this, the SSRO issued a working paper to OWG members in July 2019 setting out five principles, rooted in economics and corporate finance, which it considered were relevant to the pricing of QDCs and QSCs. The working paper included discussion of the evidence the SSRO had considered in forming its view on the relevant principles.

6 SSRO (2018) *Cost Risk and Incentives in Qualifying Defence Contracts: Recommendations to the Secretary of State for Defence*.
7 SSRO (2017) *Developing the SSRO's Approach to Calibrating Profit Rates in Single Source Contracts: Discussion Paper*.

3.11 Members of the OWG attended a workshop in August 2019 to discuss the working paper and the SSRO received written responses from ADS (on behalf of its members), seven defence contractors and the MOD. A summary of their feedback is provided at Appendix 2 to this paper. The MOD was broadly supportive of the work. Industry responses were more mixed, including: rejection by some of the use of economic theory to inform the pricing of QDCs and QSCs; concerns about whether the principles imply a move to rethink the basis on which contract profit is determined; and qualified agreement with the intent of some principles, for example, on the need to consider returns for investors in contracting companies when pricing QDCs and QSCs.

3.12 We have considered the feedback provided by stakeholders on the principles proposed and concluded that the potential for reaching agreement with stakeholders about the relevant principles is limited at this time. However, we remain of the view that a set of principles will:

a) provide an intellectually robust foundation for thinking about profit and pricing, which can inform how the SSRO delivers its statutory functions;

b) provide transparency for stakeholders in how our work is guided;

c) further promote long-term consistency in the SSRO's decision-making on pricing methodologies and guidance and, potentially, future referrals on related matters; and

d) provide a basis upon which stakeholders can hold the SSRO to account.

3.13 We will continue to explore ways to take this work forward.

BPR methodology

3.14 The SSRO is required by the Regulations to make an annual recommendation to the Secretary of State to assist him to determine the appropriate rates to be used each year in the pricing of QDCs and QSCs. The SSRO's methodology for assessing the appropriate rates[8] has been developed in consultation with stakeholders and the Secretary of State has accepted the SSRO's recommendations each year since its inception.

3.15 The SSRO's work in Phase 1 of the review of CPR identified aspects of the BPR methodology where greater clarity about the existing methodology could be provided to stakeholders and where further refinement may be desirable. The SSRO undertook a public consultation[9] during July and August on proposed changes to the BPR methodology that would:

a) remove 'small' companies from the result by introducing a more sophisticated company-size criteria;

b) calibrate the automatic filters that identify a company's activities; and

c) clarify or codify existing practice in the activity characterisations.

3.16 Overall, consultation respondents welcomed the opportunity to engage with the SSRO on the methodology. Most respondents expressed some support that the proposed changes improved the methodology. However, in all cases, industry respondents considered that the changes did not adequately address the topic areas, and some challenged the validity of the methodology in its entirety.

8 SSRO (2019) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.
9 SSRO (2019) *Single Source Baseline Profit Rate Methodology: Consultation on Changes for the 2020/21 Rates Assessment*.

3.17 Having considered the responses to the consultation, the SSRO Board approved the methodology to be applied for the 2020/21 rates recommendation in September 2019, including the changes on which we had consulted and a minor alteration to the description of the geographic search criterion to aid clarity. A summary of responses to the consultation was published in October 2019.[10] The SSRO will continue to keep its methodology for assessing the appropriate rates under review.

Risk in contract profit rates

3.18 Uncertainty about the costs that will be incurred by the contractor in performing a QDC/QSC may be reflected in the Allowable Costs of the contract. The SSRO provides guidance on how Allowable Costs should be determined. The MOD and contractors must have regard to this. We consulted in 2019 on changes to the guidance related to uncertainty and risk.[11]

3.19 The Act and Regulations also provide for an adjustment to be made at step 2 of the process for determining the contract profit rate 'to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs'.[12]
The range of the permissible cost risk adjustment (CRA) is specified in the Regulations as ±25 per cent of the prevailing baseline profit rate. The SSRO provides guidance[13] on how the CRA is to be determined, to which the MOD and contractors must have regard.

3.20 The ability of the pricing formula for QDCs and QSCs to provide an appropriate reward to contractors for the level of risk they (or the MOD) bear has been a long-standing issue for both the MOD and contractors. The SSRO first considered matters related to cost risk in QDCs and QSCs in 2017, leading to a report[14] to the Secretary of State (hereafter, the Cost risk study) to inform his review of the legislation which concluded in December that year. Since then, the MOD has been engaging with single source suppliers and the SSRO on proposals to:

a) agree a more-structured approach to determining the CRA that might enhance consistency in determining the appropriate adjustment for a given QDC/QSC; and

b) change the range of the CRA to permit different risk-transfer arrangements than are currently available.

3.21 In consideration of stakeholders' ongoing interest in this matter, the SSRO issued a working paper to members of its OWG in September 2019 as part of the review of CPR. This included updated analysis related to the CRA for contracts which became QDCs or QSCs up to 31 March 2019 and addressed matters relevant to the range of the CRA and how it is navigated. The SSRO held group and individual meetings with members of the OWG to discuss the issues raised by the working paper; and considered written responses to the working paper received from seven stakeholders, including the MOD, ADS (on behalf of its member organisations), and five contractors.

3.22 A summary of the issues considered in the working paper and the feedback stakeholders provided on it are provided in section 5, together with the SSRO's further consideration of the need for any changes in the approach to the CRA.

10 SSRO (2019) *Single Source Baseline Profit Rate Methodology: Summary of Consultation Responses*.
11 SSRO (2019) *Allowable Costs Guidance Review: Consultation on Changes for 2020/21*.
12 Section 17(2) of the Act and Regulation 11(3).
13 SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment 2019/20 (Version 5)*.
14 SSRO (2018) *Cost Risk and Incentives in Qualifying Defence Contracts: Recommendations to the Secretary of State for Defence*.

Review of reporting requirements

3.23 Defence contractors are required to provide reports to the SSRO and the MOD if they hold qualifying contracts under the regulatory framework. The reporting requirements are established by sections 24 and 25 of the Act and Parts 5 and 6 of the Regulations, which together prescribe the types of reports, their contents and the circumstances in which they must be provided. The reports fall into two broad categories, as summarised in Figure 1 below. A summary of the contents of each report can be viewed in Appendix 1 of the SSRO's Annual Compliance Report 2019.[15]

Figure 1: Reports under the regulatory framework

Report category	Reports
Contract reports (Part 5 of the Regulations) Reports required for each QDC and QSC (some of which may additionally be required on-demand) Data about contract requirements, payments, estimated and actual costs, profit, delivery and sub-contracts.	Contract Pricing Statement Contract Reporting Plan Contract Notification Report → Interim Contract Reports Quarterly Contract Reports → Contract Completion Report Contract Cost Statement
Supplier reports (Part 6 of the Regulations) Reports required about defence contractors when relevant triggers are met. Data about a contractor's overhead costs in standard categories, its strategic capacity and opportunities for SMEs in the supply chain.	**Overhead reports** Estimated Rates Agreement Pricing Statement Estimated Rates Claim Report Actual Rates Claim Report QBU Estimated Cost Analysis Report QBU Actual Cost Analysis Report Rates Comparison Report (on demand) **Strategic reports** Strategic Industry Capacity Report Small or Medium Enterprises Report

*In this table, and in the Regulations, "QBU" refers to a qualifying business unit.

3.24 In 2019/20, the SSRO's review of reporting requirements focused on:

- the defined pricing structure used in some of the contract reports in Part 5 of the Regulations;
- the reporting of amendments and variance in contract reports; and
- the overhead reports in Part 6 of the Regulations.

3.25 These themes were prioritised following engagement with stakeholders in March and April 2019. The review has considered the intended purpose of reported information, how it is being used and whether requirements are proportionate.

3.26 In developing its thinking, the SSRO has engaged with stakeholders through a series of workshops and bilateral meetings. In particular, we:

- held workshops with stakeholders on 8, 15 and 20 May 2019;
- attended a series of bilateral meetings with stakeholders between May and September 2019;

15 https://www.gov.uk/government/publications/annual-compliance-report-2019.

- released a working paper to key stakeholders on the review of reporting requirements on 2 September 2019 and invited feedback over the course of 4 weeks until 27 September 2019; and
- held workshop with stakeholders to discuss the issues raised in the working paper on 12 September 2019.

3.27 These helped the SSRO in informing its understanding of:

- the challenges faced when reporting and using the data;
- how reported data can best support the MOD in procuring and managing single source contracts; and
- whether purposes envisaged at the inception of the regime remain relevant, and the reports continue to be fit for purpose.

3.28 A summary of the issues considered in the review of reporting requirements and the feedback stakeholders provided on these are provided in sections 7, 8 and 9, together with the SSRO's further consideration of the need for any changes related to these matters.

4. Overview of matters on which input is sought

4.1 Sections 5 to 10 of this paper provide a detailed commentary on matters where the SSRO seeks views or evidence to assist in its consideration of the need for changes in the legislation which defines the regulatory framework, the SSRO's guidance or its reporting system. Views or evidence may also identify or support the need for further work or engagement on these matters.

4.2 Where potential changes are discussed, these aim to enhance the existing provisions of the regulatory framework so that it is better placed to achieve good value for money in government expenditure on qualifying defence contracts and fair and reasonable prices under those contracts for defence contractors.

Matters arising from the review of contract profit rates

Cost risk adjustment (Section 5)

4.3 In determining the contract profit rate for a QDC or QSC, the baseline profit rate may be adjusted by ±25 per cent to reflect the risk that the contractor's actual Allowable Costs may vary from its estimated Allowable Costs. Key findings are that:

a) The legislation could better reflect the rationale for making an adjustment related to the risk exposure of the contracting parties when determining the contract profit rate.

b) Stakeholders would welcome further direction on how the contract pricing method should inform the CRA. This might be provided through the legislation or the SSRO's guidance.

c) Further direction may be needed to assist the parties to determine the CRA for a contract, which could be provided through legislation or guidance. We will continue to support stakeholders' work to develop an approach to navigating the CRA range using multi-criteria analysis and will consider further the need for additional guidance.

d) A simpler approach to determine the CRA for lower-value contracts or contract amendments may be desirable to ensure proportionality. We will consider the need for this in due course.

e) Some stakeholders want to increase the range of the CRA to permit a wider range of contract profit rates to be agreed. In certain circumstances, higher or lower profit rates could contribute to contract prices that achieve value for money for the government and which are fair and reasonable to contractors. Whether a wider range of profits should be achieved by a change to the CRA range alone or in combination with other regulatory changes requires further consideration.

f) Further thought should also be given to how any change to the CRA range is to be determined and whether it continues to be defined by reference to the prevailing baseline profit rate.

Profit on cost once (POCO) adjustment (Section 6)

4.4 In determining the price of a QDC or QSC, contractors must make an adjustment to ensure that profit is only earned once on costs arising in non-competed sub-contracts or further sub-contracts with associated persons (defined as group undertakings). Key findings are that:

a) Changes to how the relationship between the primary contractor and sub-contractor or further sub-contractor is specified would make it easier for contractors to identify relevant sub-contracts and further sub-contracts and bring under consideration some additional sub-contracts or further sub-contracts for which it may be appropriate to make adjustments.

b) The Regulations should be amended to make clear that the profit to be excluded from the contract price is only a relative proportion of the profit received by the group sub-contractor or further group sub-contractor where that person is jointly owned with another person not associated with the primary contractor.

c) Consideration should be given to the threshold below which non-competed sub-contracts and further sub-contracts with associated persons are disregarded for the purpose of the POCO adjustment.

d) Further consideration is needed as to whether non-competed sub-contracts or further sub-contracts with group undertakings which can be shown to be competitively priced, or which are qualifying sub-contracts priced under the Regulations, might reasonably be disregarded for the purpose of the POCO adjustment.

e) There may be merit in amending the Regulations to permit an alternative approach to adjusting for profit earned in relevant sub-contracts or further sub-contracts where the actual amount of attributable profit cannot be determined by the primary contractor.

f) Further consideration should be given to requiring the POCO adjustment to be made to the Allowable Costs of the contract rather than the profit rate, which would address some of the difficulties experienced to date by contractors when making POCO adjustments.

g) There is a need for improved reporting by contractors to provide transparency about POCO adjustments made. Some changes might be achieved through amendments to the SSRO's reporting guidance. Other changes would require amendments to the Regulations.

Matters arising from the review of reporting requirements

Defined pricing structure (DPS) (Section 7)

4.5 The purposes of requiring costs to be split by the DPS are to provide a basis for benchmarking and improve future estimating: Key findings are that:

a) There has been limited use of the data to date, which has constrained input to the review and makes widespread change premature.

b) Application of the DPS is more likely to produce useful data if the MOD agrees the DPS and the output metrics for each contract. We intend to encourage this through guidance.

c) Some improvements can be made to DefCARS and guidance to assist application of the DPS in relation to in-service support contracts and mapping.

Amendments and variance (Section 8)

4.6 Information about amendments and variances in contract reports may support contract management and improve estimating by capturing the causes of cost growth. Key findings are that:

a) Details of amendments are not being well captured and we can try to improve this through better structuring of DefCARS and guidance on material events and on-demand reports.

b) Freeform explanations of variances are difficult to analyse and it is proposed to introduce some high-level categorisation through changes to DefCARS and guidance.

c) Definitions and examples may assist contractors to report amendments and variances.

Overheads (Section 9)

4.7 Overhead reports are designed to capture a record of overheads, enable benchmarking and identify over- and under- recovery. Key findings are that:

a) More work is required to understand the MOD's operation of its rates programme and the extent to which there should be alignment with statutory reporting.

b) There is a case for reporting agreed rates and costs (currently it is just claims), which should be pursued through legislative change.

c) The SSRO's monitoring of overhead reporting is currently impeded because it is unable to identify qualifying business units in a timely and reliable way. Change will depend on better understanding of the rates programme.

Other matters (Section 10)

4.8 We consider three additional matters which the Secretary of State may wish to address:

a) The SSRO is inviting feedback on the matters that have been raised by the MOD where different parts of a contract are priced using different profit rates. The SSRO is particularly interested in receiving input on the impact that segmented profit rates would have on contractors and the extent to which this should be reflected in reporting.

b) The Regulations describe how the Allowable Costs are to be determined under each regulated pricing method. We consider it may be helpful to amend the Regulations for the target pricing method to permit adjustments to be made to the Allowable Costs estimated at the time of agreement due to changes in specified indices or rates. This will bring the approach into line with the fixed and volume-driven pricing methods.

c) The Regulations describe the circumstances in which a final price adjustment may be applied and how it should be calculated. Some minor changes are required to how the conditions which determine whether an adjustment is made are described.

5. Cost risk adjustment

5.1 In economic theory, risk averse investors must be compensated for additional uncertainty with higher expected returns. Ensuring appropriate levels of compensation for risk exposure are available and allocated to the MOD and contractors in QDCs and QSCs is fundamental to the achievement of economically efficient risk sharing. This has implications for the achievement of contract prices that obtain good value for money in government expenditure and are fair and reasonable to contractors.

5.2 Following our consideration in the review of CPR of matters related to the treatment of risk in contract profit rates, the SSRO now seeks further views or proposals from stakeholders regarding particular aspects of the approach to the cost risk adjustment (CRA). These relate to:

a) the purpose of the CRA;

b) how the CRA range is navigated; and

c) the range of the CRA.

5.3 We discuss these in turn below.

Purpose of the CRA

Overall purpose

5.4 The purpose of the CRA, expressed in the Act and Regulations is: 'to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs'.[16] The explanatory notes to the Act further set out that step 2 is "…an adjustment to reflect the residual cost risk retained by the contractor under the QDC …This adjustment may increase or decrease the [contract profit rate]".

5.5 The SSRO's working paper set out its view that the stated purpose meant considering how the variability between estimated and actual Allowable Costs imparts financial risk to either party to the contract, bearing in mind contract terms and conditions, the regulated pricing method used and the potential impact of any final price adjustment (for excessive profits and losses). Ensuring this risk is reflected in the contract profit rate contributes to the achievement of good value for money for the government and fair and reasonable prices for contractors. The SSRO sought clarification from stakeholders of any alternative interpretations of the purpose of the CRA.

5.6 Industry respondents generally agreed with the purpose of the CRA set out in the Regulations. However, some considered that matters like wider government management of risk, the marginal effect of the contract on the overall profitability of the contractor, and comparisons to the baseline profit rate (BPR) comparator group were irrelevant because the CRA should, they believed, be determined for a QDC in isolation of these matters. ADS thought the SSRO's assessment of the purpose of the CRA was overly simplistic as, it said, it was often difficult (or impossible) to identify some risks in advance of them arising. Further work was needed, it said, to agree how allowance for 'unknown unknowns' should be calculated. Another respondent noted that the explanatory notes to the Act say the CRA is 'an adjustment to reflect the residual cost risk retained by the contractor under the QDC'. The MOD considered that the legislation was unambiguous, although has indicated there may be merit in revisiting its narrow focus on cost risk.

16 Section 17(2) of the Act and Regulation 11(3).

5.7 The SSRO notes the comments made by respondents and concludes that, while the purpose of the CRA expressed in legislation may be unambiguous, its narrow focus on variance between estimated and actual Allowable Costs may fail to adequately capture the residual cost risk retained by the contractor (or, consequently, the MOD). As a result, matters like those highlighted in the working paper that may be relevant to understanding the risk of cost variance and who bears this are considered irrelevant by some stakeholders. There is a risk that this prevents the contracting parties from fully understanding who bears financial risk associated with the contract and, therefore, who should be compensated through the contract profit rate.

5.8 The SSRO considers that Section 17(2) and Regulation 11(3), by referring only to cost variation rather than to the substantive financial risk which the parties accept when entering into a single source contract, do not adequately express the matter which is relevant in determining the adjustment. Accordingly, we consider the legislation may benefit from being framed in a way which more accurately reflects the economic rationale for why an adjustment to the rate of profit on Allowable Costs may be required in relation to risk.

We invite stakeholders' views on whether and how Section 17(2) and Regulation 11(3) might usefully be amended to better state the intended purpose and therefore facilitate more appropriate application.

Effect of contract pricing method on risk allocation

5.9 It is important that the CRA is determined in a way which accurately reflects the risk to which the contracting parties are exposed. How variance between estimated and actual Allowable Costs impacts on the contractor's actual profit will be affected by the contract's terms and conditions, the contract pricing method, and any final price adjustment.

5.10 Regulation 10(2) allows the parties to a QDC or QSC to agree which of the pricing methods specified in Regulations 10(4) to (11) is to be used for the contract.[17] Regulations 10(4) to (11) describe how the Allowable Costs used in contract pricing are to be determined in each pricing method. These will be either:

a) the costs as estimated at the time of agreement (in firm, estimate-based[18] and target pricing methods);

b) the costs as estimated at the time of agreement adjusted in accordance with specified rates or indices between the time of agreement and a specified time (in fixed and volume-driven pricing methods); or

c) the actual Allowable Costs determined during the contract or after the contract completion date (in cost-plus and estimate-based[19] pricing methods).

5.11 Accordingly, the pricing method(s) used helps to determine which party bears the impact of cost risk and to what extent.

5.12 The SSRO's working paper noted that national procurement regimes in Australia, Canada and the United States of America have a distinct component of profit related to the contract pricing method. The UK regime makes no such provision, although the SSRO's guidance on determining the CRA[20] indicates contractors 'should give consideration to the contract pricing method' (alongside other factors) and that the CRA for a cost-plus or estimate-based fee contract should be -25 per cent.

17 Regulation 10(3) allows the parties to agree that different regulated pricing methods are to be used for defined components of the contract.

18 The Allowable Costs by which the contract profit rate is multiplied.

19 The Allowable Costs which are added to the product of the contract profit rate and the Allowable Costs as estimated at the time of agreement.

20 SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment 2019/20 (Version 5)*.

5.13 The working paper considered the potential advantages and disadvantages of introducing a separate adjustment in the determination of the contract profit rate to reflect the contract pricing method(s) used for the contract.

a) The key benefit was considered to be additional transparency about how the pricing method shares risk between the contracting parties and the cost/benefit in monetary terms of doing so. Separate consideration of the pricing method would also allow the determination of the CRA to be the same for all contract types, which may enhance consistency.

b) A potential cost of separating the consideration of the pricing method was the need for additional reporting about the regulated pricing method(s) used for a QDC/QSC.

5.14 The paper also noted that a consequence of a separate adjustment for the contract pricing method(s) might be additional restriction on the range of CRA that was available for a contract using particular pricing methods – which might be either an advantage or disadvantage.

5.15 Overall, respondents to the working paper did not wish there to be a separate adjustment related to the contract pricing method. Some considered there was a risk that the pricing method provided an over-simplified view of how cost risk is allocated within the contract. Others considered that there was already too much focus on determining the contract profit rate, which accounted for only around 10 per cent of the contract price. The MOD, however, considered that the SSRO's guidance and/or the legislation should distinguish between contracts priced on estimates and those priced on actuals.

5.16 We note the feedback from stakeholders, which generally did not support a separate step to reflect the pricing method. However, the MOD's response suggested a more detailed consideration was needed of how the contract pricing method(s) should be accounted for in determining the CRA.

5.17 While some industry respondents have highlighted the potential for the pricing method to provide an over-simplified view of risk allocation in a contract, we agree with the MOD that it would be appropriate when determining the CRA for some distinction to be made between contracts priced on Allowable Costs estimated at the time of agreement and those priced on actual Allowable Costs determined during the contract or after contract completion. The potential for uncertainty about Allowable Costs to impact financially on a contractor will be greatest in the former and should be limited in the latter where Allowable Cost variances will be borne by the MOD; although there may be other financial impacts that are not reflected in the contract price.

5.18 A requirement to give consideration to the contract pricing method when determining the CRA might feature in either the legislation or the SSRO's guidance. The SSRO's guidance might additionally give direction on the principles that should inform consideration of the pricing method. We consider that any rules which might specify the range available for contracts with particular pricing methods would best be provided in the legislation, rather than the guidance. This would require thought to be given to what the appropriate ranges would be for different pricing methods, within the broader determination of the CRA range (discussed later).

5.19 The inclusion of more specific direction in the Regulations on how pricing method informs the CRA would reflect the approach observed in the procurement regimes of Australia, Canada and the United States.

5.20 The SSRO's current guidance requires that contracts using the cost-plus and estimate-based fee pricing methods should have the maximum negative adjustment (-25 per cent of the BPR) as (subject to any provisions in the contract to the contrary) it will be the MOD which bears the risk of cost variance in these contracts.

We invite views on whether there should be additional direction in the SSRO's guidance and/or rules within the legislation to specify the CRA range for contracts with different pricing methods.

Navigating the range

5.21 At present the contracting parties may agree the CRA for a QDC/QSC within the range permitted by the Regulations having regard to the SSRO's guidance.[21] The SSRO's guidance sets out a number of principles and factors which should be taken into account in determining the adjustment, for example, the contract pricing method and the relative likelihood of actual Allowable Costs being higher or lower than estimated Allowable Costs.

5.22 Of the 201 contracts which had been reported to the SSRO by May 2019 as having become QDCs and QSCs between 1 April 2015 and 31 March 2019, 95 (47 per cent) included a positive CRA and 40 (20 per cent) included a negative CRA.[22] Contracts with a negative adjustment tended to be larger in value. As a result, the overall effect of the CRA over this period was to decrease the profit that might otherwise have been paid to the contractors[23] by £87.6 million (0.3 per cent of the total price of contracts).

5.23 The SSRO's working paper considered the pros and cons of the current and alternative approaches to assisting the contracting parties to navigate the CRA range. The alternative approaches included:

a) rules-based boundaries supplemented by principles-based guidance, by which the available CRA range could be constrained by characteristics of the contract (for example, the contract pricing method) with guidance assisting the parties to navigate the available range;

b) multi-criteria decision analysis, currently being explored by the MOD and industry, in which the parties consider and score multiple criteria independently and combine them in a structured way to arrive at the CRA for the contract; and

c) a highly structured approach, previously considered and rejected by the MOD and industry, in which a mechanistic or formulaic approach is used that permits little or no discretion for the contracting parties in agreeing the adjustment.

5.24 Industry respondents provided commentary on difficulties they experienced in navigating the CRA range. These included that:

a) the absence of substantive guidance had led to a reliance on price negotiation which was challenging and time-consuming;

b) the effort required to agree the CRA could be disproportionate to the value at stake, especially for lower-value contracts;

c) some risks were not easily capable of assessment for the purpose of determining the CRA and that past performance was sometimes inappropriately used as an indicator of future risk exposure.

21 SSRO (2019) *Guidance on the Baseline Profit Rate and its Adjustment 2019/20 (Version 5)*.
22 The remaining contracts (33 per cent) had a CRA of zero.
23 Had the CRA been zero in all cases.

5.25 The MOD considered that difficulties arose because the legislation and guidance did not specify how to calculate a number from a set of assumptions.

5.26 Having reflected on the comments made by stakeholders, we consider that that there may be benefit in providing additional direction through legislation or guidance on how the CRA is agreed, to provide structure to contract negotiations and greater consistency in contract pricing. We consider potential approaches below.

Rules-based boundaries with principles-based guidance

5.27 As discussed in paragraphs 5.9 to 5.20 there may be merit in providing additional direction through legislation or guidance on how the contract pricing method informs the CRA for a given contract. Guidance might also be provided on how the nature of the work being performed under the contract could inform determination of the CRA.

Multi-criteria decision analysis

5.28 In response to our working paper, the MOD highlighted the work it was undertaking to develop a points-based approach for navigating the CRA range (based on weighting and scoring different contract-related factors). This, it said, was being piloted with suppliers. Industry respondents were divided on whether there should be a single approach for navigating the CRA range. While industry stakeholders are working with the MOD on development of the points-based approach, some expressed concerns as to whether the approach currently being developed would be successful, given the wide range and complexity of QDCs and QSCs. Some expressed a preference for principles-based guidance. Others considered a simpler approach for lower-value contracts may be desirable.

5.29 The SSRO notes the concerns raised by respondents and will continue to engage with the MOD and industry on the development of the MOD's points-based approach to determining the CRA for a contract. The value of a weighting and scoring approach, such as that proposed by the MOD, is that it can assist in structuring complex problems in a way that leads to more informed decision making. For such an approach to assist in determining the CRA, it must be able to combine multiple risk factors into a reliable evaluation of the overall cost risk of a contract and be capable of consistent application across different contracts. Trialling, evaluation and calibration of the model using real or simulated contract data will help ensure the approach operates as expected and can, therefore, be used with confidence.

5.30 We believe there is benefit from the development of more specific guidance on navigating the CRA range. We plan to develop such guidance, bearing in mind the MOD's ongoing work in this area. We will continue to support stakeholders' work to develop a points-based approach and will consider how to support its application with statutory guidance.

We welcome views from stakeholders on the development of such guidance.

Highly structured approach

5.31 Given the MOD's and industry's prior experience of attempting to develop a mechanistic approach to determining the CRA, and stakeholders' views about whether a single approach can apply across all contracts, we consider that a highly structured approach is likely to be difficult to implement. We have not given this further consideration.

Lower value contracts

5.32 Sections 18(2)(a) and (b) of the Act provide that the Regulations may disapply the requirement to take any or all of steps 2 to 6 in section 17(2) in relation to a QDC the value of which is less than the amount specified, or provide for any or all of those steps to apply in relation to such a contract with modifications set out in the Regulations. The Regulations do not take advantage of this provision and the same approach to determining the CRA is applied to all contracts.

5.33 The SSRO's working paper invited views on whether it would be beneficial for the Regulations to incorporate a simplified approach for lower-value contracts, where such a threshold might be placed, and what simplifications would be appropriate.

5.34 Respondents considered that if the principles underpinning the CRA were sound and applied reasonably there should be no need to take a different approach for lower-value contracts. However, most respondents, including the MOD and ADS, considered there was merit in exploring a simpler structured approach for lower-value contracts. One industry respondent thought this would be particularly desirable if a more complex approach for determining the CRA was introduced.

5.35 Some respondents also suggested a simpler approach be taken for determining the CRA in the case of contract amendments.

5.36 The SSRO agrees it would be desirable in all contracts for the time and effort involved in determining the CRA to be proportionate to the value at stake. This is especially important for lower-value contracts and contract amendments. If this can be achieved by a single approach to determining the CRA there should be no need for a separate approach for lower-value contracts or contract amendments. As noted above, the SSRO will continue to engage with the MOD and industry on the development of the MOD's points-based approach for navigating the CRA range and consider the need for any alternative approaches for determining the CRA in particular circumstances, and the need for specific additional guidance, once that process has concluded.

Other suggestions

5.37 One industry respondent to our working paper considered that it would be more appropriate for the default CRA for cost-plus contracts to be zero, with negative adjustments applied where contractors failed to meet key performance indicators. We received no further comments on this matter.

5.38 We note in response that such an approach would be more akin to a change in the range of the incentive adjustment to include negative values (reductions in the profit rate) for performance that fell below expectations. Were there a desire for contract profit rates to be determined in this way, the SSRO would need to review its current baseline profit methodology. However, we are not aware that such an approach is widely favoured by the MOD or its suppliers. We do not propose any further consideration of this matter at the present time.

Range of the CRA

5.39 The MOD has indicated its intention to review the limits of the CRA range. This could involve changing the maximum upward adjustment, the maximum downward adjustment or both, either uniformly or by different amounts. We believe that there is general acceptance by the MOD and industry that if the CRA range is widened it increases the need for a structured approach to its navigation in order to mitigate the risk to value for money and fair and reasonable prices that would result from its inappropriate use.

5.40 The working paper considered the limitations on agreed contract profit rates arising from the current range of the CRA (±25 per cent of the BPR). It noted the views of the MOD and industry that a wider range of adjustment would be desirable to allow different risk sharing and compensation arrangements. The paper included the SSRO's analysis of how contract profit rates achievable under the Regulations compare with those available under international procurement regimes and with corporate profits earned by the global ultimate owners of QDC/QSC contractors, the MOD's main suppliers and companies in the BPR comparator group. The SSRO's analysis showed that some companies undertaking comparable activities earned profits above and below the illustrative range of contract profit rates currently available for QDCs/QSCs.[24] The SSRO stated that this statistical evidence alone did not provide compelling evidence of the need for a major change in the CRA range and, given this, highlighted the role of judgment in determining the matter. The paper also considered how possible changes to the range of the CRA might impact on the range of profits achievable in QDCs and QSCs. It noted that there were a number of ways in which the range of the CRA might be specified in either legislation or guidance, each of which had advantages and disadvantages.

5.41 We consider a number of matters related to the range of the CRA below.

Magnitude of the range

5.42 Regulation 11(3) specifies that the CRA is to be an "amount which is within a range of plus or minus 25% of the baseline profit rate". We noted in paragraph 5.22 that about two-thirds or contracts which became QDCs or QSCs from 1 April 2015 to 31 March 2019 were reported to have a non-zero CRA. Excluding cost-plus contracts (for which the SSRO's guidance is that the maximum negative CRA be applied), 16 per cent of QDC/QSCs had a reported adjustment at or beyond ±25 per cent of the prevailing BPR.[25] The proportion of such contracts with the maximum adjustment increased from 13 per cent in 2015/16 to 23 per cent in 2018/19, although the SSRO has insufficient information to draw a conclusion as to the cause of this increase.

5.43 The SSRO's working paper sought views on difficulties experienced by stakeholders as a result of the restrictions on the range of contract profit rates achievable under the Regulations, given the current CRA range.

5.44 Industry respondents generally considered that the level of profit available has historically been too low for the risk and complexity involved in QDCs and QSCs. They reported that, as a result, it was difficult to obtain company approval for MOD single source contracts. One respondent indicated that its group was actively diversifying out of the UK market because of this. Respondents said that widening the range of the CRA would better accommodate the range of risk transfer that the MOD was seeking in some contracts.

24 The SSRO's working paper indicated an illustrative available range of contract profit rates in 2019/20 from 5.68 per cent to 15.80 per cent, based on the 2019/20 BPR (7.63pp), a POCO adjustment of 0pp, the 2019/20 SSRO funding adjustment (-0.042pp), an incentive adjustment range of 0pp to 2pp, and a capital servicing adjustment range of 0pp to 4.3pp (the smallest and largest such adjustments agreed from 1 April 2015 to 31 March 2019).

25 For the purpose of analysis, contracts were allocated to a pricing method where at least 75 per cent of the Allowable Costs in the contract were priced using that method.

5.45 The MOD considered that expansion of the CRA would allow the payment of additional profit where the contractor takes on additional risk and enable contracts with a lower profit rate than currently allowable under the Regulations to be brought under the regime. However, industry respondents considered that contracts for ancillary services or construction work – those that would typically receive a lower profit rate – would usually be competed, making the ability to agree such rates in the regime unnecessary and undesirable.

5.46 The MOD considered that evidence of adjustments being agreed at the limits of the CRA range justified greater flexibility in the range of the CRA. It stressed that the view of senior commercial officers was that the band of the CRA should be wider and this was an important consideration which the SSRO should take into account. Conversely, one industry respondent considered that given the majority of QDCs/QSCs had a CRA within the existing ±25 per cent range, the effort associated with widening the CRA range was unlikely to demonstrate value for money as only a small proportion of contracts would be affected. This same respondent considered it might be better to revise the incentive adjustment[26] to better reward contractors for risks associated with performance, transformation or innovation. It noted that the CRA, as currently drafted, did not address risks arising from these factors.[27]

5.47 The MOD noted that the SSRO's benchmarking showed numerous companies earning actual profit rates both above and below the illustrative range of contract profit rates available at the time of agreement. This, it said, supported its view that a wider CRA range would be appropriate. Some industry respondents said they had examples of contracts where the available range had not been wide enough to compensate them properly for accepting risks. However, no details of the contracts or the profit levels agreed were provided, nor what the respondents considered the proper level of compensation to be, or how this was arrived at.

5.48 The SSRO explored the economics of risk and reward (the underpinning justification for the CRA) in its *Profit Principles* working paper. This was with the intent of informing discussion of the CRA. The MOD was generally supportive, although some industry stakeholders rejected of the use of economic theory as a basis to inform the pricing of QDCs and QSCs.[28]

5.49 The SSRO acknowledges that some companies consistently earn corporate profits outside the illustrative range of contract profit rates available for contracts under the Regulations. In certain circumstances, it may be that such higher or lower profit rates could contribute to contract prices that achieve value for money for the government and which are fair and reasonable to contractors. A wider CRA would enable contracting parties to agree a wider range of contract profit rates, where this was justified by a transfer of risk which a competitive market would typically reward. We make the following observations:

a) The *Profit Principles* working paper highlighted risk, time preference, and economic (wealth) factors as the key motives for the supplier of capital to seek profit. Relating these factors to the mark-up on cost which manifests itself in a contract is challenging as the mark-up is influenced by a number of additional factors. For example, the interactions of the market for demand of the goods or services, the market for labour and capital, portfolio effects, and differences in capital structures particular to an industry or type of work.

26 An adjustment of up to 2 percentage points in determining the contract profit rate.
27 The purpose of the CRA is considered in paragraphs 5.4 to 5.8.
28 A summary of stakeholder responses to the *Profit Principles* working paper can be found in Appendix 2.

b) Low or high observed profit rates may not be correlated with low or high risk respectively. Demand side factors, such as capital productivity in different industries, can also explain profit variations, and there is no means to recognise these differences in the contract profit rate. The interaction of capital supply side factors (see a above) and demand means that profit rates may be low, even when risk is relatively high. Consequently, careful consideration is needed as to the extent to which differences in underlying financial risk explains high and low cost mark-ups.

c) Contractors are already able to achieve actual rates of profit outside of the current illustrative range. Subject to the contract pricing method and the contractor's performance of the contract, actual contract profit rates for QDCs/QSCs may be higher or lower than those agreed.

d) The potential for actual contract profit rates to vary from those agreed provides an incentive for contractors to manage contract performance and costs. This incentive may be eroded if contract profit rates outside the illustrative range were agreed at contract outset.

How the range should be determined

5.50 Our working paper also sought views on how, if it were to change, the range of the CRA should be determined.

5.51 The MOD noted that other countries' regimes have both a higher ceiling and a lower floor for the range of profit available. It questioned the paper's conclusion that these international comparators did not present a compelling argument for change in the range of the CRA. It also questioned whether the SSRO believed it would be beneficial or not for the UK regime to be closer in range to the international examples. Some industry respondents said they had examples of contracts performing equivalent tasks in overseas markets that received higher profit than in the UK. However, no details of the contracts or the profit levels were provided.

5.52 We acknowledge that some international procurement regimes appear to permit contract profit rates to be agreed within ranges that are wider than the illustrative achievable range in the UK. However, we consider that care must be taken when making direct comparison between these ranges. It is not possible to say whether the UK range should be more like those available elsewhere without considering the entirety of each regime's approach to pricing contracts, including the approach to allowed costs. We make the following observations:

a) The non-UK regimes use a weighted-average approach to determine contract profit rates. This means that, even though some specific components of cost may have higher or lower profits applied than is available in the UK, the ability of a contract as a whole to achieve the minimum or maximum profit rates available in those regimes is limited.

b) In the non-UK regimes, the contract pricing type or the activities of the contract generally restrict the range available for a particular contract. In the UK regime, the full range is available for every contract. If there were to be a wider range of profits available at the time of agreement in the UK regime this may need to be accompanied by a more segmented approach, with different ranges available dependent on the characteristics of the contract.

c) Some non-UK regimes apply to government contracts which would not (typically) be in scope of the UK regime (i.e. non-defence). These may require different rates of profit due to the nature of the market for those activities and its levels of productivity, for example, construction or ancillary services. As discussed in paragraph 5.49, the lower profit rates earned in some contracts may not be the result of lower risk (necessitating a wider CRA range). If the ability to agree lower (or higher) profit rates is required to match the norms in particular industries, other avenues for providing such a wider range may need to be explored.

5.53 No stakeholders provided suggestions for how the upper and lower limits of the CRA should be set. The MOD had hoped the SSRO's paper would answer this question. ADS considered that the CRA range needed to allow for the diverse complexity of single source contracts and the diverse business environments in which they are performed to be reflected. Some other industry respondents considered that the range needed to provide sufficient flexibility for negotiation between the contracting parties as to the contract price and risk sharing arrangements. One considered that the upper and lower limits of the range should be supported by evidence that substantiates a fair risk/reward balance for the type of work.

5.54 We consider there are a variety of methods by which the expected reward for risk might be quantified to help inform determination of the CRA range. In the working paper, the SSRO indicated that the analogy of insurance may provide insights into how the parties might value the transfer or retention of cost risk.[29] Only ADS commented on this specifically, indicating it did not think the analogy was appropriate. The SSRO maintains that it is helpful to consider the additional profit paid to a contractor above that which would be paid on a contract where the contractor bears no risk as a 'premium' paid by the MOD for risk transfer.

5.55 Elsewhere,[30] the SSRO has indicated to stakeholders that investors' expectations of returns, which vary in response to perceptions of the risk to their capital, may also be helpful in considering the range of the CRA. Data from capital markets related to the MOD's suppliers may be informative in this regard. However, this proposal has also received a mixed reception from stakeholders. The SSRO acknowledges that using such an approach to quantify the value of risk in the MOD's single source contracts is not straightforward and may require specialist input.

5.56 We remain of the view that such conventional approaches to the pricing of risk would offer insights in determining the appropriate range of the CRA. However, there does not appear to be sufficient stakeholder interest in pursuing these approaches, so we do not propose to explore these further in the near term. We would be open to pursuing this work in the future if stakeholders requested it.

5.57 In the absence of an acceptable statistical basis for determining it, a decision on the appropriate range for the CRA will be guided by policy considerations. The MOD and industry have indicated their desire for a widening of the CRA range to facilitate the agreement of contract profit rates, risk-sharing and incentivisation arrangements that are not achievable within the current parameters. In seeking to achieve these objectives through a widening of the CRA range the MOD and industry should have regard to the risks associated with any change and consider whether there may be alternative approaches to achieving the objective.

29 Methods exist in respect to insurance contracts to determine compensation for bearing uncertainty about the timing and amount of cashflows.

30 SSRO (unpublished) *Review of Contract Profit Rates 2019: Profit Principles*.

5.58 If the bandwidth of the CRA were altered, the range of available contract profit rates would change. Widening the CRA range from ±25 per cent to +100 per cent to -70 per cent (as has been proposed by some stakeholders) would more than triple the flexibility available to compensate for cost risk. Both the MOD and industry have acknowledged that a wider range would need to be accompanied by a more-structured approach to navigating the range. The SSRO has indicated that it will consider how it can better support navigation of the range through its guidance and noted above (paragraphs 5.21 to 5.38) that this may also be achieved in other ways. In the absence of a highly structured approach to navigating a wider range (which we considered in paragraph 5.31 would be difficult to implement) there will be increased reliance on the commercial officers in the MOD and contracting companies, using whatever tools or guidance are available to support them, to achieve consistency in the determination of adjustments and ensure value for money and fair prices.

5.59 The SSRO recognises the need for the pricing formula to provide flexibility to accommodate contracts which display a diverse range of characteristics. However, contracts differ in many ways and varying levels of cost risk will not be the only justification for differences in contract profit rates. Consideration of other factors influencing profitability, such as capital productivity and the market for inputs and outputs, are also relevant to the determination of profit.

5.60 It appears to us that there are a range of factors which stakeholders are seeking to address through a wider CRA range, not all of which pertain to the risk addressed by the CRA (that actual Allowable Costs in contracts may vary from estimated Allowable Costs). Accordingly, the reward available to contractors for bearing cost risk may not be the only aspect of the current six-step process that requires reconsideration.

5.61 Taking a different approach to reflecting the factors, including risk, which influence contract profits, may also result in a wider range of available contract profit rates while better supporting contract pricing. This might be achieved by, for example, being able to reflect more specifically at step 1 the level of profits typically earned in the market in which the contractor operates; changes to the mechanism for incentivising enhanced contract performance at step 5; or greater consideration in the capital servicing adjustment at step 6 of financing structure.

5.62 Relevant to this discussion are the four activity-related profit benchmarks the SSRO produces as part of its annual BPR assessment. These are:

a) develop and make (used in the BPR calculation);

b) provide and maintain (used in the BPR calculation);

c) construction; and

d) ancillary services.[31]

5.63 The construction and ancillary services profit benchmarks are not part of the BPR calculations and historically display profit rates which on average are below the illustrative range of contract profit rates currently available under the Regulations. Further analysis into the underlying causes of differences in profitability between companies may provide insights into the confluence of factors which could together reliably inform where a lower or higher contract profit rate was appropriate.

31 Further details of the activity types can be found in Appendix A of SSRO (2019) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.

5.64 The use of multiple baseline profit rates related to different activity types (as considered by the SSRO in 2015[32] and 2016[33]) or activity-specific adjustments in determining contract profit rates are potential approaches which might deliver the same range of available profit rates as a wider CRA range, but through a more complete economic framework.

We welcome stakeholders' specific proposals for changes to the range of the CRA, with supporting evidence or information which explains the rationale for the proposals. We also welcome alternative proposals for achieving a wider range of available contract profit rates.

How the range is specified

5.65 The Act allows for the CRA to be agreed within a range specified by the Regulations. The Regulations specify that range as being a percentage (currently ±25 per cent) of the prevailing BPR. This means the size of the CRA range fluctuates with the value of the BPR. For example, the range was ±2.65 percentage points in 2015/16 and ±1.91 percentage points in 2019/20.

5.66 The SSRO's working paper invited comments from stakeholders on whether it would be desirable to express the CRA range as a fixed range of percentage points up or down from the BPR, rather than as a percentage of the BPR.

5.67 Industry respondents generally agreed that the range should be a fixed percentage. One considered that if the range of the CRA was materially increased, continued linkage to the BPR would make the available range more unstable. One pointed out that the purpose of the CRA stated in the legislation ('to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs') might suggest the adjustment should be expressed with reference to cost rather than the BPR. The MOD considered any change in this regard would depend on further thought being given to what the residual element of the BPR was for.

5.68 The SSRO considers there are benefits and risks associated with each method for specifying the CRA range and that the matter merits further consideration. The current approach of specifying the range as a percentage of the BPR remains operable, but there may also be a case for specifying the range as percentage point adjustment to the BPR (in effect making it a function of cost). This alternative would require thought to be given to:

a) how the scale of the adjustment range is determined – for example, should it be set as a percentage point range that equated to ±25 per cent of the BPR at the time the adjustment were fixed, or using some other approach (see paragraph 5.50 to 5.56);

b) the frequency with which the range should be reviewed – for example, determined annually by the Secretary of State based on a recommendation from the SSRO, or prescribed in the Regulations and reviewed periodically;

c) where the range was specified – in the Regulations, as at present, or in the SSRO's guidance, depending on the frequency with which the range may need to change (see paragraphs 5.69 to 5.72); and

d) the potential impact of changes in the BPR – for example, whether a fixed negative adjustment might increase the risk of the six-step process returning a negative contract profit rate, and how this would be addressed if that risk occurred.

32 SSRO (2015) *Review of Single Source Contract Profit Rate Methodology 2015: Response to Consultation*.
33 SSRO (2016) *2017/18 Profit Rate Consultation: Summary of Responses*.

Where the range is specified

5.69 The range of the CRA is specified in Regulation 11(3).[34] Accordingly, any changes to the range will require a change to the Regulations. Were frequent changes to the CRA range considered necessary or desirable, it may be preferable for the range to be specified elsewhere, for example, in the SSRO's guidance.

5.70 The SSRO's working paper sought views on where the CRA range should be specified.

5.71 Industry respondents expressed a slight preference for the CRA range to be specified in the SSRO's statutory guidance, rather than in the Regulations. Specifying the range in the SSRO's guidance was considered to offer greater flexibility should changes to the range be required in future. The MOD considered that if the range was not specified in the Regulations the Regulations should specify a clear process for determining the adjustment.

5.72 The SSRO considers that there is unlikely to be a need for frequent change in the CRA range once changes, if any, to the present range have been determined. There is, therefore, little obvious benefit to be derived from specifying the CRA range in the SSRO's guidance rather than in the legislation.

34 Regulation 13(3) for rates agreed on a group basis.

6. Profit on cost once adjustment

6.1 Prime contractor's often sub-contract parts of the delivery of a QDC. Sub-contractors will expect to earn profit on the work they perform and will include this in the price they charge to the prime contractor. Defence contractors are often large corporate groups consisting of many companies under common ownership and it is not unusual for a prime contractor to enter into sub-contracts with other companies in its corporate group. Where this is the case, a supplier might earn profit on the same cost multiple times: once in the performance of a sub-contract and again if the price of that sub-contract is a cost in the prime contract.[35] The Act and Regulations make provision for a profit on cost once (POCO) adjustment to be made to either the costs or profit of a QDC to address this issue.

6.2 The purpose of the POCO adjustment is '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 subcontract (including any further group sub-contract)'.[36] The POCO adjustment applies to a QDC 'if, at the time of agreement, the primary contractor is party to, or proposes to enter into, a group sub-contract'.[37] A group sub-contract (GSC) is defined as a contract which contains an amount of profit; made between the primary contractor and an associated person; with a value not less than £100,000; which was awarded without a competitive process; and which enables the performance of the QDC.[38] A further group sub-contract (FGSC) to a GSC is similarly defined.[39]

6.3 Where the Secretary of State is satisfied that the Allowable Costs of the contract have been reduced by an amount equal to the 'attributable profit' on a GSC or FGSC the POCO adjustment in the contract profit rate is zero.[40] Otherwise, the POCO adjustment is a decrease in the contract profit rate to exclude from the contract price an amount equal to the attributable profit on GSCs and FGSCs included in the Allowable Costs.[41] Contractors appear to use both approaches permitted by the Regulations, although adjustments to Allowable Costs are much more common than adjustments to contract profit rates. Our work in Phase 1 of the review of CPR found that for 81 contracts which became QDCs/QSCs from 1 April 2015 to 30 September 2018 and for which data was provided on sub-contracts, about half (42) had at least one GSC or FGSC. Only one quarter (10) of these had a POCO adjustment in the contract profit rate, indicating that the majority had adjusted the Allowable Costs of the contract.

6.4 Our examination of contractor reporting about POCO adjustments, and associated queries to the SSRO's helpdesk, indicates that contractors find applying and/or reporting about the POCO adjustment difficult. Of the 159 contracts which became QDCs/QSCs from 1 April 2015 to 30 September 2018, the SSRO raised queries with contractors about their reporting of POCO adjustments in about one quarter of cases. These related to the absence of information to support the reported adjustment; apparent deviations from the legislation or SSRO guidance on how the adjustment should be calculated; and the absence of any reported adjustment in cases where there were reported GSCs or FGSCs.

35 The application of profit may occur more than twice where further sub-contracts are placed with group members.
36 Regulation 11(4).
37 Regulation 12(1).
38 Regulation 12(5).
39 Regulation 12(6).
40 Regulation 12(2).
41 Regulation 12(3).

6.5 Following our work in the review of CPR and matters arising from the SSRO's compliance monitoring, we consider that there may be merit in revisions to the approach to adjustment for attributable profit in GSCs and FGSCs. The aims would be:

a) to ensure that the POCO adjustment strikes a more appropriate balance between:

i) comprehensive treatment of attributable profit in GSCs and FGSCs; and

ii) ease of application; and

b) to enhance transparency about POCO adjustments made by contractors.

6.6 We consider below aspects of the current approach where changes might be considered in support of these aims.

Defining GSCs and FGSCs

6.7 Determining whether a sub-contract or further sub-contract is one for which a POCO adjustment is required is fundamental to accurately and comprehensively avoiding profit on profit in non-competed contracts with associated persons. The current approach defines GSCs and FGSCs with regard to:

a) the relationship of the sub-contractor or further sub-contractor to the primary contractor being one of 'group undertakings in relation to each other',[42] the meaning of which is given by section 1161 of the Companies Act 2006;[43]

b) the value of the contract being not less than £100,000; and

c) whether the sub-contract or further sub-contract was awarded without a competitive process, as defined in Regulations 59 and 60.

Relationship of relevant persons

6.8 We believe there is the potential for changes to how the relationship between the primary contractor and sub-contractor or further sub-contractor is defined that would:

a) make it easier for contractors to identify sub-contracts or further sub-contracts which are relevant for the purpose of POCO adjustment; and

b) bring under consideration some additional sub-contracts or further sub-contracts for which it may be appropriate to make adjustments.

6.9 Identifying whether a person is a group undertaking with another person (and thereby a group-sub-contractor or further group sub-contractor) can be complex, requiring consideration of voting rights, rights to appoint or remove the majority of directors and rights to exercise a dominant influence. Where group undertakings are incorrectly identified, GSCs or FGSCs may be included or excluded in error when determining the POCO adjustment, to the detriment of the MOD or contractors.

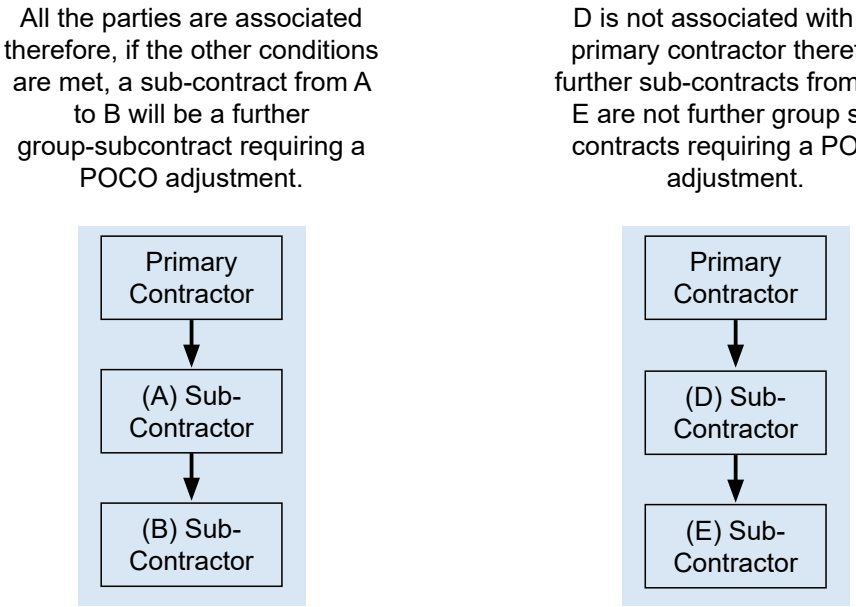
42 Section 43(3) of the Act.
43 Section 43(4) of the Act.

6.10 The current approach excludes from consideration some non-competed sub-contracts or further sub-contracts which it might be appropriate to include given the potential for the primary contractor to benefit from profit earned by a related person undertaking such a contract.

a) The Regulations do not presently require POCO adjustments to be made in relation to non-competed sub-contracts or further sub-contracts with persons who are part-owned by the primary contractor but are not 'group undertakings'. For example, where the sub-contractor is a joint venture between the primary contractor and another person or persons and the primary contractor may not have a controlling interest. While the primary contractor in these cases may not be able to direct how profit earned by the jointly owned person is used, it may be a beneficiary of dividends paid. In this way the primary contractor may be considered to have rights to extra profit that it would not have earned if the sub-contract was with a completely unrelated person or if the joint venture was considered, for the purpose of the Act and Regulations, to be an associated person. We understand the MOD is keen to address this particular issue.

b) The Regulations define a FGSC as being made between two or more persons, each of which is associated with the primary contractor or a group sub-contractor. Accordingly, non-competed contracts between a sub-contractor that is not associated with the primary contractor and a further sub-contractor that is associated with the primary contractor will be disregarded for the purpose of the POCO adjustment (Figure 2).

Figure 2: Identifying further group sub-contracts



6.11 A potential solution to the issues outlined above would be to amend the Regulations to define a GSC or FGSC for the purposes of the POCO adjustment as any non-competed sub-contract or further sub-contract with a person that is a group undertaking with the primary contractor or that is part-owned by a group undertaking.

6.12 Were such a change to be made, additional direction would also be required on how 'attributable profit' in GSCs and FGSCs is to be determined, to reflect that the primary contractor may derive only partial benefit from profit earned in those sub-contracts and further sub-contracts. We note that, currently, the Regulations require that all of the attributable profit for a GSC or FGSC is removed from the Allowable Costs or profit of the primary contractor, even if the group sub-contractor or further group subcontractor is part-owned by another person not associated with the primary contractor. Regardless of whether any changes are made to how GSCs or FGSCs are defined, we consider it would be desirable to amend Regulation 12(8)(b) to make clear that the attributable profit to be excluded from the contract price is only a relative proportion of the profit received by the group sub-contractor or further group sub-contractor where that person is jointly owned with another person not associated with the primary contractor. The Regulations should also direct how the proportion of profit that is attributable profit is to be determined.

Value

6.13 Changes to the value threshold for determining a GSC or FGSC may be desirable. Depending on whether the threshold is lowered or increased, the change will identify more or fewer contracts as GSCs or FGSCs. This will impact on:

a) how comprehensively the POCO adjustment addresses profit on profit in relevant sub-contracts and further sub-contracts; and

b) the ease of determining what adjustment is required.

6.14 The current £100,000 threshold for a contract to be a GSC or FGSC may mean some low-value, non-competed contracts with group undertakings are excluded from consideration. We have no data, however, to indicate whether there is a significant number or value of such contracts.

6.15 At present, for the purpose of identifying GSCs and FGSCs, there is no requirement to aggregate multiple contracts with the same entity which relate to fulfilment of a particular requirement for goods, works or services[44]. Introducing such a requirement may result in some non-competed sub-contracts or further sub-contracts which fall below the £100,000 threshold being included within the POCO adjustment. We have no data, however, to indicate whether there is a significant number or value of such contracts.

6.16 The rationale for the current threshold has not, to our knowledge, been explained. Regulation 5 (calculating the value of a contract)[45] indicates that when valuing a contract for other purposes[46] the value of the contract is the aggregate of the consideration which the contracting authority has paid or expects to be payable under the contract and all of those other contracts or proposed contracts with the same person (or persons associated with that person) for the purpose of fulfilling that requirement. However, 'the contracting authority must disregard a contract, or a proposed contract, which has a value of £250,000 or less where it is reasonably satisfied that the procurement has not been subdivided in order to avoid the requirements of the Act and these Regulations'. We note also that the Regulations only require the reporting of sub-contracts which have or are expected to have a value of not less than £1,000,000.[47]

44 Such a requirement exists in Regulation 5 when valuing contracts for other purposes.
45 As amended by the Single Source Contract (Amendment) Regulations 2019.
46 To determine whether it is a QDC or QSC.
47 Regulations 25 (contract notification report), 26 (quarterly contract report), 27 (interim contract report) and 28 (contract completion report).

6.17 There may be merit in aligning the threshold below which non-competed sub-contracts and further sub-contracts with associated persons are disregarded for the purpose of the POCO adjustment with that used for other purposes. This may result in some contracts that are currently considered by the POCO adjustment being excluded from consideration, reducing the comprehensiveness of the adjustment. It may also, however, make determining the adjustment easier as there may be fewer such contracts to consider. We have no data, however, to indicate whether there is a significant number or value of such contracts with values between £100,000 and the other thresholds noted above.

Competitive process

6.18 A POCO adjustment is not required if the sub-contract or further sub-contract is let following a competitive process. Regulations 59 and 60 are prescriptive in defining a competitive process and require a full competitive tender to be carried out. Contractors might, however, consider they are able to demonstrate that the price of a non-competed sub-contract or further sub-contract is comparable to a competitive or 'market' price through other means that are less onerous. For example, with reference to a catalogue price or evidence of similar prices charged to third parties.[48]

6.19 It may be desirable to permit contractors to demonstrate that sub-contracts or further sub-contracts with associated persons are competitively priced through means other than competitive tendering, negating the need for their consideration in the POCO adjustment. Were this to be allowed by the legislation, some sub-contracts or further sub-contracts may no longer be considered for the purpose of the POCO adjustment. This may reduce the comprehensiveness of the adjustment but make determining the adjustment easier as there may be fewer such sub-contracts to consider. We have no data, however, to indicate whether there is a significant number or value of sub-contracts that might be shown to be competitively priced even though not competitively tendered. Further consideration would be needed of the circumstances in which a contract which was not competitively tendered might be demonstrated to be competitively priced.

6.20 Related to this, there may also be a case for further consideration of whether sub-contracts or further sub-contracts with associated persons that are also QSCs should be excluded from the POCO adjustment. The arrangements for pricing QSCs should result in a price which obtains value for money for the government and is fair and reasonable to the contractor. This might be considered akin to a price that would have resulted had the contract been let competitively. This being the case, for the purpose of the POCO adjustment, QSCs might be treated the same as contracts which are let following a competitive process, and disregarded.

We welcome views on the various points raised in paragraphs 6.7 to 6.20 about the definition of GSCs and FGSCs, together with any specific proposals for related changes to the Regulations.

48 The issue of whether and how a contract price can be shown to be competitive with reference to, for example, a price list or other contracts is one that has wider implications for contracts regulated under the single source procurement framework. The SSRO considered the issue of alternatives to the pricing formula for QDCs and QSCs in its last review of legislation. We understand the topic remains of interest to the MOD and defence suppliers.

Determining the adjustment

6.21 Having determined which non-competed sub-contracts or further sub-contracts are relevant for the purpose of POCO adjustment, contractors must determine the attributable profit for which an adjustment is required and exclude this from the price of the primary contract. They may exclude attributable profit from the Allowable Costs of the primary contract (Regulation 12(2)) or make an adjustment of equal value to the contract profit rate for the contract (Regulation 12(3)).[49] The adjustment is to be determined at the time of agreement.

6.22 We noted in paragraph 6.12 that the current Regulations may benefit from revision to more appropriately identify the attributable profit for which a POCO adjustment is required in GSCs or FGSCs entered into with group undertakings that are part owned with another person not associated with the primary contractor. At present the Regulations require all of the profit in such GSCs or FGSCs to be adjusted for.

6.23 Some contractors have told us that they do not always know what amount of profit is included in the price of a non-competed sub-contract or further sub-contract with a group undertaking. Where a contractor is unable to determine the attributable profit, they cannot apply the POCO adjustment in either of the ways permitted by the Regulations. There may, therefore, be merit in amending the Regulations to permit an alternative approach to adjusting for profit earned in GSCs or FGSCs in these cases. For example, not applying the contract profit rate to an amount of Allowable Costs that relates to GSCs or FGSCs whose attributable profit is unknown. This would have the effect of avoiding profit being earned in the prime contract on any profit earned in the GSC or FGSC. Guidance on applying any alternative approach would need to be developed and there may need to be reporting changes to provide transparency about any alternative approach used.

6.24 We also consider there may be merit in a more substantial reconsideration of the approach to determining the POCO adjustment where attributable profit can be identified. As recommended by Lord Currie in his earlier review of single source procurement, a less complex approach may be achieved if Regulation 12 was amended to require that attributable profit on GSCs and FGSCs was excluded from the Allowable Costs of the contract. This would remove the need for an adjustment at step 3 of the process to determine the contract profit rate. As noted in paragraph 6.3, adjusting the contract profit rate is the least common of the permitted POCO adjustment approaches used by contractors.

6.25 Requiring an adjustment to the Allowable Costs of the contract, rather than profit, would mean that the adjustment would be made at the time the Allowable Costs are determined for the purpose of contract pricing. This would be either at the time of agreement for contracts priced on an estimate of Allowable Costs or, for contracts priced on actual Allowable Costs, during the contract or after contract completion, once costs have been incurred. For contracts priced on actual Allowable Costs this would have the additional benefit of addressing any difficulties that may currently arise in determining the adjustment due to uncertainty at the time of agreement about whether or not GSCs or FGSCs are to be entered into, or their attributable profit. For contracts priced on estimated Allowable Costs, a POCO adjustment to the Allowable Costs rather than the contract profit rate would permit any variations between the estimated and actual attributable profit in GSCs and FGSCs which had a significant impact on Allowable Costs and profit in the primary contract to be addressed through a final price adjustment.

We welcome views from stakeholders on the potential benefits or impacts of changes to how the adjustment is determined, together with any specific proposals for related changes.

49 We note, however, that the two approaches permitted by Regulations 12(2) and 12(3) do not appear to achieve an identical result as 12(3) does not require the removal of the primary contractor's profit associated with the attributable profit of the GSCs and FGSCs. It would be desirable to correct this inconsistency.

Transparency of adjustments

6.26 Regardless of whether there are any changes to the way in which relevant sub-contracts and further sub-contracts are identified, and attributable profit determined and adjusted for, we consider there would be merit in improved reporting about POCO adjustments. This would provide additional transparency about whether and what adjustments have been made, particularly where attributable profit is excluded from Allowable Costs.

6.27 The Regulations already require contractors to describe in the contract pricing statement the calculation that was made to determine the contract profit rate, including the POCO adjustment,[50] and to describe the facts, assumptions and calculations relevant to elements of the Allowable Costs.[51] However, our review found that for only about one third (49) of the 159 contracts which became QDCs/QSCs from 1 April 2015 to 30 September 2018 did contractors provide comments in contract reports to explain the presence or absence of a POCO adjustment.

6.28 We are, therefore, considering amending the SSRO's guidance to more explicitly require reporting by contractors of the amount of attributable profit in GSCs and FGSCs which has been excluded from the Allowable Costs of the contract where this approach to POCO adjustment is used. We also consider there may be benefit in amending the Regulations related to the reporting of sub-contracts to ensure that reports include basic information about the GSCs and FGSCs to which any POCO adjustment relates. For example:

a) aligning the threshold for reporting about sub-contracts which are GSCs with the threshold for determining whether a sub-contract is a GSC; and

b) extending the reporting requirement to include further sub-contracts where these are FGSCs.

We welcome proposals from stakeholders on how greater transparency about POCO adjustments might be achieved in a way that is not unduly burdensome for contractors.

50 Regulation 23(2)(d).
51 Regulation 23(2)(e)(i).

7. Defined pricing structure

7.1 Three of the contract reports require costs to be split by the DPS:

- the Contract Notification Report (CNR) requires an annual profile of the estimated costs at the time of agreement and the total amount of those costs that are non-recurring; [52]
- the Interim Contract Report (ICR) requires an annual profile of the estimated costs at the time of agreement, the total amount of those costs that are non-recurring and an annual profile of the costs already incurred and the forecast costs which are expected to be incurred;[53] and
- the Contract Completion Report (CCR) requires an annual profile of the estimated costs at the time of agreement, the total amount of those costs that are non-recurring and an annual profile of the actual costs.[54]

7.2 A breakdown of costs by DPS must be presented as a list of cost categories describing key components of the deliverables to be provided under the relevant contract.[55]

7.3 The Regulations provide limited detail on the form and content of a DPS. The SSRO supplies this detail. The SSRO has incorporated 16 DPS templates into DefCARS, and its reporting guidance assists contractors and the MOD to use the most appropriate DPS and provide the right level of detail.

Purpose

7.4 In its working paper, the SSRO suggested that the purpose of DPS data is to support benchmarking and parametric estimating. The requirement to split costs by the DPS breaks costs into categories that describe key components of the contract deliverables and this standardisation suggests an intention to enable comparisons to be made. Parametric estimating involves comparisons based on costs linked to metrics about the product under consideration. Contractors are required to provide output metrics that describe the quantum of contract deliverables in each report where the DPS is used. The reports that require costs to be split by the DPS are the CNR, ICR and CCR, consistent with the statement in the explanatory notes to the Act that there will be three reports designed to enable the MOD to compare the costs of comparable projects over time and improve its independent estimates, both for budgeting and to challenge contractor cost estimates.

7.5 The SSRO sought feedback from stakeholders as to whether the purpose of the DPS is to support independent estimating by the MOD for budgeting and to challenge contractor cost estimates. It also asked for examples of any instances in which the DPS data has been used by the MOD to prepare independent estimates.

7.6 The MOD confirmed that the purpose of the DPS is to support independent estimates and that building a database of DPS information was a long-term aspiration which would demonstrate value as more contracts complete. ADS emphasised that the purpose of the DPS is to provide the MOD with information and that it is not a reporting tool used by defence contractors. Some industry respondents called into question the MOD's use of DPS data and felt that awareness within the MOD could be improved. One contractor suggested that the MOD's assessment of budgets is a more bespoke activity than reports containing information on estimated and actual cost performance in DefCARS.

52 Regulation 25(2)(d) and (e).
53 Regulation 27(4)(d), (e) and (h).
54 Regulation 28(2)(d), (e) and (g).
55 Regulation 22(7).

7.7 The SSRO is satisfied that the purpose of the DPS is to support benchmarking and parametric estimating. It is understandable that industry respondents would be concerned about use of the DPS data, but the SSRO believes costs split by the DPS can be used for estimating, provided the cost categories are the right ones and care is taken when estimating. The SSRO accepts that it may take many years to build up a sufficient information base and believes that wide-ranging changes to the DPS may need to wait until estimators at the MOD have had more time to apply the data. The SSRO is focusing on some priority areas for improvement that have emerged from this review. The alleged lack of awareness of the DPS within the MOD may be best addressed through its commercial policy and training. The SSRO will consider raising awareness of DefCARS data in connection with its Data Strategy. Consideration will be given to more clearly stating the SSRO's understanding of the purpose of the DPS in its reporting guidance so that this informs the guidance and its application by contractors.

Taxonomy

7.8 Taxonomy is broadly concerned with the approach to categorising costs in the DPS. The taxonomy is crucial, as it provides the standard set of cost categories that will be used for the MOD's independent estimating. It also determines the level of granularity that can be reported. In its working paper, the SSRO asked for feedback on the following matters relating to the DPS taxonomy:

- the extent to which the current DPS taxonomy will support independent estimating by the MOD and any suggestions for change;
- circumstances in which parties have been unclear as to the appropriate DPS to apply;
- the extent to which the DPS reporting is discussed and agreed between parties, any barriers to this, and any suggestions for improvement;
- any issues experienced in applying the DPS to support contracts or other contracts and proposals for how the DPS might be better adapted in such cases;
- issues raised by differences, or alternatively, similarities, between the WBS and DPS, and whether it would be helpful to provide contractors with more flexibility within DefCARS to explain the approach they have adopted to mapping when reporting against the DPS; and
- the extent to which the four level DPS breakdown provides sufficient detail for the MOD and views on the SSRO's guidance on the level of detail.

7.9 The findings from these enquiries are set out below, along with associated proposals for change.

DPS taxonomy: cost categories and structures

7.10 The SSRO's 16 DPS templates were initially developed by the MOD based on US Military Standard 881C and were subject to review by the SSRO in early 2015. Each DPS template has three types of cost category at level two (the level below the main item to which the template relates):

- specific equipment categories for the equipment covered by the template;
- generic equipment categories;
- generic in-service support categories.

7.11 Many of the level two cost categories are broken down further into levels three and four and definitions are provided. The four levels of cost categories and the definitions together make up the taxonomy of the DPS. The approach is illustrated in Table 1, based on the submarine DPS.

Table 1: DPS example

Level 1	Level 2	Level 3	Level 4
Submarine	**Equipment specific cost categories**	More detailed breakdown of Level 2 headings	More detailed breakdown of Level 3 headings
	1.1 – Whole Boat		
	Equipment generic cost categories		
	1.2 – System Engineering		
	1.3 – Program Management		
	1.4 – Research and Development		
	1.5 – System Test and Evaluation		
	1.6 – Training		
	1.7 – Data		
	1.8 – Peculiar Support Equipment		
	1.9 – Common Support Equipment		
	1.10 – Operational/Site Activation		
	1.11 – Industrial Facilities		
	1.12 – Initial Spares and Repair Parts		
	1.13 – Additional Categories		
	In service support generic cost categories		
	1.14 – On tools manpower – maintenance, rectifications & repair		
	1.15 – Consumables/fungibles		
	1.16 – Packing, Handling, Storage & Transportation		
	1.17 – Non touch manpower		
	1.18 – Specialist Equipment		

7.12 The DPS taxonomy departs from the US Military Standard 881C and its work breakdown structure in three key ways. It uses four levels rather than seven, is principles based, and is not US military specific. US Military Standard 881C was updated in 2017 to 881D, primarily to reflect changes in the defence procurement landscape, with an increased focus on technology products. These changes have not been reflected in the DPS templates used in DefCARS.

7.13 The working paper examined a sample of reported contracts and identified that 93 per cent adopted one of the 16 standard cost templates within their reporting. Since the web-based version of DefCARS was introduced in March 2017, 98 per cent of contracts have adopted the standard reporting templates. However, around 40 per cent of contracts have used the generic ancillary services and specialist equipment DPS structures, which may not be the best representation of what is being procured and what the costs relate to. The ancillary services template has been used for contracts where the focus is support for defence equipment, not an ancillary service. If cost data for support is incorrectly split by ancillary services DPS or specialist equipment DPS, there is a risk that future estimation will be impeded because support costs for equipment will not be split into relevant categories, making it more difficult to capture and compare costs.

7.14 The SSRO sought feedback from stakeholders on the extent to which the current DPS taxonomy will support independent estimating by the MOD and any suggestions for change.

7.15 The MOD confirmed that the current DPS taxonomy supports parametric estimating and has the potential to align with information acquired from other sources as it is based on the US approach. Industry respondents questioned the extent to which comparisons could be made between contracts under the existing taxonomy and one contractor suggested it may only be possible with contracts delivered by the same contractor. A suggestion was made that rapid changes in technology may also impact comparability. Stakeholders did not, in general, challenge the principles underpinning the DPS taxonomy and only one respondent identified that an equipment template needed to change. There was some support, however, for exploring whether overuse of some DPS templates such as ancillary services may be due to difficulties with the structures. There were several representations in relation to support contracts.

7.16 The SSRO accepts that it will need to keep under review the frequency with which the taxonomy is updated and evolves. To avoid piecemeal changes to the dataset, further review of the DPS taxonomy should take place over the medium term, based on clear principles for the DPS such as those set out in Table 2.

Table 2: Proposed principles for the DPS taxonomy

Principle	
Relevance	DPS cost categories should be relevant for: • estimating the cost of a similar or follow on contract; and • estimating the cost of a programme or platform
Consistency	DPS cost categories should be consistent with: • existing DPS data; • other datasets and guidance under the regulatory framework; • MOD or government datasets; and • IFRS accounting principles.
Proportionality	DPS cost categories should be easy to map to and transition costs should be minimised.

7.17 There do not appear to be widespread issues with the equipment related cost categories in the 16 structures and as a result the SSRO is not proposing to consider changes to them in the near future. The reasons for this are that changes may impact both the relationship to the US dataset, which the MOD considers as highly important, and comparability between similar equipment contracts. Based on the feedback received, there is scope to look at the cost categories that are being used in support contracts. This subject is examined in the next section.

Stakeholder views are invited on whether the characteristics in Table 2 provide the right basis for future review of the DPS. Any further input on the proposed pace of change would be welcome.

DPS taxonomy: support contracts

7.18 The explanatory notes to the Act envisage that the DPS will be applied to at least some support contracts, referring to a "standard set of cost categories which will vary by the type of equipment being procured or maintained". The DPS templates contain additional cost categories, or lines, for in-service support, as shown in Table 1, recognising the connection between developing and making equipment and providing and maintaining equipment. In broad terms, in-service support lines relate to labour (1.14 and 1.17 in Table 1), materials (1.15 and 1.18) and logistics (1.16). The aim is to enable a support structure to be associated with each equipment type by using the relevant template. This should help MOD analysts to consider the through-life cost of a piece of equipment rather than just the capital cost to procure it.

7.19 In the working paper the SSRO highlighted that the product-orientated nature of the DPS may cause issues for reporting costs for support contracts due to the continuous nature of many of these activities and the uncertainty about the volume of support required in some contracts. The SSRO discussed whether an alternative approach for support elements within the DPS should be developed, for example by focusing on a cost-by-type orientated taxonomy (e.g. labour, overheads, materials) to provide a breakdown of the continuous costs that occur in support contracts, which could then feed into future estimates. Feedback was sought on:

- issues experienced in applying the DPS to support contracts;
- how the DPS might be better adapted to support contracts; and
- more closely aligning the DPS to the contractor's own reporting structure.

7.20 The MOD stated that the DPS information may have low value for some types of support contracts, as it does not enhance the MOD's understanding of the costs. Contractors confirmed difficulties in applying the DPS to support contracts and linking metrics to costs. Metrics are discussed below. One contractor stated that applying the DPS was easier where support was linked within a contract to a requirement for hardware rather than a separate contract for provision of support only. There was a suggestion that some support contracts might require their own bespoke cost breakdown structure.

7.21 The SSRO accepts that contractors have found it difficult to apply the DPS equipment templates to support contracts. This has led to overuse of the ancillary services DPS template, which is not sustainable as:

- the ancillary services cost categories are unlikely to be relevant to support contracts (see Table 3); and
- no link is maintained between the support provided and the equipment to which the support relates.

Table 3: Comparison of level 2 lines between equipment and ancillary services DPS

Submarines DPS: Level 2	Ancillary Services DPS: Level 2
Equipment specific cost categories 1.1 – Whole Boat	Equipment specific cost categories 1.1 – Health and safety 1.2 – Fire safety 1.3 – Security 1.4 – Maintenance, testing and inspection 1.5 – Cleaning Services 1.6 – Operational management 1.7 – Gardening Services 1.8 – Utilities 1.9 – Other
Equipment generic cost categories 1.2 – System Engineering 1.3 – Program Management 1.4 – Research and Development 1.5 – System Test and Evaluation 1.6 – Training 1.7 – Data 1.8 – Peculiar Support Equipment 1.9 – Common Support Equipment 1.10 – Operational/Site Activation 1.11 – Industrial Facilities 1.12 – Initial Spares and Repair Parts 1.13 – Additional Categories	**Equipment generic cost categories** Same
In service support generic cost categories 1.14 – On tools manpower – maintenance, rectifications & repair 1.15 – Consumables/fungibles 1.16 – Packing, Handling, Storage & Transportation 1.17 – Non touch manpower 1.18 – Specialist Equipment	**In service support generic cost categories** Same

7.22 Maintaining a link between in-service support and the equipment to which it relates seems appropriate for estimating purposes, but two principal issues arise when splitting support contract costs against the current equipment DPS templates:

- It is not clear whether a contractor should report costs against the specific equipment lines or the generic in-service support lines of the DPS. For example, labour costs for replacing components of a submarine engine could be reported against either the component lines, or against the generic support line for on tools manpower. As another example, there are two equipment categories in support, and it is unclear how these differ from the equipment that is being supported. The consequence of this lack of clarity is that contractors may choose either approach, with a consequent impact on consistency.
- There may be a reasonable question as to whether the five generic in-service support cost categories sufficiently and clearly encompass elements of support.

7.23 One approach to addressing these issues would be to:

- remove the in-service support specific rows within each equipment DPS; and
- amend the guidance to make it clear that both build and maintain costs are to be reported against the equipment component within each equipment DPS.

7.24 The in-service support elements would also be removed from the ancillary services DPS template. The level two categories of the ancillary services DPS template are shown in Table 3 and the in-service support categories do not seem to relate to these.

7.25 The proposed changes would require contractors to record support against the specialist equipment categories. The advantage of this approach is that the support may be clearly identified with the equipment in question.

Recognising that this is a complex area, the SSRO is seeking further input on its suggested proposals before making changes to its reporting guidance and the DPS templates in DefCARS.

DPS taxonomy: granularity

7.26 The SSRO noted in its working paper that the level of granularity required by the MOD for independent cost estimating is expected to differ, depending on the exercise being undertaken. The gross estimates required for the purposes of budget forecasting at the concept stage may require a lower level of granularity than a bottom-up method used when estimating the allowable costs for a contract.

7.27 At the maximum of four levels the SSRO's DPS templates will support component costs to a high level of specificity but will not support further breakdown of these costs into the lowest level (for example labour, materials, sub-contracts) or into other cost categories. Requiring greater detail in the templates could increase the uses of the data for estimating but would also increase costs of reporting, which would need to be weighed against the benefits. The SSRO expressed the view in its working paper that it may be appropriate to first achieve consistency of reporting at the current level of detail that the templates allow before steps are considered to move to a more granular level of information collection.

7.28 A DPS breakdown that employs more lines (e.g. 100 lines) will provide more detail than one which has fewer lines (e.g. 10 lines). The SSRO's reporting guidance currently recommends that the contractor and the MOD should agree the DPS and explains that the required length of the DPS will vary depending on the contract value. In its working paper, the SSRO suggested that different guidance might be given, requiring consideration of a range of relevant factors to arrive at a suitable level of detail in the DPS. Contract size would be a relevant consideration, as would risk, complexity, type of contract and military specificity. If the MOD's estimating experts are sufficiently involved in the commercial team's agreement of the DPS, it is more likely that the optimum granularity would be arrived at for each DPS applied to a contract.

7.29 The SSRO invited views on the extent to which the four-level DPS breakdown provides sufficient detail to support the MOD's independent estimates and cost comparisons. Stakeholders were also asked to comment on changes to the SSRO's reporting guidance on the level of detail required once a DPS template has been chosen.

7.30 The MOD considered there is enough detail in the current four-level DPS structure for its purposes and indicated that adding additional levels would place unnecessary burden on contractors. There was a view from respondents that it may be too early to determine the optimum level of granularity in the DPS. This would depend on the data being reviewed and used, which may take several years. Industry concerns with the DPS centred around how it fits with contracts rather than the level of detail required. Contractors were not, however, in favour of additional granularity beyond the existing four levels. One contractor said that there needed to be a way of accommodating the differences between contracts, suggesting that greater breadth was needed rather than depth (in terms of potential cost items to report against within the support elements of each DPS structure, in order to accommodate the wide range of activities that take place under support contracts). This is consistent with some of the arguments put forward by MOD, ADS and one contractor regarding the suitability of the current DPS for support.

7.31 Stakeholders submitted that the SSRO guidance linking contract value to the level of granularity was either unhelpful or should be removed. Some respondents doubted that there was a correlation between the number of DPS lines and contract value. There was agreement that the SSRO's guidance should not rigidly constrain contractors. One contractor felt that a contractor specific cost reporting structure may be a better way of getting relevant information for benchmarking and assessing performance. Another contractor identified the difficulties obtaining the cost information from sub-contractors needed to complete the DPS.

7.32 Consistent with the feedback received, the SSRO continues to hold the view that it is generally better to optimise application of the current levels of granularity provided in the DPS rather than structuring in additional detail. This is consistent with our proposal in the Selecting a DPS and Applying and mapping other cost structures to the DPS sections below. The SSRO consider that the optimum application of the DPS is if the structure to be reported for a contract is discussed and agreed between the contractor and the MOD. If this was normal practice and a lack of granularity was causing problems, then we would be prepared to consider additional levels. As feedback suggested that this does not happen in all cases we do not think this is merited at this time.

7.33 The SSRO proposes to update its reporting guidance to recommend that consideration be given to the DPS structure in advance of entering into the contract, to ensure sufficient time for an appropriate DPS structure to be agreed and included in the CNR, due 30 days after entry into the contract. It would assist if input is obtained from suitably qualified persons within the MOD before agreeing the DPS, as this is more likely to achieve a useful and achievable breakdown of costs.

The SSRO proposes changing paragraph 5.30 in its current reporting guidance to that proposed in Table 4. We welcome stakeholder views on this proposal.

Table 4: Proposed Changes to Reporting Guidance

Existing guidance	Revised guidance
Paragraph 5.30 The level of relevant detail that a contractor provides should relate to the total contract value. The larger a contract, the more detail is expected (see footnote 10). Footnote 10 – The required length of the DPS will vary depending on the contract value. As not all categories or levels need to be completed for each contract, the predicted length of the DPS is as follows: • Under £10m: 10 – 20 rows • Under £100m: 30 – 60 rows • Over £100m: 60 – 100 rows	**Paragraph 5.30** The contractor should seek to report against all the relevant DPS headings and agree the approach being taken with the MOD in advance of entering into the contract. The contractor should consider the following: • whether the number of lines selected in the DPS is proportionate for the quantum of Allowable Costs being reported; • whether the contractor needs to inform the MOD about difficulties they may have in the availability of the financial information they need to meet this reporting requirement; • the specification or requirement under the contract and the extent to which the DPS lines apply (e.g. a whole platform may require more lines to be completed than a component); and • making all reasonable efforts to include cost data accurately or at least to the nearest £10,000. At each DPS level, DefCARS will aggregate data provided at lower levels, so that at the top level (level one), the DPS will show the total allowable costs (excluding risk contingency). The DPS structure should include outputs that will be provided by sub-contractors.

Selecting and agreeing the DPS

7.34 The MOD's commercial policy provides for commercial officers to agree with the contractor the DPS that will be used for contract reporting, and to seek input from an estimating professional within the Cost Assurance and Analysis Service (CAAS) where possible.56 This approach should help ensure that the cost breakdown into the DPS supports future cost estimates and provide a feedback loop between the contracting, cost estimation and reporting processes. The SSRO sought input from stakeholders on the extent to which DPS reporting is discussed and agreed between parties, any perceived barriers, and any suggestions for improvement.

7.35 The MOD stated that for large platform contracts the DPS would be discussed with the contractor. Industry responses confirmed that the DPS was not always agreed and identified that in some circumstances this resulted in reporting difficulties. Some contractors thought that the MOD did not have a clear process for selecting the DPS and reported discussions about the DPS happening after the contract had been awarded. One contractor submitted that selecting the right structure was straightforward but that identifying the correct cost categories and level of granularity was more difficult.

56 MOD Commercial Policy – Single Source Procurement Reform – Chapter 5 Contract Reporting.

7.36 The SSRO considers that the optimal approach is for the DPS to be agreed between the contractor and the MOD, with input from estimating experts. In this way, the DPS is more likely to reflect what is being bought, treat support costs appropriately, and avoid wasted effort on the part of the contractor. The MOD's commercial policy supports this approach, although limiting CAAS input to larger contracts. The latest version of the commercial policy was introduced in March 2019 and some of the experience of industry respondents may have predated this. The SSRO's guidance provides that: "The contractor should agree which of the 16 DPS templates is to be used with the MOD before reporting."[57] We propose to strengthen this by recommending in guidance that the level of detail provided within the DPS is also agreed with the MOD. The SSRO will keep the situation under review but does not believe legislative change is required at this time.

We are proposing a change to DefCARS to allow reporting against more than one template where this is appropriate in response to stakeholder feedback that the single-equipment type structure may be unsuitable for a small number of contracts. This might include, for example, framework agreements where more than one equipment type will be provided or supported under the contract (for example allowing the selection of fixed-wing aircraft alongside rotary wing aircraft). We acknowledge that reporting in this way will be the exception rather than the rule and a change to the reporting guidance and DefCARS will be required to accommodate this. Stakeholder views are sought on this proposal.

Application and mapping other cost structures to the DPS

7.37 The Regulations require that costs reported in the QCR are split by the contractor reporting structure while in the CNR, ICRs and the CCR costs are split by the DPS. A contractor's reporting structure may be helpful to commercial officers at the MOD because it is relevant to the contract, allocating costs to individual activities undertaken to deliver the contract. By contrast, the DPS has standardised cost categories that are intended to support comparisons and may be of more assistance to MOD estimators. If the contractor's reporting structure is not the same as the DPS, the contractor will have to map from one breakdown to the other. Some contractors may find this mapping easier than others depending on how familiar they are with the DPS and whether it is used within their company for internal reporting purposes.

7.38 In the working paper, the SSRO examined 45 contracts in DefCARS for which both QCRs and ICRs have been provided and found that 4 contracts had complete alignment between the breakdown structures, 22 had substantial alignment and 19 had little or no alignment. The SSRO noted that alignment between the breakdown structures may facilitate reporting, for example by rationalising QCR and ICR reports, reducing duplication and encouraging a single dataset for cost data across contract reports. Care must be taken, however, as the Regulations clearly envisaged that the contractor's reporting structure would be used in the QCR for contract management and the DPS in the CNR, ICRs and the CCR to support estimating.

7.39 The SSRO acknowledged a view expressed by contractors that there may be a need to 'unwind' the mapping to the DPS to identify the cost driver within the contractor's accounting system in the event of a cost challenge. One feature of the US approach to cost reporting is that the codes, structure and names used to breakdown costs are fixed, but contractors can provide their own definitions to support their treatment of costs when assigning costs to the standard categories. The SSRO's reporting guidance also recommends such an approach, and DefCARS enables contractors to attach a supporting file. This data cannot be analysed easily and supporting contractors to supplement DPS element descriptions in DefCARS in an easier, more intuitive way may gather cost data that can be more easily analysed.

57 SSRO reporting guidance version 7 published on 13 December 2019, paragraph 4.25.

7.40 The SSRO invited views from stakeholders on issues raised by differences, or alternatively, similarities, between the contractor's reporting structure and the DPS, and whether it would be helpful to provide contractors with more flexibility within DefCARS to explain their approach to mapping.

7.41 The MOD confirmed that the contractor's reporting structure and the DPS serve different purposes, with the former more relevant for contract management. It recognised that some approximation would be required to map from the contractor reporting structure to the DPS. The MOD thought contractors might have difficulties applying the DPS in certain contract situations, specifically referring to difficulties with estimating costs at the beginning of particular contract types, for example multi-activity contracts.

7.42 Industry responses emphasised that mapping is required because the DPS is not extensively used within contracting companies for internal management, in part because it is focused on outputs rather than inputs. Contractors submitted that there may be significant misalignment between their own breakdown structures and the DPS, such that the mapping may take different amounts of time and there may be issues with the fidelity of the DPS data, due to allocating costs to fit the standard DPS cost categories. Some contractors felt the connections between the contractor's reporting structure and the DPS could be stronger, with one contractor submitting that more work could be undertaken to align the two. ADS questioned the utility of DPS data for contract management purposes. Respondents found mapping more difficult with support contracts, with specific reference made to the difference between refitting equipment and construction. One contractor indicated that in support contracts more than one DPS might be applicable, where the activities undertaken relate to more than one equipment type. This might be the case for framework contracts.

7.43 The feedback supports the view that the contractor's reporting structure is intended to be useful for contract management and that the DPS should support estimating. Given the different purposes, apportionment will often be required to map costs from the contractor reporting structure to the DPS. Some loss of the detail contained in the contractor breakdown structure would be expected as part of the standardisation process and provided the taxonomy of the DPS is suitable this should not impede cost estimation. The SSRO believes that mapping is likely to be most effective for estimating purposes if the contractor agrees the DPS with the MOD. Informed input from the MOD should help to avoid inconsistencies such as may arise if two contractors with a similar breakdown structure and delivering comparable contracts map their costs to different elements of the DPS. Taking a proportionate view of the required level of granularity may also make the mapping process easier for contractors. With modern cost accounting systems it should be possible to map from one cost structure to another without disproportionate cost.

The SSRO considers that it should proceed with its working paper proposal to make it easier for contractors to explain their mapping within DefCARS by adding an additional field within DefCARS to allow contractors to explain their approach. Stakeholders are asked to share any views on this.

Distinguishing contract types in DefCARS

7.44 The SSRO sought input in its working paper on the benefits of linking DPS data to information about the type of contract. This enquiry was made on the basis that it may assist an estimator to be able to easily identify the stage in the lifecycle of equipment to which the DPS data relates. The working paper explored some potential approaches to differentiating between types of contracts:

- the activity type definitions set out in the SSRO's Contract Profit Rate methodology, which split out activities undertaken by defence contractors as develop and make, provide and maintain, ancillary services and construction;
- the contract's impact on the MOD's accounts, for example, whether a contract would be considered as capital expenditure (equipment) or revenue expenditure (support); or
- the CADMID cycle, which distinguishes between different activities throughout the defence equipment life cycle and may, for example, allow the analyst to separate design phase costs from build phase costs.

7.45 The SSRO invited stakeholder views on whether a facility should be included in DefCARS to distinguish between types of contracts to enable better analysis of cost data within the DPS and, if so, the most useful categorisation of contract types.

7.46 There was limited support for requiring contractors to provide information on contract type. The MOD considered that this information could create confusion as the DPS is an output-based rather than an activity-based costing approach. ADS said that providing additional information was disproportionate and contractors considered that it was available already through the contractor's description of the contract or from other MOD sources. One contractor considered that aligning the DPS data to the CADMID cycle could be a useful distinguisher of different contract types.

7.47 The SSRO remains interested in the use of descriptive contract data to assist with analysis of DPS data. There is a potential benefit from having key information within a single dataset rather than having to combine datasets to perform analysis. Contractors rightly made the point that they are already required to provide a contract description in each contract report. The SSRO used the contract descriptions to categorise contracts by activity in the working paper but believes more can be done to maximise the utility of such data without disproportionately increasing the reporting burden. The SSRO is not proposing immediate changes to how contracts are identified in DefCARS but will continue to consider ways in which revised guidance and more structure data collection may facilitate use of contract data in support of the regulatory framework.

The SSRO has decided not to proceed with the proposals on additional categorisation within the DPS which was presented in the working paper, though this is something we may explore in future reporting guidance work on the contract description. Stakeholders are asked to share any views on this.

DPS: metrics

7.48 Cost data split by the DPS may be used to carry out parametric analysis in support of gross estimates for budgeting and, to a lesser extent, more detailed estimates to challenge contractor costs. To carry out parametric analysis, relevant metrics are required to supplement cost data. For example, the cost of an engine which allows a ship to travel at 20 knots may be different from one which travels at 25 knots. The Regulations require contractors to provide in the CRP the output metrics that will be used to describe deliverables in its contract reports and, in each report where costs are split by the DPS, the contractor must provide the estimated quantum of the key deliverables, expressed using the output metrics. The SSRO has sought to enable reported metrics to be linked to DPS data in DefCARS.

7.49 The SSRO identified in its working paper that the metrics provided in contract reports may not be consistently providing information needed to support parametric estimating. In part this is because metrics have generally not been well-reported to date, as identified in the SSRO's Annual Compliance Report.[58] The SSRO does not see the contracts which are the subject of statutory reports, which limits the extent to which it can check the correctness and completeness of reported metrics, but it has identified instances where contractors state there are no metrics associated with the contract, choose not to report metrics for security reasons, or struggle to identify the DPS element to which the metric relates.

7.50 The SSRO invited views from stakeholders on any difficulties experienced in identifying suitable metrics and aligning them to the DPS. Input was sought on areas where better reporting requirements or guidance may produce metrics that enable DPS data to be used for parametric analysis. The SSRO suggested that a coherent list of standardised metrics may help to encourage appropriate specification of metrics in contracts and reports.

7.51 Respondents differentiated metrics related to contract delivery from those required for parametric estimating and submitted that the latter may be too sensitive for reporting. The MOD considered that some metrics might only be measurable once a contract was delivered and an equipment platform was in service. ADS submitted that the requirement to report metrics should be deleted and that the MOD should already know the requirement it was procuring. Identifying suitable metrics for support contracts was problematic for industry. One contractor interpreted the requirement to report deliverables and milestones in the contract as supporting the inclusion of metrics in the statutory reports.

7.52 The SSRO does not accept the submission from ADS that there should not be a requirement to report information that is known to the MOD. Reporting requirements should be proportionate, but one of the purposes of the scheme of statutory reporting is to collect data that can be used for analysis. The obligations on the contractor to report, with review by the SSRO and enforcement by the MOD, are aimed at producing a usable database in support of single source contracting that achieves value for money and fair and reasonable prices. The work to understand the purpose of the DPS highlights the value of having relevant data alongside cost data split by the DPS to inform and guide analysis.

7.53 The SSRO considers that there was intended to be a link between the requirement to report costs split by the DPS and the requirement to report the quantum of deliverables using the output metrics described in the contract reporting plan. The deliverables are required to be listed in the same three reports in which costs are split by the DPS (the CNR, ICR and CCR) and contractors must also report the quantum of deliverables by output metric. The DPS itself is required to be presented as a list of cost categories describing deliverables to be provided under the contract.

7.54 The SSRO does not accept the suggestion that the kind of metrics required to be reported are not such as are used in parametric estimating. The Regulations define an output metric as "a quantifiable description of any goods, works or services (including a number, weight, dimension, time or physical capability, but not including a minovery value)". This description gives a broad range of metrics that could potentially be agreed and reported under the contract. It includes but does not mandate the reporting of equipment characteristics that may be of use for parametric estimating. Other metrics may relate to contract milestones, for example related to scheduling. Equipment metrics are likely to be of higher value for parametric estimating, but other metrics may still provide relevant context for estimating purposes. For example, the schedule required by the MOD may have involved risk and additional cost.

58 SSRO (2019) *Annual Compliance Report 2019*.

7.55 If metrics are not provided or not linked to the DPS, the MOD may have to combine datasets when using the DPS for estimating purposes, rather than relying on data in DefCARS. The MOD is best placed to identify the contract deliverables and associated metrics. When agreeing deliverables and metrics, the MOD can consider the extent to which they may be of assistance for future estimating, even if that is only a secondary purpose. The MOD may be able to assist contractors with their reporting by linking deliverables (i.e. the contract components) to the cost components that are to be reported by the DPS. This approach is suggested in the MOD's QDC Contractor Databook, which is used by the MOD to demonstrate that bids are compliant with the Defence Reform Act.

7.56 The SSRO proposes to update the metrics section of the reporting guidance to recommend engagement with the MOD on the metrics to be reported and whether the sensitivity is such that they may be reported in DefCARS or whether another approach is needed. DefCARS is accredited to hold information up to OFFICIAL-SENSITIVE-COMMERCIAL which is likely to be sufficient for the majority of metrics that would be reported. We will consider the extent to which reported metrics can support estimating part of our ongoing review function to ensure that MOD are providing appropriate input into the reporting process.

Stakeholder views are welcome on these proposals or any other matters addressed in this section on DPS metrics.

DPS frequency

7.57 The DPS breakdown is reported at the start and end of a contract. It is also provided in any ICRs that are required under the contract. The frequency of ICRs can be agreed between the Secretary of State and the contractor. In cases where such agreement has not been made, the reports will be required at intervals prescribed by the Regulations (see table 5 below). The MOD may additionally require on-demand ICRs.

Table 5: Frequency of ICRs required by regulation 27(2)

Contract value	Maximum interval if ICR frequency agreed	Default ICR frequency
< £50 million	5 years	3 years
≥ £50 million	3 years	1 year

7.58 In the working paper the SSRO set out its findings on the ICR reporting dates provided in contract reporting plans. It showed that there were significant numbers of shorter duration contracts for which no ICRs are expected. In general, the contracts for which ICRs will not be required are contracts of shorter duration valued below £50 million. In some instances, however, no ICRs are provided even though the duration of the contract exceeds the default and minimum agreed frequencies shown in Table 5. The SSRO sought views from stakeholders on the frequency with which the DPS breakdown is being provided and whether it is sufficient for budgeting and estimation purposes.

7.59 In response most stakeholders were clear that any frequency of DPS reporting should include reporting at the start of the contract and at the end of the contract. However, there were differing views on the frequency at which DPS data should be required during the contract. The MOD considered that the data should be submitted at three-year intervals during the contract. ADS felt that it should only be required at the start and end of the contract, while others recognised that some form of interim reporting would be necessary. One contractor was of the view that the current frequency should not be increased. Some industry respondents proposed on-demand DPS reporting as an alternative to ensure that costs would only be split by DPS when it was needed.

7.60 A distinction should be drawn between the frequency of DPS reporting and the frequency of the ICR reports. An ICR contains a substantial amount of information in addition to costs split by the DPS, which may assist the MOD with contract management. The overall purpose of ICRs and (with the exception of the DPS breakdown) their content has not been examined nor the content that is included in those reports with the exception of DPS.

7.61 The SSRO's view is that the frequency at which the DPS is provided should be such as to allow the MOD to generate independent estimates for budgeting purposes and to challenge contractor cost estimates. The requirements for the DPS breakdown in the contract notification report and the contract completion report are relatively non-contentious among stakeholders and we agree that these should remain unchanged. Actuals obtained at the end of the contract provide the best view on outturn and comparison against initial estimates and should foster better understanding of the contracts and projects alike. This will help to reveal their true cost, estimation bias and as a result improve the MOD's ability to analyse and compare estimates.

7.62 We recognise that early estimates are inherently challenging due to the nature, stage, length, scale or complexity of some contracts. As contracts progress and mature, estimates improve in accuracy, simply because more is known about the factors affecting costs. It is reasonable that the MOD may wish to have access to this more recent contract cost data. Interim reporting of costs split by the DPS may reduce the risk of estimating errors. There are several factors that may determine the required frequency for updated cost data split by the DPS, such as:

- the lifespan of an equipment platform;
- the number of contracts forming part of an equipment programme;
- the value and risk associated with different programmes and projects;
- material pricing amendments.

7.63 In general, when carrying out long-term budgeting, the impact of not having the latest available actuals and estimates may be less significant, given the uncertainty inherent in forecasting far into the future. There may be other circumstances when recent information could be needed during the contract, for example for shorter-term budgeting or when challenging a contractor's cost estimates. The Regulations currently provide the MOD with significant flexibility to obtain the DPS breakdown at the intervals it requires. The frequency of the DPS can be set at the frequency shown in Table 5, or on demand.

7.64 Our helpdesk engagement and compliance monitoring indicate that the requirements are not well understood at contracting level either in industry or the MOD. Some contractors may be required to report costs by DPS more frequently than seems appropriate to support estimating. For example, if a contract is valued at more than £50 million and ICR due dates are not agreed, the default reporting would be annual (in addition to QCRs every quarter for the purpose of contract management). We are aware of cases where dates agreed between contractors and the MOD provide for the ICRs to be submitted at a greater frequency than annually, in addition to quarterly reporting.

7.65 A case can be made for simplifying the due dates of ICRs. There may also be a way to fix the frequency of DPS reporting so that it proportionately provides costs broken down by the DPS to support the MOD's estimating. A useful change may be to ensure that costs broken down by the DPS are reported after a material pricing amendment. We are not persuaded that relying solely on on-demand reporting would be appropriate, as this risks inconsistent application across a range of contracts and may result in the DPS not being available as required.

7.66 The SSRO considers that recommending changes based on a consideration of a subset of data included in the ICR report carries a risk. Mandating changes at this stage may lead to unintended consequences and we accept that it may be appropriate to defer addressing the issue of DPS frequency until such time when a review of ICRs is complete. An alternative approach may result in separating the requirement to provide a DPS from the requirement to provide an ICR. We therefore do not propose to make any changes in legislation until ICR reports are reviewed.

At this stage the SSRO would like to seek further input on whether the current arrangements which allow the parties to agree the frequency of interim contract reports remain fit for purpose. It would be helpful to receive feedback on whether interim DPS reporting in the ICR remains appropriate or whether a different mechanism is required.

8. Amendments and variance

Purpose

8.1 There are seven contract reports that a contractor may be required to provide in respect of QDC or a QSC. In its working paper the SSRO considered the information required to be provided in the contract reports about changes in price and identified two purposes behind requiring this information:

- contract management; and
- improving cost estimation, by identifying the causes of cost growth.

8.2 The SSRO drew attention to two ways in which the contract reports appear to support these two purposes. First, the reports track details of costs and profit over the life of a qualifying contract, providing a basis on which to observe how these change from the start to the end of the contract, whether due to amendments or variances. Secondly, contractors are required to explain cost variances in a QCR, ICR or CCR, and in the CCS. The SSRO sought input on whether it had correctly understood the purposes behind requiring information about changes in price. It asked for details of how such information had been used and any issues that had been encountered.

8.3 The MOD stated that the collection of regular costing information over the life of a contract was essential to manage costs and challenge contractors in order to understand cost escalation and variances. It was acknowledged that there are gaps in the MOD's understanding of cost growth and that improvements are required. The MOD suggested that there was a need to distinguish between variances in requirements and variances between actual and estimated costs. It further added that DefCARS should support the reporting of segmented data to enable variance analysis.

8.4 ADS said that contractors' internal reports have traditionally identified and segregated variances into "performance" (which are cost changes not contract-driven) and "scope" (which are contract-driven and include tasking orders, options and discrete amendments). It noted that the contract reports do not assist reporting variances and performance and that the purpose of reporting variances is to give MOD a high level of understanding of contract performance, and to indicate future changes. Another respondent commented that the Regulations only require contractors to report variance analysis against the contracted baseline, not amendments, which the MOD systems will record. Several contractors highlighted the difficulty in identifying and distinguishing between variances and amendments. One respondent raised a challenge associated with reconciling internal reporting with data in DefCARS where there were multiple contract amendments. There was also a view that the MOD had its own systems to record the contract and amendments.

8.5 After considering the feedback, the SSRO continues to consider that the contract reports require information about price changes for the purposes of contract management and to understand the causes of cost growth to inform future estimating. The SSRO explores in this paper whether information about price changes is being collected in a way that effectively supports these purposes, recognising that such changes may be due to both pricing amendments and cost variances. The question of how changes in costs should be categorised, which is raised in the ADS response, is dealt with further below.

Definitions

8.6 The SSRO's engagement led to significant debate about what constitutes a "variance" for the purposes of the obligation to provide a quantified analysis of the causes of variance in a QCR, ICR or CCR. A view was expressed that a variance could only be measured against the latest agreed price, which would include any agreed amendments. In this context, the SSRO proposed some definitions that might be used to frame the review:

8.7 Variance means a difference between one cost and another. If the contract is priced using a pricing method that uses estimated costs, then the difference will be between the agreed costs and the actual or forecast costs. A reference to actual costs for the purposes of a variance analysis in a QCR, ICR or CCR is taken to mean costs incurred by the contractor. The forecast costs are those expected to be incurred at a later point in time.

8.8 An amendment is an agreed change to a contract. It involves some formality in contract law, consisting of an agreement, reached by the process of offer and acceptance, an exchange of consideration (something of value) and an intention by the parties that the agreement be legally binding.

8.9 The SSRO sought feedback on the definitions and additionally sought views on the extent to which different types of changes to a contract price may involve an amendment. Attention was drawn to the following:

- Tasking orders
- Additional volume in a volume-based contract
- New work under a framework or enabling contract
- Exercise of options
- Increase in fixed price based on an index, e.g. inflation
- Changing provisional rates to final
- Changes in availability under an availability contract

8.10 Two industry respondents agreed with the definitions provided and felt that the examples given above would be treated as amendments. The MOD considered that each of the above examples should require an amendment, save for the additional volume in a volume-based contract, the exercise of options and an increase in fixed price based on an index. For those, the MOD suggested that they would each constitute an "element of the original contract". One respondent expressed that it had difficulty in recognising in what circumstances the requirements of the Regulations for pricing amendments might apply. Three respondents to the working paper suggested that a workshop be held, either so that the SSRO could clarify the information it was seeking or to enable further discussion on the circumstances which may give rise to an amendment.

8.11 Several respondents indicated difficulty in identifying and distinguishing between variances and amendments. ADS and another contractor shared a similar view, suggesting that the data collected should align with contractors' internal reporting systems and standard categories. The MOD indicated that there was a need to distinguish between variances in requirements and variances between actual and estimated costs.

8.12 The feedback received from stakeholders did not challenge the definitions posed in the working paper and the SSRO proposes to reflect them as appropriate in later iterations of its guidance. There was no single view about whether the various types of price changes listed in paragraph 8.9 would require an amendment and the SSRO considers this may well depend on the terms of the contract in question. There would seem to be merit in including examples in guidance of how to report some of these changes.

The SSRO welcomes views on possible changes to the guidance to reflect definitions and examples.

Amendments

8.13 It would further the purpose of improving the MOD's estimation of costs to understand the reasons costs change from those estimated, whether due to amendments or variance. In this context, the SSRO's working paper examined the extent to which the contract reports capture information about amendments. Attention was drawn to the following:

8.14 Contractors are required to report the date and reference number of the most recent pricing amendment in any contract report, but this may not require all amendments to be referenced, depending on the number and timing of amendments compared with reporting dates.

8.15 Price changes will be reflected in a subsequent QCR, ICR or CCR, but the requirement to provide a quantified analysis of the causes of variance between any estimated costs used to determine the contract price and the total actual and forecast costs may not apply following an amendment.

8.16 The MOD may require the contractor to submit the information in a CPS, CRP, ICR or CCS on demand. The use of an on-demand CPS was considered as a means of gathering information about a price following amendment.

8.17 The SSRO invited input from stakeholders on whether reporting requirements should include information on causes of change in cost linked to amendments. If so, further input was sought on the appropriate mechanism for capturing information about amendments.

8.18 In response to the SSRO's working paper, the MOD indicated that it saw merit in being able to gather a history of contractual changes and visibility of the costs expected to be incurred through additional reporting. It would like to be able to identify the variations in costs which are attributable to amendments and those which are not. To achieve this the MOD suggested that a report which captures the same data as is required by the existing CPS could be submitted for each amendment or group of amendments. However, at the September workshop a concern about whether on-demand reports would generate a complete set of the information was discussed.

8.19 By contrast, there was a general lack of support from industry for any proposals which might result in additional reporting requirements. It was asserted that some contracts have so many amendments that reporting them would be administratively burdensome and expensive. Some industry respondents commented that the information which would need to be reported for amendments is already held by the MOD and therefore any benefit from reporting details of amendments under the regulatory framework would be disproportionate to the cost of reproducing it. One industry respondent supported the use of on-demand reporting but, in common with the MOD, suggested that this would be useful only where the report is able to capture changes in the contract profit rate.

8.20 The purposes behind the contract reports included contract management and informing future estimates. Information about changes in price resulting from pricing amendments represents part of the MOD's spending that may need to be considered when preparing future estimates. From a contract management perspective, the MOD needs to understand what it is spending on qualifying contracts, both at the level of individual contracts and at a portfolio level. It would be helpful, for both purposes, to have details of the costs associated with an amendment. The SSRO considers that it is important that the contract reports allow for an understanding of the changes in cost to a contract, whether from an amendment or a variance.

8.21 Our current view is that some summary level information on amendments is required, in order to understand the changes in cost. The reporting should allow an understanding of changes between the original price and the outturn price. The SSRO is not persuaded that mandatory reporting of detail about each and every amendment would be beneficial. There may be cases in which the number of amendments is so large that it would not be proportionate to require every amendment to be reported.

8.22 One option for gathering the required information would be to amend regulations 26(6)(f), 27(4)(i) and 28(2)(i) which require the contractor to provide (in the QCR, ICR and CCR respectively) a quantified analysis of the causes of variance between any estimated costs used to determine the contract price and the total actual and forecast costs. The regulations could be amended to clarify that the reference to "estimated costs" means the estimated costs at the date the contract became a QDC or QSC. Those regulations already contain a materiality threshold (up to 10% of variances need not be explained) and the SSRO is considering a further materiality threshold. Any categorisation of variances between those due to amendments and those resulting from some other change could be handled within DefCARS supported by the SSRO's reporting guidance. The SSRO would prefer not to recommend legislative change if information about amendments can be gathered under the existing reporting requirements.

8.23 Contractors are already required in the QCR, ICR and CCR to describe any event that has occurred, or circumstances which have arisen, since the contract was entered into, that have had or are likely to have a material effect in relation to the contract. For material events and circumstances, the required description must include the effect on costs incurred and the effect on forecast costs. There is a reasonable argument that a material pricing amendment is an event or circumstance that the contractor is required to report. The SSRO has already provided for such reporting in DefCARS and can give further attention to optimizing DefCARS and the reporting guidance to gather descriptive information about the causes of cost growth.

8.24 The facility for the MOD to require on-demand reports may provide an appropriate route to gather information on significant amendments or groups of amendment. This is not a mechanism for routinely gathering information about pricing amendments, because it depends on the MOD directing the information to be provided. The MOD suggested for example that it may be appropriate for 'groups of amendments' which the SSRO assumes is a more ad-hoc event, when appropriate for the contract. The SSRO is considering changes to reporting guidance and DefCARS to facilitate capturing information about amendments (or groups of amendments) in an on-demand CPS. The changes would include:

- enabling submission of an on-demand CPS, as the CPS is currently subsumed into the CIR;
- splitting reporting between the amendment 'segment' and the rest of the contract price, consistent with the requirements in the Schedule to the Regulations, capturing the profit steps associated with the amendment and the facts assumptions and calculations relating to the allowable costs for the amendment.

The SSRO invites input from stakeholders on its proposal to modify DefCARS and reporting guidance to collect details of material pricing amendments, using the requirement to report material events and circumstances and the facility for on-demand reporting.

Variances

8.25 The Regulations require contractors, in a QCR, ICR or CCR, to provide a quantified analysis of the causes of variance between any estimated costs used to determine the contract price and the total actual and forecast costs. This analysis must explain not less than 90 per cent of the variance. The SSRO noted two potential issues in its working paper on which it sought stakeholder input. First, the overall materiality threshold, which allows up to 10 per cent of variances to go unexplained, may still result in explanations being provided for individual variances that are not themselves material. Secondly, DefCARS supports the requirement to analyse the causes of variance by providing for a title, a brief description of the cause of variance and the amount. The title and description are entered as free text, which may constrain the ability to analyse the reported causes.

8.26 The SSRO examined the reports submitted for 201 QDCs and QSCs entered into between 1 April 2015 and 31 March 2019. At least one QCR, ICR or CCR was submitted in respect of 77 of the 201 contracts and 45 of these contracts had information submitted about a cause of variance. In some instances, it is possible to identify overarching categories, such as scope change, or rate changes due to causes such as inflation. In others, the stated causes were too specific to the particular contract to enable a clear understanding of what had driven the variance. The SSRO sought input from stakeholders on whether explanations of variances should be categorised at a high level to enable analysis of the causes of cost growth and, if so, what the appropriate categories might be and how best to collect that information.

8.27 All respondents who addressed the issue of materiality were in support of the use of an appropriate threshold to limit the required explanations of variance. ADS suggested that a level of materiality needs to be applied to reporting of outturn changes. An example was given that the Regulations would require £900 of causes to be identified in respect of a £1000 variance. Another respondent suggested that the threshold should be based on a percentage of value rather than a fixed monetary value.

8.28 Stakeholders offered mixed views on the categorisation of the causes of cost growth. The MOD and one industry respondent thought a comprehensive list of variance categories would assist in understanding the causes of cost growth. Another industry respondent submitted that variances should be categorised at a high level and suggested around six categories should be sufficient, one for contract growth awaiting an amendment, with the remainder relating to contract performance. The same defence contractor was of the view that industry have a better understanding of the causes of variance, indicating support for a free form description. By contrast, ADS and one defence contractor argued that contract types and reasons for cost growth are so varied that standard categorisation would be unhelpful or futile. As referred to in the purpose section, ADS indicated that contractors tend to segregate variances into the categories of “performance” (which are not contract-driven) and “scope” (which are contract-driven and include tasking orders, options and discrete amendments).

8.29 The SSRO is considering recommending an amendment to regulations 26(6)(f), 27(4)(i) and 28(2)(i) to add a further material threshold. It is suggested that the requirement to explain at least 90% of the variance could be supplemented by an additional provision that a variance need only be explained if it meets or exceeds the lower of the following amounts: £100,000 or 1 per cent of contract price.

The SSRO is interested to hear views on whether this would provide an effective materiality threshold for explaining variances.

8.30 The SSRO sees benefit in categorising reported explanations of variance to enable the intended use of the data to generate a wider understanding of the causes of cost growth. The categorisation can be implemented through changes to DefCARS and the SSRO's reporting guidance, relying on the current requirement to report quantified analyses of variance. The 'brief description' data field should be retained alongside the new proposed categorisation, as this free text description will provide important detail about the analysis of the cause of variance, and this detail will assist with contract management.

8.31 The SSRO recognises the concern raised by some stakeholders that it may be difficult to introduce detailed categorisation of all causes of variance. Development of a detailed, standard categorisation is expected to require significant further work and engagement, for example to explore breaking down the causes of changed assumptions. The SSRO is considering whether some high-level categorisation may be introduced as a first step. It may support decision making and learning from the data, to be able to distinguish between changes in costs due to some contractual provision that does not require an amendment, and changes for other reasons, such as the cost of a component coming in higher or lower than originally estimated. Without this distinction, it would be difficult to generate learning about the causes of cost growth. The SSRO is considering whether explanations of variance may be categorised as follows:

- changes in the requirements or scope of the contract not reflected in an amendment;
- changes in prices, for example from an index being applied in a fixed price contract not reflected in an amendment;
- changes in costing assumptions not provided by the Secretary of State (this is akin to the 'performance' category suggested by some stakeholders); and
- other changes, for example in assumptions provided by the Secretary of State.

The SSRO is interested in views on the above categorisation. The SSRO would also be interested in evidence on how easy or difficult it would be for contractors to use this categorisation when reporting variances.

Frequency of information about changes in costs and its use for cost estimation and contract management

8.32 The SSRO considered in its working paper the frequency with which information is provided about changes in costs. Consideration was given to the extent to which the reported information supports either contract management or cost estimation.

8.33 The SSRO stated that, in general, the causes of cost growth are best understood at the end of a contract. It was noted, however, that if the contract is of significant duration, there may be merit in having information about changes in costs during the term of a contract to inform cost estimation.

8.34 The SSRO identified that contract management benefits from timely, detailed information about variance in the price, so that potential issues can be identified at an early stage and to enable action to control costs. Action may be taken to limit variances, discuss changed assumptions and ensure costs are borne appropriately. If the reports are to support contract management, they should assist the MOD to recognise, understand and challenge specific causes of change.

8.35 The working paper looked at the timing of QCRs and ICRs and how this affects their use for contract management purposes. Quarterly reports may be sufficiently frequent but are only required for contracts valued at £50 million or more. For contracts valued below £50 million, reliance would be placed on ICRs, the frequencies of which are addressed in Table 5 of this paper. ICRs may be required on-demand but otherwise will be as infrequent as once every three years or, with agreement, once every five years. For a contract valued at less than £50 million, with a duration of three years or less, there is potential for no ICRs to be required and for the first report of any variances to be provided in the CCR submitted six months after the contract completion date.

8.36 The SSRO sought feedback on whether information about the causes of cost growth should continue to be provided in each QCR, ICR and CCR. It also asked whether the QCRs and ICRs were providing what the MOD needs for contract management purposes.

8.37 Stakeholders were generally supportive of the current frequency of reporting cost growth, with the MOD commenting that it would expect to monitor material cost growth on a regular basis, as would contractors. Three respondents either expressed support for the current frequency of reporting through the QCR, ICR and CCR, or stated that they had no issue with current arrangements. ADS considered the current arrangements to be proportionate, allowing for frequent updates for larger and more sensitive contracts. Two industry respondents raised wider questions about the QCR and ICR. One referred to the monthly updates on contract performance received by some MOD project teams and suggested abolishing QCRs in favour of a modified annual ICR. The other proposed less frequent reporting of all reports, with frequency being proportionate to contract value.

8.38 The MOD thought that the QCR provides valuable information to enable cost variances to be monitored, but that the ICR is less useful because it is based on the DPS rather than the contractor reporting structure, which is needed for contract management purposes. Several respondents considered that the current arrangements are either supportive of contract management or stated that they saw no issue. Another industry respondent stated that the current arrangements do not support contract management, suggesting that it is time consuming to have to reconcile the “true internal picture” with that being reported. One industry respondent indicated that the reporting of cost growth is carried out effectively outside of DefCARS, which in turn supports contract management.

8.39 The SSRO considers that, in line with the purposes identified for the contract reports, the information provided in the QCR, ICR and CCR may assist with contract management as well as informing any estimation required by the MOD. There was general support for the frequency at which information about changes in cost are reported and the SSRO is not proposing to recommend that this is changed. The SSRO has given separate consideration in this report to how often costs need to be split by the DPS, which involves considering the frequency of the ICR.

8.40 Some of the proposals made in response to the working paper dealt more broadly with the QCR and ICR than just the extent to which they provide information about changes in costs, for example suggesting that there be just an ICR and no QCR. Those proposals require more detailed input to understand the case for change and any implications. The SSRO has logged the issues for possible future consideration, based on engagement with stakeholders about prioritisation.

Duplication

8.41 In its working paper the SSRO noted that the MOD collects information about amendments and variance in a variety of ways, for example through its Earned Value Management (EVM) tool and its Contracting, Purchasing and Finance (CP&F) database. Key differences were identified between DefCARS, EVM and CP&F related to the circumstances in which they are used, who completes them, and the information obtained. The SSRO invited examples of duplication in the collection of data on amendments and variance that could be avoided and any information requirements that could be better captured.

8.42 The MOD accepted that it collects information in several formats depending on whether it is targeted at the commercial or other delivery teams. It considered that some degree of duplication (such as between CP&F and DefCARS) is unavoidable given that the systems serve different purposes and timings. It did acknowledge, however, that this should be minimised and that it continues to investigate occurrences. Industry respondents commented that there was clear overlap between CP&F and DefCARS, with one respondent suggesting that DefCARS should not be the primary repository for data. Several views were proffered that duplication arose in reports submitted to CAAS, ICPT and delivery teams. One industry respondent asserted that there was duplication in the information submitted between the ICR and QCR, particularly at the end of reporting periods.

8.43 Stakeholder feedback has confirmed there may be instances of duplication and, in general, the SSRO supports the removal of unnecessary duplication. There are instances, however, in which information is required to be submitted under the regulatory framework that may otherwise be available to the MOD, to ensure it is collected and accessible to both the MOD and the SSRO. The SSRO has not been provided with sufficient information to understand the nature and extent of the duplication and has no access to the MOD systems. In the circumstances, there would seem to be merit in the MOD first identifying any unnecessary duplication and considering whether it can be avoided by streamlining its processes.

It seems premature to contemplate proposals for legislative change at this time, but the SSRO continues to welcome evidence of unnecessary duplication.

9. Overheads

9.1 There are six overhead reports that a contractor may be required to submit under Part 6 of the Regulations.[59] The SSRO's working paper focused on the alignment between the reporting requirements and the MOD's rates programme.[60]

Purpose

9.2 The SSRO identified in its working paper the following purposes for the overhead reports that appear from the explanatory notes to the Act:

- capturing actual and estimated costs for contractor business units, split by standard categories;
- benchmarking comparable business units; and
- identifying systemic over- or under-recovery of overhead costs.

9.3 The SSRO noted that the MOD operates a rates programme, which is not referred to in either the Regulations or the explanatory notes to the Act. The rates programme is concerned with agreeing the rates used in pricing single source contracts. Selected contractors are required to submit the rates they claim for a given period together with supporting information. The MOD reviews the rates, checks the underlying costs and application of the contractor's allocation methodology, and requests additional information as necessary. The MOD may challenge aspects of a rates claim before attempting to agree the rates with the contractor.

9.4 The SSRO invited input from stakeholders on the purpose of the overhead reports and how the data is actually being used. The feedback received did not illustrate how the data is being used but a range of views were expressed around the purpose of the overhead reports.

9.5 Some contractors argued that the primary role of the overhead reports is to support central benchmarking and that they have a supplementary use for the MOD's rates programme. Others articulated their agreement towards the overhead reports playing a more prominent role in supporting and being used for the purpose of the rates programme. ADS said that the supplier reports were designed to provide data for the few key sites where the MOD's key risks lay. It added that their purpose was to ensure that rates were submitted on time and to ensure that there were no future surprises, such as the sudden appearance of redundancy or restructuring costs, or supply chain failure. In ADS' view supporting the rates programme was supplementary (apart from scheduling). It added that the scope of Part 6 needs reduction to meet its intended purpose, and the requirements of Part 6 need updating to ensure there are no additional ICPT data needs. One other respondent said that the overhead reports were intended to apply to larger sites / entities.

59 The actual rates claim report (ARCR), QBU actual cost analysis report (QBUACAR), estimated rates agreement pricing statement (ERAPS), estimated rates claim report (ERCR), QBU estimated cost analysis report (QBUECAR) and rates comparison report (RCR). These reports contain information on all cost recovery rates. We refer to these collectively as 'overhead reports'.

60 The MOD rates programme is aimed at reaching an agreement with the supplier on the overhead to be applied across all of its contracts.

9.6 The MOD considered that the SSRO's understanding is largely correct and it added that the reports are also intended to enable the MOD to do the following:

- provide efficiency incentives on overhead costs;
- assess the estimating accuracy of suppliers (estimates used in pricing compared to actuals) and persistent over- or under-estimating;
- understand the costs and benefits of supporting capability sustainment;
- have greater visibility of, and approval over, future overhead costs;
- ensure fair and reasonable prices, apply the AAR principles and monitoring potential gaming; and
- effectively manage QDCs whose prices depend in part on actual overhead costs (e.g. those using the cost plus, estimate based fee, or target pricing methods).

9.7 The intended uses of the overhead reports listed by the MOD are consistent with the purposes identified in paragraph 9.2. By capturing business unit costs in standard categories, the MOD can benchmark and use the information in support of both value for money and fair and reasonable prices. There is a clear connection with determining costs in contracts that are based on rates, which is supported by the rates programme.

9.8 The suggestion that overhead reports were intended to apply to the MOD's key risk sites or larger sites seems more connected to the Strategic Industrial Capacity Report ('SICR') than to the overhead reports. The explanatory notes to the Act refer to a strategic planning report that requires details of the key industrial infrastructure that is being paid for out of QDC prices. The purpose of the SICR is to allow the MOD to understand, for each qualifying business unit (QBU), the capabilities or activities provided for defence contracts, the capacity that is on the site to deliver them and to be advised of significant costs and the risk of losing key industrial capability before this occurs.

9.9 Having considered the feedback, the SSRO remains of the view that the overhead reports are intended to capture business unit costs in standard categories, support benchmarking and identify systematic over- and under-recovery of overheads. The context in which the information in the reports is received is important:

- The MOD agrees contracts in which costs are calculated based on estimated or actual rates. If contracts are based on estimates, it will be relevant to know the actual rates for the purposes of a final price adjustment, or application of the share in a target cost contract.
- The MOD operates a rates programme for the purposes of assessing and agreeing rates claimed by contractors. There is potential for information in the overhead reports to be used to agree contract prices or as part of the rates programme.

9.10 Further consideration is needed to understand how the MOD is using the overhead reports and whether change is required to better enable the reports in DefCARS to be used in support of the identified purposes. This needs to be part of a larger, ongoing review.

Timing of overhead report submissions

9.11 Four of the overhead reports (the ARCR, QBUACAR, ERCR and QBUECAR) must be provided three months after either the end of the contractor's accounting period, or the date on which the ongoing contract condition was first met in relation to the relevant financial year, whichever is the later. The Secretary of State may agree with the contractor an extension of up to three months to the due dates of these reports.[61] The ERAPS for a qualifying business unit is due on the same date as the ERCR for the unit, so an extension to the due date for the ERCR will also extend the due date of the ERAPS.[62]

9.12 The SSRO sought feedback in its working paper to understand the extent to which the timing of the overhead reports is optimal and whether there is merit in bringing the deadlines forward. These questions were raised against a background of two perceived issues with the MOD's rates programme. First, there was a concern that it takes an unacceptably long time to agree rates, in some instances several years. Secondly, contractors were concerned that the MOD routinely issues requests for information in support of the rates programme ahead of, and in addition to, the information required to be submitted in the overhead reports.

9.13 One industry stakeholder submitted that if the Act was intended to ensure that rates claims were submitted in a timely manner to facilitate the agreement of rates, it is not having that effect, as agreement is taking just as long as it did before. In general, industry stakeholders disagreed with shortening the deadline for the overhead reports. Some respondents considered that the current arrangements for submitting the reports for the previous financial year three months after the year end are appropriate. Others felt that contractors should have more time to submit the reports. Some argued that a six-month period after the accounting would be more appropriate given the pressures of year-end processes and requirement to complete QCRs and others explained that this also aligned with the requirement placed upon them for contracts with the USA. By contrast, some argued that the timing of submissions should reflect when the required information is available. One stakeholder said that if 'estimated rates are by reference to a company's budget then this will be available when approved and if the budget involves a "roll over" based on the closing balance sheet of the prior year, this will be after the actual results are approved. If the estimated rates are agreed on a "top down" basis (not detailed budget) then timescales may differ'.

9.14 The MOD considered that it would be beneficial to bring forward the due date for the ERCR from three months after year-end to a maximum of one month after year-end. It referred to the current facility to agree an extension of up to three months, which provided flexibility for suppliers. The MOD thought the provision for agreed extensions could be modified to allow extensions of up to five months in cases where suppliers have legitimate reasons for requiring more time to complete a report.

9.15 The SSRO is not persuaded that a sufficient case has been made for changing the due dates of the overhead reports. There are several reasons for being uncertain as to the benefit of shortening the ERCR deadline such that it would be proportionate to increase the pressure on contractors at year end:

- The delays in agreeing rates have been said to extend into years and it is unclear that changing the due date of one or more of the overhead reports by a month or two would appreciably impact such delays.
- The causes of delay have not been fully enumerated but the causes that have been explained include disputes about the treatment of costs and resourcing issues on the MOD side and changing report deadlines does not directly address either issue.

61 Regulations 34(2)(b), 35(3)(b), 36(2)(b) and 37(3)(b)
62 Regulation 38(2).

- Shortening the ERCR deadline to one month could result in contractors providing information before it is audited.[63]
- The SSRO does not have visibility of how the MOD is using the information currently provided to be confident of an appropriate alternative arrangement.

9.16 The SSRO is also not persuaded that a clear rationale for extending the current deadline to six months, which aligns with the US Department of Defense's requirement has been presented. The SSRO keeps the submission of overhead reports under review and in 2018/19 report submissions were as shown in Table 6.

Table 6 Number of supplier reports expected and submitted by report type, 1 May 2018 to 30 April 2019[64]

Report type	Number submitted	Number expected***	Number submitted on time	% submitted on time
QBU Estimated Cost Analysis Report and QBU Actual Cost Analysis Report (QBUCAR)*	52	54	48	89
Estimated Rates Claim Report (ERCR)	21	25	20	80
Actual Rates Claim Report (ARCR)	22	25	21	84
Estimated Rates Agreement Pricing Statement (ERAPS)	19	25	18	72
Rates Comparison Report (RCR)	2	2	2	100
Strategic Industry Capacity Report (SICR)	10	21	7	33
Small or Medium Enterprises Report (SME)**	8	22	7	32
Total	**134**	**174**	**123**	**71**

* The QBUACAR and QBUECAR are collectively known as the QBUCAR.
**one additional SME report was submitted below UPU level
***analysis is based on those supplier report submissions which have been received and consideration of their timeliness.

9.17 The data in Table 6 shows relatively good submission rates for overhead reports, better than for some other types of reports, such as the initial contract reports[65] and the strategic supplier reports. It is not clear in the circumstances that there is a good case to support extending the due dates. It is doubtful that the proposal to move the deadline from three months to six months would serve to ease any burden associated with the number and timing of reports, as it would simply result in the deadline coinciding with the next round of QCRs. The current arrangements already provide for extensions of up to three months, and these may be agreed to suit a contractor's workflow in appropriate cases.

63 We understand from industry stakeholders that ERCRs are dependent on the supporting QBUECAR, that are derived from the previous year's approved/audited actuals recorded in the QBUACAR.
64 See also SSRO (2019) *Annual Compliance Report 2019* at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/832017/SSRO_Annual_Compliance_Report_2019_-_web__1_.pdf
65 See Table 1 in SSRO (2019) *Annual Compliance Report 2019* at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/832017/SSRO_Annual_Compliance_Report_2019_-_web__1_.pdf

9.18 The most significant delays in agreeing rates have been attributed to disagreements between the MOD and the contractor about the treatment of costs. Disputes about the quantum or allocation of business unit costs may be difficult to resolve, particularly if the issue will affect later years or other business units. There is no evidence that receiving one or more of the overhead reports sooner would help to resolve such disputes. A more effective approach may be for a referral to be made to the SSRO for an opinion or a determination on the extent to which a cost is an allowable cost, but no such referral has yet been made in respect of overheads. As the legislation is currently framed, such a referral would need to be related to an actual or a potential QDC or QSC.[66] It may not always be possible to identify a contract that will serve as a suitable vehicle for the referral. Assuming that a contract can be identified, the SSRO would be required to consider the overhead cost applied to a particular contract when the central concern is with an aspect of the business unit's costs.

We welcome stakeholder feedback on whether referrals to the SSRO for opinions and determinations about rates should be expressly provided for in the legislation and whether this may facilitate agreement of rates. The SSRO would welcome further input on the typical timetable of agreeing the rates and the points at which delays occur.

9.19 The requirement of a referral being linked to an actual or a potential QDC or QSC is also relevant in a wider context. To the extent that the parties may wish to raise matters of principle, not linked to the particular contract, this may enhance the operation of the framework.

The SSRO would appreciate input from stakeholders about the merits of it being able to give advice or opinions, on request, on matters of general application to the operation of the regulatory framework. These requests would not need to be linked to a particular contract.

Overlap between the regulatory framework and the rates programme

9.20 Overhead reports are required to be submitted in relation to qualifying business units (QBUs). In broad terms, a QBU is defined as a unit, undertaking or group that provides a total value of at least £10 million of goods, works or services for one or more QDCs or QSCs in a financial year.[67] In connection with its working paper, the SSRO reviewed the QBUs captured by the regulatory framework for which there are overhead reports in DefCARS. It found that DefCARS recorded a total of 29 QBUs. By comparison, the MOD rates programme for 2019 includes 97 business units involved in single source contracts.

9.21 The MOD requests a range of information in support of its rates programme. A data request is sent to business units in the rates programme to capture assumptions, cost recovery bases, estimates and actual claims (the rates programme data request). This data is intended to enable the MOD to assess and agree the rates with the suppliers so that the rates are applied across all their contracts. The MOD may request additional data for the purpose of investigating costs and may visit sites to capture and analyse further information. The SSRO compared the rates programme data request from 2018 with the reporting requirements and found overlap between their content. However, further evidence and analysis is required to understand the points of difference between the data required as part of reporting requirements and the rates programme.

66 Sections 20(5) and 35(1)(a) of the Act and Regulation 51.
67 Regulation 32(1).

9.22 The SSRO sought stakeholder views on the reasons for different coverage between QBUs and the business units in the rates programme. The SSRO also sought input on whether there were efficiencies that may be gained from greater alignment between the MOD's information requests and the information required in overhead reports.

9.23 A few industry respondents said that supplier reports (of which overhead reports form part) were designed to provide data for a limited number of key sites. In their view, the QBU definition required more overhead reporting than was initially intended and its scope requires reduction. They submitted that the rates programme was intended to provide rates for a wider scope of entities involved in pricing single source contracts. One stakeholder added that greater alignment between the regulatory framework and the rates programme would be a significant change and the MOD would need to provide an appropriate funding mechanism for contractors. Another industry stakeholder thought that the difference in coverage is understandable as QBUs have a threshold of £10 million value of work on qualifying contracts whereas the MOD rates programme targets key contracts.

9.24 Various views were presented by industry stakeholders, but most mentioned the duplication in content between the statutory reports and other information requests. One respondent considered the SSRO reporting as in addition to, and possibly complementary to, information required for the MOD rates agreement, which another considered far more comprehensive than the data required for DefCARS but noted that the MOD requirements were being reviewed against the SSRO reports to remove any duplication. Other respondents suggested that the reports need to be reviewed to identify if they are delivering the intended outcomes, questioning the need for similar information to be provided direct to the MOD. Overall, the responses highlighted the need for the reports to be reviewed to identify if they are delivering the outcomes as intended and to understand the reasons as to why the requirement is duplicated by providing the information to the MOD. ADS also noted that the requirements of Part 6 of the Act are too complex and are often misunderstood by contractors.

9.25 The MOD explained that the rates programme includes a mixture of QBUs and other business units. It would like greater alignment between the two sets of business units and thought that a greater proportion of business units could be made QBUs by basing the QBU definition on the business units that are required by the rates programme. The MOD did not specify its criteria for including business units in the rates programme, nor did it state how the QBU definition should be changed to bring about greater alignment.

9.26 The SSRO accepts there is a lack of alignment between the set of business units in the rates programme and the set of QBUs under the regulatory framework. It is evident from the larger number of business units in the rates programme that not all those business units are QBUs. It is also understood that not every QBU is included in the rates programme. For example, there are some US companies in respect of which the MOD has an arrangement with the US Department of Defense for the Defense Contracts Management Agency to assure the contractor's rates.

9.27 It is not entirely clear why the current QBU definition has been set as it has. It is difficult to find a basis in either the legislation or the explanatory notes for the suggestion that overhead reports were only intended to be provided in relation to specific sites. The QBU definition is clearly targeted at suppliers with larger contracts given the threshold requirement for the supplier to hold at least one qualifying contract valued at £50 million or more, but this does not necessarily link to larger sites, nor does it capture only the largest suppliers, such as the 11 global ultimate owners that held 66% of qualifying contracts in 2018/19. Proportionality may well have been a consideration in setting the QBU thresholds, connected with the reporting burden attached to the submission of overhead reports, strategic supplier reports (the Strategic Industry Capacity Report (SICR) and SME) or both. If so, it is not clear why the current QBU definition was considered the optimal solution.

9.28 The SSRO does not know the MOD's precise reasons for including specific business units in the rates programme. We understand that not all business units whose rates are included in single source contracts are part of the rates programme. Furthermore, the business units that are included in the rates programme are not necessarily the same from year to year, as business units enter and exit the programme. There are clearly choices made about which business units need to be included in the programme by reference to some criteria which have not been provided. The SSRO is aware of a published document entitled 'Pricing – Contractor Rates: the CAAS Recovery Rates Programme'[68], but this appears to be out of date.

9.29 The SSRO recognises that the MOD would prefer greater alignment between QBUs and business units in the rates programme, but believes further consideration needs to be given to establishing the case for legislative change and determining how the change could best be achieved. It is not clear that making more business units into QBUs and thus requiring overhead reports to be submitted by statutory deadlines would address the principal difficulties associated with the provision of rates information, nor that the benefits obtained would outweigh any additional costs of reporting.

9.30 If it is accepted that there should be greater alignment between the overhead reports and the rates programme, then devising an appropriate solution would require further information from the MOD as to its rationale or criteria for the size and type of suppliers included in both the QBU category and the rates programme. Once this is understood, further consideration can be given to how the legislation should be amended to capture the right business units at the right times. The fact that the business units included in the rates programme change from time to time would need to be accommodated. Consideration would also need to be given to differentiating the triggers for overhead reports and strategic supplier reports, as contract value currently triggers both requirements and both may not be required to address perceived difficulties with the rates programme.

9.31 The SSRO accepts that data is needed on business unit costs to inform the MOD's assessment of rates claims. The purpose behind the overhead reports is to capture business unit costs in standard categories, support benchmarking and identify systematic over- and under-recovery of overheads. It seems reasonable that a standard data set provided through the overhead reports may need to be supplemented by additional information to inform the MOD's investigation of rates. There is potential for inefficiency, however, if the MOD routinely makes additional requests for data included in the statutory reports, or that could be included in those reports. Further exploration of the MOD's rates programme and associated information requests may enable the SSRO to identify whether the data collected in DefCARS could be modified to better support the MOD's requirements and minimise any additional requests made to industry. For example, DefCARS could be used as a database to inform the MOD's programme with more detailed questions to be set separately in the MOD's information request.

9.32 Before making recommendations about further alignment, the SSRO would welcome further input on the following matters:

- the criteria for including business units in the MOD's rates programme;
- the processes followed in the rates programme and how these differ between QBUs and other business units;
- how the statutory reports are being used or are intended to be used in support of the rates programme.

68 www.metasums.co.uk/uploads/asset_file/Contractor rates.pdf

We invite feedback on how arrangements can be modified so that overhead reports received in DefCARS best support the MOD to determine rates and price contracts and on how the overlap between the information provided in DefCARS and the information requests from the ICPT can be minimised.

Sequence of reporting periods for estimated and actual claims

9.33 Contractors are required to submit an actual costs report for a QBU (the QBUACAR) as well as an estimated costs report (the QBUECAR). The SSRO expects that the QBUACAR and QBUECAR should relate to consecutive accounting periods. There are several reasons for this. First, the QBUACAR and QBUECAR are submitted at the same time and it would be duplicative if they both related to the same accounting period. Secondly, the QBUECAR supports the ERCR, which clearly relates to "the accounting period immediately following the relevant accounting period". Thirdly, the contractor is required in the QBUACAR to provide cost analysis information and, if a QBUECAR was submitted in the previous financial year, must restate the cost analysis information from the earlier report and explain any difference.[69] This comparison would be more meaningful if it is a check on whether the previously given estimate aligns with what has been submitted in actual claim.

9.34 The SSRO identified in its working paper that regulation 37(7) requires the QBUECAR to contain costs analysis information for the "relevant accounting period". This mirrors the period already covered by the QBUACAR,[70] rather than the period to which the ERCR relates. The SSRO invited feedback on whether the QBUECAR should be aligned with the ERCR, by requiring cost analysis information for the accounting period immediately following the relevant accounting period.

9.35 ADS and another industry respondent were not aware that there was any issue with the timing of the QBUECAR or ERCR. However, ADS thought that what was required was to address the requirement to report each MOD financial year on contractor accounting periods ending in that financial year. It was concerned that reports can be required for years that preceded the entity having a qualifying contract.

9.36 Other respondents, including the MOD agreed that the ERCR and QBUECAR should cover the same period, that being the accounting period immediately following the relevant accounting period. One respondent explained that it already reconciled ERCR data with the QBUECAR; another respondent considered that it is possible to do estimates by March for the year N+1, where N is the preceding financial year (January to December) and N+1 is the following year. This respondent added that once the accounts are audited and submitted no formal changes to budget and forecasts are made. Another respondent thought that the SSCR worked as interpreted but explained that it would be useful to align the QBUECAR and ERCR submission with the contractor's financial year.

9.37 The SSRO does not see there is a problem with overhead reports covering years preceding the contractor having a QDC or QSC as asserted by ADS. It may be the submission was related to submission of the SICR and SME reports rather than the overhead reports. Regulations 40(1) and 45(2) set out that the SICR and SME reports are due within twelve months after either the end of the designated person's accounting period, or the date on which the on-going contract condition was first met in relation to the relevant financial year, whichever is later. If the ongoing contract condition is met between the end of the contractor's financial year and the end of the MOD's financial year then a SICR and SME report are required for the year prior to the ongoing contract being met.

69 Regulation 35(8).
70 Regulation 35(7).

These have not been the subject of our analysis but the SSRO would welcome feedback from the MOD and industry as to whether there may be rationale to require this data for the preceding years. The SSRO is also seeking feedback on any suggestions to address the issue.

9.38 The feedback received confirms that the QBUECAR reporting period should align with that of the ERCR. Some stakeholders were not aware of the problem because they have been reading and applying regulation 37(7) in the intended manner, even though the actual language in the regulation is different.

The SSRO proposes to recommend to the Secretary of State that regulation 37(7) is amended by inserting the words "the accounting period immediately following" before the words "the relevant accounting period". We would welcome any further feedback on the proposed recommendation.

Reporting agreed rates

9.39 The explanatory notes to the Act indicate an intention that overhead reports should be submitted again once costs have been agreed by the MOD. This has not been reflected in the Regulations, which require only the actual and estimated claims and associated costs to be reported. The MOD will hold the agreed rates and costs in some form, as it agrees them with the contractor, but this does not necessarily meet the intention that the overhead reports should capture business unit costs in standard categories and support benchmarking. The SSRO invited feedback on whether there is benefit in collecting information on agreed rates and costs and suggestions for how this might best be achieved.

9.40 ADS, and contractors who supported the ADS submission, explained that the MOD already has information on agreed rates (actuals and estimates) and so would have the appropriate data to undertake the required analysis. ADS and one other industry respondent considered that the SSRO suggestion would duplicate the requirement for information already being provided and add unnecessary burden and cost without increasing benefits. A further industry respondent emphasised that the MOD has information on agreed rates and asserted that the purpose of the legislation was to get non-compliant contractors to submit actual and estimated rates for audit by MOD. It argued that requiring compliant contractors to input agreed rates would penalise them and recommended that if this requirement is changed the MOD should provide an appropriate funding mechanism. Another respondent also referred to the amount of work required to provide agreed overhead reports and the associated cost.

9.41 Three industry respondents suggested ways in which the agreed rates could be recorded. The following solutions were proposed:

- The contractor could submit the agreed rates and costs instead of the actual and estimated claims. The Regulations would still impose due dates for rate claims, but these would not be contained in statutory reports.
- The MOD should input details of agreed rates and costs into the DefCARS system, by adjusting the QBUCAR disallowed costs column to get the total cost.
- The MOD could request that the QBUACAR is updated to reflect the agreed rates position and that this could be done via a correction report or by developing an on-demand report that brings forward data from the claim and enables agreed data to be easily recorded, for example with a 'tick box' to indicate whether the claim was agreed.

9.42 One industry respondent suggested that information on disallowed costs should be used by the SSRO to consider an adjustment to the BPR. The SSRO's methodology does not currently use overheads rates or make allowance for disallowed costs in the calculation of the BPR. The relative benefits of such approach are yet to be established and stakeholders are welcome to set out the case in support of this as part of the future review of the BPR methodology.

9.43 The MOD thought it essential that DefCARS records information on agreed rates and costs in addition to the initial claims. It also considered it clear that there is value in having the updated actual and estimated rates claims once agreed in addition to the original QBUCAR, and suggested that on-demand QBUCARs could be used. If agreed costs and rates are not in DefCARS, the database will be incorrect and the recorded rates inconsistent with those applied to contracts.

9.44 The SSRO does not accept the suggestion that as the MOD already has the data it should not be submitted by the contractor and may instead be input by the MOD. This would be inconsistent with the general scheme of the statutory reporting provisions, which is based on submission by the contractor, monitored by the SSRO and enforced by the MOD. It is the involvement of all three parties that helps to ensure a database of reported information that can be used in support of the regulatory framework. The SSRO also considers that making the information available through the submission of ad-hoc on-demand QBUCARs may not be appropriate if the information is fundamental to the MOD rates programme.

9.45 The SSRO accepts that if rates and costs are to be captured for benchmarking purposes, then there may be merit in requiring the agreed rates and costs to be provided rather than just the claims. It must be recognised, however, that there will be a cost associated with requiring contractors to submit the agreed figures. The SSRO does not have visibility of the associated costs but believes these need to be weighed against the perceived benefits of having the additional data.

The SSRO is prepared to recommend a legislative change to require reporting of agreed rates and costs. Before doing so would like to receive further information in relation to how the MOD is using the data or intends to use the data. The further information that the SSRO has called for in relation to the rates programme would assist with the further consideration of this issue. The SSRO would also welcome feedback on the impact of capturing the agreed rates and costs information, including the associated costs.

QBU compliance monitoring

9.46 A designated person must submit reports for its QBUs if the ongoing contract condition is met in a relevant financial year. The ongoing contract condition is met if a contractor is party to at least one QDC or QSC valued at £50 million or more and there remain obligations outstanding for the supply of goods, works or services under one or more of those contracts at any time in a relevant financial year.[71] If the ongoing contract condition is met, the designated person will be the contractor's ultimate parent undertaking if the contractor is part of a group, but otherwise will be the contractor.[72]

71 Section 25 of the Act and Regulation 31.
72 Regulation 32(6)(b).

9.47 The SSRO's duty is to keep under review the extent to which persons subject to reporting requirements are complying with them. The discharge of the SSRO's duty is impeded, however, if it cannot identify with any certainty whether a contractor has a business unit that qualifies as a QBU in a given year. The SSRO cannot determine for itself whether a business unit is a QBU, because there is no requirement for contractors to report details of the contribution made by each business unit to qualifying contracts in each relevant financial year. If the contractor submits a SICR, then it is required to specify a list of all the QBUs of the designated person. From this the SSRO may be able to determine whether all of the required QBU submissions have been made.

9.48 The SSRO outlined its concerns in the working paper and sought feedback from stakeholders on the best way for dealing with the current lack of information in DefCARS to identify QBUs. One option put forward in the working paper was for contractors to report the value contributed by each business unit or expected to be contributed by each business unit in each year in contract reports submitted for each QDC or QSC. This would enable DefCARS to collect and aggregate the value of goods, works or services contributed by each business unit to QDCs and QSCs. From this, a preliminary view could be reached about whether a business unit had met the financial threshold to become a QBU, which would provide a basis on which to raise appropriate queries if overhead reports were not submitted.

9.49 A variety of views were put forward by industry respondents:

- ADS considered the SSRO's proposal disproportionate as it would require contractor groups to identify all business units and provide negative assurance that the test had not been met. It argued that the contractor should be relied on to identify business units that are QBUs and report on them and that this exercise may be subject to challenge by the MOD given the MOD's knowledge of parts of groups completing significant elements of work. This view was supported by one industry respondent directly and also by others through their support of the ADS submission. Another industry respondent provided insight into its own arrangements, stating that in its view it was the MOD's responsibility to ensure that the on-going conditions are met to ensure compliance which amounted to the contractor reviewing every potential or actual QBU (direct and indirect) annually to see what level of cost is attributable to QDCs or QSCs to ascertain if the £10 million threshold is breached for supplier reporting and agreeing this with the MOD.
- One industry respondent suggested that a contractor could simply agree with the MOD which units needed to be reported as QBUs each year, as long as there was an appropriate requirement for rates and the associated resource to review the information was available.
- Another industry respondent thought that the SSRO itself should be able to make a simple assessment about whether a QBU qualifies for supplier reports. A QBU's contracts will have a cost profile by year. When there are multiple QBUs performing [on a single contract], the SSRO could contact relevant companies as appropriate to address these issues.

9.50 The MOD stated that QBUs are listed in the SICR and put forward the view that in principle a list of all QBUs should therefore be available through the SICR submissions, although it acknowledged that the SICR was not recorded in DefCARS. It added that there may be value in extending the current requirement to differentiate between business units and Pricing QBUs as this would provide clearer identification of those business units considered QBUs and allow review of those not considered QBUs. The MOD also reiterated its view that the current definition of a QBU should be reviewed.

9.51 The SSRO is not persuaded by the ADS argument that an additional requirement to report the value contributed by each business unit or expected to be contributed by each business unit in each year would be disproportionate, particularly given that this exercise must take place anyway to determine if the qualifying threshold has been met. In addition, when making any submission under Part 5 of the Regulations, a contractor is already required to list any business unit in relation to which a cost recovery rate has been used in determining the price payable under the contract[73] and so should already have identified all applicable pricing business units.

9.52 The suggestions made by industry for a simple agreement between industry and the MOD for which units should report does not seem to satisfy the transparency intent of the legislation. It is preferable to have an objective and clear methodology to identify which business units become qualifying business units. This is particularly important if there is any dispute later on as to whether a unit should have reported as a qualifying business unit or not.

9.53 In terms of the proposals that the SSRO may be able to determine QBUs, we agree the SSRO may be able to make an initial assessment as to whether a contractor's profile of costs appear to trip reporting requirements, and indeed may do so as part of its overall compliance approach. However, it seems unsatisfactory to rely upon this as the SSRO does not hold contractual information to confirm the anticipated costs reported by business unit, nor can it confirm that the contractor has indeed reported each business unit that is contributing to providing goods, works or services for qualifying contracts. The suggestion also appears to be out of line with the SSRO's statutory review function, whereby the SSRO's role is to keep under review the extent to which contractors are meeting reporting requirements and any enforcement action for non-compliance is up to the MOD.

9.54 The MOD's proposal to rely on the SICR report raises some important considerations. First, reliance on the SICR means the information may be available with significant delay as the SICR is submitted some nine months after the overhead reports become due. This may present a difficulty as the time limit for issuing a compliance notice for a failure to comply with reporting requirements is six months after the date the report is due. If the SSRO brings a compliance issue to the MOD's attention, it will be too late for the MOD to take enforcement action. Secondly, the information obtained in SICRs to date has not allowed the SSRO to consistently and reliably identify whether a contractor has business units that are QBUs. In its 2019 Annual Compliance Report, the SSRO noted that of the 21 SICR submissions expected during the period 1 May 2018 to 30 April 2019 only 10 submissions had been made, of which three were submitted later than required under the Regulations.

9.55 The SSRO's view is that the current arrangements prevent the MOD from confidently identifying QBUs and therefore prevents the SSRO from identifying compliance issues and bringing concerns to the attention of the MOD in time for enforcement action to be taken. Before recommending any change, it would be preferable to understand the MOD's criteria for selecting business units for reviewing rates, which would allow us to consider whether the QBU definition needs to change to align with this selection process. Once the purpose of the overlap between the regulatory framework and the rates programme has been properly addressed, issues with compliance can be considered further.

We welcome any further feedback on the SSRO views on QBU compliance monitoring.

73 Regulation 22(2)(l).

Benchmarking and standardisation

9.56 The Regulations require contractors to provide cost data in the QBUACAR and QBUECAR. DefCARS currently collects standardised data through the QBUCAR reports which aims to allow the MOD to conduct analysis of a QBU's overhead costs. The SSRO's reporting guidance supports standardisation by providing a glossary of cost categories and definitions.

9.57 In its working paper, the SSRO suggested there may be scope to improve standardisation and support benchmarking by further analysing submitted data and considering the definitions of cost categories. The SSRO acknowledged that this was potentially a significant piece of work requiring close liaison with stakeholders. Stakeholder views were invited on how best to capture data for use in benchmarking. Input was also sought on the merit of developing DefCARS and guidance to further standardise rates and cost data submitted through the overhead reports and suggestions on priority areas of focus.

9.58 Several industry respondents, including ADS, doubted that benchmarking is appropriate, useful or practicable. This is because data will differ from business to business as contractors set up their companies in different ways and make their own judgements on what to include in each cost category and that there may be other reasons for cost discrepancy such as historic pension schemes. The comparability of long-term contracts and new contracts that are at the mercy of new technological advances was raised as a further complicating factor.

9.59 Some industry stakeholders offered further comments on benchmarking. One industry stakeholder noted that benchmarking may be better served by reports such as the QBUCAR. There was also a view that to facilitate benchmarking through the QBUCAR clear definitions of cost attribution to categories are required.

9.60 Industry respondents were concerned about the additional cost associated with standardisation which would arise from mapping to a standard. One respondent considered that the cost data can be standardised as most companies have sophisticated IT systems but that standardising the rates is more complex as the rates are a function of how costs are recovered in the Questionnaire on the Method of Allocation of Costs (QMAC) and other aspects. It said that it has standardised its rates claim across all its units and the method of rate calculation and noted that the effort to get standardisation across industry would be huge as even within the same legal entity there are different approaches. Another contractor did not support standardisation arguing that the rates and cost data is unique to individual contractors and their costing systems. It noted that standardisation across individual contractor units is not often achieved. Another contractor was concerned that over standardisation for the purposes of benchmarking risks losing the granularity and value of the data.

9.61 The MOD acknowledged that extreme care is needed in benchmarking because of differences in the definition of cost categories. It also noted the importance of a comprehensive understanding of the QMAC used when benchmarking rates.

9.62 The MOD agreed that there may be merit in developing DefCARS and guidance to further standardise rates and cost data submitted through the overhead reports, although this would have to be balanced by flexibility required by the differences between businesses accounting structures and accounting. This is particularly the case for the QBUCAR which requires data to be allocated into standard categories. The MOD considered that it would be useful where genuine comparisons can be made:

- for a particular QBU over time, even if supplier cost allocation approaches change;
- between the different QBUs of one supplier; and
- between suppliers.

9.63 The MOD further suggested the following changes to improve the validity of comparisons:

- requiring suppliers to split out direct labour rates (used for pricing direct labour) from indirect recovery rates (used to price overheads), rather than allowing combined labour and overhead rates; and
- requiring suppliers to split out which costs are recovered in non-MOD contracts, MOD contracts that do not use rates (e.g. competitively won contracts), and MOD contracts that do use rates (split by QDCs/QSCs and contracts not covered by the SSCRs).

9.64 Stakeholders had a range of views on the ways to take forward the work on benchmarking. Most of those who commented saw merit in further exploration with input from the MOD and industry. There was a suggestion of a workshop to discuss how best to interpret the reported data and achieve common ground. Some contractors considered that before benchmarking is done, the MOD should do some further work to review of the purpose and benefits realised from such benchmarking or outline information the MOD intends to use.

9.65 The SSRO accepts that benchmarking is a complex exercise which requires additional information to understand the context. However, we disagree that there is no utility in benchmarking the overhead costs. At the inception of this regime there has been a recognition of the risks associated with overheads over-recovery. It is because a contractor may act on an incentive to try to allocate as much overhead as possible to a well-funded single source product. The effective management and control of overhead resources and costs is therefore key in ensuring that taxpayers get value for money. Benchmarking can allow the MOD to leverage data and experience from other units and to apply additional pressure on contractors to be efficient, both at the point of pricing and beyond.

9.66 While we accept that standardisation is achievable, it would require a programme of work with stakeholders to identify the optimal data set and to explore the scope of possible benchmarking, taking account of the comments and concerns raised in response to the working paper. We agree with suggestions from some stakeholders that the MOD is best placed to first outline its approach to benchmarking, including setting its objectives. It is important for the MOD to define comparator units or organisations based on a set of relevant characteristics. We recognise that where overhead payments are used for the maintenance of a strategic capability this raises some additional challenges in terms of comparator groups.

We welcome any further feedback stakeholders may have on the SSRO views on benchmarking and standardisation.

10. Other matters

10.1 We highlight below three additional matters related to the Regulations which we have identified through our work and which the Secretary of State may wish to address in his next review of the single source procurement framework.

Segmented contract profit rates

10.2 When the SSRO carried out its work on the 2017 review of legislation, the MOD asked that it consider the merits of changing the legislation to support the use of more than one contract profit rate within a contract, or alternatively the use of blended rates. The MOD explained that many of its contracts have different components relating to different types of work.

10.3 The SSRO concluded that the legislation does not permit profit segmentation and indicated that any legislative change would need to permit the six steps to be calculated differently across defined components of a single contract. The SSRO set out several matters that the MOD should consider before making a legislative change.

10.4 As part of the current review of legislation, the SSRO issued a working paper in September 2019. In its response, the MOD raised the importance of ensuring that, where different parts of a contract are priced using different profit rates, DefCARS separates out the costs and profit payable for each part.

The SSRO is inviting feedback on the matters that have been raised on segmentation of profit rates in contracts. The SSRO is particularly interested in receiving input on the impact that segmented profit rates would have on contractors and the extent to which this should be reflected in reporting.

Contract pricing methods

10.5 We noted in paragraph 5.10 that the Regulations specify six pricing methods which may be used in QDCs and QSCs. The Regulations describe how the Allowable Costs used in contract pricing are to be determined in each pricing method. In four of the pricing methods (firm, fixed, volume-driven and target) the Allowable Costs are determined based on Allowable Costs as estimated at the time of agreement.

10.6 Under the firm pricing method and the target pricing method the Allowable Costs are the Allowable Costs as estimated at the time of agreement.[74]

10.7 The fixed pricing method requires, and the volume-driven pricing method permits, the Allowable Costs estimated at the time of agreement to be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time. Different times, indices or rates may be specified in relation to different Allowable Costs.[75]

10.8 The effect of any agreed adjustments to the Allowable Costs estimated at the time of agreement is to mitigate some of the risk that the actual Allowable Costs will vary from the estimated Allowable Costs. We understand that longer-term MOD contracts may contain variation of price (VOP) clauses which help to manage inflation risk in a variable element of the contract price.

74 Regulations 10(4) and 10(11).
75 Regulations 10(5) and 10(10).

10.9 We consider that it may be helpful to amend the Regulations to acknowledge that specified adjustments may be made to the Allowable Costs estimated at the time of agreement for contracts using the target pricing method; to bring this into line with the approach taken for the fixed and volume-driven pricing methods. This change might be achieved by amending Regulation 10(11) or by introducing a new pricing method. Depending on the approach taken there may be a need for corresponding changes to DefCARS and the SSRO's reporting guidance.

We invite comment from stakeholders on the need for any changes to the Regulations related to this matter and proposals for how any changes should be implemented.

Final price adjustment

10.10 Section 21 of the Act provides for a final price adjustment to be made in certain circumstances 'which allows excessive profits (or losses) on fixed price contracts to be shared, rather than falling entirely on the contractor or the MOD'.[76] Regulation 16 describes the circumstances in which an adjustment may apply and Regulation 17 sets out the procedure for calculating it.

10.11 Regulations 17(2), (3) and (4) describe the conditions which determine whether and how the price is to be adjusted. These conditions are expressed as percentages by which the outturn profit rate exceeds the contract profit rate (the profit rate at the time of agreement). For example, the condition in Regulation 17(2) is satisfied if a contract's outturn profit rate exceeds the contract profit rate by at least 5 per cent but less than 10 per cent. Accordingly, if the contract profit rate is 10 per cent the condition is satisfied if the outturn profit rate is at least 10.5 per cent[77] but less than 11 per cent.[78]

10.12 The calculation of the subsequent adjustment in contract price is determined by the definitions of 'excess' levels (1, 2 and 3) provided in, respectively, Regulations 17(6)(a), (b) and (c). These are defined with reference to the same quantities (5, 10 and 15) as are present in the conditions described in Regulations 17(2), (3) and (4) but with reference to 'percentage points' rather than 'per cent'.

10.13 We believe that the conditions described in Regulations 17(2), (3) and (4) are intended to be defined as percentage point differences between the outturn profit rate and the contract profit rate, not percentage differences. As things are, the condition for making an adjustment may be met but the corresponding adjustment may be calculated as zero.

10.14 Amending the various uses of '%' in Regulations 17(2), 17(3) and 17(4) to 'percentage points' would align these conditions with the values used to define the excess levels in Regulation 17(6). So amended, using our earlier example, if the contract profit rate is 10 per cent the condition at Regulation 17(2) will be satisfied if the outturn profit rate is at least 15 per cent[79] but less than 20 per cent.[80] This aligns to the way excess levels 1 and 2 are defined in Regulations 17(6)(a) and (b).

76 Explanatory Memorandum to the Single Source Contract Regulations 2014.
77 10 per cent + (5 per cent of 10 per cent).
78 10 per cent + (10 per cent of 10 per cent).
79 10 per cent + 5 percentage points.
80 10 per cent + 10 percentage points.

Appendix 1: Glossary of terms

AAR	Appropriate, Attributable to the contract and Reasonable in the circumstances (the requirements of Allowable Costs as specified by the Act)
Act	the Defence Reform Act 2014
BPR	Baseline Profit Rate
CAAS	[the MOD's] Cost Assurance and Analysis Service
CRA	Cost Risk Adjustment
CPR	Contract Profit Rate
DefCARS	Defence Contract Analysis and Reporting System
DPS	Defined Pricing Structure
ICPT	[the MOD's] Indirect Cost Pricing Team
MOD	the Ministry of Defence
POCO	Profit On Cost Once (adjustment)
QBU	a Qualifying Business Unit
QMAC	Questionnaire on the Method of Allocation of Costs
Regulations	the Single Source Contract Regulations 2014 (as amended)
SICR	Strategic Industrial Capacity Report

Appendix 2: Stakeholder responses to a working paper on profit principles

Introduction

A2.1 Section 39(1) of the Defence Reform Act (the Act) requires the SSRO to keep under review the provisions made by Part 2 of the Act and the Single Source Contract Regulations 2014 (the Regulations). In so doing, the Act requires the SSRO to aim to ensure that:

a) good value for money is obtained in government expenditure on qualifying defence contracts, and

b) persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.

A2.2 In support of this statutory aim, during 2019, the SSRO is undertaking a review of contract profit rates expected or earned by contractors in qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs); the non-competed contracts which are subject to the Regulations. As part of the review of CPR members of the SSRO's Operational Working Group (OWG)[81] agreed that it would be helpful to codify a set of principles which could inform the determination and monitoring of contract profit rates in QDCs and QSCs.

A2.3 The SSRO considers that a lack of common understanding among stakeholders on the principles which underpin the payment of profit in QDCs and QDCs has hindered debate on whether the current arrangements for pricing these contracts result in prices and, in particular, profits that are fair and reasonable. Suppliers continue to challenge the SSRO's methodology for determining the baseline profit rate,[82] which has been accepted by the Secretary of State,[83] and the MOD and suppliers have been unable to agree on potential changes to the size and application of the cost risk adjustment, which rewards contractors that embrace more cost risk in QDCs and QSCs. Some suppliers have also expressed a more general view that profits earned in QDCs/QSCs are insufficient to satisfy the expectations of their investors for returns on their invested capital. This, they say, may have a consequential impact on the MOD's ability to procure the goods and services needed for the UK's defence and security.

A2.4 The SSRO issued a working paper to OWG members in July 2019 setting out five principles which it considered were relevant to the pricing of QDCs and QSCs. The working paper included discussion of the evidence the SSRO had considered in forming its view on the relevant principles. This included features of MOD's approach to procurement and the market for MOD contracts; competition theory; the purposes of economic regulation; aspects of the UK regulatory framework for single source defence procurement; and consideration of the concepts of 'value for money' and 'fair and reasonable prices'. The paper also considered the SSRO's monitoring and review of the implementation of the Act and Regulations to date, and the implications of the principles identified for future monitoring and review.

A2.5 Members of the OWG attended a workshop in early August to discuss the content of the working paper and the SSRO received written responses to the working paper from ADS (on behalf of its members), seven defence contractors and the MOD. We are grateful to those who provided input to this work. This paper provides a brief summary of the feedback provided by OWG members and sets out the SSRO's plans in the light thereof.

81 Comprising representatives of the Ministry of Defence (MOD), ADS Group (ADS) and single source defence contractors.
82 SSRO (2019) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.
83 Gavin Williamson, Secretary of State for Defence (2019) *Baseline Profit Rate 2019-20 for Single Source Defence Contracts: Written statement - HCWS1417*.

Feedback on the proposed principles

A2.6 We provide below a summary of the feedback provided by stakeholders on the principles proposed by the SSRO.

General comments

A2.7 Respondents welcomed the opportunity to engage in a debate on profit principles but questioned the degree of priority that had been attached to it. Some industry respondents considered it was a matter that would be better discussed after review by the Secretary of State of the arrangements for cost risk adjustment (expected in 2020). One considered there was too much emphasis on profit and not enough on cost or the MOD's procurement process.

A2.8 Several industry respondents questioned the SSRO's purpose in seeking to define profit principles. Some, who assumed the principles indicated plans for changes to the approach to determining profit, considered change was premature as too few contracts had yet completed to provide a robust evidence base for change.

A2.9 Several industry respondents dismissed the SSRO's attempts to ground profit principles in economics, considering this to be too theoretical and insufficiently grounded in the realities of defence contracting.

A2.10 Industry respondents expressed differing views on the six-step process for determining the contract profit rate for a QDC/QSC. Some thought it demanded too much precision, was too complex, and took too long to agree. One suggested that a form of structured negotiation, similar to that used by other governments, may be preferable to the six-step process. Another considered the process was okay provided that the profit rate achievable was higher than at present. One considered that in agreeing the principles relevant to contract profit it was important to note that steps 1 and 6 accounted for over 90 per cent of the average contract profit rate at the time of agreement.

A2.11 Some industry respondents, including ADS, thought that the SSRO's statutory aims with respect to ensuring good value for money and fair and reasonable prices were too vague and, consequently, unmeasurable; necessitating change. One suggested the SSRO's aims should be widened to include consideration of the financial sustainability of the UK defence industry when reviewing the operation of the Act and Regulations.

A2.12 The MOD agreed with most of the working paper content but considered that the logic underpinning the SSRO's argumentation was not sufficiently clear in some cases.

Principle 1

> Good value for money and fair and reasonable prices are supported by a contract profit rate that gives the contractor an appropriate and reasonable return on the fixed and working capital it employs in performing the contract (and the satisfactory determination of Allowable Costs).

A2.13 Some respondents agreed with basic premise of the principle but disagreed with the SSRO's interpretation of Regulation 11(7)[84] and the focus on providing an appropriate and reasonable return on fixed and working capital. They considered that the contract profit rate resulting from the six-step process was intended to provide a return on fixed and working capital and a return on costs. One suggested that further definition of 'good value for money' and 'fair and reasonable prices' was required and that it would be helpful to explain how the principle informed the six steps taken to determine the contract profit rate for a QDC or QSC.

84 The SSRO's reading of Regulation 11(7) is that the contract profit rate after step 6 should provide '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'. We do not consider that the adjustment at step 6 should, in isolation from steps 1 to 5, provide such a return.

A2.14 Some noted that measuring capital employed was complex and subject to (mis) interpretation. One noted that there might be considerations other than the level of return on capital employed when deciding whether to enter into a contract. One industry respondent was unclear whether the principle referred to a return on capital employed by the contractor or a return on shareholder investment.

A2.15 A number of industry respondents, including ADS, inferred from the principle that the SSRO was considering proposing changes in the approach to determining contract profit: moving away from the current approach in which the contract profit rate derived from the six-step process is applied to the Allowable Costs.

A2.16 Industry respondents noted that value for money was not measurable at the level of an individual contract or using economic analysis. One considered that, in any event, it was for the MOD and the armed forces using defence capability (and not the SSRO) to determine whether value for money was being delivered.

A2.17 The MOD considered that the principles needed to clarify that whether a return was appropriate and reasonable would depend on the contractor's exposure to the risk of losing its capital assets. It believed that the return should be considered with reference to the capital already employed in the business, not the return required to attract new capital.

Principle 2

> The contract profit rate, when applied to Allowable Costs, should enable the contractor to earn a return commensurate with that achieved by firms in a competitive market for the supply of goods and services which are the product of comparable economic activities.

A2.18 Industry respondents expressed differing views on the appropriateness of a comparability principle. Some considered that the single source nature of regulated contracts indicated that there was no market from which profit comparisons could be drawn. One noted that very few of the MOD's single source suppliers derived a significant proportion of their revenue from MOD single source contracts. This, it suggested, meant that their dominant business behaviours were appropriate to businesses operating in competitive markets.

A2.19 Several industry respondents commented on a perceived lack of comparability between the companies in the baseline profit rate comparator group and their activities and the companies undertaking QDCs/QSCs and the activities undertaken in those contracts. Key issues raised by respondents were the size of the comparator companies; the level of complexity or risk present in the activities undertaken; the demanding regulatory standards faced by QDC/QSC contractors; whether or not comparators undertook government contracts; and the presence of non-UK or state-owned companies in the comparator group which might have, respectively, different economic circumstances or different profit motives to QDC/QSC contractors.

A2.20 Industry respondents also made a number of comments about other aspects of the baseline profit rate methodology, notably, the use of historic profits; the use of company-level profit indicators to determine a baseline profit rate for contracts; the use of the median and not the mean as a measure of central tendency; and the absence of adjustments in comparator company profits for costs which respondents say are disallowed in QDCs and QSCs.

A2.21 One expressed concern about the impact of contract profit rates on the long-term financial sustainability of QDC/QSC contractors and the need for contract profit to cover the contractor's cost of capital.

A2.22 The MOD considered that the returns on QDCs/QSCs should be comparable to the returns on competitive contracts carrying a comparable level of risk. It considered that there may be significant differences in the risk profile between competitive and single-source contracts. It noted that the contractor in the latter case would not have to assess the perceptions and economic position of competitors when pricing a contract.

Principle 3

> The return on a QDC/QSC is appropriate and reasonable where it fairly contributes to meeting an investor's long-term expectations for returns on capital invested, given the risks to that investment.

A2.23 There was general agreement from industry respondents about the importance of returns to attract investors. Some respondents, however, found the shift in focus from returns on capital employed (Principle 1) to returns on invested capital (Principle 3) confusing.

A2.24 One industry respondent suggested that consideration needed to be given to the fact that investors might hold a portfolio of assets with varying risk profiles. The risk profile of the portfolio might differ from the assets within it; giving rise to different expectations of returns.

A2.25 One industry respondent considered that the consideration of the relative risk of returns from QDCs/QSCs versus returns from similar contracts let competitively needed to be reflected through the rates recommended by the SSRO for the baseline profit rate and step 6 adjustment. Others considered there was a need to adjust published financial data when comparing returns on contracts with returns made by companies or for consideration to be given to the comparability of the risk profile of contracts undertaken by companies in the baseline profit rate comparator group.

A2.26 One industry respondent considered that no QDC/QSC was entirely risk-free for the contractor, even if it made use of the cost plus-pricing method. It said, there were always some unquantifiable risk in contracts and liabilities arising from contract terms against which it was not possible to insure. This made the application of a maximum negative cost risk adjustment inappropriate for such contracts. It suggested, rather, that the default presumption for any contract should be a maximum positive cost risk adjustment which would be reduced by agreement between the parties if risk was transferred back to the contracting authority.

A2.27 The MOD disagreed with the principle. It considered that shareholders' expectations of return were contingent on the price paid to acquire shares which may be influenced by historic returns as well as expected future returns and be disconnected from the capital employed in the business.

Principle 4

> Where contractors perform at the expected level of efficiency, they should earn the contract profit rate that was estimated at the time of contract agreement.

A2.28 Industry respondents were generally satisfied with the intent of the proposed principle but considered that it would be more appropriate to refer to 'cost' than 'efficiency' and to note that the profit rate is 'agreed' and not merely 'estimated' at the time of agreement.

A2.29 Some other industry respondents considered there were many factors which might influence contract cost performance, not just the contractor's level of efficiency. One considered that this made it difficult to discern and, therefore, monitor the causes of deviation between estimated and actual costs.

A2.30 Another industry respondent considered the proposed principle implied that the contract profit rate for a QDC/QDC should not change on contract amendment, as was potentially the case when a contract experienced a pricing amendment.

A2.31 The MOD considered the principle would be true on average, but it inferred that the principle might hinder its ability to transfer risk to contractors when applied at the individual contract level.

A2.32 Respondents disagreed with the suggestion in the working paper that an estimate of Allowable Costs should be set such that the risk of cost under- or over-runs were not materially different, to incentivise cost control. ADS considered that the possibility that actual costs might vary from estimated costs did not provide the contractor with any more of an incentive to improve cost control or efficiency than did other aspects of contract pricing. Another industry respondent considered that the risk surrounding contract costs would be affected by a range of factors including the contractor's prior experience in undertaking the same or similar work and the terms of the contract. The MOD inferred that it meant pricing contract costs at the median of a range of estimates, which might not take sufficient account of any skewness in the range of those estimates.

Principle 5

> Fairness requires consistency in the determination of contract profit rates (and Allowable Costs) such that relevant differences are consistently considered while irrelevant differences are consistently ignored.

A2.33 Some industry respondents agreed that the consistent, unbiased application of the profit calculation process, taking account of relevant contract and contractor characteristics was desirable. However, some were unsure that the SSRO would be able to monitor whether fairness in applying the Regulations had been achieved. One indicated that in practice there were inconsistencies in the application of the Regulations by MOD commercial teams and single source contractors. One questioned what might be considered a relevant or irrelevant difference for the purpose of contract pricing. One found the principle confusing and rejected its inclusion.

A2.34 ADS considered the principle unnecessary as the Regulations required the contract profit rate to be determined in accordance with the six-step process and with regard to the SSRO's guidance. It considered that it was inappropriate to interpret the meaning of 'fair' in isolation from the expression 'fair and reasonable' which was used in the legislation. The expression, it said, had been in long usage within the context of government contracting but had no precise meaning, only interpretations.

A2.35 Despite considering the proposed principle unnecessary, ADS did, however, consider that consistency was a relevant consideration in determining levels of cost risk adjustment and incentive adjustment and in agreeing what evidence was required to support contract pricing. Another industry respondent considered that fairness also required that the principles related to profit and Allowable Costs in QDCs/QSCs were consistently applied when considering the profits of comparator group companies which informed the SSRO's assessment of the appropriate baseline profit rate.

A2.36 While the MOD agreed that consistency should be maintained in pricing contracts unless there were a good reason for differential treatment, it considered that the principles should seek to establish when differentiation may be appropriate.

Other comments

A2.37 ADS and another industry respondent proposed an alternative principle, that 'contract profit rates on single source contracts performed under the Regulatory Framework should be broadly in line with those earned by contractors performing single source contracts in other advanced economies'. It considered this would ensure the UK defence market continued to be attractive for suppliers.

A2.38 It also noted that the legislation did not require the SSRO to assess contract profit with reference to relevant measures of capital in order to evaluate if reasonable returns were being made.

A2.39 Other industry respondents provided additional comments on other aspects of QDC/QSC pricing. One highlighted that there was inequality in the mechanics of the final price adjustment which allowed the MOD to reclaim a greater proportion of excess profit from the contractor above the specified threshold than the contractor could recover from the MOD where its loss exceeded the specified threshold. It also considered that the assessment of working capital for the purpose of the capital servicing adjustment should disregard positive cash balances arising from the MOD's payment policy. Another highlighted the need for proper consideration of costs that were indirectly attributable to contracts to ensure that contract prices were fair and reasonable to contractors. It suggested that headquarters and back office services costs might be a relevant area for specific review by the SSRO at a future date.

Next steps

A2.40 We have considered the feedback provided by stakeholders on the principles proposed and concluded that the potential for reaching agreement with stakeholders about the relevant principles is limited at this time. However, we remain of the view that a set of principles will:

a) provide an intellectually robust foundation for thinking about profit and pricing, which can inform how the SSRO delivers its statutory functions;

b) provide transparency for stakeholders on how our work is guided;

c) further promote long-term consistency in the SSRO's decision-making on pricing methodologies and guidance and, potentially, future referrals on related matters; and

d) provide a basis upon which stakeholders can hold the SSRO to account.

A2.41 We will continue to explore ways to take this work forward.