Single Source Regulations Office
Minutes of the Extraordinary Board Meeting
Board Room, Finlaison House,
15-17 Furnival Street, London, EC4A 1AB

Friday 8 January 2016
9.30am to 12.00pm

Board members present:
Jeremy Newman (Chair)
Jane Attwood
Marta Phillips
Clive Tucker
Marcine Waterman (Chief Executive)
Neil Swift (Director of Corporate Resources)

Others present:
Justine Wharton (minutes)
Malcolm Botting
Simon Mahony
David Galpin
Sarah Quartermain
Duncan Nott
Andrew Stewart
Anton Hume

1. Welcome, Apologies and Announcements

1.1. The Chair welcomed Board members and colleagues to the Extraordinary SSRO Board meeting.

1.2. There were no apologies, announcements or declarations of interest.

1.3. **There were no declarations of interest.**

2. Baseline profit rate – methodology and guidance

2.1. Simon Mahony, Chief Analyst, introduced the single item on the agenda, the profit methodology and guidance paper. Section 19 of the Defence Reform Act ("the Act") stated that, for each financial year, the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate and capital servicing rate.

2.2. The Board considered a proposed new approach to calculating the baseline profit rate at its 4 September 2015 extraordinary meeting, and agreed to consult on that approach. The Board considered the responses to the consultation at its 9 December 2015 meeting.

2.3. The government's response had expressed concerns that the SSRO's six proposed rates as set out in the consultation document risked adding complications to contract negotiations, and instead proposed four separate rates. These were: a zero rate for not for profit organisations; a pass through rate for items where the MOD has taken on the majority of price or performance on sub-contracts; a rate for facilities and commodities; and one combined rate for manufacture and servicing of specialised military equipment.

2.4. Section 18 of the Defence Reform Act provided for the SSRO to issue guidance in relation to the steps set out in Section 17(2) of the Act relating to the calculation of the contract profit rate. The SSRO originally issued such guidance in March 2015. The Board agreed at its 9 December 2015 meeting that updated guidance would be required, including substantially amended sections on ‘step 1’ for selecting the appropriate baseline profit rate, and for ‘step 2’ on assessing cost risk, along with minor changes elsewhere. The Board agreed that the SSRO should consult on the amended guidance.

2.5. Simon Mahony set out that subject to the Board’s discussion and approval the final methodology would be published in January 2016, alongside responses to the consultation, the SSRO’s response to the consultation, and a six week consultation on the updated guidance on setting the contract profit rate. The Board would make its assessment on the appropriate profit rates at its meeting on 25 January 2016, in order to make recommendations to the Secretary of State before 31 January 2016.

3. Government response to the consultation

3.1. The Board approved a zero rate for not for profit organisations, to be used for “those organisations that are either not permitted to make a profit, or do not wish to make a profit.” The Board agreed that the guidance should set out the implications for some of the other steps used to determine the contract profit rate when applied to a zero baseline profit rate.

3.2. The Board recognised that for some defence contracts the risk under one or more sub-contracts is held by the MOD (referred to by the MOD as “pass through” arrangements). The Board considered that in these circumstances the prime contractor should not receive the same level of profit on those components of the contract as they do on the overall contract. Without being able to apply more than one baseline profit rate to a contract, one or more composite rates would be needed to deal with pass through arrangements. The Board considered how a composite rate might be constructed but was not satisfied there was a reasonable way to do this, which is suitably objective and reflects the consultation responses received. The Board noted that the appropriate rate would vary depending on the contract activity, the value of the sub-contract compared to the larger contract and the proportion of risk that the MOD has picked up.

3.3. The Board instead agreed that the SSRO should issue guidance that: “We recognise that for some defence contracts the risk under one or more sub-contracts is ‘passed through’ to the MOD. In these circumstances the prime contractor should not receive the same level of profit on those components of the contract as they do on the overall contract. In such cases, the MOD and contractor need to find an approach to avoid excess profit. We note that the primary contractor may receive a project management fee provided this is an Allowable Cost.”

3.4. The government consultation response stated a preference for a composite rate that covered both ‘develop and make’ and ‘provide and maintain’ work (described by the MOD as ‘manufacture and support’) as some contracts covered four aspects.

3.5. The Board approved the provision of a composite rate that combined the two categories of ‘develop and make’ and ‘provide and maintain’, and was calculated by adding the medians of these rates and diving by two. The Board agreed the proposed guidance “consideration should be given” to using this composite rate where both elements were in excess of one third of the total contract costs. The Board considered the SSRO should monitor the use of the composite rate.

3.6. The government had proposed a ‘facilities and commodities’ rate that included IT, back office and routine support services, commodities and construction. The Board agreed that IT, back office and routine support services were covered by the ancillary services activity type already proposed.

3.7. The Board noted that in the majority of cases where commodities were purchased they would expect there to be an easily available market or comparator price that would provide a better approach to achieving value for money. The Board agreed that, where contracts came within the single source procurement framework such items could attract the ‘develop and make’ rate.

3.8. The Board approved a construction rate, based on a comparator group for construction. The Board discussed the appropriate types of companies to include in this comparator group.

4. Proposed methodology for setting baseline profit rates and capital servicing rates

4.1. The Board approved six rates:

- design and make;
- provide and maintain;
- ancillary services;
- zero rate;
- a composite rate; and
- construction rate.

4.2. The Board discussed and approved the approach to capital servicing. The approach was to set three capital servicing rates, based on interest and corporate bond rates. This largely mirrored the approach carried out by the Review Board for Government Contracts in the past. The Board agreed that for the fixed and working capital (positive) servicing rates, it would be based on appropriate corporate bond rates. The previous 'Yellow Book' methodology used data based on a BBB- credit rating. However, the Board approved the use of a BBB credit rating as the right proxy for credit ratings of contractors with QDCs as this was assessed as the most appropriate rating, based on the ratings for the top defence suppliers to the MOD for 2014/15.

4.3. The Board agreed that the interest rates achieved by sterling denominated debt at a BBB credit rating issued during the calendar year would be used in the calculations and agreed these would be analysed over the same time periods as used in the previous methodology. A 15 year bond rate with a seven year moving average would be used for fixed capital and a one year bond rate with a three year moving average is used for working capital (positive). When calculating the rolling averages, data relating to a BBB- bond rate was used for previous years and data based on BBB bond rates would be used for the 2016/17 rate onwards.

4.4. The Board agreed that the SSRO would adjust its assessment of the appropriate baseline profit rates to remove capital servicing, and this would then be added back to the contract profit rate at step 6, using contractor-specific capital figures along with the capital servicing rates published by the Secretary of State.

4.5. The Board were clear that the SSRO would publish the baseline profit rate with and without capital servicing. In the long term, the Board signalled that the best approach would be to reward a return on capital through the baseline profit rate.

4.6. For working capital (negative) the Board approved the use of the Bank of England statistics on interest for short term deposits, with a three year rolling average. The Board agreed this methodology would ensure greatest simplicity and transparency.

The Board:

- **a) considered the government's response to the consultation (section 4);**
- **b) approved the proposed methodology for setting baseline profit rates and capital servicing rates (section 5); and**
- **c) approved the draft methodology document (Appendix 1), the draft SSRO response to the consultation (Appendix 2), and the consultation document on the SSRO's guidance to the process for determining the contract profit rate (Appendix 3), and delegated to the Chair and Chief Executive authority to approve the final documents to publication.**

5. Next steps

5.1. Following the Chair and Chief Executive's approval of the final documents for publication, the documents would be published in January 2016, including a six week public consultation period for the draft updated guidance.

5.2. The Board at its next meeting on 25 January 2016 would be provided with recommended rates resulting from the final methodology (for the five non-zero baseline profit rates and the three capital servicing rates).

6. Any other business

6.1. There was no other business.

7. Date of next meeting

7.1. The next meeting of the Board would take place on 25 January 2016.