SSRO

Single Source
Regulations Office

2015 Contract Profit Rate

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Background

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Under the Defence Reform Act 2014 (the Act), the Single Source Regulations Office (SSRO) is required annually to review the figures used to determine the Contract Profit Rate for pricing single source contracts. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

The SSRO must recommend the new rates to the SofS by 31 January 2015 in order for the SofS to issue the rates by 15 March 2015. Under the current 'Yellow Book' regime, the rates are calculated by the Review Board for Government Contracts (the Review Board), an Advisory Non Departmental Public Board sponsored by the Ministry of Defence (MOD). The Review Board has been charged with developing the baseline profit rate and capital servicing allowances for the final time in 2015. The SSRO Board agreed to adopt the Review Board's recommended baseline profit rate and capital servicing allowances for 2015.

Legal position

Section 17 (2) of the Act sets out the steps for determining the contract profit rate for qualifying defence contracts. Such steps provide for adjustments to be made based on the rate and funding adjustment described in Section 19(1) of the Act.

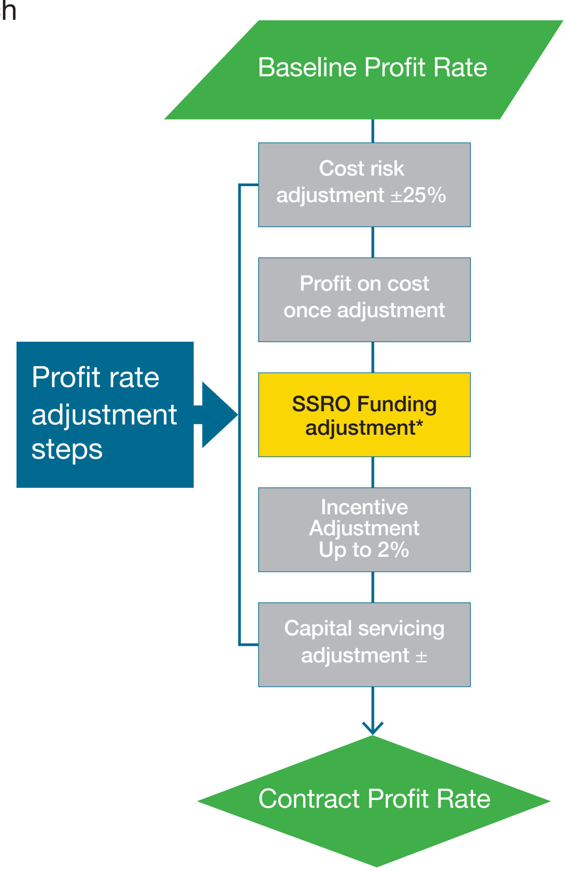
In accordance with its obligations under Sections 19(2) and 19(3) of the Act, and in order to assist with the determination of these rates, the SSRO's assessment of the rates is set out in this publication.

Contract profit rate

The contract profit rate is set by the formula illustrated in the flow chart below. The adjustments should be applied in the order shown and explained in figure 1.

The baseline profit rate is common across all single source contracts and, as the flow chart shows, is the starting point for determining the contract profit rate to be applied in the pricing formula.

Figure 1: Contract profit rate formula flow chart



* Not applicable until 2017

Figure 1: Steps required in applying the adjustments to the baseline profit rate to determine the contract profit rate

Step 1
Determine the baseline profit rate which is in force at the relevant time.

Step 2
Adjust that rate by an agreed amount, being an amount falling within specified parameters above or below the baseline profit rate, so as to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs.

Step 3
Deduct an agreed amount from the amount resulting from step 2, so as to ensure that profit arises only once in relation to those allowable costs under the contract in respect of which the Single Source Contract Regulations 2014 (the Regulations) provide that a deduction may be made.

Step 4
Deduct the SSRO funding adjustment which is in force at the time mentioned in step 1 from the amount resulting from step 3. This step will not apply until 1 April 2017.

Step 5
Where the Secretary of State determines that the amount resulting from step 4 should be increased so as to the give the primary contract a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount specified by the Secretary of State. Any increase must not exceed the maximum increase of 2 per cent.

Step 6
Take the amount resulting from step 5 and add to or subtract from it an agreed amount, so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purpose of enabling the primary contractor to perform the contract.

This adjustment:
(a) is to be made having regard to the capital servicing rates determined under section 19 of the Act; but

(b) does not apply to the extent that the costs of the fixed and working capital employed by the primary contractor are allowable costs under the contract.

The contract profit rate is:
(a) the amount found at the end of step 6; or

(b) in a case where step 6 is disapplied under section 18(2)(a) of the Act, the amount found at the end of the last of the steps in subsection 18(2) that apply in that case.

The Secretary of State or an authorised person, and the primary contractor, must have regard to guidance issued by the SSRO in relation to any of the steps set out above.

The role of the SSRO in adopting the Review Board's 2015 rate

The SSRO Board agreed to endorse the Review Board's baseline profit rate and capital servicing adjustment for the year beginning 1 April 2015, should it receive adequate assurance about the robustness of the process and data used to determine them.

In undertaking its due diligence, SSRO officials shadowed the work of the Review Board and received adequate access to its methodology, models and data. The steps taken to assure the SSRO of the robustness of the baseline profit rate can be summarised under the following five headings:

- principles defined and adopted in setting rates;
- details of methodology deployed;
- processes undertaken;
- quality and type of data used; and
- results of sensitivity analysis and changes in rates.

Following a process of due diligence, the SSRO has received adequate assurance on the process and data used to produce the baseline profit rate and capital servicing adjustment. The methodology is documented and where necessary pragmatic steps have been taken, with Review Board approval, to develop the approach.

The process followed by the Review Board

The Review Board has been setting the baseline profit rate based on the principle of comparability, where it is assumed the defence sector's return on profit should be equal on average to the overall return earned by British industry having regard to both capital employed and cost of production. This principle has not been challenged this year but the SSRO Board has indicated that it intends to review the methodology for future years.

The papers that the SSRO has been granted access to have allowed it to understand the changes over time, and the rationale for the methods employed.

The baseline profit rate is currently derived from calculating Earnings Before Interest and Tax (EBIT) minus capital servicing allowance and then expressing the value as a percentage of cost of production. It is therefore a measure of profit made on cost of production when the cost of servicing capital has been removed.

The capital servicing adjustments are in three parts

- fixed capital servicing allowance;
- working capital servicing allowance (positive); and
- working capital servicing allowance (negative).

Due to volatility related to thin trading volumes in this class of bond the rates used are a proxy, derived from BBB bonds with an appropriate adjustment factor.

The Review Board download data from Worldscope's Datastream service to support the calculation of the baseline profit rate. Data are downloaded to calculate the capital servicing allowances. The SSRO has reviewed this process and confirm the steps have been followed.

A sample of data is also extracted from the published financial statements from company accounts. This data is used to verify the Worldscope data through reconciliation.

Where the data differs queries are raised with Worldscope. This year approximately 65 queries were raised with Worldscope.

Going forward

The SSRO will start work early in 2015 to conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate.

The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:

- the principle of comparability;
- the exclusion of companies under price regulation;
- the inclusion of companies which are UK based but whose activities are predominately overseas;
- the treatment of R&D tax credits; and
- the use of simple rolling averages.

2015 Baseline Profit Rate

		2011 Annual Review	2012 Annual Review	2013 General Review	2014 Annual Review	2015 Annual Review
		%	%	%	%	%
FCSA	Fixed Capital Servicing Allowance	6.65	6.54	6.39	6.20[1]	5.94[1]
WCSA(pos+)	Working Capital Servicing Allowance (applied to positive working capital balances)	4.25	2.86	2.43	2.07[1]	1.72[1]
WCSA(neg-)	Working Capital Servicing Allowance (applied to negative working capital balances)	n/a	n/a	1.42	1.25[1]	1.03[1]
BPR	Baseline Profit Rate	9.04	9.25	10.16	10.70	10.60

Note 1. The 2015AR CSAs shown above were calculated using data for periods to 30 November 2014.
Note 2. n/a is used in the key data table prior to 2013, since separate positive and negative working capital adjustments have only been made since that date.

Each year, the baseline profit as a percentage of cost of production is calculated using data from the reference group in the financial year. A simple three year average is used to calculate the baseline profit rate for the following year. The baseline profit rate for 2015 is therefore the average of the 2011/12, 2012/13 and 2013/14 baseline profit as a percentage of the cost of production figures.

The three year average is used to smooth out large changes in the annual figure. Changes in the trend of the baseline profit rate will lag due to the impact of previous years.

The recommended 2015 baseline profit rate is 10.60 per cent based on a three year rolling average.

The recommended 2015 baseline profit as a percentage of cost of production in 2013/14 is 9.88 per cent.

Adjustments to the baseline profit rate

Cost risk adjustment

The Baseline Profit Rate should first be adjusted for an agreed amount, falling within the ± 25% of the BPR, to reflect the risk that a supplier's actual costs differ from the estimated costs used in the determination of the allowable costs in the pricing formula.

The SSRO will first consult on its guidance before publishing its guidance here.

Profit on cost once

Once adjusted for risk, the profit rate will if necessary be adjusted to ensure that profit only arises once in relation to a particular element of the allowable costs. This is in accordance with the profit on cost once (POCO) principle.

The SSRO will first consult on its guidance before publishing it guidance here.

SSRO funding adjustment

The SSRO will recommend the funding adjustment to the SofS having regard to any guidance issued by the SofS. This adjustment does not apply before 1 April 2017.

Incentive adjustment

The SSRO will issue guidance on when and how to use an incentive adjustment of no more than 2 per cent of contract price.

The SSRO will first consult on its guidance before publishing its guidance here.

Capital servicing adjustment

The final adjustment to be made is the capital servicing adjustment. This adjustment allows suppliers to recover their reasonable costs of capital (whether working or fixed capital) related to qualifying defence contracts.

The SSRO will first consult on its guidance before publishing it guidance here.

Appendix 1

The table below shows the baseline profit rate over time.

Reference group year	Baseline profit as % of cost of production	Baseline profit rate (3 year rolling average)
2006/07	10.04%	
2007/08	9.56%	
2008/09	8.27%	9.29%
2009/10	9.29%	9.04%
2010/11	10.19%	9.25%
2011/12	10.99%	10.16%
2012/13	10.92%	10.70%
2013/14	9.88%	10.60%

The chart below show the annual figure as bars and the rolling average as a line.