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Regulations Office

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# Sub-contracts reported in Qualifying Defence Contracts 2015/16

28 July 2016

Defence suppliers are required by Regulation 22 of the Single Source Contract Regulations 2014 to submit reports to the Single Source Regulations Office about qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). The types of contract reports and the data to be provided in each are prescribed in Part 5 of the Regulations.

The contract reports include information about the supply chains for each QDC and QSC. This information is provided for:

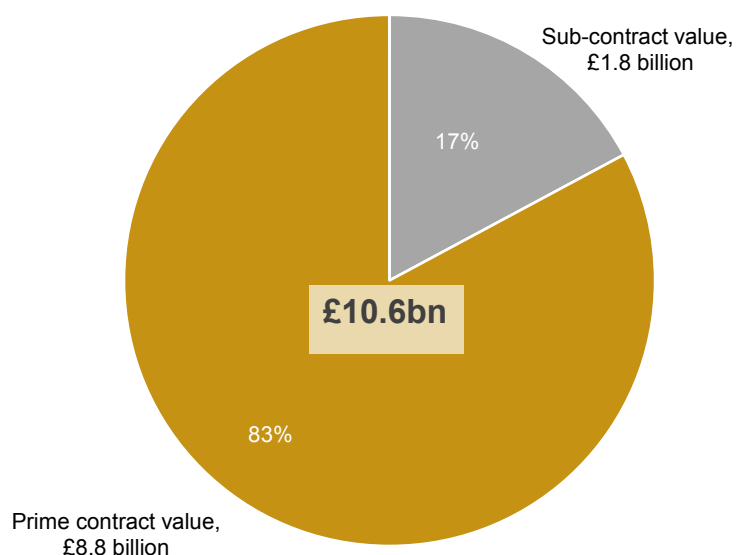
- sub-contracts valued at £1 million or more; and
- the 20 highest value sub-contracts.

While some contractors have voluntarily provided additional information, the limited reporting obligation means the reported sub-contracts represent only a portion of the total number and value of sub-contracts, and the actual value is likely to be higher. This report provides an analysis of the reported sub-contracts for 33 QDCs/QSCs entered into within the period 1 April 2015 to 31 March 2016.

## Key points

- Reported sub-contracts comprise 17 per cent (£1.8 billion) of the total value of QDCs/QSCs (£10.6 billion) in 2015/16.
- Of the 33 QDCs/QSCs analysed, 19 QDCs/QSCs reported having at least one sub-contract worth over £1 million.
- Suppliers reported a total of 112 sub-contracts, with an average of six per QDC/QSC (excluding those who reported no sub-contracts).
- Forty per cent (£720 million) of all reported planned sub-contracting expenditure occurs between 10 suppliers acting as either the prime contractor or sub-contractor. Of this, 8 per cent (£60 million) is where a supplier has sub-contracted out to another company within the same group.
- Only 4 per cent of reported sub-contracts are with small and medium enterprises (SMEs) but reporting requirements mean there is not sufficient transparency to determine the actual number of SME sub-contracts, which are likely to be smaller in value.

**Figure 1: Total value of reported sub-contracts as a proportion of total QDC/QSC contract value, 2015/16**



*Note: one QDC has been excluded from the analysis, so the total QDC/QSC value does not align with the £11.1 billion value reported for 34 QDCs in previous SSRO statistical bulletins.*

Figure 1 shows the value of reported sub-contracts compared to the total QDC/QSC value. This is based on a total QDC/QSC contract value of £10.6 billion (where one QDC has been excluded). The total value of sub-contracts within each QDC/QSC ranged from £0.5 million to £880 million.

Figure 2 shows the value of reported sub-contracts as a proportion of contract value within each QDC/QSC. Of the 33 QDCs/QSCs analysed, 19 QDCs/QSCs reported having at least one sub-contract worth over £1 million, and 14 did not report any sub-contracts. Sub-contracts (where at least one sub-contract was reported) account for between 3 per cent and 85 per cent of the contract value for individual QDCs/QSCs. Fourteen QDCs/QSCs reported no sub-contracts of over £1 million in value.

**Figure 2: Sub-contract value as a percentage of contract value in individual QDCs/QSCs, 2015/16**

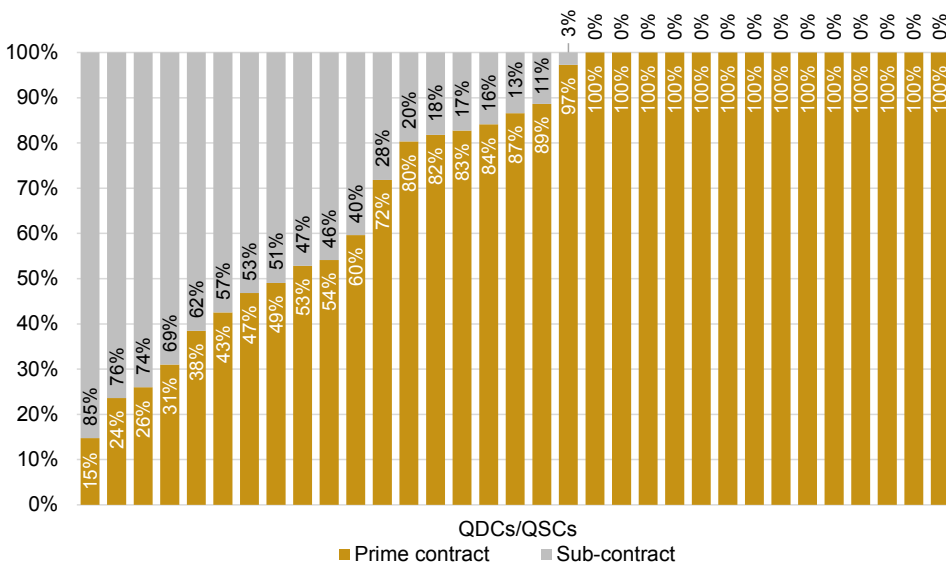
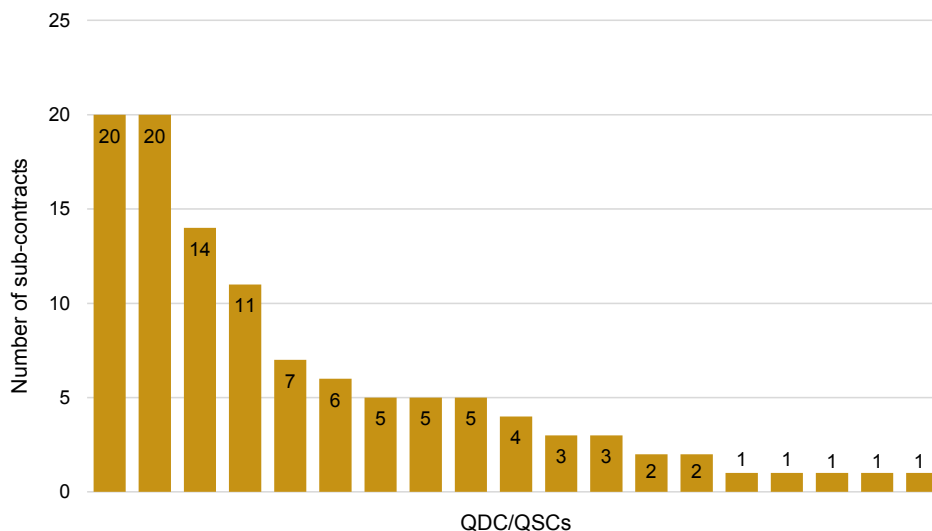


Figure 3 shows the number of sub-contracts entered into within each QDC/QSC, where at least one sub-contract has been reported. Two QDC/QSCs reported 20 sub-contracts, the maximum number that is required for QDC/QSC reporting purposes. These QDCs/QSCs could potentially have additional sub-contracts worth more than £1 million, but there is no reporting requirement in this regard. The average number of reported sub-contracts within QDCs/QSCs (excluding those who reported no sub-contracts) is six. Of the 112 reported sub-contracts, just five were with small and medium enterprises (SMEs). There may be additional sub-contracts with SMEs which are not captured in these contract reports as the requirement is to record only the 20 highest value sub-contracts of over £1 million.

**Figure 3: Number of reported sub-contracts in individual QDCs/QSCs, 2015/16**



## Sub-contracting between suppliers with a QDC/QSC

The SSRO has conducted analysis looking at the relationship between the prime contractors and sub-contractors in the 19 contracts with reported sub-contracts, highlighting instances where the ultimate parent companies of prime contractors own companies within the group who are also sub-contractors to other suppliers. Fifteen individual prime contractors are involved in QDCs/QSCs with reported sub-contracts (either as a prime contractor or sub-contractor). As some of these contractors share the same ultimate parent company, this in turn relates to 13 separate ultimate parent companies.

Forty per cent (£720 million) of all reported planned sub-contracting expenditure within QDCs/QSCs in 2015/16 is shared between 10 ultimate parent companies with QDCs/QSCs, either as the prime contractor or the sub-contractor. Of this, 8 per cent (£60 million) is where a supplier has sub-contracted out to another company within the same group. Focusing on the number of sub-contracts, 30 per cent of all reported sub-contracts within QDCs/QSCs were between the same 10 suppliers with QDCs/QSCs (34 out of 112 sub-contracts).

The profit on cost once (POCO) adjustment is made to the profit rate on a contract to ensure that, where there are sub-contracts within a group of companies, profit arises only once in relation to Allowable Costs under the contract that also relate to the price payable under any group sub-contract.

The POCO adjustment recognises the fact that the price of a sub-contract may include an amount for the sub-contractor's profit. If the total value of the sub-contract is an Allowable Cost (if the full amount satisfies the AAR test), then there is potential for profit to be earned twice.

There will be a zero per cent POCO adjustment if the Secretary of State is satisfied that the Allowable Costs of the qualifying defence contract that relate to a group sub-contract (or further group) sub-contract have been decreased by an amount equal to the attributable profit on that group (or further group) sub-contract.

If the Secretary of State is not satisfied that there has been an appropriate reduction in the Allowable Costs attributable to the group (or further group) sub-contract, then the POCO adjustment is the amount agreed by the parties to the QDC by which the contract profit rate must be decreased in order to exclude the attributable profit.

There are four ultimate parent companies in our analysis who have reported a sub-contract to another company within the same group, but not all suppliers have reported a POCO adjustment. Where suppliers have reported a POCO adjustment, the data provided does not show whether these sub-contracts include an element of profit or not to determine whether a POCO adjustment has been correctly applied. The SSRO is liaising with suppliers to investigate these adjustments.

## Data sources and methodology

The data in this report is sourced from either the contract notification report, which suppliers are required to submit to the SSRO within one month of the initial reporting date for a contract (usually the date the contract is entered into, unless it becomes a QDC/QSC by amendment), or the quarterly contract report, which is required from QDCs/QSCs with a contract value of £50 million or more within one month of the end of each calendar quarter. The templates and user guides for both of these reports are available on the SSRO's website<sup>1</sup>. Data from these reports are collated in the Defence Contract Analysis and Reporting System (DefCARS).

Only QDCs/QSCs which reported a time of agreement before 1 April 2016 have been included in this release, as notified to the SSRO by the Ministry of Defence, separate to the submitted contract notification reports. The data was extracted from the database on 4 July 2016, and any reports received after this have not been included in the analysis.

Suppliers are required to submit the expected value of the sub-contract agreed for pricing purposes, including any options or incentive payments, which may not reflect the actual value at the end of the contract. Only the highest value 20 sub-contracts with a value over £1 million need to be reported to the SSRO. However, some suppliers provide details of sub-contracts below £1 million.

<sup>1</sup> <https://www.gov.uk/government/collections/qualifying-defence-contracts-reporting-templates-and-user-guides>

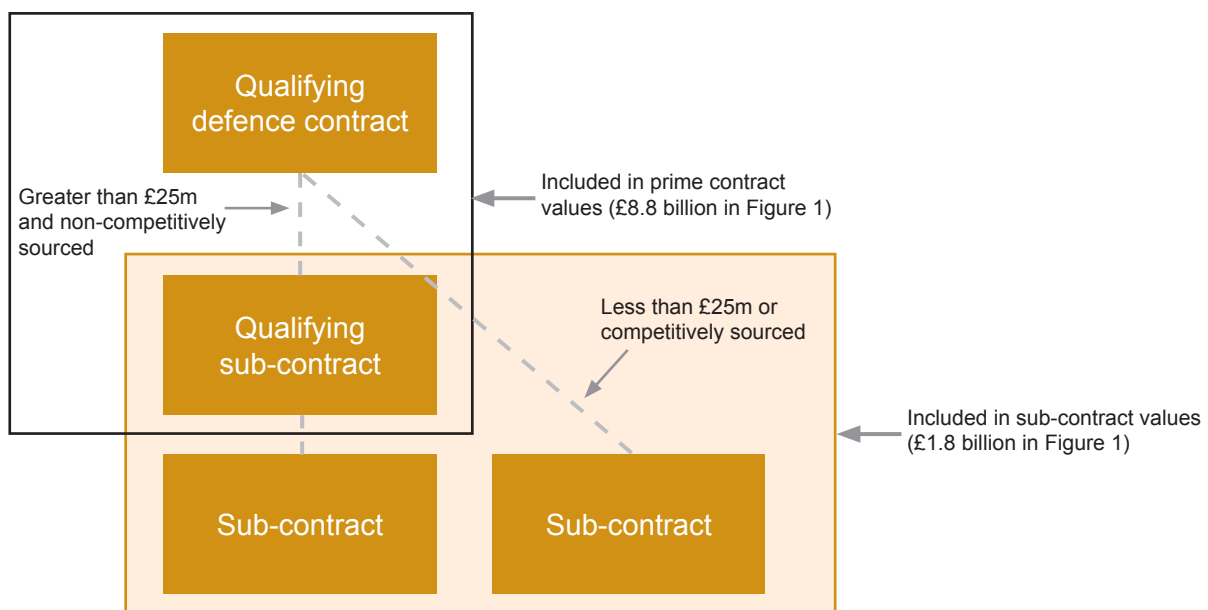
Suppliers are able to submit sub-contract values in currencies other than pounds sterling. Where this has occurred, we have used the exchange rate published by the Bank of England<sup>2</sup> as of the first day of the month in which a report was first submitted for that QDC/QSC.

One QDC was excluded from the analysis due to outstanding queries around the sub-contract data reported. A further three sub-contracts were excluded from another QDC due to queries regarding their eligibility as sub-contracts.

To produce the analysis of sub-contracting across parent companies, an exercise was undertaken to map all of the prime contractors and sub-contractors to their ultimate parent company. For this purpose, a company was considered to be a parent if it controls a majority of voting rights and other types of control were not considered. Where a company has no single entity with a controlling majority, the company itself is considered the ultimate parent company of the corporate group. Where a company could not be reliably identified due to poor data quality, the sub-contract was assigned to the 'other' category.

If a sub-contract of a QDC is awarded without competition, and has a value of more than £25 million, it becomes a QSC. For the purposes of this analysis, the QSC itself is reported as a sub-contract to a QDC and the sub-contracts within a QSC are also reported (see Figure 4 for an overview of how QSCs are treated in this analysis). There are around £0.2 billion of QSCs within the analysis, included within both the prime contract value and sub-contract value.

**Figure 4: Diagram showing how QDC, QSC and sub-contracts have been treated in the analysis**



The sub-contract values reported are those used for contract pricing purposes, and may not reflect the final value of the sub-contract once it is completed. All figures are provisional, and may be updated in future statistical releases.

Due to the commercial sensitivity of this data, the SSRO does not release any information that will enable identification of individual contracts or suppliers included within the analysis. For more information on the SSRO's handling of commercially sensitive information, see the SSRO's statement on its website<sup>3</sup>.

### Further information

The SSRO welcomes any queries or feedback you may have on this statistical release. If you would like to get in touch, please email us at [helpdesk@ssro.gov.uk](mailto:helpdesk@ssro.gov.uk).

<sup>2</sup> <http://www.bankofengland.co.uk/boeapps/iadb/Rates.asp?Travel=NlXlRx&into=GBP>

<sup>3</sup> <https://www.gov.uk/government/news/handling-commercially-sensitive-information>