SSRO

Single Source Regulations Office

Assuring value, building confidence

Guidance on adjustments to the Baseline Profit Rate - Response to consultation

March 2016

Contents

Background

1. Introduction

1.1 The *Guidance on adjustments to the Baseline Profit Rate* sets out the principles and methodologies that contractors and the Ministry of Defence (MOD) must have regard to when entering into a qualifying defence contract.

1.2 Section 17(2) of the Defence Reform Act (the "Act") and Regulation 11 of the Single Source Contract Regulations (the "Regulations") require that the contract profit rate for any qualifying defence contract must be calculated by taking the following six steps.

Step 1	baseline profit rate
	+
	–
Step 2	cost risk adjustment
	–
Step 3	profit on cost once
	–
Step 4	SSRO funding adjustment
	+
Step 5	incentive adjustment
	+
	–
Step 6	capital servicing adjustment
	contract profit rate

1.3 Section 18 of the Act provides for the SSRO to issue guidance in relation to the steps set out in Section 17(2). The SSRO published *Guidance on adjustments to the Baseline Profit Rate* on 27 March 2015.

The consultation

2. The process

2.1 On 25 January 2016, the SSRO published a consultation on its *Guidance on adjustments to the Baseline Profit Rate*. The consultation closed on 29 February 2016. The five week consultation period was shorter than originally planned due to statutory guidance received late from the Secretary of State. However, the SSRO is clear that a five week consultation is adequate, as the consultation covered amendments to existing guidance, rather than an entirely new set of guidance. The SSRO is committed to consulting on updates to its guidance.

2.2 The SSRO consultation set out changes to the *Guidance on adjustments to the Baseline Profit Rate*. The scope of the consultation was informed by the SSRO's experience of how the guidance has been applied over the course of the last year. Specifically, the SSRO proposed revisions to the introduction, Step 1, Step 2, Step 3, Step 6 and the section on 'Opinions and determinations'.

2.3 The consultation was published on the SSRO's website[1] and emailed to our stakeholders, with a consultation response form for stakeholders to complete.

2.4 In total, we invited 74 stakeholders to respond to the consultation, including government bodies, defence industry contractors, academics, professional associations, think tanks and regulatory bodies.

3. Breakdown of responses

3.1 We received 12 responses to the consultation. Table 1 contains the breakdown of responses. Where stakeholders have agreed, we have published their full responses on the SSRO's website.

Table 1: Breakdown of respondents

	Government	Industry	Regulators/ other Government Bodies	Trade and Professional Associations and Think Tanks	Research/ Academics	Consultants	Media	Total
Number of stakeholders invited to comment	1	30	19	11	5	5	3	74
Total number of responses received	1	7	0	1	0	3	0	12
Percentage of responses received	100	23	0	9	0	60	0	16

1 https://www.gov.uk/government/consultations/consultation-on-contract-profit-rate-guidance

4. Overall response and decisions to feedback

4.1 The largest number of responses related to Step 2. These focused on the application of a cost risk adjustment and where subcontract risk is held by the Secretary of State. Responses to other issues are summarised in section 5.

4.2 We received a number of other suggested amendments and where we felt it appropriate we have accepted these suggestions and amended the guidance. A number of comments not directly relating to the drafting of the guidance were received, which the SSRO has taken note of and will take into account as appropriate in the discharge of its relevant functions.

Issue – the application of the cost risk adjustment

4.3 Half of respondents sought additional clarification on definitions and terminology used with respect to cost risk. Requests were made for clarification on the definitions of the high, medium and low cost risk levels in relation to setting the cost risk adjustment. We received comments from eight respondents in relation to the principles to consider when determining the cost risk adjustment.

4.4 The updated guidance states that for those pricing methods where estimated, rather than actual, Allowable Costs are used to determine the amount of Allowable Costs paid, the starting position is that a zero cost risk adjustment should apply. Examples have been provided of the circumstances in which a positive adjustment and a negative adjustment may apply.

4.5 The SSRO accepts that inclusion of cost risk in the price should not necessarily rule out a positive cost risk adjustment. Nevertheless, when determining a cost risk adjustment, consideration should be given to the relative likelihood and the extent to which actual Allowable Costs could fall above or below estimated Allowable Costs (refer to paragraph 7.11 of the guidance). This will be determined in part by the magnitude of any cost risk in the price.

4.6 The SSRO has updated the list of the principles to consider when determining the cost risk adjustment in response to the comments we received. The table in section 5 provides more details.

Issue – the adjustment to be made where subcontract risk is held by the Secretary of State

4.7 The consultation document stated that an adjustment to Allowable Costs could be made in circumstances where cost risk on subcontracts costs are held by, or assigned to, the Secretary of State. This was challenged by eight respondents.

4.8 The SSRO is clear that in circumstances where cost risk on subcontract costs are held by, or assigned to, the Secretary of State, the prime contractor should not receive the same level of profit they would have received had they held the risk themselves. We accept that any adjustment in this regard should be applied through use of a cost risk adjustment only.

5. Additional issues raised by respondents

5.1 The table below summarises additional comments made by respondents and the SSRO's responses.

Table 2: Additional issues raised by respondents

Paragraph	Description of issue	SSRO Response
Step 1	One respondent requested clarification as to whether "Take the baseline profit rate which is in force at the relevant time" refers to the rate in force at the time of agreeing the contract.	Section 17(2) of the Act defines the meaning of 'the relevant time' and as such we do not consider it necessary for further clarification in the guidance.
Step 2	One respondent requested reinstatement of a more prescriptive relationship between the cost risk adjustment and the contract pricing method.	Cost-plus or estimate-based fee pricing methods should attract a minus 25 per cent cost risk adjustment. For the other methods, the risk of actual Allowable Costs differing from estimated Allowable Costs will be determined by the individual characteristics of that contract with reference to principles set out in paragraph 7.11 of the guidance.
Step 2	One respondent questioned the inclusion of Protection Against Excessive Profits and Losses (PEPL) as a consideration for the cost risk adjustment.	The principle of considering final price adjustments when determining the cost risk adjustment has been removed.
Step 3	Three stakeholders stated that the calculation of the POCO adjustment remains more complex than necessary. While some made specific suggestions aimed at improving the table presenting the current 12 stage process, others suggested removing the calculation altogether and to instead place the onus on the contractor to demonstrate that all inter-group profit has been removed from the price by a method of their own choosing.	It is important that the POCO guidance remains in order to set out the process to take so that the calculations are properly evidenced and consistent.
Step 3	Four stakeholders stated that the Regulations only require the contractor to consider its first tier of subcontracts when calculating the POCO adjustment.	Regulation 12, Calculation of profit on cost once adjustment includes the definition of "further group subcontract", which extends to subcontracts at each level.
Step 4	Four stakeholders said it would be helpful to know how the SSRO funding adjustment would be calculated to help contractors assess the impact.	The SSRO will consult on this issue in summer 2016.
Step 5	The relevance of the incentive adjustment was questioned by two stakeholders as they believed that the MOD is unlikely to use such incentives. In addition, one respondent suggested amendments to increase the flexibility in application of the incentive adjustment by removing the guidance that the adjustment is applied exceptionally.	The term "exceptionally" in the guidance refers to the fact that an incentive adjustment is not routine. Our records show that, as of March 2016, 14 per cent of QDCs have had the incentive adjustment applied.

Paragraph	Description of issue	SSRO Response
Step 6	Two respondents said that the application of the capital servicing adjustment should be reviewed. Of particular concern was the extent to which it drew on the Yellow Book, and that it required modernising and simplifying.	We agree that the capital servicing adjustment requires review. The SSRO will explore options for making the cost of servicing capital an Allowable Cost and setting capital servicing rates to zero as part of its review of the Act and Regulations, and plans to engage with stakeholders this year on the issue.
Opinions and determinations	One respondent sought additional clarity on the consequences of a failure by a contracting authority and a subcontractor to agree a 'profit allowance' rate in accordance with the statutory guidance. One respondent requested that the guidance should state that the prime contractor should be held harmless in the event of a price adjustment which falls on a subcontractor as the result of a determination.	Regulation 18 of the Single Source Cost Regulations gives the parties to a contract the right to seek a determination from the SSRO as to whether the adjustment under step 2, 3 or 6 is appropriate. In such a case the SSRO could make a determination and, if it considers the amount of the adjustment was not appropriate, could determine that the contract price is to be adjusted by a specified amount. As both the right to seek a determination and the SSRO's functions in such a case are dealt with by legislation, it would not be appropriate for the SSRO to remove or limit these in statutory guidance.

6. Next steps

6.1 The statutory guidance published today takes effect from the date of publication and will apply to all contracts awarded or entered into from this date.

6.2 The statutory guidance on adjustments to the baseline profit rate was published on 24 March 2016.