Changes to Contract Profit Rate Guidance

Consultation Response Form

Overview

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Please respond by 29 February 2016.

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Your details

Name:

Paul Everitt

Organisation:

ADS Group

Position:

Chief Executive

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Yes [√] No [ ]

Please write your comments below:

Overview

ADS welcome the opportunity to comment on the SSRO's proposed changes its to Contract Profit Rate Guidance. We have analysed the updated document and chosen to comment on the sections where we believe industry would most benefit from further information and clarification on the proposed changes.

ADS recommend that the SSRO holds an industry workshop on this consultation which would enable the SSRO to communicate its aims and objectives, and assist industry's understanding of the proposed changes. ADS would be happy to facilitate such engagement with industry on this guidance document.

ADS believe that, going forward, industry would also benefit from workshops prior to the publication of consultation documents. This will enable industry to respond to consultations from a position of knowledge and understanding, ensuring the SSRO receives a meaningful response from stakeholders.

Section 7 – Principles of Risk Adjustment

Section 7.3 (page 6)

Section 7.3 states: '*For qualifying defence contracts that are based on the cost-plus or estimate-based pricing methods, the cost risk adjustment should be minus 25 per cent, because actual Allowable Costs are used to determine the costs to be paid, although the MOD and the contractor should always have regard to the principles at paragraph 7.11.*'

It is currently unclear which of the six pricing methods (set out under Regulation 10(4) to 10(11)) are being referred to in section 7.3. Greater clarity on this matter would enable ADS to better understand the intent and impact of the proposed change.

The inclusion of the expression '*actual Allowable Costs are used to determine the costs to be paid*', for example, creates significant uncertainty, particularly in respect of Target Cost Incentive Fee (TCIF) contracts. Regulation 10(11-12) states '*the allowable costs are the allowable costs as estimated at the time of the agreement*'. However, for TCIF contracts, in practice, the price is determined by the target and the actual costs. This is an important issue for ADS members and clarification is required before a detailed view can be formulated.

While the circumstances described in section 7.5 may on very rare occasions exist, the Regulations only allow a Contract Profit Rate calculated in accordance to the six step process to be used.

Section 7.5 (page 7)

It is difficult to envisage a contracting context whereby the expression '*cost risk associated with one or more subcontracts is held by, or assigned to, the Secretary of State*' would apply. ADS would appreciate a further explanation of the circumstances in which the SSRO would apply the proposed measures in order to enable us to formulate a view on this matter.

Discussions held within the industry expert group considered that this section may refer to situations whereby the Contractor was:

1. Receiving goods or services provided free of charge on a Government Furnished Asset (GFA) basis; or
2. Purchasing goods or services specified by MOD and incorporating them in the Contract deliverables.

In the case of the former, the Contractor has no liability for the GFA until it is delivered to him where upon he is responsible for its safekeeping etc. until returned to MOD as part of the Contract Deliverables. There are, however, instances where the Contractor may have to perform inspections and tests on GFA equipment on receipt in order to satisfy itself that they are in a fit state to be incorporated in the Contract Deliverables. It is noted that goods under GFA arrangements are often found to be defective in some respect upon receipt and they often require remedial work (either undertaken by the Contractor or the OEM) before becoming fit for use. Furthermore, in such circumstances, goods are often delivered late, requiring the Contractor to adjust its programme in order to recover the situation.

In these circumstances, the Contactor still carries cost and programme risk even when purchasing goods specified by MOD for incorporation in Contract Deliverables. The Contractor must still place the subcontract (possibly a QSC), and manage it through to completion, including pre-delivery acceptance testing and inspection. The Contractor may also bear system integration risk, overall programme delivery risk and system performance risk.

ADS believe the Contractor should be rewarded for the risks it takes.

A further point to consider is that reducing the profit on either (a) work associated with incorporating GFA; or (b) procuring and incorporating items specified by MOD on items into Contract Deliverables will be reflected in lower return on sales. This could have the unintended consequence of adversely affecting shareholder value and the attractiveness of investing in UK defence. In such circumstances, Contractors may decline to purchase goods and services specified by MOD for incorporation into Contract Deliverables and insist these are instead supplied as GFA.

ADS also questions whether the proposed introduction of a cost risk adjustment as described in section 7.7 and adjusting the Allowable Costs as described in section 7.12 *et seq* are permissible under the Regulations.

Section 7.9 (page 7)

ADS believe that contracts should be priced at the *mean expected* Allowable Cost and should include the risk allowance at this point, thereby attracting the Contract Profit Rate. The approach set out under section 7.9 does not appear to consider the *volatility of the risk* that should to be reflected in the Allowable Cost. This is an essential aspect of calculating a fair and reasonable price.

ADS also believe it would be beneficial for the SSRO to provide further clarity as to whether their intention is to permit pricing at some point other than the mean expected Allowable Cost.

ADS members would welcome an opportunity to engage with the SSRO on these matters in order to gain a better understanding of the SSRO's approach and to further explore what is achievable under the Regulations.

Section 7.10 (page 7)

ADS believe that further information is required to clarify the baseline against which risks would be assessed and from which the outcome could be agreed as being '*a medium level of risk of actual Allowable Costs differing from estimated Allowable Costs, and/or the risk is shared between the contractor and the MOD.*' For example, it is unclear if this is intended to be decided based on the comparator group as a whole or the median contractor within the comparator group. Clarity is also required around the assessment process and the methodologies to be used.

ADS also believe there exists a need for maximum price contracts to be considered separately, as the proposed changes may lead to further adjustments in risk profiles.

Section 7.11 (pages 7-8)

7.11 (d): Industry would benefit from a clear definition of 'Risk' and confirmation of how it is applied in this context. It should also be noted that the inclusion of a risk in the Risk Register does not change the nature of the risk or the likelihood of it maturing when priced at the mean or its volatility.

7.11(e) and (f): The comments against section 7.9 (above) also apply to these sections.

7.11(g): Further clarity is required as to what this means in practice before a view can be formulated. ADS is unsure whether it suggests that pricing can be at a point other than the arithmetic mean.

7.11(h): Industry would benefit from clarity regarding the circumstances in which the SSRO envisage applying these adjustments and the SSRO's objectives in doing so. It is unclear how and when a Contractor could pass risk onto a third party via contract terms. If this were to occur, the Contractor would still retain the overall risk of delivering on time and for equipment performance. In high(er) technology situations where innovative solutions are required, subcontracting can also increase risk. Further information, including examples, is required to enable ADS to understand the SSRO's intention and to offer comments.

7.11(i): This section appears to refer to the Protection Against Excess Profits and Losses adjustment. Again, clarification would be welcome to enable ADS to better understand the SSRO's intention behind the proposed revision and to formulate a view.

7.11(k): The context of and reason for this adjustment are unclear. Further information would assist ADS' understanding of the SSRO's intentions and allow us to offer comments.

7.11(m): Industry would benefit from greater clarity in relation to the '*cost risk under subcontract(s) that may be 'passed through' to a party other than the contractor*'. Should it refer to a situation whereby the Contractor passes elements of its risk into its supply chain, it is not currently apparent how this would be measured or assessed for the purposes of the section.

7.14: Further information is required regarding the definition of '*excess profit*' in the circumstances described and how it would be measured or assessed.

Should a Contractor simply be procuring on behalf of the MOD, it would still incur management and administration costs in placing, monitoring and receiving the goods (or services) and the associated risks. If a Contractor feels it is being forced into ordering goods and services on its own account and into passing the costs through its books without the addition of profit it may seek for the goods (or services) to be made available on a GFA basis.

ADS also questions whether the Regulations permit Allowable Costs to be reduced in this manner. ADS would welcome clarity on whether this is permissible under the Regulations.

7.15: Should the Secretary of State for Defence make a specific request, the Contractor will still incur administration costs. ADS believe these should be Allowable Costs and attract the Contract Profit Rate.

Section 10 - Methodology to determine the POCO adjustment (page 11)

Step 3, Section 10.1, Stage 1: The proposed revision appears to extend the reach of the Guidance beyond that allowed under Regulation 61. This Regulation requires the Contractor only to consider its first tier suppliers and does not extend further into the supply chain.

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Step 3, Section 10.1, Stage 2: ADS believe the process should apply to direct subcontracts only. Any subcontract placed by a lower tier subcontractor on a higher tier affiliate lies outside of the Regulations.

Step 3, Other Steps, Various Places: It is unclear if the term 'primary' contract refers to the primary cost of the prime contractor or to some other category of Allowable Cost. This requires clarification before ADS can provide comments.

Section 12 - When to apply the Incentive adjustment (page 13)

Step 5, Section 12.2: Precedent suggests that the MOD is unlikely to use incentives in such circumstances. For example, the section refers to performance over and above that specified in the contract which to be effective, this must be allowed for by the contract terms. On a practical level, MOD has openly discouraged early delivery as it disrupts the department's budgeting process.

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Name:

David Green

Organisation:

BAE Systems

Position:

Finance Director, Shared Services

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Yes [X] No [ ]

Please write your comments below:

In our view, the changes made to the previous guidance on this topic fall into two camps. The first appear to be largely housekeeping, the second contain more substantive changes which are commented on below.

As a general point, the changes move the guidance to a more rules-based approach, away from the principles-based approach which is a retrograde step in our view.

The major changes of substance are in the section on the cost-risk adjustment. Our feedback is as follows:

- Paragraph 7.9: Positive adjustment & cost risk in the price

  This appears to replace 5.6(h) from the existing guidance but is far more restrictive. The wording suggests that if any risk, regardless of quantum and the level of uncertainty, is provided for in a price build then there can be no positive adjustment to the baseline profit rate. This does not make sense as it assumes that parties to a contract have perfect knowledge of the risks before entering into the contract.

  Paragraph 5.6(h) from the existing guidance is much preferred as it directs that any allowance for contingency included in allowable costs should be considered when setting the cost risk adjustment. This allows both parties to the contract to make a value judgement having regard to this principle.

- Paragraphs 7.5, 7.7, 7.12 - 7.15: Negative adjustment and subcontractor performance risks

  These paragraphs provide guidance in circumstances when a prime contractor has a subcontract but that the terms of the prime contract provide some level of commercial protection by MOD to the prime contractor from the performance of the subcontractor. Whilst the language in your proposal is extremely difficult to follow, we have interpreted it to mean that, in these circumstances, contractors might be expected to reduce the profit on the cost of the subcontract to below the baseline profit rate less the full negative cost risk adjustment, and to achieve that by effectively disallowing what would

otherwise normally be allowable costs. We do not believe this to be sensible - a cost is either allowable or disallowable and should not be arbitrarily disallowed when convenient.

Further, the likely practical impact this guidance will have is for contractors to exclude such subcontracts from their scope of work and seek to receive the output from these subcontracts as Government Furnished Equipment from MOD. This reverses well-established practices, transferring programme risk back to MOD.

BAE Systems' view is that the principles set out in the existing guidance were more than sufficient to allow the two parties to a single source contract to agree the cost risk adjustment. We view these amendments as superfluous and they should not be included.

- Paragraph 7.11(i): Principles to consider: Final price adjustments

  The cost risk adjustment is designed to reflect the risk of the contractor's actual allowable costs differing from its estimated allowable costs. With the inclusion of this point in the list of principles to consider when setting the cost risk adjustment, we are concerned that the existence of the Protection against Excessive Profits & Losses (PEPL) mechanism will be regarded as an argument to limit the level of a positive cost risk adjustment. In our view PEPL is a "longstop" mechanism that specifically mitigates against the risk of excess profits or losses and is applied retrospectively with full knowledge of actual costs. It must therefore be overtly excluded from being a factor in determining the cost risk adjustment.

In addition, the section on Opinions & Determinations has been amended. In paragraph 21.5, we would want it made clear that, in the case of a qualifying subcontract, any price adjustment arising from a determination falls to the subcontractor with the prime contractor held harmless in that the originally agreed subcontract price between prime and subcontractor remains in totality an Allowable Cost.

The sections on Profit On Cost Once (POCO) and Capital Servicing Allowances are largely unchanged from the previous incarnation. Nevertheless, we recommend the following changes:

- The language used to describe the derivation of capital employed and cost of production is a direct lift from the Yellow Book and remains outdated. We believe this should be modernised and streamlined;
- The guidance states that average capital employed should be calculated with reference to the opening and closing balance sheets. We consider an average based on each month's balance sheet would be more accurate. We suggest the guidance is changed to allow an appropriate averaging method to be agreed between the parties;
- The principle of the POCO adjustment is not disputed, however, we recommend that the complex calculation for the adjustment is deleted and the onus is placed upon the contractor simply to demonstrate that all inter-group profit has been removed from the price.

In summary, BAE Systems has some serious reservations over the amended guidance.

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Name:

Michael Hayes

Organisation:

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Position:

Commercial Director, Boeing Defence UK Ltd

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Yes ☑ No ☐

Please write your comments below:

Para 7.4. Cost Risk Adjustment: Version 1 of the Guidance included a table indicating that Firm, Fixed and Volume Driven Prices should attract +25% cost risk adjustment. This level of adjustment is still appropriate and, for clarity, the table should be reinstated.

Para 7.5. Cost Risk Adjustment: This paragraph is confusing, contains no examples, seeks to inappropriately use Allowable Costs to adjust profit and, in any case, is inconsistent with the DRA legislation and should be deleted.

Para 7.6. Cost Risk Adjustment: This paragraph is essentially a duplicate of para 7.3 and should be deleted.

Para 7.7. Cost Risk Adjustment: This paragraph is essentially a duplicate of para 7.5 and should be deleted.

Para 7.8. Cost Risk Adjustment: This paragraph confuses the cost risk of actual and estimated costs differing with general risk 'ownership' and the latter concept should be deleted from this paragraph.

Para 7.9. Cost Risk Adjustment: Programme, schedule and cost risks are appropriate contract costs. The Cost Risk Adjustment is to deal with the variability of contract price, so both should be allowable on any individual contract.

Para 7.10. Cost Risk Adjustment: What is medium risk?

Para 7.11b. Cost Risk Adjustment: This sub-paragraph is badly worded. It needs to say something to the effect of 'be based on an assessment of the difference between actual Allowable Costs and estimated Allowable Costs'.

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Para 7.11d. Cost risk Adjustment: This sub-paragraph makes no sense and could usefully be deleted.

Para 7.11e. Cost Risk Adjustment: Insurance is not a risk mitigator.

Para 7.11g Cost Risk Adjustment: The thrust of this sub-paragraph is unclear. If this means a Monte Carlo 'S' – Curve, it should say so?

Para 7.11 h and m. Cost Risk Adjustment: These two sub-paragraphs are saying the same thing and should be combined.

Para 7.13. Cost Risk Adjustment: Sub-contracts require to be managed no matter where the risk profile lies and all costs are supposed to be AAR, so there is no need to restate that principle here.

Para 7.14. Cost Risk Adjustment: This is entirely unreasonable as there will always be management / administration charges. In addition this paragraph confuses cost, profit and risk.

Para 7.15. Cost Risk Adjustment: This is entirely unreasonable as there will always be management / administration charges. In addition this paragraph confuses cost, profit and risk.

Page 10. Profit on Cost Once: In the flow diagram 'Secretary of State' should read 'contracting Authority'.

Page 11. Profit on Cost Once: Stage 1 is inconsistent with the Regulations, where the requirement is to list first-tier Sub-contractors only.

Para 11, 12 & 13. Incentive Adjustment: 'Secretary of State' should read 'contracting Authority' throughout.

Para 11.2. Incentive Adjustment; 'rate' should read 'adjustment'.

Para 13.1b&c. Incentive Adjustment: The last sentence of b is inconsistent with the first sentence of c. Further, the concept of an Incentive Adjustment for over-delivering must be enshrined in the contract terms to give effect, where appropriate, to the Adjustment.

Appendix A. Applicable Costs: Insert 'and Capital Servicing Allowances' after 'Allowable Costs'.

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Name:

Tim Watkins

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Director

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Yes [Y] No [ ]

Please write your comments below:

Overview

The SSRO have consistently employed the following consultation methodology:

1. Publishing a fully developed paper, having had no engagement with MoD/Industry
    a. Papers therefore have serious deficiencies as they have no understanding of the MoD/Industry and have many poor outcomes and unintended consequences. Indeed some papers show little or no grip on the nature of the subjects that MoD/Industry understands well.
2. The consultation is a window for participants to submit their responses
    a. There is no engagement with the parties at this stage to get to the detail of the issues.
    b. Many issues are complex, and require discussion to reach understanding, particularly for a new body with no knowledge and experience of the defence landscape.
3. At the conclusion of the consultation, the SSRO tends to go with its first thoughts, even when there is an overwhelming lack of support for some of the proposals.

The body of guidance that the SSRO is producing is seriously not fit for purpose, and with this consultation in point, it is not evolving, but getting poorer. The SSRO can only improve the quality by engaging meaningfully with industry and MoD (bipartite or tripartite), or the new system will fall into chaos.

The SSRO must now focus on engaging with parties to reset the Statutory Guidance it has issued so far, and not expand its activities until this critical work is completed to an adequate standard.

Specific issues

'Cost risk associated with subcontracts is assigned to the Secretary of State'. This is a new issue addressed throughout the consultation paper; it appears to try to 'shoe-horn' a result that is not in accordance with the Act and Regulations. It should be addressed in a fully developed way in the update of the Act/Regulations:

1. If the contractor is not adding value to the sub-contract, then the MoD should contract directly and free issue to the contractor, removing the issue.

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2. If contractors do not receive a reward for sales passing through their business, their return on sales will be diluted, destroying shareholder value. They will not be willing to include the sub-contract statement of work in their contract. The MoD have placed prime contracts as they don't have the skills nor knowledge of how to manage more than a prime contractor, and it lowers their overall risk position (even if key elements of the sub-contract risks lay with the MoD, integration risk will remain with the prime).
3. 7.5 & 7.7 is inconsistent with the legislation (differing profit rate and not allowing a return on costs), this guidance cannot change the legislation.
4. 7.9 is fundamental, the SSRO have not understood the nature of risk in any way. Contractors should price at the mean expected allowable cost, this means that if the contract was run an infinite number of times, the outcome would be at the contracted profit rate. To price at this point will require the inclusion of risks at that mean expected outcome, this has not lowered or changed risk. The risk faced is the level of VOLATILITY on that outcome.
    a. Consider two contracts with cost of 100 with a risk allowance of 10 included:
        i. Example 1 has a variability of 1 for two standard deviations around that 10 allowance (95% of outcomes will outturn at 99-101 for a normal distribution)
        ii. Example 2 has a variability of 50 for 2 s.d. (95% of outcomes will outturn between 50-150)
        iii. Example 2 in this facile example is riskier, but they both have the same cost risk included. The SSRO must consider variability and its skewed nature (maximum underrun = zero cost, maximum overrun infinite) before proceeding.
5. 7.10 is too vague, what are medium risks to be compared to? The reference group or some other measure (it should be the reference group, or the single median contractor, and how is that to be performed?). Maximum prices additionally need to be considered as this further changes the risk profiles.
6. 7.11(d) From the issue in point 4 is incorrect. The SSRO is very loose in its use of terms around risk. Inclusion in a risk register (4) does not change the risk faced when priced at the mean, the volatility has not changed.
7. 7.11(e) See point 4
8. 7.11(f) See point 4
9. 7.11(g) This is an odd section, it suggests that pricing can be outside the arithmetic mean. If the SSRO means this and understands this, then the risk debate requires significant expansion and change. I expect this is a lack of understanding.
10. 7.11(h) The contract itself will not pass on any risk, the contractor may seek to through subcontracting, but will remain at risk to the MoD.
11. 7.11(i) This section is unclear, but the asymmetry in PEPL in the MoD's favour may increase the risk and therefore the profit to contractors
12. 7.11(k) poorly drafted, and not understood.
13. 7.11(m) if the contractor is successful in passing some risk then they are managing well, however they will always be ultimately responsible to the MoD. This should therefore be irrelevant (and how can this take account of sub-contract terms that are not in place at the time of pricing).
14. 7.13, this section is offensive and out-with the law. What does the SSRO mean by a 'management charge'? See answer to point 2. Even if the contractor has no risk, he has costs of placing and managing the sub-contract, which must be allowable, the alternative is that contractors will simply demand the sub-contract supply to be provided GFE. MoD costs will increase, and they have neither ability nor resource to manage such contracts.
15. 7.14 and 7.15 what is 'excess profit'. See above, this is offensive and a poor sticking plaster that is out-with the law and will lead to unintended consequences. As ever the SSRO needs to engage with MoD/Industry to resolve this adequately.

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Consultation Response Form

16. Although not changed POCO remains too complicated, the parties should be free to agree whatever method, and reference to the SSRO if it cannot be agreed.
17. The system for calculating the SSRO funding adjustment should now be populated.
18. CSAs, this is in part a cut and paste from the GACs/Yellow Book. I suggest with trepidation (based on the level of quality output and lack of engagement from the SSRO), but this section needs modernisation, after detailed dialogue with the MoD and Industry NOT by the SSRO rewriting it in a vacuum.

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Your details

Name:

Sir Brian Burridge

Organisation:

Finmeccanica

Position:

Senior Vice President, Finmeccanica UK Corporate

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Yes [x] No [ ]

Please write your comments below:

General issues

The draft guidance is unclear in many areas (particularly in the articulation of the Cost Risk Adjustment Process) and we believe that it requires significant further work to provide an understandable framework to parties to a potential qualifying contract. The underpinning Act of Parliament and Regulations are both complex and there is a significant risk of errors by contracting authorities and sub-contractors in setting of the profit allowance for QSCs.

Further, the draft only addresses the setting of the profit rate for QDCs and does not inform the requirements as applied to sub-contracts. The contracting authorities responsibility for agreeing each of the steps in setting the profit rate for QSCs and the extent of the engagement of MoD needs to be addressed within the Statutory Guidance.

In addition, the Statutory Guidance needs to include within the section on "Opinions and Determinations" the consequences of a failure by a contracting authority and sub-contractor to agree profit allowance in accordance with the Statutory Guidance (without good reason to set it aside) and between whom any adjustment flows (MoD, the contracting authority, the sub-contractor).

For the reasons stated above, we believe that a redraft of the guidance is required, followed by a further period of consultation, to avoid the risk of errors and unintended consequences arising when the guidance eventually becomes operational.

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Your details

Name:

Terry Hersey

Organisation:

Metasums Ltd

Position:

Director

Changes to Contract Profit Rate Guidance

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Yes [Y] No [ ]

Please write your comments below:

General issues

The draft statutory guidance issued by the SSRO has major deficiencies.

- In many areas it does not provide the parties to a potential qualifying defence contract with an understandable framework.
- In some areas the proposals included look to have been ill considered or arbitrary.
- There are matters that were raised by contributions to the first consultation on SSRO's statutory guidance on 'adjustments to the baseline profit rate applicable to individual QDCs and QSCs' that remain unaddressed.
- Whilst the SSRO draft in paragraph 2.1 states that statutory guidance issued by the SSRO under Section 18(1) of the Act applies to all QDCs and QSCs detailed application of the requirements of the Act and regulations require the parties to fully understand the modification to the Act and regulations required when considering application to sub-contracts (e.g. regulations 64 and 65). The Act and the regulations are, as a consequence of the drafting methodology adopted by Parliament, a difficult read and consequently there is significant risk of errors by contracting authorities and sub-contractors in setting of the profit allowance for QSCs. Guidance here is a key area where the SSRO should make the law more accessible. The draft only addresses the setting of the profit rate for QDCs and does not inform the requirements as applied to sub-contracts. The contracting authorities responsibility for agreeing each of the steps in setting the profit rate for QSCs and the extent of the engagement of MoD needs to be addressed within the statutory guidance.
- The SSRO's statutory guidance should include within Opinions and Determinations the consequences of a failure by a contracting authority and sub-contractor to agree profit allowance in accordance with the statutory guidance (without good reason to set it aside) and between whom any adjustment flows (MoD, the contracting authority, the sub-contractor).

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Consultation Response Form

Detail

7.3 The estimate based pricing methods set out in regulation 10(7) and 10(8) have wholly different risk characteristics. Under (7) the allowable costs are estimated whilst under (8) the allowable costs are the actual costs determined during the contract performance or after contract completion. The first (7) may be used within a contract to set out the pricing arrangement for options that are at contract award unpriced because the SoW is at that time under-developed e.g. PDS. 10(7) would also be used for framework contracts. The prima facie level of pricing risk for (7) should be included within the same grouping as firm or fixed contract prices. For 10(8) where prices are agreed during the contract performance the risk level may be far from low (as many companies undertaking UOR will attest)

7.5 it is unclear as to which contracts the SSRO has in mind. If the Secretary of State holds all the cost risk associated with one or more the subcontracts then is unclear as to me as to why there is a subcontract as the Secretary of State could have assumed responsibility to GFE/GFI the supply on time in conformance with the prime contractors expressed needs. Is the issue restricted to Alliance contracts where may take MoD a proportion of the risk that would otherwise fall to the prime contractor? I am uncertain as to the authority of the SSRO to define Allowable Costs to include a deduction of the profit allowance. The lack of clarity within this paragraph renders many of the paragraphs that follow seriously opaque.

7.7 this again deals with cost risk assumed by the Secretary of State and it is unclear as to whether this is seeking to address TCIF arrangements through the supply chain (is this what is meant by a proportion of the cost risk) or alliance arrangements something else. Neither the Act nor the regulation make clear on the rights of MoD to recover funds directly from a prime contractor or the subcontractor e.g. for failures of its subcontractor to adhere to the pricing formula and associated statutory guidance. This wording just makes it even less clear, when statutory guidance should have been developed to inform the parties.

7.9 this is just unclear. An element of the profit is the reward for taking cost risk, the estimated allowable cost is the mean expected allowable incurred cost. The SSRO needs to make a clear statement consistent with the act and the regulations approved by Parliament.

7.10 consideration needs to be given to any maximum price and the cost risk sharing distribution. Medium level of risk compared to what; should it be the risk that is on average incurred by the median company used by the SSRO is setting of the baseline profit allowance? Further clarification should be included within the statutory guidance.

7.11(b) I'd have preferred 'evaluation' rather than 'assessment'

7.11(c) I am not sure what is meant by 'contract requirement' but it looks to be unnecessarily restrictive, contractors may incur costs on sustaining development, obsolescence

7.11(d) this is ill considered; risk register deal with causes of risk whilst estimates deal with the effects and uncertainties. Risk register deals with events whilst estimates also deal with performance and quality of judgements applied to facts.

7.11(e) firstly the English is wrong. Secondly cost should only be included in estimates to the extent that they are on average expected to be incurred; there should be evidence or support to judgements that this is the case. Reference to good business practice should be removed as either the management is adequate or the work should be placed elsewhere.

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Consultation Response Form

7.11(f) this is garbage. The risk adjustment is to reflect the risk that the contractor is undertaking of a cost overrun, if estimates of allowable cost are set at the mean expected allowable cost outturn then the volume of cost included within under runs is exactly equal to the volume of costs included within over runs.

7.11(g) I have no idea what the SSRO are saying here. Are you saying that cost estimates do not have to be evaluated at the arithmetic mean. This would be tantamount to saying that estimated allowable cost is not be expected allowable cost outturn and therefore the profit allowance either includes an element of cost that is expected to be incurred or the allowable cost estimate includes cost that is not expected on average incurred

7.11(h) this is just ordinarily unclear. For example MoD take the development flight risk under a specific DEFCON included in contracts, effectively insuring the contractor.

7.11(i) this needs to be rewritten before contractors are able to comprehend what the SSRO intends

7.11(j) not my area of expertise but I'd always thought that the force majeure event gave rise to an excusable delay and that any cost that was incurred as a consequence of the event felt to the party that may or may not have had insurances in place to deal with the consequences. SSRO may know better than me.

7.11(k) I think this should have been a further sentence within J above

7.11(m) is the SSRO saying something very obvious or something far more profound? If a contractor has fixed price subcontract then its risk is limited to those risks that the subcontractor has not assumed e.g. they have to remain in business; the specification and SoW requirements let upon them need to fulfil the contract needs; goods or services need to be delivered to agreed schedule.

7.13 what is a 'management charge'? Is this to be taken to be any overhead recovery is applicable to the contract or just a word invented by the SSRO to mean costs that need to be reduced because the profit rate they consider to be applicable to the contract is greater than the minimum the law prescribes? I personally find it offensive that the SSRO also talk to project management costs associated with the subcontract, if these project management costs are being reasonably and actually incurred in the performance of the contract then they should be considered an allowable cost which is Appropriate Attributable and Reasonable. It may be that the SSRO was looking at the denominator used for the apportionment of costs across contracts; if the denominator is not, in the opinion of the SSRO, reasonable then the denominator should be altered one that is reasonable; this would not per se render the cost allocated to a contract as failing to meet the Attributable test.

7.14 is the SSRO doing anything other than using allowable cost to effect a profit rate applicable to the contract that is less than the minimum prescribed within the legislation

7.15 comments are as included in 7.14 above

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Name:

Charly Wason

Organisation:

Ministry of Defence

Position:

Head of SSAT

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Yes [x] No [ ]

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Please write your comments below:

BASELINE PROFIT RATE (STEP 1)

No comments

COST RISK ADJUSTMENT (STEP 2)

Para 7.2 - The opening sentence should not refer to a "general approach" for the "purposes of this guidance" because what it describes is the legislative basis of making the risk adjustment.

Suggest 1st sentence of para 7.2 should be amended to:

~~*For the purpose of this guidance, the general approach to determining the cost risk adjustment is driven by the risk of actual Allowable Costs differing from estimated Allowable Costs.*~~ *The purpose of the risk adjustment is to incorporate into the contract profit rate an adjustment to reflect the above or below average risk that the* "contractor's actual costs in delivering the requirement (which would be allowable under a pricing method which recovered incurred costs)*, will differ from the estimated allowable costs used in agreeing the contract price. While one factor will be the proportion of actual versus estimated costs included in the pricing method, other factors also drive risk. The* ~~*actual adjustment will*~~ *should be agreed between the parties* ~~*determined*~~ *by considering the principles stated at paragraph 7.11, alongside the pricing method.*

Para 7.5 - This proposes to amend the guidance so as to reflect the appropriateness of a lower rate of profit on subcontracted costs that are 'passing through' a procuring entities books. The MOD firmly supports the principle of more appropriate, lower rates of profit on pass through costs.

The MOD agrees that the cost risk adjustment is, in the interim, the best mechanism to deal with pass through costs, and that the higher the proportion of pass through costs to the total cost, the higher the adjustment should be (i.e. the higher the negative adjustment to the Step 2).

However, when the maximum permitted negative adjustment (-25% of BPR) does not achieve an appropriate reduction in the contract profit rate (to reflect a high proportion of pass through costs), the MOD does not agree that an adjustment should be made to any part of the estimated allowable costs. The MOD believes this would contravene the DRA/SSCR in that a contractor is entitled to allowable costs that meet the requirements to be appropriate, attributable and reasonable. The MOD believes that overriding that requirement and adjusting AAR costs because the current CPR calculation is not flexible enough in some circumstances, could be subject to legal challenge, and is not the right way to proceed.

MOD wishes to engage in full consultation with the SSRO over the coming year, on the BPR, to address pass through costs and other matters. In the meantime pass-through costs that remain part of a QDC should be considered when setting an appropriate Step 2 risk adjustment to the BPR.

Para 7.9 - Suggest amend *"reflect that the cost risk..."* to *"reflect the extent to which the cost risk..."*

Para 7.10 - I think this heading and para would be better immediately after para 7.5. It effectively states what the BPR is there to reward, which then sets up the explanations of

why you might make a negative or positive adjustment. So I would reposition para 7.10 and amend to make it more explicit. I suggest:
"The BPR is intended as the return appropriate for an average risk contract. Accordingly, no adjustment should be made where the MOD and the contractor agree there is a medium level of risk of actual Allowable Costs differing from estimated Allowable Costs, and/or the risk is shared between the contractor and the MOD".

Para 7.11 (c) - This seems almost too obvious a condition to need stating. So it would be helpful if the SSRO could provide an example of an adjustment which might be considered not entirely consistent with the contract requirement.

Para 7.11 (j) and (k) - Need to be merged

POCO (STEP 3)

Flow diagram, page 10 - Remove "Sec of State not satisfied" boxes, which are superfluous

Para 10.1 - Suggest a new para 10.1 is added so that existing para 10.1 becomes para 10.2 and so on. New para 10.1 as follows:
"The information upon which the POCO calculation is constructed is the information held by the prime contractor and their supply chain. Although the calculation will need to be scrutinised by the MOD and the final adjustment agreed between the parties, it is the responsibility of the prime contractor to propose the POCO adjustment, or demonstrate why no adjustment is required"

INCENTIVE ADJUSTMENT (STEP 5)

Para 12.1 - Suggest amend to:
"The incentive adjustment is not automatic and will be applied at the discretion of the Secretary of State for Defence" ~~*exceptionally for qualifying defence contracts".*~~

Suggest new para 13.3 - One of the concerns of users with step 5 is a perceived lack of flexibility in application. Suggest addition of new para, as follows:
"Provided that the total incentive payments made under the contract do not exceed the 2% of allowable costs set by the legislation, those payments may be assigned at the Secretary of State's discretion, according to which areas of contract performance the Secretary of State most wishes to incentivise".

CAPITAL SERVICING ADJUSTMENT (STEP 6)

Para 15.1 Greater clarity could be achieved by a cleaner separation of the two separate elements under discussion in this paragraph. Suggest redraft as follows:
"The capital servicing adjustment ~~*alongside the statutory guidance on Allowable Costs,*~~ *ensures that a contractors receives an appropriate and reasonable* ~~*are not only paid a*~~ *return on their investment in fixed and working capital.A contractor will also be compensated for the consumption of the useful economic value of fixed assets employed on a QDC by the inclusion of depreciation charges in allowable costs.*

Para 16.1 - Suggest new para 16.1 so that existing para 16.1 becomes 16.2 and so on. Suggest new para 16.1 as follows:

"The CSA calculation requires input of three pieces of contractor held data - the Fixed Capital, Working Capital and Cost of Production. Although the calculation will need to be scrutinised by the MOD and the final adjustment agreed between the parties, it is the responsibility of the contractor to propose the CSA adjustment, since it is based upon the contractor's data.

[End]

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Name:

Matthew Swales

Organisation:

Northrop Grumman Sperry Marine B.V.

Position:

UK Defence Business Manager

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Yes ☑ No ☐

Please write your comments below:

Proposed changes to the Single Source Cost Standard - paragraphs 7.12 to 7.15

It is the view of Northrop Grumman Sperry Marine B.V. that the facility to reduce the profit earned on a contract through the reduction in management fees or project management costs is inherently unfair and unreasonable and shouldn't form part of the Single Source Cost Standards.

If, after having been through investigation of whether they are Appropriate, Attributable and Reasonable, management fees and project management costs are deemed as being allowable they should then form part of the contract price regardless of whether risk sits with the Contractor or Secretary of State.

If it is the Contracting Authority's view that the management fees or project management costs are too high in relation to the amount of risk being held by the Contractor then this should be highlighted as not being Reasonable and disallowed, or negotiated, as a part of the investigation of the cost base rather than arbitrarily when setting the profit rate.

Furthermore, risk is not the only component of what makes a profit rate fair and reasonable and by allowing the possibility that the contract profit rate could be excessively reduced by the risk adjustment gives rise to the possibility that the contract as a whole is inequitable and no longer representative of the profit being earned for similar work within the reference group of companies.

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Your details

Name:

Chris Manton

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Rockwell Collins UK Limited

Position:

Senior Manager, Contracts

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Consultation responses

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Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes [x] No [ ]

Please write your comments below:

The guidance would appear to imply that adjustment for risk can only incur when there is a high risk that the eventual allowable costs would differ from the estimate. Where a medium risk exists then there should remain an opportunity to take risk into account by variance of the profit rate although that adjustment would be at a proportionally different rate. The inference that where the medium risk is shared by the Parties ignores the possibility that the risk may still turn to reality and either the MoD or the Contractor would want to reasonably protect their respective positions.

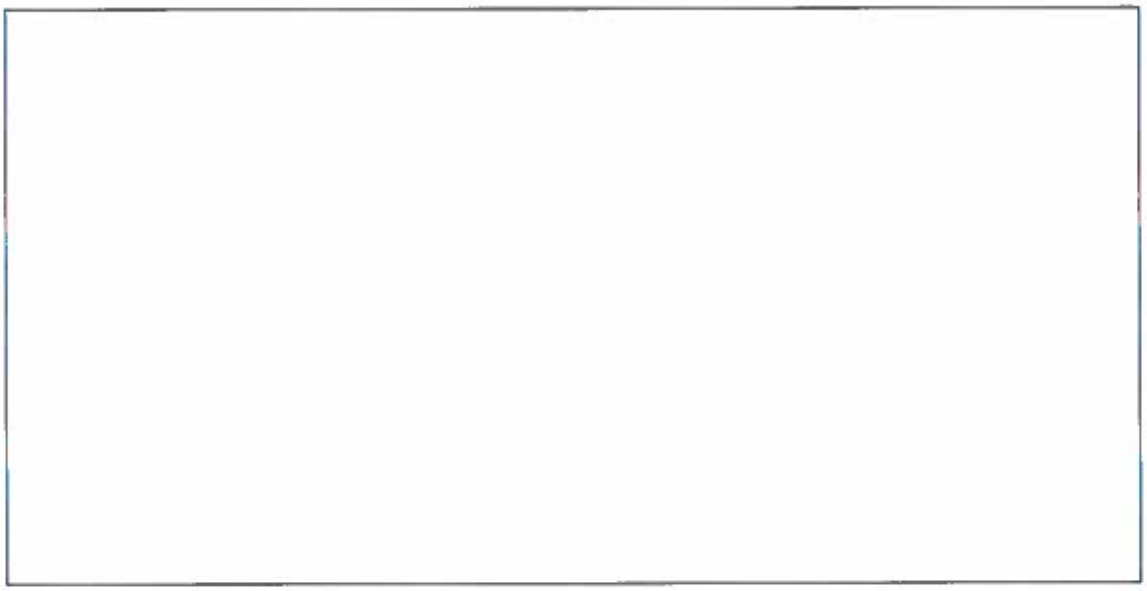
Within the mechanics of agreeing the profit rate the MoD needs to take into account the commercial practices of industry and the approval process that is to be followed in agreeing a position. Often these processes can be intensive and would cause a business to incur cost each time a business needed to "re-approve" a bid, whilst a pragmatic business would allow for negotiation within it's approval process it should be appreciated that re-bid costs are presumably not an allowable cost and therefore are not recoverable by industry.

Industry would likely suffer an adverse impact through the need to manage multiple rates and whilst this is to a point ok the MoD needs to ensure consistency in its dealings. This assumes consistent training and guidance within the PTs.

Whilst it is reasonable to minimise adjustment due to Force Majeure the risk still stands and the both parties need to understand the implications uncertainty and not use to the detriment of the other party nor use it to delay contract award.

Changes to Contract Profit Rate Guidance

Consultation Response Form



Changes to Contract Profit Rate Guidance

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Overview

The Defence Reform Act 2014 ("the Act") provides a new legislative basis for the Single Source Procurement Framework. Section 18(1) of the Act specifies that the SSRO may issue guidance in relation to any of the steps set out in section 17(2), and that contractors and the MOD must have regard to this guidance.

The SSRO is consulting on changes to the 'Contract Profit Rate Guidance' document which contains guidance on the adjustments to the Baseline Profit Rate. The guidance 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. The guidance was originally published on 26 March 2015, following a public consultation

This six steps to be used when determining the contract profit rate are set out in the guidance:

- 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; and
- Step 6 - capital servicing adjustment.

The revised 'Contract Profit Rate Guidance' was published on 25 January and is available on the SSRO's website at:

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

Amendments have been made to Step 2, Step 6 and 'Opinions and Determinations' and changes are highlighted in the revised guidance document.

Following consultation, we will publish the final guidance by the end of March 2016.

This is a public consultation held over a five week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 29 February 2016.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address: consultations@ssro.gov.uk.

You can also send responses to us at:

Changes to Contract Profit Rate Guidance

Consultation Response Form

Contract Profit Rate Guidance Consultation
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London
EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

David Scillitoe

Organisation:

Yusani Limited

Position:

Director

Changes to Contract Profit Rate Guidance

Consultation Response Form

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Yes ☑ No ☐

Please write your comments below:

General

1. This document does not appear to meet the professional standards expected of a regulator. Terms are used inconsistently. There is a lack of definition for terms that must have special meaning or interpretation. Subparagraphs have bullet points when there should be some alpha-numeric sequence that enable a full reference to be given to the subparagraph. The use of a double column is unhelpful to the reader when complex issues are being described.
2. The passing reference [para 1.2] to the application of the guidance to qualifying subcontracts is unhelpful to a subcontractor and requires interpretation. As there will be many times more qualifying subcontracts than qualifying defence contracts, there needs to be more emphasis and guidance specifically in respect of those subcontracts.
3. Some of the language used is out of date with current International Financial Reporting Standards (IFRS) and should be updated to align with those Standards.
4. Some of the guidance is inconsistent with the Regulations and is likely to lead to the risk of a judicial review, challenging the credibility of the SSRO and embarrassing the Secretary of State.

Detailed Comments

5. Step 2. Para 7.3. This is a statement that is so broad that it will be misinterpreted. Specific reference should be made to the regulations describing the different pricing methods. The statement may be correct for Reg 10(6), but it is not correct for the pricing methods described in Regs 10(7) to (11), all of which are estimate-based pricing methods for the assessment of the profit allowance, but which have varying degrees of risk.
6. Step 2. Para 7.5. The circumstances described are so exceptional, that they should not be set out as a general principle. There needs to be examples given of these circumstances, so that they can be easily recognised. Nevertheless, the Regulations make no provision for differential profits depending on the nature of the work – only a Contract Profit Rate can be computed from the Steps. Furthermore, the Regulations do not allow an adjustment to the allowable costs to avoid what is described as an "excess" profit [2nd bullet point and para 7.12].

Changes to Contract Profit Rate Guidance

Consultation Response Form

7. Step 2. Para 7.7. The Regulations make no provision for differential profits depending on the nature of the work – only a Contract Profit Rate can be computed from the Steps.
8. Step 2. Para. 7.8. Expressions of "high risk" and "majority of risk" need to be defined or explained further.
9. Step 2. Para 7.9. An element of profit is the reward for taking cost risk, so this guidance is conceptually wrong. The risk also depends on the range of the estimate and the variability of it.
10. Step 2. Para 7.10. Expression of "medium level" needs to be defined or explained further. How is a maximum price TCIF contract to be assessed?
11. Step 2. Para. 7.11. Principles need to be clear; these are not clear at all:
    a. 7.11.b. Use of "how" is unclear.
    b. 7.11.c. Use of "entirely" and "requirement" is unnecessary.
    c. 7.11.d. This needs to be rephrased to be understandable. Rather than say "be consistent with", it might be clearer to say "reflect", as the estimate deals with the consequences of the risk approach, etc.
    d. 7.11.e. How do you take into account the "extent" unless it's 100%? How do you measure "good business practices" – it's either adequate or not?
    e. 7.11.f. This is unnecessary to state, as the estimate is prepared on this basis.
    f. 7.11.g. What does this mean? Examples will be needed. The implication is that the estimate is taken at other than the 50th percentile, which should not be the case.
    g. 7.11.h. Give examples of this concept. How does a contractor "pass on" the risk to a third party?
    h. 7.11.i What does this mean?
    i. 7.11.j. MoD contracts do not provide an indemnity from these circumstances, so they must still be a risk. If the contract contains a special term that provides some protection for these circumstances then that will be taken into account as a result of the third (and seventh) bullet; however, it is not MoD practice to give a full force majeure provision and even then the cost risk is not mitigated, as there is no price adjustment for those events, only a timescale adjustment.
    j. 7.11.k. This presumably is meant to be part of item j?
    k. 7.11.m. How to assess what proportion of risk has been "passed through"?
12. Step 2. 7.14 What is "excess profit" in this circumstance? Some management or administration charge must apply if the subcontract is being processed through the books of the contractor. The SSRO has no standing to remove allowable costs.
13. Step 2. 7.15 There must be the possibility of administration charges even if there is no "management".
14. Step 3. 10.1
    a. Stage 1 is wholly inconsistent with Regulation 61. The requirement is a first tier requirement only for each "contractor" ie the Regulations only require the contractor to look at his first tier subcontracts.

b. Stage 2. The addition of "direct" before "group subcontracts" is necessary as any subcontracts placed back to the group by a lower tier subcontractor are not relevant.

c. Stages 4, 5, 6 and 8 refer to calculations being net of CSAs. It would be clearer to say at the outset in 10.1 that attributable profit does not include any capital servicing adjustment made under step 6 of regulation 11 [Reg 12(8)(a)]. Indeed, CSAs are to be applied to each and every level in the supply chain including contractors in the same group. A separate comment needs to be made in the guidance on CSAs to avoid confusion.

d. Stage 12. What are "primary" Allowable Costs? Are these a different category of allowable costs or are they the allowable costs of the primary contractor. The use of English in the Stage is confusing.

15. Step 4. It would be helpful to know now how this adjustment is to be calculated, and what the adjustment would be if it did apply now – even if it does not apply until 2017. This would help contractors gauge the effect of this adjustment.

16. Step 5. Para 12.2. This guidance is unrealistic. The purpose of the contract is to specify what is required and by when. It is very unlikely that MoD would want to incentivise early performance or performance beyond that specified. It would be necessary for any of these incentives to be tightly defined within the contract.

17. Step 5. Para 13.1. The last sentence seems contradictory with Para 12.2.c., which seems to anticipate the possibility of going beyond the contract requirement.

18. Step 5. Para 13.1.i. It is not clear how this might work. For example, what is the situation if an incentive is attributed to the speed of a vessel (which is achieved) but the delivery of the vessel is late (resulting in a breach of contract)? Or would the principle apply only to incentives related to delivery in the example given?

19. Step 5. Para 13.1.j. The expression "legal" should be replaced with "legislative" as the contract is a legal obligation.

20. Step 6. Para 14.2.b. This needs further guidance from the SSRO. It is assumed that this refers to direct costs under the contract, as indirect cost will include depreciation, as referred to in para 15.1.

21. Step 6. Para 16. This section needs to state the period that is to be used for the calculation. For fixed, firm and target pricing methods either the guidance should say that the CSAs should be based on

    a. ratios that existed for a given previous period, or

    b. a forecast of the ratios that will exist during the performance of the contract.

    If a. then should this be the closing figures at the end of the period, or an average of a given prior period?

22. Step 6. Para 16.5. This should reiterate that CSAs are to be applied to each and every level in the supply chain including contractors in the same group.

23. Step 6. Para 17.1. The reference to "unit of their business most relevant to the qualifying defence contract" presumably refers to circumstances when more than one business unit within a legal entity is involved in the contract performance – it would be helpful if this was clearer. The involvement of a business unit in another legal entity will have its own capital employed calculation.

24. Step 6. Para 17.4.f. Non-current assets recorded as actively seeking a purchaser should be included – it should be made clear that these are not excluded. Subpara i., delete the first "in" as it is not necessary.

25. Step 6. Para 17.5. In subpara c., replace "work in progress" with "any inventory" to be consistent with the prior wording. In subpara f., replace "employed" with "a". Subpara g., this needs to be aligned with IFRS language. Subpara h., should refer to "MOD" and not "government", which hasn't been used before. Subpara i., insert "an" before "agreed".
26. Step 6. Para 17.7. After "capital employed" insert "in the business unit", for clarity.
27. Step 6. Para 17.8. The phrase "consideration needs to be given to identify those costs that are obviously" is confusing and unhelpful; replace with "property, plant and equipment, and intangible assets that did not arise as a direct consequence of a business combination are considered".
28. Step 7. Para 17.9. Delete "and sufficient", as adequate evidence is always sufficient.
29. Step 7. Para 18.1. The last sentence seems unnecessarily restrictive; what about: revenue less PBIT, plus or minus movement in inventory, and adjustments for treatment of amortisation, impairment of intangible assets and fair value hedges?
30. Step 7. Para 18.3.h.ii. After "construction" insert "after delivery" in order to clarify the exclusion.
31. Appendix A. Explanation of group subcontract. Para b. The reference to "person associated with the primary contractor" is unhelpful in defining a "group sub-contract". Much guidance is needed in interpreting the phrase "person associated with the primary contractor" for the different corporate groupings and associations encountered in the industry.
32. Appendix A. Explanation of Applicable Costs. After "Allowable Costs" insert "and CSAs"; after "profit" at the end add "(excluding CSAs)" for clarity.