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Capital servicing adjustments in qualifying defence contracts

25 October 2016

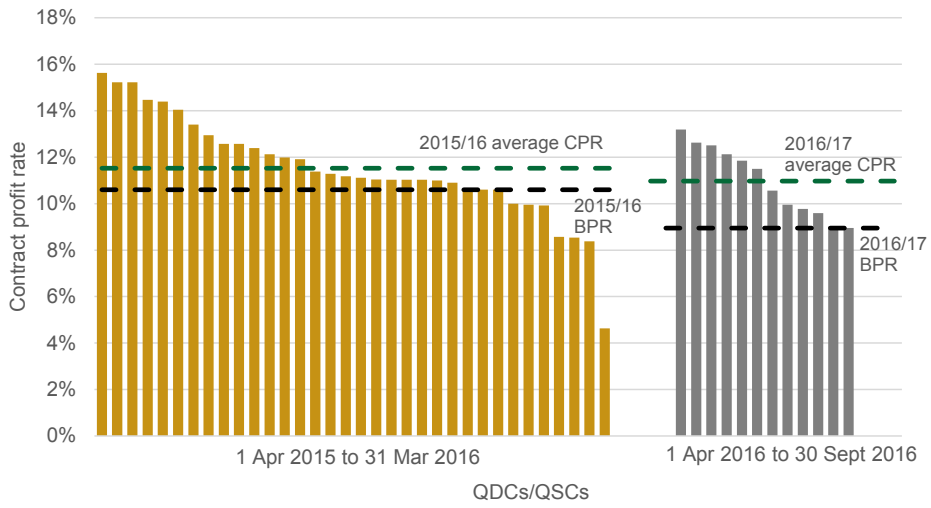
The Defence Reform Act 2014 (the Act) requires that the price payable under a qualifying defence contract (QDC) or qualifying sub-contract (QSC) must be determined in accordance with the formula: price = (CPR x AC) + AC. CPR is the contract profit rate for the contract and AC is the Allowable Costs under the contract. When agreeing the contract profit rate, contractors and the MOD must follow a six-step process set out in section 17(2) of the Act and Regulation 11 of the Single Source Contract Regulations 2014 (the Regulations).[1] The sixth step in the process is the capital servicing adjustment (CSA). The CSA aims to ensure that the primary contractor receives 'an appropriate and reasonable return' on the fixed and working capital they employ in contract delivery. This bulletin presents analysis of the CSA applied to QDCs and QSCs agreed between 1 April 2015 and 30 September 2016. It uses data reported to the Single Source Regulations Office by defence contractors, as required by Regulation 22 of the Regulations.[2]

Key points

- In 2015/16, the average contract profit rate reported by contractors was 11.52 per cent (compared to the prevailing baseline profit rate (BPR) of 10.60 per cent). The average contract profit rate reported in the first half of 2016/17 was 10.97 per cent (compared to the prevailing BPR of 8.95 per cent).
- On average, the CSA is the largest adjustment made to the BPR when calculating the contract profit rate. It accounted for 1.10 percentage points of the average contract profit rate in 2015/16 and 1.55 percentage points of the average for contracts agreed in the first half of 2016/17.
- Of the 46 QDCs/QSCs examined, 11 (24 per cent) had a CSA of zero. The other 35 had CSAs ranging from 0.30 percentage points to 3.67 percentage points.
- As expected, where data was available, we found that contractors with more-capital-intensive operations tended to agree higher CSAs on their QDCs/QSCs.

Contract profit rates in QDCs/QSCs

Figure 1: Contract profit rates reported in individual QDCs/QSCs



1 Full details of the six-step process can be found in SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate.*

2 Data remain subject to verification by the SSRO. The types of contract reports and the data to be provided in each are prescribed in Part 5 of the Regulations.

In 2015/16, the average contract profit rate for the 34 QDCs/QSCs reported by contractors was 11.52 per cent.[3] This was 0.92 percentage points higher than the BPR in 2015/16 (10.60 per cent). The average contract profit rate for the 12 QDCs/QSCs reported in the first half of 2016/17 was 10.97 per cent. This was 2.02 percentage points higher than the BPR in 2016/17 (8.95 per cent) (Figure 1).

Contractors are required to report to the SSRO the adjustments made in deriving the contract profit rate for a QDC/QSC. On average, the CSA is the largest of the adjustments made to the BPR when calculating a contract profit rate.

Calculating the CSA[4]

The CSA is calculated by reference to the following data:

- The fixed capital and working capital, together forming the total capital employed, for the unit of the contractor's business that is most relevant to the QDC or QSC.[5] This may be a subsidiary company, division or site location.[6]
- The cost of production, generally defined as the material, labour and overhead costs of the contractor's business unit, subject to certain adjustments.[7]
- The capital servicing rates published each year by the Secretary of State for fixed capital, positive working capital, and negative working capital (see table).[8]

Capital servicing rates	2015/16	2016/17
Fixed capital servicing rate	5.94%	5.08%
Positive working capital servicing rate	1.72%	1.40%
Negative working capital servicing rate	1.03%	0.74%

The proportions of fixed and working capital identified by the contractor for the business unit delivering a particular QDC are applied to the respective capital servicing rates to determine an average capital servicing allowance for the contract. This allowance is then scaled using the ratio of the cost of production (CP) to total capital employed (CE) (the CP:CE ratio) for the business unit. Accordingly, contractors with more-capital-intensive operations (those that have lower CP:CE ratios) benefit from larger adjustments than those with less-capital-intensive operations (higher CP:CE ratios).[9]

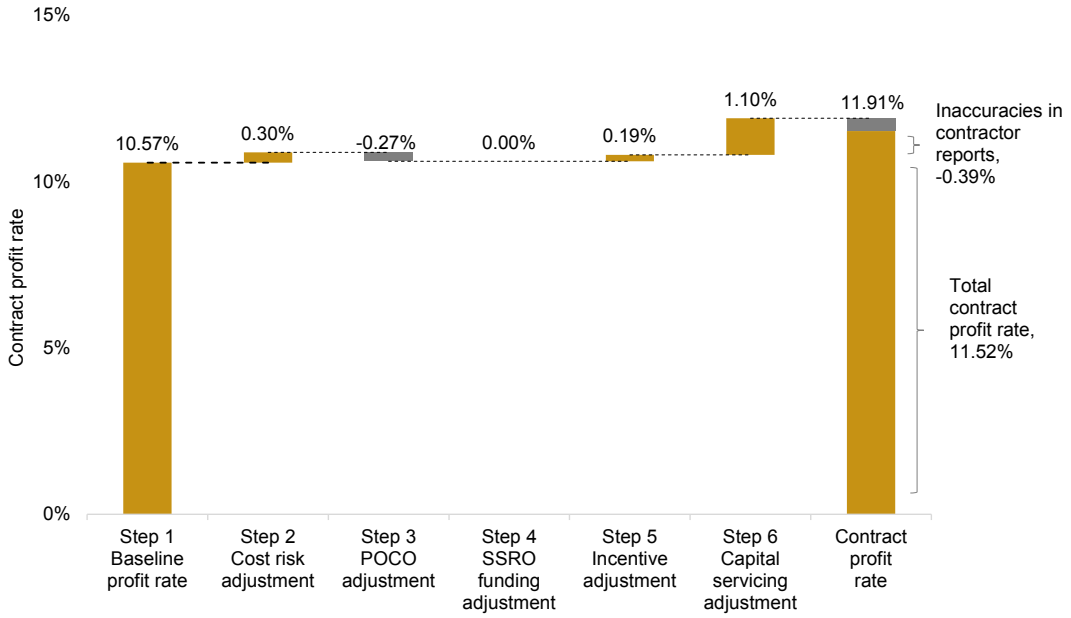
A contractor should propose the CSA for a particular contract to the MOD, supported by the facts, assumptions and calculations relied upon. The MOD should scrutinise those data and request any further information required to agree the final adjustment.

3 This is slightly lower than the value given in SSRO (2016) *Profit Rates Reported in Qualifying Defence Contracts 2015/16*, which was based on 30 QDC/QSCs reported at the time of publication.
4 Full details of how the CSA is calculated can be found in SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate*.
5 Taken as the average of the opening and closing balances for the period under review. A number of items are generally excluded from the calculation of capital employed, such as goodwill, investments in shares and securities, surplus cash and capital not efficiently employed. (See SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate*.)
6 Exceptionally these data may relate to the whole business.
7 The cost of production excludes items such as capital expenditure, capital servicing costs and costs not considered Allowable under the guidance published by the SSRO. (See SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate* and SSRO (2016) *Single Source Cost Standards: Statutory Guidance on Allowable Costs*.)
8 For more detail on how the capital servicing rates are calculated see SSRO (2016) *Single Source Baseline Profit and Capital Servicing Rates Methodology*.
9 Implicit in the calculation of the CSA is an assumption that the CP:CE ratio of the contracting business unit gives an accurate representation of the CP:CE ratio of the contract.

Applying the CSA

For QDCs/QSCs signed in 2015/16, the CSA added 1.10 percentage points to the BPR, on average (Figure 2).

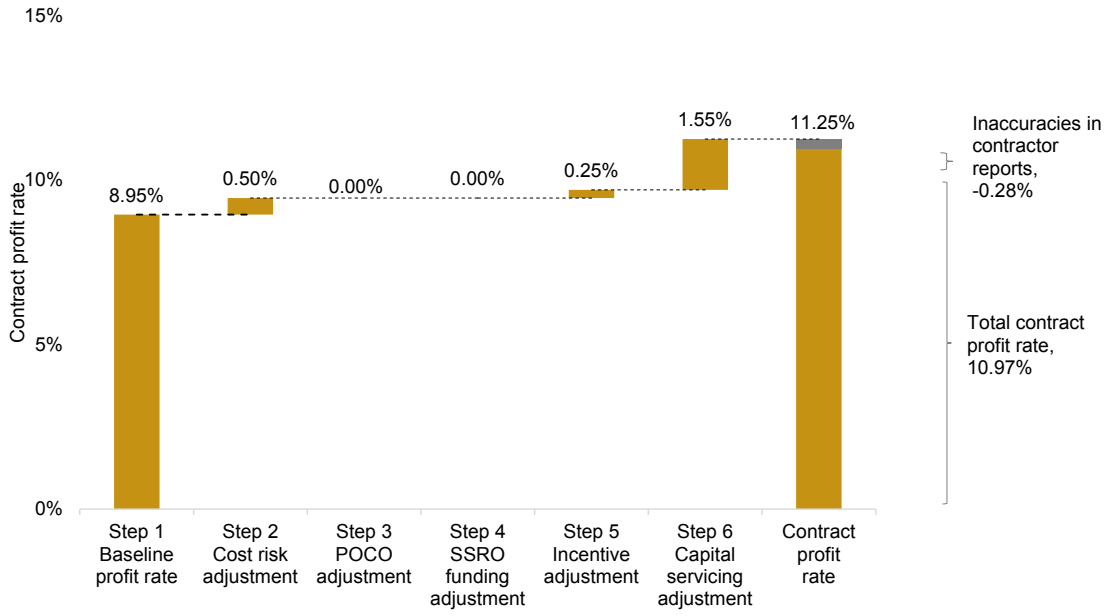
Figure 2: Average (mean) profit rate adjustments for QDCs/QSCs agreed in 2015/16



Note: Based on 34 QDCs/QSCs agreed between 1 April 2015 and 31 March 2016. The average BPR is below 10.60% due to one QDC using a mix of the 2015/16 and 2016/17 BPRs, due to a contract amendment.

In the first half of 2016/17, the CSA added 1.55 percentage points to the BPR, on average (Figure 3).

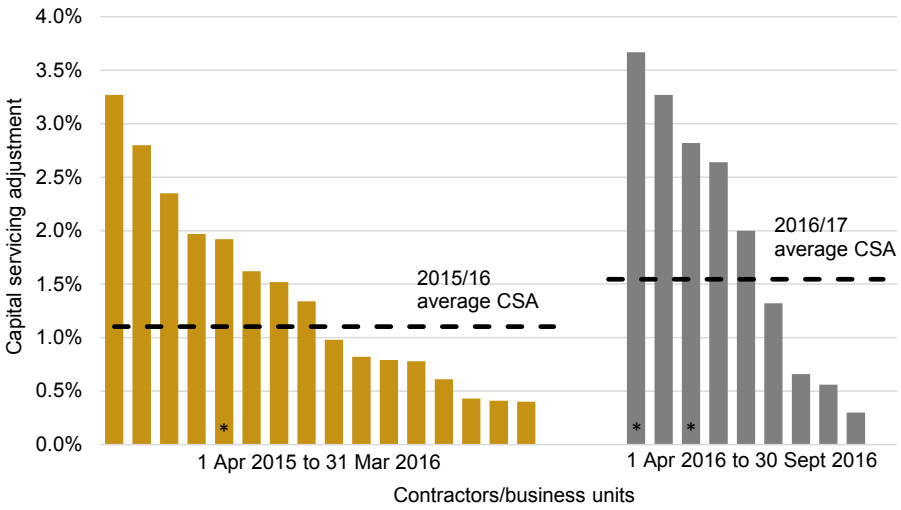
Figure 3: Average (mean) profit rate adjustments for QDCs/QSCs agreed in 2016/17



Note: Based on 12 QDCs/QSCs agreed between 1 April and 30 September 2016.

Of the 46 QDCs/QSCs examined 11 (24 per cent) had a CSA of zero. The other 35 (related to 19 contractors/business units) had CSAs ranging from 0.30 percentage points to 3.67 percentage points (Figure 4).

Figure 4: Capital servicing adjustments by contractor/business unit



*Note: As the CSA is usually calculated at a business unit level, different QDCs/QSCs entered into by the same contractor in a given year typically have the same CSA. Where a contractor/business unit agreed more than one QDC/QSC with a CSA these are grouped together in the chart. Three columns marked * show CSAs calculated using contract-level data. The chart excludes cases with a zero CSA.*

Data underpinning the CSA

Of the 35 contracts with a non-zero CSA, reports for 22 (submitted by 15 contractors) provided supporting data detailing the costs of production, capital employed, and capital servicing rates used in CSA calculations.

For 11 of the 22, CSAs had been calculated using data related to a business unit.

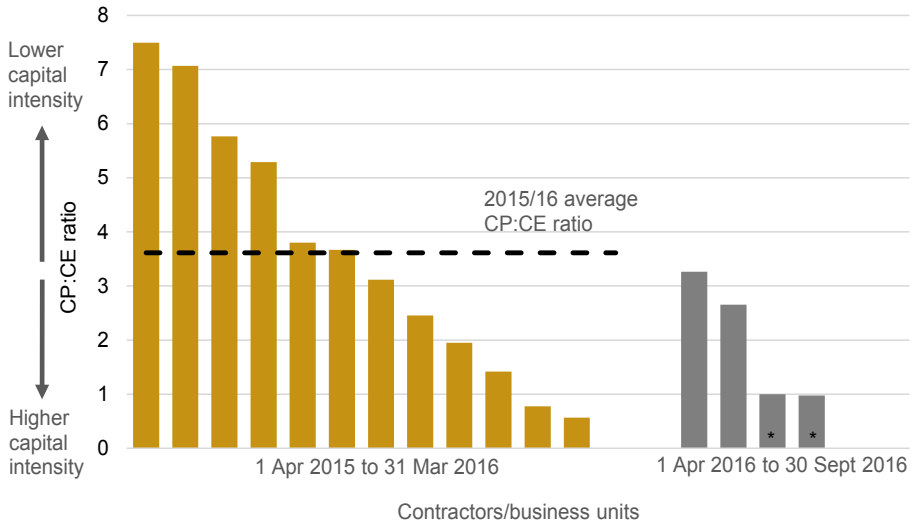
- Seven of these related to registered companies with published accounts. (In all but one case the SSRO was able to fully or partially reconcile data used in the CSA calculation with data published in the companies' financial accounts.)
- Four of the 11 were business units that were sub-divisions of registered companies. (In only two of these cases was it possible to reconcile data with the published accounts of the company of which the business unit was a part.)

Three of the CSAs had evidently been calculated using contract-level data. In the remaining eight cases it was not clear whether the data used to calculate the CSA related to the contracting business unit or the contract.

The data reported exhibit considerable variation in the capital intensity of the contractors/business units entering into QDCs/QSCs.[10] The least-capital-intensive contractor/business unit had a CP:CE ratio more than 12 times higher than the most-capital-intensive: 7.5 compared to 0.6 (Figure 5).

10 For this analysis all cases are assumed to be contractors/business units, unless explicitly stated.

Figure 5: CP:CE ratio by contractor/business unit

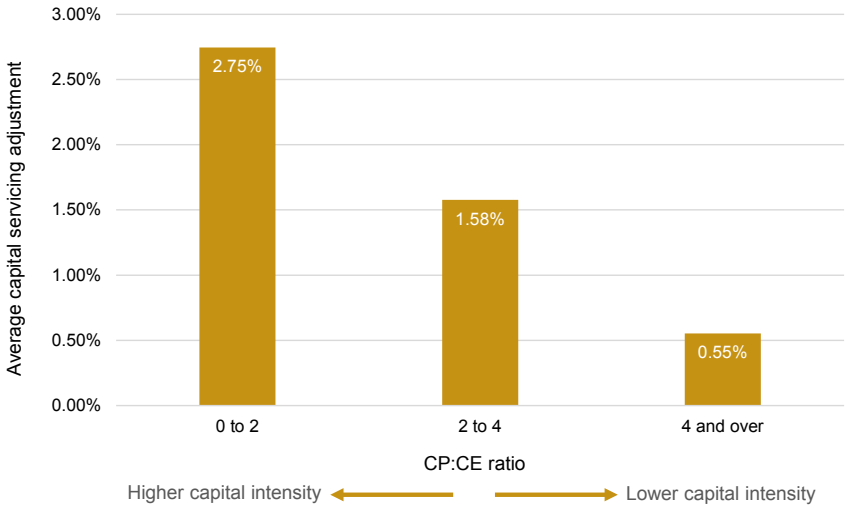


*Note: One contractor/business unit reported data for both 2015/16 and the first half of 2016/17. Two columns marked * show the CP:CE ratios calculated using contract-level data. The third contract for which CSA data was reported at the contract level is excluded due to data quality issues.*

The data also indicates that the contractors/business units entering into QDCs/QSCs in the first half of 2016/17 tended to be more capital intensive than those entering into QDCs/QSCs in 2015/16, with CP:CE ratios below the average for 2015/16. Although based on a small number of contractors/business units, this goes some way to explaining the higher average CSA reported by contractors in the first half of 2016/17.

The CSA may be expected to positively adjust the contract profit rate for contractors with higher capital intensities. In the cases where data on capital intensity of contractors/business units was available, we found that those with higher capital intensity tended to have higher CSAs (Figure 6).

Figure 6: Capital servicing adjustments relative to contractor/business unit CP:CE ratio



Note: Based on data reported for 21 QDCs/QSCs agreed from 1 April 2015 to 30 September 2016. One case is excluded due to data quality issues.

Data sources and methodology

The data in this report is sourced from either the contract notification report or contract pricing statement, 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 capital employed and cost of production data is sourced from supporting information which suppliers submit alongside these reports. The templates and user guides for all of these reports are available on the SSRO's website.[11] Data from these reports are collated in the Defence Contract Analysis and Reporting System (DefCARS).

Only reports for QDCs/QSCs which were submitted before 30 September 2016 have been included in the analysis for this bulletin. Some figures may have changed between this and previous statistical bulletins as suppliers have submitted new reports with corrected or updated data.

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 website.[12]

Further information

The SSRO welcomes any queries or feedback you may have on this statistical release. You can contact us by emailing helpdesk@ssro.gov.uk.

11 https://www.gov.uk/government/collections/qualifying-defence-contracts-reporting-templates-and-user-guides

12 https://www.gov.uk/government/news/handling-commercially-sensitive-information