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**SSRO**

Single Source  
Regulations Office

## Contract Profit Rate

Guidance on adjustments to the  
Baseline Profit Rate

20.02.15

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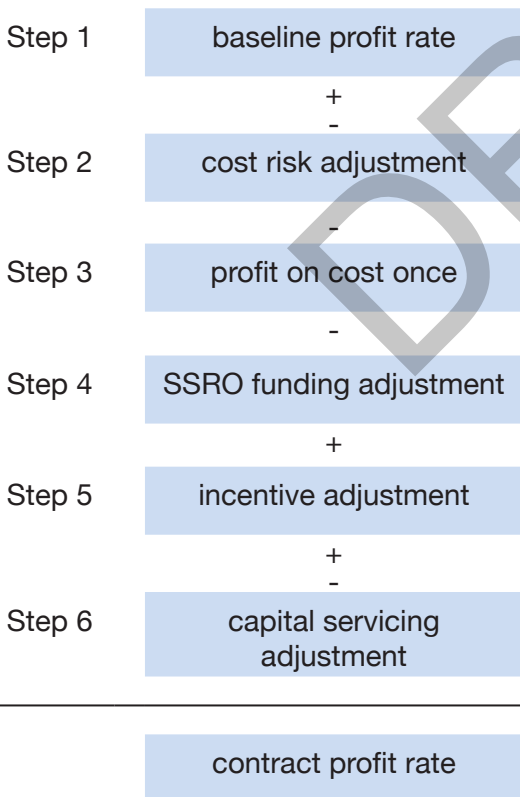
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# Introduction

## 1. About this Guidance

1.1 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:



1.2 Among its other statutory and non-statutory functions, Section 18 of the Act provides for the SSRO to issue guidance in relation to the steps set out in section 17(2).

1.3 This document contains the guidance to be used when determining:

- 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.

1.4 It is a legal requirement to have regard to this guidance.

## 2. Previous Guidance

2.1 This guidance replaces the ‘Government Profit Formula and its Associated Arrangements’, which set out the adjustments which could be made to the Baseline Profit Rate.

2.2 For those contracts currently in force the previous methodology remains in place.

## 3. Application of this Guidance

3.1 This is statutory guidance issued by the SSRO under Section 18(1) of the Act. It applies to all qualifying defence contracts and qualifying sub-contracts (subject to the restrictions set out in the Act and Regulations).

# Cost Risk Adjustment

## (Step 2)

### 4. Basis of Cost Risk Adjustment

- 4.1 Section 17(2) of the Act, and Regulation 11(3), set out the requirement for the incentive adjustment:

*“Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25% of the baseline profit rate, so as to reflect the risk of the primary contractor’s actual allowable costs under the contract differing from its estimated allowable costs”.*

- 4.2 The cost risk adjustment guidance is principles, rather than rules, based.

### 5. Regulated Pricing Methods

- 5.1 Regulation 10 (2) states that the parties to a qualifying defence contract may agree which regulated pricing method is to be used for that contract. The parties can also agree a different pricing method for defined components of the contract (Regulation 10(3)).

- 5.2 There are six regulated pricing methods that the parties to a qualifying defence contract may decide to use, as set out in Regulation 10 (4)-10(11). All regulated pricing methods use either an estimate or actual allowable cost base. For the purpose of this guidance, which risk adjustment principles to apply is driven by the proportion of actual versus estimated costs included in the pricing method.

- 5.3 The six regulated pricing methods are:

#### (1) Firm pricing method

- (a) Allowable costs are estimated at the time of the agreement.

#### (2) Fixed pricing method

The allowable costs are the allowable costs as:

- (a) estimated at the time of the agreement; and  
 (b) adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).

#### (3) Volume-driven pricing method

The allowable costs are the allowable costs per unit of volume multiplied by the actual volume of output of the contract.

The allowable costs:

- (a) must be estimated at the time of agreement; and  
 (b) may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different allowable costs).

**(4) Target pricing method**

- (a) Allowable costs are estimated at the time of the agreement.
- (b) Although not in the Regulations, depending on the terms of the qualifying defence contract, target pricing costs might not be wholly estimated or wholly actual allowable costs.

**(5) Cost-plus pricing method**

- (a) Allowable costs are the actual costs determined during the contract or after the contract completion date.

**(6) Estimate-based fee pricing method**

- (a) Allowable costs by which the contract profit rate is multiplied are the allowable costs as estimated at the time of agreement.
- (b) Allowable costs added to the product of the contract profit rate and the allowable costs determined at the time of agreement, as stated above in paragraph (a), are the actual allowable costs determined during the contract or after the contract completion date.

**Negative Adjustment**

6.2 For qualifying defence contracts that are cost-plus or estimate-based, the cost risk adjustment should be -25% as whether or not actual costs are different to the estimated cost has no effect on the contract price.

**No Adjustment**

6.3 The target pricing method generally shares risk between contractor and the MOD and therefore should aim to have a cost risk adjustment of zero.

However:

- (i) The zero cost risk adjustment is dependent on the terms and conditions of the contract. If the terms of the contract show a greater number and or value of estimated allowable costs than actual allowable costs then a positive cost risk adjustment could be negotiated. Alternatively, when a greater share of actual allowable costs are stated within the terms of the contract than estimated allowable costs then this could indicate a negative cost risk adjustment could be negotiated.

**6. Principles of risk adjustment**

**Overarching Principles**

6.1 The following principles should be used as the starting point for negotiating the cost risk adjustment.

**Positive Adjustment**

6.4 When firm, fixed or volume-driven pricing methods are used then the cost risk adjustment should be +25%, because the contractor bears all the risk.

Regulated Pricing Method	Actual allowable costs used	Allowable costs estimated at time of agreement
Firm pricing		✓
Fixed pricing		✓
Volume-driven		✓
Target pricing	✓	✓
Cost-plus	✓	
Estimate-based fee	✓	

However:

- (i) A full +25% adjustment is dependent on the riskiness of the qualifying defence contract, taking into account the overarching principles indicated above. It is possible that less than the full +25% (and even a negative) cost risk adjustment could be applied to a firm, fixed or volume-driven pricing method, if it is routine in nature or generally deemed a low risk contract.
- (ii) For fixed contracts that overrun, where the contractor seeks to secure a renegotiation on price, the increase on profit should be deducted or clawed back from any additional funds agreed.

6.5 On occasions when a risk has not been covered in either allowable cost base or the terms and conditions of the contract for a qualifying defence contract, the cost risk adjustment should not be used as a compensatory method for either party.

#### Additional Principles to consider

- 6.6 In addition to taking into account the regulated pricing method used by the contractor, the following principles must also always be applied when determining the cost risk adjustment. The adjustment should:
- only consider uncertainties that impact on allowable costs;
  - be based upon an assessment of how actual allowable costs

- may differ from estimated allowable costs;
- be entirely consistent with the contract requirement and the contractor's proposed solution to deliver them;
- be consistent with the overall project approach to risk, such as risk allocation, management, and risk registers;
- be made once the project approach to risk is of appropriate maturity;
- take into account the extent to which the cost risk has been mitigated, for example through good business practices or insurance;
- take into account any cost risk exposure which has been mitigated through contract terms and conditions;
- take into account any contractual terms that pass on some or all of the cost risks onto a party other than the contractor;
- take into account any allowance for contingency that may have been included in particular elements of the allowable costs;
- assume good practice risk mitigation and management processes are in place;
- do not take into account uncertainty resulting from force majeure for example an unforeseeable natural phenomenon; and
- be based on auditable assumptions.

#### Overview of Regulated Pricing Method versus Cost Risk Adjustment

-25% Cost Risk Adjustment	0 Cost Risk Adjustment	+25% Cost Risk Adjustment
Cost plus	Target pricing	Firm
Estimate-based fee		Fixed
		Volume-driven

# Profit on Cost once Adjustment (Step 3)

## 7. Basis of POCO Adjustment

- 7.1 Section 17(2) of the Act, and Regulation 11(4), set out the requirement for the incentive adjustment:

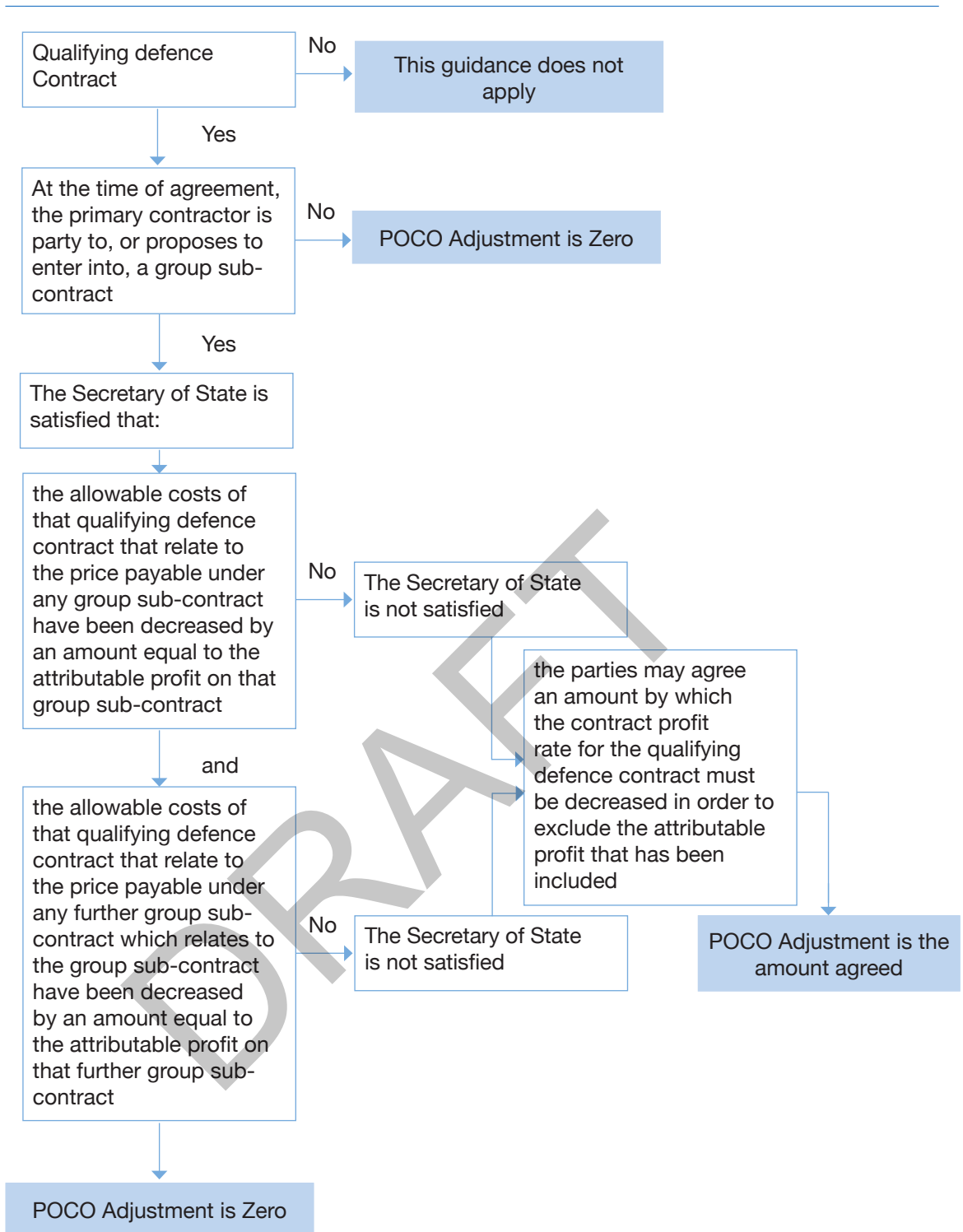
*“Deduct from the amount resulting in step 2 the adjustment determined in accordance with regulation 12 (“the POCO adjustment”), so as to ensure that profit arises only once in relation to those allowable costs under the contract that relate to the price payable under any group sub-contract (including any further group sub-contract)”*

- 7.2 This adjustment ensures that if a party to a qualifying defence contract enters into a single source sub-contract with another group member, and this sub-contract is necessary to enable the performance of the qualifying defence contract, then profit arises only once in relation to those allowable costs under the qualifying defence contract that relate to price payable under any group sub-contract. This is also the case for any further single source sub-contracts to other group members.

## 8. Application of POCO adjustment

- 8.1 The POCO adjustment applies to a qualifying defence contract if, at the time of the agreement, the primary contractor is party to, or proposes to enter into, a group sub-contract.
- 8.2 The purpose of this guidance is to provide a consistent methodology for contractors and the MOD to follow when agreeing a POCO adjustment amount.
- 8.3 The POCO adjustment does not apply:
- to Single Source sub-contracts with a value less than £100,000;
  - to any profit included in sub-contracts to non-group members;
  - to any profit included in sub-contracts to group members if these subcontracts were awarded competitively; or
  - to any profit made by the sub-contractor outside the delivery of the qualifying defence contract.
- 8.4 The diagram on the next page demonstrates when a POCO adjustment should be made:





## 9. Methodology to determine the POCO adjustment for POCO

9.1 The table below demonstrates the 11 stage process that contractors and the MOD must have regard to when agreeing the POCO adjustment amount.

Stage	Ref	Process
<b>for the prime contract:</b>		
1	-	Document the expected contract supply chain, identifying all the sub-contracts at each level and whether the award of each is expected to be the result of a competitive process or not (as per regulation 61).
2	-	Identify the group sub-contracts within the supply chain which are not the result of a competitive process.
<b>for the prime contract and each group single source sub-contract:</b>		
3	Ax	Identify the applicable costs for the primary contract and each group sub-contract from Stage 2
4	Px	Calculate the: <ul style="list-style-type: none"> <li>- profit applied to each group sub-contract identified at Stage 2; and</li> <li>- profit net of Step 3 (POCO) and Step 6 (CSA), to be applied to the primary contract.</li> </ul>
<b>for the primary contract POCO adjustment:</b>		
5	$\Sigma Ax$	Sum the total applicable costs in the primary and group sub-contracts (net of primary CSAs).
6	$\square$	Calculate the contract profit rate for the prime contract net of Step 3 (POCO) and Step 6 (CSA). This will be: <i>Step 1 (BPR) +/- Step 2 (risk adj.) - Step 4 (SSRO funding adj.) + Step 5 (incentive adj.)</i> .
7	$\Sigma Ax \times \square$	Multiply the total applicable costs ( $\Sigma Ax$ ) by the profit rate ( $\square$ ). This gives the total profit the group should receive from the qualifying defence contract (net of primary contract CSAs)
8	$\Sigma Px$	Sum the total attributable profit applied at all levels (net of Step 3 and Step 6 for the primary contract)
9	$POCOR = (\Sigma Ax \times \square) - \Sigma Px$	To calculate the POCO reduction, subtract the total attributable profit applied ( $\Sigma Px$ ) from what should be allowed ( $\Sigma Ax \times \square$ ). This is the reduction to the price that will result from the Step 3 POCO adjustment.
10	AC	Determine the Allowable Costs included in the primary contract (including sub-contractor costs)
11	$POCO \text{ adj.} = \frac{POCOR}{AC}$	The POCO adjustment is the POCO reduction divided by the Allowable Costs for the primary contract. This is the Step 3 adjustment, which will result in a reduction to the profit (or zero if no profit has been charged at lower levels).

### Key:

Ax – applicable costs for the primary and group sub-contracts

Px – attributable profit for primary and group sub-contracts (net of prime Step 3 and Step 6)

$\Sigma Ax$  – total applicable costs for the contract (net of primary contract CSAs)

$\square$  – profit rate that should be applied only once, this is the CPR net of Step 3 and Step 6

$\Sigma Px$  – total profit included in the proposed contract price

POCOR – the amount Step 3 should reduce the price to ensure profit arises once (the POCO reduction)

AC – the Allowable Costs for the primary contract

POCO adjustment – the Step 3 adjustment

# SSRO funding adjustment (*Step 4*)

This adjustment does not apply until 1 April 2017

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# Incentive adjustment

## (Step 5)

### 10. Basis of incentive adjustment

- 10.1 Section 17(2) of the Act, and Regulation 11(6), set out the requirement for the incentive adjustment:

*“Where the Secretary of State determines that the amount resulting from step 4 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount (“the incentive adjustment”) specified by the Secretary of State, that amount not to exceed two percentage points.”*

- 10.2 This document provides guidance for the Secretary of State to use when determining when to apply the incentive adjustment to a qualifying defence contract or qualifying defence sub-contract and what to consider when setting the rate between zero and 2 per cent.
- 10.3 The incentive adjustment guidance is principles, rather than rules, based.

### 11. When to apply the Incentive adjustment

- 11.1 The incentive adjustment is not automatic and will be applied exceptionally for qualifying defence contracts.

- 11.2 It may be desirable for the Secretary of State to include a positive incentive:

- (a) when requesting equipment to be produced by a certain date (but not including this as a contractual requirement); or
- (b) if a contractor exceeds all its set Key Performance Indicators in the performance of a contract.

### 12. Principles of applying the Incentive adjustment

- 12.1 When considering whether to apply an incentive adjustment the Secretary of State should consider the following principles:

- (a) **The inclusion of an incentive adjustment is at the Secretary of State’s discretion.** The determination of the incentive adjustment is the responsibility of the Secretary of State, who must have regard to this guidance.
- (b) **The incentive adjustment must relate to the performance of the contract to which it applies.** The adjustment cannot be in recognition for performance on other contracts, or for performance that is not specified as a contractual requirement.
- (c) **The incentive adjustment must be used for delivering performance above the contractually required level.** The contract should be priced on the basis that a contractor

- will deliver the performance specified in the contract. Simply meeting this performance level will not result in an incentive adjustment.
- (d) **The incentive adjustment must relate to performance enhancements which benefit the Secretary of State.** The additional value delivered to the Secretary of State through the achievement of incentivised elements must be tangible and demonstrable.
- (e) **The incentive adjustment can be applied to any qualifying defence contract, or qualifying sub-contract using any regulated pricing method.** The incentive adjustment relates to performance incentives and not cost incentives. Therefore an incentive adjustment can be applied to a qualifying defence contract using any regulated pricing method.
- (f) **The incentive adjustment must be within a range of up to 2 per cent.** A positive incentive adjustment will not be applied to all qualifying defence contracts and is not an entitlement.
- (g) **The link between the incentive adjustment and performance must be simple and measurable.** The criteria for achievement must be measurable and set objectively.
- (h) **The link between the incentive adjustment and performance must be stated in the contract.** The criteria for achievement and payment must be clearly stated in the contract. This includes:
- (i) the required level of performance;
  - (ii) how it will be demonstrated;
  - (iii) when it will be measured, and
  - (iv) if incentivised performance is delivered, when incentive payments will be made.
- (i) **Incentive adjustments must not be paid if the performance results in a breach of contract (unless this is explicitly allowed for in the contract).** If a contractor is in breach of contract, they are not entitled to any incentive adjustments related to that breach of contract. Where the incentive payment has been made and a breach of contract related to the incentive materialises, then the incentive payment to the contractor will be retrieved.
- (j) **The incentive adjustment must not be linked to legal obligations.** An incentive adjustment must not be given for compliance with the Act, Regulations, or other legal obligations.
- (k) **The incentive adjustments must not be linked to a reduction in the allowable costs of the contract.** Reducing allowable costs of a contract is rewarded via the chosen regulated pricing method. The incentive adjustment must not be used to incentivise allowable cost reduction.
- 12.2 Subject only to this guidance and the maximum incentive adjustment of two percentage points provided for in Regulation 11(6), the Secretary of State can determine the amount of an incentive adjustment and when to apply an incentive adjustment to a qualifying defence contract.

# Capital Servicing Adjustment (Step 6)

## 13. Basis of Capital Servicing Adjustment

- 13.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the incentive adjustment:

*“Take the amount resulting from step 5 and add to or subtract from it an agreed amount (“the capital servicing adjustment”), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.”*

- 13.2 Regulation 11(8) requires that:

*“In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State*

- (a) must have regard to the capital servicing rates in force at the time of the agreement;*
- (b) must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are allowable costs under the contract; and*
- (c) may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor’s obligations under the contract.”*

## 14. Importance of Step 6 Adjustment

- 14.1 The capital servicing adjustment, alongside the statutory guidance on allowable costs, ensures that contractors are not only paid a return on their fixed and working capital, but that they are also compensated for the fixed and working capital costs. This is done by including depreciation as an allowable cost.
- 14.2 The three capital servicing rates published by the Secretary of State each year are:
- (a) for fixed capital;
  - (b) for positive working capital; and
  - (c) for negative working capital.
- 14.3 To determine this appropriate and reasonable return, contractors must determine the level of fixed and positive/negative working capital and apply these standard rates.

## 15. Calculating the Capital Servicing Adjustment

- 15.1 The aim of this guidance is to set out the process to be followed in order to calculate the capital servicing adjustment that will be used in Step 6 of the contract profit rate.

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- 15.2 The calculation is structured around the above-mentioned three elements of capital servicing used when fulfilling qualifying defence contract, or qualifying sub-contract obligations - fixed capital and working capital (positive and negative). These elements of capital cost when combined are classified in this guidance as being 'capital employed'.
- 15.3 The total cost of capital employed is then assessed in conjunction with the total 'cost of production' in order to apply a rate of capital servicing (by way of a ratio) that is proportionate to the level of capital employed and used in the cost of production for a qualifying defence contract or qualifying sub-contract.
- 15.4 The capital servicing rates published by the Secretary of State are then applied to determine the capital servicing adjustment to be used in Step 6 of the calculation of the contract profit rate.
- 15.5 The diagram on the next page sets out the four computations to be followed in order to determine the capital servicing adjustment. A simple worked example is described at Appendix B to this guidance.

Computation 1
Determine Ratio of Capital Employed versus Cost of Production
Fixed Capital Cost Plus Working Capital Cost (Positive or Negative) <b>EQUALS</b> Total Capital Employed
Divided by Cost of Production <b>EQUALS</b> Cost of Production as a Proportion of Capital Employed (CP:CE)

Computation 2
Determine the individual Proportions of Total Capital Employed
Fixed Capital Cost Divided by Total Capital Employed <b>EQUALS</b> Fixed Capital as a proportion of Capital Employed
Working Capital Cost (Positive or Negative) Divided by Total Capital Employed <b>EQUALS</b> Working Capital as a proportion of Capital Employed

Computation 3
Apply Capital Servicing Allowances
Fixed Capital as a proportion of Capital Employed Multiplied by Fixed Capital Servicing Allowance <b>PLUS</b> Positive Working Capital as a proportion of Capital Employed Multiplied by Positive Working Capital Servicing Allowance <b>PLUS</b> Negative Working Capital as a proportion of Capital Employed Multiplied by Negative Working Capital Servicing Allowance <b>EQUALS</b> Capital Servicing Allowance

Computation 4
Calculate the Capital Servicing Allowance for Step 6
Capital Servicing Allowance Divided by Cost of Production as a Proportion of Capital Employed (CP:CE) <b>EQUALS</b> Capital Servicing Allowance to be used in Step 6 of CPR



- 15.6 The following sections of this guidance set out the principles to be followed in order to assess the level of capital employed and the total cost of production.
- 16. Calculation of Capital Employed**
- 16.1 A contractor must initially establish the average capital employed for the unit of their business most relevant to the qualifying defence contract (or qualifying defence sub-contract), such as subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement.
- 16.2 If figures cannot reasonably be isolated then, in exceptional circumstances, capital employed can be calculated for a contractor's business as a whole.
- 16.3 The next step is to allocate the capital employed in the balance sheet (the net assets) between those items that qualify for capital servicing allowances and those that do not.
- 16.4 The list below indicates those items that will generally be excluded in determining the total capital employed:
- a. goodwill;
  - b. adverse (debit) balances in retained earnings;
  - c. investments in shares and securities;
  - d. shares held in and permanent loans to subsidiary companies being capital not employed in the business of the parent company;
  - e. cash demonstrably surplus to requirements (for example short term investments, deposits, and cash demonstrably in excess of the amount required for working cash resources for day to day operations);
  - f. capital not employed efficiently, such as:
    - i. in land and buildings not in occupation;
    - ii. plant and machinery demonstrably not in use;
    - iii. where held for speculative purposes or for long term expansion not yet planned; or
    - iv. where there has been unreasonable delay in disposal of surplus assets.
  - g. certificates of tax deposit; and
  - h. advance payments by the MOD relating to single source contracts, which should be deducted from assets and not included in capital employed.
- 16.5 The following items can generally be included in assets (these may result in an addition or a deduction from balance sheet figures dependent upon circumstances):
- a. Assets in the course of construction.
  - b. Trading balances with subsidiary, affiliate and other group companies.
  - c. Inventories, which can be included in capital employed based on costs derived from values recorded in the statutory accounts. This is subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by Auditor Attestation. If a contractor has not already done so in its balance sheet then interim payments on account of work in progress are to be deducted.
  - d. Patents and trade-marks, which may be included in capital employed to the extent that a company can demonstrate that they are 'live' and contribute to its earnings, even if they are not shown in the contractor's balance sheet.
  - e. Development expenditure, which may be included in capital employed up to the value shown in the balance sheet 'net' of provisions. This is provided that orders have been received, or

are likely to be received, for the product under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.

- f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as capital employed, and is not deducted from assets.
- g. Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed.
- h. Prepayments by the government on non-competitive contracts, calculated after adjusting the contractor's work in progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted except where otherwise agreed.
- i. Where costs are spread over several years in accordance with agreed spreading criteria any amount not written off at a balance sheet date will be included as an asset in capital employed.
- j. The net balance sheet figure for debtors is included in capital employed.

16.6 Further general adjustments will then be applied in addition to creditors' figures captured in the financial statements.

- a. Where non-current assets have been acquired under finance leases, the amount included in the balance sheet as a creditor will be treated as a source of capital, and therefore not deducted.
- b. All loans (including bank overdrafts) are treated as a

source of capital, and therefore not deducted.

- c. Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed moneys such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.
- d. Mainstream corporation tax and deferred taxation are treated as a source of capital, and therefore not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.
- e. Launch aid is usually treated as a creditor in computing capital employed, and as such is deducted from launching costs as the equivalent of cash on account of work done.
- f. Declared dividends are treated as a source of capital, and therefore not deducted.
- g. Provisions for future cost liabilities, where excluded from allowable costs should be treated as a source of capital, and therefore not deducted.

16.7 Provided no further adjustment has taken place in the group accounts, a contractor's total capital employed is taken as being the average of its total net assets as shown in the relevant opening and closing balance sheets for the entity for the period under review.

#### Fixed and Working Capital

16.8 In order to calculate the split of total capital employed between fixed and working capital (positive

or negative), consideration needs to be given to identify those costs that are obviously 'fixed' in nature from the balance sheet. This figure is then subtracted from the total capital employed figure (as described above) and the balance is then determined as being 'working capital' for these purposes.

## 17. Calculation of Cost of Production

17.1 The information required for the calculation of cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as the financial or management accounts. It will normally include all of the material, labour and overhead costs of the business unit subject to adjustment for certain items outlined in the paragraphs below.

17.2 Costs of production, annualised where appropriate, is computed for the same relevant unit for which capital employed is computed. Among other items, it should include:

- a. direct costs; and
- b. indirect costs, with the exception of those items set out below.

17.3 However, it should exclude :

- a. capital expenditure;
- b. the cost of raising and servicing loan capital;
- c. distribution of profits;
- d. notional transactions;
- e. costs related to assets excluded from capital employed;
- f. discounts allowed on sales;
- g. any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim;
- h. the cost of premiums and payments for insurance which cover:
  - i. that element of consequential loss insurance that relates to

loss of profit; and

- ii. the contractor's own defects in materials or workmanship incident to the normal course of construction, such as the costs to repair defects in materials or workmanship, and for breach of contract;
- i. compensation payments of an abnormal nature to the extent that they are excluded from overheads;
- j. lump sum additions to pension schemes to the extent that they are excluded from overheads;
- k. subscriptions and donations of a political or charitable nature; and
- l. credits, grants or refunds deducted from overheads.

### Calculation of capital services adjustment

17.4 Having followed the processes outlined above, the information available should then be sufficient to allow the four computations to be completed.

17.5 Appendix B to this document sets out a worked example of the calculations required having determined the key information.

# Opinions and Determinations

## 18. Opinions and Determinations

- 18.1 Section 35(1) of the Act requires the SSRO to give an opinion or make a determination on the appropriateness of the cost risk adjustment, profit on cost once adjustment, and capital services adjustment, on referral from:
- (a) the Secretary of State;
  - (b) an authorised person;
  - (c) the primary contractor; or
  - (d) the person who proposes to enter into the contract with the Secretary of State (in the case of a proposed contract).
- 18.2 In making a determination, the SSRO must have regard to the information that was available to each party and the statutory guidance in place, at the time of the agreement and the terms of the contract.

# Appendix A: Glossary of terms

## **Group sub-contract**

Group sub-contract means a contract:

- (a) the price payable under which includes an amount of profit;
- (b) which is made between the primary contractor and any person associated with the primary contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of the qualifying defence contract.

## **Further Group sub-contract**

Further group sub-contract means a contract:

- (a) the price payable under which includes an amount of profit;
- (b) which is made between two or more persons, each of which is associated with the primary contractor or a group sub-contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of a competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of a group sub-contract or further group sub-contract.

## **Attributable Profit**

The attributable profit is:

- (a) where all of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, all the profit element in the price payable under that group sub-contract or further group sub-contract;

- (b) where only part of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, that part of the profit element in the price payable under that group sub-contract or further group sub-contract which relates to the output necessary for that performance.

Attributable profit does not include:

- (a) any capital servicing adjustment made under step 6 of regulation 11;
- (b) any profit which is received by a person which is not associated with the primary contractor.

**Group Sub-contractor**

A group sub-contractor means a person with which the primary contractor makes a group sub-contract.

**Applicable Costs**

For the purpose of the POCO adjustment calculations, Applicable Costs includes allowable costs but excludes the attributable profit.

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# Appendix B: Worked Example for Capital Servicing Adjustment

The worked example shown below incorporates the four main computations that need to be followed in order to determine the capital services adjustment in step 6 of the CPR.

To aid the worked example shown below we have provided the following illustrative information:

1. Total Capital Employed:
  - Example a): £4,000,000;
  - Example b): £4,500,000; and
  - Example c): £2,500,000.
2. Fixed Working Capital: £3,000,000 (in all three examples).
3. Working Capital (by way of calculation i.e. total capital employed less fixed working capital):
  - Example a): £1,000,000;
  - Example b): £1,500,000; and
  - Example c): (£500,000).
4. Cost of Production: £6,000,000 (in all three examples).

**This therefore allows “Computation 1” to be completed, although it will be based on actual figures for individual contractors.**

This worked example uses the following recently-published capital servicing rates for 2015:

- Fixed Capital Servicing Allowance: 5.94%;
- Working Capital Servicing Allowance for positive working capital: 1.72%; and
- Working Capital Servicing Allowance for negative working capital: 1.03%.

These rates, published annually, are as provided in the SSRO 2015 Contract Profit Rate document.

	Example (a)	Example (b)	Example (c)
<b>CP:CE ratio calculation:</b>			
(a) Fixed capital	£3,000,000	£3,000,000	£3,000,000
(b) Working capital	£1,000,000	£1,500,000	(£500,000)
(c) Total capital employed	£4,000,000	£4,500,000	£2,500,000
(d) Total cost of production	£6,000,000	£6,000,000	£6,000,000
(e) CP:CE ratio (D/C)	1.50	1.33	2.4
<b>This completes Computation 1</b>			
<b>Computation 2</b>			
(f) Fixed Capital as a proportion of Capital Employed (a / c)	0.75	0.66	1.20
(g) Positive Working Capital as a proportion of Capital Employed (b / c)	0.25	0.34	-
(h) Negative Working Capital as a proportion of Capital Employed (b / c)	-	-	(0.20)
<b>Capital Servicing Allowances (published annually but given in this worked example)</b>			
(i) Fixed Capital Servicing Allowance	5.94%	5.94%	5.94%
(ii) Working Capital Servicing Allowance (positive)	1.72%	1.72%	1.72%
(iii) Working Capital Servicing Allowance (negative)	1.03%	1.03%	1.03%
<b>Computation 3</b>			
Fixed Capital Servicing Allowance (f x i)	4.46%	3.92%	7.13%
Positive Working Capital Servicing Allowance (g x ii)	0.43%	0.58%	(0.20%)
Negative Working Capital Servicing Allowance (h x iii)	-	-	
<b>Capital Servicing Allowance "x"</b>	<b>4.89%</b>	<b>4.50%</b>	<b>6.93%</b>
<b>Computation 4</b>			
Capital Servicing Allowance for step 6 ("x" / e)	3.26%	3.38%	2.89%



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