

SSRO

Single Source
Regulations Office

Assuring value, building confidence

2017/18 Profit rate consultation

July 2016

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Introduction

1. Introduction

- 1.1. This consultation document explains how the SSRO intends to update its profit rate methodology and adjustment guidance in recommending multiple rates and to implement the SSRO funding adjustment ('Step 4') for 2017/18.
- 1.2. This document sets out the reasons the SSRO has selected six baseline profit rates and the activity types that underpin them. It explains how the SSRO intends to calculate the baseline profit rates and how they should be used to determine the contract profit rate. It concludes by setting out the SSRO's approach to calculating the funding adjustment step in recommending the baseline profit rate.
- 1.3. A feature of the MOD's single source procurement is that it covers a wide variety of functionally diverse contracts. These can include for example the development of capital assets for transfer to the MOD and the leasing of existing privately-owned capital for use by the MOD, through to contracts requiring the contractor to incur operating costs only, and facility maintenance.
- 1.4. In 2016/17 we considered recommending multiple baseline profit rates, but postponed this following the receipt of statutory guidance from the Secretary of State. For 2017/18 the SSRO is planning to recommend six baseline profit rates because there is no single group of comparable companies that covers all aspects of work done under single source contracts. An approach involving multiple rates will help ensure credibility, providing more appropriate returns that are demonstrably fair and reasonable, as well as representing value for money for the taxpayer. From our research, no other country sets a single profit rate for all types of defence contract¹.
- 1.5. The SSRO's 'develop and make', 'provide and maintain', 'construction' and 'ancillary services' activity types incorporate a range of activities relating to the design, development, manufacture, servicing and capacity provision of equipment, engineering, construction, IT support, facilities support and administrative services.

¹ USA, Canada, Germany, France, Netherlands and Australia

Background

2. 2015 methodology consultation

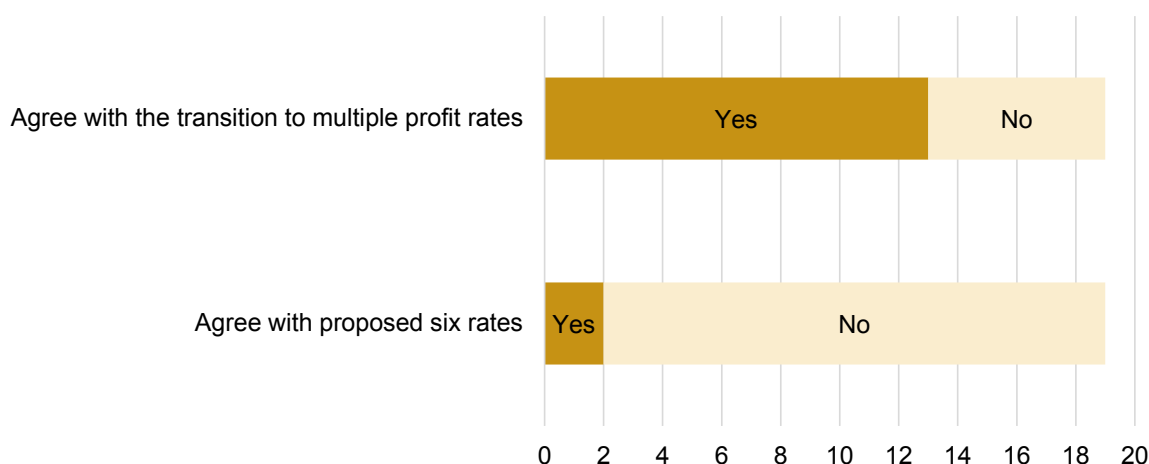
- 2.1. In deciding how to recommend the 2016/17 rates, the SSRO concluded that a single baseline profit rate did not allow for the diversity of products and services covered in single source contracts.
- 2.2. On 25 September 2015, the SSRO issued its proposed baseline profit methodology and launched a public consultation. The consultation closed on 20 November 2015. The SSRO consulted on a new approach based on setting the following multiple baseline profit rates:
- contract manufacture;
 - contract design and development;
 - ancillary support services;
 - equipment upkeep,
 - maintenance and support (including training);
 - capacity provision; and
 - IT.
- 2.3. The SSRO asked two questions about multiple rates in its 2015 methodology consultation. The responses and the SSRO's conclusions on these particular questions are included here. The SSRO considered all feedback it received from the consultation. Full details about other aspects of this consultation, including the SSRO's response can be found on the [SSRO website](#).

Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

- 2.4. Around two thirds of respondents stated that they agreed with the transition to multiple profit rates based on contract activity. A similar number of respondents also highlighted that introducing multiple baseline profit rates could add complexity to the methodology and application of the rates in practice (12 out of 19).

Do you agree with the six types of activity for which baseline profit rates will be provided?

- 2.5. Few stakeholders who responded to the consultation agreed with the proposed six activity types (set out at paragraph 2.2). Around two thirds of respondents stated the proposed activity types did not accurately reflect the nature of work undertaken in single source contracts or that work on QDCs did not neatly fit into the proposed categories.

Figure 1: Responses to September 2015 questions on multiple rates

- 2.6. Some respondents made suggestions for additional activity types, including 'prime contracting and systems integration', 'preproduction activity' and 'provision of nuclear related services'. Other suggested categories included a 'zero profit rate' for contracts with not-for-profit organisations; a 'pass-through' category for items where the MOD has taken on the majority of price or performance risk on sub-contracts; and rates for 'facilities and commodities', including back office functions, construction and 'manufacture of and support of specialised military equipment'.
- 2.7. Some respondents expressed a concern that dividing companies into smaller reference groups by activity type would lead to greater volatility in baseline profit rates, and that stability in rates for long term planning was needed.
- 2.8. Around two thirds of respondents stated there was a need for clear definitions of the type of work covered by each activity category. Stakeholders stated that this would assist with allocating QDCs to activity types, particularly where contracts cover multiple activities, and would help to avoid extended contract negotiations between contractors and the MOD.

3. Response to the 2016/17 consultation and proposals for 2017/18 multiple baseline profit rates

- 3.1. After careful consideration of the response to the September 2015 consultation, the SSRO changed the baseline profit rates it had been intending to recommend for 2016/17.
- 3.2. The SSRO has previously said that it “will work towards having multiple profit rates in future, for adoption first in 2017/18”². This has been made clear in communications with the MOD and industry. In deciding the appropriate multiple rates to recommend for 2017/18, the SSRO considers that those developed in response to the 2015 methodology consultation are appropriate (paragraph 3.3). The SSRO is now engaging with its stakeholders to gather further feedback on this proposal.
- 3.3. The multiple rates have been changed from the September 2015 proposals in order to simplify their application to QDCs. Consolidating activity types also increases the number of comparator companies in each activity reference group, and increases the stability of the rates over time. These are associated with four separate activity types, a composite activity category (as was used for recommending the 2016/17 baseline profit rate) and a zero rate. The six rates are:
 - develop and make;
 - provide and maintain;
 - ancillary services;
 - construction;
 - a composite rate for ‘develop and make’ and ‘provide and maintain’; and
 - a zero rate category for contracts with organisations that are not permitted or do not wish to make a profit and/or where the MOD and contractor agree a zero rate is appropriate.
- 3.4. The SSRO believes these activity types appropriately cover the range of contract activities within QDCs, as well as keeping the implementation of multiple rates simple.

Develop and make, provide and maintain, ancillary services and construction

- 3.5. The ‘develop and make’ and ‘provide and maintain’ activity types incorporate a broader range of activities than in the initially proposed six categories. This simplifies the allocation of QDCs to baseline profit rates, particularly where there are multiple activities included in a contract.
- 3.6. Manufacturing and design contract activities will attract the ‘develop and make’ baseline profit rate. The comparator companies in this reference group are not restricted to those undertaking ‘contract’ work and so may include companies that produce speculative development products. In-service and capacity provision contract activities will use the rate for ‘provide and maintain’.
- 3.7. Separate rates for ‘ancillary services’ and ‘construction’ are recommended as the SSRO believes any QDCs for these services should receive an appropriate reward for the routine work carried out under these contracts and should be differentiated from more complex activities. It would be usual for both ancillary services and construction contracts to be competed.
- 3.8. The SSRO believes that the majority of additional activity types suggested to the SSRO have been related to military equipment and services, so are incorporated within the revised activity types. However, construction activities were highlighted in the September 2015 consultation and the SSRO believes that these activities should also attract a separate rate, to differentiate these from work related to military equipment and services. Therefore a ‘construction’ baseline profit rate is recommended.

² Press release, 21 January 2016, New method for calculating profit rate on single source defence contracts announced by SSRO

Composite rate

- 3.9. A composite rate for contracts including 'develop and make' and 'provide and maintain' activities is recommended, as the SSRO recognises there may be some QDCs which include activities related to both of these activity types. The composite profit rate was calculated by taking a simple average of the two profit rates for the 'develop and make' activity type and the 'provide and maintain' activity type. This composite rate should be used where there are significant elements of both 'develop and make' and 'provide and maintain' activities in one contract. The rate is set at the mean of the two underlying activity types.

Zero rate

- 3.10. The SSRO is also recommending a 'zero rate' to be used where the contract is with an organisation that is not permitted or does not wish to make a profit or where both parties agree that a zero rate is appropriate. Under current legislation this could not be achieved without the creation of a zero profit rate.

4. Calculation of multiple baseline profit rates for 2017/18

- 4.1. In overview, the SSRO's published methodology that will be applied to assess multiple rates, identifies comparable companies tailored to the activities, including assets and contract risks, involved in QDCs and QSCs. These companies form the comparator reference groups for each activity type. The characteristics of comparable companies analysed for each of the 'ancillary services' and 'construction' activity types are at Appendix A. The characteristics are unchanged from 2016/17 for the 'develop and make' and 'provide and maintain' activity types³.
- 4.2. As part of the process, NACE Rev 2 industry codes and relevant text search terms are used to identify the basket of comparable companies for each activity type. The NACE codes and text search terms the SSRO intends to use for the 'ancillary services' activity type and the 'construction' activity type are at Appendix B. There are no selection criteria for the zero rate.

5. Principles of application of appropriate baseline profit rate

- 5.1. The following paragraphs set out proposed guidance on when a single activity type rate, the composite activity rate or a zero baseline profit rate should be used.

Single activity type contract

- 5.2. The MOD and the contractor should choose an appropriate baseline profit rate of those listed at 3.1 that best applies to the contract requirements. In doing so the MOD and the contractor should have regard to the descriptions of typical work activities in Table 1 below.
- 5.3. In principle, one method of determining the appropriate baseline profit rate should be on the basis of the main contract activity, according to the Allowable Costs. For example, the main contract activity type could be determined by assigning the contractor's obligations to each activity type category and apportioning the total Allowable Costs associated with these to each category. The main contract activity is the category with the greatest proportion of Allowable Costs.
- 5.4. The SSRO acknowledges that a number of functions will need to be performed in contracts where there is one main activity type. However, the baseline profit rate for the main activity, rather than for all input activities, should be selected for the whole contract.

³ The pre-existing selection criteria for 'Develop and make' and 'Provide and maintain' are published in the SSRO's March 2016 Baseline profit and capital servicing rates methodology.

Composite rate for 'develop and make' and 'provide and maintain'

- 5.5. As a guide, if the proportion of the activities ('develop and make' and 'provide and maintain') are both in excess of one third of the total Allowable Costs then consideration should be given to using this composite rate.
- 5.6. Where the MOD and contractor agree that there is more than one activity type, the MOD and the contractor can also agree to use separate contracts for each activity and apply the appropriate baseline profit rate to each contract.
- 5.7. The contract pricing method used does not affect the selection of a baseline profit rate.

Zero profit rate contracts

- 5.8. There may be circumstances in which the MOD desires to enter into a contract with an organisation that is not permitted or does not wish to make a profit. In these circumstances the MOD and contractor should agree to apply a zero rate. A consequence of using this zero rate should be that a Step 2 risk adjustment of zero should also be applied.

6. Hindsight review of QDCs

- 6.1. In order to demonstrate that a 'develop and make' or a 'provide and maintain' activity type can be easily matched to a defence contract we have assigned one of these types to the existing 38 QDCs which the SSRO has been notified of in 2015/16 and so far in 2016/17. The result is shown in Figure 2.

Figure 2: First 38 QDCs/QSCs by activity type category (as at 1 June 2016)
- contract numbers

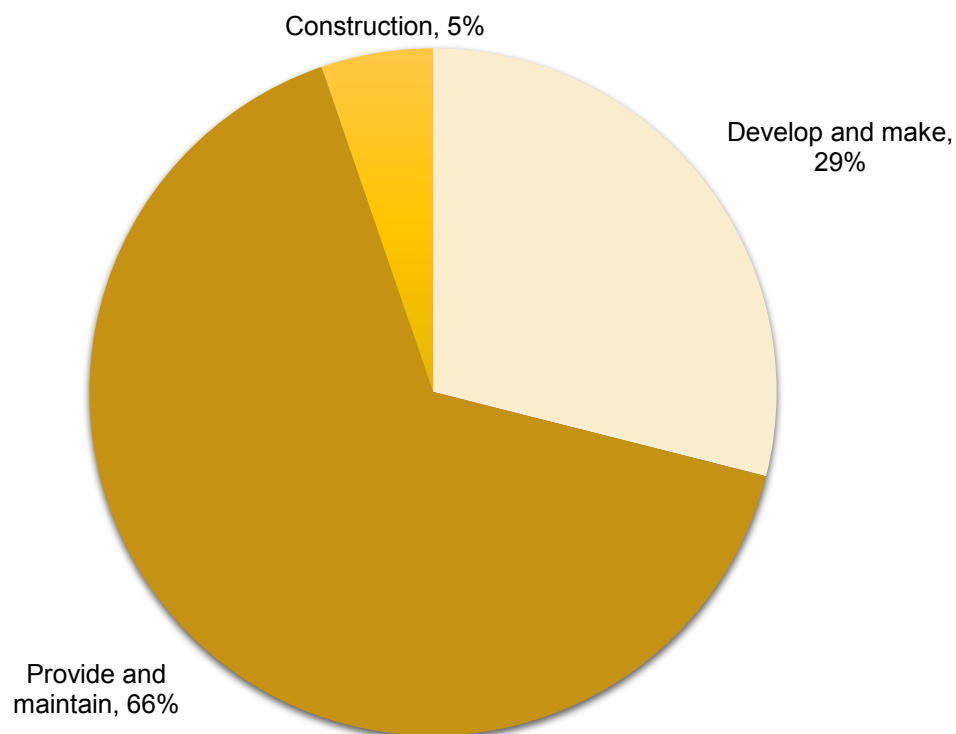


Table 1: Baseline profit rates and example contract activities within each category

Rate	Description of category
1. Develop and make	<p>This category includes manufacturing or assembly of goods or equipment to order based on designs or specifications provided. It also covers the disposal of equipment, the purchase of long-lead items for manufacture, prime contracting and systems integration and upgrade activities.</p> <p>It also includes research, design and development of technical intellectual property for goods, equipment, engineering or software performed to order, typically in line with any agreed design brief or specification.</p> <p>Activities within concept, assessment, demonstration, manufacture and disposal phase contracts should fall within this category.</p>
2. Provide and maintain	<p>This category includes any work undertaken that either provides the MOD with a capability where the contractor owns the assets, or where the contract covers work on in-service equipment.</p> <p>It includes servicing and upkeep for the MOD owned equipment, including ongoing engineering and maintenance and includes training related to the introduction and operation of equipment.</p> <p>Activities within 'in-service' phase contracts and contracts for the provision of availability of equipment should typically fall within this category. Provision of asset hours (for example flying hours for an aircraft) through hiring out or leasing equipment to the MOD should also be included.</p>
3. Ancillary services	<p>This category includes back office and routine support services, for example clerical work or upkeep of grounds and facilities.</p> <p>Typical activities include IT support services (for example data processing, network hosting, IT repairs and maintenance, IT security services); facilities support services (for example property cleaning, property repairs and maintenance, gardening, security services); and administrative support services (for example business outsourcing such as data management, bookkeeping).</p>
4. Construction	<p>This category applies to contracts for construction or related activities which include architectural, engineering and/or building services. The buildings or sites being constructed, designed or planned would include, for example, those that are industrial or commercial in nature i.e. factories, warehouses, docks, plants, metal structures and office accommodation.</p>
5. Composite rate for 'develop and make' and 'provide and maintain'	<p>This category should include a combination of 'develop and make' and 'provide and maintain' activities. This rate should be used when both proportions of 'develop and make' and 'provide and maintain' activities are in excess of one third of the total contract costs.</p>
6. Zero rate	<p>This category should apply to a contract with a supplier which is not permitted or does not wish to make a profit and/or when the MOD and contractor agree that a zero rate is appropriate.</p>

7. The SSRO funding adjustment

- 7.1 The SSRO's view is that a levy or licence would be a superior funding mechanism but would require legislative change to implement. We have engaged with our key stakeholders on this issue, but insufficient support was received to justify the SSRO recommending an immediate alternative to the funding adjustment. The SSRO will continue its longer term consultation on the funding adjustment as part of its review of the Defence Reform Act and Single Source Contract Regulations.

- 7.2 This section sets out the SSRO's intended approach to calculate the funding adjustment.

Calculation and application of the funding adjustment

- 7.3 The method to calculate the funding adjustment calculation is intended to set it at a level that allows the MOD to recover half of the SSRO's costs through a reduction in the amounts paid on single source contracts shared across contractors based upon the value of their QDCs.

- 7.4 The SSRO funding adjustment is calculated as:

SSRO funding adjustment =

$$\frac{\text{SSRO costs - costs of additional tasks requested by the Secretary of State}}{\text{Total value of QDCs}}$$

- 7.5 The SSRO costs and the costs of additional tasks requested by the Secretary of State are the arithmetic averages of the three full financial years preceding the year of the recommendation. All SSRO costs including referrals and one-off items will be included unless specifically incurred as a result of a request for additional work by the Secretary of State. The part year costs incurred during the set-up year (2014/15) and costs incurred by the MOD in establishing the SSRO will not be included.
- 7.6 SSRO costs and the costs of additional tasks requested by the Secretary of State will be drawn from the audited financial statements in the preceding three financial years. Where audited financial information is not yet available for three years it will be based on those years that are available. For the 2017/18 funding adjustment the SSRO will use audited financial information for the year 2015/16 only.
- 7.7 The total value of QDCs will be an arithmetic average of the annual sum of the Total Allowable Costs (including any Risk Contingency Allowance) values reported in the Contract Pricing Statement Report for all QDCs signed in each of the three preceding financial years. Where contract amendments are made the most recently reported values will be used but each contract will be included only once in the calculation.
- 7.8 QDC data will be drawn from the period which aligns to that used for SSRO running costs. Where information is not available for three years it will be based on those years that are available. For the 2017/18 funding adjustment the SSRO will use reported Allowable Cost values from 1 April 2015 until 31 March 2016.
- 7.9 The SSRO expects the MOD to reconcile the intended and actual level of recovery at contract closure. A review will take place every five years of the level of SSRO cost recovery by the MOD and an assessment made of any under- or over-recovery from contracts concluded in the previous five years. This may result in a further adjustment being made if it is practical and proportionate to do so.
- 7.10 The funding arising from the calculation set out above is subtracted from the amount arising from Step 3 in the six step process to determine the contract profit rate.

8. Related publications

- 8.1 Examples to illustrate the direction of travel of the [Baseline profit and capital servicing rates methodology 2017/18](#) and [Guidance on adjustments to the baseline profit rate 2017/18](#) have been published alongside this consultation document. The first of these explains the process by which the SSRO calculates the baseline profit rate(s), capital servicing rates and the SSRO funding adjustment. The second is concerned with the application of these, by contractors, in determining a contract profit rate.

Appendix A – Comparable companies analysed

Table A1 – Characteristics of comparable companies analysed

Rate	Types of companies analysed
Construction	<p>Companies that undertake construction of an industrial nature (for example factories, warehouses, plants or metal structures).</p> <p>Companies that undertake construction activities on a contract basis (with constructions based on designs and specifications received).</p> <p>The companies undertake pure construction or engineering activities and do not own or hold land for long term appreciation purposes.</p> <p>The companies do not bear any significant market risk in respect of the buildings or sites they are constructing.</p> <p>Companies undertaking construction activities that bear contract risk, procurement risk, staff risk and some quality control risk in respect of these activities, and are responsible for the management of the construction project.</p> <p>Companies undertaking comparable construction activities are not expected to own land banks and, as such, developers of residential properties are not considered comparable.</p> <p>Companies involved in comparable construction activities including architectural, engineering and/or building activities.</p>
Ancillary Services	<p>Companies undertaking:</p> <ul style="list-style-type: none"> • IT support services (for example data processing, network hosting, IT repairs and maintenance and IT security services) • Facilities support services (for example property cleaning, property repairs and maintenance, gardening and security services) • Administrative support services (for example business outsourcing such as data management, bookkeeping and clerical work) • Companies undertaking these support services which do not bear any significant risks other than the risk of failing to provide the contracted support services

Appendix B – Industry codes and text search terms used in activity type search strategies

Table B1 – Industry codes (NACE Rev 2) and Text Search terms used in Construction search strategy

Construction	
NACE Rev 2 codes	2511 – Manufacture of metal structures
	2599 – Manufacture of other fabricated metal products
	2891 – Manufacture of machinery for metallurgy
	2892 – Manufacture of machinery for mining, quarrying and construction
	2899 – Manufacture of other special purpose machinery
	4110 – Development of building projects
	4120 – Construction of residential and non-residential buildings
	4211 – Construction of roads and motorways
	4213 – Construction of bridges and tunnels
	4291 – Construction of water projects
	4299 – Construction of other civil engineering projects
	4311 – Demolition
	4312 – Site preparation
	4329 – Other construction installation
	4390 – Other specialised construction activities
Text search:	(construct* or build* or engineer* or architect*)

Table B2 – Industry codes (NACE Rev 2) and Text Search terms used in Ancillary Services search strategy

Ancillary Services	
NACE Rev 2 codes	6311 - Data processing, hosting and related activities
	6312 – Web portals
	8110 - Combined facilities support activities
	8121 - General cleaning of buildings
	8122 - Other building and industrial cleaning activities
	8129 - Other cleaning activities
	8211 – Combined office administrative service activities
	8219 – Photocopying, document preparation and other specialised office support activities
	8291 – Activities of collection agencies and credit bureaus
	8292 – Packaging activities
	8299 – Other business support service activities
Text search:	(outsourc* or support* or maint*) OR ((clean* or maint* or facil* or industr* or upkeep*) OR (office* or data* or cleric* or admin* or IT!))

