SSRO

Single Source Regulations Office

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Profit rates reported in Qualifying Defence Contracts 2015/16

25 May 2016

Defence suppliers are required to submit data about qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs) to the Single Source Regulations Office (SSRO).

This report provides an analysis of the planned contract profit rates reported in the contract pricing statements (CPS) for 30 QDCs/QSCs entered into within the period 1 April 2015 to 31 March 2016. The SSRO was notified by the Ministry of Defence of 34 QDCs/QSCs signed during this period and had only received data from suppliers for 30 of these contracts, at the time these statistics were prepared. Four suppliers had failed to submit their CPS report at this time and this will be highlighted in the SSRO's Annual Compliance Report. Data presented is as submitted by the suppliers. All figures are provisional, and may be updated in future statistical releases.

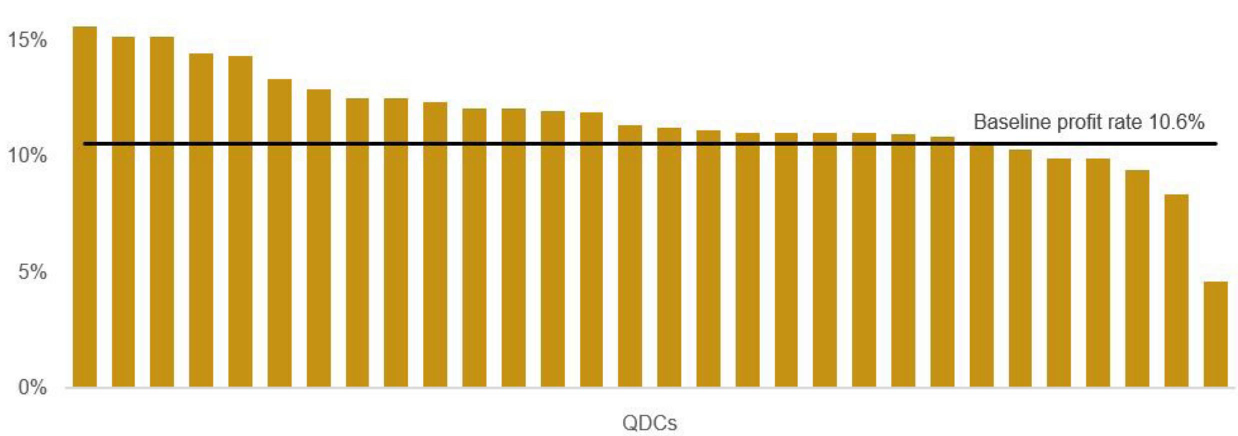
The contract profit rates reported are those used for contract pricing purposes, and may not reflect the profit rates earned by suppliers once contracts are completed. The contract profit rate is calculated using six steps, as further explained in the 'Contract Profit Rate adjustments' section below.

Key points

- On average, QDCs/QSCs reported a contract profit rate of 11.7 per cent in 2015/16. Excluding the Profit On Cost Once (POCO) adjustment, it was 12.0 per cent.
- Contract profit rates for individual QDCs/QSCs ranged from around 5 per cent to just under 16 per cent.
- The largest average adjustment to the baseline profit rate was for capital servicing, at an average of 1.2 percentage points.

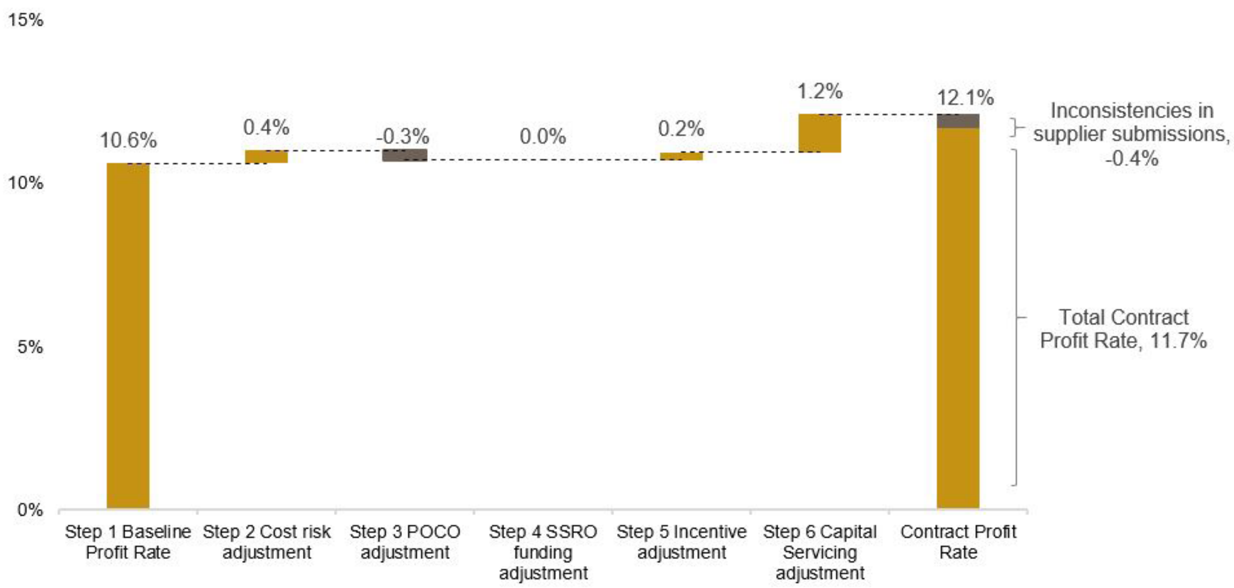
Figure 1 shows the range of contract profit rates reported in QDCs/QSCs in 2015/16. All but seven of these contracts reported a higher contract profit rate than the baseline profit rate of 10.6 per cent, once the subsequent steps had been applied.

Figure 1: Contract profit rates reported in individual QDCs/QSCs in 2015/16



The average adjustment for each of the profit rate steps for all 30 QDCs/QSCs is shown in Figure 2 below. The average contract profit rate reported was 11.7 per cent in 2015/16. The largest average adjustment to the baseline profit rate was for capital servicing, at an average of 1.2 percentage points. The average cost risk adjustment was 0.4 percentage points; this adjustment can be either positive or negative according to the risk of variation between estimated contract costs and actual costs. The baseline profit rate was fixed at 10.6 per cent during 2015/16, and the SSRO funding adjustment was not applicable during this period. See Figure 4 for an overview of how the contract profit rate is calculated using the six steps.

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



Note: the average profit rate adjustments do not sum exactly to the average contract profit rate reported by suppliers. The difference of 0.4 percentage points is due to inconsistencies within five submitted QDC/QSC reports that are currently being investigated by the SSRO.

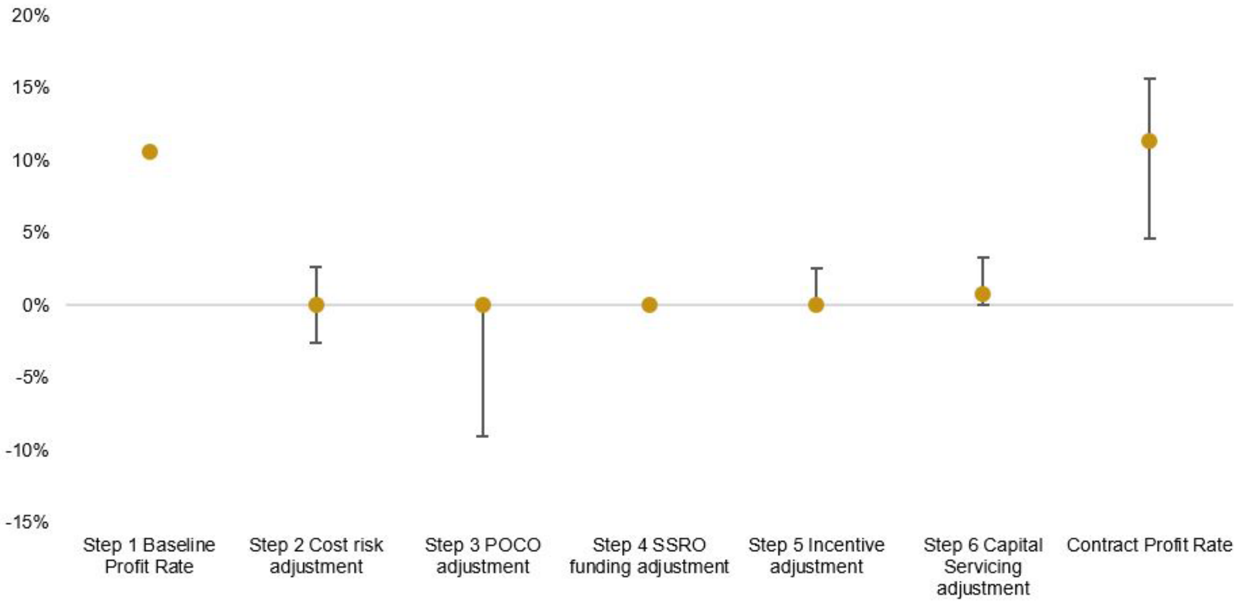
Figure 3 shows the minimum, median and maximum profit rate adjustments reported by suppliers (bars denote minimum and maximum values).

The POCO adjustment[1] had the largest range in values, from around 0 to minus 9 percentage points. The POCO adjustment will always be a zero or negative adjustment. The cost risk adjustment showed the second largest range of values (approximately 5 percentage points). Six contracts reported a negative cost risk adjustment, whilst 14 had a positive cost risk adjustment, and 10 reported a zero risk adjustment. Three QDCs/QSCs reported the maximum positive cost risk adjustment (+25 per cent of the baseline profit rate), whilst one QDC/QSC reported the maximum negative adjustment (-25 per cent of the baseline profit rate).

Four out of 30 QDCs/QSCs reported an incentive adjustment, and 23 QDC/QSCs reported a positive capital servicing adjustment, whilst seven reported a zero adjustment for capital servicing.

1 The profit on cost once (POCO) adjustment ensures that if a party to a QDC enters into a single source sub-contract with another group member, and this group sub-contract is necessary to enable the performance of the QDC, then profit arises only once in relation to Allowable Costs included in the group sub-contract price.

Figure 3: Median and range of profit rate adjustments for QDCs/QSCs in 2015/16



Data sources and methodology

The data in this report is sourced from the contract pricing statements, 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 by amendment). The template CPS and user guide is available on the SSRO's website. Data from these reports are collated in the Defence Contract Analysis and Reporting System (DefCARS).

Only QDCs/QSCs which reported a 'contract signed date' before 1 April 2016 have been included in this release, as notified to the SSRO by the Ministry of Defence, separate to the submitted CPS reports.

Averages for each of the profit rate steps include all data points including where an adjustment does not apply (as is the case with the POCO adjustment for many QDC/QSCs). This is treated as a zero in the calculations.

The SSRO makes an annual recommendation to the Secretary of State for Defence in relation to the baseline profit rate to be used each year. Under Section 19(2) of the Defence Reform Act the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate and capital servicing rates.

The SSRO's methodology for calculating the baseline profit rate uses a 'net cost plus' profit measure (otherwise known as 'return on total cost'). This is calculated by dividing operating profit (Earnings Before Interest and Tax) by total expenses (Revenue minus Earnings Before Interest and Tax). The baseline profit rate is adjusted for capital servicing, which may be added back into the final contract profit rate, through the Step 6 capital servicing adjustment.

As mentioned, this release uses profit rates agreed for pricing purposes, and may not reflect actual profit rates achieved at the end of the contract. For example, incentive adjustments are included, but these may or may not apply to the final contract price, depending on the outcome of the contract. The SSRO will also publish statistics on the actual profit rates achieved in contracts, once this data has been collected following contract completion.

The contract price is determined by multiplying the contract profit rate by the Allowable Costs in a contract, and then adding this to the Allowable Costs.

All figures are provisional, and may be updated in future statistical releases.

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 statement on its website.

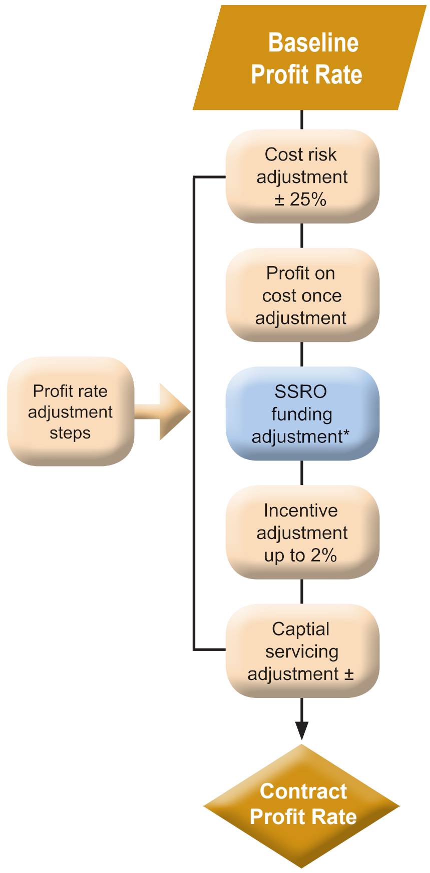
Further information

The SSRO welcomes any queries or feedback you may have on this statistical release. If you would like to get in touch, please email us at helpdesk@ssro.gov.uk.

Adjustments to the baseline profit rate

The Defence Reform Act 2014 and the Single Source Contract Regulations 2014 together prescribe a six-step process which must be used to determine the contract profit rate for a QDC or QSC.

Figure 4: Profit rate adjustment steps



* Not applicable until 2017

- **Step 1:** Baseline profit rate, set by the Secretary of State for Defence each year.
- **Step 2:** Cost risk adjustment, to reflect the risk of the contractor's actual costs under the contract differing from its estimated costs, up to a maximum of plus or minus 25 per cent of the baseline profit rate.
- **Step 3:** Profit on cost once (POCO) adjustment, to ensure that profit arises only once in relation to those Allowable Costs under the contract in respect of which the Single Source Contract Regulations 2014 provide that a deduction may be made.
- **Step 4:** SSRO funding adjustment, not in effect until 1 April 2017.
- **Step 5:** Incentive adjustment, where the SofS decides to give the primary contract a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State. Any increase must not exceed the maximum increase of 2 per cent.
- **Step 6:** Capital servicing adjustment, 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 purpose of enabling the primary contractor to perform the contract.

For further information on the profit rate adjustments, refer to the SSRO's Guidance on adjustments to the baseline profit rate.