



SSRO

Single Source
Regulations Office

Assuring value, building confidence

Contract Profit Rate

Guidance on adjustments to the Baseline Profit
Rate - January 2016

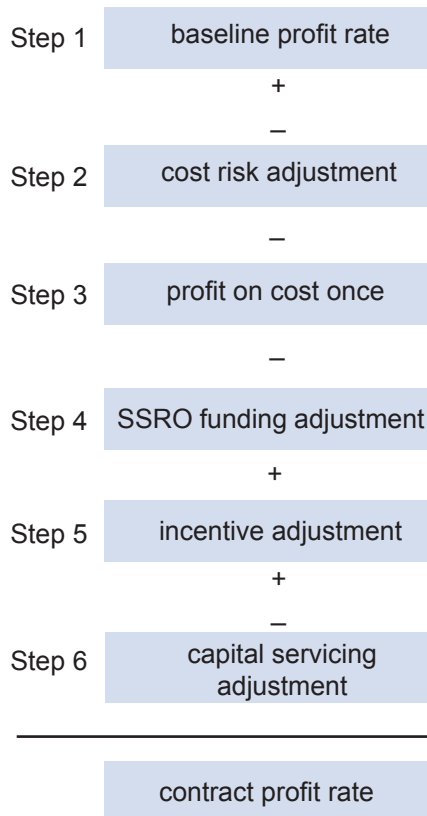
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Introduction

1. About this Guidance

1.1 Section 17(2) of the Defence Reform Act 2014 (the “Act”) and Regulation 11 of the Single Source Contract Regulations 2014 (the “Regulations”) require that the contract profit rate for any qualifying defence contract must be calculated by taking the following six steps:



1.2 In accordance with Section 30 of the Act, Part 2 of the Act and the Regulations “apply to qualifying subcontracts (and to subcontractors) as they apply to qualifying defence contracts (and to primary contractors).” This means that the six steps also apply to calculating the profit rate for qualifying subcontracts.

1.3 Section 18 of the Act provides for the Single Source Regulations Office (SSRO) to issue guidance in relation to the steps set out in section 17(2).

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

- Step 1 – baseline profit rate;
- Step 2 - cost risk adjustment;
- Step 3 - profit on cost once adjustment;
- Step 4 - SSRO funding adjustment;
- Step 5 - incentive adjustment; and
- Step 6 - capital servicing adjustment.

2. Application of this Guidance

2.1 This is statutory guidance issued by the SSRO under Section 18(1) of the Act. It applies to all qualifying defence contracts and qualifying subcontracts. It is a legal requirement to have regard to this guidance.

2.2 This document provides guidance on the adjustments to make to the baseline profit rate when determining the contract profit rate for all qualifying defence contracts and qualifying subcontracts.

3. Statutory Reports

- 3.1 In relation to any qualifying defence contract, or qualifying subcontract, the primary contractor (or subcontractor) must provide statutory reports as described in Part 5 of the Regulations.
- 3.2 Regulation 23(1) requires a contract pricing statement be provided for the qualifying defence contract within one month of the initial reporting date. Additional information can be found in the user guide for the contract pricing statement.
- 3.3 As stated in Regulation 23(2)(d) the Contract Pricing Statement has to describe the calculation made under Regulation 11 to determine the contract profit rate. This includes all adjustments that were made under steps 1 to 6 as detailed in this guidance document. The calculation is detailed in the profit worksheet of the report template.

Baseline profit rate

(Step 1)

4. Basis of Baseline Profit Rate

4.1 Section 17(2) of the Act and Regulation 11(2) set out the requirement for the baseline profit rate as the first step in determining the contract profit rate to be applied in the pricing formula:

“Take the baseline profit rate which is in force at the relevant time”.

4.2 The SSRO is required annually to review the figures used to determine the contract profit rate for pricing single source contracts. Section 19(2) of the Act requires that, for each financial year, the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate for qualifying defence contracts.

4.3 Section 19(4) of the Act states that the Secretary of State must publish the baseline profit rate for each financial year in the London Gazette, no later than 15 March in the preceding financial year.

Cost Risk Adjustment (Step 2)

5. Basis of Cost Risk Adjustment

- 5.1 Section 17(2) of the Act, and Regulation 11(3), set out the requirement for the cost risk 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”.

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

6. Regulated Pricing Methods

- 6.1 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)).

- 6.2 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) to 10(11). All regulated pricing methods use either an estimate or actual Allowable Cost base.

7. Principles of risk adjustment

General Approach

- 7.1 Contractors and the MOD must have regard to the following approach and principles when negotiating the cost risk adjustment to the baseline profit rate. The terms and conditions of each individual contract should always be considered when determining the adjustment.

7.2 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. 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 be determined by considering the principles stated at paragraph 7.11 alongside the pricing method.

7.3 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.

7.4 For all other pricing methods, the adjustment can vary between minus 25 per cent to plus 25 per cent, depending on the risk of actual Allowable Costs differing from estimated Allowable Costs, using the following guidance and the principles stated at paragraph 7.11.

7.5 In addition, the SSRO recognises that for some defence contracts the cost risk associated with one or more subcontracts is held by, or assigned to, the Secretary of State. In these circumstances the prime contractor should not receive the same level of profit on the contract as they do on the overall contract. In such circumstances, the following approaches, separately or in combination as required, should be used to avoid excess profit:

- a cost risk adjustment (see paragraph 7.7); and
- an adjustment to Allowable Costs (see the updated Single Source Cost Standards at paragraph 7.12).

Negative Adjustment

7.6 A negative adjustment should be made where the MOD and the contractor agree there is a low (or no) risk of actual Allowable Costs differing from estimated Allowable Costs.

7.7 Additionally, in the circumstance where all, or a proportion, of the cost risks associated with one or more subcontracts are held by, or assigned to, the Secretary of State the cost risk adjustment should be amended proportionately so as to reflect the reduced risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs, thus recognising the reduced risk held by the prime contractor associated with the subcontract(s).

Positive Adjustment

7.8 A positive adjustment should be made where the MOD and the contractor agree there is high risk of actual Allowable Costs differing from estimated Allowable Costs, this can be evidenced by the contractor, and the contractor bears the majority of the risk.

7.9 If a contract price already includes cost risk then there should be no positive adjustment, to reflect that the cost risk has already been considered.

No Adjustment

7.10 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.

Principles to consider

7.11 In addition to taking into account the regulated pricing method, the contractor and the MOD must have regard to the following principles (which are not exhaustive) when determining the cost risk adjustment. The adjustment should:

- a. only consider uncertainties that impact on Allowable Costs;
- b. be based upon an assessment of how actual Allowable Costs may differ from estimated Allowable Costs;
- c. be entirely consistent with the contract requirement;
- d. be consistent with the overall project approach to risk, such as risk allocation, management, and risk registers (and be recorded in the risk register);
- e. take into account the extent to which the cost risk has been mitigated, for example through good business practices or insurance;
- f. take into account risk of both cost under-runs and over-runs;
- g. if cost models are used, take into account where estimated costs are on the cost distribution;

h. take into account any contractual terms that pass on some or all of the cost risks onto a party other than the contractor;

i. take into account the 'final price adjustment' arrangements (for target cost, firm, fixed and volume pricing methods) in place;

j. not take into account uncertainty resulting from force majeure;

k. for example an unforeseeable natural phenomenon;

l. be based on reasonable documented assumptions; and

m. take into account any cost risk under subcontract(s) that may be 'passed through' to a party other than the contractor.

any subcontract(s) there remains excess profit then the Allowable Costs management charges should be adjusted downwards or set to zero in order to reflect an appropriate profit rate.

7.15 Any management fees to manage a subcontract where all risks are held by the Secretary of State will only be Allowable at the specific request of the Secretary of State.

Proposed changes to the Single Source Cost Standards

7.12 In the circumstance where a proportion of risk associated with one or more subcontracts is held by, or assigned to, the Secretary of State, the following shall apply.

7.13 The management charges or project management costs associated with that subcontract(s) should be reviewed to ensure they follow the Appropriate, Attributable and Reasonable criteria, with particular focus on the Attributable element of cost. Any costs that do not comply should be excluded.

7.14 If, after the deduction of the maximum 25 per cent cost risk adjustment on the baseline profit rate, and given the level of risk held by the Secretary of State in

Profit on Cost once Adjustment (POCO) (Step 3)

8. Basis of POCO Adjustment

8.1 Section 17(2) of the Act, and Regulation 11(4), set out the requirement for the POCO 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 subcontract (including any further group subcontract)”.

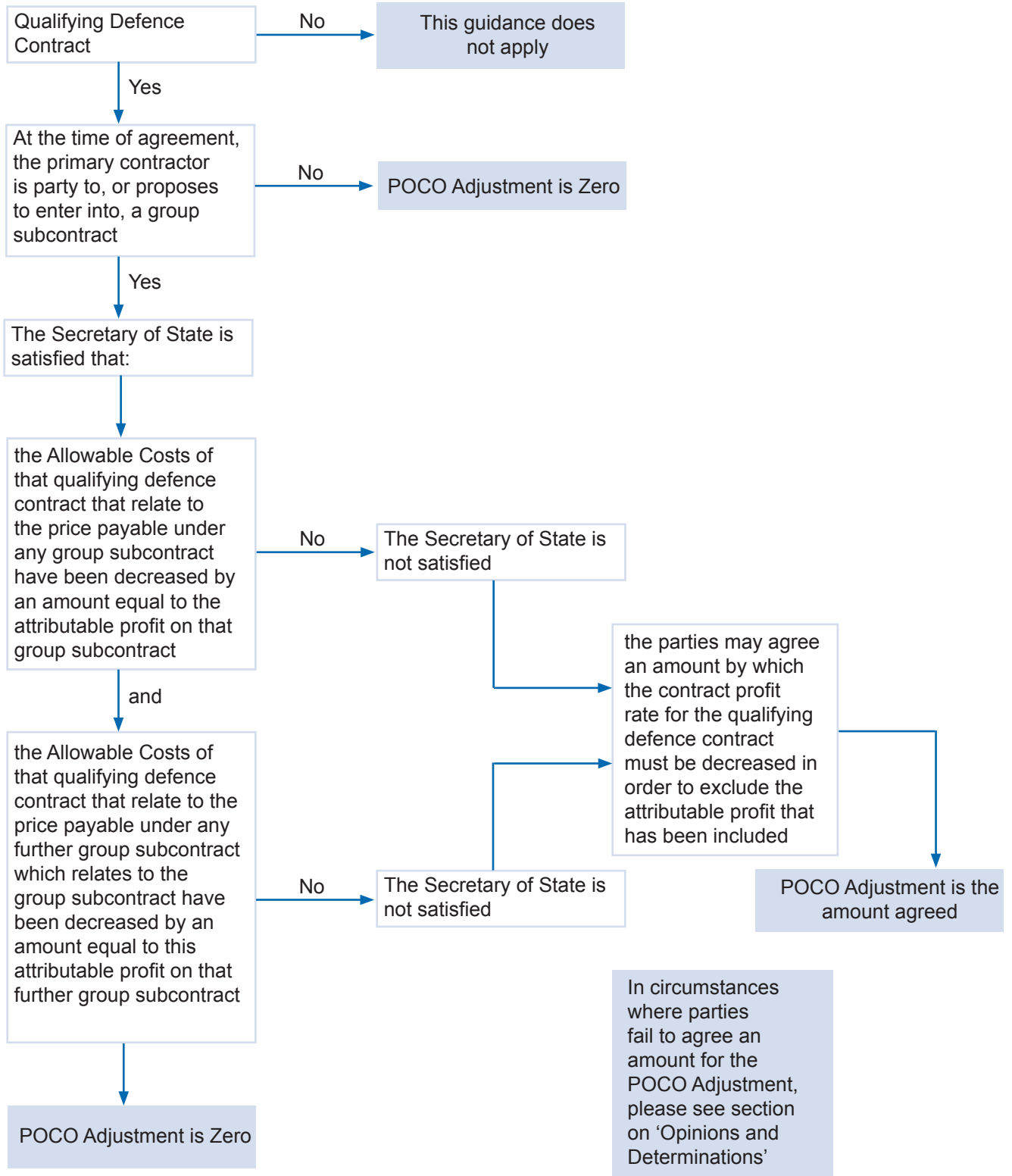
8.2 This adjustment ensures that if a party to a qualifying defence contract enters into a non-competitive subcontract with another group member, and this group subcontract is necessary to enable the performance of the qualifying defence contract, then profit arises only once in relation to Allowable Costs included in the group subcontract price. This is also the case for any further single source subcontracts to other group members.

9. Application of POCO adjustment

9.1 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 subcontract.

- a. The purpose of this guidance is to provide a consistent methodology for contractors and the MOD to follow when agreeing a POCO adjustment amount.
- b. The POCO adjustment does not apply:
 - to non-competitive subcontracts with a value less than £100,000;
 - to any profit included in subcontracts to non-group members;
 - to any profit included in subcontracts to group members if these subcontracts were awarded competitively; or
 - to any profit included in the price of the subcontractor outside the delivery of the qualifying defence contract.

9.2 The diagram on the next page demonstrates when a POCO adjustment should be made.



10. **Methodology to determine the POCO adjustment**
- 10.1 The table below demonstrates the 12 stage process that contractors and the MOD must have regard to when agreeing the POCO adjustment amount.
- 10.2 Please refer to Appendix A for a glossary of the terms used below.
- 10.3 Please refer to Appendix B for a high level worked example of the process to aid users.

Stage	Ref	Process
for the primary contract:		
1	-	Document the expected contract supply chain, identifying all the subcontracts at each level.
2	-	Identify the group subcontracts within the supply chain which are not the result of a competitive process.
for the primary contract and each group single source subcontract identified at Stage 2:		
3	AC	Identify the applicable costs for the primary contract and each group subcontract.
4	P	Calculate the attributable profit: <ul style="list-style-type: none"> • applied to each group subcontract; and • applied to the primary contract, net of Step 3 (POCO) and Step 6 (CSA).
for the primary contract POCO adjustment:		
5	$\sum AC$	Sum the total applicable costs in the primary and group subcontracts (net of primary CSAs).
6	π	Calculate the contract profit rate for the primary contract net of Step 3 (POCO) and Step 6 (CSA). This will be: Step 1 (BPR) +/- Step 2 (risk adj.) - Step 4 (SSRO funding adj.) + Step 5 (incentive adj.).
7	$\sum AC \times \pi$	Multiply the total applicable costs ($\sum AC$) by the profit rate (π). This gives the target profit that the group should receive from the qualifying defence contract (net of primary contract CSA).
8	$\sum P$	Sum the total attributable profit applied at all levels (net of Step 3 and Step 6 for the primary contract).
9	$POCO_R = (\sum AC \times \pi) - \sum P$	To calculate the POCO reduction, subtract the total attributable profit applied ($\sum P$) from the target profit ($\sum AC \times \pi$). This is the reduction to the price that will result from the Step 3 POCO adjustment.
10	$\sum A$	Determine the Allowable Costs included in the primary contract (including group subcontractor prices) for the purposes of the pricing formula.
11	POCO adj	The POCO adjustment is the POCO reduction ($POCO_R$) divided by the Allowable Costs for the primary contract ($\sum A$). 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).
12	-	Apply the POCO adjustment to the primary Allowable Costs ($\sum A$) alongside Steps 1,2,4,5&6 and cross check the calculated contract price to expectations.

SSRO funding adjustment (Step 4)

This adjustment will be zero until 31 March 2017.

Incentive adjustment (Step 5)

11. Basis of incentive adjustment

11.1 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.”

11.2 This document provides guidance for the Secretary of State to use when determining when to apply the incentive adjustment to a qualifying defence contract and what to consider when setting the rate between zero and 2 per cent.

11.3 The incentive adjustment guidance is principles, rather than rules, based.

12. When to apply the Incentive adjustment

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

12.2 It may be desirable for the Secretary of State to include a positive incentive in the following circumstances:

a. as a reward for delivering equipment early; or

b. delivering over and above the basic contractual requirement; or

c. if a contractor exceeds all its set Key Performance Indicators in the performance of a contract.

12.3 Please note, this is not an exhaustive list of circumstances that will trigger an incentive adjustment.

13. Principles of applying the Incentive adjustment

13.1 When considering whether to apply an incentive adjustment the Secretary of State must have regard to 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.

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- 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 subcontract 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 measureable. 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. If a contractor is in breach of contract, they are not entitled to any incentive adjustments directly related to that element of the contract in breach.
 - j. The incentive adjustment must not be linked to legislative 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.
- 13.2 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)

14. Basis of Capital Servicing Adjustment

- 14.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the Capital Servicing 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.”

- 14.2 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.”

15. Importance of Step 6 Adjustment

- 15.1 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.

- 15.2 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.

- 15.3 To determine this appropriate and reasonable return, the MOD and contractors must have regard to these rates.

16. Calculating the Capital Servicing Adjustment

- 16.1 This guidance provides a process that should be followed in order to calculate the capital servicing adjustment that will be used in Step 6 of the contract profit rate.

- 16.2 The calculation is structured around the above-mentioned three elements of capital servicing used when fulfilling qualifying defence contract, or qualifying subcontract 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’.

- 16.3 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 subcontract.
- 16.4 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.
- 16.5 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 C to this guidance.

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

Computation 3
Apply Capital Servicing Rates
Fixed Capital as a proportion of Capital Employed
Multiplied by
Fixed Capital Servicing Rate
PLUS
Positive Working Capital as a proportion of Capital Employed
Multiplied by
Positive Working Capital Servicing Rate
<u>OR (if negative)</u>
Negative Working Capital as a proportion of Capital Employed
Multiplied by
Negative Working Capital Servicing Rate
<u>EQUALS</u>
Capital Servicing Rate

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

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

16.6 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.

17. Calculation of Capital Employed

17.1 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 subcontract), such as subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement.

17.2 If figures cannot reasonably be isolated then, in exceptional circumstances, capital employed can be calculated for a contractor's business as a whole.

17.3 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.

17.4 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;
- 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. where advance payments by the MOD relating to single source contracts have not been accounted for in a way that reduces them.

17.5 The following items can generally be included in assets in determining the total capital employed in the business unit (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, may be included to the extent that a company can demonstrate that they are registered in the name of the contractor and have not lapsed (or the contractor has a valid licence to use) and they actively or defensively contribute to the conduct of the business, even if they are not shown in the contractor's balance sheet.
- e. Development expenditure may be included up to the value shown in the balance sheet 'net' of amortisation and impairment. This is provided that orders have been received, or are likely to be received, for the product developed or 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 employed source of capital, 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.
- i. Where costs are spread over several years in accordance with agreed spreading schedule
- any amount not incorporated into prior period pricing rates at a balance sheet date will be included as an asset in capital employed.
- j. The net balance sheet figure for trade receivables is included in capital employed.
- 17.6 Further general adjustments will then be applied in addition to creditors' figures captured in the financial statements.
- a. Finance lease creditors 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. Current tax liabilities or assets 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. Declared dividends are treated as a source of capital, and therefore not deducted.

f. Non-current liabilities, including pension liabilities, should be excluded.

17.7 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

17.8 For these purposes, 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'.

17.9 Adequate and sufficient evidence should be provided to support the calculation of both fixed and working capital.

18. Calculation of Cost of Production

18.1 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.

18.2 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.

18.3 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 external 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;

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- l. credits, grants or refunds deducted from overheads; and
 - m. any other costs not considered Allowable under the guidance published by the SSRO.

Calculation of capital services adjustment

- 18.4 Having followed the processes outlined above, the information available should then be sufficient to allow the four computations to be completed.
- 18.5 Appendix C to this document sets out a worked example of the calculations required having determined the key information.

Opinions and Determinations

19. Overview

19.1 The Act and Regulations make provision for opinions or determinations by the SSRO on the appropriateness of a cost risk adjustment (or group cost risk adjustment), profit on cost once adjustment (or group profit on cost once adjustment), or capital services adjustment (or group capital services adjustment) in the circumstances set out below.

19.2 The following sections are not designed to replicate or replace the Act or Regulations. They are included to provide assistance to users for when an opinion or determination may be sought.

19.3 For further information, please refer to “Guidance on Referral Procedures to the SSRO under the Defence Reform Act 2014 and the Single Source Contract Regulations 2014”.

20. Opinions

20.1 The SSRO must give an opinion on the appropriate amount of a cost risk adjustment (or group cost risk adjustment), POCO adjustment (or group POCO adjustment) or capital servicing adjustment (or group capital servicing adjustment) for a qualifying defence contract (if the contract price were to be re-determined) or a proposed qualifying defence contract, or a qualifying subcontract (if the contract price were to be re-determined) or a proposed qualifying subcontract on referral from, as the case may be:

a. the Secretary of State;

b. an authorised person;

c. the primary contractor (in the case of a qualifying defence contract);

d. the person who proposes to enter into a contract with the Secretary of State (in the case of a proposed qualifying defence contract);

e. the contracting authority (in the case of a qualifying subcontract); or

f. the person who proposes to enter into the qualifying subcontract.

20.2 The SSRO may give an opinion on any matter in relation to a qualifying defence contract or proposed qualifying defence contract, or a qualifying subcontract or proposed qualifying subcontract, on joint referral from:

a. the Secretary of State and the primary contractor in the case of a qualifying defence contract, or the Secretary of State and any other proposed party to the contract in the case of a proposed qualifying defence contract; or

b. the Secretary of State and the subcontractor in the case of a qualifying subcontract, or the Secretary of State and the proposed subcontractor, in the case of a proposed qualifying subcontract.

21. Determinations

21.1 The SSRO may determine whether the amount of an agreed cost risk adjustment, POCO adjustment or capital servicing adjustment is appropriate on referral from:

a. the Secretary of State;

b. the primary contractor (in the case of a qualifying defence contract); or

c. the subcontractor (in the case of a qualifying subcontract).

21.2 In the case of a qualifying defence contract, the SSRO may also determine whether the amount of an adjustment agreed on a group basis is appropriate.

21.3 In making a determination, the SSRO must have regard to the following:

a. the information that was available to each party at the time of the agreement; and

b. the statutory guidance that was in place at the time of the agreement.

21.4 In making a determination in relation to the cost risk adjustment, the SSRO must also have regard to the terms of the contract.

21.5 If the SSRO determines the amount of an adjustment was not appropriate, it may determine the contract price for a qualifying defence contract is to be adjusted by a specified amount. In the case of a qualifying subcontract, the SSRO may determine that a payment of a specified amount must be made to or by the Secretary of State.

Appendix A: Glossary of terms

Group subcontract

Group subcontract 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 subcontract

Further group subcontract 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 subcontractor;
- 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 subcontract or further group subcontract.

Attributable Profit

The attributable profit is:

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

A group subcontractor means a person with which the primary contractor makes a group subcontract.

Applicable Costs

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

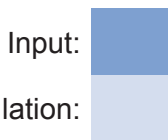
Appendix B: Worked Example of POCO adjustment

The example below involves a prime contractor that holds a group subcontract to deliver its qualifying defence contract. This group subcontractor has in turn let two other group subcontracts.

Expected contract price

The diagram below reflects the expected price of the contract if profit on allowable subcontract costs is only applied once as per Section 15 of the Defence Reform Act.

Key:

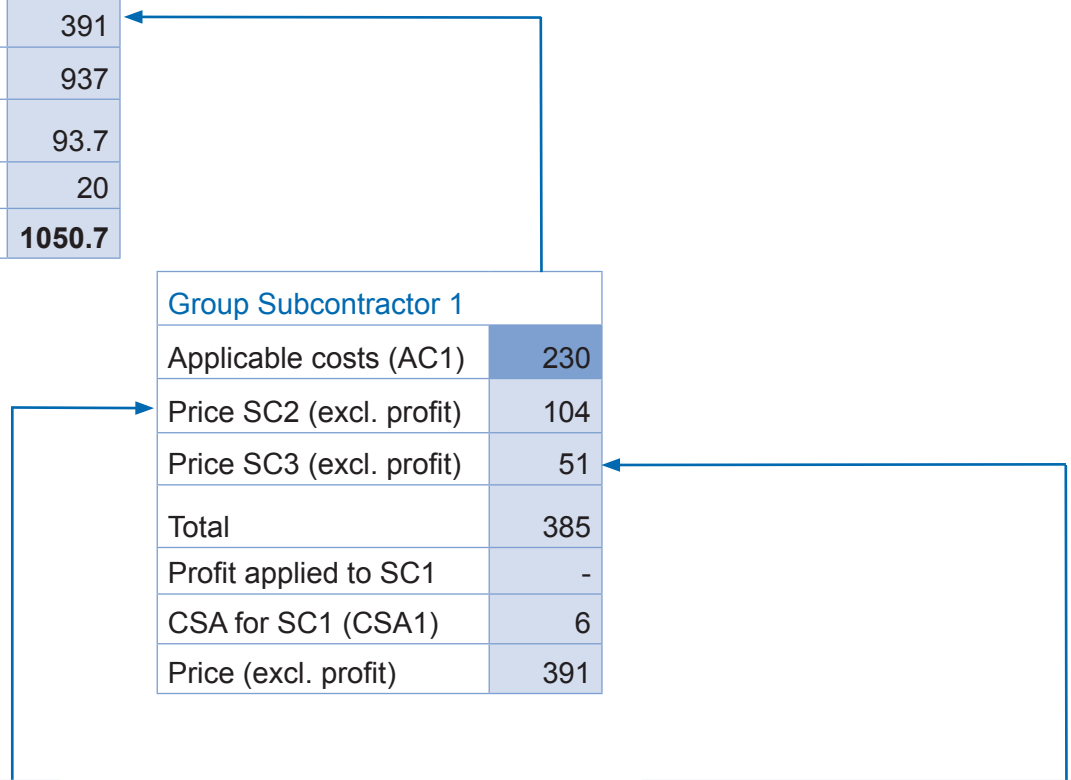


Primary contractor	
Applicable costs (ACP)	546
Price SC1 (excl. profit)	391
Total Allowable costs	937
Profit (steps 1,2,4,5)	93.7
CSA for Prime (CSAP)	20
Price (excl. profit on profit)	1050.7

Group Subcontractor 1	
Applicable costs (AC1)	230
Price SC2 (excl. profit)	104
Price SC3 (excl. profit)	51
Total	385
Profit applied to SC1	-
CSA for SC1 (CSA1)	6
Price (excl. profit)	391

Group Subcontractor 2	
Applicable costs (AC2)	100
Profit applied to SC2	-
CSA for SC2 (CSA2)	4
Price (excl. profit)	104

Group Subcontractor 3	
Applicable costs (AC3)	50
Profit applied to SC3	-
CSA for SC3 (CSA3)	1
Price (excl. profit)	51

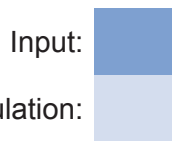


Methodology to determine the POCO adjustment

To calculate what the POCO adjustment is, apply the stages that have been described in the main body of this document.

The diagram below reflects [Stage 1-4](#) of the methodology (reflecting profit applied at suppliers' rates at each level). These figures are used in the calculations that follow.

Key:



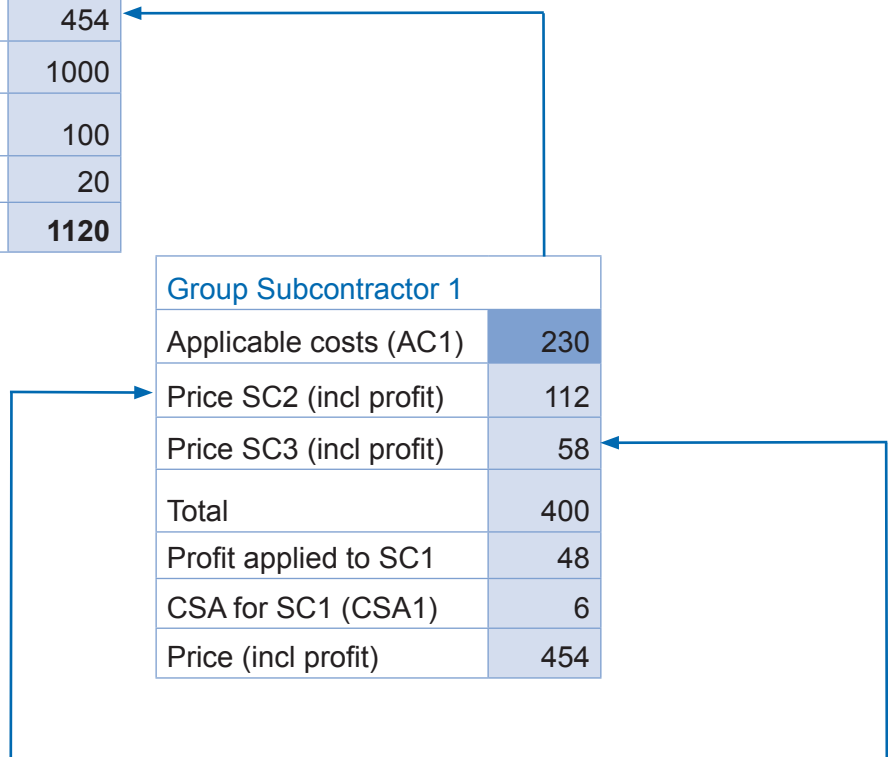
Profit and CSA rate inputs		
	CSAs	Profit rate applied
Primary (steps 1, 2, 4 & 5)	2%	10%
Group Subcontractor 1	1.5%	12%
Group Subcontractor 2	4%	8%
Group Subcontractor 3	2%	14%

Primary contractor	
Applicable costs (ACP)	546
Price SC1 (with profit)	454
Total Allowable costs	1000
Profit (steps 1,2,4,5)	100
CSA for Prime (CSAP)	20
Price (incl profit on profit)	1120

Group Subcontractor 1	
Applicable costs (AC1)	230
Price SC2 (incl profit)	112
Price SC3 (incl profit)	58
Total	400
Profit applied to SC1	48
CSA for SC1 (CSA1)	6
Price (incl profit)	454

Group Subcontractor 2	
Applicable costs (AC2)	100
Profit applied to SC2	8
CSA for SC2 (CSA2)	4
Price (incl profit)	112

Group Subcontractor 3	
Applicable costs (AC3)	50
Profit applied to SC3	7
CSA for SC3 (CSA3)	1
Price (incl profit)	58



Stage 5 - Total applicable costs to the QDC (excl. Primary CSA but incl. lower tier CSAs)	
ACP (not incl. CSAP)	546
SC 1 (AC1 + CSA1)	236
SC 2 (AC2 + CSA2)	104
SC 3 (AC3 + CSA3)	51
ΣAC = Total applicable costs	937

Stage 6 - Primary Contract Profit Rate net of steps 3 and 6	
π = Steps 1,2,4,5 only	10%

Stage 7 - Profit that the group should get (net of Primary CSA)	
Total target profit net of Prime CSA (Σ AC x π)	93.7

Stage 8 - Total attributable profit (net of step 3 and CSAs on the Primary QDC)	
Profit (steps 1,2,4,5)	100
Profit applied to SC1	48
Profit applied to SC2	8
Profit applied to SC3	1
ΣP = Total profit at all levels	163

Stage 9 - Reduction in price to ensure profit only arises once	
Total target profit (Σ AC x π)	93.7
<i>deduct</i> Total profit at all levels (Σ P)	163.0
POCO_R = POCO reduction	-69.3

Stage 10 – Prime Allowable costs included in the pricing formula	
Prime Allowable Costs (Σ A) for pricing formula (as per section 15 of the DRA)	1000

Stage 11 - Calculate the Step 3 POCO adjustment	
POCO _R <i>divided by</i> Allowable Costs (Σ A) (Stage 10)	1000
POCO adjustment	-6.93%

Stage 12 - Apply to Prime Allowable Costs and cross check to expected price	
Prime Allowable Costs (Σ A)	1000.0
Profit for steps 1,2,4 and 5	10.0%
Step 3 adjustment (POCO)	-6.93%
Step 6 adjustment (CSAs)	2.0%
Contract Profit Rate (CPR)	5.07%
Price (Σ A+ Σ A*CPR)	1050.7
<i>Check this calculated price against the price expected (as above)</i>	

Appendix C: 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 Contract Profit Rate formula.

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 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 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)
CP: CE ratio calculation:			
(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
This completes Computation 1			
Computation 2			
(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)
Capital Servicing Rates (published annually but given in this worked example)			
(i) Fixed Capital Servicing Rate	5.94%	5.94%	5.94%
(ii) Working Capital Servicing Rate (positive)	1.72%	1.72%	1.72%
(iii) Working Capital Servicing Rate (negative)	1.03%	1.03%	1.03%
Computation 3			
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%	-
Negative Working Capital Servicing Allowance (h x iii)	-	-	(0.20%)
Capital Servicing Allowance "x"	4.89%	4.50%	6.93%
Computation 4			
Capital Servicing Adjustment for step 6 ("x" / e)	3.26%	3.38%	2.89%

