



# SSRO

Single Source  
Regulations Office

*Assuring value, building confidence*

Developing the SSRO's approach to  
calibrating profit rates in single source  
contracts: Discussion paper

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# 1. Introduction

## Background

- 1.1. The Single Source Procurement Framework came into force in December 2014, following Parliamentary approval of the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations (the Regulations). It aims to ensure that when the government does not secure the benefits of competition, contracts for defence equipment and support are priced in a way that helps to achieve a balance between value for money for taxpayers and fair and reasonable returns for contractors.
- 1.2. To achieve these aims, the Act and Regulations require:
  - the parties in qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs) to use a set methodology for agreeing the contract profit rate to be applied to contract costs;
  - contract costs to meet set criteria in order to be considered Allowable; and
  - contractors to provide reports giving greater transparency to contract costs.
- 1.3. The SSRO is responsible for:
  - keeping the Regulations and Part 2 of the Act under review;
  - making a recommendation each year to the Secretary of State on the baseline profit rate (BPR) , capital servicing rates and SSRO funding adjustment to be used in calculating contract profit rates;
  - providing guidance on the application of the six-step process for agreeing a contract profit rate;
  - providing guidance on the principles to apply when deciding if costs are Allowable;
  - providing guidance on reporting and assessing contractors' compliance with reporting requirements; and
  - providing opinions and legally binding determinations in response to referrals from the Ministry of Defence (MOD), contractors and sub-contractors;

## Monitoring contract profits

- 1.4. Monitoring and interpretation of actual contract profit rates is essential to provide assurance that contract prices are securing value for money for taxpayers and giving fair and reasonable returns to contractors. This forms part of the SSRO's ongoing monitoring of the regime (Appendix 1). It will provide the basis for periodic review of the profit rate methodology and the SSRO's statutory guidance (Appendix 2).
- 1.5. The statutory reports submitted by contractors provide the data the SSRO needs to monitor profits at the start, during and at the end of contracts. How the SSRO then interprets, in aggregate, whether the profits observed through monitoring deliver value for money and are fair and reasonable requires further thought and discussion with stakeholders. Questions that need to be addressed include:
  - What risks to contract delivery are pertinent to contract pricing and how should the allocation of these risks between contract parties affect returns?

- What are the appropriate benchmarks against which to judge if contract profits are delivering value for money and fair and reasonable returns?
- How does profit on costs in contracts affect returns on capital for investors in the contracting companies?
- What, if any, public information from the financial markets is relevant to the SSRO's consideration of whether returns are fair and reasonable?

### **This paper**

- 1.6. This paper was initially shared with the MOD, its prime contractors, HM Treasury and UK Government Investments (UKGI) in February 2017, as a discussion document. Its aim was to promote a dialogue with these stakeholders about how the SSRO will monitor and seek to understand, over time, the actual profits being earned on single source contracts. We invited comments on the paper during February and March 2017. We received written comments on the paper from six contractors and from ADS, on behalf of defence contractors. Two questions relevant to the paper were also discussed with representatives of the MOD and contractors at the SSRO's Senior Stakeholder Forum in March 2017.<sup>1</sup>
- 1.7. This final version of the paper has been updated to include in sections 2 to 5 the feedback we received from stakeholders during February and March 2017. A new section has been added summarising how the SSRO will be taking forward work on the issues raised in the paper.
- 1.8. The remainder of the paper is structured as follows:
- Section 2 (Defence Reform Act) summarises the regulatory framework introduced by the Act and how the data we receive from contractors will help us monitor the profits being earned across QDCs and QSCs.
  - Section 3 (Interpreting profitability) identifies a number of technical and other factors that influence the way that the profits seen in contracts are interpreted and benchmarked against other measures of contractors' profitability. It sets out areas for further consideration, including the long-term potential for using return on capital employed as a cross-check for profits earned on contract costs.
  - Section 4 (A fair and reasonable return for industry) presents data on a range of public financial market indicators for the ten holding companies that (through their subsidiaries) received the highest contract payments from the MOD in 2015/16. These indicators provide insights into the financial health of the MOD's contractors from the perspective of investors and shareholders. Such indicators are commonly used by economic regulators to assess the financial health of regulated companies. They may provide a useful cross-check for the SSRO's monitoring of contract profits.
  - Section 5 (Market structure) summarises data published by the MOD on the supplier base for the MOD's non-competitive defence contracts and discusses its implications for how the SSRO interprets the effect of the regime on profitability at a corporate level.

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<sup>1</sup> 1) How can the SSRO demonstrate a balance between value for money to the taxpayer and a fair and reasonable return for industry? 2) How could return on capital employed provide a cross check for contract profit rates?

- Section 6 (Next steps) describes how the SSRO intends to develop further its understanding of the issues raised in this paper, with input from the MOD and its contractors, government and other stakeholders, in order that it can make evidence-based decisions about the appropriate way to resolve them.

### **Evidence base**

1.9. The issues and analysis presented in this paper have been informed by:

- discussions with the MOD and its contractors, HM Treasury and UK Government Investments during meetings in autumn 2016;
- feedback provided by the MOD, its contractors and other stakeholders on an initial version of this paper shared in February 2017;
- consideration of data contractors are required to provide in their statutory reports and data they publish in their financial statements;
- a review of public financial market indicators and other data available to investors and shareholders about the MOD's contractors; and
- engagement with other UK regulatory bodies on the approaches they take to monitoring the financial health of the organisations they regulate.

### **Feedback**

1.10. The SSRO continues to welcome feedback from all interested parties on the content of this paper and the issues it raises. Comments can be sent to [vmstudies@ssro.gov.uk](mailto:vmstudies@ssro.gov.uk). As indicated in Section 6, the SSRO will continue to engage with stakeholders on these issues as part of its forward work programme.

## 2. The Defence Reform Act

- 2.1. This section summarises important features of the Act and Regulations. It discusses how the SSRO will use the data provided to it in statutory reports to monitor, over time, the profits earned on QDCs and QSCs.
- 2.2. Feedback received from stakeholders on the content and issues raised is summarised at the end of the section.

### Aims of the regulatory framework

- 2.3. The absence of competition in a procurement process alters the relationship between buyer and seller. To ensure that the MOD does not pay more than is reasonable when buying from a single source contractor (reducing value for money), the regulation of QDCs and QSCs controls the costs in contracts and the profits earned on these by contractors.
- 2.4. But there is a risk that, if regulated contract profits are unreasonably low, contractors will be unable to satisfy their investors' and shareholders' expectations for returns on investment. This might be because the contract price does not provide a return that exceeds the contractor's cost of capital, or because there are greater returns to be made by investing capital in other activities. In the long term this may result in under-investment, with consequences for the supply of defence equipment and support.
- 2.5. If the government pays more than is reasonable for defence equipment and support it may be limited in how much it can afford to buy (Figure 1). The government's ability to acquire the equipment and support it needs will also be limited if contractors no longer enter into regulated contracts due to an absence of available capital. In the unlikely event of a contractor's financial failure, there may be consequential impacts for national security and prosperity. As the overseer of the regime, the SSRO is responsible for providing assurance that a balance is being struck between value for money and fair and reasonable returns.

**Figure 1: Balancing value for money and fair and reasonable returns**

Profit rate	Effect	Consequences and risks
Unreasonably high	Regulation ineffective in securing value for money for taxpayers.	<ul style="list-style-type: none"> <li>• Government limited in what defence equipment and support it can afford to buy.</li> <li>• Return on investment exceeds reasonable rate.</li> </ul>
Reasonable returns for industry	<b>Value for money and fair and reasonable returns are balanced.</b>	<ul style="list-style-type: none"> <li>• Government able to buy the defence equipment and support it wishes to.</li> <li>• Contractors able to reward investors reasonably.</li> </ul>
Unreasonably low	Regulation has adverse impact on contractors' access to capital or financial sustainability.	<ul style="list-style-type: none"> <li>• Government unable to buy defence equipment and support as contractors can't or won't agree contracts.</li> <li>• Wider economic effects if contractors face capital constraints.</li> </ul>

Source: SSRO

## Regulating profits

- 2.6. The Act and Regulations contain several mechanisms for regulating the price of contracts and the profits earned on them:
- a methodology for agreeing the contract profit rate;
  - a requirement for contract costs to meet set criteria in order to be considered Allowable;
  - regulated contract pricing mechanisms; and
  - a final price adjustment, calculated on contract completion, if the actual profit earned on a contract is different to the agreed contract profit rate.

### *The contract profit rate*

- 2.7. The Act specifies that the price payable under a QDC or QSC is to be determined by a formula:

$$\text{Price} = (\text{CPR} \times \text{AC}) + \text{AC}$$

CPR is the contract profit rate and AC is the Allowable Costs within the contract.

- 2.8. The contract profit rate is derived by applying a six-step process set out in the Act and Regulations. The SSRO publishes guidance on the application of the process.<sup>2</sup> The process starts with the prevailing BPR set by the Secretary of State. It includes a capital servicing adjustment (CSA) which aims to ensure that contractors receive an appropriate and reasonable return on the fixed and working capital they employ in contract delivery through an uplift in the profit rate.<sup>3</sup>
- 2.9. The SSRO makes an annual recommendation to the Secretary of State on the BPR and the capital servicing rates to be used in calculating the CSA. The BPR recommendation is based on an assessment of the profits earned by comparable companies undertaking economic activities similar to those that contribute to the delivery of QDCs and QSCs. The capital servicing rates are set with reference to corporate bond rates and interest for short-term deposits.<sup>4</sup>

### *Allowable Costs*

- 2.10. The SSRO is responsible for providing guidance that the MOD and contractors must have regard to on what constitutes an Allowable Cost in a QDC or QSC.<sup>5</sup> The SSRO's guidance details the principles to be applied when determining whether costs are Allowable. To be Allowable, a cost must be:
- Appropriate – that is, one that would be expected to be incurred;
  - Attributable to the contract – that is, incurred directly or indirectly for the purpose of the contract and necessary to it; and

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<sup>2</sup> SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate*. The steps are: 1. Baseline Profit Rate; 2. Cost risk adjustment; 3. Profit on cost once adjustment; 4. SSRO funding adjustment; 5. Incentive adjustment; and 6. Capital servicing adjustment.

<sup>3</sup> For further information on the CSA see SSRO (2016) *Capital Servicing Adjustments in Qualifying Defence Contracts*.

<sup>4</sup> For details see SSRO (2016) *Baseline Profit and Capital Servicing Rates Methodology*.

<sup>5</sup> SSRO (2016) *Single Source Cost Standards: Statutory Guidance on Allowable Costs*.



- Reasonable in the circumstances – that is, not exceeding the level that might normally be expected to be incurred.

#### *Contract pricing methods*

2.11. The Regulations specify that the parties to a contract may agree which of six regulated pricing methods (Appendix 3) is to be used for a QDC (or component thereof). The pricing methods determine the extent of the parties' exposure to cost overruns and, therefore, the potential for the actual profit rate for the contract at completion to vary from the contract profit rate agreed at the outset. For example, in a 'firm price' contract, cost overruns are borne by the contractor, but the contractor retains savings from lower-than-expected costs. If the actual costs are higher than estimated when the contract was agreed the actual profit rate at contract completion will be lower than the agreed contract profit rate. But if actual costs are lower than estimated, the actual profit rate will be higher than the agreed contract profit rate.

#### *The final price adjustment*

2.12. The Regulations specify that a final price adjustment should be made in some contracts where there is variance between the actual and agreed contract profit rates due to differences between actual and estimated contract performance.<sup>6</sup> The Act and Regulations state no specific purpose for conducting a final price adjustment, but through the reallocation of excess profit or loss, this mechanism ensures a balance is struck between value for money for taxpayers and fair and reasonable returns for contractors.

2.13. The scale of the final adjustment to contract price, and consequently profit, depends on the degree of variance between the actual and agreed contract profit rates. No adjustment is made where the actual profit rate is between 0 per cent and 5 percentage points (pp) above the contract profit rate ('excess level 1') (Figure 2). Where the actual profit rate is:

- at least 5pp above the contract profit rate, but less than 10pp above ('excess level 2'), the contract price is reduced by 25 per cent of the profit above excess level 1;
- at least 10pp above the contract profit rate, but less than 15pp above ('excess level 3'), the contract price is reduced by:
  - 25 per cent of the profit above excess level 1; and
  - 50 per cent of the profit above excess level 2; and
- at least 15pp above the contract profit rate, the contract price is reduced by:
  - 25 per cent of the profit above excess level 1; and
  - 50 per cent of the profit above excess level 2; and
  - 75 per cent of the profit above excess level 3.<sup>7</sup>

2.14. Where the actual Allowable Costs exceed the contract price (so that the contractor makes a loss), the contract price is increased by:

- 25 per cent of the excess costs up to the 'loss level' (an amount 5 per cent higher than the contract price); and

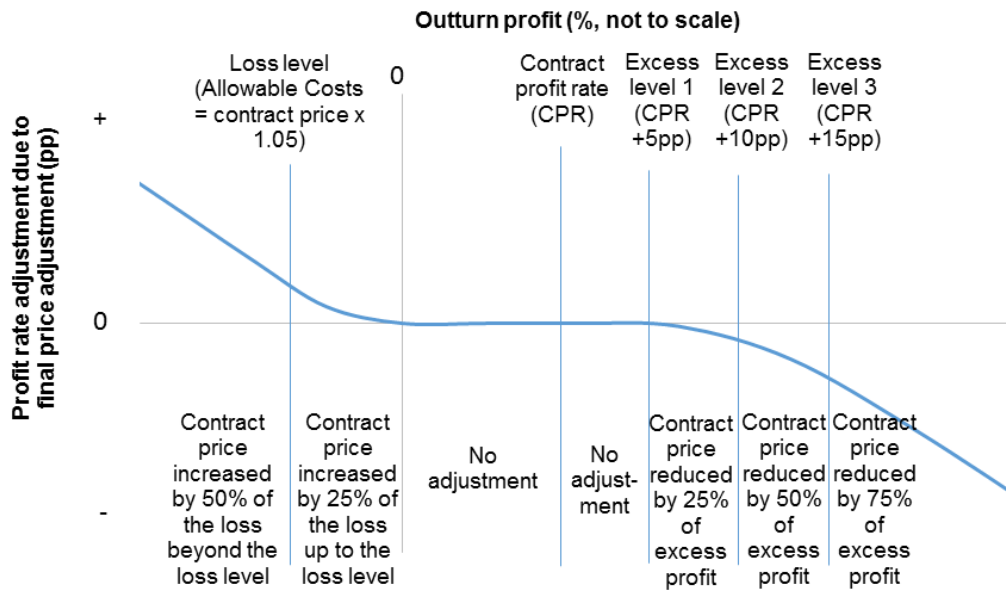
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<sup>6</sup> The final price adjustment may apply to contracts priced using the firm, fixed or volume-driven pricing methods and may only apply where the amount of any adjustment would be at least £250,000.

<sup>7</sup> Worked examples of the application of the final price adjustment are provided in Appendix 4.

- 50 per cent of the excess costs beyond the loss level.

**Figure 2: The effect of the final price adjustment on actual contract profit rate**



Source: SSRO

### Monitoring profits

2.15. Prior to the Act and Regulations coming into force, the Review Board for Government Contracts was responsible for recommending a target rate of return for non-competitive government contracts. The Review Board undertook periodic monitoring of the actual profits achieved on government contracts to assess variance from the target rate of return (Appendix 5). It received information on profits achieved from two sources:

- annual returns prepared voluntarily by contractors for the Review Board on a confidential basis; and
- reports summarising the results of the MOD's post-costing investigations for individual contracts.

2.16. The MOD has continued to have the right to undertake post-costing of contracts in some cases. However, the transition from the Yellow Book regime (overseen by the Review Board) to the framework introduced by the Act and Regulations (overseen by the SSRO) has resulted in a break in the systematic independent monitoring of variances between actual and expected profits earned on non-competitive defence contracts.

2.17. The reporting requirements introduced by the Act and Regulations give greater transparency of costs and profit throughout the life of QDCs and QSCs than was available to the Review Board. Consequently, the SSRO's monitoring of contract profit rates, which we describe below, will provide a more comprehensive and timely analysis of variance between actual and expected profits earned by contractors.

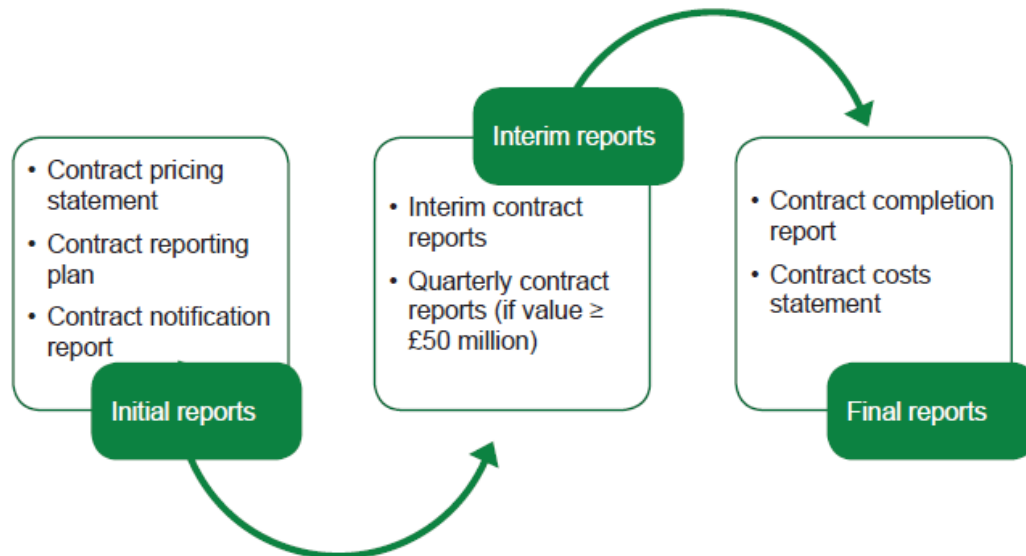
## Statutory reports

2.18. Contractors and persons associated with them<sup>8</sup> are required to provide the SSRO and the MOD with information about the contracts, their business unit costs and related activities.<sup>9</sup>

### Contract reports

2.19. Contractors must submit reports about the QDCs or QSCs to which they are party when signed, during contract delivery, and on contract completion (Figure 3).

**Figure 3: Contract reports**



Source: SSRO

2.20. The contract reports contain a range of data about contract requirements, payments, estimated and actual costs and profit, factors affecting delivery and subcontracts.

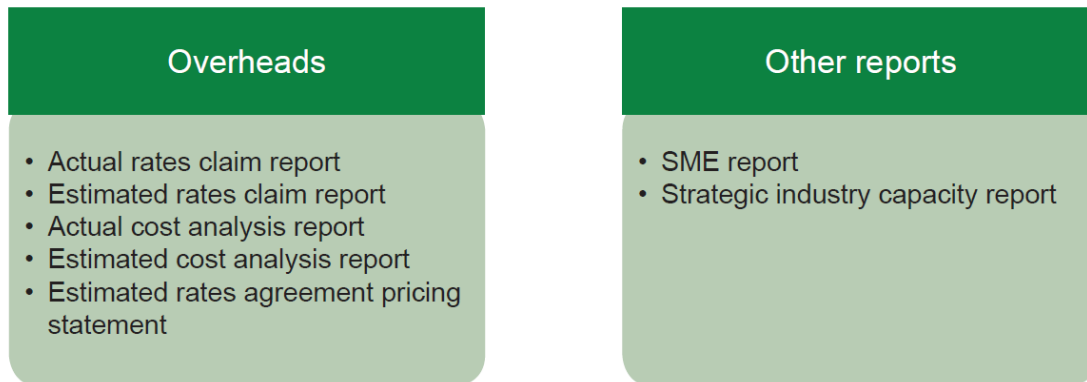
### Supplier reports

2.21. In some circumstances the Regulations require undertakings that are associated with contractors to report details of their businesses that are relevant to those contracts. These reports provide information about the undertaking's overheads, engagement with small and medium-sized enterprises and industrial capacity. There are seven standard reports (Figure 4).

<sup>8</sup> Appendix 6 provides an explanation of the meaning of different terms related to contractors and associated persons.

<sup>9</sup> Parts 5 and 6 of the Regulations detail the standard reports that contractors and persons associated with them are required to submit and when. Further details about all the reports can be found on the SSRO's website at <https://www.gov.uk/government/collections/qualifying-defence-contracts-reporting-templates-and-user-guides>.

**Figure 4: Supplier reports**



Source: SSRO

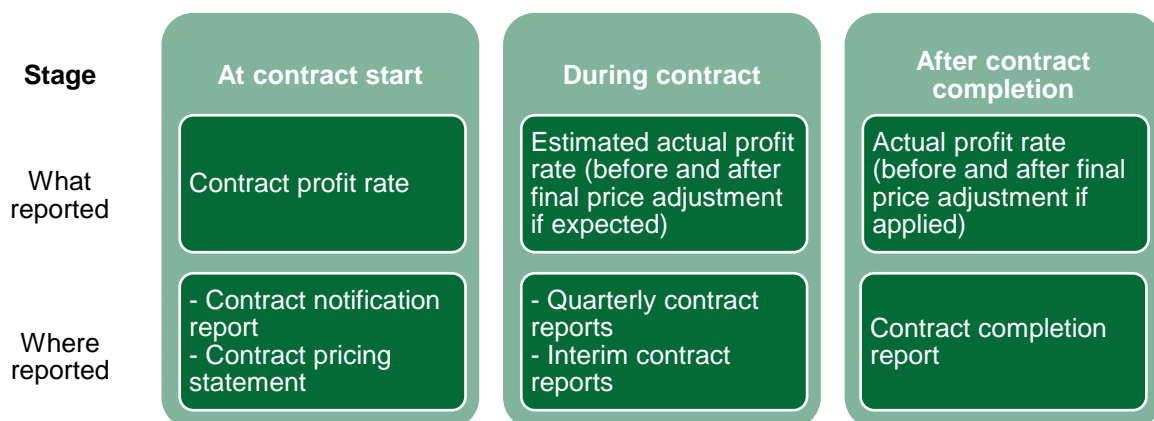
**Using report data**

2.22. The SSRO uses the data provided in reports to support its programme of studies and analysis which help it to keep the Regulations under review, inform opinions and determinations, and help it to develop statutory guidance required by the Act. The SSRO has published several statistical releases based on its analysis of contract report data which increase transparency for stakeholders about regulated contracts.

2.23. The SSRO will use statutory contract reports to monitor contract profits. The reports provide information on estimated or actual profit at all stages of the contract lifecycle (Figure 5). For cohorts of contracts agreed in a given year we will monitor:

- at contract start – contract profit rates;
- during contracts – estimated actual profit rates (before and after any final price adjustment if expected); and
- after contract completion – actual profit rates (before and after any final price adjustment if applied).<sup>10</sup>

**Figure 5: The SSRO will monitor profits throughout the contract lifecycle**



Source: SSRO

<sup>10</sup> The contract completion report is the last contract report submitted by a contractor. While some costs may still be estimated at the time of submission, it provides the most accurate assessment of the actual profit rate for the contract.

2.24. There will be three key measures against which the SSRO will benchmark, in aggregate, the profit rates observed for cohorts of contracts at different stages in the contract lifecycle (Figure 6).

**Figure 6: Measures for benchmarking observed profit rates**

Measure	What it is	Relevance
Baseline profit rate (BPR)	The BPR is the three-year rolling average of the median profit level indicator of the group of comparable companies after deducting allowances for the servicing of capital employed.	The BPR is the starting point of the six-step process for calculating the contract profit rate. Comparing the contract profit rate with the BPR for the year in which it was agreed reveals the effect of the six-step adjustments.
Unadjusted underlying profit rate (UUPR)	The UUPR is the three-year rolling average of the median profit level indicator of the group of comparable companies before deducting allowances for the servicing of capital employed.	The UUPR provides a measure of the overall profitability of comparable companies. Comparing contract profit rates and (estimated) actual profit rates with the UUPR reveals the extent of variation from the profits earned by comparable companies.
Contract profit rate	The contract profit rate agreed between the parties using the six-step profit rate methodology.	Comparing the (estimated) actual profit rate to the contract profit rate reveals the extent of variation in profit resulting from variances between estimated and actual costs.

Source: SSRO

*At contract start*

2.25. Data on contract profit rates can be taken from contract pricing statements which contractors must provide within one month of the date the QDC is entered into<sup>11</sup> or the date the contract becomes a QDC following a contract amendment. We expect to report at least annually on contract profit rates for cohorts of contracts agreed in a given year. We will examine the average and the range for each cohort.

2.26. The SSRO's most recent analysis found that the adjustments agreed on a contract-by-contract basis as part of the six-step process resulted in a range of contract profit rates. In aggregate, the adjustments made contract profit rates higher than the BPR. The average contract profit rate reported by contractors in 2015/16 was 11.52 per cent (compared to the prevailing BPR of 10.60 per cent). The average contract profit rate reported in the first half of 2016/17 was 10.97 per cent (compared to the prevailing BPR of 8.95 per cent).

2.27. The analysis of contract profit rates allows us to identify the aggregate effect of different adjustments, for example, the cost-risk or capital servicing adjustments. We can also observe trends in how these are applied across successive cohorts of contracts. For example, the SSRO's analysis shows that, to date, the CSA has been the largest adjustment made to the BPR when calculating contract profit rates.<sup>12</sup>

<sup>11</sup> The time of agreement, not contract signature date if that date is different.

<sup>12</sup> SSRO (2016) *Capital Servicing Adjustments in Qualifying Defence Contracts*.

### *During contracts*

- 2.28. During contracts, quarterly and, in some cases, interim contract reports (submitted at least every three years) will provide regular updates on any changes in the expected level of costs and, consequently, profits being earned in those contracts (both before and after any anticipated final price adjustment). We expect to report annually on updated estimates of actual contract profit rates for cohorts of contracts agreed in a given year. We will examine the average and the range for each cohort.
- 2.29. These regularly updated estimates of actual profit rates will be an important early indicator of any significant and systemic variances from contract profit rates. They will also provide us with the opportunity to identify variances between the profits contractors expect to earn on contracts and the profits earned by the group of comparable companies used in the calculation of the BPR in the year the contracts were signed.

### *At contract completion*

- 2.30. After contracts end we will monitor actual profits, using data from contract completion reports. We expect to report annually on the actual profits achieved on contracts before and after any final price adjustment for cohorts of contracts agreed in a given year. We will examine the average and the range for each cohort. We will also monitor use of the final price adjustment.
- 2.31. Contract completion reports are required to be submitted within six months of the contract completion date. The SSRO's analysis of planned contract duration for contracts agreed in 2015/16 and the first half of 2016/17, shows that, for these contracts, the number of contract completion reports submitted in any year will remain below 10 until 2019/20. A full set of contract completion reports for the contracts signed in 2015/16 is not expected to be submitted until 2025/26.
- 2.32. Therefore, in the short term, low levels of contract completions will provide us with only a limited view of:
- the actual profits being earned in cohorts of QDCs and QSCs; and
  - variances from contract profit rates or the profits earned by the group of comparable companies used in the calculation of the BPR in the year the contracts were signed.

## **Feedback from stakeholders**

### **Aims of the regulatory framework**

1. One respondent questioned the use of the terms 'value for money for the taxpayer' and 'a fair and reasonable return to contractors'. These, it was said, did not accurately reflect the SSRO's objectives set out in the Defence Reform Act 2014. (The Act refers to value for money in relation to 'government expenditure on qualifying defence contracts' and 'a fair and reasonable price' for those contracts.) This nuance was felt to be important. It was also suggested that we should not seek to 'balance' these objectives but achieve them simultaneously.
2. Respondents noted the global nature of the defence industry and highlighted that the MOD's contractors either operated in overseas markets or had overseas parent companies. As a result, an assessment of what was fair and reasonable would need to take account of the level of returns that were available to contractors in international single source procurement regimes.

3. Respondents commented that balancing value for money and fair and reasonable returns required a long-term 'strategic' rather than a short-term 'contract by contract' approach. However, they said the assessment of value for money was something that would need to be undertaken at the contract level, based on an understanding of what contracts were delivering. One noted that the assessment of value for money was completely subjective.
4. Respondents noted that there was a risk that monitoring contract profits or corporate profitability would be too slow to detect significant issues before defence industrial capacity had already been eroded, for example, due to firms exiting the market or not bidding for new work.
5. It was proposed that an assessment of what was fair and reasonable would need to consider the different perspectives of prime contractors, second-tier contractors and small and medium-sized enterprises.
6. Respondents indicated that, in considering value for money, the SSRO should consider national prosperity, jobs, strategic capability, operational capacity, long-term investment and export potential. Some felt that the SSRO did not adequately recognise the benefits to the taxpayer that flow from a vibrant defence industry, which would be fostered if returns were fair and reasonable.
7. There was a perception that the SSRO was not sufficiently focused on fair and reasonable returns for industry. That the MOD had knowledge of the recommended BPR for the next financial year ahead of industry was seen as an example of a lack of even handedness on the part of the SSRO as it gave the MOD an advantage in negotiating contracts towards the financial year end.
8. Respondents noted that profit formed a small proportion of the total price of a qualifying defence contract. As such, monitoring contract profits could not provide assurance that contract prices were delivering value for money to taxpayers (nor, we might assume, a fair and reasonable return for contractors).

#### **Using report data**

9. While respondents felt that interim and quarterly contract reports would give good insights into actual contract profit rates as contracts matured, they questioned the proposals for benchmarking these against the baseline profit rate or unadjusted underlying profit rate. There were concerns that such comparisons might lead to an unnecessarily biased view of actual contract profit rates. It was suggested that the only appropriate benchmark for the actual contract profit rate is the contract profit rate agreed at the outset.
10. One respondent commented that the reporting requirements were disproportionately burdensome for contractors with lower value QDCs. An increase in the threshold for a contract becoming a QDC was suggested as a solution to this. There was a particular reporting challenge, it was suggested, for companies which were structured in a way that made it difficult for them to identify Allowable Costs within corporate overheads.

### 3. Interpreting profitability

3.1. In section 2 we described how the SSRO would use the data in contract reports to monitor the profits expected or achieved at the start, during and after the end of contracts. This section introduces technical and other factors that influence how we:

- interpret observed profit in contracts; and
- relate contract profit rates to other indicators of contractors' profitability to help understand whether contract profit rates deliver value for money and fair and reasonable returns.

3.2. These issues require further exploration as part of the SSRO's ongoing review and development of the profit rate methodology and its guidance. Further stakeholder engagement and evidence review is planned to identify how we respond to the issues in the short and longer term.

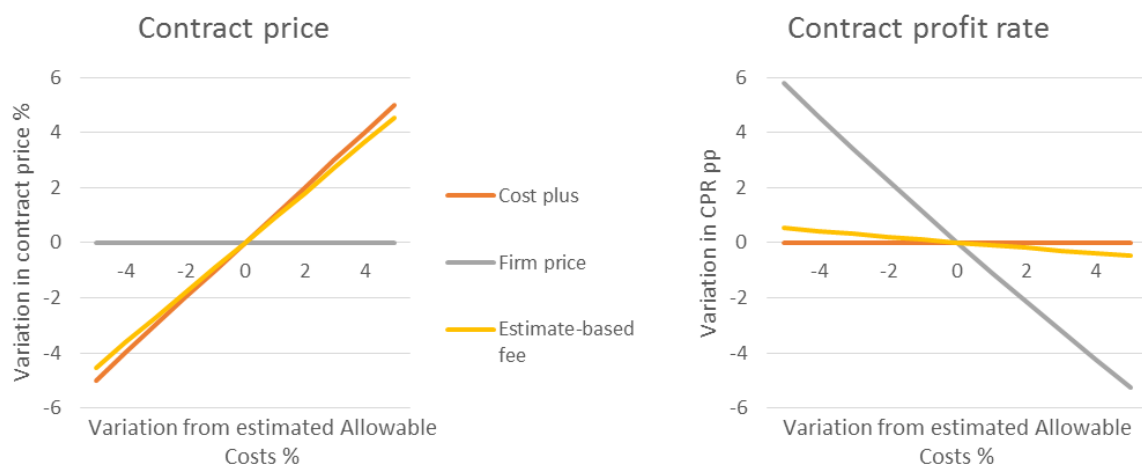
3.3. Feedback received from stakeholders on the content and issues raised is summarised at the end of the section.

#### Contract pricing methods

3.4. We noted above that the parties to a QDC (or component thereof) may agree to use one of six regulated pricing methods (Appendix 3). The pricing method determines the extent of the parties' exposure to cost overruns and the level of risk for the contractor that they will achieve lower-than-expected profits.

3.5. The interpretation of contract profit rates must take account of the level of risk borne by contractors. A high or low profit rate should not automatically be considered unreasonable without a consideration of how risk has been allocated. For example, in firm price contracts, where contractors bear the risk of costs exceeding estimates, contractors will be rewarded with higher returns if costs are lower than expected. Higher profit rates for contractors that accept more risk may still represent value for money for taxpayers if the overall price of the contract is at an acceptable level (Figure 7).

**Figure 7: Illustrative example of variation in contract price and contract profit rate as a result of variation from estimated Allowable Costs for three contract pricing methods**



Source: SSRO



- 3.6. By monitoring the use of different contract pricing methods, the SSRO can consider how risk is being distributed, in aggregate, between the MOD and its contractors. For example, the SSRO's analysis of contract pricing methods in 2015/16<sup>13</sup> found that while most contracts agreed in 2015/16 (25 out of 34) use the firm pricing method, this represents only 7 per cent of the total value of QDCs and QSCs in 2015/16.
- 3.7. Over time we can use the data reported by contractors to examine in more detail the relationship between contract pricing method and variation in costs and profit. We would expect to find a positive correlation between the level of risk borne by contractors and the level of their reward.

### Indicators of profitability

- 3.8. There are many different indicators of profitability which can be measured at different levels in a corporate structure: the contract, the contractor or the ultimate parent undertaking. Some of these indicators are integral to the profit rate methodology, or would be useful aids to the SSRO's monitoring of contract profits. Some, such as the return on capital employed, are used by organisations to measure and manage their performance and inform investment decisions (Figure 8).

**Figure 8: Different profit indicators**

Different profit indicators			
	Profit on cost	EBIT and other profit indicators	Return on capital employed
Parent / holding company	Informs the calculation of the BPR that underpins contract profit rate		A key indicator of profitability to be assessed against the cost of capital
Contracting business unit*			
Contract	Reported by contractors in statutory reports		A useful cross check for the contract profit rate but difficult to measure

Notes: \* - Contracting business units may not be separate legal entities with published financial statements. They may be controlled subsidiaries of one or more parent or holding company.

Source: SSRO

- 3.9. The ability to define profit in different ways and to measure it at different levels raises a number of issues that need to be addressed in order that the SSRO:
- draws appropriate conclusions from the data it uses in the profit rate methodology and for benchmarking observed contract profits; and
  - ensures consistency between its monitoring of contract profits and both the profit rate methodology and Allowable Costs guidance.

<sup>13</sup> SSRO (2016) *Contract Pricing Methods Reported in Qualifying Defence Contracts 2015/16*.

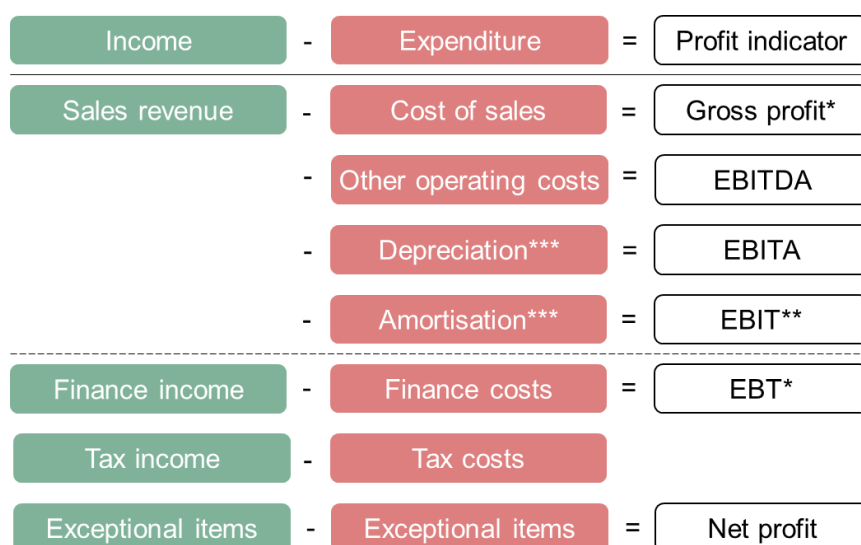
3.10. The issues we discuss below concern:

- the choice of appropriate profit indicators for specific purposes;
- how indicators of profitability are derived; and
- the necessity or desirability of adjusting indicators to enhance comparability.

### Earnings before interest and tax

3.11. The Act specifies that the contract profit rate is applied to the Allowable Costs in the contract, so the SSRO uses profit on cost as a key indicator of profitability for calculating the BPR. This indicator provides comparability and consistency with the SSRO's guidance on Allowable Costs. The current SSRO methodology defines profit on cost using earnings before interest and tax (EBIT). This measure of profit is before borrowing costs, the impact of tax and exceptional items. It therefore measures the return a company makes on its core operations as reported in statutory accounts (Figure 9). If not directly reported in the financial statements, it can be easily calculated.

**Figure 9: Defining and measuring profit**



**Notes:**

\* Defined in International Financial Reporting Standards (IFRS)

\*\* The Financial Reporting Council accepts this is an IFRS measure provided the only differences between it and EBT are finance costs and income.

\*\*\* Accounting estimates of non-cash expenditure.

Source: SSRO

3.12. EBIT is a useful measure of earnings because it is attributable to the entire cost of production incurred. It takes account of overheads and accounting estimates including depreciation and amortisation. Overheads feature heavily in defence contracts and will be charged to the MOD. Defence companies also have considerable fixed and intangible assets so depreciation and amortisation will typically be significant costs. While EBIT is not defined in IFRS, the UK Financial Reporting Council recognises it as an IFRS measure provided that the only differences between it and earnings before tax (EBT, which is defined in IFRS) are the result of finance costs and income.

- 3.13. Some of the MOD's contractors suggest that to improve comparability in the profit rate methodology we should use a different measure of profit, or make other adjustments to the reported results of companies whose profits are used for benchmarking. We discuss these points below and will further consider alternative measures as we keep the profit rate methodology under review.

#### *Amortisation*

- 3.14. Some contractors have highlighted a preference for the use of EBITA (earnings before interest, tax and amortisation) as a measure of profit rather than EBIT. They have pointed out that the levels of profit shown by EBITA can be significantly higher than EBIT where the level of amortisation is high. The use of EBITA rather than EBIT in the calculation of the BPR would result in a higher BPR.
- 3.15. The SSRO recognises this difference, but also notes that its current guidance on Allowable Costs in contracts<sup>14</sup> permits contractors to be reimbursed for any amortisation costs which meet the criteria to be Allowable: that is, being Appropriate, Attributable and Reasonable in the circumstances. The use of EBITA rather than EBIT could have an unintended consequence, in that it may reward contractors for costs that might not have been incurred in the delivery of a QDC or QSC. Any change in the profit measure used to calculate the BPR to take account of amortisation would need to be made in conjunction with a review of the approach to amortisation costs in the Allowable Costs guidance.

#### *Adjustment for costs that may not be Allowable*

- 3.16. A commonly raised issue is that the profits reported by companies in financial statements that the SSRO uses to calculate the BPR are based on costs which, in some cases, might not be considered Allowable for the purpose of a QDC or QSC.<sup>15</sup>
- 3.17. As the SSRO noted in the response to its 2017/18 profit rate methodology consultation, it would be impractical for the SSRO to restate historical reported results that are presented in aggregated databases and it would not enhance comparability.<sup>16</sup> Even if possible, to the extent any such costs may be Allowable, making such adjustments would result in contractors being able to be reimbursed for these items at a flat rate in all QDCs, irrespective of whether or not they are incurred in the delivery of an individual contract.
- 3.18. The issue is also relevant to the SSRO's interpretation of observed profits in contracts. The costs reported in contract reports which inform the calculation of profit are only those which meet the criteria to be considered Allowable in accordance with the SSRO's statutory guidance. The exclusion of non-Allowable Costs in measuring contract profit will make contract profit appear higher than if non-Allowable Costs were included.

#### *Alternative performance measures and adjustments to reported results*

- 3.19. Contractors have identified other adjustments that might be made to EBIT that they have reported in their financial statements. In some cases these are sources of income, such as profits on disposal of assets and non-operating revenue, which would have the effect of increasing the value of EBIT. In the case of exceptional items of expenditure, adjustments would have the effect of reducing the value of EBIT.

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<sup>14</sup> SSRO (2016) *Single Source Cost Standards: Statutory Guidance on Allowable Costs*.

<sup>15</sup> Costs will be Allowable if they satisfy the tests of being Appropriate, Attributable and Reasonable.

<sup>16</sup> SSRO (2016) *2017/18 Profit Rate Consultation: Summary of Responses*.

- 3.20. The management of companies must make judgements about how to present financial performance in their financial statements which are subject to external audit. The auditor must provide an opinion about the financial statements to provide investors and other stakeholders with assurance about the reported results. Financial reporting must comply with accounting standards, for example, IFRS. It is widely recognised that, alongside audited results, management may present alternative performance measures (APMs). These are not required by IFRS, but often used to explain financial performance and provide additional context. A variety of terms like ‘adjusted’, ‘underlying’ or ‘before exceptional items’ are often used to define profit. Management will decide whether income and expenditure items are exceptional (for example, restructuring costs) or whether they occur sufficiently regularly that they are, in effect, ‘business as usual’.
- 3.21. The Financial Reporting Council has examined and commented on the use of APMs by companies.<sup>17</sup> In particular, the FRC observed that explanations are not always given as to why it is necessary to adjust for certain items. It also observed in a sample of 18 cases<sup>18</sup> that there was considerable variation between EBIT and the reported APMs. The APMs were between 200 per cent above and 70 per cent below EBIT. The APM was only below EBIT in four cases (22 per cent).
- 3.22. Our comments above about the practicality of making adjustments apply here also. In the light of the FRC’s findings, we think other adjustments are likely to have an adverse impact on comparability in the calculation of the BPR. The SSRO would, however, be happy to consider further evidence from stakeholders on these adjustment issues.

### **Accounting standards**

- 3.23. International accounting standards are an important part of financial reporting. They guide the judgements made by management about what and how to report, with auditors ensuring reports are appropriate and reasonable. These standards help investors to decide which investments they should make by increasing comparability and consistency across global companies.
- 3.24. Accounting standards evolve as approaches to financial reporting adapt. Examples include:
- FRS102 The Financial Reporting Standard applicable in the UK and Republic of Ireland;
  - IFRS15 (applicable for reporting periods starting after 1 January 2018) which specifies how and when revenue from long-term contracts should be recognised in financial statements; and
  - IFRS 16 (applicable for reporting periods starting after 1 January 2019) which specifies how leases will be recognised, measured, presented and disclosed.
- 3.25. The SSRO must have regard to changes in UK and international accounting standards to ensure its statutory guidance is aligned with the most recent approach. We also need to understand the impact of changes in standards on the reported profits of companies used for benchmarking in the profit rate methodology.

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<sup>17</sup> Financial Reporting Council (2016) *Corporate Reporting Thematic Review: Alternative Performance Measures (APMs)*.

<sup>18</sup> The study consisted of a desktop review of the interim statements of 20 listed companies spread across the FTSE100, FTSE250 and smaller companies.

3.26. The SSRO's monitoring and benchmarking of contract profits also needs to consider the difference between the basis on which contract reports are completed and the basis for reporting in financial statements. Our Allowable Costs guidance states that the allocation of costs to a contract should be based on a contractor's normal accounting system and policies in line with generally accepted accounting principles. Contract reports completed on a mixture of 'cash' and 'accruals' bases may, however, present a different picture of the (estimated and actual) flow of income and expenditure, and consequently profit, during the life of a contract than would appear in the contractors' annual financial statements, prepared on an accruals basis.

3.27. At present the SSRO has separate guidance on:

- Allowable Costs (which relate to the income and expenditure account in financial statements); and
- the calculation of fixed and working capital employed (which relate to the balance sheet in financial statements) to inform the capital servicing adjustment applied at step six of the profit rate methodology.

It may be helpful for us to bring together the guidance on Allowable Costs and capital items into a single articulation of financial reporting, and we welcome views from stakeholders on this.

### **Return on capital employed**

3.28. At the ultimate parent level, the return on capital employed (ROCE) is a key indicator of profitability that would be considered by management, investors and shareholders to inform investment appraisals. ROCE is also considered by economic regulators and competition authorities in other sectors as an appropriate measure of profitability where capital can be reliably valued. It can be compared to external benchmarks or to the organisation's cost of capital to assess whether returns are consistent with those that would be expected in a competitive market. In its recent energy market investigation, the Competition and Markets Authority (CMA) noted that ROCE was a more informative measure of profitability than EBIT margin as it had a clear economic interpretation.<sup>19</sup>

3.29. The SSRO is interested to explore how ROCE may be used to help calibrate the profits being earned in QDCs and QSCs. Issues that need to be explored include:

- how capital is measured and attributed to contracts;
- who funds capital investment – including the respective contribution of private investment and taxpayer funding via the MOD; and
- the timing of different flows of capital funding.

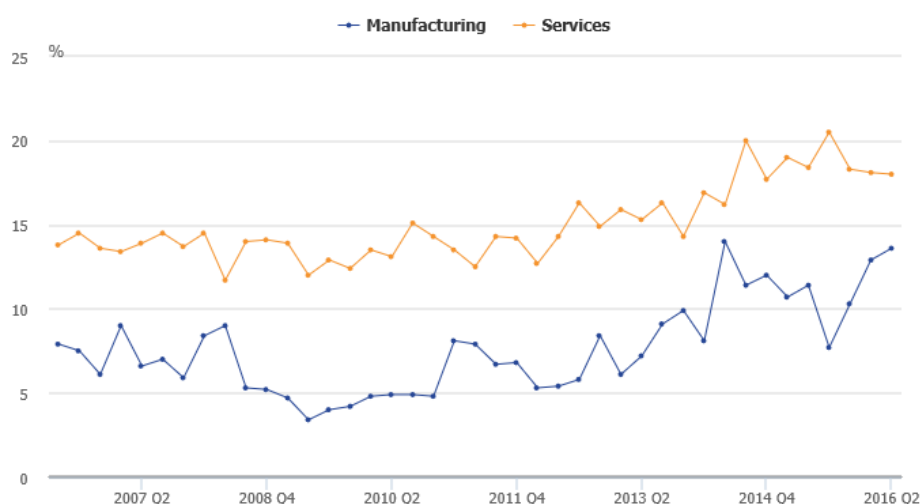
3.30. In calculating ROCE the definition and measurement of capital employed, as well as profit (discussed above), is clearly of great significance. There are different types of capital and different ways of valuing them. The exclusion or underestimation of the value of some assets may lead to the appearance of higher-than-actual rates of return.

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<sup>19</sup> Competition and Markets Authority (2016) *Energy Market Investigation: Final Report*.

- 3.31. The profit rate methodology currently rewards capital employed in contract delivery by means of the capital servicing adjustment. This provides an uplift to the contract profit rate and is applied to costs throughout the life of the contract. The SSRO provides guidance on the calculation of the capital servicing adjustment that ensures a contractor receives an appropriate and reasonable return on its investment in fixed and working capital.<sup>20</sup> The SSRO's definition of fixed and (positive or negative) working capital excludes intangible assets. We inherited this definition from the Yellow Book regime that operated prior to the Act and Regulations came into force. Intangible assets can, however, be a significant proportion of some defence contractors' capital.
- 3.32. Definitions are important if we wish to introduce cross-checks, such as comparing the ROCE for the MOD's contractors against external benchmarks. The Office for National Statistics (ONS) publishes data on the net rate of return<sup>21</sup> on capital employed for UK private non-financial corporations (Figure 10). In due course, we are open to the possibility that this may be a useful benchmark against which to compare the observed ROCE for the MOD's contractors, provided we understand the impact of definitional differences.

**Figure 10: Net rate of return of manufacturing and services companies, Quarter 2 (Apr to Jun) 2006 to Quarter 2 (Apr to Jun) 2016**



Source: Office for National Statistics<sup>22</sup>

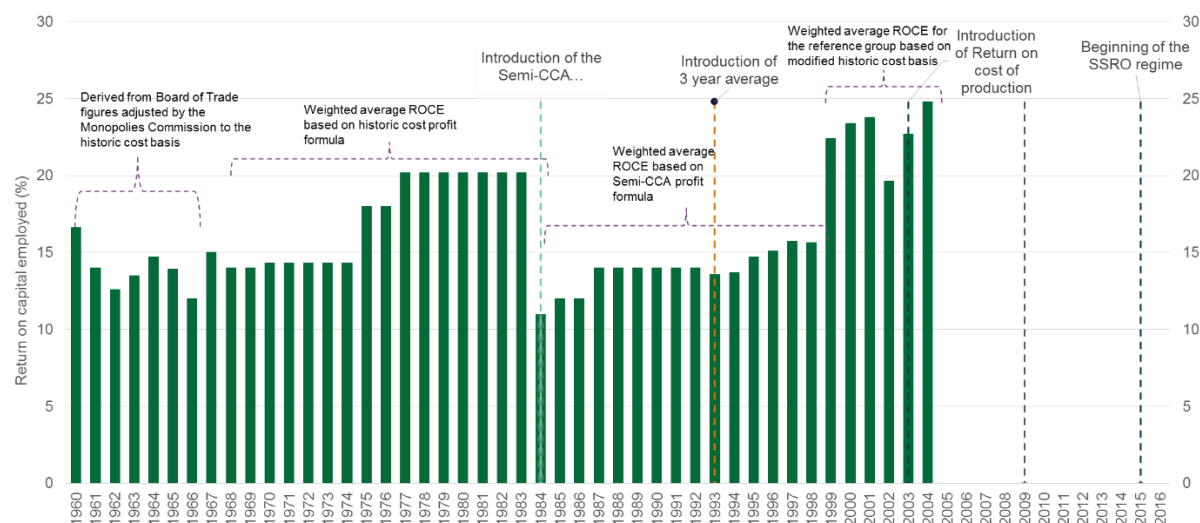
- 3.33. We know from the Review Board for Government Contracts' reviews of the profit rate for non-competitive government contracts, prior to the Act and Regulations coming into force, that defining and measuring capital employed, and attributing it to activities, can present significant challenges. Repeated changes in the Review Board's approach to measuring the ROCE for the UK industry reference group, which was used historically in setting the profit rate for government contracts, demonstrate the differences that arise as a result of changes in what is measured or how it is measured (Figure 11).

<sup>20</sup> SSRO (2016) *Contract Profit Rate: Guidance on Adjustments to the Baseline Profit Rate*.

<sup>21</sup> In the ONS definition, 'net' means the present value of the capital assets used after excluding capital consumed. The net rate of return is calculated as: (Gross operating surplus less capital consumed) / net capital employed (on a replacement cost basis).

<sup>22</sup> <https://www.ons.gov.uk/economy/nationalaccounts/uksectoraccounts/bulletins/profitabilityofukcompanies/aprtojun2016>

**Figure 11: The return on capital employed for the UK industry reference group 1960 to 2004**



Source: Review Board for Government Contracts annual and triennial review reports

### Return on capital employed in contracts

- 3.34. In the long term, it may be desirable to measure the ROCE in specific QDCs and QSCs to provide a cross check for expected or actual contract profit rates. However, accurately measuring the amount of capital employed in a contract is complex.
- 3.35. As noted earlier, the capital servicing adjustment (CSA) applied at step six of the process for calculating a contract profit rate aims to ensure contractors receive an appropriate and reasonable return on the fixed and working capital they employ in contract delivery, through an uplift in the contract profit rate. The CSA is calculated with reference to capital servicing rates which are recommended each year by the SSRO and set by the Secretary of State. The baseline profit rate which is used at step one of the process for setting a contract profit rate is calculated using the profits of comparable companies that have been downwardly adjusted (using the same methodology) to make allowance for the costs of servicing fixed and working capital.
- 3.36. The proportions of fixed and working capital identified by a contractor for the business unit delivering a particular QDC are applied to the respective capital servicing rates to determine an average capital servicing allowance for the contract. This allowance is then scaled using the ratio of the cost of production (CP) to total capital employed (CE) (the CP:CE ratio) for the contracting business unit. Accordingly, contractors with more-capital-intensive operations (those that have lower CP:CE ratios) benefit from larger adjustments than those with less-capital-intensive operations (higher CP:CE ratios).
- 3.37. The SSRO's recent examination of the adjustments applied to contracts<sup>23</sup> found that, in aggregate, the CSA is the largest adjustment in the six step process for agreeing a contract profit rate. It increased the average contract profit rate by 1.10 percentage points in 2015/16 and 1.55 percentage points in the first half of 2016/17. Of the 46 QDCs the SSRO examined, one quarter had a CSA of zero with the remainder having adjustments ranging from 0.30 percentage points to 3.67 percentage points.

<sup>23</sup> SSRO (2016) *Capital Servicing Adjustments in Qualifying Defence Contracts*.

- 3.38. In most cases adjustments were based on the CP:CE ratio for the business unit undertaking the contract. Rarely had a contractor attempted to measure the capital employed in a contract to derive a contract-specific CP:CE ratio.
- 3.39. The SSRO will continue to monitor data being provided in contract reports about the capital employed in contracts to understand how this can best be measured at the contract level. This will enable us to consider, in due course, the potential to use ROCE at the contract level as an additional cross-check for profits earned on contract costs.

### **Time periods**

- 3.40. Our consideration of corporate profitability needs to take account of the potential for normal variation over time. As noted by the CMA in its guidelines for market investigations, the returns of firms will vary over time as result of cyclical factors, marketing initiatives, past innovation or superior efficiency.<sup>24</sup> Whichever indicators of profitability we are considering, we will need to be alert to the effect that the time period selected has on interpretation. Shorter time periods may be more significantly affected by abnormal results than longer time periods.
- 3.41. The CMA aims to avoid distortions caused by unusual macroeconomic conditions or one-off events by examining profitability over a full business cycle. For its recent energy market investigation it examined information on six large energy firms covering a six- to eight-year period. The BPR is set using a three-year rolling average of the median profit-level indicator for groups of comparable companies in order to smooth the effect of variation from one year to the next. We welcome views on the appropriate time frame over which we should consider the profitability of the MOD's contractors when calibrating profit rates in single source contracts.

### **Feedback from stakeholders**

#### **Contract pricing methods**

1. Respondents said more consideration needed to be given to how contractors could be incentivised to improve performance (schedule and cost) and bear more risk to the mutual benefit of the MOD and contractors. The level of reward available for contractors was important in achieving this. The final price adjustment was felt to provide a disincentive to exceptional performance by contractors.
2. Understanding of the allocation and reward for risk was felt to be significantly underdeveloped with the regime. Respondents sought clarity on how we might examine whether risk and reward were appropriately correlated.

#### **Earnings before interest and tax**

3. Respondents challenged our presentation of the treatment of exceptional items in the derivation of different measures of corporate profit; noting that exceptional items are not defined in international financial reporting standards. Accordingly, they suggested it was impossible to consistently derive a company's profits before exceptional items from group accounts.

<sup>24</sup> Competition Commission (2013) *Guidelines for Market Investigations: Their Role, Procedures, Assessment and Remedies*.



#### *Amortisation*

4. Respondents reiterated a preference for the use of earnings before interest, tax and amortisation as a more appropriate measure of profit. They disagreed with our assertion that there would be unintended consequences from using this metric.

#### *Adjustment for costs that may not be Allowable*

5. Respondents reiterated their view that it was inappropriate and inequitable for the baseline profit rate to be set based on profits that were calculated on costs that might not be Allowable in a qualifying defence contract.
6. Respondents noted that the allocation of indirect costs (such as sales and marketing or research and development) to contracts was more likely to be controversial than for direct costs (labour, materials and subcontracts).
7. It was suggested that the current approach to Allowable Costs in contracts was not sufficiently equitable in allocating indirect costs between MOD and non-MOD contracts. Some proposals were made as to how areas of contention might be addressed.

#### *Alternative performance measures and adjustments to reported results*

8. Respondents again indicated a preference for the SSRO to adjust company reported results used in setting the baseline profit rate, to exclude the impact of non-recurring items on reported profit levels. It was suggested that their inclusion might inappropriately depress profit in the comparator group (although, we can assume, it may also serve to inflate profit). It was stated that such adjustments had been made under the Yellow Book regime that operated prior to the Defence Reform Act 2014.

#### **Accounting standards**

9. Respondents agreed with the need to take into account changes in accounting standards.
10. There was little support for the suggestion that we might bring together guidance on Allowable Costs and the calculation of fixed and working capital for the capital servicing adjustment. Respondents were unclear what the benefit of doing so would be and sought further clarity on the proposal. One thought this might signal a desire to roll the capital servicing adjustment into the baseline profit rate. It was felt this would be detrimental to comparability in setting the baseline profit rate given the different capital structures of the comparable companies.

#### **Return on capital employed (ROCE)**

11. Respondents felt that ROCE was an important consideration in rewarding contractors. (One suggested that return on invested capital was a more appropriate measure, which had been omitted from the discussion paper). However, they did not support the suggestion that ROCE could be used as a cross-check for contract profit on costs. They noted that defence is a 'capital light' industry (which, we conclude, would have the corresponding effect of making returns on capital employed appear high). Respondents said that care would therefore be needed in measuring ROCE to avoid 'unreliable outcomes'. Respondents noted the difficulty of measuring capital employed in contract delivery in a consistent way. This was not currently required in contract reports. Some respondents thought it would be difficult to compare ROCE on a like-for-like basis.

12. Despite the concerns about ROCE, a business-specific capital servicing adjustment (CSA) was thought to be an important mechanism to ensure that rewards were commensurate with capital employed. This was particularly important given the differences in the size and capital intensity of contractors and the extent to which the MOD invested in capital to support contract delivery. It was noted however that the CSA only applied to fixed and working capital and not to goodwill on acquired businesses, on which shareholders would expect companies to deliver a return on investment in perpetuity.
13. Respondents also noted some contractors do not employ material capital but provide intellectual property through their skilled workforces.

**Time periods**

14. Respondents agreed that it was important to consider profitability over a period of time, to avoid distortions that might occur in a single year from exceptional items of income or expenditure. It was noted that the timing of profit recognition would vary depending on the length of the contract. Given the long-term nature of some contracts, a longer averaging period was preferred by respondents.

## 4. A fair and reasonable return for industry

- 4.1. This section of the paper presents a range of public financial market indicators for the ten holding companies that (through their subsidiaries) received the highest contract payments from the MOD in 2015/16 (referred to below as 'the suppliers').<sup>25</sup> Public financial market indicators provide valuable insights about the financial health of companies from the perspective of investors. Such indicators are commonly used by economic regulators in the UK to assess the financial health of regulated companies. They may provide a useful cross-check for the SSRO's monitoring of contract profits.
- 4.2. Feedback received from stakeholders on the content and issues raised is summarised at the end of the section.

### Objectives

- 4.3. There are two purposes for presenting this data. The first is to respond to comments received from some of the MOD's contractors about the need to take a 'top-down' view of profitability; that is, from the perspective of shareholders and investors, rather than looking at profits earned on cost in contracts. The data presented in this section indicate that the suppliers are, in general, attractive to investors and providing them with reasonable rates of return. We do not discern that there has been any substantive change in these indicators resulting from the introduction of the profit rate methodology for QDCs and QSCs. This suggests that there is no need at present for a stringent monitoring regime. But we recognise it is early days. The data provide a baseline for subsequent monitoring of these indicators.
- 4.4. The second aim is to promote discussion about the appropriateness of these indicators for monitoring the financial health of the MOD's contractors. The SSRO is keen to discuss with the MOD's contractors how these indicators should be interpreted. We also want to identify whether there are any alternative financial market indicators that we might usefully include in our monitoring.
- 4.5. Most of the indicators look backward. In presenting the data the SSRO does not intend to make predictions about the future financial performance of any of the suppliers featured in the analysis. There will clearly be many factors impacting on the performance of individual companies and their attractiveness to investors. It is not the SSRO's intention to guide, in any way, the decisions of investors.
- 4.6. The indicators focus on issues of relevance to equity and debt investors (Figure 12).

**Figure 12: Investor considerations**

Equity	Debt
<ul style="list-style-type: none"><li>• Share price</li><li>• Shareholder returns</li><li>• Earnings forecasts</li><li>• Beta</li></ul>	<ul style="list-style-type: none"><li>• Credit ratings</li><li>• Debt issuance</li></ul>

Source: SSRO

- 4.7. The section concludes by considering the weighted average cost of capital (WACC) for the suppliers. WACC is commonly recognised by management, investors and

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<sup>25</sup> The MOD publishes statistics annually on its spending with contractors. More detail on the MOD's contract spending is provided in section 5 of this paper.

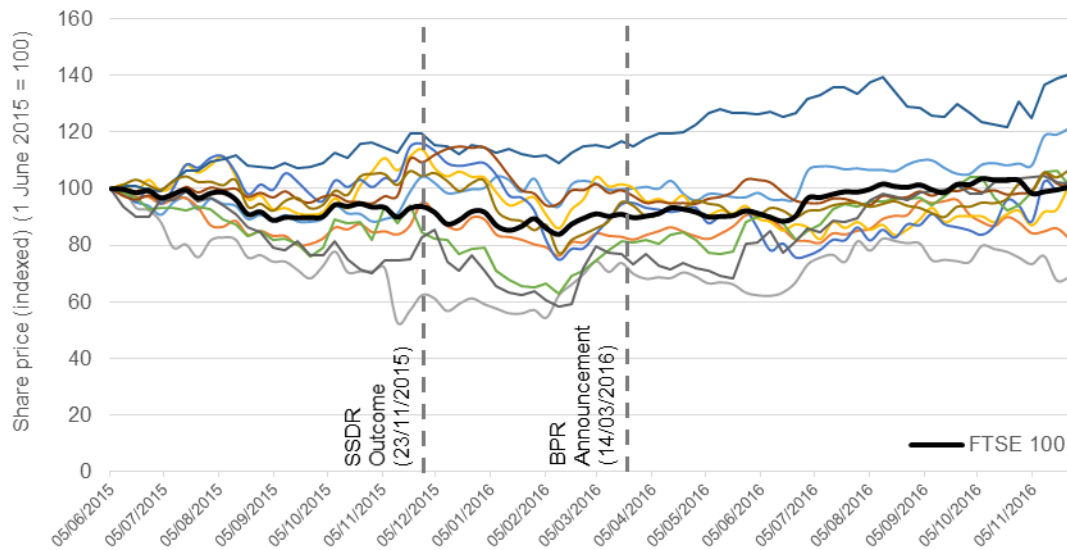
economic regulators to be the appropriate benchmark against which to assess the return on capital employed for an undertaking.

## Equity market indicators

### Share price

- 4.8. Shares in the MOD's ten main suppliers are listed and traded on stock markets. The aggregate market capitalisation of the suppliers at 1 December 2016 was in excess of £240 billion. Share prices track the value at which investors have agreed to buy and sell shares over time, taking account of expectations of future dividends or share price variation, the underlying financial health of the share issuer, and how these factors compare to the opportunities presented by investing in other shares or assets. Share prices can vary as a result of factors specific to the share issuer or due to other factors in the economies in which share issuers operate. Stable or rising share prices are an indicator that investors have confidence in the ability of the share issuer to deliver financial returns.
- 4.9. The SSRO examined the performance of share prices for the suppliers over an 18-month period from 1 June 2015 to 1 December 2016 (Figure 13). For six of the suppliers share prices were broadly similar at the end of the period as at the start. This performance echoes that of the FTSE 100 index over the same period.<sup>26</sup> During the period the majority of the suppliers saw share price variation within plus or minus 20 per cent. One supplier saw its share price increase by 40 per cent in the period examined.

**Figure 13: Share price performance for the MOD's main suppliers**



Source: SSRO analysis of data from Bloomberg

- 4.10. The SSRO observes no strong evidence that the suppliers' share prices were affected by two events of potential relevance to their future financial performance:
- the outcome of the UK government's Strategic Defence and Security Review (SSDR) on the 23 November 2015 which set out priorities for future UK defence spending; and
  - the announcement by the Secretary of State on the 14 March 2016 of a reduction

<sup>26</sup> This index is provided for illustration. Not all the suppliers are listed on the London Stock Exchange.

in the BPR from 10.60 per cent for 2015/16 to 8.95 per cent for 2016/17.

4.11. The data suggest that wider market and operational factors have had greater impact on the suppliers' share prices than either of these events.

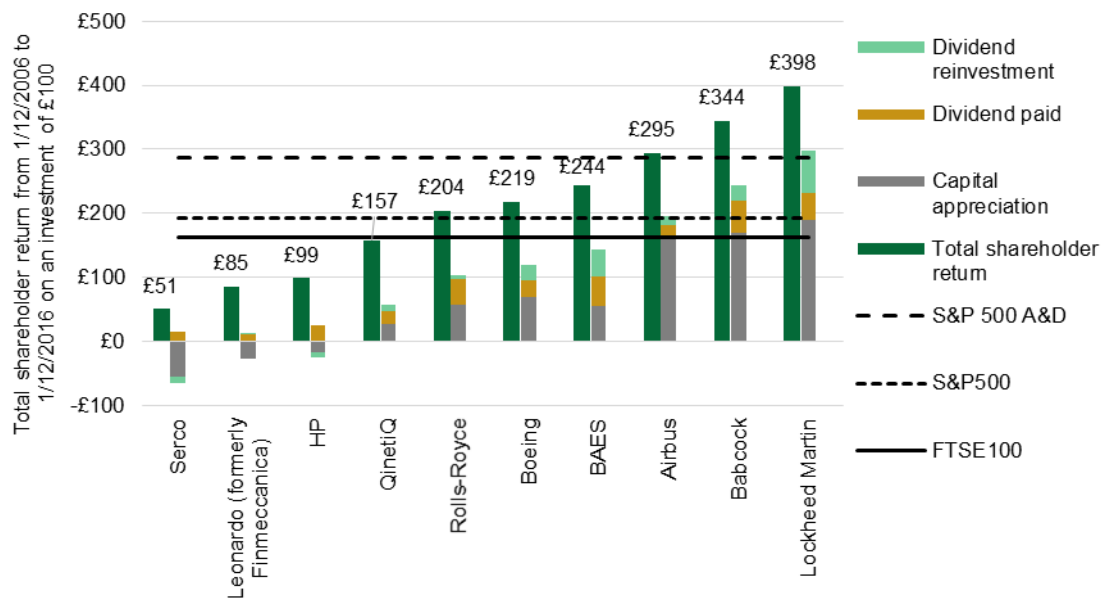
### Shareholder returns

4.12. Shareholders generate income from dividends and capital gains from rising share prices. Shares may also fall in value. Examining the returns to shareholders from dividends and capital appreciation over a period of time gives an indication of the value generated by share issuers for their shareholders.<sup>27</sup>

4.13. The SSRO examined the returns for shareholders from a £100 investment in each of the suppliers over a ten-year period from 1 December 2006 to 1 December 2016 (Figure 14).<sup>28</sup> Seven of the suppliers saw a positive return on the initial investment. Six of these saw returns that were greater than those achieved by the FTSE 100 and S&P 500 indexes; with the original investment more than doubled over the period. Shares in three of the suppliers yielded returns that exceeded the S&P 500 A&D, an index of US firms operating in the aerospace and defence sectors. Over the time period considered, for the seven cases that saw a positive return on the initial investment:

- capital appreciation accounted for between 38 per cent and 82 per cent of the returns for shareholders; and
- dividend payments accounted for between 11 per cent and 37 per cent of the returns for shareholders.

**Figure 14: Ten-year shareholder returns for the MOD's main suppliers**



Source: SSRO analysis of data from Bloomberg

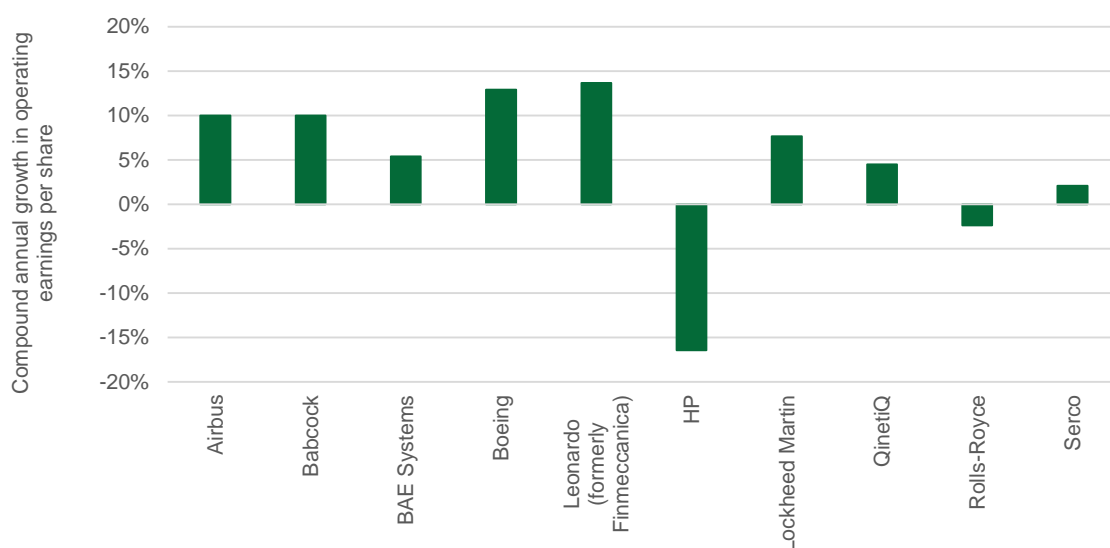
<sup>27</sup> The analysis assumes continuous ownership of shares over the period and the reinvestment of dividends into the investment.

<sup>28</sup> No adjustment is made for inflation over the period.

### Earnings forecasts

- 4.14. Equity analysts forecast the potential for growth in operating earnings for share issuers. These forecasts give an indication of the likely future earnings for shareholders.
- 4.15. The SSRO examined, for the suppliers, the most recent analyst estimates of long-term compound annual growth of operating earnings per share over the next full business cycle (three to five years) reported by Bloomberg at 1 December 2016. Eight of the ten suppliers were forecast to see annual growth in operating earnings per share over this period (Figure 15).

**Figure 15: Long-term compound annual growth rate of operating earnings per share**



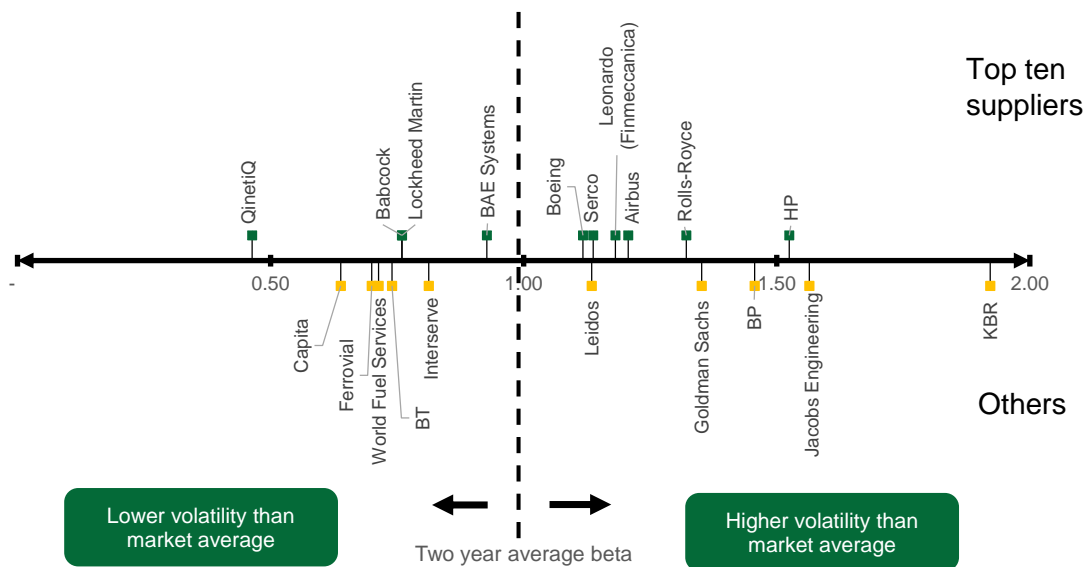
Source: SSRO analysis of data from Bloomberg

### Market betas

- 4.16. Beta is a measure of the variability of a share's price relative to the overall variability of share prices in the stock market on which it is traded. A beta value of one implies no difference from the variability seen in the market. A value lower than one signals less variability than the market. A value higher than one reflects greater variability than the market. Accordingly, beta values provide an indication of the additional level of risk shareholders face that the value of their investments will fluctuate, compared with the wider share market.
- 4.17. The SSRO examined average beta values for the suppliers, relative to the markets on which their shares trade,<sup>29</sup> over a two-year period from 1 December 2014 to 1 December 2016 (Figure 16). Beta values for the suppliers ranged from 0.46 to 1.52. We found a similar range of average beta values among other suppliers to the MOD. Four of the suppliers had beta values lower than one.

<sup>29</sup> For example, the FTSE 100 index was used as a reference benchmark for the calculation of beta values for the UK suppliers.

**Figure 16: Market betas for the MOD's main suppliers**



Notes: The MOD's ten main suppliers are shown in the top half of the chart. The bottom half of the chart shows, for comparison, a number of other holding companies paid more than £50 million by the MOD in 2015/16.

Source: SSRO analysis of data from Bloomberg

## Debt market indicators

### Credit ratings

- 4.18. Credit ratings are opinions issued by ratings agencies on the creditworthiness of organisations issuing debt to finance their activities. Ratings give an indication of the ability of those organisations to service their debt obligations. There are three main credit ratings agencies: Standard and Poor's (S&P), Moody's and Fitch. Each uses a similar classification system (Appendix 7).
- 4.19. Unlike some other regulated industries, there is no expectation or licence condition that the MOD's contractors will maintain any particular level of credit rating. The SSRO examined credit ratings for the suppliers as at 30 January 2017 (Figure 17). Two are not currently rated by any credit rating agency. Of those that are rated, seven have investment-grade credit ratings. The other has the highest non-investment-grade rating.

**Figure 17: Credit ratings for the MOD's main suppliers at 30 January 2017**

Supplier	Standard & Poor's	Moody's	Fitch
Airbus Group Se	A+	A2	A-
Babcock International Group PLC	BBB	-	-
BAE Systems PLC	BBB	Baa2	BBB
Leonardo SpA (formerly Finmeccanica)	BB+	Ba1	BB+
HP Inc	BBB	Baa2	BBB+
Lockheed Martin Corporation	BBB+	Baa1	BBB+
QinetiQ Group PLC	-	-	-
Rolls-Royce Holdings PLC	BBB+	A3	A
Serco Group PLC	-	-	-
The Boeing Company	A	A2	A

Note: A hyphen (-) indicates that no rating is available.

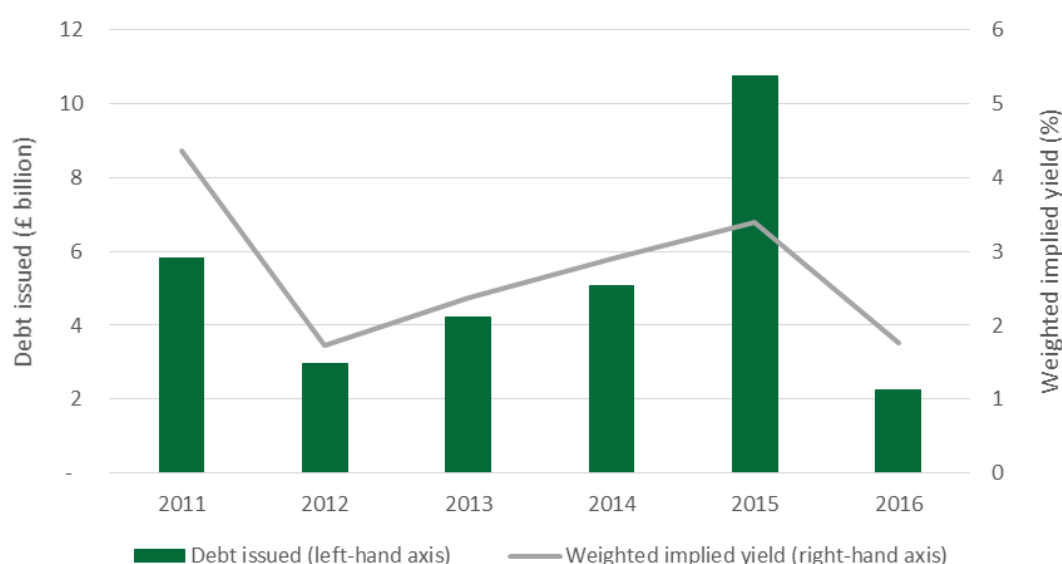
Source: Agencies' long-term credit ratings at 30 January 2017

#### Debt issuance

4.20. The suppliers' ability to access debt funding at competitive rates, whether in the form of bank loans or the issuance of corporate bonds, gives an indication of how they are perceived by capital providers. Data on bank lending is not in the public domain. The SSRO has therefore only examined bond issuances.

4.21. We observe that eight of the suppliers have raised capital through bond issuances from 2011 to 2016 (Figure 18). Between them these suppliers have issued approximately £31 billion of debt. Using data on the annual coupons associated with these debt issuances we calculated an implied yield to provide a broad indication of borrowing costs. Over the period, the implied yields (weighted by the value of debt issued) ranged from 1.7 per cent to 4.4 per cent.

**Figure 18: Debt issued by the MOD's main suppliers 2011 to 2016**



Note: The chart shows aggregated data for eight of the suppliers.

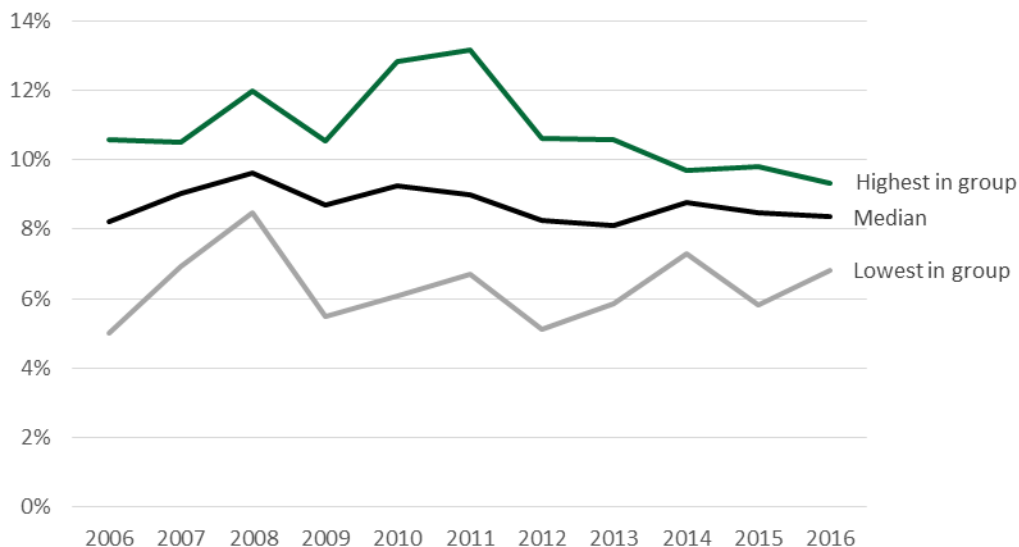
Source: SSRO analysis of data from Bloomberg



## Weighted average cost of capital

- 4.22. The weighted average cost of capital (WACC) is an indicator of the cost of a firm's debt and equity. It combines the costs of each form of capital according to its relative contribution to the firm's capital structure.
- 4.23. An approximate measure of the WACC for the suppliers is available through the Bloomberg financial data service. The SSRO examined the estimated post-tax WACC for the suppliers over the period from 2006 to 2016 (Figure 19). On average, the post-tax WACC remained broadly stable throughout this period; between 8 and 10 per cent.

**Figure 19: The estimated post-tax WACC for the suppliers**



*Notes: The chart shows the median, highest and lowest estimated post-tax WACC for the suppliers based on Bloomberg's standard methodology where:*

$$WACC = (Market\ Capitalisation / Total\ Capital) \times Cost\ of\ Equity + (Debt / Total\ Capital) \times Cost\ of\ Debt \times (1 - Tax\ Rate) + (Preferred\ Equity / Total\ Capital) \times Cost\ of\ Preferred\ Equity$$

*The Cost of Equity is defined as: Risk free rate + Country Premium x Applied Beta.*

*The Cost of Debt is derived from bonds with a similar credit rating.*

*Source: SSRO analysis of data from Bloomberg*

- 4.24. Some suppliers publish details of their WACC in their financial statements and the bases on which these are calculated (Figure 20). However, definitional differences should be taken into account before drawing comparisons between companies or with the data presented in Figure 19.

**Figure 20: WACC reported by suppliers**

Supplier	Pre- or post-tax	2016 (%)	2015 (%)	2014 (%)
Airbus Group Se				
Airbus	-	-	8.4	9.4
Airbus helicopters	-	-	8.2	9.0
Airbus Defence and Space	-		8.0	8.7
Babcock International Group PLC	Pre-tax	~9.2	-	-
	Post-tax	~7.0-8.0	~7.0-8.0	-
BAE Systems PLC	Post-tax	-	7.47	7.12
Leonardo SpA (formerly Finmeccanica)				
Helicopters	Post-tax	-	8.7	9.1
DRS	Post-tax	-	7.9	7.6
SES	Post-tax	-	7.7	9.0
Aeronautics	Post-tax		7.2	9.1
HP Inc			-	
Lockheed Martin Corporation			-	
QinetiQ Group PLC			-	
Rolls-Royce Holdings PLC	Pre-tax	-	13	13
Serco Group PLC			-	
The Boeing Company			-	

Notes: A hyphen (-) indicates data was not available.

Source: Suppliers' financial statements

4.25. Other economic regulators commonly use WACC to assess the reasonableness of the return on assets achieved by companies whose activities are subject to regulation. UK regulators take different approaches to calculating the cost of capital. Members of the UK Regulators Network (UKRN) publish details of their cost of capital decisions and are working together to share good practice on cost of capital issues.<sup>30</sup>

4.26. Some regulators undertake extensive analysis of the financial performance of regulated organisations (Appendix 8). The approaches taken present a range of alternatives that may merit further consideration for monitoring the financial health of the MOD's single source contractors if low-level monitoring identifies concerns. We welcome the views of stakeholders on this.

#### Feedback from stakeholders

1. Respondents felt the indicators presented may be useful in determining the overall health of the contractors supplying the MOD, although questioned their usefulness in assessing whether the government was getting value for money or contractors receiving fair and reasonable prices.
2. Some respondents felt it was premature for the SSRO to be attempting to draw any conclusions from long-term trends in financial market data given that the regime introduced by the Defence Reform Act had only been operating for two years.

<sup>30</sup> UK Regulators Network (2016) *Cost of Capital – Annual Update Report: 2015-16*.

3. Respondents queried aspects of the metrics shown and noted issues affecting interpretation. For example, suggesting that the weighted average cost of capital (WACC) should be assessed on capital invested not capital employed, and that the operation of share buyback programmes would have an impact on expected earnings per share. External market factors, and timing issues would also need to be taken into account in interpreting financial market data.
4. It was suggested that an assessment of returns on assets (against the WACC) was less appropriate for the defence contractors (for which human capital was a material factor in performance) than for other regulated industries (which were usually required to make large capital infrastructure investments). However, it was also suggested that the WACC observed (8-10 per cent after tax) might provide a useful benchmark for contract profit rates (which would, therefore, need to be 10-12.5 per cent before tax, assuming no disallowed costs).
5. Respondents felt that the approach to setting contract profit rates tended towards a 'one size fits all' solution. They wished for greater flexibility for contract profits to match the level of competitive profits evident in the industries in which contractors usually operated, and the return on investment expected by their shareholders. Multiple baseline profit rates were seen as a potential solution to this problem.

## 5. Market structure

- 5.1. This section presents the SSRO's analysis of data published by the MOD<sup>31</sup> in autumn 2016 on its spending with contractors and our estimate of the MOD's spending within QDCs and QSCs. The profit rate methodology, which is applied to contracts, takes no specific account of the individual circumstances of contracting companies. The SSRO's ability to observe the effect that regulation of contract profits has on individual contractors is influenced by:
- the dependency of the contractor on non-competitive MOD contracts; and
  - the proportion of the MOD's spend on non-competitive contracts that is subject to regulation under the profit rate methodology.
- 5.2. Feedback received from stakeholders on the content and issues raised is summarised at the end of the section.

### Overview

- 5.3. For some of the MOD's contractors, regulated contracts represent a significant proportion of their revenue. The profitability of these contractors will be more directly affected by the profit rate methodology. However, the long-term nature of some regulated contracts may mean that the impact of changes in contract profit rates may not be discernible in corporate profitability for a number of years. The examination of profits during contracts and the consideration of other indicators of financial health, as discussed earlier in this paper, will provide early warning of any issues affecting the ability of these contractors to secure the capital they need to continue operating.
- 5.4. Conversely, for some other contractors, regulated contracts represent a very small proportion of revenue. For these, the profit rate methodology will have an indiscernible impact on profitability at a corporate level. These contractors, however, may be sensitive to the level of profit earned on regulated contracts as they may have a wider range of alternative ways to deploy their capital to secure the best return for capital providers. The SSRO will look to the MOD to highlight any difficulties it experiences agreeing contracts with these contractors, which may indicate that the profit rate methodology is having an adverse impact.
- 5.5. We present below our analysis of the most recently published data, and will continue to monitor this.

### Dependency of contractors on MOD single source contracts

- 5.6. Restrictions on publishing certain data about QDCs prohibit us from identifying the level of MOD spend in QDCs with particular contractors. However, the MOD does publish statistics annually on its overall expenditure with contractors. The MOD's data includes the amount of contract payments in the year to organisations paid more than £5 million and the amounts of payments to holding companies<sup>32</sup> paid more than £50 million. This includes some information on amounts spent through non-competitive contracts, though not specifically regulated contracts.

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<sup>31</sup> MOD (2016) *Finance & Economics Annual Bulletin: Trade, Industry & Contracts 2016*.

<sup>32</sup> Holding companies are defined by the MOD as those which are the ultimate parents – full or part – of other companies – either subsidiaries or joint ventures.

### *Holding companies*

5.7. In 2015/16, there were 52 holding companies paid more than £50 million by the MOD.<sup>33</sup> The MOD has for many years published data on the percentage of its spend with the ten most-highly-paid holding companies that was due to contracts that were competitively tendered or non-competitive. The MOD's data show that the ten holding companies receiving the highest payments in 2015/16 earned a combined total from all contracts of £10.2 billion. This was over 42 per cent of the MOD's total procurement spend. Two-thirds (67 per cent, £6.8 billion) of the payments to this group of holding companies were the result of non-competitive contracts (Figure 21). This accounted for 78 per cent of all (£8.8 billion) non-competitive contract payments in 2015/16.

**Figure 21: Non-competitive contract payments in 2015/16 for ten holding companies receiving the highest overall contract payments that year**

Holding Company	MOD non-competitive contract spend 2015/16 (£m)	Non-competitive contract spend as % of all MOD spend
BAE Systems PLC	3,416	93
Babcock International Group PLC	820	53
Leonardo SpA (formerly Finmeccanica)	712	96
Rolls-Royce Holdings PLC	707	86
QinetiQ Group PLC	451	88
The Boeing Company	343	70
Airbus Group Se	208	27
Lockheed Martin Corporation	99	19
HP Inc	42	7
Serco Group PLC	30	6
Total	6,829	67

Source: SSRO analysis of MOD data

5.8. For only three of these companies did the MOD's non-competitive contract payments in 2015/16 represent more than 10 per cent of global revenue in 2015: QinetiQ (60 per cent), BAES (20 per cent) and Babcock (20 per cent). For five of the ten companies, the MOD's non-competitive contract payments represented less than 1 per cent of global revenue in 2015.<sup>34</sup>

### *Contractors*

5.9. The MOD spends a significant proportion of its procurement budget with a relatively small group of contractors. In 2015/16, 335 organisations were paid more than £5 million by the MOD. The MOD reports that this group represent less than 2 per cent of the 18,000 organisations paid in 2015/16, but it received 92 per cent of the MOD's direct expenditure. The 20 most-highly-paid of these organisations accounted for over half of all the MOD's procurement expenditure that year.

5.10. Some of these contractors depend heavily on the MOD's non-competitive contracts. For the first time in 2016 the MOD published data showing the proportion of spend with contractors paid more than £5 million that was due to contracts that were competitively tendered or were non-competitive. The SSRO's analysis found that for 6 of the 20 most-highly-paid organisations<sup>35</sup> the MOD's non-competitive contract payments equated to more than half of their UK turnover in 2015 (Appendix 9).

<sup>33</sup> MOD (2016) *Finance & Economics Annual Bulletin Trade, Industry & Contracts 2016*.

<sup>34</sup> Airbus Group Se; HP Inc; Lockheed Martin Corporation; Serco Group PLC; The Boeing Company.

<sup>35</sup> For which financial statements were available at the time of the SSRO's analysis.

## Proportion of spend in QDCs

- 5.11. While we have identified here the significance of non-competitive contract payments to turnover for some of the MOD's contractors, currently, only a minority of that spend is in regulated contracts. This means that the overall profitability of contractors is less sensitive to changes in contract profit rates than suggested by the level of non-competitive contract payments.
- 5.12. The SSRO's analysis estimates that between 15 and 20 per cent of the MOD's non-competitive spending in 2015/16 was associated with QDCs agreed in that year. The remaining non-competitive spend in 2015/16 being a combination of:
- payments related to unregulated contracts agreed in 2015/16; and
  - payments related to unregulated contracts agreed prior to 2015/16.<sup>36</sup>
- 5.13. As existing contracts end and new contracts are entered into the proportion of contracts, and therefore payments to contractors, which are subject to the profit rate methodology will increase. The rate at which this will happen will vary for different contractors depending on the number, value and duration of their existing contracts and the rate at which they sign new contracts.
- 5.14. Accordingly, there will be differences in the rate at which the MOD's contractors and their ultimate parents become exposed to the impact of changes in contract profit rates.

### Feedback from stakeholders

1. The analysis of the MOD's supplier base was thought useful for demonstrating that the regime was dominated by a few contractors with large contracts. It was suggested that more attention should be focused on these contractors/contracts rather than bring more contracts into the regime – as would be the case if the £5 million threshold for a contract becoming a qualifying defence contract was lowered. One respondent indicated that it was already difficult for prime contractors to find companies to bid for or agree to qualifying subcontracts due to the requirements imposed by the single source procurement framework.
2. Respondents agreed strongly that it would be difficult to relate contract profits to corporate profitability or financial health in companies with a diverse portfolio of activities beyond the MOD's single source contracts.
3. Some noted that the defence industry was not comparable to regulated industries such as water or energy, where the performance of companies was entirely contingent on regulated activities. This, it was suggested, made any attempt to use corporate profitability as a cross-check for contract profits a meaningless exercise for all but a few of the MOD's contractors.

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<sup>36</sup> Non-competitive contracts signed prior to 2015/16 would have been subject to agreement under the 'Yellow Book' regime that preceded the implementation of the Act and Regulations. Under the Yellow Book, the Review Board for Government Contracts set a profit rate for contracts and guidance on how this might be adjusted to take account of the level of risk borne by the contracting parties. There were, however, no reporting obligations placed on contractors prior to the implementation of the Act. Consequently, we do not know what proportion of spend in 2015/16 was the result of contracts signed in earlier years that were subject to the government profit formula.

## 6. Next steps

6.1. The SSRO has a statutory duty to ensure that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts. On a contract-by-contract basis it is for the MOD to determine that qualifying defence contract prices represent value for money, having regard to the guidance provided by HM Treasury<sup>37</sup> and the Single Source Contract Regulations. Across the population of qualifying defence contracts, the SSRO will fulfil its statutory duty by:

- making an annual recommendation to the Secretary of State on the baseline profit and capital servicing rates that should be used in agreeing contract prices;
- providing guidance on Allowable Costs and the calculation of contract profit rates;
- assessing compliance with reporting requirements; and
- keeping the impact and operation of the single source procurement framework under review.

6.2. This paper has set out how the SSRO will use the data provided by contractors in statutory reports to monitor actual contract profit rates as part of our routine monitoring of the impact and performance of the single source regime. We will report on this annually.<sup>38</sup> We accept that it will take time for us to be able to draw conclusions from the data we observe given that the Regulations have only been in force since December 2014.

6.3. There remain a number of issues that the SSRO must continue to keep under review in order that it can effectively assess whether the profits it observes in qualifying defence contracts are contributing to the achievement of value for money and fair and reasonable prices. The SSRO remains committed to taking an evidence-based approach to determining the appropriate response to the issues in the short and longer term. This paper has highlighted the issues and provided a summary of the feedback we received on them in February and March 2017 from the MOD and its contractors.

6.4. The SSRO will continue to explore the issues through its forward work programme. We will provide the MOD and its contractors with further opportunities to share insights with us, and seek the wider views of government and other stakeholders. This will help us determine how to address the issues through the SSRO's statutory guidance or our periodic reviews of the Act and Regulations.

6.5. We welcome the opportunity to have a continued dialogue with all interested parties on the issues. The table below (Figure 22) summarises the key issues and how they feature in the SSRO's forward work programme.

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<sup>37</sup> For example, HM Treasury (2011) *The Green Book: Appraisal and Evaluation in Central Government* and HM Treasury (2013) *Managing Public Money*.

<sup>38</sup> The SSRO's first annual report on the single source regime will be published in June 2017, subject to the approval of the SSRO Board.

**Figure 22: Taking forward issues in the SSRO's work programme**

Issue	Brief summary	Where taken forward in SSRO work programme
Contract pricing methods	The interpretation of contract profit rates must take account of risk and how this is allocated between the contracting parties. We would expect to see a positive correlation between profits and risk exposure.	The SSRO's study on risk in 2017 will examine evidence on the interaction between contract risk, Allowable Costs, profit rate adjustments and contract pricing methods. It will also consider how these interactions can be monitored by the SSRO going forward.
The use of EBIT as a profit level indicator	Contractors challenge the use of EBIT as a profit level indicator. They would prefer the SSRO to use an indicator that takes account of amortisation costs; make adjustments to reported results for exceptional items; and address the issue of non-Allowable Costs included in the calculation of profit for companies in the baseline profit rate comparator groups.	The SSRO will consider these issues as part of future development of the profit rate methodology.
Accounting standards	The SSRO must have regard to changes in UK and international accounting standards to ensure its statutory guidance is aligned with the most recent approach.	The SSRO periodically reviews its guidance on Allowable Costs and adjustments to the baseline profit rate. We will review in 2017 (and periodically thereafter) what updates are needed to take account of changes in accounting standards.
Guidance on balance sheet items	At present the SSRO has separate guidance on the treatment of balance sheet items for the purpose of calculating Allowable Costs and the capital servicing adjustment.	The SSRO periodically reviews its guidance on Allowable Costs and adjustments to the baseline profit rate. We will review in 2017 the consistency and alignment of guidance on balance sheet items.
Return on capital employed	Return on capital employed (or return on invested capital) might act as a cross-check for profit earned on cost in contracts, but requires further work. Contractors say that the capital servicing adjustment is important, but measuring capital use in contracts is difficult, and not currently required. The SSRO's definition of capital employed excludes intangible assets, which contractors say are important to contract delivery. Returns on capital at the group company level are, for many, too weakly correlated to contract profits to provide a meaningful benchmark. Definitional differences make benchmarking problematic.	<p>The SSRO is undertaking a review of the Act and Regulations to inform recommendations for change to the Secretary of State in June 2017. The review is considering the scope of capital employed for the purpose of calculating the capital servicing adjustment.</p> <p>The SSRO periodically reviews its guidance on Allowable Costs and adjustments to the baseline profit rate. Reviews in 2017 will consider what changes would be helpful to improve the evidence base on capital employed in contracts.</p>



Issue	Brief summary	Where taken forward in SSRO work programme
Using financial market indicators to assess defence industry health	The MOD's contractors have highlighted a need for the SSRO to consider profitability from the perspective of shareholders and investors. Financial market indicators may be useful but care is needed in the interpretation of data. For only a few companies is the level of MOD single source contracts likely to be material to financial market perceptions. A retrospective assessment may, in any event, be too slow to highlight issues that may be related to the single source regime, but observation of indicators would be helpful in assessing their usefulness.	The SSRO has indicated that defence industry health will be one of the factors it monitors annually when assessing the impact and performance of the single source regime. The SSRO's first annual report on the single source regime is due for publication in June 2017. The SSRO will give further consideration to the use of financial market indicators as part of the work to prepare the 2017 annual report.

Source: SSRO

## Appendix 1: Monitoring the effectiveness and impact of the single source regime

1. The SSRO's first annual monitoring report is due for publication in June 2017. As we have stated previously, that report will consider ten factors that are important indicators of the single source regime's effectiveness and impact, including variances between outturn and expected profit rates and defence industry health (Figure 23).<sup>39</sup>

**Figure 23: Ten factors the SSRO will use to monitor the effectiveness and impact of the regime**



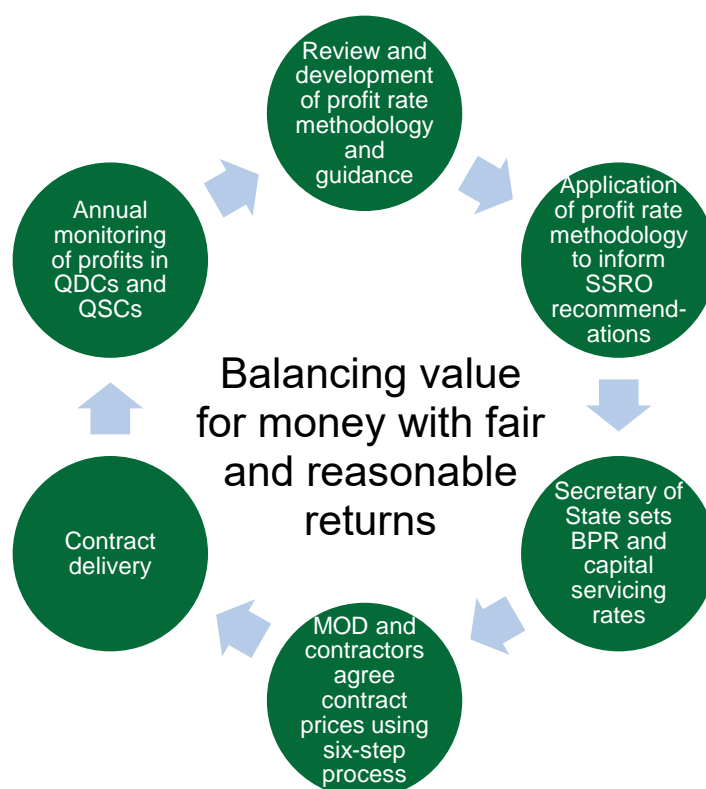
Source: SSRO

<sup>39</sup> SSRO (2016) *Monitoring the Impact and Performance of the Single Source Regulatory Framework*.

## Appendix 2: Refining the profit rate methodology and guidance

1. The SSRO completed a major review and consultation on the profit rate methodology in 2015.<sup>40</sup> In 2016, the SSRO was asked by the Secretary of State ‘further to develop’ the methodology,<sup>41</sup> and we consulted on additional changes<sup>42</sup> to inform the 2017/18 recommendation to the Secretary of State.<sup>43</sup>
2. The SSRO’s ongoing monitoring of profits in QDCs and QSCs will inform periodic review and development of the profit rate methodology and SSRO guidance to ensure a balance is struck between value for money for taxpayers and fair and reasonable returns for contractors (Figure 24). Where we identify changes to the profit rate methodology or guidance are required, those will be subject to stakeholder consultation.
3. The SSRO may make recommendations to the Secretary of State for changes to the Act and Regulations if it thinks more substantive revisions are needed.<sup>44</sup>

**Figure 24: Monitoring contract profits will inform review and development of the profit rate methodology and guidance**



Source: SSRO

<sup>40</sup> SSRO (2015) *Review of Single Source Contract Profit Rate Methodology 2015: Response to Consultation*.

<sup>41</sup> Michael Fallon MP, Secretary of State for Defence (2016) *Single Source Contracts: Written Statement* – HCWS618.

<sup>42</sup> SSRO (2016) *2017/18 Profit Rate Consultation: Summary of Responses*.

<sup>43</sup> The recommendation for 2017/18 will be made by the end of January 2017.

<sup>44</sup> The Secretary of State for Defence is required to conduct periodic reviews of the regulatory framework for single source defence contracts. The SSRO will provide its recommendations for the first of these by June 2017. Its consultation on possible recommendations for change is ongoing at the time of publishing this paper (SSRO (2017) *Consultation on recommendations: Review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014*).

### Appendix 3: Regulated pricing methods for a QDC or QSC

1. The Regulations specify how costs should be treated in each of the six regulated pricing methods that are used in pricing QDCs and QSCs (Figure 25). This affects the level of profit earned by contractors in those contracts and the potential for the actual profit rate to be higher or lower than the contract profit rate initially agreed.

**Figure 25: Regulated contract pricing methods**

Pricing method	Description
Firm	The Allowable Costs are the costs estimated at the start of the contract. The profit earned by the contractor is calculated by applying the profit rate to the estimated costs agreed at the start of the contract.
Fixed	The Allowable Costs are the costs estimated at the start of the contract, with an adjustment in accordance with a specified index at a specified time or times. The profit earned by the contractor is calculated by applying the profit rate to the Allowable Costs at the end of the contract once the index change is known.
Cost-plus	The Allowable Costs are the actual costs incurred to deliver the requirement, established at the end of the contract. The profit earned by the contractor is calculated by applying the profit rate to the actual costs of completing the work.
Estimate-based fee	The Allowable Costs are the actual costs incurred to deliver the requirement, established at the end of the contract. The profit earned by the contractor is calculated by applying the profit rate to the estimated costs agreed at the start of the contract.
Volume-driven	The Allowable Costs are the cost per unit at the time of agreement, multiplied by the actual number of units produced by the end of the contract. The costs estimated at the time of agreement may be adjusted in accordance with a specified index at a specified time or times. The profit earned by the contractor is calculated by applying the profit rate to the Allowable Costs incurred at the end of the contract, once the number of units produced are known.
Target	Target pricing sets an estimated target cost and target profit. The Allowable Costs are the target costs estimated at the start of the contract. The target profit earned by the contractor is calculated by applying the profit rate to the target costs. An agreed variation mechanism is used to adjust the price payable to the contractor, should the costs change from pre-determined parameters. Cost savings or overruns against the target cost are shared between the contractor and MOD on a pre-agreed basis.

Source: SSRO

## Appendix 4: Final price adjustment – worked examples

1. We provide below, for clarification, illustrations of how the final price adjustment would be applied in different cases of variation between estimated and actual Allowable Costs (AC) (Figure 26).
2. The illustrations are based on a firm price contract where with the following characteristics:
  - Estimated AC = £100 million.
  - Contract profit rate (CPR) = 10 per cent.
  - Contract price = £110 million.
3. The columns on the left hand side of the table show examples where actual AC are higher than estimated. The columns on the right hand side show examples where actual AC are lower than estimated.
4. The illustrations should be considered in conjunction with the explanation of the application of the final price adjustment provided in section 2 of this paper.

**Figure 26: Illustrations of the application of the final price adjustment**

Variation in AC (%)		Actual Allowable Costs higher than expected			0.0	Actual Allowable Costs lower than expected		
		20.0	15.0	10.0		-5.0	-10.0	-15.0
<b>Contract outturn</b>								
Actual AC (£m)		120.0	115.0	110.0	100.0	95.0	90.0	85.0
Actual profit or loss (£m)	= <i>Contract price - Actual AC</i>	-10.0	-5.0	0.0	10.0	15.0	20.0	25.0
Actual CPR (%)	= <i>Actual profit or loss / Actual AC</i>	-8.3	-4.3	0.0	10.0	15.8	22.2	29.4
Variance from contract profit rate (pp)	= <i>Actual CPR - CPR</i>	-18.3	-14.3	-10.0	0.0	5.8	12.2	19.4
<b>Analysis of profit/loss (£m)</b>								
Loss up to loss level	<i>Loss level = contract price + 5%</i>	-5.5	-5.0	0.0				
Loss exceeding loss level	<i>Loss level = contract price + 5%</i>	-4.5	0.0	0.0				
Profit up to Excess level 1	<i>Excess level 1 = CPR + 5pp</i>				10.0	14.3	13.5	12.8
Profit up to Excess level 2	<i>Excess level 2 = CPR + 10pp</i>				0.0	0.8	4.5	4.3
Profit up to Excess level 3	<i>Excess level 3 = CPR + 15pp</i>				0.0	0.0	2.0	4.3
Profit above excess level 3	<i>Excess level 3 = CPR + 15pp</i>				0.0	0.0	0.0	3.8
Total		-10.0	-5.0	0.0	10.0	15.0	20.0	25.0
<b>Final price adjustment (£m)</b>								
For loss up to loss level	<i>Add 25% of value to contract price</i>	1.4	1.3	0.0				
For loss exceeding loss level	<i>Add 50% of value exceeding contract price</i>	2.3	0.0	0.0				
For profit up to excess level 1	<i>No adjustment</i>							
For profit up to excess level 2	<i>Deduct 25% of value from contract price</i>				0.0	-0.2	-1.1	-1.1

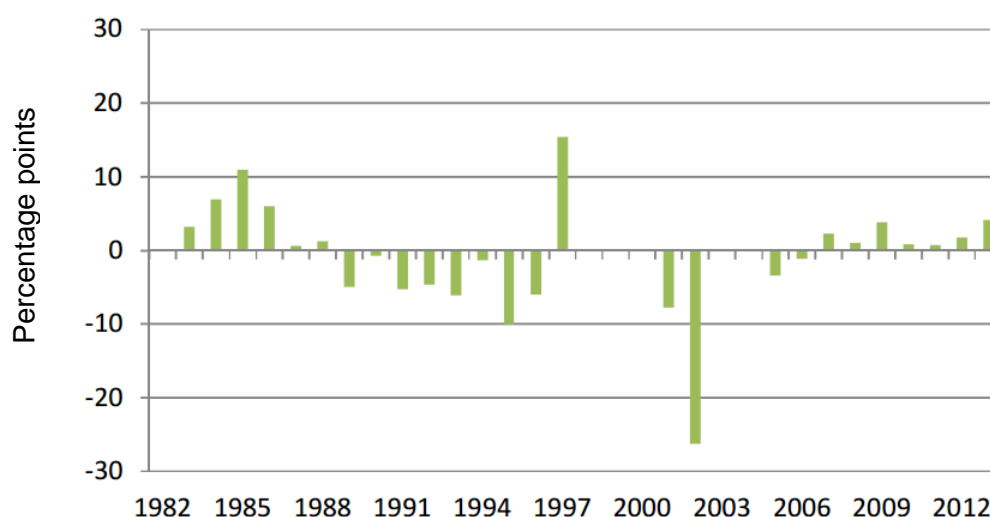
Variation in AC (%)		Actual Allowable Costs higher than expected				Actual Allowable Costs lower than expected		
		20.0	15.0	10.0	0.0	-5.0	-10.0	-15.0
For profit up to excess level 3	<i>Deduct 50% of value from contract price</i>				0.0	0.0	-1.0	-2.1
For profit above excess level 3	<i>Deduct 75% of value from contract price</i>				0.0	0.0	0.0	-2.8
Total		3.6	1.3	0.0	0.0	-0.2	-2.1	-6.0
Final price adjustment (FPA)	<i>Only applied if value exceeds £0.25m</i>	3.6	1.3	0.0	0.0	0.0	-2.1	-6.0
<b>Adjusted contract outturn</b>								
Adjusted contract price (£m)	<i>= Contract price + FPA</i>	113.6	111.3	110.0	110.0	110.0	107.9	104.0
Actual AC (£m)		120.0	115.0	110.0	100.0	95.0	90.0	85.0
Adjusted actual profit or loss (£m)	<i>= Adjusted contract price - Actual AC</i>	-6.4	-3.7	0.0	10.0	15.0	17.9	19.0
Adjusted actual CPR (%)	<i>= Adjusted actual profit or loss / Actual AC</i>	-5.3	-3.3	0.0	10.0	15.8	19.9	22.4
Effect of adjustment on CPR (pp)	<i>= Actual CPR – Adjusted actual CPR</i>	3.0	1.1	0.0	0.0	0.0	-2.4	-7.1

Source: SSRO

## Appendix 5: Historic variation between expected and actual profits

1. In 2014, the Review Board for Government Contracts published an analysis of variance between the target rate of return for non-competitive government contracts and the actual profits achieved on those contracts as reported by contractors in annual returns related to 2012.<sup>45</sup> In that year there was a variance of 4.10 percentage points between the average expected profit on cost for contracts subject to the government profit formula (8.55 per cent) and the actual profit (12.65 per cent).<sup>46</sup> Across the £5.1 billion total value of the contracts analysed, this variance (if sustained) would equate to an additional £0.2 billion of profit for contractors.
2. The Review Board observed wide variation between actual and expected profits for individual contractors: ranging from 31 percentage points below expected to 44 percentage points above expected. Contractors reported that these variations were the result of improved efficiency, renegotiation of contracts and the recognition of profit toward the end of contracts.
3. The Review Board's analysis of annual returns noted a much greater degree of variance between average profit expected and achieved in some years (Figure 27). The level of variance was generally lower in the period following the introduction of new profit formula arrangements following the 2003 General Review.

**Figure 27: Review Board estimates of the variance of actual returns from target rate**



*Notes: No returns were collected for the period 1997 to 1999 and 2003 to 2004.*

*Source: Review Board for Government Contracts (2014) Report on the Annual Review of the Profit Formula for Non-competitive Government Contracts (p14).*

4. The Review Board also examined the results of the MOD's post-costing of contracts to see how closely contract costs matched targets. In 2014 the Review Board examined post-costing reports for 16 contracts with a total value of £739 million. These reports showed that costs were lower than target in 12 cases and higher than target in 4 cases. In two of the cases where costs were lower than target the MOD negotiated refunds to the Exchequer totalling £2.9 million.

<sup>45</sup> Thirty-seven contractor business units provided returns analysing work performed in 2012 on contracts totalling £5.1 billion. The Review Board concluded these returns provided a material level of coverage of the population of contracts subject to the Government Profit Formula.

<sup>46</sup> The Review Board's estimates were based on a weighted average calculation of contracts with a variety of profit rates and which would have started in a number of different years.

5. The Review Board expressed concern over a number of years at the low number of post-costing analyses undertaken by the MOD. This, it said, limited the parties' ability to improve cost estimating or to identify contracts where either party may be entitled to a pricing adjustment.



## Appendix 6: Use of terms

1. The Act uses a number of different terms to describe the 'persons' (in a legal sense, meaning a natural person or a corporation<sup>47</sup>) that are:
  - parties to QDCs and QSCs;
  - associated with persons that are parties to QDCs and QSCs; and
  - required to submit reports.
2. We provide below a summary of the key terms (highlighted **bold**) to clarify terms used in this paper.

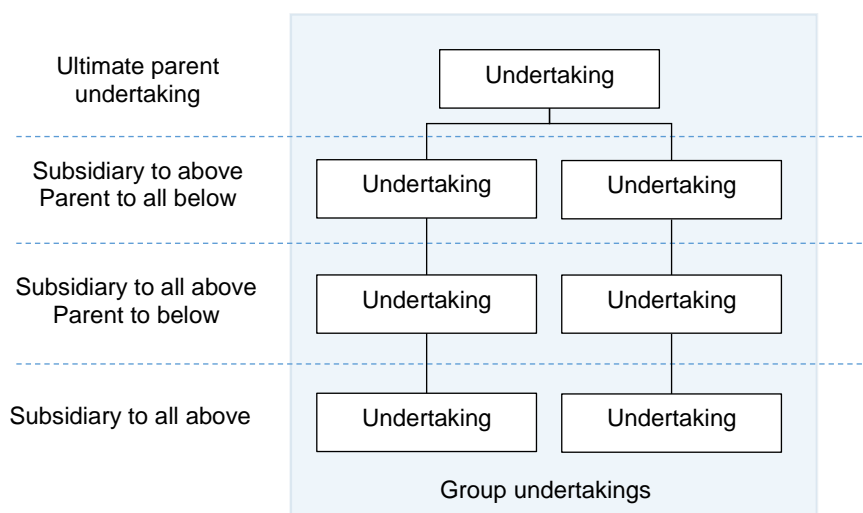
### Contractor

3. The Act defines two types of **contractor**:
  - **primary contractor**, being a person who has a QDC with the Secretary of State for goods, works or services for defence purposes;<sup>48</sup> and
  - **sub-contractor**, being a person who provides anything under a QSC.<sup>49</sup>

### Associated persons

4. The Act and Regulations place certain obligations on contractors and persons **associated** with them to provide reports. Contractors may be associated<sup>50</sup> with other persons if they are **group undertakings** in relation to each other (Figure 28).

**Figure 28: Simple illustration of relationships between group undertakings**



Source: SSRO

<sup>47</sup> *Royal Mail Steam Packet Co v Braham* (1877) 2 App Cas 381 at 386.

<sup>48</sup> Defence Reform Act 2014, section 14(2)(a).

<sup>49</sup> Defence Reform Act 2014, section 28(2)(b).

<sup>50</sup> Defence Reform Act 2014, section 43(3). In this context, group undertaking has the meaning given by section 1161 of the Companies Act 2006.

5. The Companies Act 2006 defines an **undertaking** as:<sup>51</sup>
  - (a) a body corporate or partnership; or
  - (b) an unincorporated association carrying on a trade or business, with or without a view to profit.
6. Undertakings may be a group undertaking in relation to another undertaking where they are:<sup>52</sup>
  - (a) a **parent** undertaking or **subsidiary** undertaking of that undertaking, or
  - (b) a subsidiary undertaking of any parent undertaking of that undertaking.
7. An undertaking is a parent undertaking in relation to another undertaking, a subsidiary undertaking, if:<sup>53</sup>
  - (a) it holds a majority of the voting rights in the undertaking; or
  - (b) it is a member of the undertaking and has the right to appoint or remove a majority of its board of directors; or
  - (c) it has the right to exercise a dominant influence over the undertaking:
    - (i) by virtue of provisions contained in the undertaking's articles; or
    - (ii) by virtue of a control contract; or
  - (d) it is a member of the undertaking and controls alone, pursuant to an agreement with other shareholders or members, a majority of the voting rights in the undertaking.<sup>54</sup>
8. An undertaking shall be treated as a member of another undertaking:<sup>55</sup>
  - (a) if any of its subsidiary undertakings is a member of that undertaking; or
  - (b) if any shares<sup>56</sup> in that other undertaking are held by a person acting on behalf of the undertaking or any of its subsidiary undertakings.
9. An undertaking is also a parent undertaking in relation to another undertaking, a subsidiary undertaking, if:<sup>57</sup>
  - (a) it has the power to exercise, or actually exercises, dominant influence or control over it; or
  - (b) it and the subsidiary undertaking are managed on a unified basis.

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<sup>51</sup> Companies Act 2006, section 1161(1).

<sup>52</sup> Companies Act 2006, section 1161(5).

<sup>53</sup> Companies Act 2006, section 1162(2).

<sup>54</sup> Schedule 7 to the Companies Act 2006 supplements the provision on parent and subsidiary undertakings and provides explanations regarding terms used in this paragraph and the paragraphs below.

<sup>55</sup> Companies Act 2006, section 1162(3).

<sup>56</sup> Companies Act 2006, section 1162(7) notes that references to shares, in relation to an undertaking, are to allotted shares.

<sup>57</sup> Companies Act 2006, section 1162(4).

10. A parent undertaking is treated as the parent undertaking of undertakings in relation to which any of its subsidiary undertakings are, or are to be treated as, parent undertakings. Subsidiary undertakings are defined accordingly.<sup>58</sup>

### **Designated person**

11. Reports on overheads, forward planning and SMEs are required to be submitted by a **designated person**.<sup>59</sup> If a contractor is associated with one or more other persons then the designated person will be the contractor's **ultimate parent** undertaking. In all other cases the contractor is the designated person.

12. An undertaking is the ultimate parent undertaking in relation to two or more persons who are associated with each other, or in relation to itself and one or more persons who are associated with it, if the undertaking:

- (a) is a parent undertaking of those other persons; and
- (b) is not a subsidiary undertaking in relation to another undertaking.<sup>60</sup>

### **Qualifying business unit**

13. Reports on overheads are required to be provided in relation to each **qualifying business unit** (QBU) or **pricing QBU**, depending on the report.<sup>61</sup> In addition, the strategic industry capacity report is required to contain information about QBUs.<sup>62</sup>

14. Regulation 2(1) defines a **business unit** as either:

- (a) a unit:
  - (i) which carries on any activities for the purposes of an undertaking; and
  - (ii) for which separate financial accounting statements are produced; or
- (b) an undertaking, or group of two or more undertakings, for which a single set of financial accounting statements is produced which is separate from the financial accounting statements of each of those undertakings.

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<sup>58</sup> Companies Act 2006, section 1162(5).

<sup>59</sup> Single Source Contract Regulations 2014, regulations 34 to 40 and 45.

<sup>60</sup> Defence Reform Act 2014, section 25(9).

<sup>61</sup> Single Source Contract Regulations 2014, regulations 34 to 39.

<sup>62</sup> Single Source Contract Regulations 2014, regulations 40 to 43.

## Appendix 7: Credit ratings

1. We present below the ratings awarded by the three main credit ratings agencies (Figure 29).

**Figure 29: Credit ratings**

	Investment grade										
<b>Standard &amp; Poor's</b>	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+
<b>Moody's</b>	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	Baa3	Ba1
<b>Fitch</b>	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+

	Non-investment grade				
<b>Standard &amp; Poor's</b>	BB	BB-	B+	B	B-
<b>Moody's</b>	Ba2	Ba3	B1	B2	B3
<b>Fitch</b>	BB	BB-	B+	B	B-

*Source: Ratings agencies*

## Appendix 8: Other regulatory approaches

1. A number of other regulators undertake monitoring of the financial health of regulated organisations. We highlight below a number of the approaches taken.

### Ofwat

2. Ofwat introduced the financial monitoring framework in 2015 to collect, analyse and report on information on the relative performance and financial strength of the water and wastewater companies in England and Wales (appointed companies) which it regulates. The framework enables Ofwat to monitor changes in the financial position of appointed companies over time and inform its approach to targeted and proportionate regulation.
3. Its Monitoring Financial Resilience report (November 2016) sets out the regulator's analysis of the relative performance of the appointed companies; their solvency, liquidity, risk management and longer-term financial viability and resilience in light of anticipated investment programmes. It is based on information that companies published in their annual performance reports for the 2015/16 financial year in July 2016 and their responses to additional questions that Ofwat asked them about their published data. The publication aims to improve transparency of reporting and accountability of the companies to stakeholders. Ofwat published an initial pilot report in October 2015 using data that was publicly available at that time.

#### **Ofwat's financial monitoring framework: Aims**

The purpose of the financial monitoring framework is to:

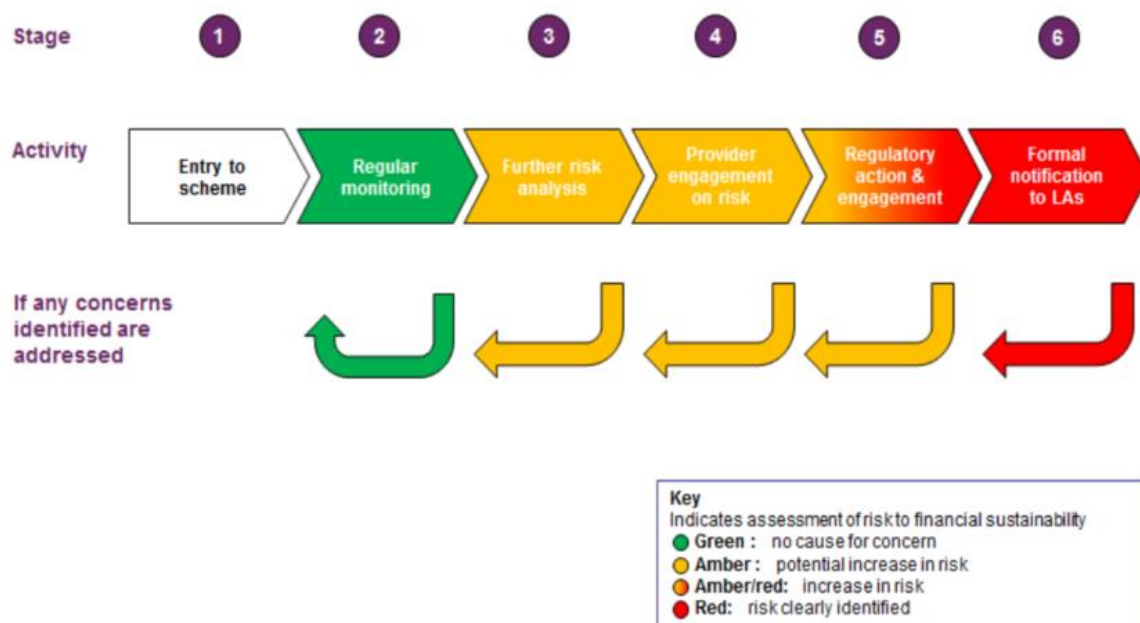
- enhance visibility and transparency of financial and capital structures in the sector;
- assist Ofwat in monitoring the financial stability of the businesses that it regulates and enable other stakeholders to consider and challenge the sector in its identification and management of risk;
- identify financial, structural and systemic risk which may impact on service delivery over time and prove harmful to customers; and
- help Ofwat in determining when it needs to use the regulatory tools available to it to intervene to protect customers' interests.

### Care Quality Commission

4. The Care Quality Commission (CQC) is the independent regulator of health and social care in England. The CQC has a duty to oversee the financial health of difficult-to-replace providers of residential and non-residential adult social care services, so that it can give an early warning if they are likely to fail. The aim of CQC's Market Oversight scheme is to protect people using adult social care services from having their care interrupted where a large or specialist care provider is at risk of financial failure and has to close one or more of its services.
5. The Market Oversight scheme came into effect in 2015. It was introduced following the threat to care services experienced in 2011 when Southern Cross, a large national care provider, faced severe financial difficulties. The scheme focuses on providers who are large in size or have specialisms that would be difficult to replace at local, regional or national level. Legislation sets out the size criteria for which providers are included. A specialist panel makes recommendations to the Secretary of State for Health about which specialist providers should be included.

6. The scheme works by CQC collecting and monitoring information about a provider's finances and quality of care. CQC uses this to assess the level of risk to the provider's financial sustainability. Its regular monitoring uses financial and performance information provided quarterly by providers. CQC undertakes further in-depth analysis where it identifies issues, to understand how these are being addressed. Where it believes risks have increased significantly, it will increase engagement with the provider to get more information about its intentions and ability to reduce risk. Where CQC consider that business failure is likely it will notify local authorities in the areas affected so that they may draw up contingency plans to preserve continuity of care (Figure 30).

**Figure 30: The CQC Market Oversight model**



Source: CQC (2015) Market Oversight of 'Difficult to Replace' Providers of Adult Social Care: Guidance for Providers.

### NHS Improvement

7. NHS Improvement is responsible for overseeing NHS foundation trusts, NHS trusts and independent providers. It was formed in April 2016 to bring together the functions previously undertaken by Monitor, the NHS Trust Development Authority and a number of other organisations concerned with improving NHS services.
8. NHS Improvement has a statutory duty to assess financial risk at independent providers of commissioner requested services (CRS).<sup>63</sup> Monitoring of financial risk aims to:
  - identify any signs of a provider getting into financial difficulty early enough for all concerned to take steps to safeguard essential NHS services;
  - allow commissioners to concentrate on securing health services for NHS patients, confident that risks to the continuity of essential services are being monitored; and
  - be proportionate: in order not to discourage providers from moving into new NHS services, expanding their existing NHS services to benefit patients or continuing to treat NHS patients.

<sup>63</sup> Monitor (2014) *Risk Assessment Framework for Independent Sector Providers of NHS services*.

9. The monitoring framework uses three elements to assess risk:

- an indicative risk rating, adapted from the approach to monitoring NHS foundation trusts, covering liquidity and debt service;
- other high-level information on financial performance – including revenue, margins, working capital and cash flow – in order to make a broader risk assessment; and
- other relevant information with a bearing on financial robustness – such as debt repayment schedules, exception reports and auditor opinions.

## Appendix 9: Non-competitive contract payments 2015/16

1. The SSRO's analysis of data published by the MOD<sup>64</sup> in autumn 2016 shows that for 6 of the 20 organisations<sup>65</sup> receiving the highest contract payments in 2015/16,<sup>66</sup> non-competitive contract payments equated to more than half or their turnover in 2015 (Figure 31).

**Figure 31: Non-competitive contract payments 2015/16 as a proportion of UK turnover for top 20 organisations paid more than £5 million by the MOD in 2015/16**

Organisation Name	Total MOD spend with organisation 2015/16 (£ million)	% of MOD spend in non-competitive contracts	MOD non-competitive spend as % of UK turnover in 2015*	Ultimate Parent Company
BAE Systems Surface Ships Ltd	1,513	96%	>90%	BAE Systems Plc
BAE Systems Marine Ltd	1,100	90%	>90%	BAE Systems Plc
AWE Management Ltd	926	100%	>90%	AWE Management Ltd <sup>a</sup>
Devonport Royal Dockyard Ltd	745	93%	>90%	Babcock International Group
Hewlett Packard Enterprise Defence and Security UK Ltd	595	7%	n/a	HP Inc
BAE Systems (Operations) Ltd	561	89%	<10%	BAE Systems Plc
Rolls-Royce Power Engineering Plc	537	100%	>70%	Rolls-Royce Holdings Plc
AgustaWestland Ltd	518	99%	>40%	Leonardo SpA (formerly Finmeccanica)
Airtanker Ltd	502	0%	n/a	Airtanker Holdings Ltd <sup>b</sup>
QinetiQ Ltd	493	81%	>60%	QinetiQ Group Plc
MBDA UK Ltd	449	89%	>40%	MBDA <sup>c</sup>
British Telecommunications Plc	356	2%	<1%	BT Group Plc
Boeing Defence UK Ltd	349	56%	<1%	The Boeing Company
Aspire Defence Ltd	342	0%	n/a	Aspire Defence Holdings Ltd
Airbus Defence and Space Ltd	325	1%	<1%	Airbus Group SE
Thales UK Ltd	259	65%	>10%	Thales SA
General Dynamics UK Ltd	239	17%	<10%	General Dynamics Corp
CarillionAmey Ltd	214	0%	n/a	CarillionAmey Ltd
Serco Ltd	194	12%	<5%	Serco Group Plc
Capita Business Services Ltd	185	0%	0%	Capita Plc

<sup>64</sup> MOD (2016) *Finance & Economics Annual Bulletin Trade, Industry & Contracts 2016* (supplementary tables).

<sup>65</sup> Excludes payments to other government departments and foreign governments.

<sup>66</sup> For which financial statements were available at the time of the SSRO's analysis.



Notes:

Excludes payments to other government departments and foreign governments.

n/a – data on turnover not available at the time of analysis

\* – Payments as a percentage of turnover are calculated based on data published in company financial statements for the 2015 accounting period. Values are indicative due to inconsistencies in the time periods for which the numerator and denominator are reported.

a – AWE Management Ltd is jointly owned by Lockheed Martin (51%), Serco (24.5%), and Jacobs Engineering (24.5%).

b – Airtanker Holdings Ltd is jointly owned by Airbus (40%), Rolls-Royce (20%), Thales (13.3%), Babcock (13.3%), and Cobham (13.3%).

c – MBDA is jointly owned by BAE Systems (37.5%), Leonardo (formerly Finmeccanica) (25%), and Airbus (37.5%).

*Source: SSRO analysis of contract spending data from MOD (2016) Finance & Economics Annual Bulletin Trade, Industry & Contracts 2016 (supplementary tables) and turnover data from contractors' financial statements.*