SSRO

Single Source
Regulations Office

# Review of legislation

Findings after consultation on contract profit rate steps and reporting requirements, June 2020

# Contents

# 1. Executive summary

1.1 The SSRO is required to keep under review the provision of the regulatory framework for single source defence contracts established by the Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations). We undertook two reviews in 2019/20, aimed at considering selected aspects of the regime in detail, and providing input to the Secretary of State's next periodic review, scheduled to complete in December 2020.

1.2 Our reviews considered aspects of contract pricing and the transparency requirements placed on defence contractors, reflecting the two key elements of the regulatory framework. Our review topics and associated themes are set out in Table 1. We chose these topics in consultation with stakeholders, recognising that issues had arisen with the operation of the regime in these areas and that more detailed exploration could identify any problems and potential solutions.

**Table 1: SSRO reviews and selected themes**

| Reviews | Themes |
|---|---|
| Contract profit rates (CPR) | Cost risk adjustment (CRA)<br>Profit on cost once (POCO) adjustment |
| Reporting requirements | Defined pricing structure (DPS)<br>Amendments and variances<br>Overheads |

1.3 We worked closely with stakeholders to progress the reviews. This included issuing working papers to the MOD and industry in September and October 2019, consulting publicly from December 2019 to February 2020, and holding several workshops.[1] We would like to thank everyone who participated. We have considered all the feedback received in reaching the conclusions identified in this report.

1.4 We have identified several ways in which the functioning of the regulatory framework can be improved. Our findings are summarised in Table 2 and include proposals for legislative changes and proposals of further work on our guidance or the operation of the SSRO's Defence Contracts Analysis and Reporting System (DefCARS). The following paragraphs provide an outline across this scope.

1.5 We found a lack of clarity regarding the operation of the **CRA** and, to assist contracting parties to agree an appropriate adjustment, we have proposed that the definition of the CRA be amended to include reference to who bears the risk. We have also set out areas in which our guidance can be updated in relation to the CRA, subject to any legislative changes made following the Secretary of State's review. These are aimed at emphasising the role of the regulated pricing method, exploring multi-criteria decision analysis, and encouraging a proportionate approach when agreeing the adjustment.

1.6 We are concerned that the current provisions for the **POCO** adjustment are not dealing optimally with improper profit layering. We consider that an adjustment to costs should be the only way to achieve POCO, and that changes should be made to deal with situations of influence (as opposed to control), part-ownership, and where the parties can't identify the attributable profit. We propose an increase in the price threshold at which sub-contracts are considered and reporting of the amount of attributable profit.

1 SSRO (2019), *Review of the single source regulatory framework 2020: Consultation*, https://www.gov.uk/government/consultations/review-of-the-single-source-regulatory-framework-2020-consultation

1.7 We remain of the view that splitting costs by the **DPS** can provide a valuable source of information for the MOD to use in estimating. We propose to revise our guidance on the level of detail required in the DPS, and to continue encourage contractors to engage with the MOD when selecting the DPS and any metrics to be reported. We have identified areas for future guidance and DefCARS development to enable consistent reporting of support, reporting against multiple DPSs, and explanations of mapping to the DPS.

1.8 We think it would be proportionate to introduce a further materiality threshold on the reporting of variances. Otherwise, we intend to proceed with further work on **amendments and variances**, designed to support understanding of why costs change in contracts. This will aim to introduce definitions and examples into our guidance, identify ways to improve reporting of amendments, and explore high level categorisation.

1.9 Through our consideration of **overhead reports**, we identified barriers to referring rates disputes to the SSRO, and to unilateral referral of questions related to the operation of the regulatory framework. We have proposed expansion of the grounds on which matters can be referred to the SSRO, to ensure that disputes and queries can be raised with the SSRO as needed. We set out a legislative change needed to correct an error in the reporting period of the Qualifying Business Unit Estimated Cost Analysis Report ('QBUECAR'). Otherwise, we intend to carry out a further review looking at both overhead recovery and reporting, to identify any improvements we can make through our pricing guidance, reporting guidance, DefCARS, or by recommending legislative change.

1.10 We identified two additional **miscellaneous legislative changes** in the course of our reviews. One of these deals with the target pricing method and proposes that the target price can be adjusted by reference to changes in indices or rates. The other change is to address a drafting error in relation to the final price adjustment, to refer to percentage points rather than percentages.

1.11 When concluding this report, we have considered the Covid-19 pandemic and its impact on both government and industry. We are mindful that the full impact of and (policy) response to the pandemic will continue to evolve. We intend to engage with the Secretary of State's planned, periodic review of the legislation and for our findings to inform that work. We have deferred finalising recommendations to the Secretary of State's review so that we can consider and respond to these developments in the coming months. However, we will move forward now with improvements that we can make to the regime, including through our reporting guidance in relation to the DPS and with planned follow-up projects on overheads, and amendments and variances.

**Table 2: Summary of SSRO findings after consultation**

| Proposed changes to legislation | |
|---|---|
| CRA definition: Clarify that the adjustment should reflect the contract's exposure to cost risk.<br><br>POCO: Reduce the level of prescription in the legislation and leave more room for statutory guidance.<br><br>POCO mechanism: Remove the adjustment to the profit rate to leave a single way to achieve POCO by adjusting the Allowable Costs.<br><br>Modify the POCO adjustment so that: competitive tendering is not the only way to justify profit layering; part-ownership arrangements are effectively captured; the CPR can be substituted where attributable profit is not known; there is a £1 million sub-contract threshold; and POCO applies to situations of influence as well as control. | POCO transparency: Require reporting of attributable profit.<br><br>Variances: Add another materiality threshold, so variances are only explained when they exceed the greater of £100,000 or 1% of the contract price.<br><br>Overheads: Enable rates dispute or matters concerning the operation of the regulatory framework to be referred to the SSRO without the need for joint referral or identification of a contract.<br><br>Overhead reporting: Align the QBUECAR reporting period with that for the ERCR.<br><br>Miscellaneous legislative changes: Allow adjustment of target prices for indices and rates. Amend the final price adjustment to correctly refer to percentage points. |
| **Guidance and DefCARS changes** | **Other planned and future work** |
| CRA: Emphasize the impact of the regulated pricing method on the adjustment, explore points-based approach, and promote a proportionate approach to agreeing the cost risk adjustment.<br><br>DPS: Revise guidance on the level of detail required when costs are broken down by DPS and emphasize the role of the MOD in selecting the DPS and setting metrics.<br><br>Amendments: Introduce further definitions and examples to the guidance and improve the arrangements in DefCARS and guidance for on-demand reporting and reporting material events and circumstances.<br><br>Variances: Explore high-level categorisation of variances in DefCARS and guidance.<br><br>DPS: Make changes to DefCARS and guidance to remove the support rows from equipment structures and enable contractors to explain mapping to the DPS and report against multiple structures.* | DPS: Monitor the impact of revised guidance in relation to DPS selection and reporting of metrics to inform future review.<br><br>Overheads: Carry out a further review of overhead recovery and reporting, as set out in the SSRO Corporate Plan 2020-2023. |

*This work would be prioritised as part of the SSRO's work on the Corporate Plan in consultation with industry and the MOD.

# 2. Background

## The regulatory framework

2.1 The regulatory framework for single source defence contracts came fully into effect in December 2014. It establishes a scheme of regulation that:

- controls the prices of qualifying contracts (qualifying defence contracts or QDCs and qualifying sub-contracts or QSCs); and
- requires transparency on the part of defence contractors regarding their prices and strategic matters such as their capacity to continue to meet the government's requirements.

2.2 These measures are applied to contracts that have not been the subject of competition to ensure that:

- good value for money is obtained in government expenditure on qualifying defence contracts, and
- persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts.

## The SSRO

2.3 The SSRO was established to support the operation of the regulatory framework. Our functions include:

- assessing and recommending the appropriate rates for use in pricing contracts;
- issuing statutory guidance on pricing contracts, reporting and penalties;
- providing opinions and determinations on the functioning of the framework;
- analysing matters relevant to the operation of the framework;
- monitoring the extent to which reporting requirements are complied with; and
- keeping the provision of Part 2 of the Act and the Regulations under review and making recommendations for change to the Secretary of State.

2.4 In carrying out our functions we are expressly required to seek to achieve the aims described in paragraph 2.2.[2]

2.5 The SSRO carried out its reviews of contract profit rates and reporting requirements as part of its duty to keep the provision of the regulatory framework under review. We intend to reflect these findings in recommendations to the Secretary of State in due course to inform the next periodic review of the regulatory framework.

2 Section 13(2) of the Act.

## Review by the Secretary of State

2.6 The Secretary of State must carry out periodic reviews of the regulatory framework.[3] The first review was completed in December 2017 and, following that review, the Regulations were amended by three statutory instruments in 2018 and 2019:

- The Single Source Contract (Amendment) Regulations 2018 addressed some drafting deficiencies in the Regulations, narrowed the exclusion of contracts made within the framework of an international co-operative defence programme and replaced the exclusion of contracts made wholly for the purposes of intelligence activities with an exclusion of contracts which pose a risk to national security. It also excluded contracts which were new but, in substance, a novation of existing contracts which were not qualifying contracts.
- The Single Source Contract (Amendment) (No. 2) Regulations 2018 introduced additional, detailed provisions for re-determining the price of a qualifying contract following amendment.
- The Single Source Contract (Amendment) Regulations 2019 required contractors to provide greater transparency about the supply chains for qualifying contracts, clarified terminology in respect of contract price and value, and addressed some ambiguities.

2.7 The Act requires that subsequent reviews are undertaken at least every five years, with the second review required by 17 December 2022. The MOD indicated that the Secretary of State would complete the second periodic review in December 2020.[4]

## The SSRO's engagement

2.8 We engaged with stakeholders before deciding the topics and themes to be covered in our reviews. This began with engagement on our Corporate Plan 2019-2022 from late 2018 to March 2019. We discussed the themes at our operational working group in April 2019 and at workshops with stakeholders in May 2019.

2.9 We issued working papers to stakeholders in September 2019, in which we called for input relevant to the review themes. We held workshops to discuss these matters with industry and the MOD in September 2019.

2.10 We consulted publicly on a range of proposals between 20 December 2019 and 28 February 2020 and identified areas in which we would benefit from further input. We held two workshops in January and February 2020 to discuss the matters set out in the consultation document. We received 14 written responses to our consultation document, broken down as follows:

- eight defence contractors;
- ADS;
- a public body;
- the MOD;
- two consultants; and
- one other respondent.

3 Section 39(3) of the Act.
4 Section 14 of the Explanatory Memorandum to the Single Source Contract (Amendment) Regulations 2019 at https://www.legislation.gov.uk/uksi/2019/1106/pdfs/uksiem_20191106_en.pdf

2.11 In the interests of transparency, we have published responses where we have the respondent's consent. Some responses have been anonymised at the respondent's request.

2.12 The MOD's response to the consultation indicated that it would not respond substantively to the matters raised by the SSRO. This has limited the SSRO's ability to reach conclusions in several areas, as indicated throughout this document.

## Review of Contract Profit Rates

2.13 We undertook a review of contract profit rates expected or earned by contractors in qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). QDCs and QSCs are non-competitive or single source contracts which are subject to the Regulations. The review of contract profit rates was intended to help us:

a. better understand contract profits in QDCs and QSCs;

b. understand factors that have influenced these contract profits; and

c. consider whether and what changes may be needed to legislation or our monitoring, methodologies or guidance to better achieve the intent of the legislation.

2.14 Our review of CPR was undertaken in two phases. The first phase looked broadly at the contract profit rates agreed to date and the second involved a more detailed consideration of specific issues.

2.15 As part of the first phase, we considered stakeholder feedback provided in previous consultations and engagement on matters relevant to the CPR. We analysed contract pricing data for 159 contracts agreed from 1 April 2015 to 30 September 2018. This was supplemented by analysis of financial data for contractors and their global ultimate owners, and for comparator group companies. We shared our findings with members of the SSRO's Operational Working Group (OWG) in April 2019.

2.16 Drawing on the findings from our analysis and discussions with stakeholders, in phase two the SSRO undertook work to develop the approach to the consideration of risk in the determination of contract profit rates and detailed consideration of the POCO adjustment. We issued a working paper in September 2019, calling for input related to the CRA and the POCO adjustment. We held group and individual meetings with members of the OWG. We received seven responses to the working paper, including from the MOD, ADS (on behalf of its member organisations), and five contractors. We considered these responses in drawing up our proposals set out in the subsequent consultation that we published on 20 December 2019.[5]

2.17 We provide our conclusions in respect of the CRA in section 4, the POCO adjustment in section 5 and miscellaneous pricing matters in section 9. In each section we summarise the matters consulted on, the feedback received, and explain how this has been considered.

5 The other strands of work in the second phase were profit principles and the company size and data quality criteria for the baseline profit rate methodology. This work has concluded separately, and details are available at www.gov.uk/government/organisations/single-source-regulations-office

## Review of reporting requirements

2.18 Defence contractors are required to submit reports if they hold qualifying contracts under the regulatory framework. These reports are a fundamental transparency component of the regime, providing information that should be used to support the MOD's procurement decisions, contract management and development of the regulatory framework.

2.19 Sections 24 and 25 of the Act and Parts 5 and 6 of the Regulations prescribe the types of reports, their contents, and the circumstances in which they must be provided. The reports fall into two broad categories: contract reports and supplier reports, as summarised in Figure 1 below.[6]

**Figure 1: Reports under the regulatory framework**

| Report category | Reports |
|---|---|
| **Contract reports**<br>(Part 5 of the Regulations)<br>Reports required for each QDC and QSC<br>(some of which may additionally be required on-demand)<br>Data about contract requirements, payments, estimated and actual costs, profit, delivery and sub-contracts. | Contract Pricing Statement<br>Contract Reporting Plan<br>Contract Notification Report<br>→<br>Interim Contract Reports<br>Quarterly Contract Reports<br>→<br>Contract Completion Report<br>Contract Cost Statement |
| **Supplier reports**<br>(Part 6 of the Regulations)<br>Reports required about defence contractors when relevant triggers are met.<br>Data about a contractor's overhead costs in standard categories, its strategic capacity and opportunities for SMEs in the supply chain. | **Overhead reports**<br>Estimated Rates Agreement Pricing Statement<br>Estimated Rates Claim Report<br>Actual Rates Claim Report<br>QBU Estimated Cost Analysis Report<br>QBU Actual Cost Analysis Report<br>Rates Comparison Report (on demand)<br>**Strategic reports**<br>Strategic Industry Capacity Report<br>Small or Medium Enterprises Report |

*In this table, and in the Regulations, "QBU" refers to a qualifying business unit.

2.20 Our review of reporting requirements considered the intended purpose of reported information, how it is being used and whether reporting requirements are proportionate. We prioritised three themes following early engagement with stakeholders from late 2018 to May 2019:

- the defined pricing structure used in some of the contract reports;
- the reporting of amendments and variance in contract reports; and
- the overhead reports specified in Part 6 of the Regulations.

6 A summary of the contents of each report can be viewed in Appendix 1 of the *SSRO's Annual Compliance Report 2019*: https://www.gov.uk/government/publications/annual-compliance-report-2019.

2.21 To develop our thinking, we engaged with stakeholders through a series of workshops and bilateral meetings between May and September 2019. We released a working paper to key stakeholders on 2 September 2019 and invited feedback. We received eight responses from ADS, six defence contractors and the MOD, which helped shape our understanding of:

- the challenges faced by stakeholders when reporting and using the data;
- how reported data can best support the MOD in procuring and managing single source contracts; and
- whether the purpose of these reports envisaged at the inception of the regime remain relevant, and whether the reports continue to be fit for purpose.

2.22 We provide our conclusions in respect of the DPS in section 6, amendments and variances in section 7, and overheads in section 8. Miscellaneous matters related to reporting are dealt with in section 9. In each section we summarise the matters consulted on, the feedback received, and explain how this has been considered.

# 3. Overview of our conclusions

3.1 This section summarises the conclusions we have reached following our reviews. Our conclusions have been informed by our knowledge of the regulatory framework and its operations, obtained through delivering our statutory functions, and by the feedback from engagement with stakeholders. Sections 4 to 9 set out in detail the matters consulted on and the feedback received, along with our considerations and conclusions.

3.2 We have identified the need for changes to the legislation, our guidance and our DefCARS reporting platform. In each case our aim is to enhance the existing provisions of the regulatory framework, to facilitate good value for money in government expenditure on qualifying defence contracts and fair and reasonable prices under those contracts for defence contractors. In some areas, we have identified the need for further work and engagement with the MOD and industry. Work on some of these matters is included in the SSRO's Corporate Plan 2020-2023.

## CPR: Cost risk adjustment (CRA) (Section 4)

3.3 Our review considered how the cost risk adjustment is defined and operationalised and whether this can be improved. We examined the following issues:

- the definition of the cost risk adjustment and how cost risk is distributed between the contracting parties;
- the impact of the contract pricing method on risk allocation;
- how to support parties to navigate the available cost risk adjustment range;
- whether the current range of the cost risk adjustment of ±25 per cent of the BPR should be revised.

3.4 We found that the legislation does not explicitly require consideration of which party bears the risk when setting the CRA. We consider this is fundamental and should not be left only to statutory guidance.

**Legislative changes**

We propose that the following changes to legislation are considered:

- Amendments to section 17(2) of the Act and regulation 11(3) to provide that the adjustment to the baseline profit rate at step 2 should reflect the contractor's exposure to cost risk if it materialises, in addition to reflecting the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs.

3.5 We identified areas in which the SSRO can support application of the cost risk adjustment through changes to our statutory guidance. Subject to prioritisation, we intend to progress the following:

- Developing the link between the cost risk adjustment and the pricing method in our guidance, given that the contract pricing method is a main determinant of how cost risk is distributed between the contracting parties.
- The SSRO will continue to observe and support the MOD's proposal for a points-based approach to navigating the cost risk adjustment, which we consider has the potential to assist contracting parties to more easily reach agreement. Once the MOD's approach has been finalised and agreed, it will need to be determined how the principles of cost risk adjustment, as set out in the SSRO's statutory guidance, might need to be modified to support the application of a points-based system.

- Making explicit that that parties should take a proportionate approach to agreeing the cost risk adjustment.

3.6 Our belief is that further work is required on the range of the CRA.

## CPR: Profit on cost once (POCO) adjustment (Section 5)

3.7 Our review identified areas that need improvement if the POCO adjustment (step 3 of the contract profit rate) is to operate as intended. The rules currently set out in legislation do not envisage some of the varied circumstances which arise in respect of sub-contracting. The existence of two methods for adjustment is unnecessary, with the cost adjustment being a better, direct solution. A single, principles-based approach in the legislation is preferable, allowing for more detailed statutory guidance to address identified issues.

3.8 In our view legislative change is needed to enable a range of issues to be addressed in guidance. We consider the requirement for control of the sub-contractor should be more sophisticated, so that POCO extends to situations where separate persons co-operate to achieve artificial profit layering. We can see merit in expanding the competition exclusion to situations that can be shown to be equivalent to the outcome of competitive tendering. The current treatment of part ownership arrangements is defective and needs to be modified to capture the contractor's part share of attributable profit.[7] Situations in which the contractor has incomplete information about attributable profit also need to be addressed.

3.9 In our view the current threshold of £100,000 disproportionately requires consideration of low value contracts. We consider that raising the threshold to £1 million is appropriate, while empowering the contracting authority to include contracts below the threshold if it is reasonably satisfied that contracts have been subdivided to avoid operation of the POCO adjustment. The adoption of a £1 million threshold aligns with the value threshold for reporting details of sub-contracts in contract reports. There is currently a lack of visibility over profit layering and in our view contractors should be required to report the attributable profit in sub-contracts to enable monitoring of this aspect of the regime.

**Legislative changes**

We propose that the following changes to legislation are considered:

1. Replace some specified terms in the legislation with overarching principles, which can be supported by statutory guidance:
   (a) POCO applies in circumstances where the primary contractor has significant influence over the sub-contractor.
   (b) Sub-contracts are out of scope if their price is equivalent to a competitive price.
   (c) The adjustment reflects part-ownership of sub-contractors.
   (d) The detail of what constitutes attributable profit is described in statutory guidance.
2. Alternatively, aspects of this proposal could instead be remedied through additional legislation rather than guidance. We would be pleased to work with the MOD on the detailed legislative changes if that approach is preferred.
3. Delete the existing option to address POCO through the contract profit rate, requiring any applicable adjustment to be made to the contract costs.
4. Raise the threshold sub-contract value for a POCO adjustment to £1 million whilst including provision for the contracting authority to include lower value contracts if the authority considers contracts have been sub-divided to avoid POCO.
5. Require contractors to report the attributable profit for sub-contracts where a POCO adjustment has been made.

7 Attributable profit is the element of profit which arises from profit layering which the POCO adjustment is designed to deduct from the contract price

## Reporting requirements: Defined pricing structure (DPS) (Section 6)

3.10 Our review considered:

- the intended purpose of the DPS and whether the DPS could meet its purpose;
- use of the DPS; and
- the proportionality of reporting against the DPS

3.11 We concluded that the DPS has the potential to achieve its purpose of supporting benchmarking and parametric estimating and challenging contractor cost estimates. There is limited evidence of the current DPS dataset being used by the MOD. This is likely to be linked to the level of maturity of the dataset, and may be expected to change as the database grows. We found contractors received limited input from the MOD in selecting and applying the DPS. As a result, the costs and benefits of the DPS could not be fully understood.

3.12 We identified some areas for improvement where a sufficiently clear problem could be isolated and changed, with clear potential benefits and low risk of unintended consequences. We propose the following changes to DefCARS and our reporting guidance to support the following:

- engagement with the MOD about the appropriate DPS and the metrics to support the DPS;
- explanations by contractors in DefCARS of their mapping to the DPS;
- application of multiple DPS structures to contracts that support more than one equipment type; and
- easier application of the DPS to support contracts by removing the support specific lines within each DPS structure.

3.13 We will monitor the application of the DPS and the support provided to contractors. We aim to keep track of issues associated with practical use of the DPS taxonomy, reporting guidance and associated DefCARS functionality.

3.14 Current arrangements for reporting interim contract reports (ICRs) could lead to a greater frequency of reporting the DPS than is required. We have not proposed legislative changes at this stage, as our review focused on the frequency at which the DPS is required, rather than being a full review of ICRs and their potential uses. We identify some options that can be considered as part of the Secretary of State's review.

## Reporting requirements: Amendments and variance (Section 7)

3.15 Our review identified areas that we consider require improvement in relation to the reporting of amendments and variance. This reported information is important as it will assist with contract management and improving cost estimation, by identifying the causes of cost growth. We consider that many of the changes can be made through improvements to our reporting guidance and DefCARS, and as a result, our considerations for legislative change have been confined to one area.

**Legislative changes**

We propose that the following changes to legislation are considered:

- Amendments to regulations 26(6)(f), 27(4)(i) and 28(2)(i) to include a new materiality provision for reporting variances. Contractors should only be required to explain 90% of variances when the quantum of all variances exceed £100,000 or 1% of the contract price, whichever is the greater.

3.16 We plan to implement improvements to our reporting guidance and DefCARS in relation to reporting amendments and variance.[8] The work we intend to take forward, and engage with stakeholders on, is as follows:

- further definitions and examples to assist contractors in meeting their reporting requirements;
- guidance on how to report the impact of a material pricing amendment, and improved structuring of this information in DefCARS;
- simplified on-demand report capability within DefCARS, making capture of amendment information in an on-demand CPS easier; and
- categorisation of reported variances.

3.17 We agree with the removal of unnecessary duplication in the reporting of amendments and variances, but we consider it is necessary to better understand the nature and extent of any duplication before proposing legislative change. We have previously recommended that the MOD first considers whether its processes are giving rise to duplication and we would be happy to support a MOD-led review.

## Reporting requirements: Overheads (Section 8)

3.18 Our review identified areas that may require improvement in relation to overhead reporting:

- Delays in agreeing overheads.
- The relationship between overhead reports and the MOD's information requirements, particularly for benchmarking.
- Monitoring of compliance with overhead reporting requirements.

3.19 We established lower than anticipated use of the overhead reports by the MOD, which limited the feedback we received from the MOD. As a result, our considerations of legislative change have been confined to two areas.

8 SSRO (2020), *SSRO Corporate Plan 2020-2023*, https://www.gov.uk/government/publications/ssro-corporate-plan-2020-2023

**Legislative changes**

We propose that the following changes to legislation are considered:

- Expand the grounds on which referrals can be made to the SSRO to include matters related to the agreement of rates that may be used in qualifying defence contracts or matters concerning the operation of the regulatory framework, without the need to identify a specific contract or for the referral to be made jointly by the MOD and contractor.
- Amend Regulation 37(7) to reflect the original intention of these requirements by aligning the QBU actual cost analysis report (QBUECAR) reporting period with that of the estimated rates claim report (ERCR).

3.20 The overhead reports can be used to support agreement of contractor rates as part of the MOD's rates programme, and to agree contract prices. Reaching conclusions about how to realise the potential of the reports, depends on the MOD's operation of the rates programme, its use of the reports, and reasons for differences between the rates programme and reporting requirements.

3.21 We propose to carry out a further review of overhead recovery and reporting.[9] We have identified a number of issues that could be examined as part of the review:

- the relationship between the overhead reports and the MOD's rates programme;
- whether the data on agreed rates and costs should be captured in DefCARS;
- benchmarking and standardisation of data in the overhead reports;
- the trigger for overhead reports and whether this can be separated from that for strategic reports and the requirements made less complex; and
- the efficacy of compliance monitoring arrangements in relation to reporting overheads.

3.22 Our ability to advance analysis and to draw firm conclusions following a further review will depend on the participation of key stakeholders, particularly the MOD. We believe, however, that with careful consideration there is potential to significantly advance issues affecting overhead recovery and reporting, and help ensure that the regime supports value for money and fair and reasonable prices.

## Other matters (Section 9)

### Segmented contract profit rates

3.23 The SSRO continues to see potential benefit in legislative change to support profit segmentation and remains of the view that the recommendations on these matters set out in its 2017 Review of the Legislation should be considered before deciding to make changes. In addition, should the MOD change the legislation to support profit segmentation, it is important that it also considers whether any change in the reporting requirements is needed.

### Contract pricing methods

3.24 Our review identified an area that may need improvement in relation to the target pricing method. At present, the target pricing method uses Allowable Costs estimated at the time of agreement; we consider that parties might want to place the risk and reward of inflation and currency risk with the contracting authority rather than the contractor and having the option would be consistent with the approach currently taken for the fixed and volume-driven pricing methods.

9 SSRO (2020), *SSRO Corporate Plan 2020-2023* https://www.gov.uk/government/publications/ssro-corporate-plan-2020-2023

**Legislative changes**

We propose that the following changes to legislation are considered:

- Amend regulation 10(11) to additionally specify that the Allowable Costs estimated at the time of agreement may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different Allowable Costs).

### Final price adjustment

3.25 Our review identified a drafting error in the regulations relating to the final price adjustment where the graduated conditions for making a final price adjustment in the contracting authority's favour are specified in per cent rather than percentage points, and so do not correspond to the graduated threshold definitions used in the calculation. We consider this was unintentional and the definition of the conditions should be aligned to the definitions in the calculation; otherwise the condition may be met when the calculation outcome is zero.

**Legislative changes**

We propose that the following changes to legislation are considered:

- Make amendments to regulation 17 as follows:

  (a) In paragraph (2), substitute "5% but less than 10%" with "5 percentage points but less than 10 percentage points"

  (b) In paragraph (3) substitute "10% but less than 15%" with "10 percentage points but less than 15 percentage points"

  (c) In paragraph (4) substitute "15%" with "15 percentage points"

# 4. Cost risk adjustment

## Introduction

4.1 As part of the consultation the SSRO sought stakeholder views and proposals regarding three aspects of the approach to the cost risk adjustment (CRA). These were:

a. the purpose of the CRA;

b. the range of the CRA; and

c. how the CRA range is navigated.

4.2 The following sections summarise responses to the consultation together with the SSRO's commentary on how these responses have informed our conclusion in the areas on which we consulted. There is a conclusion in each section, which includes proposals for legislative change where appropriate.

## The purpose of the cost risk adjustment

### Summary of consultation

4.3 Section 17(2) of the Act and regulation 11(3) provide for an adjustment to the baseline profit rate '…so as to reflect the risk of the primary contractor's actual Allowable Costs under the contract differing from its estimated Allowable Costs'. The consultation document restated the SSRO's position that the drafting of the legislation could be improved to emphasise that profit should only be adjusted to account for cost risk which contracting parties are exposed to, and that this would better ensure value for money and fair and reasonable prices. This was based on our view that:

- There are two fundamental considerations in adjusting profit in respect of risk. Firstly, risk magnitude (how big the risk is) and, secondly, exposure (who bears the consequences of the risk materialising).
- The legislation does not expressly capture the latter of these two points and this should be remedied to give due weight not only to the existence of cost risk, but also who is exposed to it should it materialise.

4.4 The consultation sought views on whether and how section 17(2) and regulation 11(3) might usefully be amended to better state its intended purpose and therefore facilitate more appropriate application.

### Stakeholder response to consultation

4.5 The majority of respondents that commented on this matter indicated support for the SSRO's view, as set out in paragraph 5.7 of the consultation, that the legislation on the CRA should be revised to more clearly explain that the adjustment at step 2 should reflect the residual cost risk retained by the contractor. In doing so, one industry respondent commented that the legislation should clarify that the cost risk adjustment compensates parties for profit volatility and not cost volatility and this should be supported by clearer terminology.

4.6 Respondents provided a list of considerations (see Table 3 below) which they said were related to the risk associated with undertaking a QDC, could result in a cost to the contractor, and which should have explicit consideration when determining the CRA. This list was in addition to the considerations set out in the consultation (contract pricing method, terms and conditions, and final price adjustment) which were viewed by one respondent as an oversimplification of the considerations that impact on cost variance. One respondent commented that further guidance should be provided on the factors to be considered to support agreement of the cost risk adjustment.

4.7 Industry responses also discussed the way in which the cost risk adjustment interacts with cost risk in the estimate of Allowable Costs. One view expressed was that the legislation should provide a clear delineation between known and identified risks that are included in the estimate of an Allowable Costs and those risks that are apportioned to the cost risk adjustment.

**Table 3: List of considerations provided by respondents**

| List of considerations provided by respondents |
|---|
| Respondents identified the following list of considerations they consider relevant to the determination of the cost risk adjustment:<br>• Liquidated damages (LD's);<br>• Unrecovered costs on a termination for default;<br>• Costs that are allocated or apportioned to a single qualifying contract e.g. excess consumption of scarce systems engineering resource;<br>• Wider enterprise business risks: e.g. Suitably qualified and experienced person (SQEP) labour availability, capability, capacity, obsolescence, sharing;<br>• Market factors: e.g. Market or product withdrawal, commercial terms and prices, OEM's;<br>• Enterprise and site risks: e.g.: Employee liabilities / Union issues, pension shortfalls, latent defects, business continuity, regulatory changes, security, transformation, improvement;<br>• Disallowed contract costs: e.g. Selling and marketing cost, LD's, rework, acquired intangibles;<br>• The timing of risks and claims beyond contract completion, especially with regard to claims, latent defects, subcontractor insolvency, security, regulation;<br>• Effects of other projects that are inflight possibly affecting the outcome of this project;<br>• Maturity of the technical risk register;<br>• Maturity of the Assumptions, Exclusions and Dependencies register;<br>• Level of management contingency included in the estimated Allowable Costs;<br>• Experience of the contractor of delivering similar contracts;<br>• Technical complexity of the deliverables;<br>• Availability of historic data used for parametric cost modelling;<br>• Level of general economic and financial uncertainties in the market (i.e. inflation, volatility in currency markets, etc) and how these are dealt with in the contract; and<br>• Duration of the contract. |

4.8 A number of respondents noted that it can be difficult to demonstrate the financial impact of risk they labelled as "intangible" in arriving at an agreed cost risk adjustment. No clear definition of what constituted an intangible risk was given. It was said that one "intangible" risk was the delayed agreement of rates, although it was not clear why this was considered to be the case or why it would justify an adjustment to profit, given that the parties must still agree the price and, in appropriate cases, the contract can be amended to reflect agreed rates. Some industry respondents also identified 'unknown unknowns', as those risks which cannot be valued inside an estimate of Allowable Cost, or as sources of risk that the contractor cannot identify. These were said to contribute to the variance between the estimate of Allowable Costs and the actual Allowable Costs. Industry respondents view these sources of risk as difficult to quantify.

4.9 Lastly, one respondent noted that risks that arise in relation to a qualifying contract, may impact on concurrent contracts, specifically when allocating scarce resources across a contractor's portfolio, and consideration of these enterprise wide risks should be taken into account. The respondent suggested that contracts that require proportionally more scarce resource should yield higher returns for investors.

### SSRO's considerations

4.10 We welcome the support from respondents that the drafting of section 17(2) and regulation 11(3) should be updated. The responses support our view that the adjustment would benefit from reference to the residual cost risk retained by the contractor under the QDC, where that risk is not included in the estimate and may introduce profit volatility. In other words, the CRA should be related to the contractor's exposure to cost risk. These matters are currently covered in the SSRO's statutory guidance on the application of step 2.[10]

4.11 The SSRO updated its statutory guidance on Allowable Costs (version 5) to address how the CRA interacts with Allowable Costs. It specifies how the parties should apply the requirements of Allowable Costs where there is risk and uncertainty (Part H of section 5).[11] The guidance delineates between the cost risk related to estimated costs and that related to the cost risk adjustment. We believe this will assist parties to agree the factors particular to each contract which are relevant to the determination of the CRA and that this addresses issues raised by respondents.

4.12 We note the concern that risk apportionment between contracting parties should not be oversimplified. We agree that cost risk may arise for many reasons. However, we consider it is appropriate, when setting the CRA, to focus on the following key mechanisms provided in the legislation for apportioning the crystallised cost risk between contracting parties:

- the contract pricing methods,
- terms and conditions of the contract, and
- any final price adjustment.

4.13 We wish to update our statutory guidance on the cost risk adjustment to reflect the legislative intent and the relevance of the key mechanisms we have identified. This can only occur once the Secretary of State's review has concluded and the position on the CRA is clear.

4.14 Stakeholders provided various risk factors (see Table 3) they said should be taken into account when arriving at a cost risk adjustment. These factors can be included in consideration of the CRA if they create a risk that the actual Allowable Costs may deviate from their estimated amount. The factors should not be included in consideration of the CRA if they would result in costs that do not meet the requirements of Allowable Costs (which some respondents refer to as "disallowed costs"). We can see no justification for agreeing higher contract profit rates to compensate contractors for the risk of having to bear costs that are neither appropriate, attributable to the contract or reasonable in the circumstances. We believe it is the existing principle of risk to Allowable Costs which should determine what should be a relevant consideration for the CRA, rather than a pre-determined list which would be inflexible and unresponsive to varying circumstance. The SSRO continues to favour principles which may be referred to in any circumstances rather than rules and prescription which may not.

10 SSRO (2020), *Guidance on the baseline profit rate and its adjustment*, https://www.gov.uk/government/publications/guidance-on-the-baseline-profit-rate-and-its-adjustment-version-6

11 SSRO (2020) *Allowable Costs guidance*, https://www.gov.uk/government/publications/allowable-costs-guidance-version-5

4.15 The SSRO considers that the CRA is not the right approach for dealing with unknown risks for the following reasons:

- Unknown risks cannot be foreseen or valued.
- There cannot be an entirely satisfactory manner of determining an appropriate cost risk adjustment for such risks.
- It is unclear how a CRA could be judged to support an attractive or viable commercial proposition if the risks to the contractor are entirely unknown or have no reliable financial measure against them.

4.16 The better approach for dealing with unknown risks is for contractual mechanisms to be put in place to apportion unanticipated risks to the satisfaction of the parties, should they arise, based on the available information.

4.17 We note the concern raised by some respondents that uncertainty about the accuracy of provisional cost recovery rates reflects a cost risk until the rates are agreed. We consider, however, that the matter of delayed rates agreements should be addressed through the application of regulation 14, which deals with re-determination of the contract price when there is a pricing amendment. Re-determination of the contract price should mitigate cost risk in full, putting these risks out of scope of the CRA.

4.18 The SSRO agrees with the respondent who noted that scarcity typically increases prices. For example, scarcity of skilled labour can increase wages (a cost matter) and scarcity of financial capital can increase the return contracts offer to investors (a profit matter). The regime provides for consideration of these matters through the Allowable Costs and the six steps that determine the contract profit rate. In theory, cross-factor rewards, for example where labour supply influences capital returns (i.e. contract profit), could be considered but the complexities involved may prohibit proportionate practical application. Modifying the scope of the CRA to include consideration of inter-contract risk (rather than intra contract risk as is currently the case) would require a change to the legislation. The argument that the conduct of a single source MOD contract poses a unique and distinct risk to the performance of concurrent non-single source MOD contracts is one which the SSRO would need to see evidence of before commenting further on the matter.

### Conclusions

The SSRO is of the view, as stated in its consultation, that there are two fundamental matters which require consideration when adjusting profit for risk. Firstly, how big is the risk and, secondly, who is exposed to the risk? It should therefore be clear that the adjustment to the baseline profit rate at step 2 is to reflect both:

a. the magnitude of the cost risk associated with undertaking the contract activities which is a direct product of the risk that the estimated costs differ from the actual Allowable Costs of the contract; and

b. a contractor's exposure to that cost risk which would represent a cost to the contractor meeting the requirements of AAR if it materialised, and which is not avoided, reduced or transferred from the contractor either through a provision under the contract, the regulated pricing method in the contract or any other action by the contracting parties or any third party.

We believe contracting parties will consider both these matters in the agreement of the CRA. This is not expressly required by the legislation, but is covered in the SSRO's statutory guidance as a reasonable approach to the application of step 2. Our general view is that where an outcome can be achieved through existing legislative provisions, including the SSRO's power to issue statutory guidance in relation to the profit rate steps under section 18(1) of the Act, there should be no need to make proposals for legislative change. However, we do see it as an omission that a contractor's exposure to cost risk is not present in the legislation. We propose that the requirement to consider who is bearing cost risk is included in the legislation to ensure it is given due weight when agreeing the cost risk adjustment.

## Effect of the contract pricing method on risk allocation

### Summary of consultation

4.19 The contract pricing method is a determinant of which party bears the impact of cost risk and to what extent, amongst other aspects of the contract that allocate risk. SSRO guidance on determining the CRA states that contractors 'should give consideration to the contract pricing method' (alongside other factors) and that the CRA for a contract which applies a cost-plus or estimate-based fee pricing method should be minus 25 per cent of the baseline profit rate.

4.20 In the consultation, the SSRO invited views on whether there should be additional direction to specify the CRA range for contracts with different pricing methods. The consultation also invited views on whether this direction should be set out in legislation, in the SSRO's guidance or both.

### Stakeholder response to consultation

4.21 Generally, respondents did not comment as to whether a separate adjustment to reflect the contract pricing method used for the contract should be employed in the determination of a contract profit rate. The SSRO has taken this to mean that it is not one of the primary concerns of stakeholders to further pursue the pricing method as a determinant of the CRA.

4.22 There were concerns about specifying anything mandatory about the CRA approach in relation to the contract pricing method. One respondent was not supportive of introducing mandatory adjustments to the regulated pricing method. In their view, mandatory adjustments do not support the concept of a fair return for industry as it does not account for the risk and uncertainty inside an estimate of allowable cost nor those factors that are accounted for when considering the appropriate CRA adjustment. Another respondent agreed with the latter, stating that the regulated pricing method is just one factor that is relevant to determining the CRA, and it would not be appropriate to tie a set range to one particular contract pricing method.

4.23 Two respondents sought further clarification on why an estimate-based fee attracts a minus 25 per cent CRA and disagreed with the SSRO's guidance. The respondents expressed concern on whether under the estimate-based fee pricing method, a variance between the estimate and actual Allowable Costs, specifically if the actual Allowable Costs increase during the lifetime of the contract, would be a fair return. The industry respondent would therefore welcome additional guidance on how to price risk into the estimate of an estimate-based fee contract.

4.24 One consultant stated that the contract pricing method is largely determined by the MOD and does not believe that the same contract pricing method should not necessarily lead to the same CRA where different types of work activities are undertaken. The consultant provided an example of two contracts placed on a cost plus basis where the work to be performed on one contract is cutting-edge technology and likelihood of changes and evolution of the statement of work (SoW) is high and the other where the work is for routine technical support and maintenance but the SoW only becomes clear during the progress of the contract performance. They challenged the idea that both contracts should attract the minus 25 per cent CRA due to the scarcity of resource anticipated to be required, technical challenge and impact on business resource risk is different. Similarly, another industry respondent noted that linking the range of the cost risk adjustment to type of work activity, in which contracts for defence goods and services attracted a wider adjustment than those for commercial goods and services, irrespective of contract pricing method may be another option.

**SSRO's considerations**

4.25 The contract pricing method allows the contracting parties to apportion risk and influences how much risk they will absorb. We therefore believe it should remain central to the determination of the CRA, whilst not diminishing other relevant factors. Contract pricing methods are specified in legislation and defined for QDCs and QSCs, and can guide the determination of the CRA.

4.26 Stakeholders raised concerns regarding mandatory or separate adjustments in respect of the regulated pricing method. We believe it is possible to both use the pricing method to inform the appropriate CRA and take into account other relevant factors. As noted in the consultation, in non-UK regimes, the contract pricing type generally restricts the range of profits available for a particular contract. In contrast the full range is available for every contract in the UK regime. Adopting a more segmented approach, with different ranges available dependent on the characteristics of the contract could help expedite agreement of the CRA. We understand caution must be taken when comparing aspects of different regimes and that it can potentially drive unanticipated behaviours. However, this is an approach which should be well understood in the UK, having been operated under the Yellow Book regime. It is the SSRO's view that an explicit link between the cost risk adjustment and the contract pricing method, as currently specified in the case of cost plus and estimate based-fee contracts, provides a straightforward and quicker route to agreeing contract profit rates. Any further development of our guidance on this point would need to reflect the Secretary of State's decision on the width of the CRA.

4.27 The SSRO considers that it is appropriate for its statutory guidance to provide that an estimate-based fee attracts a minus 25 per cent cost risk adjustment. Estimated Allowable Costs are used to calculate the contract profit for an estimate-based fee contract, but the contractor is paid its actual Allowable Costs. We recognise that the contractor's actual costs may differ from the estimated costs, but this is not a cost risk to the contractor, as it is paid its actual costs. A variation in costs also neither increases nor reduces the agreed amount of profit and therefore that a minus 25 per cent adjustment is appropriate given the contractor is paid its actual Allowable Costs.

4.28 We remain of the view that a minus 25 per cent CRA, where the estimate-based fee (or cost plus) pricing methods are used, is appropriate and that statutory guidance remains the appropriate route to stipulate these. This approach provides an expeditious route to agreeing contract profit rates for those contracts where the negative impact of cost risk does not reduce the amount of profit earned through the contract. We were not persuaded by the example provided to challenge the minus 25 percent CRA for cost plus contracts, nor by the accompanying reasons, which bring together a range of factors (see 4.17). Given that in any cost plus contract the contractor's exposure to risk that actual Allowable Costs will deviate from the estimate is nil, we cannot see on what basis differential CRAs could be justified.

**Conclusions**

The SSRO are of the view that a separate adjustment aimed at tailoring the range of the CRA to the characteristics of the regulated pricing method has merit and is operable as a standalone mechanism. We believe a more structured approach to incorporating the choice of regulated pricing method into the discussion on risk can help to focus agreement on the CRA within a particular range, and avoid nugatory effort focusing on ruling out inappropriate adjustments, but which either party might find in its commercial interest to propose. This would simplify an aspect of the contract profit rate determination and leave a narrower range subject to negotiation, which will naturally reduce the incentive for protracted contract negotiations, as there is less at stake financially for each contracting party.

We are not proposing legislative change at this time due to the limited response on the matter of pricing method from respondents. We believe there remains a strong case for the CRA to be guided by the choice of contract pricing method, alongside other relevant matters. In the absence of any legislative provision for differing CRA ranges based on pricing method, statutory guidance remains in our view the most appropriate route to achieve this. We will consider the case for modifying our guidance on this relationship in light of any decision made by the Secretary of State on the future of the CRA.

## Navigating the range

**Summary of consultation**

4.29 The consultation set out the following approaches to assist contracting parties to navigate the CRA range:

a. rules-based boundaries supplemented by principles-based guidance, by which the available CRA range could be constrained by characteristics of the contract (for example, the contract pricing method), with guidance assisting the parties to navigate the available range;

b. multi-criteria decision analysis, in which the parties consider and score multiple criteria independently and combine them in a structured way to arrive at the CRA for the contract; and

c. a highly structured approach previously considered but not taken forward by the MOD and industry. Mechanistic or formulaic approaches that permit little or no discretion for the contracting parties in agreeing the adjustment.

4.30 The SSRO invited stakeholders to provide their views on the development of more specific guidance on navigating the CRA range. We noted that the MOD is considering a points-based approach to navigate the cost risk adjustment, which incorporates weighting and scoring of different factors. If the points-based approach proceeds, the SSRO will consider how this may be supported with statutory guidance. We have attended workshops to observe MOD and contractor commercial staff test the proposed approach on existing contracts.

**Stakeholder response to consultation**

4.31 There were mixed views on what would be the most desirable approach to assist contracting parties on how to navigate the CRA.

4.32 Some industry respondents stated that a rules-based approach would be too restrictive as they believed rules would not be sufficiently well defined, leading to technical challenges and protracted decision making. In addition, one consultant concluded that a computational approach to navigating the cost risk adjustment would not succeed as it would require significant sophistication.

4.33 Some industry respondents agreed with the premise that a points-based model may reduce the time to agreement for contracting parties and allow for more informed debate.[12] Where there was support for a points-based system, this was conditional on how effective it is in the context of a real situation. There were concerns that an excessive number of variables would prevent a consistent approach and therefore would benefit from a greater level of granularity of benchmarking data, which is not yet available. Another respondent submitted that negotiations on the cost risk adjustment would not be facilitated by a multi criteria or spreadsheet approach as it would also need to be influenced by broader environmental and political issues.

4.34 Those who agreed with a points-based system preferred that the approach is stipulated in statutory guidance rather than legislation and that it is presented as guidelines rather than a prescriptive mechanical calculation. They said that this would allow the SSRO to respond more quickly to any unintended consequences than if the approach was mandated in legislation.

4.35 Industry respondents concluded that continued use of a principles-based approach is preferable, irrespective of whether a points-based approach is established. Several of the respondents thought that further statutory guidance would be desirable. This would support contracting parties to make a qualitative assessment on how to navigate the range and could help interpret possible revisions in the legislation on the purpose of the CRA.

**SSRO's considerations**

4.36 The SSRO's statutory guidance adopts a principles-based approach to assist contractors to navigate the cost risk adjustment and feedback from respondents tends to support this approach. We agree that additional guidance may be useful to assist contracting parties. A greater degree of prescription may be required to support decision making if a proposal to widen the magnitude of the cost risk adjustment is taken forward. A wider range of CRA can give rise to a greater risk to the achievement of value for money and fair and reasonable prices. We will review the requirement to update our guidance in light of the conclusions of the Secretary of State's review.

12 We understand from the consultation feedback that not all respondents have been involved in this process of developing the points-based proposed by the MOD and were therefore not familiar with the emerging proposal.

4.37 We are supportive of a points-based approach to navigating the range of the CRA, as it has the potential to make a positive contribution to a structured discussion around risk and be a useful aid to negotiation on step 2 cost risk adjustment. The SSRO agrees with industry respondents who express the view that the approach would benefit from further development and testing and we welcome continued work with the MOD and other stakeholders. We recognise that there are advantages in adopting a points-based model, one of which is that it may expedite agreement on the cost risk adjustment. However, the approach is still in development and there are challenges to overcome if it to be operationalised effectively.

4.38 It is important to strike the right balance between legislation and guidance when considering navigating the range in a points-based system. Our view is that where an outcome can be achieved through existing legislative provisions, including the SSRO's power to issue statutory guidance in relation to the profit rate steps under section 18(1) of the Act, there should be no need to propose legislative change to implement a points-based system. Statutory guidance can be developed to provide a principles-based approach to support the navigation of the cost risk adjustment. Reliance on statutory guidance, rather than legislation, will provide the necessary flexibility to respond in a more rapid fashion to any unintended consequences that arise, for example, in the event that the CRA is widened.

**Conclusions**

We will review our guidance on the CRA in light of the conclusions of the Secretary of State's review. We will continue to observe and contribute to the development of proposals for a points-based approach and consider the implications for statutory guidance.

## Range of the CRA

**Summary of consultation**

4.39 Regulation 11(3) specifies that the CRA is to be an "amount which is within a range of plus or minus 25% of the baseline profit rate". The MOD considered whether it may be beneficial to change the limits of the CRA range. This could involve changing the maximum upward adjustment, the maximum downward adjustment or both, either uniformly or by different amounts. The consultation invited stakeholders to provide specific proposals for changes to the range of the CRA, with supporting evidence or information which explains the rationale for the proposals. We also explored the idea of multiple baseline profit rates and activity specific adjustment and sought alternative proposals for achieving and justifying a wider range of available contract profit rates.

**Stakeholder response to consultation**

4.40 Industry respondents held differing views in response to whether the range should be revised and if so, what would be the appropriate range of adjustment. Some respondents did not believe changing the range of the CRA was the current priority, whilst others recommended a change, with the majority of those seeking an increase to the maximum available adjustment.

4.41 Industry respondents made a number of proposals in support of altering the range, namely:

a. An extension on the positive side of the range, to allow for differentiation of risk between contracts for off the shelf or routine commercial goods and services and contracts for more complex weapon systems for defence.

b. A wider bandwidth, to overcome a reduced baseline profit rate.

c. An adjustment which would enable qualifying defence contracts to attract the profit range of companies in the comparator group of the baseline profit rate.

d. Consideration of the range of the CRA in relation to investors' expectations of returns, which vary in response to perceptions of the risk to their capital.

4.42 Some industry respondents said that their concerns about the methodology for calculating the BPR remain unaddressed and any revision to the magnitude of the CRA should not precede changes to the methodology. They made specific reference to the composition of the comparator group. In their view, it would not be optimal to implement a change to the CRA at this time, as this would compound the complexity of pricing contracts, delay agreement of prices and not encourage better incentivisation.

4.43 One respondent suggested linking the parameters of the CRA to the range exhibited by the BPR comparator group and submitted this would support a comparator group that encountered the same risks and complexity as defence companies. The respondent asserted that the range of the CRA would then be approximately -30 per cent and +100 per cent of the BPR, based on the range of profit rates reported by companies in the baseline profit rate comparator group for 2019/20. This respondent did not agree with a range of -70 per cent and +100 per cent (described as the MOD's proposal), as in their view a full minimum adjustment would not achieve a fair price.

4.44 Two industry respondents referenced the interaction between risk in estimated cost and the CRA when considering an appropriate range. One respondent suggested that a clear delineation between uncertainty accounted for through cost risk in Allowable Costs and risk compensated through the CRA supported the proposal for the magnitude of the CRA to remain unchanged. Another industry respondent noted that a CRA with a narrow positive upside may encourage contractors to press for more recompense through costs, risk and uncertainty, or to elect an alternate pricing method, which could delay contract negotiation.

4.45 In explaining why, in their view, the range should be broadened, one respondent suggested that firm priced contracts under the single source regime are not comparable to firm priced contracts that exist outside of the regime. They said that the former do not incentivise contractors to control costs since they do not recoup the benefits from any efficiencies incurred. To remedy this, the industry respondent suggested that a higher CRA would serve to incentivise the contractor to implement efficiencies.

4.46 Respondents did not directly respond to our request for input on the use of multiple baseline profit rates to reflect differing levels of profit associated with activity types and did not provide any additional alternatives to widening the contract profit rate. One respondent raised setting the range of profits in accordance with activity type when addressing our consultation on the role of the pricing method in agreeing the CRA. In that context it was suggested that contracts for defence goods and services should attract a wider adjustment than those for commercial goods and services.

**SSRO's considerations**

4.47 Stakeholder feedback focused on changing the overall profit rates that the regime offers, but did not analyse the sufficiency (or otherwise) of the existing ±25 per cent range. We consider that the central question to be resolved before revising the CRA band is whether the current range sufficiently differentiates between expected profits for those who take cost risk and can successfully manage it, and those who do not.[13] The feedback provided was not developed to the extent of demonstrating how things should change where this was referenced in the consultation feedback. We believe from input provided by the MOD outside of this consultation that it would expect lower profit rates to be attainable where contractors take little or no risk.

13 The capital servicing adjustment provide a further mechanism by which risk is reflected in contract profit rates due to the risk premium embedded in the capital servicing rates.

4.48 The SSRO has not identified any evidence in support of the industry view that the limit on the upper range of profits under the regime adversely affects aspects of performance, nor that contractors are under-rewarded in single source contracts for the risks they take. We do not agree with the claim that contractors do not benefit from efficiencies delivered through performance improvements under a firm price contract. The firm price method requires that the Allowable Costs are estimated at the time of agreement, and the contractor achieves a higher profit if it outperforms against the estimates, a feature which we support and should be maintained. The potential for increased profit in these circumstances provides an incentive to control costs. The incentive will typically be greater where margins are narrow, with the corollary being that the margin to accommodate cost growth is greater where profit rates are higher.

4.49 There is evidence available that that the regime offers flexibility to agree a range of contract profit rates and that those rates are comparable to profit rates achieved on average by the MOD's main single source contractors. We have no reason to conclude that the regime should aim to offer profits that greatly exceed rates that the most profitable contractors typically earn on their broader portfolio of contracts.

4.50 Where we have evidence of contractor profit rates being systematically below the range of contract profit rates, we observe the contractor's work being low value added, although not consistently low in terms of cost risk. It may be possible for contractors to sustain lower rates of profit where their work is considered "risk free", but we are cautious about attempting to identify such cases in the current economic climate. Risk-free rates are normally measured with respect to return on capital and the CRA may not be best suited to dealing with this issue. We can see merit in further examining risk free rates, the relationship to contractor's balance sheets and the way capital is treated in the determination of profit in order to progress this issue.

4.51 We accept that not every profit rate which can be observed in a competitive market (for example those of the BPR comparator group) can be achieved as a contract profit rate under the regime. The market rates are both higher and lower, positive and negative. We have previously identified that the profit rates achievable under the regime compare favourably with the returns of the MOD's principal suppliers. If further analysis suggests that profit rates should be achievable which currently are not, then the underlying factors associated with that profit outcome should be identified and incorporated into the determination of the contract profit rate, considering all of the six steps in their totality.

4.52 We are interested in the submission that the range of the CRA could be set such that the range of contract profit rates achievable under the regime more closely reflects those observed in the BPR comparator group (or another suitable benchmark). The approach assumes that:

- contract profit rates should be achievable under the regime which currently are not; and
- cost risk is the dominant explanatory factor for variation in profit exhibited.

4.53 Consistent with our view above on identifying the underlying factors related to profit, we believe the reasonableness of these assumptions should be tested by further analysis before developing a methodology. Provided that changes to the regime do not disrupt the available data set, data on completed contracts submitted through the regime should allow cost risk in QDCs to be measured and may inform development of a methodology in due course. There are insufficient numbers of completed contracts to undertake such an analysis in the short term.

4.54 In our work on profit principles we stated that the contract profit rate, when applied to Allowable Costs, should enable the contractor to earn a return commensurate with that achieved by firms in a competitive market for the supply of goods and services which are the product of comparable economic activities. We maintain this is an important guiding principle. In this context we note that:

- At present there is a single BPR based on an assessment of economic activities that contribute to the delivery of QDCs and QSCs.
- The capital servicing adjustment concerns itself with the cost of debt with respect to the capital employed qualifying contract and represents a narrow aspect of return on capital.

4.55 Greater consideration of activity type and the cost of capital would be in line with this principle and capture many facets associated with the determination of profit which are not directly associated with cost risk.

4.56 We understand that the MOD are considering the role of activity type in the determination of contract profit rates in their work on the CRA. The SSRO already publishes profit benchmarks for companies undertaking different economic activities which might be beneficial for this purpose. We will support the MOD in any further work they may wish to undertake in progressing work to take account of it more thoroughly in contract profit rates.

4.57 In respect of the feedback that there should be clear delineation between uncertainty accounted for through cost risk in Allowable Costs and risk compensated through the CRA, we believe this should already be clear. The Allowable Costs guidance[14] states that:

a. for a contractor's estimated cost to be Allowable Costs the estimate should aim to anticipate the actual Allowable Cost the contractor will incur in performing the contract (H.1.4); and

b. The cost risk adjustment should not be used to include within the contract price any element of the estimated costs that have been identified, as these should be considered in the determination of the estimated Allowable Costs (H.4.1).

4.58 Having regard to this guidance means that contractors should not be seeking recompense through Allowable Costs for those matters which are reserved for the CRA, or vice versa, as one respondent suggested was the case. On the issue of choosing a regulated pricing method and that causing delay, the SSRO is clear that the regulated pricing method is a mechanism to apportion risk between the contracting parties and should be selected with that in mind. Contracting parties should not be prevented from choosing a pricing method which is suitable given the cost risk exposure to the contractor and the available range of the CRA.

4.59 The responses to the consultation that supported a change to the CRA range seek to address a variety of issues, not all of which relate specifically to the risk that actual allowable costs may deviate from an estimate. For example, it has been suggested that the CRA might be used to counteract changes in the BPR or to recoup "disallowed" costs. In our view, the CRA should not be used to address issues with contract pricing which do not relate to compensation for cost risk, as this would be inconsistent with the definition of the CRA and its intended purpose.

14 SSRO (2020) *Allowable Costs guidance*, https://www.gov.uk/government/publications/allowable-costs-guidance-version-5

4.60 Given the current economic uncertainty the SSRO sees considerable value to the MOD and contractors in maintaining stability in the regime and the determination of contract profit. Maintaining a consistent flow of data on profits in completed contracts which could, in due course, provide a solid quantitative foundation upon which to judge the suitability of the ±25 per cent adjustment as the economy stabilised. Increasing influence of the CRA on contract profit, should not be at the expense of consideration of other matters which appear to relevant, but are not captured in the six steps and would not be in the interest of fair and reasonable prices and value for money.

4.61 The SSRO notes the residual concerns held by industry about the BPR methodology. We have responded to the issues raised in previous stakeholder response papers, and we continue to consider that the methodology is fit for purpose and provides a basis for delivering value for money for government and fair and reasonable prices for contractors. Our analysis supporting the SSRO's profit recommendation shows that BPR benchmark companies earn profits that are comparable to those of the MOD's single source contractors and that defence companies are well represented in the group. The result is that contract profit rates extend to what the MOD's main single source suppliers achieve on average across their business. We are not embarking on fundamental changes to the BPR methodology and we do not consider that it presents any impediment to work on the CRA. We continue to explore incremental improvements to the BPR methodology and, in 2020/21, we are planning to carry out a review of amortisation and impairment of intangible assets acquired in business combinations.

**Conclusions**

We remain open to the view that a broader range of contract profit rates may be justified in some circumstances than can presently be achieved under the regulatory framework. To the extent that stakeholders consider the overall rates of profit achievable to be too constraining, this is a product of all the six steps and therefore needs to be considered in respect of the factors which make up that process (and potentially some which currently do not). Our belief is that further work is required to test relevant assumptions and consider whether all factors which can be shown to determine profit in a competitive market are given due weight in the regime. The role that the CRA might have in achieving such an outcome should be one of the considerations.

## Other issues

**Lower value contracts**

4.62 Sections 18(2)(a) and (b) of the Act provide that the Regulations may disapply the requirement to take any or all of steps 2 to 6 in section 17(2) in relation to a QDC the value of which is less than the amount specified, or provide for any or all of those steps to apply in relation to such a contract with modifications set out in the Regulations. The SSRO consulted on the possibility to take advantage of this provision to simplify the agreement of contract profit rates for lower-value contracts, where the threshold for a lower-value contract might be placed, and what simplifications would be appropriate.

4.63 Our consultation on this issue was prompted by feedback from stakeholders that the time and effort to agree the CRA was sometimes disproportionate given the size of some contracts. We agree the principle of proportionality in respect of the agreement of the CRA but have yet to identify any further practical steps which could be brought forward in legislation to better facilitate this. Whilst we received general expression of support for proportionality from respondents, there were no specific suggestions upon which to base a proposal to change the legislation. One industry respondent thought that a simplified approach would not be reasonable if it reduced the profit paid to smaller contracts. A stakeholder has previously noted that if the principles underpinning the CRA were sound and applied reasonably there should be no need to take a different approach for lower-value contracts, which we agree with.

4.64 Our allowable cost guidance states the parties should take a proportionate approach when deciding the type and standard of information required to determine that a cost is allowable, considering:

a. the specific requirements and circumstances of the contract;

b. the materiality of particular costs; and

c. what it is reasonable to expect would be available.

4.65 We believe these principles can apply equally to the agreement of the CRA, or any of the six steps. We will consider the inclusion of these principles within our contract profit rate guidance at the next available opportunity.

# 5. Profit on cost once adjustment

## Introduction

5.1 As part of the consultation, the SSRO sought stakeholder views or proposals regarding two aspects of the profit on cost once adjustment (POCO). These were:

a. various technical matters relating to the scope and determination of the adjustment; and

b. transparency of the approach taken.

5.2 The following sections summarise responses to the consultation together with the SSRO's commentary on how these responses have informed our conclusion in the areas on which we consulted. Each section concludes with considerations and, where appropriate, proposals for legislative change.

5.3 The Defence Reform Act 2014 makes provision for step 3 of the contract profit rate:

*Step 3 Deduct an agreed amount from the amount resulting from step 2, so as to ensure that profit arises only once in relation to those Allowable Costs under the contract in respect of which the regulations provide that a deduction may be made*

5.4 Regulation 11(4) provides that the adjustment is to ensure that profit arises only once in relation to the Allowable Costs under the contract that relate to the price payable under any group sub-contract (including any further group sub-contract). Regulation 12 describes the process to calculate the POCO adjustment. The adjustment deducts an amount from the contract price to effectively prevent layered profit[15] on affected non-competitive intra-group transfers. The only profit applied to the costs of those sub-contracts should be the contract profit rate of the qualifying contract.

## Scope, application, and determination

5.5 We have two general observations concerning the operation of the POCO provisions:

a. Principles-based vs rules based: the existing POCO arrangements are rules-based, with the scope and calculation specifically described. This contrasts with other aspects of the legislation that are principles-based.

b. Legislation vs Guidance: the existing POCO arrangements are described in detail in the legislation. This contrasts with aspects of the regulatory framework where principles are provided but detailed application is left to statutory guidance issued by the SSRO.

5.6 The SSRO issues guidance on the POCO adjustment, but has limited scope to affect its operation because of the degree of prescription in legislation. This provides limited flexibility to make changes to the scheme when issues are encountered during implementation. The situation is different in relation to Allowable Costs, where the legislation specifies the principles of allowable costs and the SSRO is empowered to provide guidance on how the principles should be applied. The other steps for determining the contract profit rate are also less prescriptive than the POCO adjustment.

15 Except for any capital servicing adjustment made under step 6, which is retained.

5.7 We support an approach in which the principles of the POCO adjustment are specified in the legislation rather than detailed rules, supported by explanatory SSRO statutory guidance. This should allow a more a flexible approach for dealing with inappropriate profit layering that:

a. addresses the variety of circumstances encountered in single source contracting, including any new approaches to contracting;

b. responds within a reasonable timeframe to issues raised by stakeholders; and

c. incorporates relevant findings from referrals to the SSRO.

5.8 We have identified several aspects of the POCO adjustment where changes could be made to improve its operation. These are set out below. Our preferred approach is for the changes to be made by expressing more general principles in the legislation and allowing the required details to be covered in guidance. Table 4 summarises the aspects of the POCO adjustment we have considered and identifies where a more principles based approach could be taken.

**Table 4: Summary of alternative approaches to the POCO adjustment**

| Aspect of POCO | Current approach | Alternative approach |
|---|---|---|
| Sub-contractors in scope: association | Regulation 12(5)(b) and (6)(b) applies by reference to whether a person is "associated", which requires a legal test. | Express the principle that POCO applies where there is significant influence and allow application to be described in guidance. |
| Sub-contracts in scope: competition | Regulation 12(5)(d) and (6)(d) refers to regulations 59 and 60, which requires a legal test. | Express the principle that sub-contracts with prices equivalent to a competitive price are excluded and allow application to be described in guidance. |
| Application of the adjustment | Two options available: a decrease to Allowable Costs (regulation 12(2)); or to the contract profit rate (regulation 12(3)). | Provide only for a decrease to be made to Allowable Costs. |
| Determination of the adjustment | "Attributable profit" is defined in regulation 12(7) and (8) with reference to specific components of the price, and some allowed exclusions. | Allow for "attributable profit" to be described in guidance. |
| Sub-contracts in scope: value and associated transparency | Value threshold of £100,000 set by regulation 12(5)(c) and (6)(c). No clear link between POCO requirements and the reporting of sub-contract information in contract reports. | Adopt a £1 million threshold, which aligns with sub-contract reporting and facilitates clear links between the POCO adjustment and the information reported about sub-contracts. Introduce an overarching principle to prevent unwarranted sub-division. |

## Relationship of relevant persons (associated parties)

### Summary of consultation

5.9 Our consultation set out proposals to bring under consideration some additional sub-contracts or further sub-contracts for which it may be appropriate to make POCO adjustments (paragraphs 6.8 to 6.12). This included:

1) expanding the definition at regulation 12(5)(b) and (6)(b) to include other persons related or connected to the primary contractor, but which do not meet the threshold for being "associated" within the meaning of section 43(3) of the Act (for example, joint ventures); and

2) expanding the definition at regulation 12(6)(b) to include further sub-contracts where the further sub-contractor is associated with the primary contractor, but a non-associated sub-contractor sits between the primary contractor and the further sub-contractor.

### Stakeholder responses to consultation

5.10 Several respondents noted that financial reporting standards require parent companies to identify and report subsidiaries and some considered that these definitions of ownership and control should be the basis of deciding whether a sub-contract is a group or further group sub-contract and should be considered for a POCO adjustment.

5.11 Most respondents submitted that control should be the key factor in determining if a POCO adjustment should be made. They considered that if a contractor did not have control over a sub-contractor then, assuming the entities are operated independently and each incur legitimate costs, it was reasonable that both should be permitted to earn margin. Some considered that receipt of dividends from a part-owned sub-contractor would be too remote to warrant consideration.

5.12 One respondent noted that as the proportion of ownership decreases, the potential benefit of profit layering is proportionally diminished. The respondent pointed out that any adjustment is likely to be small and it may not be value for money to investigate and calculate them.

### SSRO's considerations

5.13 We recognise that accounting standards have definitions of control for the purposes of identifying and consolidating subsidiaries. However, these definitions are not the current test for requiring a POCO adjustment, which is that a sub-contractor is a "group undertaking" within the meaning of s.1161 of the Companies Act 2006. This definition involves a legal test that focuses on whether one undertaking controls another.

5.14 We think that control is not the only factor that can influence the extent to which profit layering in sub-contracts is appropriate. In coming to this view, we have considered the following alternative regimes:

- Transfer pricing for corporate tax purposes is principally concerned with profit on intra-group transfers and draws on a wider range of considerations than whether one party is controlled by another. For example, it uses a "40% test" for joint ventures[16] and not all transactions would be risk-assessed by HMRC for enquiry.[17]

16 HMRC (2016), *Internal Manual: 412060 participation in the management, control or capital of a person*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm412060

17 HMRC (2016), *Internal Manual: 482040 transfer pricing risk indicators: general*, https://www.gov.uk/hmrc-internal-manuals/international-manual/intm482040

- Accounting standards use a concept of "significant influence"[18], which is the power to participate in the financial and operating policy decisions of the investee—generally greater than 20% ownership—as a threshold for additional reporting and disclosure of information in a group's financial statements, even though the associated company is not controlled.

5.15 We consider that where one undertaking exercises significant influence over another, there may be an opportunity to co-operate and structure arrangements to achieve profit more than once. The POCO adjustment should apply to those circumstances to prevent artificial generation of profit layering, just as it does in situations of control.

5.16 We agree that a proportionate approach should be taken to the POCO adjustment. The time and effort spent investigating and making adjustments should be proportionate to the risk that an adjustment is required and the potential value of layered profit.

**Conclusions**

We consider that the legislation should extend the scope of the POCO adjustment by specifying the principle that POCO applies where the contractor's corporate group has "significant influence" over the undertaking with which the contractor is contracting. The circumstances in which there is "significant influence" can then be described in statutory guidance.

In developing guidance, we would draw on practice in transfer pricing and accounting standards that deal with the assessment, analysis and reporting of company profit. We would tailor our approach to address the risk factors that allow contractors to influence the double-application of profit under the regime.

## Competitive process

**Summary of consultation**

5.17 In the consultation (6.18 to 6.20) we sought input about the competitive process, described at regulations 59 and 60, that must be followed for a contract with an associated person to be outside the scope of the POCO adjustment. We thought that contractors might be able to demonstrate that the price of a non-competed sub-contract or further sub-contract is comparable to a competitive price through other means that may be less onerous.

**Stakeholder responses to consultation**

5.18 Most respondents welcomed proposals for less restrictive means of demonstrating a sub-contract is competitively priced. Suggestions included the use of catalogue prices or prices charged to third parties. The definition of commercial items in FAR 2.101[19] was also suggested as a basis for such an approach.

5.19 One response highlighted that where the MOD has contributed towards development costs, they might expect to pay a lower price than third parties to reflect that investment. Another response cautioned against rules that may encourage contractors to restructure their businesses or alter their procurement policies to maximise advantage.

18 IFRS (2011), *IAS 28 Investments in Associates and Joint Ventures,* https://www.ifrs.org/issued-standards/list-of-standards/ias-28-investments-in-associates-and-joint-ventures/

19 https://www.acquisition.gov/content/2101-definitions

### SSRO's considerations

5.20 Profit layering is a normal part of a competitive supply chain. The POCO adjustment is aimed at preventing inappropriate profit layering, in which a single source contractor creates intra-group transfers with the result that the MOD is charged profit more than once. The legislation recognises the distinction between appropriate and inappropriate profit layering by excluding sub-contracts that are the result of a competitive process (regulations 12, 59 and 60).

5.21 There may be other circumstances in which it can be established that profit layering is appropriate. It would be consistent with the aim of fair and reasonable pricing for contractors to be able to claim profits that could legitimately be earned in a competitive market. We consider that sub-contracts could be excluded from POCO where the contractor can demonstrate that the price, or estimate of a price, of a sub-contract or further sub-contract is comparable to a competitive or 'market' price.

5.22 We agree that caution is required when introducing a different approach. We do not agree, however, that a change will encourage undesirable practices. The onus should be on the contractor to demonstrate that the contract is excluded and the SSRO can provide guidance as to the evidence required.

5.23 We note that regulations 59 and 60 are referenced elsewhere in the legislation for the assessment of a qualifying sub-contract. We can see why the scope for full compliance with all aspects of the regime might be different than the scope for the application of a POCO adjustment and do not consider that the scope of POCO and QSC assessment, with regard to competition, need to be aligned.

### Conclusions

We have identified a case for excluding sub-contracts from application of the POCO adjustment where it can be demonstrated that the price is equivalent to a competitive price. This should be considered alongside the MOD's intended review of "commercially priced items" as an alternative means of establishing a fair price.

## Applying the POCO adjustment: profit or costs

### Summary of consultation

5.24 The legislation currently provides for two methods of adjustment in respect of POCO: to the Allowable Cost or to the contract profit rate. In 6.24 to 6.25 of the consultation we proposed that regulation 12 be amended to require attributable profit to be removed from Allowable Costs (existing regulation 12(2)), and that the option to make an adjustment at step 3 be deleted (existing regulation 12(3)).

### Stakeholder responses to consultation

5.25 Few respondents commented on whether replacing the two options for dealing with POCO with a single approach was beneficial. The responses we received were mixed, with some thinking it would be a positive move towards simplifying POCO, and others submitting that the two options give flexibility and no change is required.

### SSRO's considerations

5.26 We believe that having one method for dealing with profit on profit would be beneficial because it would make the system clearer and easier to apply. The POCO adjustment is targeted at profit being layered through a supply chain, which results in profit being recorded as costs in the prime contract, on which a further layer of profit is added. The direct way to ensure profit is applied only once is to remove the profit of group sub-contracts from the cost of the prime contract. This is the approach currently provided for through an adjustment to the Allowable Costs (regulation 12(2)). The alternative approach of applying the POCO adjustment at step 3 (regulation 12(4)) does not remove the group sub-contract profits from the costs of the primary contract. Instead it creates an equivalent price outcome via a top-down adjustment to the contract profit rate. This distorts the contract profit rate percentage and means it is not a direct reflection of the expected profit of the contract. In effect, some profit is reported within costs, which may confuse the overall understanding of the split between what the MOD pays for profit and costs. We do not see the justification for an adjustment at step 3, when the profits can be removed from Allowable Costs (regulation 12(2)) and avoid the distortion we have identified.

5.27 Previous analysis indicated around 50 (25%) of 200 qualifying contracts reported group sub-contracts when reporting the top 20 sub-contracts with a value greater than £1 million[20]; in these cases, and in cases where other group or further group sub-contracts exist, we would expect a POCO adjustment to have been made. 17 (9%) of those same 200 qualifying contracts made an adjustment at step 3.[21] The reported data does not clearly identify when Allowable Costs have been adjusted to remove group sub-contract profit (see conclusions below regarding transparency) but, on the basis that an adjustment must be made and we can identify those contracts for which an adjustment is made to profit, we can extrapolate that where a POCO adjustment is made it is most commonly made to costs. It seems that the adjustment to Allowable Costs is already the preferred method of contracting parties, as well as being the direct way to ensure profit is applied once.

### Conclusions

We consider that the legislation should be amended so that all future adjustments for attributable profit are made to the Allowable Costs of the qualifying contract (the existing regulation 12(2)). This would require removal of the 'step 3' sub-heading of section 17(2), removal of regulations 11(4) and 12(3), associated changes to bring POCO into consideration for Allowable Costs (section 20), and other matters including:

1) transitional arrangements for existing contracts to allow them to continue to report and conclude contracts on the existing basis.
2) retaining aspects of regulation 12, for example the requirement at regulation 12(3) that the "parties may agree an amount", so that the regulations continue to confer responsibility on the parties to determine and make the adjustment.
3) provision for the SSRO to continue to issue guidance on the POCO adjustment, which it currently makes by issuing guidance on the profit steps under section 18(1). This might be achieved by directly providing for the SSRO to issue guidance on the POCO adjustment or achieved by incorporating the POCO adjustment into the definition of Allowable Costs (section 20).

5.28 We would be pleased to work with the MOD to develop these changes in full.

20 Reported under regulation 25(2)(l), as it was before *The Single Source Contract (Amendment) Regulations 2019* came into force.
21 As of 30 April 2019. SSRO (2019), *Annual qualifying defence contract statistics 2018/19*, https://www.gov.uk/government/publications/annual-qualifying-defence-contract-statistics-201819

## Determining the adjustment: part ownership

### Summary of consultation

5.29 In the consultation (6.12 and 6.22) we proposed that attributable profit is defined in a way that takes account of part ownership of a sub-contractor by the prime contractor and that regulation 12(8)(b) might be amended to achieve this.

### Stakeholder responses to consultation

5.30 Few respondents commented on this proposal, but those that did thought that if a contractor should only recover profit once, it is logical that this should also apply on a proportional basis to part-owned sub-contractors. Some respondents considered that regulation 12(8)(b) already achieves this outcome, and submitted that this was its intended effect.

### SSRO's considerations

5.31 We can see that regulation 12(8)(b) may have been intended to provide for proportional adjustment in the case of part ownership of an associated party. In our view it does not actually have that effect.

5.32 Regulation 12(8)(b) provides that attributable profit does not include profit received by a person which is not associated with the primary contractor. The regulation is clearly intended to limit the operation of the POCO adjustment by providing that a contractor should not be prevented from earning profit on profit in circumstances where that profit is received by an arms-length organisation.

5.33 According to the price formula in section 15 of the Act, the price of a sub-contract includes its profit and is paid by the primary contractor to the sub-contractor. That profit is "received" by the sub-contractor and, if the sub-contractor is a "group sub-contractor", they are by definition associated with the prime contractor.[22] We consider this is the ordinary and natural meaning of "received", as used in regulation 12(8)(b). This construction leaves no work for regulation 12(8)(b) to do, as the attributable profit will always be received by a person associated with the prime contractor.

5.34 Some stakeholders consider that the word "received" should be interpreted more broadly to refer to the subsequent distribution of profit from the sub-contractor to others who are not associated with the prime contractor. As stated, we consider that the profit under the group sub-contract will always have been received in the first instance by a person associated with the contractor. To achieve the outcome urged by some stakeholders, additional words would need to be read into regulation 12(8)(b). For example, the word "ultimately" could be inserted in front of "received", but it would be complicated, if not impossible, to try to identify who ultimately receives profits. It is difficult to arrive at an alternative that does not involve substantial rewriting of regulation 12(8)(b).

22 This description applies to further group sub-contracts and further group sub-contractors as it applies to group sub-contracts and group sub-contractors.

### Conclusions

Our view is that a correct application of regulation 12(8)(b) will never result in profit being excluded that is for the benefit of a third party, which seems to have been its intended effect. In the circumstances, the provision should be amended to operate in an effective way.

However, as explained in paragraph 5.7 above, our view is that many aspects of the POCO adjustment, including the specific definition of 'attributable profit', should be set out in statutory guidance. With this in mind, we consider that regulations 12(7) and (8) should be replaced with provision for the SSRO to issue guidance on the determination of attributable profit. Our initial position, subject to further review and consultation, is that guidance would only require adjustment for the proportion of profit that the prime contractor's corporate group receives. For example, where a 60/40 joint arrangement exists only 60% of the sub-contract's profit would be adjusted for.

## Determining the adjustment: unknown profit

### Summary of consultation

5.35 In the consultation (6.23) we reflected on feedback from contractors that they do not always know what amount of profit is included in the price of a group or further group sub-contract. We asked for views on how this might be addressed.

### Stakeholder responses to consultation

5.36 Respondents submitted that they sometimes experience difficulties in obtaining profit information from sub-contractors, particularly international sub-contractors and those with whom the prime contractor does not contract directly. Several respondents stated that they have agreed an alternative approach with the MOD, in which a zero contract profit rate is applied to the Allowable Costs that relate to a group sub-contract. This was thought by those respondents to satisfy the principle of POCO, despite not following the requirements of the legislation[23].

### SSRO's considerations

5.37 There is provision in the Act for contractors to be required to provide the contracting authority with details of attributable profit. Section 20(4) of the Defence Reform Act empowers the Secretary of State to require a primary contractor to show that a cost claimed by the primary contractor as an allowable cost is appropriate, attributable to the contract and reasonable in the circumstances (the AAR principles). The Secretary of State may require the contractor to demonstrate that the price of a sub-contract satisfies the AAR principles and, as part of this requirement, the Secretary of State may seek to scrutinise the amount of profit paid to the sub-contractor. There is no express obligation on sub-contractors to provide the primary contractor with details of its profit, but as the companies are associated, the relevant information will be in the possession of the corporate group, and management action should be possible to enable appropriate information sharing. We do not think exceptions should be made for circumstances where parts of the same group who are contracting with each other chose to not share information about the profit in those contracts. We can see that some allowance may need to be made if the sub-contractor is unable to provide this information, for example if it is prevented from doing so by law, although we were not provided with any specific examples where this had occurred.

23 The approach fails in two aspects: 1) a price determined on this basis would not follow the pricing formula in s.15 as the contract profit rate must be determined by the six step and applies to all Allowable Costs; and 2) the approach is not the one described in regulation 12.

5.38 The regulations could be changed to introduce new statutory obligations on non-QSC sub-contractors to provide profit information. It is unclear that this would be a proportionate means of dealing with cases in which the sub-contractor refuses to provide the information, nor that it would be effective.

5.39 Where a contractor is unable to obtain the information required to apply the POCO adjustment, there is currently no provision in the legislation for alternative approaches to be employed which would give a similar effect. The work-around that stakeholders have applied is to not apply the contract profit rate to the price of the sub-contract, which effectively modifies the pricing formula and results in the component of the Allowable Costs that are group sub-contracts having a profit rate of 0% applied. Previous analysis by the SSRO revealed that 17 (11%) contracts had reported applying this approach.[24] This approach has disadvantages over the required implementation of the POCO adjustment, for example:

a. The approach only affects group sub-contracts (i.e. direct sub-subtracts) and no adjustments are made for further group sub-contracts.

b. It is unclear how contractors are demonstrating that the price of sub-contracts meets the AAR test[25] (see Allowable Costs guidance 2.3) in the absence of information on the profits earned.

c. An amount of profit received by the group is being reported as a cost in the QDC. This makes the contract profit rate lower than the actual profit rate and is detrimental to the benchmarking of contract profit rates.

d. It provides a route for contractors to structure their procurement arrangements in a way that would avoid transparency.

5.40 The work-around being applied by stakeholders is not currently provided for in the legislation. In our view it produces sub-optimal outcomes for the reasons given above and it should be discouraged.

5.41 An alternative approach if the contractor can demonstrate to the MOD that it is unable to determine the amount of attributable profit, because it is prevented from obtaining the relevant information, may be for the parties to agree that the attributable profit is calculated on the basis that the profit rate on costs in the group sub-contract is the same as the contract profit rate. Applying the existing POCO adjustment process, the parties would observe the same impact on the contract price as with the work-around that has currently been applied but would not encounter the issues outlined in a) and c) above. However, further engagement with stakeholders is needed to determine whether the issues at b) and d) can be resolved.

**Conclusions**

We have expressed the view that determination of ‘attributable profit’ should be set out in statutory guidance rather than being defined in detail in legislation. Dealing with situations of imperfect information is something that could be better handled by principles that can be applied to the specific facts and circumstances of a contract, with facility for the SSRO to provide guidance and the option for referral to the SSRO if agreement cannot be reached.

24 Analysis of data from contracts included in the SSRO’s Q2 2018/19 statistical bulletin. Out of 159 contracts, 49 provided commentary to explain the presence or absence of a POCO adjustment, and of those 17 indicated that the contract profit rate for the QDC/QSC had not been applied to the element of Allowable Costs that related to the price of group sub-contracts.

25 Appropriate, attributable to the contract, and reasonable in the circumstances.

## Transparency and value

### Summary of consultation

5.42 We consulted on proposals (6.26 to 6.28) to require reporting of basic information about group sub-contracts and further group sub-contracts, including the amount of attributable profit. We also consulted on proposals (6.13 to 6.17 and 6.26 to 6.28) to change the threshold value for a group sub-contract or further group contract defined at regulation 12(5) and (6)(c) from £100,000 to another threshold.

### Stakeholder responses to consultation

5.43 Some respondents noted that MOD typically incorporates information access rights into contracts through DEFCON 802/812 and submitted that additional reporting would result in duplication. Others thought that the SSRO could issue additional guidance about what it expects to see reported under the current requirements and that this would enable further information to be obtained about POCO.

5.44 One respondent thought that any additional requirements should be restricted to group sub-contracts and not include further group sub-contracts, on the grounds of immateriality and the difficulties a contractor might have in obtaining the required information from suppliers they do not contract with directly. Another respondent thought that there was no need for the SSRO to require information on profits that might have been made but are not (i.e. the attributable profit that has been removed by the POCO adjustment process).

5.45 Four respondents commented on the threshold value and thought there was merit in aligning the POCO threshold to other thresholds on the grounds of materiality. One stakeholder stated that there was no evidentiary base for the current threshold. One respondent thought that introducing a requirement for aggregation would add complexity to an already complex area.

### SSRO's considerations

5.46 There are two problems with the current arrangements that we consider should be dealt with together:

a. the legislation employs a £100,000 sub-contract value threshold as an anti-avoidance measure, which seems disproportionate, as it requires analysis of many low value sub-contracts, and may be ineffective because it leaves scope for avoidance below the threshold;[26] and

b. information reported to the SSRO about attributable profit is inconsistent and unstructured, despite the calculation itself being structured and set out in legislation. This makes it difficult to understand and monitor the extent of group sub-contracts, or the impact that the regulations are having on preventing profit on profit.

5.47 We consider that a threshold is necessary in regulation 12(5) and 12(6) to identify the group subcontracts that should be routinely considered to ensure POCO. We are concerned that a threshold of £100,000 is too low, resulting in a disproportionate effort to identify relatively small amounts of attributable profit to be dealt with under the POCO adjustment. It would be more proportionate to raise the threshold but to allow the contracting authority to require inclusion of contracts below threshold if it is reasonably satisfied that contracts have been subdivided to avoid operation of the POCO adjustment. We have considered other thresholds used in the legislation and we propose adoption of a £1 million threshold, which aligns with the value threshold for reporting details of sub-contracts in contract reports.

26 We understand the setting of a low threshold was intended to discourage the breaking up of contracts to avoid a POCO adjustment.

5.48 We consider that information about attributable profit is needed to understand the extent of profit layering. This will enable the contracting parties and the SSRO to better observe compliance and numerically assess the extent of profit layering in order to prioritise resources applied to this area of the regime. Contractors are already required to report details of sub-contracts with a value below £1 million in DefCARS.[27] The additional information requirement would not be disproportionate because contractors are already required to know this information to calculate the POCO adjustment.

5.49 We consider that a specific requirement to report attributable profit is a more complete solution than relying on existing powers available in the legislation to provide reporting guidance. We accept that the reporting requirements of the contract pricing statement (regulation 23) could be clarified by the SSRO to require structured reporting about POCO adjustments, similar to the approach taken with the capital servicing adjustment (CSA) calculator. However, this would only capture sub-contracts entered into prior to the initial reporting period. It is considered that the SSRO specifying in guidance that attributable profit should be provided is more amenable than a requirement to report through QCRs, ICRs and CCRs.

5.50 Respondents noted that MOD might already have access to information about POCO adjustments. In general, we do not accept the argument that information should only be included in statutory reports if it is not otherwise available to the MOD, although we accept that reporting requirements should be proportionate. There is merit in having information regarding the POCO adjustment consistently reported and collected in DefCARS, rather than being collected on an ad-hoc, contract-by-contract basis. This would better enable checking of the quality of the data being collected and provide an accessible repository of the data.

5.51 We have not seen an evidentiary basis for the Part 5 sub-contract reporting threshold (£1 million contract value), with which we propose to align the POCO thresholds. This does not remove the argument that the threshold would be more proportionate than the current threshold of £100,000. In due course, we may be able establish the coverage this threshold gives over all sub-contracts and assess whether it is appropriate.

5.52 We accept the submission that reporting requirements should not be extended to further group sub-contracts, as this would create an obligation on the prime contractor to source the information from its group sub-contractors. We think that there is insufficient evidence at this time to justify the additional burden. Additional reporting should only apply to sub-contracts already required to be reported in the CNR, QCR, ICR, and CCR.

**Conclusions**

We consider that the threshold value for requiring a POCO adjustment should be raised to £1 million, while empowering the contracting authority to include contracts below threshold if it is reasonably satisfied that contracts have been subdivided to avoid operation of the POCO adjustment. Contractors should be required to report the following additional information:[1]

a. whether the sub-contract is a group sub-contract; and

b. the value of its attributable profit.

1 Regulations 25(2)(l), 26(6)(k), 27(5)(e), and 28(2)(p).

27 Regulations 25(2)(l), 26(6)(k), 27(5)(e), and 28(2)(p).

## Other POCO matters

5.53 The following paragraphs are matters relating to POCO on which we did not specifically consult.

**Use of the word "associated"**

*Stakeholder responses to consultation*

5.54 Stakeholders told us that using the word "associated" can be confusing because "associate" is defined differently in accounting standards, as "an entity over which the investor has significant influence" [IAS 28.3]. Using the word 'associated' could have an unintended consequence of misapplication.

5.55 The definition of "associated" in the Act and Regulations is stated in section 43(3) with reference to the "group undertaking" definition in Companies Act 2006 Section 1162:

*a "group undertaking", in relation to an undertaking, means an undertaking which is a parent undertaking or subsidiary undertaking of that undertaking, or a subsidiary undertaking of any parent undertaking of that undertaking.*

*SSRO's considerations*

5.56 We recognise that the term "associated" may have a number of meanings when applied in different contexts (such as accounting standards). Respondents did not suggest an alternative word and we think that other similar words will also have other uses. It is unfortunate that accounting standards use a similar word to describe something quite different, but the legislation and our guidance are clear what the definition of 'associated' is for those purposes and is adequate for contracting parties.

**BPR comparator group**

*Stakeholder responses to consultation*

5.57 One respondent thought that consideration was needed about how POCO issues are dealt with by comparator group companies.

*SSRO's considerations*

5.58 We have considered this matter. In essence, the POCO adjustment is a mechanism to remove the effect of the application of mark-ups upon mark-ups arising from certain intra-group transaction. The baseline profit rate is calculated using information from consolidated group financial statements; this means that comparator companies eliminate all intra-group transactions and present financial statements that describe transactions only with third parties. On a contract basis, this is the equivalent to a POCO adjustment being made to all intra-group transactions – which is much further reaching than the requirements placed on QDC contractors.

### Events after the contract's time of agreement

*Stakeholder responses to consultation*

5.59 One respondent thought that consideration was needed about the application of POCO to group sub-contracts that were not contemplated at the time of agreement but were subsequently entered into.

*SSRO's considerations*

5.60 We agree that this aspect of the POCO adjustment could result in profit being applied more than once. If assumptions made about sub-contracting when a qualifying contract is entered into are incorrect then the amount deducted under the POCO adjustment may be too much or too little. Those assumptions could relate to its value, price, who it is placed with, or the method by which it is negotiated.

5.61 We note that the proposal to make POCO a cost matter, rather than a profit matter, will prevent this issue for contracts priced with actual Allowable Costs (e.g. cost-plus). For other pricing methods, we consider these are specifically designed to transfer risk and reward. We do not consider that costs arising from the choice of sub-contracting arrangements should be treated differently to costs arising from other risks and rewards, assuming these are estimated and scrutinised appropriately at the time of agreement.

*Conclusions*

We note that the proposal to make POCO a cost matter will address this issue, and it should also be applied to the calculation of the final price adjustment (regulation 17). That calculation uses "outturn costs", which might be determined differently to Allowable Costs. We consider that outturn costs should also reflect the impact of actual sub-contracting arrangements to ensure that POCO is properly taken into account for pricing methods to which a final price adjustment applies.

### "Thin primes" and the POCO adjustment

*Stakeholder responses to consultation*

5.62 One respondent noted that where different cost risk adjustments and incentive adjustments apply to a sub-contract compared to the prime contract this creates issues that manifest through the POCO adjustment. In a workshop some stakeholders told us that this has a significant unintended consequence with "thin primes": that any cost risk adjustment or incentive adjustment are in effect stripped out by the POCO adjustment, and that the contract profit rate for the prime may be totally removed or even negative. Respondents did not put forward any proposal for change.

*SSRO's considerations*

5.63 A "thin prime" is a contracting approach where the prime contractor takes a relatively small role in the overall delivery and engages sub-contractor(s) to carry out the work. For example, a thin prime might be a local subsidiary of a large international corporate group or a jointly-owned company set up by a consortium as a vehicle to manage a specific joint contract. The net effect of the POCO adjustment is that the profit that is applied to costs is the contract profit rate of the prime contract and Table 5 illustrates an outcome under a reasonable, simplified set of assumptions when contracting through a thin prime where the contract profit rate for the prime will be negative.

**Table 5: Thin prime illustration**

| Thin prime illustration |
| --- |
| **Fact pattern**<br>a. A contracting authority wants to purchase complex customised equipment for a firm price using a thin prime because it wants to contract with a UK-based entity. This "thin prime" will enter into a firm price QSC with a foreign-based associated company (i.e. a group sub-contract) for delivery of the entire requirement.<br>b. The QDC contractor incurs no costs; all work is performed by the QSC.<br>c. The QSC's Allowable Costs are £260 million.<br>d. Assume: the baseline profit rate is 8%; and in both contracts the SSRO funding adjustment (step 4) incentive adjustment (step 5) and capital servicing adjustment (step 6) is zero.<br>e. The QDC has no cost risk itself because all the work is sub-contracted at a firm price; the thin prime therefore agrees a contract profit rate of 6% (BPR-25% CRA).<br>f. The QSC sub-contractor takes significant risk that actual Allowable Costs differ from estimated Allowable Costs and therefore agrees a 10% contract profit rate (BPR+25% CRA) and a contract price of £286 million (ie £260 million Allowable Costs plus £26 million profit).<br>**Requirement for a POCO adjustment**<br>The POCO adjustment applies; therefore either:<br>a. the Secretary of State must be satisfied that the Allowable Costs of the QDC are reduced by the 'attributable profit' of the group sub-contract; or<br>b. the parties agree a POCO adjustment.<br>**QDC Price Outcome**<br>The attributable profit on the sub-contract is all the profit element in the price payable, £26 million. Therefore either:<br>a. the Allowable Costs of the QDC are £260 million (£286 million reduced by £26 million, as described by regulation 12(2)), with a contract profit rate of 6%. The QDC therefore has a contract price of £275.6 million; or<br>b. the Allowable Costs of the QDC are £286 million, with a contract profit rate of minus 3.64% (ie. 6% minus 9.64%, the POCO adjustment as described by regulation 12(3)). The QDC therefore has a contract price of £275.6 million.<br>In both cases, the thin prime would be required to pay the sub-contractor £286 million through the QSC, but it is only paid £275.6 million by the contracting authority through the QDC.<br>**Overall Profit Outcome**<br>The overall profit for the group is the QDC price less the Allowable Costs of the QSC.<br>The price of the QDC in both cases is £275.6 million; the Allowable Costs of the QSC are £260 million; this results in a profit of £15.6 million, which is an overall profit rate for the group of 6%. |

5.64 The target profit outcome of the current POCO arrangements is that the profit rate applied to costs is the contract profit rate of the prime contract with no profit layering. As shown in Table 5, this creates some outcomes which we consider may not best support fair and reasonable prices, notably when there are differences between the contract profit rate of the prime contract and the profit rate of the sub-contract, and where the price of the sub-contract is a large proportion of the Allowable Costs. We see the outcome as suboptimal because the POCO reduction is greater than the extra profit arising solely due to group sub-contracting. For example, the POCO adjustment results in lower profits being paid to the group than in either of the following situations in which profit is applied only once:

a. if the sub-contract were instead made directly with the contracting authority; or

b. if the requirements of prime contract and sub-contract had been let as a single contract and was not sub-contracted.

5.65 We can see no obvious reason why the POCO adjustment should result in an outcome were less profit is paid to group than if profit applied only once on the allowable cost arising under a qualifying contract based on its respective CPR.[28] We see two potential routes for further examination on changes to the POCO adjustment to remedy this issue, and a further mitigation not requiring legislative change:

a. determining the contract profit rate steps of the prime contract on a 'consolidated' basis, so that the cost risk adjustment reflects the cost risk to the primary contractor and any group and further group sub-contractors;

b. re-defining the 'attributable profit' for the POCO adjustment to indirectly achieve an outcome equivalent to each contract being placed independently of one another, rather than it being "all the profit element in the price payable" of the sub-contract; and

c. contractors avoiding entering into group contracting and sub-contracting arrangements which would result in a POCO adjustment of the nature described in this section.

5.66 This is a substantial issue which the SSRO has not consulted on. We do not have a sufficiently developed evidence base or view to make a proposal for a change in legislation. However, the SSRO would be pleased to work with the MOD on such matters before completion of the Secretary of State's review, or in future reviews, if it helps facilitate a solution to the issue.

**Taxation**

*Stakeholder responses to consultation*

5.67 Several respondents considered that the POCO adjustment had implications for corporation tax, particularly where the adjustment applies to sub-contracts placed with non-UK sub-contractors. It was not made clear what the specific implications were, either in respect of the existing arrangements around POCO, or other areas for development outlined in the consultation.

*SSRO's considerations*

5.68 We agree that, as suggested by ADS, that any developments the Secretary of State takes forward on POCO should be consistent with tax rules.

28 We note that in more typical sub-contracting arrangements, where a substantial amount of the cost is generated from within the prime contract itself, the issue is relatively less pronounced.

# 6. Defined pricing structure

## Introduction

6.1 Several contract reports (the CNR, ICR and CCR) require a breakdown of costs by the defined pricing structure (DPS). The DPS is a list of cost categories describing key components of the deliverables to be provided under the relevant contract. The Regulations provide limited detail on the DPS and therefore the SSRO provides detailed guidance to assist contractors.

6.2 We conducted a review of the DPS which focused on three key areas:

- the purpose of the DPS and whether the DPS could meet its purpose;
- use of the DPS; and
- the proportionality of reporting against the DPS.

6.3 We suggested in a working paper that the purpose of the DPS is to support benchmarking and parametric estimating and to challenge contractor cost estimates. This statement of purpose was not disputed by stakeholders and the MOD confirmed that its intended use was to support independent estimates. The principal feedback from stakeholders in relation to the purpose of the DPS expressed concern that the purpose was not being realised because the information was not being fully utilised. We were satisfied that the purpose of the DPS is clear and that the focus for all stakeholders should be on data quality and utilisation of the data for decision making purposes.

6.4 During the review, we were able to identify and engage with potential future users of the DPS within MOD, such as cost estimators and cost engineers. We observed some indicators and received stakeholder feedback which suggested that the MOD's use of the system was not fully developed. This limited our ability to reach a conclusion that the DPS is optimised to suit the needs of MOD estimators, but we remain of the view that a standardised cost dataset such as the DPS has the potential to provide great utility in this area, provided that it is used and populated.

6.5 With regards to proportionality, we explored whether there was any potential to align the cost data captured in contract reports to reduce duplication in reporting. We were satisfied that the data captured by the DPS in the CNR, ICR and CCR and by the work breakdown structure (WBS) in the QCR serves different purposes, namely estimating and contract management respectively. We considered that a need remained for both datasets to be captured. The granularity of data required in the DPS is another aspect of proportionality. We considered that a richer dataset and more MOD engagement with the DPS would enable a clearer view of the benefit weighed against the cost of reporting by DPS in addition to the WBS. We have positioned proportionality as a key principle to guide any future review of the DPS when the MOD's use of the data has increased.

6.6 We do not propose legislative change to the DPS at this time. More time should be allowed for DPS data to develop. We believe that over time there will develop an increasingly rich, structured cost dataset, which can be used by the MOD to inform procurement decisions. A further, full review would be merited when the dataset has had further opportunity to mature.

## General conclusions from the review of DPS

6.7 The review could not fully consider the costs and benefits of the DPS for the following key reasons:

- The dataset is not sufficiently rich at this time.
- The MOD has engaged in a limited way with the DPS.
- There is limited learning to date.

6.8 There are significant numbers of QDCs and QSCs within the regime, but few have completed and provided actual cost data, and the regime does not yet cover the full range of expected contracts. The dataset will continue to grow and add value in coming years, as existing contracts complete and a greater breadth of contracts come under the regime.

6.9 DPS data is captured primarily to support an estimating purpose, for long term budgeting and forecasting and to assist the MOD in challenging contractor cost estimates. The MOD should support contractors to determine the DPS structure to be used so that outputs are optimised to their estimating needs. In the consultation, contractors indicated a low level of support from the MOD when agreeing the DPS. The MOD updated its commercial policy in March 2019 to encourage greater engagement, which we would expect to increase involvement by the MOD in selection of the DPS. We found limited evidence of the DPS dataset being used by the MOD. This is likely to be linked to the level of maturity of the dataset, and may be expected to change as the database grows.

6.10 Contractors have generally adopted the view that there is no direct utility to themselves from splitting costs by the DPS, as it does not reflect their own internal cost or production approaches. We consider that contractors would benefit if the DPS results in better estimation and improves budget management. Contractors may also benefit from greater transparency over inputs to the MOD's estimating processes.

6.11 This review focused on issues that have been identified to date, which principally relate to inputs, such as applying the DPS and preparing and submitting data against it. We expect that further issues will be identified in due course, as a result of greater use of DPS data and changes in the defence landscape. This review focused on issues that have been identified to date, which mainly relate to inputs – applying the DPS and preparing and submitting data against it.

## Taxonomy

### DPS taxonomy: cost categories and structures

*Summary of consultation*

6.12 There are 16 DPS templates, which reflect different types of equipment, systems or services that the MOD may procure under a single source defence contract. Each structure features hierarchical cost categories, of which many costs are broken down into three or four levels. The categories are supported by definitions. Together this makes up the taxonomy of the DPS.

6.13 The SSRO's 16 DPS templates were initially developed by the MOD based on US Military Standard 881C and were introduced by the SSRO in early 2015. During the initial engagement on this project, MOD highlighted that there was comparability between the structures that enabled them to purchase data from the US, in order to support their use of the DPS. The US Military Standard 881C was updated in 2017 to 881D, primarily to reflect changes in the defence procurement landscape, with an increased focus on technology products. These changes have not been reflected in the DPS templates used in DefCARS and their inclusion has not been raised as a priority by stakeholders.

6.14 The SSRO expressed the view, based on its review of the DPS and stakeholder engagement prior to the consultation, that there did not appear to be widespread issues with the equipment related cost categories in the 16 structures and as a result the SSRO did not propose to change them in the near future. The reasons for this are that changes may impact both the relationship to the US dataset[29], which the MOD considers important, and comparability between similar equipment contracts. Based on the feedback received, the SSRO considered that there is scope to look at the cost categories that are being used in support contracts. This type of short-term review is examined in the next section.

6.15 The SSRO suggested that it will need to keep under review the frequency with which the taxonomy is updated and evolves due to changes in what equipment and systems are being procured along with practical experience in relation to applying the taxonomy to the reporting of single source defence contracts. The reasons for this, which were set out in the consultation document, were that it appeared as though the DPS structures being used by contractors were not always the best representation of what is being procured and what the costs relate to. We identified that the ancillary services template had been used far more frequently than we would have expected, based on our understanding of the contracts within the regime. To avoid piecemeal changes to the dataset, the SSRO considered that a more detailed, substantive review of the DPS taxonomy should take place over the medium term, based on clear principles for the DPS such as those set out in Table 6.

6.16 Stakeholder views were invited on whether the characteristics in Table 6 provide the right basis for future review of the DPS. Input was also invited on the pace of change with regard to updates to the taxonomy.

**Table 6: Proposed principles for the DPS taxonomy**

| Principles | |
|---|---|
| Relevance | DPS cost categories should be relevant for:<br>• estimating the cost of a similar or follow on contract; and<br>• estimating the cost of a programme or platform |
| Consistency | DPS cost categories should be consistent with:<br>• existing DPS data;<br>• other datasets and guidance under the regulatory framework;<br>• MOD or government datasets; and<br>• IFRS accounting principles. |
| Proportionality | DPS cost categories should be easy to map to and transition costs should be minimised. |

*Stakeholder responses to consultation*

6.17 Seven respondents commented directly on this topic. Several industry respondents considered a need for a review of the DPS, with three partially or fully agreeing with the SSRO's suggested principles of relevance, consistency and proportionality as the basis for review. One contractor felt that a review should include engagement with specialists in parametric estimating to confirm the DPS's suitability and to identify their requirements, whilst another considered that a review should include all involved stakeholders and attempt to pull together an all-purpose cost dataset that served as a 'single version of the truth'.

29 The SSRO's 16 DPS templates were initially developed by the MOD based on US Military Standard 881C. There is therefore a degree of comparability between single source contract data captured in relation to US defence procurement and data captured using the DPS.

6.18 One contractor felt that consistency was less important than having cost categories that reflected a company's own production methods. Two other respondents called for greater alignment between the DPS and the contractor's own WBS or production methods. A further respondent felt that there should be some flexibility within the DPS to recognise that businesses are structured differently and recover costs in different ways.

6.19 ADS, along with several defence contractors highlighted the importance of understanding how the MOD intends to use the DPS, with some questioning the benefits that the data may provide. One contractor felt that it would be helpful to have examples of a completed DPS for each of the various equipment types to help contractors understand the mapping and encourage consistency. ADS considered that the relevance of the taxonomy and value of the DPS data is likely to diminish over time owing to technological change, changes in production methods and what is procured within the equipment budget (for example, an increasing reliance on autonomy, Artificial Intelligence and unmanned systems). ADS also felt that DPS data had very little utility unless accompanied by a narrative or some other sort of supporting information.

*SSRO's considerations*

6.20 We note that several contractors expressed a preference that the DPS was more closely aligned to their own WBS or business processes. To support the purpose of the DPS, the cost structures need to be standardised and therefore cannot be company specific. A WBS breakdown of costs serves a different purpose (i.e. facilitating contract management) and therefore the SSRO does not support greater alignment between the DPS and company specific WBS. In response to the working paper, MOD also outlined a clear preference that the DPS is comparable with external data sources.

6.21 There was support for the principles of relevance, consistency and proportionality. Given the relative immaturity of the DPS dataset, we do not have a wide range of examples available to review the data in these themes, but we expect this to be possible in the future. We consider that relevance, consistency and proportionality are appropriate considerations to guide our thinking on the DPS taxonomy, in response to any issues that are raised with us or when conducting a later review of the DPS. Candidates for any future review include the taxonomy, application of the DPS by the MOD, and any reporting issues notified to, or identified by, the SSRO.

*Conclusions*

We are not proposing changes to the DPS taxonomy, which is defined in the SSRO's guidance rather than in legislation. We will monitor application of the DPS pending any further, detailed review. We remain open to evidence from stakeholders on technical matters related to the DPS to inform the development of our reporting guidance and to build a body of knowledge for the review.

**DPS taxonomy: support contracts**

*Summary of consultation*

6.22 The SSRO identified potential issues with reporting support contracts against the DPS structures and use of the ancillary service DPS. We observed that the ancillary services DPS had been used for many support contracts rather than using the relevant equipment specific structures. We suggested that having support specific lines as well as equipment specific lines within each DPS structure could create confusion when applying the DPS, as costs may apply to both the support activity and the component. We sought stakeholder input on removing the support specific lines from the DPS so that all design, build and support costs would be recorded against the component focused lines.

*Stakeholder responses to consultation*

6.23 Five respondents commented directly on the proposals. ADS challenged our view that maintaining a link between in-service support and the equipment to which it relates seems appropriate and asserted that it is not backed by supporting reasoning. ADS submitted that the techniques used for equipment maintenance and support are often different.

6.24 One contractor thought that removing the support specific lines within each DPS structure would be feasible in some situations but may not be suited to complex systems where a service may touch more than one DPS element. In this situation it was thought that a contractor may need to present data at a more consolidated level to avoid confusion. A further contractor felt that the DPS structures should be split according to the life-cycle of the equipment being procured:

- design and build;
- in-service support and major repair;
- end of life and disposal.

6.25 It thought that each stage should have discrete DPS structures.

*SSRO's considerations*

6.26 We acknowledge concerns raised around the difference between equipment and support. At contract-level there are likely to be differences in the estimating approaches used, reflecting the different operating approaches undertaken in a contract to build when compared to a maintenance contract. If the DPS is to provide cost data for use in estimating, particularly long-term budgeting and forecasting, then we consider it is beneficial to understand the through-life cost of a capability. For this reason, we see merit in requiring a link within the DPS between the equipment and the support required to maintain it. We prefer this to establishing a support focused DPS structure which attempts to bring the diverse array of support activities across the sector into a single taxonomy, as the activities would not be specific to a particular equipment type.

6.27 The proposal to remove the support specific lines within each DPS structure remains our preferred approach, as it deals with a key challenge presented within the current taxonomy. Activity-type cost categories (such as Post-Design Services) are included alongside component-type categories (such as Airframe, within the Ordnance System DPS), when in reality a cost may relate to both, and this may create confusion and inconsistent approaches. We consider that removing activity-type categories will allow for greater consistency as there should be less scope for conflict with regards to which DPS line to report costs against. There is likely to be a need for additional guidance to help industry and MOD stakeholders when undergoing the process of selecting, mapping and applying the DPS.

*Conclusions*

The SSRO intends to develop revised DPS structures which remove the support specific elements. Any changes will be addressed in reporting guidance which supports stakeholders involved in the selection, mapping and application of the updated structures. We will consult with stakeholders before introducing such changes.

### DPS taxonomy: granularity

*Summary of consultation*

6.28 In the consultation, the SSRO expressed the view that the DPS is more likely to be applied optimally if the structure to be reported for a contract is discussed and agreed between the contractor and the MOD. This approach would be more likely to achieve a useful and achievable breakdown of costs. It would also provide an opportunity to involve the estimating community within the MOD and to understand whether the degree of granularity that can be achieved within the current structures is sufficient. Without such feedback, we did not consider that additional granularity was merited at this time.

6.29 We proposed to update the SSRO's reporting guidance (see Table 7) to emphasise that consideration be given to the DPS structure in advance of entering into the contract. This is to ensure that there is sufficient time for an appropriate DPS structure to be agreed and included in the Contract Notification Report, which is due 30 days after entry into the contract. The update additionally provided contractors with an updated set of principles to consider with regards to the appropriate granularity required for the DPS, to replace the current provision which is focused on contract value.

**Table 7: Proposed guidance changes in relation to the granularity of the DPS from the consultation**

| Existing guidance | Revised guidance |
|---|---|
| **Paragraph 5.30**<br><br>The level of relevant detail that a contractor provides should relate to the total contract value. The larger a contract, the more detail is expected (see footnote 10).<br><br>Footnote 10 – The required length of the DPS will vary depending on the contract value. As not all categories or levels need to be completed for each contract, the predicted length of the DPS is as follows:<br><br>• Under £10m: 10 – 20 rows<br>• Under £100m: 30 – 60 rows<br>• Over £100m: 60 – 100 rows | **Paragraph 5.30**<br><br>The contractor should seek to report against all the relevant DPS headings and agree the approach being taken with the MOD in advance of entering into the contract.<br><br>The contractor should consider the following:<br><br>• whether the number of lines selected in the DPS is proportionate for the quantum of Allowable Costs being reported;<br>• whether the contractor needs to inform the MOD about difficulties they may have in the availability of financial information they need to meet this reporting requirement;<br>• the specification or requirement under the contract and the extent to which the DPS lines apply (e.g. a whole platform may require more lines to be completed than a component); and<br>• making all reasonable efforts to include cost data accurately or at least to the nearest £10,000.<br><br>At each DPS level, DefCARS will aggregate data provided at lower levels so that at the top level (level one), the DPS will show the total allowable costs (excluding risk contingency). The DPS structure should include outputs that will be provided by sub-contractors. |

*Stakeholder responses to consultation*

6.30 Five respondents commented directly on the proposed guidance change. Four of the five considered that the requirement for accuracy to the nearest £10,000 was not merited for the DPS. Reasons cited included the scale of the overall equipment budget, the scale of individual contracts and the discrepancies inherent in mapping from a contractor's WBS to DPS. Two respondents proposed £100k as an appropriate precision, whilst another proposed the higher of £10,000 or 0.1% of the contract value.

6.31 Two contractors expressed support for the draft guidance in general whilst ADS proposed two specific drafting changes:

- Paragraph one – amend to "The contractor should report only against relevant DPS headings and…"
- Paragraph two – amend to "The contractor and MOD should consider the following:"

*SSRO's considerations*

6.32 We propose to make changes in response to the suggestions by ADS, although we have not fully accepted the proposed drafting. We see little substantial difference between our drafting "all the relevant DPS headings" and that of ADS "only…relevant DPS headings", but we intend to adopt a more neutral expression: 'The contractor should report against the relevant DPS headings'. We understand that ADS would like the MOD to also consider the matters listed in the guidance. We agree on the benefits of the contractor discussing the DPS with the MOD, but we must recognise that the SSRO's role is to provide statutory guidance on reporting requirements to contractors and not the MOD. We intend to modify the proposed guidance to say: "The contractor should consider the following things when discussing with the MOD:" We intend to implement the rest of Table 7 in line with our consultation.

6.33 We have considered contractor views that the precision of the DPS that is required within the SSRO's reporting guidance should be raised from the current level of £10,000.[30] Proportionality is a key consideration, but we wish to avoid a situation where contractors do not provide a level of granularity that the MOD requires. To support consideration of proportionality we propose to modify the guidance to provide that contractors should report at the current level of accuracy unless the MOD agrees that a lower level of precision is required.

*Conclusions*

The SSRO will introduce the guidance in Table 7, subject to the revisions outlined above. Our intention is to include the changes in the next Reporting Guidance update.

30 This guidance already exists within the SSRO's reporting guidance on contract reports.
SSRO (2019), *DefCARS - supplier report guidance - Version 7*, paragraph 4.31, page 29, https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance

### Selecting and agreeing the DPS

*Summary of consultation*

6.34 The SSRO expressed a view that the optimal approach to selecting the DPS is for it to be agreed between the contractor and the MOD, with input from estimating experts. In this way, the DPS is more likely to reflect what is being bought, treat support costs appropriately, and avoid wasted effort on the part of the contractor. The MOD's commercial policy has supported this approach since March 2019, although it limits CAAS input to larger contracts. The SSRO's guidance provides that: "The contractor should agree which of the 16 DPS templates is to be used with the MOD before reporting."[31] The SSRO proposed to strengthen this by recommending in guidance that the level of detail provided within the DPS is also agreed with the MOD. The SSRO expressed an intention to keep the situation under review but did not consider legislative change to be required at this time.

6.35 In response to the SSRO's working paper, a contractor had indicated that reporting against more than one DPS might be required for certain contracts. We proposed a change to DefCARS to allow reporting against more than one template where this is appropriate in response to stakeholder feedback that the single-equipment type structure may be unsuitable for a small number of contracts. This might include, for example, framework agreements where more than one equipment type will be provided or supported under the contract. We acknowledged that reporting in this way will be the exception rather than the rule and that a change to the reporting guidance and DefCARS would be required to accommodate this. We sought stakeholder views on this proposal.

*Stakeholder responses to consultation*

6.36 Six respondents commented directly on this topic. Some of the responses provided in relation to other questions (such as on taxonomy) also raised relevant points in this area. In response to the benefits of MOD engagement, respondents emphasised that they have experienced a lack of engagement by the MOD on the DPS. Some highlighted that it would be helpful for an owner of the agreement process within the MOD to be identified.

6.37 ADS and a contractor expressed support for permitting the selection of multiple DPS structures for one contract, though the contractor felt that permitting it only in the case of framework agreements was too narrow. They considered it was possible this requirement might arise in systems integration or in-service support contracts. A further contractor opposed the proposed change as they believed it provided the potential for misuse by the MOD. This is because the contractor considers that some tasks under framework agreements should be QDCs in their own right. It was thought that having a single contract may increase the reporting burden as the MOD is likely to fall back on non-statutory reporting for individual tasks purchased under the framework.

*SSRO's considerations*

6.38 There did not appear to be opposition to emphasising the role that the MOD can play in selecting and agreeing the DPS, although contractors were concerned about whether this support will be provided. That is a matter that the SSRO can monitor. We agree that it may be helpful for the MOD to identify who within the MOD should provide input on the DPS but we do not consider this is something the SSRO should cover in its guidance. It is primarily a matter for the contractor and the MOD should be free to change the person or persons responsible from time to time without the need for corresponding changes to the SSRO's reporting guidance.

31 SSRO (2019), *DefCARS - supplier report guidance - Version 7*, paragraph 4.25, page 28, https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance

6.39 There was some support for the SSRO's proposal to permit reporting against more than one DPS in appropriate circumstances. We continue to believe that it will help to inform future estimating if costs can be captured in relevant DPS categories throughout the life of the equipment. If a contract relates to more than one equipment type, then the aim would be to make multiple DPS templates available so that the costs can be correctly captured. We envisage that changes will be needed in the following areas:

- revised reporting guidance to explain the changes to contractors (and to the MOD when they are supporting contractors in selecting and agreeing the DPS);
- an update to DefCARS functionality;
- a minor update to the DPS templates to provide a unique code for each line, with the first part of the code representing the equipment type.

6.40 We accept the caution raised by one contractor that there is potential for the MOD to request information outside of the regulatory framework. This is always a possibility, however, and we do not believe that providing an avenue for reporting costs against more than one DPS structure would materially increase the likelihood of the MOD taking that step.

*Conclusions*

The SSRO will revise its guidance to emphasise input from the MOD to selection of the DPS. We expect to engage further with stakeholders in due course on development of reporting guidance and DefCARS to enable reporting against multiple DPS templates in appropriate cases. We will monitor the selection and agreement process to check whether it operates effectively.

**Reporting costs against the DPS**

*Summary of consultation*

6.41 The SSRO recognised that the DPS and the contractor's own WBS largely serve different purposes. The DPS is primarily to support estimating and the WBS is primarily to support contract management. We noted that apportionment will often be required to map costs from the contractor reporting structure to the DPS. Consequently, the SSRO would expect some loss of the detail contained in the contractor breakdown structure as part of the standardisation process. Provided the taxonomy of the DPS is suitable this should not impede cost estimation.

6.42 The SSRO set out the view that mapping is likely to be most effective for estimating purposes if the contractor agrees the DPS with the MOD. Informed input from the MOD should help to avoid inconsistencies such as may arise if two contractors with a similar breakdown structure and delivering comparable contracts map their costs to different elements of the DPS. Taking a proportionate view of the required level of granularity may also make the mapping process easier for contractors. With modern cost accounting systems it should be possible to map from one cost structure to another without disproportionate cost.

6.43 In its working paper, the SSRO acknowledged a view expressed by contractors that there may be a need to 'unwind' the mapping to the DPS to identify the cost driver within the contractor's accounting system if it was used by the MOD to challenge a contractor's cost. One feature of the US approach to cost reporting is that the codes, structure and names used to breakdown costs are fixed but contractors can provide their own definitions to support their treatment of costs when assigning costs to the standard categories. The SSRO's reporting guidance also recommends such an approach, and DefCARS permits contractors to attach a supporting file to do so. Where data is provided through a supporting file, this data cannot be analysed easily and the SSRO suggested that it could facilitate the provision of supporting information by the contractor in DefCARS and make that information easier to analyse.

6.44 The SSRO considered that it should proceed with its working paper proposal to make it easier for contractors to explain their mapping within DefCARS by adding an additional field within DefCARS to allow contractors to explain their approach. Stakeholders were asked to share any views on this.

*Stakeholder responses to consultation*

6.45 Five respondents commented directly on the topic. ADS considered that the proposed change to DefCARS to make it easier for contractors to explain their mapping was unnecessary as the MOD already understands the data. ADS thought that providing more data raises the prospect of more data quality queries to contractors without adding significant additional analytical value. Two contractors highlighted a desire for greater alignment with their own WBS or production methods rather than having a need to map to the current DPS. A further contractor questioned the benefit of contractors mapping cost data when no input is provided by MOD. One contractor expressed doubt that any explanation of the mapping was needed, given the difference of purpose of reporting cost by DPS when compared to the WBS. Another contractor felt that the capability to provide commentary would be helpful when it made sense to do so, provided that it is optional.

*SSRO's considerations*

6.46 We have explained in the Taxonomy section that standardisation within the DPS is preferable for estimating purposes, rather than having contractors provide costs in a format that reflects their own WBS or production techniques. A consequence of imposing that standardisation is that we accept the need for contractors to map and apportion costs when using the DPS, which we accept may cause some distortions in the data as costs may be mapped to the DPS cost categories on a one-to-one, one-to-many, many-to-one or even many-to-many basis. This is acknowledged in the current reporting guidance. We consider the analytical value to be derived from standardisation to outweigh the losses from any distortion taking into account the aim of estimating to support long term budgeting and cost challenge by the MOD, and the current level of granularity of the DPS, which is at a higher level than the taxonomy used in the United States.

6.47 We do not believe that providing the facility for contractors to explain their mapping to the DPS imposes an additional reporting burden on contractors. There is no change proposed to the reporting requirements in the legislation. Paragraph 4.31 of the current reporting guidance already requires contractors to explain their mapping, but at present this is not well supported by an appropriate technical solution in DefCARS, which has led to the mapping being seldom provided. Our intention is to provide an effective mechanism in DefCARS to enable contractors to explain their mapping, which can in turn provide additional context to support analysis.

6.48 ADS rightly highlighted the value of having supporting information to give meaning to the DPS. We consider that an explanation of the mapping approach is potentially valuable contextual data for an analyst. DefCARS is a central repository of data that is designed to support structured analysis and is an appropriate system in which to make the data available to estimators. ADS commented that providing this commentary on mapping was likely to prompt additional, needless compliance queries. The SSRO's Compliance and Review Methodology and the MOD's Commercial Toolkit both seek to encourage relevant queries to be raised and resolved. If compliance queries are not raised appropriately, that should be confronted as a separate issue and should not prevent efforts to correctly set the reporting guidance and DefCARS to enable contractors to comply with reporting requirements. We can also see potential for mapping information to reduce compliance queries, as it should better inform reviewers about the split of costs into the DPS.

*Conclusions*

We propose to develop the reporting guidance and DefCARS to support contractors to explain their approach to mapping. We expect to consult with stakeholders in relation to any revised reporting guidance.

## Distinguishing contract types in DefCARS

### Summary of consultation

6.49 The SSRO had as part of its working paper presented a proposal on the benefits of linking DPS data to information about the type of contract. We did not present a specific proposal in the consultation document, but we confirmed that we remained interested in how better descriptive contract data could assist with analysis of DPS data. We invited stakeholders to share any views on linking DPS data to contract type.

### Stakeholder responses to consultation

6.50 Five stakeholders provided further comments on this topic, with four arguing that DPS data should not be linked to the type of contract. One respondent proposed that a drop-down list could be added alongside the contract description to categorise the contract type. The same stakeholder indicated a note of caution about the value of contractor to contractor comparisons of DPS data due to the different ways in which contractors recover costs on contracts. ADS indicated that the information contained in the contract description should be sufficient to understand what the contract is about. In response to another question, a contractor indicated that the DPS itself should be differentiated by contract activity with discrete categories for each.

### SSRO's consideration

6.51 Introducing categories to describe the contract type in DefCARS could provide an additional level of granularity that supports estimating. We note the suggestion by ADS that this could be obtained from contract titles, but our initial view is that it would be more time consuming and less reliable to obtain information about contract type in this way. We continue to see the benefit, in general, of providing structured data collection which facilitates more efficient analysis. If we proceed in future to develop a proposal, we will consider the suggestion by one contractor that a drop-down menu could be used, as this offers a way to proceed that should not place any material burden on contractors.

### Conclusion

The SSRO may seek, in future, to standardise contract description information in DefCARS. Any such work will be subject to prioritisation.

## DPS metrics

### Summary of consultation

6.52 The SSRO indicated in its consultation that, for parametric analysis, relevant metrics are required to supplement DPS cost data. We considered reported metrics as part of the review. The SSRO does not see qualifying contracts, which limits our ability to check whether reported metrics relate to contracts. We identified, however, that metrics are not well reported in contract reports at the present time and may not be providing useful information to support parametric estimating. The SSRO suggested that a coherent list of standardised metrics could assist with the reporting of metrics. This might also assist with identifying metrics for support contracts, which industry found difficult.

6.53 Respondents to the SSRO's working paper said it was important to differentiate between metrics which were related to contract delivery from those required for parametric estimating and submitted that the latter may be too sensitive for reporting. The SSRO expressed the view in the consultation document that both types of metrics were likely to be required to be reported to meet the reporting obligations.

6.54 ADS argued, in response to the working paper, that the requirement to report metrics should be deleted as the MOD should already understand what they are procuring. The SSRO confirmed in our consultation that we did not accept this view, as the obligations on the contractor to report are aimed at producing a database that can be used for analytical purposes to improve single source procurement. We did, however, recognise that the MOD is best placed to:

- identify the contract deliverables and associated metrics,
- assist with linkage to the DPS, and
- support the contractor to ensure the right information is reported.

6.55 Stakeholder views were invited on these proposals or any other matters addressed in the section on DPS metrics. The SSRO proposed to update the metrics section of its reporting guidance to include engagement with the MOD on metrics.

### Stakeholder responses to consultation

6.56 Four respondents commented on this topic. One industry stakeholder thought that a standardised set of metrics could be helpful but would not assist with linking metrics to elements of the DPS. This respondent thought that the link between metrics and DPS elements was likely to be a many-many relationship which could be complex.

6.57 Another respondent agreed that the MOD should engage in confirming with the contractor which metrics should be reported but it was not clear to them who in the MOD would have responsibility for this. ADS supported this view and said the MOD should confirm whether the SSRO's proposals would benefit its parametric estimating activities.

6.58 A respondent contended that metrics reporting should be part of the contract requirement and not included in statutory reporting. They identified issues with defining and agreeing the appropriate metrics at the beginning of the contract. Another industry stakeholder expressed the view that CAAS[32] have long had the parametric estimating capability which the MOD requires and already hold information which is of greater value than that collected through the statutory reports.

32 Cost Assurance and Analysis Service. This is the MOD's centre of excellence for pricing and costing support to its acquisition community.

### SSRO's considerations

6.59 The term "output metric" is defined in the legislation but some contractors continue to have difficulties in identifying and reporting these metrics. Some metrics have been reported which are suitable for estimation purposes but others appear more useful for contract management or some other purpose. We have considered the reasons put forward by industry for removing the requirement to report metrics, but we are not persuaded that these justify removing the requirement. It is by no means clear that it is too difficult to report relevant metrics and we believe more effort can be made to improve the quality of reporting. If the quality of reported metrics is improved then we see the potential for this information to provide a useful source of data to support the MOD's parametric estimating. We believe this should be attempted first, so that meaningful feedback can be obtained from the MOD's estimators.

6.60 The SSRO proposed leaving the legislation unchanged and improving its reporting guidance to support better reporting of metrics and easier linking of metrics to the DPS. An alternative would be to refine the legislation to clarify the purpose of metric reporting and better define output metrics, but we believe the current wording can work as intended if the guidance is improved and the MOD supports implementation. Our view is that metrics reporting can be improved by MOD involvement in the process, particularly where metrics are needed for parametric purposes. Ideally the metrics to be reported would be considered before entry into the contract to inform the initial reports. We do not dismiss the concerns expressed by industry about who will provide support on behalf of the MOD. This will need to be considered by the MOD and kept under review but does not present a barrier to our proposal.

6.61 We considered whether the reporting of metrics would be improved through standardisation. In addition, if time is allowed for the reporting of metrics to improve, then standardisation can be informed by a larger and better set of metrics. This could be assisted by introducing a standard set of metrics in the SSRO's reporting guidance and DefCARS. Before taking this step, we would need greater input from the MOD. The SSRO can revisit standardisation in future, once we have improved our existing reporting guidance on metrics.

### Conclusion

We propose to improve our guidance on metrics to emphasise that contractors involve the MOD in identifying the output metrics to be included in contract reports and how these should be linked to the DPS. We will monitor whether the reporting of metrics improves over time, so that we can consider introducing a standard set of metrics or propose changes to the reporting requirements.

## DPS frequency

### Summary of consultation

6.62 The SSRO considered whether the frequency of DPS reporting is appropriate for budgeting and estimation purposes. We noted that the requirements for the DPS breakdown in the contract notification report (CNR) and the contract completion report (CCR) are relatively non-contentious, but there are concerns about the frequency at which DPS data is reported in interim contract reports (ICRs). We accepted that as contracts progress and mature, it is reasonable that the MOD may wish to have access to more recent contract cost data to reduce the risk of estimating errors. However, we could see evidence of some contractors being required to report costs by DPS more frequently than seems appropriate to support estimating. In some cases, this was due to the frequency of the default reporting dates, and in others by agreement between the parties.

6.63 We recognised that the current arrangements related to reporting ICRs may not be optimal. The mechanism for determining the due dates of ICRs is not well understood at contracting level, either in industry or the MOD. There is potential for the parties to want to use ICRs for purposes other than estimating, such as contract management of contracts priced below £50 million, for which costs split by DPS may not be required. We noted in the consultation document that a case could be made for simplifying the due dates of ICRs. We did not propose changes to the ICR arrangements, as we felt that further examination was needed of the purpose and content of the ICRs and prior to consultation we had only considered one aspect of the ICRs (the requirement to split costs by DPS). We sought further input on the following matters:

- whether the current arrangements which allow the parties to agree the frequency of interim contract reports remain fit for purpose; and
- whether interim DPS reporting in the ICR remains appropriate or a different mechanism is required.

**Stakeholder responses to consultation**

6.64 We received five responses on the topic from industry stakeholders. The respondents questioned whether the current arrangements around the DPS frequency remain fit for purpose. Most considered that the provision of the DPS should be limited to the beginning and the end of the contract and any other DPS reporting should be provided on an on-demand basis. Some respondents suggested that the DPS should be a separate requirement to the existing reports and that the DPS could be replaced by the contractor's WBS in the CNR, ICR and CCR. One contractor thought that the DPS would add value at pricing points, to provide a benchmark, and at completion, to compare against an estimate and provide a benchmark for future similar contracts. This contractor questioned the value in submitting ICRs when larger contracts already require QCRs.

**SSRO's considerations**

6.65 The SSRO recognises that the current arrangements around the DPS frequency may benefit from a wider review and alignment with the MOD processes related to both:

- challenging contractor cost estimates at the point of negotiating a price; and
- generating independent estimates to inform specific negotiations or for budgeting purposes.

6.66 We are not persuaded by the submission that the DPS breakdown should be removed from the contract notification report (CNR) and the contract completion report (CCR). The start and end of the contract are reasonable points at which to have costs broken down by DPS and this seems to be generally accepted by stakeholders. The CNR will split the agreed costs by DPS and the CCR will split costs that are closer to the actual costs.

6.67 We believe there is scope to improve the requirements for interim DPS reporting, which may be occurring too frequently in some instances for the MOD's estimating needs. We have noted the following potential issues with the frequency at which ICRs are required:

- If a contract is valued at more than £50 million and ICR due dates are not agreed, the default reporting would be annual, with QCRs provided quarterly for contract management.
- In some instances ICR dates have been agreed between contractors and the MOD at a greater frequency than annually.
- ICRs and QCRs are sometimes due in short succession where a significant proportion of the data required in both reports is the same.

6.68 We have considered several options for improving the current arrangements for meeting the MOD's needs for interim contract reporting, which may be applied separately or in combination to support estimating or contract management:

- The mechanism for setting the due dates for ICRs could be simplified. This would aid understanding of when reports are due and support informed decisions where there is a choice about frequency.
- ICRs could be required less frequently, for example by changing the default reporting period. This approach may not be acceptable if ICRs are also used for other purposes than estimating, such as contract management.
- ICRs could be made reports that are only submitted on demand. This risks inconsistent application across a range of contracts and may result in the DPS not being available as requested.
- The requirement in the ICR to split costs by the DPS could be removed and replaced with the contractor's WBS, creating a separate reporting requirement for interim reporting of costs split by the DPS. This would add a new reporting requirement.

6.69 We are cautious about proposing an approach to improving interim reporting based on our review to date. We set out only to consider the frequency at which costs split by the DPS are required and did not examine the rest of the requirements in the ICR. We also did not receive input from the MOD in response to the consultation document, which is needed to better understand its uses of the ICRs and its requirements for interim reporting. In the circumstances, we are concerned that proposing changes may lead to unintended consequences.

**Conclusions**

We have identified some options for improving the arrangements for interim reporting but we consider this area would benefit from further consideration and input from the MOD's estimating experts. We consider that the matter should be further considered as part of the Secretary of State's review, with attention given to:

- the MOD's requirements for interim reporting, including for estimating and contract management;
- the appropriate timing for interim DPS reporting to support estimating; and
- proportionality.

# 7. Amendments and variance

## Introduction

7.1 The SSRO has considered the information required in contract reports about changes in price and identified two purposes behind this information:

- contract management; and
- improving cost estimation, by identifying the causes of cost growth.

7.2 The SSRO identified ways in which the contract reports appear to support these two purposes. The contract reports track details of costs and profit over the life of a qualifying contract, providing a basis on which to observe how these change from the start to the end of the contract, whether due to amendments or variances. Interim and final contract reports require a quantified analysis of the causes of variance, subject to a materiality threshold, and an explanation of events and circumstances that have had or are likely to have a material effect in relation to the contract. The MOD can require some contract reports to be submitted on an on-demand basis to get updated information.

7.3 Having identified those matters, the SSRO consulted on the following:

a. possible changes to reporting guidance to reflect definitions and examples;

b. a proposal to modify DefCARS and reporting guidance to collect information on material pricing amendments;

c. a proposal to amend the legislation to add a new materiality threshold for explaining variances; and

d. categorisation of explanations of variance and how easy or difficult such categories would be to apply.

7.4 As part of the SSRO's consultation it also invited any further evidence of duplication between the information collected in statutory reports and that requested by the MOD or held in other information systems.

## Definitions

### Summary of consultation

7.5 The SSRO had proposed definitions of amendment and variance in its working paper. In the consultation document, the SSRO noted that the definitions had not been challenged by stakeholders and signalled an intention to reflect them in reporting guidance. We provided an opportunity for any further views on the definitions.

7.6 The SSRO identified in its working paper some of the different circumstances in which a contract price may change and sought views on the extent to which such changes involve an amendment. There was no single view about whether the various types of price change proposed would require an amendment. We indicated in the consultation document an intention to include examples of possible pricing amendments in the SSRO's reporting guidance. We identified that whether a price change required an amendment would be dependent on the terms of the contract.

7.7 In the consultation the SSRO welcomed views on possible changes to its reporting guidance to reflect definitions and examples.

**Stakeholder responses to consultation**

7.8 One industry stakeholder stated that they would like to see a revised definition of 'variance' which explained whether the change in cost was due to performance or variations to scope. They argued that the definition[33] which the SSRO had provided was too narrow and didn't address the variance to cost that could occur when changes were made to an agreed contract price. They also considered that the relationship between baseline contract value, and an amendment or variance needed to be explored further. Feedback was provided that variances resulting from MOD decisions could not easily be reported in DefCARS.

7.9 An industry stakeholder supported changing guidance to make this topic easier to understand. They considered that there would be occasions when a contract price would change as the result of an amendment[34] and this would be reflected in DefCARS but others when an amendment would not impact the price reported in the contract reports. The stakeholder welcomed the potential classification of amendments and variances but said that industry should be involved in identifying what these were. Another industry stakeholder thought that the SSRO's guidance needed to be strengthened to provide clarity on the information which was sought on amendments and to improve the descriptive information provided by contractors to explain cost variances caused by contract amendments.

7.10 ADS supported a clear definition of terms to drive consistency in reporting. It provided the following definition of a contract amendment and a variance:

a. A contract amendment means a written alteration in the terms and conditions of a contract accomplished by mutual action of the parties to the contract or to record a unilateral exercise of a right contained in the contract or to record the effect of an autonomous feature of the contract.

b. A variance is any change in cost or the price of the contract that is not attributable to an amendment.

7.11 ADS also considered that amendments and variances were already reported within contract reports along with an analysis of changes in the contract price. They outlined situations in which they would expect a contract to be amended. For example, ADS asserted that where there was an agreed or unilateral change to the scope or contract value this should be covered by an amendment. Application of inflation or some other index to a contract would also require an amendment to allow payment.

**SSRO's considerations**

7.12 It is clear from responses that there is support for better definitions of 'amendment' and 'variance', and for the provision of examples. We agree that the terms 'amendment' and 'variance' used in the legislation may benefit from further explanation. We feel this can be adequately addressed in the SSRO's guidance, without the need to include further definition in the legislation. By providing definitions and examples in its reporting guidance, the SSRO can seek to assist contractors to better understand how the terms relate to reporting requirements and promote consistency in reporting.

7.13 We are grateful for the input received from stakeholders on our suggested definitions of the terms 'amendment' and 'variance'. Rather than concluding work on those definitions at this time, we propose to consider the definitions and examples alongside the changes that we intend to investigate to the reporting of amendments and variance, highlighted in the rest of this section below. We will engage further with stakeholders on the definitions and examples as part of the forthcoming work.

33 A variance means a difference between one cost and another.

34 Contractors are required under the Regulations to report the date of the latest amendment and the new contract price, providing a forecast against this new price. Any difference between the new price and the forecast would be a variance.

### Conclusions

The SSRO does not propose legislative change in this area. We intend to include further definitions and examples in our reporting guidance to assist contractors in meeting their reporting requirements. This work will be undertaken as part our planned work on amendments and variance, described in the SSRO Corporate Plan 2020-23. We will, as part of our normal process, engage with stakeholders on any revised reporting guidance.

## Amendments

### Summary of consultation

7.14 The SSRO, in its consultation document, identified a need for a proportionate level of information on amendments. We sought people's views about how this could be achieved under the existing legislation.

7.15 The SSRO considered it important that contract reports allow for an understanding of the changes in cost to a contract, whether from an amendment or a variance. The focus of this aspect of the consultation was on the extent to which legislative change might be necessary or whether DefCARS and the SSRO's reporting guidance changes could support collecting information about material pricing amendments.

7.16 Stakeholders had previously expressed views about collecting information on amendments. Industry did not support any proposals which might result in additional reporting requirements. The MOD indicated that it would like to be able to identify the variations in costs which are attributable to an amendment and those that are not.

7.17 The SSRO identified on-demand reports as one way in which the MOD could capture information about a price following amendment. There is an existing facility in the legislation for the MOD to require on-demand reports, and these may provide an appropriate route to gather information on significant amendments or groups of amendments. We noted, however, that on-demand reports in DefCARS do not currently split the amendment from the rest of the contract price, which might limit the visibility the MOD can gain from such reports. The SSRO also thought that there may be a need to collect some summary level information about the impact of amendments on the estimated contract price. We preferred that this be collected under existing reporting requirements rather than as a result of further legislative change. We noted that contractors are already required in the QCR, ICR and CCR to describe and report the effect on costs incurred and the effect on forecast costs of any event that has occurred, or circumstances which have arisen, since the contract was entered into.

7.18 The SSRO proposed that DefCARS and reporting guidance be developed to:

- gather descriptive information about causes of cost growth, based on the requirement for contractors to describe events or circumstances which have or are likely to have a material effect in relation to the contract (which might reasonably include material pricing amendments); and
- enable the capture of information about amendments in an on-demand CPS. This would include separating out the CPS from the CIR and, consistent with the Schedule to the Regulations, splitting reporting between the amendment 'segment' and the rest of the contract price.

7.19 The SSRO sought feedback on its proposals to modify DefCARS and reporting guidance to collect details of material pricing amendments based on the requirement to report material events and circumstances, and the facility for on-demand reporting.

**Stakeholder responses to consultation**

7.20 A consultant agreed that the information collected should be proportionate and not required for all amendments. It disagreed that section 26 of the Defence Reform Act 2014 could be relied on to require information about amendments, suggesting that the MOD's cognisance of contract amendments would prevent pricing amendments from being material events or circumstances. The consultant thought that treating an amendment as a material event or circumstance would have unintended consequences, such as requiring the contractor to report uplifts arising from index fluctuations.

7.21 ADS agreed that not all contract amendments should be reported. However, it felt there was only a weak argument that reporting information about amendments would assist with cost estimation and understanding cost change. It called for evidence of the benefits to be gained, noting that the MOD already have access to this information (including contractually, through contract conditions), and suggested that the MOD should identify the information it requires as part of a fundamental review of the reports and reporting regime. ADS thought that DefCARS is unable to facilitate the reporting of multiple profit rates and that any benefits to be obtained would be contingent on the changes required to implement profit segmentation. It explained that this would ensure that both the original contract and any contract amendments are recorded in DefCARS, which would avoid costly reconciling of the contract price against the cost and profit shown in DefCARS.

7.22 One industry stakeholder welcomed the opportunity to provide details of material events and saw the value of on-demand reporting. This was on the basis that the purpose of the reports is to track realised cost over the contract period. It urged a proportionate approach in terms of the scope and detail of reporting required and was concerned to ensure that the effort required of all contractors was equal. Another industry stakeholder supported reliance on the requirement to report material events. It also, however, raised the issue of duplication, noting that it felt the MOD already has access to the relevant information, and suggested that only high-level information therefore need be reported. It urged caution in the use of on-demand reporting, particularly for large contracts with regular price changes, suggesting that they should be limited to an annual CPS. Additionally, it noted that DefCARS would need to be developed to separate the elements of the CIR and allow for submission of only the required element. It also called for consideration of any unintended consequences of the proposals for other contract reports.

7.23 One respondent commented that amendments on some contracts can be frequent, providing an example of a contract which had many amendments in one year. As a result, they aggregate many individual amendments into one large amendment for reporting purposes. In this case, it suggested, it would be challenging to identify the cause of each of the amendments as there could be many to report. The same stakeholder considered that improvements to guidance were preferable to legislative changes, as a means of encouraging contractors to improve the descriptive information about cost growth caused by contract amendments.

**SSRO's considerations**

7.24 After considering the feedback from stakeholders, we believe the SSRO should support the legislative purpose of gathering information about the causes of cost growth to inform contract management and estimating. We can facilitate the collection of appropriate levels of information within the existing reporting requirements, by modifying the reporting guidance and DefCARS, without the need for legislative change. We will aim to ensure that information collected:

- adds value,
- is standardised where possible, and
- is proportionate.

7.25 There was support for our view that it would not be reasonable to require information to be reported about every amendment. Some respondents remained concerned about how reporting of amendments can be implemented in a proportionate way that gives the MOD the information it needs on causes of costs growth (the benefit) without contractors needing to provide detail on every amendment which is likely to be costly. We recognise from the feedback that it may not be necessary or practicable to identify the causes of every single amendment to a contract. We want to simplify rather than complicate reporting arrangements on amendments, and we have made the following findings relevant to any further work on reporting guidance and DefCARS:

a. Contractors are clear on the requirement to report material events and circumstances but their relationship to amendments needs to be clarified in reporting guidance, and the structure of this information may need improving in DefCARS to better facilitate this.

b. Amendments that are not material need not be reported individually, but any aggregate change to the price should be reported in update reports.

c. There is little benefit at this stage in asking contractors to categorise the cause or causes of each individual amendment.

d. Improvements to the on-demand report facility in DefCARS would allow the impact of pricing amendments on the overall contract price to be more easily reflected in a Contract Pricing Statement.

7.26 We do not agree with ADS that the case for reporting information about amendments is weak. We have identified good reasons to collect information about amendments and variances, in support of contract management and cost estimation. The fact that the MOD could potentially access the information in some other way is not decisive against requiring the information, as there are multiple instances in which information could be obtained in other ways but Parliament has required the information to be provided in statutory reports. The statutory reporting provisions aim to build a body of useful information by requiring the contractor to submit the data, the SSRO to monitor submission and the MOD to enforce submission. It is important under this model that reporting requirements are proportionate, and we propose to take this into account in the planned further work on reporting guidance and DefCARS. The SSRO's views on duplication are explained in Section 6.

7.27 We do not support the argument that the material events or circumstances that contractors are required to report in a QCR, ICR or CCR do not include amendments because the MOD would already know about them. The words used in regulations 26(6)(h), 27(5)(b) and 28(2)(j) are of broad effect and not limited by any test of whether the MOD could, should or does already know the information. The requirement to report material events and circumstances makes the information available for analysis and appropriate action by the MOD. We are content that a material pricing amendment constitutes a material event or circumstance as it results in the MOD having to pay materially more or less for a requirement which has either stayed the same or has also changed. The work planned to develop reporting guidance and DefCARS should assist contractors to determine when an amendment has had or is likely to have a material effect in relation to a contract. The SSRO will consider whether any changes needed to the existing structure of reporting for events and circumstances. We will engage with stakeholders on any proposed changes in due course.

7.28 There were mixed views from respondents on whether on-demand reports were the best vehicle for capturing information about amendments. However, the MOD are likely to request an on-demand CRP and CPS following a material pricing amendment, as this is recommended in its Commercial Policy.[35] The SSRO had previously captured stakeholder views on on-demand reporting and has recognised that the process in DefCARS for submitting on-demand reports should be simplified. The benefits of making these changes outweigh the costs. It intends to achieve this by splitting out the CRP and the CPS from the CNR for on-demand reports[36] and facilitating reporting in a CPS of only amendment-specific information if no other details of the contract need to be changed. This will also enable the gathering of more structured information about amendments where required on-demand by MOD.

7.29 We note the concern by some in industry that on-demand reporting could become burdensome if requested too often. We are not persuaded, however, that this represents a problem requiring any legislative intervention. It is for the MOD to use the requirement for on-demand reporting proportionately and contractors can seek an opinion from the SSRO if they consider the MOD has acted unreasonably. The MOD can act proportionately by requiring reports at appropriate points following material pricing amendments, but also not require reports when not necessary. As explained above, we do not consider that reporting every non-material amendment would provide helpful information, and would risk being too onerous. We propose to enhance DefCARS and reporting guidance to make it easier to report amendments.

**Conclusions**

The SSRO does not propose legislative change in relation to reporting amendments. We consider that changes to reporting guidance and DefCARS would be beneficial, and will consider these as part of the work on amendments and variance referred to in our Corporate Plan 2020-2023. These changes are:

a. providing clarity in reporting guidance on how to report the impact of a material pricing amendment, and improving the structure of this information in DefCARS; and

b. simplifying the on-demand report capability within DefCARS, and making capture of amendment information in an on-demand CPS easier.

## Variances

**Summary of consultation**

7.30 Contractors are required to report[37] a quantified analysis of the causes of variance between any estimated costs used to determine the contract price and the total actual and forecast costs. This analysis must explain not less than 90 per cent of the variance.

7.31 In the consultation document, the SSRO sought views on amending regulations 26(6)(f), 27(4)(i) and 28(2)(i) to add a further materiality threshold. We proposed that the requirement to explain at least 90 per cent of the variance could be supplemented by an additional provision that a variance need only be explained if it meets or exceeds the lower of the following amounts: £100,000 or 1 per cent of the contract price.

35 MOD (2020), *Single Source Contract Regulations 2014 Guidance – Chapter 5 (Contract Reporting)*, paragraph 51 (Version 4 dated 1 March 2020), https://www.aof.mod.uk

36 The SSRO still sees benefit in the three initial contract reports being merged to reduce the burden on contractors.

37 In a QCR, ICR or CCR.

7.32 In the consultation document the SSRO highlighted that in some contract reports submitted to date it is possible to identify overarching categories such as scope change or rate changes due to causes such as inflation as the cause of a cost variance. In others, the stated causes are too specific to the particular contract to enable a clear understanding of what had driven the variance which was being reported.

7.33 The SSRO explored the possibility of better categorisation of causes of cost growth in its working paper on this topic. Stakeholders had mixed views on whether use of standard categories would be beneficial. ADS indicated that contractors tend to segregate variances into the categories of "performance" (which are not contract-driven) and "scope" (which are contract-driven and include tasking orders, options and discrete amendments). The MOD and one industry stakeholder thought that a comprehensive list of variance categories would assist in understanding the causes of cost growth. Other industry stakeholders argued that contract types and reasons for cost growth were so varied that standard categorisation might not be helpful.

7.34 In the consultation document the SSRO re-stated that it still saw benefit in categorising explanations of variance and was considering whether some high-level categorisation might be a sensible starting position. Without some form of high-level categorisation, it might be difficult to draw learning from the causes of cost growth. The SSRO presented the following as possible categories to explain variances for stakeholder comment:

- changes in the requirements or scope of the contract not reflected in an amendment;
- changes in prices, for example from an index being applied in a fixed price contract not reflected in an amendment;
- changes in costing assumptions not provided by the Secretary of State; and
- other changes, for example in assumptions provided by the Secretary of State.

**Stakeholder responses to consultation**

7.35 ADS suggested that the Regulations should be amended to remove the requirement to provide a quantified analysis of the causes of variance, as the MOD could rely on getting this information in other contract reporting they receive outside of DefCARS. If the requirement was to remain, then ADS indicated support for the SSRO's proposal of an additional materiality provision.

7.36 Four industry stakeholders had differing views on the materiality proposal. One thought the threshold would be beneficial but thought that it should only apply to certain categories of cause of cost variance, for example those which were expected under the contract. Another stated that they did not understand how the two materiality thresholds would work together as the requirement to explain 90 per cent of the total variance might oblige the contractor to report below £100k or 1%. Another stakeholder thought that the threshold should be the higher of 1% or £100k. Finally, a stakeholder suggested that the level of variance analysis should be lowered from the current 90 per cent level.

7.37 ADS said that the case needed to be built for how the MOD would use the information by category as this was currently unclear. It reiterated that this information was being provided in other contract reports. It considered that rather than standard categories, free form text descriptions by the contractor would be more helpful.

7.38 Several industry stakeholders provided comments on the proposed categorisation of causes of variance. Two stakeholders did not support the introduction of categorisation whereas the other two did. One indicated that the categories could be developed and become more credible as more reports were submitted. One thought that the reporting regime needed to further mature before such a change could be made. Two stakeholders welcomed the classification of variances but indicated that industry should have the opportunity to comment on them before implementation and that the MOD and the SSRO should clarify how the information would be used.

**SSRO's considerations**

7.39 We do not support the ADS proposal to remove the requirement to provide an analysis of the causes of variance. ADS appeared to accept that the MOD might need to understand the causes of variance in support of contract management and cost estimation but thought the information could be obtained from reports required by contracts. Consistent with views expressed elsewhere in this report, we do not find it compelling to argue that there may be other ways for the MOD to obtain information than in the statutory reports. The key question is whether the requirement is proportionate and that is a matter we have sought to address by reference to the materiality threshold.

7.40 Respondents did not disagree with the SSRO's proposals to introduce an additional materiality threshold to ease the burden on contractors to report variances. Some indicated that it needed to be explained more clearly and there were mixed views on the threshold that should be set. The SSRO considers that an additional materiality provision in the legislation which sets the quantum of variance that needs to be explained would ensure reporting focuses on the right issues. We proposed that the requirement to explain at least 90 per cent of the variance could be supplemented by an additional provision that a variance need only be explained if it meets or exceeds the lower of the following amounts: £100,000 or 1 per cent of the contract price. However, we accept the feedback that the threshold should be the higher of £100,000 or 1% of the contract, as we consider this will promote proportionality. It would make the materiality threshold consistent with that which is used in the legislation in relation to reporting payments (regulations 25(2)(g), 27(4)(j) and 28(2)(l)).

7.41 Some stakeholders were unsure how these two thresholds would work together. This is perhaps best explained through an example as provided in Table 8. If the new threshold is applied first it will determine whether any variance needs to be explained. Once it has been confirmed that a variance needs to be explained then the existing materiality threshold will determine the amount that needs to be explained. Table 8 shows the variances which would need to be explained in a number of update reports.

**Table 8 – New variance threshold example**

| | Update report 1 | Update report 2 | Update report 3 |
|---|---|---|---|
| QDC price | £5m | £5m | £5m |
| Variance from original estimate | £0.07m | £0.14m | £0.24m |
| New threshold (£100,000 or 1% of contract price) | £0.1m | £0.1m | £0.1m |
| New threshold met? | N | Y | Y |
| 90 per cent of variance | £0.063m | £0.126m | £0.216m |
| Requirement to explain 90 per cent of variance | N/A as first threshold not met | Explain £0.126m variance | Explain £0.216m variance |

7.42 We intend to continue to explore the introduction of better categorisation of the causes of cost growth reported as variances, even though mixed views were received from respondents. We believe that categorisation will assist analysis of variances and can be introduced without legislative change by further developing our reporting guidance and DefCARS. The categories would exist alongside the existing free text descriptions. We consider that a facility for categorisation need not be burdensome on contractors and we would engage with them to identify the correct categories. The intention is for the categories to remain at a high level, for example as set out in the consultation, rather than try to capture more detailed categories. Examples to assist with categorisation could be provided in reporting guidance to make reporting easier. It is proposed to develop proposals for the reporting guidance and DefCARS and we will engage with stakeholders further on these. The suggestion by some respondents that they would like to be involved in this is welcomed. We would also expect MOD involvement in this process to ensure that the categories used would provide information of value. We will take this forward as part of the amendments and variance work we have set out in our Corporate Plan 2020-23.

**Conclusions**

The SSRO proposes that consideration is given to amending regulations 26(6)(f), 27(4)(i) and 28(2)(i) to include the new materiality provision for reporting variances discussed above.

The SSRO intends to begin to engage stakeholders before deciding whether to develop categorisation of reported variances in some form within DefCARS and will consider these as part of its work on amendments and variance referred to in the SSRO Corporate Plan 2020-2023.

## Frequency of information about changes in costs and its use for cost estimation and contract management

**Summary of consultation**

7.43 The SSRO explored the frequency with which information about changes in costs should be provided. We noted that contract management benefits from timely, detailed information about variance in the contract price so that immediate action can be taken to control costs. Stakeholders have previously indicated that they were supportive of the current frequency of reporting cost growth. The MOD expects to monitor material cost growth on a regular basis, as do contractors. Some industry stakeholders commented that the QCR provides valuable information to enable cost variances to be monitored because it is based on the contractor's reporting structure, which is needed for contract management purposes. They considered the ICR was less useful for contract management because it is based on the DPS and places costs in standardised categories. The SSRO indicated in its consultation document that wider review of the QCR and ICR was not being undertaken at this time but had been logged for possible future consideration.

**Stakeholder responses to consultation**

7.44 One industry stakeholder stated that they did not believe that the MOD use the information in DefCARS to manage contract performance and therefore did not support more frequent reporting of this information through statutory reporting. Another industry stakeholder said that they would welcome the opportunity to review whether QCRs and ICRs could be combined into a single report.

### SSRO's considerations

7.45 We understand that one respondent proposed changes to the current arrangements for QCRs and ICRs, and we recognise this view could be held more widely. We did not propose such a change in our consultation and we consider that a better understanding is needed of how the information in QCRs and ICRs is used by the MOD before changing the current arrangements around interim reporting. There is some evidence of MOD delivery teams using interim reports for contract management purposes, but we have not conducted a detailed examination of the MOD's use of information about changes in costs across all QDCs.

7.46 The SSRO is not making any proposals about the wider set of information included within QCRs and ICRs and the frequency with which this is reported, as these matters were not the subject of this review. The main difference between both reports is the reporting of costs by the contractor's own reporting structure (within QCRs), largely for contract management purposes, and the defined pricing structure (within ICRs), largely for parametric analysis and cost estimating purposes. There is the possibility that both cost structures could be in the same report, but this would need to be explored further before such a fundamental change in reporting could be proposed. The SSRO does not have current plans to explore this, but stakeholders are welcome to continue to provide SSRO with feedback about whether this topic should be addressed to assist it with its corporate planning each year.

### Conclusions

No proposals are being made about the frequency by which cost variances are reported.

## Duplication

### Summary of consultation

7.47 In the consultation document, the SSRO identified other MOD information sources which provide reports on amendments and variances. We explained that we do not have sufficient information to understand the nature and extent of the duplication and that we do not have access to the MOD systems. The MOD had considered that some degree of duplication is unavoidable given that the sources identified have different purposes and timings but did acknowledge that duplication should be minimised. The SSRO stated that there would seem to be merit in the MOD first identifying any unnecessary duplication and considering whether it can be avoided by streamlining its processes. The SSRO said that it seemed premature to contemplate proposals for legislative change at this time, and it sought further information to understand the nature and the extent of duplication.

### Stakeholder responses to consultation

7.48 Some industry respondents highlighted duplication arising from reporting requirements included in contractual terms. One respondent thought the extent of these requirements was not well understood and cautioned against additional reporting requirements as this would add to the duplication. Another respondent stated that for the vast majority of contracts, the MOD will receive regular (and in many cases monthly) reporting packs on cost and schedule performance that gives them a more immediate and in-depth view of performance than the statutory reports.

7.49 Industry respondents also suggested ways to improve current arrangements. One respondent suggested that the MOD and the SSRO needed to work together to compare the various aspects of reporting to identify where duplication existed. Another proposal was that all parts of the MOD and the SSRO should be able to access a central repository containing all information relating to amendments and variances. A third stakeholder suggested that requirements needed to be simplified and clarified. A respondent suggested that the MOD needed to specify its contract management requirements to inform the SSRO's recommendations.

7.50 ADS submitted that the benefits of any reporting changes needed to be demonstrated as the proposed information collection on amendments and variances already existed within the MOD. Another stakeholder suggested that if the MOD was of the view that it did not regularly receive the information it needed, or if the MOD communication channels were not working effectively to share information collected, the route to solving this was not through further statutory reporting.

**SSRO's considerations**

7.51 The MOD's Commercial Policy[38] directs MOD delivery teams that when agreeing additional contract specific reporting requirements, they must take account of the information they will receive via the statutory reports, to avoid duplication of information and unnecessary cost. It appears from some of the feedback received as part of this review that duplication is still occurring, although we are not able to establish the extent of this. We were not provided with specific examples of duplicate information requirements in statutory and non-statutory reports.

7.52 Stakeholders have suggested that the SSRO needs to work with the MOD to identify the extent to which there is duplication. This is something we consider to be important and are open to being involved in a MOD led review. We can see that for some contracts there might be a need for additional reporting by contractors to supplement the high-level nature of the information captured in the statutory reports. A review by the MOD would be required to determine whether this additional reporting was capturing unique information and not that already included in the statutory reports.

**Conclusions**

The SSRO agrees with the removal of unnecessary duplication in the reporting of amendments and variances, but we consider it is necessary to understand the nature and extent of any duplication before proposing legislative change. We have previously suggested that the MOD first considers whether its processes are giving rise to duplication and we would be happy to support a MOD-led review. We would welcome specific examples of duplication from contractors.

38 MOD (2020), *Single Source Contract Regulations 2014 Guidance – Chapter 5 (Contract Reporting)* (Version 4 dated 1 March 2020), https://www.aof.mod.uk/

# 8. Overheads

## Introduction

8.1 There are six overhead reports that a contractor may be required to submit under Part 6 of the Regulations.[39] The reports are intended to:

- capture actual and estimated costs for contractor business units, split by standard categories;
- benchmark comparable business units; and
- identify systematic over- or under-recovery of overhead costs.

8.2 We engaged with stakeholders and invited input to help frame proposals for improvements in relation to overheads reporting. The feedback informed our working papers and consultation. We established a lower than anticipated use of the overhead reports by the MOD, which limited our ability to clearly identify problems and proposals for change.

8.3 In our consultation document, we identified one proposal for legislative change to correct an error in the sequencing of two reporting periods (QBUACAR and QBUECAR). We identified the potential for improved benchmarking and standardisation but thought this was a substantial piece of work that should be deferred. We described some issues in respect of which we sought further input:

- Delay in agreeing rates and the potential for submission timing and changes to referrals to impact on this.
- Lack of alignment between overhead reporting requirements and the MOD's rates programme.
- Absence of a requirement to report agreed rates.
- Difficulty in identifying qualifying business units from reported information.

8.4 We set out the results of our consultation in this section, our views on the feedback received and our conclusions. The MOD did not provide feedback to our consultation and, taken together with the previous evidence of limited use of the reports within the MOD, this has constrained our ability to draw up firm proposals. We consider that the choices made by the MOD in operating the rates programme and the reasons for differences from the reporting requirements need to be clearly understood before proposing changes.

8.5 We recognise the need for further review in relation to overheads. The SSRO's Corporate Plan 2020-2023 provides for a multi-year programme of work in relation to overheads and we intend to engage with stakeholders about the scope of that review.

39 The actual rates claim report (ARCR), QBU actual cost analysis report (QBUACAR), estimated rates agreement pricing statement (ERAPS), estimated rates claim report (ERCR), QBU estimated cost analysis report (QBUECAR) and rates comparison report (RCR). These reports contain information on all cost recovery rates. We refer to these collectively as 'overhead reports'.

## Timing of reports and facilitating the agreement of rates

### Summary of consultation

8.6 At the early stages of the review, stakeholders raised issues concerning the timing of the overhead reports, which we sought to explore in our working paper. In response to the working paper, the MOD and industry had different perspectives on the current reporting deadline, each arguing for a shift in the deadline but in different directions and for different reasons:

- The MOD considered that it would be beneficial to bring forward the due date for the ERCR from three months after year-end to a maximum of one month after year-end to address delays in agreeing the rates.
- In general, industry stakeholders disagreed with shortening the deadline for the overhead reports. Some argued that a six-month period after year-end would be more appropriate to give them time to complete the information and to avoid coinciding with other reporting deadlines.

8.7 The SSRO recognised in its consultation document that there can be significant delays in agreeing rates. We noted that:

- The MOD operates a rates programme to agree the rates that contractors will use when pricing contracts. Selected contractors are required to submit the rates they claim for a given period together with supporting information. The MOD reviews the rates, checks the underlying costs and application of the contractor's allocation methodology, and requests additional information as necessary. The MOD may challenge aspects of a rates claim before attempting to agree the rates with the contractor.
- Overhead reports are required three months after the end of the contractor's accounting period, or the date on which the ongoing contract condition was first met in relation to the relevant financial year, whichever is later.

8.8 We indicated that we were not persuaded a sufficient case had been made for changing the due dates of the overhead reports, giving the following reasons:

- delays in agreeing rates are significant and extend into years (a matter on which stakeholders were in agreement);
- delays can result from disagreements about the treatment of costs, which may be difficult to resolve if they affect later years or other business units;
- bringing forward the due date of overhead reports by a month or two would be unlikely to address disagreements;
- extending the due dates from three months to six months would be unlikely to ease any burden associated with the number and timing of reports; and
- the Secretary of State may agree with the contractor an extension of up to three months to the due dates of these reports.[40]

40 Regulations 34(2)(b), 35(3)(b), 36(2)(b) and 37(3)(b). The ERAPS for a qualifying business unit is due on the same date as the ERCR for the unit, so an extension to the due date for the ERCR will also extend the due date of the ERAPS Regulation 38(2).

8.9 The SSRO questioned whether a more effective approach to resolving delays in rates agreements may be to increase opportunities for parties to make a referral to the SSRO for an opinion or a determination. The legislation enables a referral to be made on the extent to which a cost is an allowable cost. We noted that, as the legislation is currently framed, such a referral would need to be related to an actual or a potential QDC or QSC, and that to date no such referral has been made in relation to overhead costs.[41] We sought to establish:

- whether the use of referrals could facilitate more expeditious agreement of rates; and
- whether there are merits in the SSRO being able to give advice or opinions, on request, on matters of general application to the operation of the regulatory framework without the need for a linked QDC or QSC.

8.10 The SSRO also welcomed further input on the typical timetable for agreeing the rates and the points at which delays occur.

**Stakeholder responses to consultation**

8.11 Six respondents provided input in relation to whether there should be express provision in the legislation for referrals to the SSRO for opinions and determinations about rates. The feedback was mixed with the majority of those who commented not in favour of legislative change in this area.

8.12 ADS said that if the parties were unable to find a suitable contract then the rates would be immaterial. Another respondent was of similar view, stating that if a QBU had a QDC or a prospective QDC the legislative change would not be required. ADS added that its members believe that most of the delay in agreeing rates rests with the MOD due to the amount of time it takes to review and audit contractor submissions. One contractor explained that it did not support the proposal on the basis that definitions of “indirect” and “direct” differ across contractors which could result in varying treatment of the same cost type. Another contractor felt that the proposal is problematic as it would involve the SSRO at a tactical level.

8.13 In contrast, two contractors agreed that it would be helpful for the framework to enable referrals on the allowability of indirect costs without needing to reference a QDC or QSC. One contractor felt that such referrals should be limited to opinions, as determination would add too much time to the rates agreement programme. The other respondent thought that that such a referral should be permissible only where it is a joint referral.

8.14 We received five responses on the merits of the SSRO being able to give advice or opinions on matters of general application to the operation of the regulatory framework without the need to link to a particular contract. Contractors broadly supported the proposal and found it helpful, with one suggesting that this could be provided on an informal basis, outside of the process for opinions or determinations. ADS said that it is a step in the right direction towards recognising that some overheads are not contract specific but are needed to maintain the enterprise. ADS noted that it previously recommended that the SSRO issues general guidance in addition to statutory guidance. It added that a decision would be required to determine if a referral should be initiated by both parties or by one party. Some contractors noted the need for expedition or informality when giving advice or opinions on matters of general application.

41 Sections 20(5) and 35(1)(a) of the Act and Regulation 51.

### SSRO's considerations

8.15 We recognise that there may be multiple causes of delay when agreeing rates. For example, the MOD may take longer than expected to assess rates claims, as argued by ADS, the suppliers' submissions might not have been provided on time, as asserted by the MOD, or there may be disagreements about the treatment of costs. The SSRO is not in a position to comment on all the potential causes of delay that may arise from the MOD's process.

8.16 One of the causes of delay is where there is disagreement about some aspect of the rates calculation. The ability to make a referral to the SSRO for an opinion or a determination can resolve issues and shorten the time taken to reach agreement. Referrals can be made in circumstances permitted by the legislation, which relevantly include the following:

- referrals for an opinion or a determination about the extent to which a cost is allowable (sections 20 and 35 of the Act); and
- referrals for an opinion about any matter relating to a qualifying contract if the referral is jointly made by the parties.

8.17 We have seen evidence that these referral mechanisms have enabled the parties to unblock a disagreement about the rates calculation. Equally, however, we have seen evidence of parties finding it difficult to adapt these grounds of referral to a rates disagreement. We consider that the current grounds for referral may be inconvenient for the resolution of rates disagreements for the following reasons:

- An issue that prevents agreement of a rate may concern an aspect of the rate calculation, rather than being contract specific.
- The rates agreement process takes place prior to application of an agreed rate to a contract. The rates may be in dispute for some time before a suitable vehicle is identified for referral.
- The opinion or determination will only formally relate to the referred contract, leaving open the possibility of further dispute about application of the rate to other contracts.

8.18 The facility in section 35(3) of the Act for the SSRO to give an opinion on any matter related to a qualifying contract, provided it is jointly referred by the parties, does not provide an adequate means of covering disagreements that are not contract-specific. In the first place, the joint referral mechanism depends on identification of an actual or potential qualifying contract, when the dispute may arise when no such contract has been identified. Secondly, one of the parties to the disagreement may refuse its consent to the referral, preventing it from being used as a resolution mechanism.

8.19 The SSRO supports strengthening of the referral regime by expanding the circumstances in which parties can refer issues to the SSRO for clarification or resolution. This should leave the choice about whether to refer in the hands of the person or persons empowered to make the referral. The SSRO previously recommended legislative change to expand the grounds on which parties may make referrals to include:

- all profit rate steps; and
- the question of whether a contract is a QDC or QSC.[42]

42 See Section 12 of the SSRO 2017 Review of Legislation.
SSRO (2018), *Review of single source regulatory framework*, https://www.gov.uk/government/publications/review-of-single-source-regulatory-framework

8.20 For the reasons given above, we consider that a wider power to refer disputes related to rates should be considered. Such a measure should not require the referral to relate to a cost in an actual or proposed qualifying contract. It should nevertheless be a proportionate mechanism. Consideration should be given to practicalities, such as the likely use of the mechanism, so that it can be appropriately resourced.

8.21 Our proposal is focused on rates agreements, as that is the area explored in the review. We have seen other situations, however, in which the ability to refer a question for resolution has been unduly restricted by the circumstances specified in the Act and the Regulations. The provision in section 35(3) which permits a joint referral on any question related to a qualifying contract is not a sufficient answer, as this relies on the agreement by both parties. For example, a potential referral about application of one of the exclusions in the Act has been complicated by the need to identify a specific contract and to obtain the agreement of both parties to the referral. We can see merit in the MOD pursuing a change that permits referral by the MOD or a contractor of questions for the SSRO's opinion concerning operation of the regulatory framework.

8.22 We intend to investigate how the SSRO may provide additional guidance on matters of general application within the SSRO's existing powers. We are wary of the term "non statutory guidance" used by ADS, as the SSRO is bound to operate within its statutory functions, but there is potential to identify areas where more detailed guidance can be provided, such as examples or explanations of how principles may be applied. There is scope to consider the role of stakeholders in developing guidance, the way additional guidance fits with existing guidance, and how development of detailed guidance fits with our other functions in respect of referrals, compliance and reviews.

**Conclusions**

In the SSRO's view, consideration should be given to amending the legislation to enable:

- referral of rates-related disputes for opinion or determination without the need for a joint referral or identification of an actual or proposed qualifying contract;
- referral of questions for opinion on any matter concerning the operation of the regulatory framework without the need for a joint referral.

We welcome further engagement with the MOD as part of the Secretary of State's periodic review of the regulatory framework.

## Sequence of reporting periods for estimated and actual claims

**Summary of consultation**

8.23 Contractors are required to submit an actual costs report for a QBU (the QBUACAR) as well as an estimated costs report (the QBUECAR). The current wording in regulation 37(7) requires the QBUECAR to contain costs analysis information for the "relevant accounting period" which mirrors the period already covered by the QBUACAR.[43] This means that both QBUACAR and QBUECAR reports would be required at the same time and in relation to the same accounting period, which fails to differentiate the reports and limits the utility of the information required. Given that the QBUECAR is intended to support the ERCR, and the ERCR relates to "the accounting period immediately following the relevant accounting period", it appears there is an error in regulation 37(7) and the reporting period for the QBUECAR should be corrected. The SSRO consulted on amending regulation 37(7) so that QBUECAR reporting period is aligned with the ERCR and requires cost analysis information for the accounting period immediately following the relevant accounting period.

43 Regulation 35(7).

8.24 ADS raised a concern that reports can be required for years prior to the date on which the supplier had a qualifying contract triggering the requirement for overhead reports. It was not clear to the SSRO how such a problem arises and, in the consultation document, we suggested that this concern might have been more correctly aimed at submission of the SICR and SMER rather than the overhead reports. Regulations 40(1) and 45(2) set out that the SICR and SMER are due within twelve months after either the end of the designated person's accounting period, or the date on which the on-going contract condition was first met in relation to the relevant financial year, whichever is later. If the ongoing contract condition is met between the end of the contractor's financial year and the end of the MOD's financial year, then a SICR and SMER are required for the year prior to the ongoing contract being met.

8.25 The SSRO sought feedback from the MOD and industry as to whether there may be a rationale to require this data for the preceding years and on any suggestions to address the issue.

**Stakeholder responses to consultation**

8.26 Those who provided feedback on the proposed changes to regulation 37(7) were broadly supportive of the approach. Some stakeholders were not aware of the problem because they have been reading and applying regulation 37(7) as requiring the QBUECAR to relate to the period following that of the QBUACAR, i.e. the period we believe is consistent with the intention that the QBUECAR should support the ECAR, even though the actual language in the regulation has the two reports covering the same period.

8.27 ADS argued that overhead reports can be required for years preceding the entity having a qualifying contract. It said that the rules regarding whether a contractor has qualified under Part 6 of the legislation are complex and give rise to perverse reporting requirements. ADS did not elaborate further on that point, but suggested that the requirements should be aligned with the contractor's financial year end rather than 31 March. One contractor which supported the ADS proposal suggested further work in this area between the industry, MOD and the SSRO. Another respondent noted that their financial year aligns with 31 March and therefore they did not experience any issues.

**SSRO's considerations**

8.28 The changes to regulation 37(7) are relatively straightforward to implement and non-contentious across our stakeholders.

8.29 We explained in the consultation document that we were not convinced that overhead reports can be required for years preceding the entity having a qualifying contract, as asserted by ADS. We thought this may only be possible in respect of the strategic reports (the SICR and SMER). The responses have not demonstrated that there is such a problem in relation to overhead reports. We accept that the requirements in respect of the due dates for overhead reports and strategic supplier reports, and the periods to which they relate are complex, and we developed reporting guidance in this area to assist contractors. The guidance provides examples to help identify which reports are due, for which period and when they need to be submitted.[44]

44 SSRO (2019), *DefCARS - supplier report guidance - Version 7*, https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance

8.30 We acknowledge that there may be circumstances where the SICR and SMER will be required for the period before the business unit qualified as a QBU. This will take place in cases where the relevant financial year (which runs from 1 April to 31 March) and the contractor financial year do not align (e.g. 1 January to 31 December).[45] We have not, however, identified a case for amending the legislation for the following reasons:

- We have not observed an issue caused by the reporting periods for the strategic reports (SICR and SMER).
- The strategic reports were not the subject of our current review and we did not seek feedback in our consultation document on making changes to the reporting period.
- We have no input from the MOD on the rationale for requiring this data for the preceding years, which makes it difficult to conclude that there is a problem that needs to be addressed.

8.31 If stakeholders are concerned that the reporting periods for the SICR and SMER create problems, this is a matter that could be raised with the MOD in connection with the Secretary of State's planned periodic review of the legislation.

**Conclusions**

The SSRO proposes that regulation 37(7) is corrected so that the QBUECAR reporting period is aligned with that of the ERCR and it requires cost analysis information for the accounting period immediately following the relevant accounting period.

## Overlap between the regulatory framework and the rates programme

**Summary of consultation**

8.32 The SSRO's early engagement on overhead reports disclosed that industry stakeholders were concerned about duplication of content and associated burden due to the MOD issuing information requests in support of its rates programme ahead of, and in addition to, the information submitted in the overhead reports. The rates programme requests are aimed at capturing information to enable the MOD to assess and agree rates with suppliers that will be applied across all contracts. The MOD typically issues a comprehensive request at the start of the rates assessment process and, in some cases, it may request further data for the purpose of investigating costs and may visit sites to gather and analyse information.

8.33 Part 6 of the Regulations requires suppliers to provide overhead reports in relation to qualifying business units (QBUs). In broad terms, a QBU is defined as a unit, undertaking or group that provides a total value of at least £10 million of goods, works or services for one or more QDCs or QSCs in a financial year.[46] To better understand the relationship between the MOD's information requests and the information captured by the regulatory framework, the SSRO reviewed the QBUs captured by the regulatory framework for which there are overhead reports in DefCARS. At the time of that review in 2019, DefCARS recorded a total of 29 QBUs, while the MOD rates programme included 97 business units. The criteria for inclusion in the rates programme were not made explicit, but it was clear that a mixture of QBUs and other business units were covered. It appeared that not every QBU is included in the rates programme. One reason for this may be that the MOD has an arrangement with the US Department of Defense for the Defense Contracts Management Agency to assure the rates of some suppliers.

45 This is illustrated by Example 4 of our reporting guidance on preparation and submission of supplier reports. SSRO (2019), *DefCARS - supplier report guidance - Version 7*, https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance

46 Regulation 32(1).

8.34 The SSRO compared the rates programme data request from 2018 with the reporting requirements and found overlap between their content. However, determining the exact overlap requires understanding of the definitions used in the MOD requests and is further complicated by the content of those requests changing from time to time.

8.35 The SSRO's review and consultation focused on two key areas:

- the extent to which it is possible to reconcile the differences in coverage between QBUs and the business units in the rates programme; and
- whether there is some scope to align the information that is required as part of the MOD's rates programme and the information required in overhead reports.

8.36 The SSRO identified matters on which further input was required to be able to make proposals for change and these included:

- the criteria for including business units in the MOD's rates programme;
- the processes followed in the rates programme and how these differ between QBUs and other business units;
- how the statutory reports are being used or are intended to be used in support of the rates programme.

8.37 We also invited stakeholder feedback on how arrangements can be modified so that overhead reports received in DefCARS best support the MOD to determine rates and price contracts and on how the overlap between the information provided in DefCARS and the information requests from the ICPT can be minimised.

**Stakeholder responses to consultation**

8.38 ADS asserted that no consideration was given to ICPT information requirements at the time the regime was developed. It thought there should be a thorough review of the arrangements, to rationalise the reports and produce a coherent set that reflects experience to date. ADS also urged a review of the £50 million threshold in the QBU definition, arguing that it was not achieving the original intention that supplier reports should only be applied to major contractor sites in the UK.

8.39 Some contractors supported the provision of all necessary information once, with access for multiple users. One of the industry stakeholders referred to a CAAS recovery rate programme update and thought the process could be optimised by aligning the review of overhead reporting in the regime with that update. This point was echoed in other responses that stressed the need to avoid unnecessary duplication.

8.40 Another contractor said that the overhead reports were designed for a different purpose and was of the view that they should be required once costs and rates are agreed. It suggested that agreed rates reports could then be used as a reference for pricing, post costing and final pricing purposes. The contractor suggested the agreed BUCAR could be used for benchmarking. Noting the purposes of the various overhead reports, it said that information contained in them differed from what the MOD requires to conduct detailed rates and cost agreement which it thought would be more specific to the QBU, its organisation and submitted Questionnaire: Method and Allocation of Costs (QMAC).

8.41 Similar views were raised by another respondent, who said that the statutory reports do not currently contribute to the rates programme and that more detailed data is provided to CAAS during this process. This contractor was not convinced that arrangements need to be modified and submitted that if the overhead reports were to be required to support the rates programme, they would need to be framed differently and pointed out that DefCARS requires high level submissions.

**SSRO's considerations**

8.42 The overhead reports capture rates claims and cost data for a limited set of business units. The cost data is captured in overhead reports with the aim of capturing business unit costs in standard categories, supporting benchmarking and identifying systematic over- and under-recovery of overheads. There is a lack of clarity as to how the information is used by the MOD, particularly in relation to the rates programme.

8.43 The MOD requests information from suppliers for the purposes of agreeing and investigating rates for business units included in the rates programme. If a QBU is included in the rates programme, then the contractor will likely receive such an information request, in addition to submitting the overhead reports. This may raise a concern about duplication and proportionality.

8.44 The current QBU definition requires overhead reports only from suppliers with larger contracts (at least one valued at £50 million or more) and in respect of business units that make a £10 million contribution to qualifying contracts in a given year. The definition seems designed to limit the circumstances in which supplier reports are required but we do not feel able to say from our review whether the thresholds are set correctly for overhead reports. This may be informed in due course by the MOD's use of the data. We can see no evidence that the thresholds were designed to limit overhead reports to larger sites, as ADS submitted. It is possible that different considerations may apply to the circumstances in which overhead reports are required and those in which strategic reports (SICR and SME) are required. It is understood the MOD intends to review some aspects of SICR and SME requirements as part of the Secretary of State's next periodic review, which may provide an opportunity to further consider the reporting threshold.

8.45 The relationship between overhead reports which are based on the QBU definition and the MOD rates programme that captures a broader set of business units is not yet sufficiently clear to the SSRO. This should be considered in the context of the business units included in the rates programme to better understand the areas of overlap. The triggers for overhead reports and strategic supplier reports should be reviewed in this context, as they may need to be separated. Any potential to make the reporting requirements under Part 6 of the Regulations less complex and confusing should also be explored. At the same time, consideration can be given to the content of the reports, their use by the MOD and any potential to avoid duplication with the information requests issued as part of the rates programme. Such a review can inform whether the reporting guidance and DefCARS should be modified to collect the data required in overhead reports in a way that better supports the MOD's requirements and minimises any additional requests made to industry.

8.46 Some helpful arguments have been presented by contractors in support of such a review in future but further information is required from the MOD, addressing:

- reasons for restricting the QBU definition to its current scope;
- criteria for including business units in the rates programme;
- use made of the overhead reports, in the rates programme or otherwise;
- whether additional information requests made in the rates programme can be optimised given overlap with the statutory requirements.

8.47 We agree with the suggestion from some industry respondents that this area requires wider review to understand the issues better before contemplating any alignment between the regulatory framework and the rates programme.

8.48 Our Corporate Plan 2020-2023 sets out a programme of work in relation to overheads, which will consider recovery and reporting of overheads. This will necessitate working closely with the MOD and industry to identify improvements that ensure the regime more effectively supports the achievement of value for money and fair and reasonable prices.

**Conclusions**

We are not making proposals for legislative change at this time. We have planned further work on overheads over the next three years that we expect to provide a better foundation for action in future.

## Reporting agreed rates

**Summary of consultation**

8.49 The SSRO suggested in its consultation document that, if the data in the overhead reports is intended to be captured for benchmarking purposes, then there may be merit in requiring the agreed rates and costs to be provided in addition to the claimed rates and costs. The explanatory notes to the Act indicate that overhead reports should be submitted again once costs have been agreed by the MOD, but this is not reflected in the Regulations, which require only the actual and estimated claims and associated costs to be reported. Recognising the need to balance the cost and benefits associated with additional reporting, the SSRO asked for further information in relation to how the MOD is using the data, or intends to use the data, and the impact of capturing the agreed rates and costs information, including the associated costs of compliance.

**Stakeholder responses to consultation**

8.50 The SSRO received seven responses on the issue of submitting agreed rates and costs. ADS and a consultancy stakeholder did not support the change and questioned the utility of this information, asserting that the MOD would already have the information from other sources. ADS suggested that interim reporting was for the purpose of identifying trends and spikes in costs and that the actuals are only needed at the end of the contract to determine the final price adjustment. Overall, ADS supported a wider review of reports with a view to establishing whether a case can be made for including agreed costs and, if so, how the information can be provided into DefCARS.

8.51 Contractors also commented on reporting agreed rates. One respondent saw merit in requiring reporting of agreed rates and costs but noted that the agreement of rates can often take several years. Another respondent considered that agreed rates and costs could only be provided by contractors on an on-demand basis due to the different timelines in which rates are agreed. This contractor suggested that submission of any reports should be delayed until rates are agreed to avoid duplication. A similar point was raised by another contractor, who questioned the value of providing some of the current reports and their updates. To avoid any duplication and nugatory effort, this contractor recommended that supplier reports should only be due when the business unit rates are promulgated and contract reports when the contract is priced in accordance with a regulated method.

**SSRO's considerations**

8.52 The SSRO does not accept the suggestion that the data on agreed rates should not be reported by contractors just because it is available to the MOD from other sources. This would be inconsistent with the general scheme of the statutory reporting provisions, which aims to build a body of useful information based on a model of data being submitted by the contractor, monitored by the SSRO and enforced by the MOD.

8.53 We accept the point made by the MOD in response to the working paper that the claimed rates and costs included in overhead reports may be different from those applied to contracts. We note that the contract reports already require provision of information on cost recovery rates and we consider that the benefits of collecting information on agreed rates and costs in overhead reports needs further examination before making changes to the reporting requirements. Relevant issues and questions to explore include:

- The impact of not recording agreed rates and costs in the overhead reports.
- Whether collecting the data is likely to advance the purposes of the overhead reports.
- The best way to collect the data if it is needed in the overhead reports to support the MOD's consideration of rates and agreement of contracts.

8.54 There will be an opportunity to carry out further work in this area as part of our planned further work on overheads. We will work with stakeholders to better understand the MOD's data needs and the role of statutory reporting in meeting those requirements.

**Conclusions**

The SSRO is not proposing a legislative change to require reporting of agreed rates and costs in the overhead reports at this stage.

## QBU compliance monitoring

### Summary of consultation

8.55 A designated person must submit reports for its QBUs if the ongoing contract condition is met in a relevant financial year. The ongoing contract condition is met if a contractor is party to at least one QDC or QSC valued at £50 million or more and there remain obligations outstanding for the supply of goods, works or services under one or more of those contracts at any time in a relevant financial year.[47] If the ongoing contract condition is met, the designated person will be the contractor's ultimate parent undertaking, if the contractor is part of a group, but otherwise will be the contractor.[48]

8.56 The SSRO outlined in the consultation document its duty to keep under review the extent to which persons subject to reporting requirements are complying with them. It identified that discharge of this duty is impeded as the SSRO cannot identify with any certainty whether a contractor has a business unit that qualifies as a QBU in a given year. This means that the SSRO cannot determine for itself whether a business unit is a QBU, because there is no requirement for contractors to report details of the contribution made by each business unit to qualifying contracts in each relevant financial year. If the contractor submits a SICR, then it is required to specify a list of all the QBUs of the designated person. From this the SSRO may be able to determine whether all the required QBU submissions have been made. Having identified these issues, the SSRO invited further feedback on QBU compliance monitoring from stakeholders.

### Stakeholder responses to consultation

8.57 A variety of views were put forward by industry respondents. The majority of industry stakeholders were in favour of maintaining the status quo.

8.58 One contractor stated that the current processes are adequate and that the SICRs provide the required information. Another contractor proposed that the SSRO should pay particular attention to contracts over £50 million and that a simple analysis of whether a QBU meets the reporting requirements was possible based on CIRs (the DefCARS reports containing information required by the CPS, CNR and CRP), ICRs and QCRs. To overcome the difficulty that arises where there is more than one QBU feeding into a contract, the contractor suggested looking at the relevant rates tabs in some of the reports.

8.59 ADS said that SICRs provide visibility of a contractor's business units and that the MOD will be able to identify the structure from information provided to CAAS and the ICPT when pricing contracts and as part of the rates programme. The latter point was echoed by one of the contractors that responded. ADS added that the MOD can request further information if required and that the contractor and MOD should agree which business units will be reported. It noted that the number of rates suppliers is different from the number of QBUs. A consultancy stated that certain overseas governments have laws that restrict disclosure of some of the information sought in Part 6 reports.

47 Section 25 of the Act and Regulation 31.
48 Regulation 32(6)(b).

### SSRO's considerations

8.60 The SSRO is not persuaded by the argument that the SICR should be relied upon to identify QBUs. The reasons for this were set out in the consultation. First, reliance on the SICR means the information may be available with significant delay as the SICR is submitted some nine months after the overhead reports become due. This may present a difficulty as the time limit for issuing a compliance notice for a failure to comply with reporting requirements is six months after the date the report is due. If the SSRO brings a compliance issue to the MOD's attention, it will be too late for the MOD to take enforcement action. Secondly, SICRs may themselves be delayed. In the 2019 Annual Compliance report the SSRO detailed that only 10 of the 21 expected SICR submissions had been made in the period 1 May 2018 to 30 April 2019. Thirdly, the paucity of information obtained through SICRs to date has not allowed the SSRO to consistently identify whether a contractor has business units that are QBUs.

8.61 In our view, the current arrangements prevent the MOD and the SSRO from confidently identifying QBUs. They prevent the SSRO from identifying compliance issues and bringing concerns to the attention of the MOD in time for enforcement action to be taken. Our preference is to have timely, reliable reporting of information about QBUs so that the SSRO can objectively keep under review the extent to which contractors are meeting reporting requirements. However, we have explained above that we see merit in reviewing the QBU definition by reference to the set of business units for which overhead reports are required. We consider that this review needs to be completed before it would be sensible to consider proposing a change to the reporting of QBUs. Once the overlap between the regulatory framework and the rates programme has been properly explored, issues with compliance can be considered further.

### Conclusions

The SSRO is not proposing any legislative change to enable QBU compliance monitoring at this time. We consider this should be considered further as part of a future review of statutory reporting requirements in support of the MOD's consideration of overhead recovery.

## Benchmarking and standardisation

### Summary of consultation

8.62 The Regulations require contractors to provide cost data in the QBUACAR and QBUECAR. DefCARS currently collects standardised data through both reports, which aims to allow the MOD to conduct analysis of a QBU's overhead costs. The SSRO's reporting guidance supports standardisation by providing a glossary of cost categories and definitions. The SSRO considers that there may be scope to improve standardisation and support benchmarking by further analysing submitted data and considering the definitions of cost categories.

8.63 The SSRO engaged with stakeholders in advance of the consultation and the feedback received helped us in understanding the different perspectives on the issue of benchmarking. Some doubted the utility of benchmarking but there was a broad support for further exploration of the subject with input from the MOD and industry, including a review of the purpose and benefits realised from such benchmarking.

8.64 In its consultation, the SSRO acknowledged that this was potentially a significant piece of work requiring close liaison with stakeholders to identify the optimal data set and to explore the scope of possible benchmarking, taking account of the comments and concerns raised by stakeholders. We also recognised the need for the MOD to support the review by outlining its approach to benchmarking, including setting its objectives. It is important for the MOD to define comparator units or organisations based on a set of relevant characteristics.

**Stakeholder responses to consultation**

8.65 In line with the previously raised points, a number of industry stakeholders were sceptical about the benefits and utility of benchmarking. ADS argued that the concept overlooks the fact that single source procurement is used only when there is no other reasonable alternative. It was of the view that for benchmarking to be effective:

- There must be a reasonable number of sources.
- Costs must be collected in the same (or very similar) manner.

8.66 ADS said that comparing the costs between single source contractors for a task or function will be meaningless unless their QMACs have been standardised.

8.67 Similar points were raised by a consultancy and one defence contractor who noted that each contractor will have significant differences in how they are structured and how they collect, allocate and categorise costs and that acts as a barrier to useful standardisation. The contractor added that the costs of remapping all internal management information to a different format or methodology would be prohibitive. While standardisation at a highly summarised level would be possible, the contractor did not think that it would facilitate informative benchmarking.

8.68 Several stakeholders reiterated the need for further work in this area. Some suggested that before standardisation and benchmarking can be achieved, the MOD should outline and agree with industry its approach to benchmarking, its objectives, and how this will work.

**SSRO's considerations**

8.69 In response to the ADS points, we do not accept that benchmarking the overhead costs may never provide meaningful utility to the MOD and that the concept overlooks the fact that single source procurement is used only when there is no other reasonable alternative. Benchmarking is particularly important in the single source context and while the pool of comparative information may be limited, benchmarking still appears to be achievable.

8.70 At the inception of this regime, the risks of over-recovery of overheads was recognised in circumstances where a contractor has an incentive to allocate as much overhead as possible to a well-funded single source product. The effective management and control of overhead resources and costs is key to ensuring that the government gets good value for money, while contractors receive a fair and reasonable profit. Benchmarking can allow the MOD to identify well-performing business units and to leverage this data to apply additional pressure on contractors to be efficient, both at the point of pricing and beyond.

8.71 The SSRO recognises that benchmarking is a complex exercise which requires additional contextual information for optimum effect, such as the QMAC and an understanding of differences in the definition of cost categories. We remain of the view that a further programme of work with stakeholders would be needed to identify the methodology, optimal data set and the scope of possible benchmarking. This work would provide an opportunity to explore the uses, previously set out by the MOD in response to the working paper, that these reports could enable the MOD to:

- determine whether costs apportioned to MOD contracts are appropriate, attributable and reasonable;
- identify efficiency incentives on overhead costs;
- assess the estimating accuracy of suppliers; and
- understand the costs and benefits of supporting capability sustainment.

8.72 In addition, this would allow examination of some matters of detail raised by the MOD earlier in the process such as:

- moving away from combined labour and overhead rates in favour of splitting out direct labour rates (used for pricing direct labour) from indirect recovery rates (used to price overheads);
- requiring suppliers to split out which costs are recovered in non-MOD contracts, MOD contracts that do not use rates (e.g. competitively won contracts), and MOD contracts that do use rates (split by QDCs/QSCs and contracts not covered by the SSCRs).

8.73 However, for the review to achieve its purpose, the MOD and contractors must be involved to determine the extent to which DefCARS and guidance can be developed to further standardise rates and cost data submitted through the overhead reports to support the validity of comparisons.

**Conclusions**

The SSRO will engage with stakeholders to explore the scope of possible benchmarking and standardisation as part of its work on overheads referred to in paragraph 8.5 above. This should aim to identify how data gathered in DefCARS can assist the MOD's benchmarking activities. The MOD and the contractors' further involvement would be key in being able to make progress in this area.

# 9. Other matters

## Segmented contract profit rates

### Summary of consultation

9.1 As part of the 2017 Review of Legislation, the MOD asked the SSRO to consider the merits of changing the legislation to support the use of more than one contract profit rate within a contract, or the use of blended rates, for contracts which employ different components for different activities. The SSRO advised that the legislation does not permit profit segmentation in this way but that we could see potential benefits in changing the legislation to permit it.[49] We set out matters for the MOD to consider before being satisfied that a change should be made.

9.2 In response to the SSRO's working paper, the MOD raised the importance of ensuring that DefCARS separates out costs and profit for contract components where they are priced using different profit rates. In the consultation document, the SSRO referenced the recommendations it made to the Secretary of State in 2017. We sought further feedback on segmentation of profit rates, the potential impact on contractors and the extent to which it should be reflected in reporting.

### Stakeholder responses to consultation

9.3 An industry stakeholder stated that they did not support the use of multiple or blended profit rates within a contract, indicating that the profit rate should be assessed based on the primary purpose of the contract as a whole. Various reasons were cited, including that comparator companies used for determining the baseline profit rate (BPR) do not use segmentation, that it would distort profit, the cost risk adjustment (CRA) and actual costs, and that it would drive the wrong behaviour by being used to reduce the overall contract profit rate (CPR). In reference to the MOD's feedback as part of the 2017 Review of the Legislation, where it was said that restricting contracts to a single CPR may incentivise the disaggregation of contracts, the contractor indicated that this was already happening and creating cross-dependency and reliance risks between those divided contracts. Another industry stakeholder considered that the reporting of blended profit rates and price segmentation would lead to inconsistencies in the reporting and interpretation of DPS data.

9.4 One industry stakeholder questioned the value of additional reporting in circumstances where most of the CPR is generated through the BPR and the capital servicing adjustment (CSA), which are outside the control of the contracting parties, suggesting that the focus should be on cost as recommended in Lord Currie's Review of Single Source Pricing Regulations. It was suggested that material amendments should be effected by a separate contract and minor amendments should rely on the originally negotiated CPR. Another industry stakeholder made similar observations, recommending that tasking orders should be considered as part of the base contract when the requirement is well understood, or a new profit rate agreed when there is a new development or significant change. They suggested that segmentation would over-complicate an already difficult process of agreeing the CPR, which through the CRA already takes account of different activity types and uncertainties. It was suggested that rather than focussing on something that will have a marginal impact on the overall CPR, efforts should instead be on contract requirements.

49 SSRO (2018), *Review of single source regulatory framework*, https://www.gov.uk/government/publications/review-of-single-source-regulatory-framework

9.5 ADS referenced the existing complexity in agreeing the CPR which is based on a “six by six matrix” (the six step process for up to six pricing methods), to which segmentation will add additional burden. It warned that the proposal would likely lead to contractors altering cost structures to maximise profits and rejecting perceived low-paying activities.

9.6 Conversely, a consultant supported the use and reporting of segmented profit rates where multiple pricing methods are used and proposed that more granular information should be reported. This might include, it was suggested, an individual Contract Pricing Statement for each pricing method, and the equivalent of a ‘Contract Line Item Number’ used in the US system, for the purposes of accurate estimating and contract management. This, it was said, would assist with determining the price of contract amendments, since it would be easy to identify the original CPR associated with each component.

**SSRO’s considerations**

9.7 The feedback received on this matter was useful for the SSRO to consider some examples of current practice when QDCs are priced. It is consistent with that received as part of the SSRO’s 2017 Review of Legislation that segments of contracts are being priced in ways which do not appear to be supported by the legislation.

9.8 The SSRO maintains its position set out in its 2017 Review of Legislation that the MOD may want to consider the merits of changing the legislation to support the use of more than one contract profit rate within a contract, or alternatively the use of blended rates. We recognise that an amendment to a contract could be priced using a different baseline profit rate which is provided for in the legislation. The price of the amendment might also be built up based on different calculations at steps 2-6 than were used to determine the original price of the contract. The SSRO will explore as part of the work on amendments and variances whether changes can be made to DefCARS and the reporting guidance to facilitate improved reporting, but within the constraints of the legislation as it currently stands or as amended by the MOD in the future. Stakeholders would be consulted on any changes though the normal process.

**Conclusions**

Before changing the legislation to support profit segmentation, the MOD should consider the matters set out in the SSRO’s recommendations to the 2017 Review of Legislation. In addition, the MOD should consider whether any change in the reporting requirements is needed.

## Contract pricing methods

**Summary of consultation**

9.9 In paragraph 10.5 to 10.9 of the consultation document, we proposed that the Regulations are amended to allow target prices to be adjusted as a result of changes in specified indices or rates. This proposal recognised that longer-term MOD contracts it the inclusion of a variation of price (VOP) or exchange rate variation (ERV) clauses can help to manage inflation and currency risk in a variable element of the contract price. However, the legislation does not current provide for this, which we consider to be an undesirable limitation. Allowing such adjustment will be consistent with the approach currently taken for the fixed and volume-driven pricing methods. There is no obvious reason why target price contracts should be excluded from this provision given the Allowable Costs are those estimated at the time of agreement.

**Stakeholder responses to consultation**

9.10 Respondents generally supported the proposed change.

9.11 Some respondents suggested a broader review of the regulated pricing methods, including, for example, a consideration of maximum pricing, prospective price redetermination (or pricing periods), 'commercial off the shelf (COTS) pricing, and a legislative implementation of the practice of "provisional pricing" to expedite the delivery of contract.

**Conclusions**

We propose that amendment to regulation 10(1) is considered to additionally specify that the Allowable Costs estimated at the time of agreement may be adjusted in accordance with changes in specified indices or rates between the time of agreement and a specified time (and different times, indices or rates may be specified in relation to different Allowable Costs).

We note that MOD are considering "commercially priced items" as a way of establishing a fair and reasonable price for some or all of the contract. We will continue to engage with MOD on this work.

## Final price adjustment

**Summary of consultation**

9.12 In 10.10 to 10.14 we set out proposals to correct a potential drafting error in the regulations that relates to the calculation of the final price adjustment.

**Stakeholder responses to consultation**

9.13 Few respondents commented on this proposal; those that did supported the change or did not object to it.

9.14 One respondent commented on the final price adjustment more broadly and suggested it should be replaced with a more expansive post-award audit of contracts They also considered that the current approach would penalises contractors with sound estimating systems and incentivises contractors with poor estimating systems and processes to continue with their practices.

**Conclusions**

We propose that the following changes to legislation are considered:

- In regulation 17(2), substitute "5% but less than 10%" with "5 percentage points but less than 10 percentage points"
- In regulation 17(3) substitute "10% but less than 15%" with "10 percentage points but less than 15 percentage points"
- In regulation 17(4) substitute "15%" with "15 percentage points"

The SSRO is currently developing its approach to analysis and reporting on completed contracts and we consider it is too early at this stage to make any proposals about the final price adjustment more broadly, or to comment on any unintended consequences of its application.

# 10. Other matters on which the SSRO did not consult

10.1 Stakeholders provided feedback on a number of topics that the SSRO did not consult on. This section summarises some of the feedback received and the SSRO's response.

## Baseline Profit Rate

10.2 Respondents raised concerns about the methodology used to assess the baseline profit rate (BPR). These were:

a. comparability with MOD suppliers;

b. IT sector representation;

c. the geographic composition;

d. the choice of average;

e. the company size threshold; and

f. impairment and amortisation.

10.3 These matters have been raised and discussed previously and the SSRO has responded to them. Where those responses have been published, they are provided below.

10.4 Five respondents argued for a review of the BPR methodology in its entirety. In three cases they were of the view that this is a more pressing concern than the amending the cost risk adjustment (CRA), and two believed that resolving the issues they raised would result in a suitable starting point for achieving an appropriate CRA range.

10.5 The SSRO is confident that the baseline profit rate is a fair and reasonable starting point for the contract profit rate calculation because it is set with reference to the actual returns of comparable companies. The methodology takes steps to remove loss-making companies, uses the most appropriate average given the characteristics of the data, and only incorporates companies that perform comparable economic activities in comparable countries. We address matters related to the CRA elsewhere in this document. The concerns raised are addressed under the subsequent sub-headings.

**Baseline profit rate: Comparison with MOD suppliers**

*Stakeholder responses to consultation*

10.6 Four respondents expressed dissatisfaction with the composition of the comparator group. They argued that in a significant number of cases the work of comparator group companies bore little resemblance to that undertaken by contractors performing QDCs or QSCs; and that they would not be subject to the same cost risks that are undertaken by single source suppliers.

10.7 One respondent proposed that instead of using NACE codes to select the comparator group, the selection process should be based on characteristics of global ultimate owners (GUOs) of QDC/QSC contractors, such as their market value of equity to its book value, and corporate revenues.

10.8 One respondent disagreed with the new £10.2 million company size threshold while another welcomed the development but believed it to be still too low on the basis that it does not recognise some aspects of contracting. They both proposed setting company size threshold at £50m to represent a more realistic assessment of the gearing needed to absorb a £5m QDC (i.e. 10% of the annual turnover).

*SSRO's considerations*

10.9 The approach to comparability is based on the OECD transfer pricing guidelines.[50] This provides guidance on the application of the "arm's length principle", which is the international consensus on transfer pricing. The principle of comparability relates to undertaking economic activity that is included in whole or in part in the activity types that contribute to the delivery of QDCs and QSCs. The SSRO responded to the issues raised above in paragraph 2.10 of the 2019 BPR consultation responses document[51] and we consider the response remains valid.

**Baseline profit rate: IT sector representation**

*Stakeholder responses to consultation*

10.10 One respondent noted that the IT sector, i.e. computers (hardware and software, including COTS software), telecoms, cloud software services, etc. was not represented in the comparator group.

*SSRO's considerations*

10.11 Work to establish the economic activities relating to IT which are not present in the existing comparator group and form a material part of QDCs and QSCs would help establish if a revision to the activity characterisation is required.

## Baseline profit rate: Geographic composition of the comparator group

*Stakeholder responses to consultation*

10.12 One respondent argued that the geographic composition of the comparator companies skews the outcome due to the different circumstances outside the UK. They note that there are still state owned companies in Western Europe, or state interests held in certain companies, which detracts from the need to maintain shareholder value; and that there is inability to make a fair comparison with North American companies due to insufficient granularity of their published data.

*SSRO's considerations*

10.13 We have published extensive analysis on the effect of geographical composition on the BPR which does not support the view of a skewed outcome.[52] The methodology only uses companies in the analysis who report sufficient data and we typically find North American companies' data to be sufficient. The SSRO also responded to issues on geography in paragraphs 3.33 and 3.34 and in Table 2 in paragraph 3.2 of the 2019 BPR methodology consultation responses document.[53] We consider those responses remain valid.

**Baseline profit rate: The choice of average**

*Stakeholder responses to consultation*

10.14 Four respondents expressed concerns on the use of the median instead of a weighted mean. One of them argued that it distorts the BPR and does not provide a return comparable to the activities that defence contractors perform.

50 OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, https://doi.org/10.1787/tpg-2017-en

51 SSRO (2019), *Summary of consultation* responses, https://www.gov.uk/government/consultations/ssro-single-source-baseline-profit-rate-methodology-consultation

52 SSRO (2020), *Supporting analysis 2020/21*, https://www.gov.uk/government/publications/2020-contract-profit-rate

53 SSRO (2020), *Review of single source contract profit rate methodology 2015: Response to consultation*, https://www.gov.uk/government/consultations/review-of-single-source-contract-profit-rate-methodology-2015

*SSRO's considerations*

10.15 The SSRO has responded to feedback on the choice of average in Table 2 in paragraph 3.2 of the 2019 BPR methodology consultation response document. Question 13 of the SSRO's profit Q&A document explains why the median is the most appropriate choice of average.[54] We consider those responses remain valid.

**Baseline profit rate: The choice of profit level indicator, or adjusting for impairment and amortisation**

10.16 Three respondents noted the non-adjustment for impairment and amortisation in the methodology, which one respondent claimed introduces inconsistences in the methodology. Two of the respondents recommended the use of Earnings before interest tax and amortisation (EBITA) instead of Earnings before interest and tax (EBIT) as a corrective measure, while the third respondent proposed company-by-company adjustments.

*SSRO's considerations*

10.17 Question 15 of the SSRO's profit Q&A document sets out why the methodology does not make adjustments other than for the capital servicing adjustment (CSA) and we consider the response remains valid. The SSRO is exploring further work in relation to this as a potential priority for a future corporate plan.

10.18 A response from an industry trade body stated that they understood amortisation of intangibles, particularly the costs of business integrations, to be disallowed in the pricing of single source contracts. We would like to draw stakeholders' attention to Part G of Section 5 of the SSRO's Allowable Costs guidance; this guidance provides for both amortisation costs and impairment costs to be Allowable Costs if they satisfy the AAR test.

54 SSRO (2020), *Key questions and answers regarding the methodology 2020/21*, https://www.gov.uk/government/publications/2020-contract-profit-rate

## Other issues

10.19 The respondents also provided feedback on other matters which the SSRO did not consult on. Of these, several are matters which we understand are being considered by the MOD in their review of legislation work. These are summarised in table 9. The remaining feedback is included in the stakeholders' non-confidential responses published alongside this report. The MOD may wish to consider whether these should be in scope of its work on the Secretary of State's review. We have summarised those matters in table 10.

**Table 9: Feedback on matters on which the SSRO did not consult but which are being covered by the MOD's review**

| Issue | Comment |
|---|---|
| Removing CRA from the 6 Steps | One respondent recommended a review to assess the benefits of removing the CRA (as it is a point of contention) and replacing it with a significant range for negotiating adjustments to the BPR. It hypothesised that cost savings would be made across industry, as protracted CRA and BPR negotiations could be avoided. |
| Lower value contracts | One company and one consultant supported a change to the Act and Regulations to give power to the MOD and Industry to agree the profit rates for lower value contracts changes/variations. They considered that the process should be simplified and not subjected to the six-step process in order to minimise delays and disruptions. In addition, the company argued that better guidance would permit easier navigation of the CRA range and therefore reduce the disproportionate effect on lower-value contracts. |
| Off-the-shelf pricing | A company noted that the current six-step profit regime stifles the previously robust relationship between contractor and customer that provided sufficient flexibility to meet unexpected changes and customer requests within a broader interpretation of the statement of work. An industry group suggested a review of that method of determining the Contract Price, to introduce greater flexibility which achieves fair and reasonable prices for the contractor and value for money for MOD outcome, i.e. allowing all or part of a price to be determined by reference to commercial prices etc. |
| Procedural issues | One consultant noted that currently companies carry out two parallel contract pricing negotiations, one with CAAS and another with the commercial team. They proposed the reintroduction of a Contractor Exit Review, i.e. where under "no price agreed, no offer of contract" (NAPNOC) guidelines the CAAS price investigation concludes with Contractor Exit Review findings before the commercial negotiations commence. |
| Incentive adjustment | One consultant and one company submitted incentive adjustment related responses. The consultant noted that there is a lack of clarity within the statutory guidance as to when the incentive adjustment is operational, and value for money is not often well understood by the parties to contracts. Both respondents argue that widening its range would serve as a vehicle for better outcomes and VFM. |

**Table 10: Feedback on matters on which the SSRO did not consult that we understand are not being covered by the MOD's review**

| Issue | Comment | SSRO response |
|---|---|---|
| Cost estimation | One consultant raised a query on their understanding of the matter of "the relative likelihood of actual Allowable Costs being higher or lower than estimated Allowable Costs" in the SSRO's guidance on determining the CRA and queried its computation basis with reference to skewness and the behaviour of random variables under the central limit theorem (CLT). | The intent of this guidance at 5.21 is to direct users of the guidance to consider the potential for there to be asymmetry in the risk that actual allowable cost may vary from their estimated value, depending on whether that variance is positive or negative. In other word the relative balance of risk and opportunity. In a statistical sense this would mean considering skewness of a distribution of cost estimates. For example, in selecting appropriate distributional input assumptions (such as skewness) for stochastic modelling. There is no requirement to have recourse to the (or any) CLT in this respect, and in any case the assumptions of the common form of the CLT are unlikely to hold. |
| Value for money | One respondent sought for the SSRO to develop with government a definition of value for money which takes account of wider economic matters related to the prosperity of the UK, and this should be included in business cases and budget setting. | The UK government's policies on value for money assessments and how wider economic issues and tax should be taken into account in decisions on public spending are set out across a number of publicly available documents, including but not limited to:<br>• Managing public money<br>• The Green Book: appraisal and evaluation in central government<br>• Business case guidance for projects and programmes<br>• MOD guide to investment appraisal and evaluation (JSP 507)<br>The SSRO would welcome the opportunity to contribute to any developments in these areas where this was sought by government and was relevant to the delivery of our statutory functions. |
| Transparency | The SSRO received a response from an academic who suggested that the legislation is revised to include a requirement for the Secretary of State to publish a report of a review carried out under section 39(3) of the Defence Reform Act 2014. He proposed specific amendments to section 39 of the Act to bring it more in line with the practice for reviews carried out under the Small Business, Enterprise and Employment Act 2015. | Publishing the outcome of the Secretary of State's reviews of the regulatory framework can enhance understanding of how the regime is working, support implementation, and provide a basis for further engagement. The SSRO supports measures that would increase transparency in this way. The MOD should consider the merits of such a change as part of its work on the Secretary of State's second review under section 39(3). |

# Appendix 1: Glossary of terms

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|---|---|
| **AAR** | Appropriate, Attributable to the contract and Reasonable in the circumstances<br>(the requirements of Allowable Costs as specified by the Act) |
| **Act** | the Defence Reform Act 2014 |
| **BPR** | Baseline Profit Rate |
| **CAAS** | [the MOD's] Cost Assurance and Analysis Service |
| **CCR** | Contract Costs Report |
| **CLT** | Central Limit Theorem |
| **CSA** | Capital Servicing Adjustment |
| **CNR** | Contract Notification Report |
| **CRA** | Cost Risk Adjustment |
| **CPR** | Contract Profit Rate |
| **DefCARS** | Defence Contract Analysis and Reporting System |
| **DPS** | Defined Pricing Structure |
| **EBIT** | Earnings before interest and tax |
| **EBITA** | Earnings before interest, tax and amortisation |
| **ERCR** | Estimated Rates Claim Report |
| **FAR** | [the US's] Federal Acquisition Regulation |
| **ICPT** | [the MOD's] Indirect Cost Pricing Team |
| **ICR** | Interim Contract Report |
| **IFRS** | International Financial Reporting Standards |
| **JSP** | Joint Service Publication |
| **LD** | Liquidated Damages |
| **MOD** | the Ministry of Defence |
| **NACE** | *Nomenclature statistique des activités économiques dans la Communauté européenne* (Statistical Classification of Economic Activities in the European Community) |
| **NAPNOC** | [the MOD's] 'No Agreed Price No Contract' principle |
| **OECD** | the Organisation for Economic Co-operation and Development |
| **OWG** | [the SSRO's] Operational Working Group |
| **POCO** | Profit On Cost Once |
| **QBU** | a Qualifying Business Unit |
| **QBUACAR** | QBU Actual Cost Analysis Report |

| | |
|---|---|
| **QBUECAR** | QBU Estimated Cost Analysis Report |
| **QCR** | Quarterly Contract Report |
| **QDC** | Qualifying Defence Contract |
| **QMAC** | Questionnaire on the Method of Allocation of Costs |
| **QSC** | Qualifying Sub-Contract |
| **Regulations** | the Single Source Contract Regulations 2014 (as amended) |
| **SICR** | Strategic Industrial Capacity Report |
| **SME** | Small and Medium-sized Enterprises |
| **SMER** | SME Report |
| **SQEP** | Suitably Qualified and Experienced Person |
| **SoW** | Statement of Work |
| **UK** | United Kingdom of Great Britain and Northern Ireland |
| **US** | United States of America |
| **VFM** | Value for Money |
| **WBS** | Work Breakdown Structure |