



SSRO

Single Source
Regulations Office

Contract Profit Rate

Guidance on adjustments to the
Baseline Profit Rate

27.03.15

Contents

Introduction	2
1. About this Guidance	2
2. Application of this Guidance	2
Cost Risk Adjustment (Step 2)	3
3. Basis of Cost Risk Adjustment	3
4. Regulated Pricing Methods	3
5. Principles of risk adjustment	4
Profit on Cost once Adjustment (POCO) (Step 3)	6
6. Basis of POCO Adjustment	6
7. Application of POCO adjustment	6
8. Methodology to determine the POCO adjustment for POCO	8
SSRO funding adjustment (Step 4)	9
Incentive adjustment (Step 5)	10
9. Basis of incentive adjustment	10
10. When to apply the Incentive adjustment	10
11. Principles of applying the Incentive adjustment	10
Capital Servicing Adjustment (Step 6)	12
12. Basis of Capital Servicing Adjustment	12
13. Importance of Step 6 Adjustment	12
14. Calculating the Capital Servicing Adjustment	12
15. Calculation of Capital Employed	15
16. Calculation of Cost of Production	17
Opinions and Determinations	18
17. Overview	18
18. Opinions	18
19. Determinations	19
Appendix A: Glossary of terms	20
Appendix B: Worked Example of POCO adjustment	22
Appendix C: Worked Example for Capital Servicing Adjustment	25

Introduction

1. About this Guidance

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

Step 1		baseline profit rate
	+	
	-	
Step 2		cost risk adjustment
	-	
Step 3		profit on cost once
	-	
Step 4		SSRO funding adjustment
	+	
Step 5		incentive adjustment
	+	
	-	
Step 6		capital servicing adjustment
		contract profit rate

1.2 Section 18 of the Act provides for the SSRO to issue guidance in relation to the steps set out in section 17(2).

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

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

2. Application of this Guidance

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

2.2 This document provides guidance on the adjustments to be made to the baseline profit rate when determining the contract profit rate for all qualifying defence contracts and qualifying sub contracts. The methodology in the “Yellow Book” used to determine the Total Contract Profit Allowance, is not relevant to qualifying defence contracts or qualifying sub-contracts.

2.3 For those non-qualifying defence contracts or non-qualifying sub-contracts in force on 1 April 2015 the previous methodology established by the ‘Government Profit Formula and its Associated Arrangements’ remains in place.

Cost Risk Adjustment

(Step 2)

3. Basis of Cost Risk Adjustment

- 3.1 Section 17(2) of the Act, and Regulation 11(3), set out the requirement for the cost risk adjustment:

“Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25% of the baseline profit rate, so as to reflect the risk of the primary contractor’s actual allowable costs under the contract differing from its estimated allowable costs”.

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

4. Regulated Pricing Methods

- 4.1 Regulation 10 (2) states that the parties to a qualifying defence contract may agree which regulated pricing method is to be used for that contract. The parties can also agree a different pricing method for defined components of the contract (Regulation 10(3)).
- 4.2 There are six regulated pricing methods that the parties to a qualifying defence contract may decide to use, as set out in Regulation 10 (4)-10(11). All regulated pricing methods use either an estimate or actual allowable cost base. For the purpose of this guidance, the general approach to determining the cost risk adjustment is driven by the proportion of actual versus estimated costs included in the pricing method.

- 4.3 The six regulated pricing methods are:

(1) Firm pricing method

- (a) Allowable costs are estimated at the time of the agreement.

(2) Fixed pricing method

The allowable costs are the allowable costs as:

- (a) estimated at the time of the agreement; and
(b) 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).

(3) Volume-driven pricing method

The allowable costs are the allowable costs per unit of volume multiplied by the actual volume of output of the contract.

The allowable costs:

- (a) must be estimated at the time of agreement; and
(b) 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).

- (4) Target pricing method**
 - (a) Allowable costs are estimated at the time of the agreement.
- (5) Cost-plus pricing method**
 - (a) Allowable costs are the actual costs determined during the contract or after the contract completion date.
- (6) Estimate-based fee pricing method**
 - (a) Allowable costs by which the contract profit rate is multiplied are the allowable costs as estimated at the time of agreement.
 - (b) Allowable costs added to the product of the contract profit rate and the allowable costs determined at the time of agreement, as stated above in paragraph (a), are the actual allowable costs determined during the contract or after the contract completion date.

5. Principles of risk adjustment

General Approach

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

Negative Adjustment

5.2 For qualifying defence contracts that are cost-plus or estimate-based, the cost risk adjustment could be -25%. The actual adjustment will be determined by also considering the principles stated at 5.6.

No Adjustment

5.3 The target pricing method generally shares risk between contractor and the MOD and therefore a cost risk adjustment of zero may be appropriate.

However:

- (i) The zero cost risk adjustment to the baseline profit rate is dependent on the terms and conditions of the contract. If the terms of the contract show a greater value of estimated allowable costs than actual allowable costs then a positive cost risk adjustment could be negotiated. Alternatively, when a greater share of actual allowable costs are stated within the terms of the contract than estimated allowable costs then this could indicate where a negative cost risk adjustment to the baseline profit rate could be negotiated.

Positive Adjustment

5.4 When firm, fixed or volume-driven pricing methods are used then the cost risk adjustment could be up to +25%, where the contractor

Regulated Pricing Method	Actual allowable costs used	Allowable costs estimated at time of agreement
Firm pricing		✓
Fixed pricing		✓
Volume-driven		✓
Target pricing	✓	✓
Cost-plus	✓	
Estimate-based fee	✓	

bears the majority of the cost risk and this can be evidenced by the contractor.

However:

- (i) A full +25% adjustment to the baseline profit rate is dependent on the cost risk included in the qualifying defence contract, taking into account the principles indicated below. It is possible that less than the full +25% (including a negative) cost risk adjustment could be applied to a firm, fixed or volume-driven pricing method, if it is routine in nature or generally deemed a low risk contract.
 - (ii) For fixed, or target priced contracts that overrun, where the contractor is culpable, and not the MOD, then where the contractor seeks to secure a renegotiation on price, any positive cost risk adjustment should be deducted or clawed back from any additional funds agreed.
- d. be consistent with the overall project approach to risk, such as risk allocation, management, and risk registers;
 - e. take into account the extent to which the cost risk has been mitigated, for example through good business practices or insurance;
 - f. take into account any cost risk exposure which has been mitigated through contract terms and conditions;
 - g. take into account any contractual terms that pass on some or all of the cost risks onto a party other than the contractor;
 - h. take into account any allowance for contingency that may have been included in particular elements of the allowable costs;
 - i. not take into account uncertainty resulting from force majeure for example an unforeseeable natural phenomenon; and
 - j. be based on reasonable documented assumptions.

- 5.5 On occasions when a cost risk has not been included in either allowable cost base, or the terms and conditions of the contract for a qualifying defence contract, the cost risk adjustment to the baseline profit rate should not be used as a retrospective method to amend this for either party.

Principles to consider

- 5.6 In addition to taking into account the regulated pricing method, the contractor and the MOD must have regard to the following principles (which are not exhaustive) when determining the cost risk adjustment. The adjustment should:
- a. only consider uncertainties that impact on allowable costs;
 - b. be based upon an assessment of how actual allowable costs may differ from estimated allowable costs;
 - c. be entirely consistent with the contract requirement;

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

6. Basis of POCO Adjustment

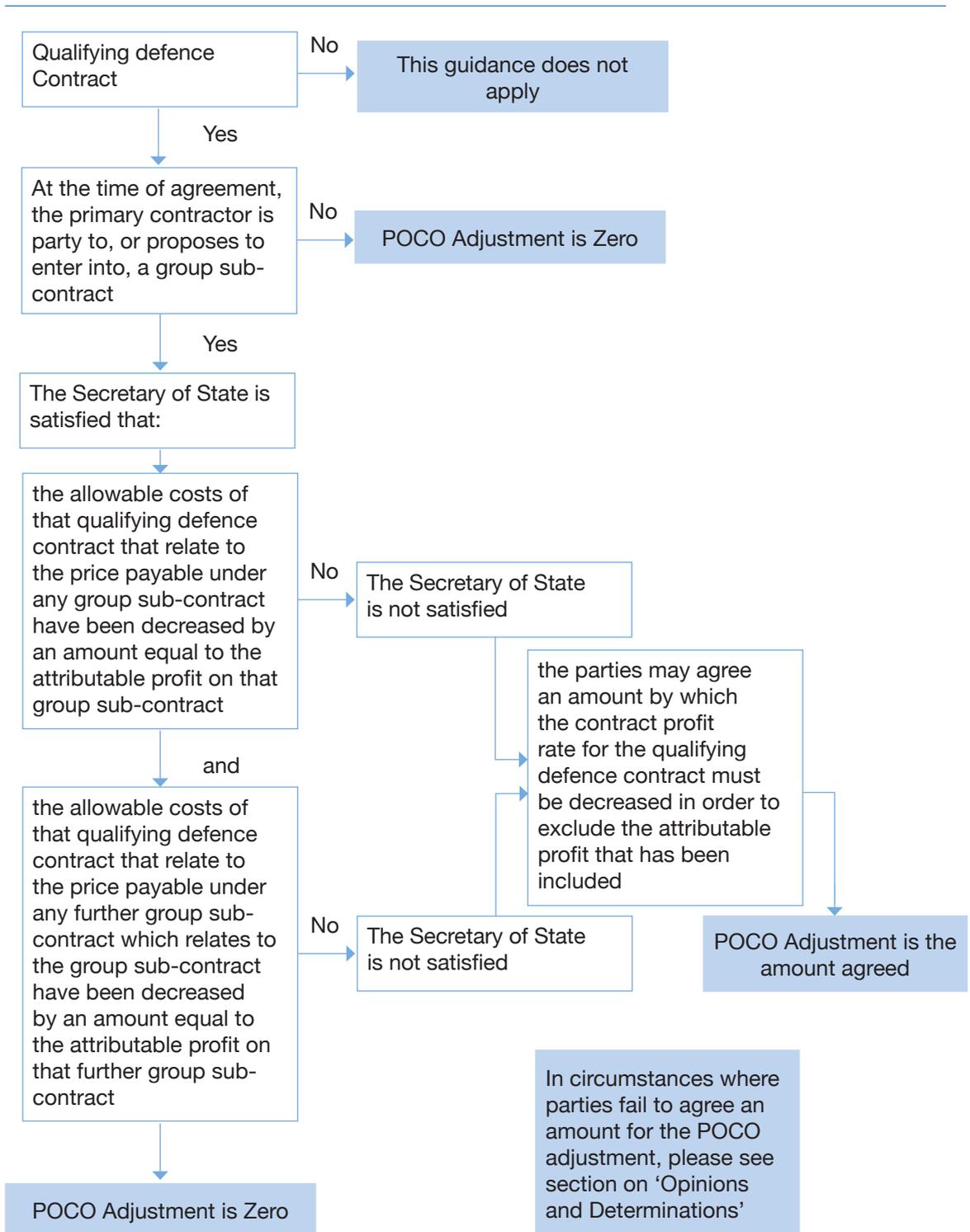
- 6.1 Section 17(2) of the Act, and Regulation 11(4), set out the requirement for the POCO adjustment:

“Deduct from the amount resulting in step 2 the adjustment determined in accordance with regulation 12 (“the POCO adjustment”), so as to ensure that profit arises only once in relation to those allowable costs under the contract that relate to the price payable under any group sub-contract (including any further group sub-contract)”

- 6.2 This adjustment ensures that if a party to a qualifying defence contract enters into a non-competitive sub-contract with another group member, and this sub-contract is necessary to enable the performance of the qualifying defence contract, then profit arises only once in relation to those allowable costs under the qualifying defence contract that relate to price payable under any group sub-contract. This is also the case for any further single source sub-contracts to other group members.

7. Application of POCO adjustment

- 7.1 The POCO adjustment applies to a qualifying defence contract if, at the time of the agreement, the primary contractor is party to, or proposes to enter into, a group sub-contract.
- 7.2 The purpose of this guidance is to provide a consistent methodology for contractors and the MOD to follow when agreeing a POCO adjustment amount.
- 7.3 The POCO adjustment does not apply:
- to non-competitive sub-contracts with a value less than £100,000;
 - to any profit included in sub-contracts to non-group members;
 - to any profit included in sub-contracts to group members if these subcontracts were awarded competitively; or
 - to any profit included in the price of the sub-contractor outside the delivery of the qualifying defence contract.
- 7.4 The diagram on the next page demonstrates when a POCO adjustment should be made:



8. Methodology to determine the POCO adjustment for POCO

- 8.1 The table below demonstrates the 11 stage process that contractors and the MOD must have regard to when agreeing the POCO adjustment amount.
- 8.2 Please refer to Appendix A for a glossary of the terms used below.
- 8.3 Please refer to Appendix B for a high level worked example of the process to aid users.

Stage	Ref	Process
for the prime contract:		
1	-	Document the expected contract supply chain, identifying all the sub-contracts at each level.
2	-	Identify the group sub-contracts within the supply chain which are not the result of a competitive process.
for the prime contract and each group single source sub-contract:		
3	Ax	Identify the applicable costs for the primary contract and each group sub-contract from Stage 2.
4	Px	Calculate the: <ul style="list-style-type: none"> - profit applied to each group sub-contract identified at Stage 2; and - profit net of <i>Step 3</i> (POCO) and <i>Step 6</i> (CSA), to be applied to the primary contract.
for the primary contract POCO adjustment:		
5	ΣAx	Sum the total applicable costs in the primary and group sub-contracts (net of primary CSAs).
6	\square	Calculate the contract profit rate for the prime contract net of <i>Step 3</i> (POCO) and <i>Step 6</i> (CSA). This will be: <i>Step 1</i> (BPR) +/- <i>Step 2</i> (risk adj.) - <i>Step 4</i> (SSRO funding adj.) + <i>Step 5</i> (incentive adj.).
7	$\Sigma Ax \times \square$	Multiply the total applicable costs (ΣAx) by the profit rate (\square). This gives the total profit the group should receive from the qualifying defence contract (net of primary contract CSAs).
8	ΣPx	Sum the total attributable profit applied at all levels (net of <i>Step 3</i> and <i>Step 6</i> for the primary contract).
9	$\text{POCOR} = \frac{(\Sigma Ax \times \square) - \Sigma Px}{AC}$	To calculate the POCO reduction, subtract the total attributable profit applied (ΣPx) from what should be allowed ($\Sigma Ax \times \square$). This is the reduction to the price that will result from the <i>Step 3</i> POCO adjustment.
10	AC	Determine the <i>Allowable Costs</i> included in the primary contract (including applicable group sub-contractor costs).
11	$\text{POCO adj.} = \frac{\text{POCOR}}{AC}$	The POCO adjustment is the POCO reduction divided by the Allowable Costs for the primary contract. This is the <i>Step 3</i> adjustment, which will result in a reduction to the profit (or zero if no profit has been charged at lower levels).

Key:

- Ax – applicable costs for the primary and group sub-contracts
Px – attributable profit for primary and group sub-contracts (net of prime *Step 3* and *Step 6*)
 ΣAx – total applicable costs for the contract (net of primary contract CSAs)
 \square – profit rate that should be applied only once, this is the CPR net of *Step 3* and *Step 6*
 ΣPx – total profit included in the proposed contract price
 POCO_r – the amount *Step 3* should reduce the price to ensure profit arises once (the POCO reduction)
AC – the Allowable Costs for the primary contract
POCO adjustment – the *Step 3* adjustment

SSRO funding adjustment

(Step 4)

This adjustment will be zero until 31 March 2017.

Incentive adjustment

(Step 5)

9. Basis of incentive adjustment

- 9.1 Section 17(2) of the Act, and Regulation 11(6), set out the requirement for the incentive adjustment:

“Where the Secretary of State determines that the amount resulting from step 4 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount (“the incentive adjustment”) specified by the Secretary of State, that amount not to exceed two percentage points.”

- 9.2 This document provides guidance for the Secretary of State to use when determining when to apply the incentive adjustment to a qualifying defence contract and what to consider when setting the rate between zero and 2 per cent.
- 9.3 The incentive adjustment guidance is principles, rather than rules, based.

10. When to apply the Incentive adjustment

- 10.1 The incentive adjustment is not automatic and will be applied exceptionally for qualifying defence contracts.
- 10.2 It may be desirable for the Secretary of State to include a

positive incentive in the following circumstances:

- (a) as a reward for delivering equipment early; or
- (b) delivering over and above the basic contractual requirement; or
- (c) if a contractor exceeds all its set Key Performance Indicators in the performance of a contract.

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

11. Principles of applying the Incentive adjustment

- 11.1 When considering whether to apply an incentive adjustment the Secretary of State must have regard to the following principles:
- (a) **The inclusion of an incentive adjustment is at the Secretary of State’s discretion.** The determination of the incentive adjustment is the responsibility of the Secretary of State, who must have regard to this guidance.
 - (b) **The incentive adjustment must relate to the performance of the contract to which it applies.** The adjustment cannot be in recognition for performance on other contracts, or for performance that is not specified as a contractual requirement.

- (c) **The incentive adjustment must be used for delivering performance above the contractually required level.** The contract should be priced on the basis that a contractor will deliver the performance specified in the contract. Simply meeting this performance level will not result in an incentive adjustment.
 - (d) **The incentive adjustment must relate to performance enhancements which benefit the Secretary of State.** The additional value delivered to the Secretary of State through the achievement of incentivised elements must be tangible and demonstrable.
 - (e) **The incentive adjustment can be applied to any qualifying defence contract, or qualifying sub-contract using any regulated pricing method.** The incentive adjustment relates to performance incentives and not cost incentives. Therefore an incentive adjustment can be applied to a qualifying defence contract using any regulated pricing method.
 - (f) **The incentive adjustment must be within a range of up to 2 per cent.** A positive incentive adjustment will not be applied to all qualifying defence contracts and is not an entitlement.
 - (g) **The link between the incentive adjustment and performance must be simple and measurable.** The criteria for achievement must be measurable and set objectively.
 - (h) **The link between the incentive adjustment and performance must be stated in the contract.** The criteria for achievement and payment must be clearly stated in the contract. This includes:
 - (i) the required level of performance;
 - (ii) how it will be demonstrated;
 - (iii) when it will be measured, and
 - (iv) if incentivised performance is delivered, when incentive payments will be made.
 - (i) **Incentive adjustments must not be paid if the performance results in a breach of contract.** If a contractor is in breach of contract, they are not entitled to any incentive adjustments directly related to that element of the contract in breach.
 - (j) **The incentive adjustment must not be linked to legislative obligations.** An incentive adjustment must not be given for compliance with the Act, Regulations, or other legal obligations.
 - (k) **The incentive adjustments must not be linked to a reduction in the allowable costs of the contract.** Reducing allowable costs of a contract is rewarded via the chosen regulated pricing method.
- 11.2 Subject only to this guidance and the maximum incentive adjustment of two percentage points provided for in Regulation 11(6), the Secretary of State can determine the amount of an incentive adjustment and when to apply an incentive adjustment to a qualifying defence contract.

Capital Servicing Adjustment (Step 6)

12. Basis of Capital Servicing Adjustment

- 12.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the incentive adjustment:
- “Take the amount resulting from step 5 and add to or subtract from it an agreed amount (“the capital servicing adjustment”), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.”*
- 12.2 Regulation 11(8) requires that:
- “In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State*
- (a) must have regard to the capital servicing rates in force at the time of the agreement;*
 - (b) must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are allowable costs under the contract; and*
 - (c) may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor’s obligations under the contract.”*

13. Importance of Step 6 Adjustment

- 13.1 The capital servicing adjustment, alongside the statutory guidance on allowable costs, ensures that contractors are not only paid a return on their fixed and working capital, but that they are also compensated for the fixed and working capital costs. This is done by including depreciation as an allowable cost.
- 13.2 The three capital servicing rates published by the Secretary of State each year are:
- (a) for fixed capital;
 - (b) for positive working capital; and
 - (c) for negative working capital.
- 13.3 To determine this appropriate and reasonable return, contractors must determine the level of fixed and positive/negative working capital and apply these standard rates.

14. Calculating the Capital Servicing Adjustment

- 14.1 The aim of this guidance is to set out the process to be followed in order to calculate the capital servicing adjustment that will be used in Step 6 of the contract profit rate.

- 14.2 The calculation is structured around the above-mentioned three elements of capital servicing used when fulfilling qualifying defence contract, or qualifying sub-contract obligations - fixed capital and working capital (positive and negative). These elements of capital cost when combined are classified in this guidance as being 'capital employed'.
- 14.3 The total cost of capital employed is then assessed in conjunction with the total 'cost of production' in order to apply a rate of capital servicing (by way of a ratio) that is proportionate to the level of capital employed and used in the cost of production for a qualifying defence contract or qualifying sub-contract.
- 14.4 The capital servicing rates published by the Secretary of State are then applied to determine the capital servicing adjustment to be used in Step 6 of the calculation of the contract profit rate.
- 14.5 The diagram on the next page sets out the four computations to be followed in order to determine the capital servicing adjustment. A simple worked example is described at Appendix C to this guidance.

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

Computation 2
Determine the individual Proportions of Total Capital Employed
Fixed Capital Cost Divided by Total Capital Employed EQUALS
Fixed Capital as a proportion of Capital Employed

Working Capital Cost (Positive or Negative) Divided by Total Capital Employed EQUALS
Working Capital as a proportion of Capital Employed

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

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

- 14.6 The following sections of this guidance set out the principles to be followed in order to assess the level of capital employed and the total cost of production.
- 15. Calculation of Capital Employed**
- 15.1 A contractor must initially establish the average capital employed for the unit of their business most relevant to the qualifying defence contract (or qualifying defence sub-contract), such as subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement.
- 15.2 If figures cannot reasonably be isolated then, in exceptional circumstances, capital employed can be calculated for a contractor's business as a whole.
- 15.3 The next step is to allocate the capital employed in the balance sheet (the net assets) between those items that qualify for capital servicing allowances and those that do not.
- 15.4 The list below indicates those items that will generally be excluded in determining the total capital employed:
- a. goodwill;
 - b. adverse (debit) balances in retained earnings;
 - c. investments in shares and securities;
 - d. shares held in and permanent loans to subsidiary companies;
 - e. cash demonstrably surplus to requirements (for example short term investments, deposits, and cash demonstrably in excess of the amount required for working cash resources for day to day operations);
 - f. capital not employed efficiently, such as:
 - i. in land and buildings not in occupation;
 - ii. plant and machinery demonstrably not in use;
 - g. certificates of tax deposit; and
 - h. where advance payments by the MOD relating to single source contracts have not been accounted for in a way that reduces them.
- 15.5 The following items can generally be included in assets in determining the total capital employed in the business unit (these may result in an addition or a deduction from balance sheet figures dependent upon circumstances):
- a. Assets in the course of construction.
 - b. Trading balances with subsidiary, affiliate and other group companies.
 - c. Inventories, which can be included in capital employed based on costs derived from values recorded in the statutory accounts. This is subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by Auditor Attestation. If a contractor has not already done so in its balance sheet then interim payments on account of work in progress are to be deducted.
 - d. Patents and trade-marks, may be included to the extent that a company can demonstrate that they are registered in the name of the contractor and have not lapsed (or the contractor has a valid licence to use) and they actively or defensively contribute to the conduct of the business, even if they are not shown in the contractor's balance sheet.
 - e. Development expenditure may be included up to the value
- iii. where held for speculative purposes or for long term expansion not yet planned; or
 - iv. where there has been unreasonable delay in disposal of surplus assets.

shown in the balance sheet 'net' of amortisation and impairment. This is provided that orders have been received, or are likely to be received, for the product developed or under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.

- f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as employed source of capital, and is not deducted from assets.
- g. Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed.
- h. Prepayments by the government on non-competitive contracts, calculated after adjusting the contractor's work in progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted.
- i. Where costs are spread over several years in accordance with agreed spreading schedule any amount not incorporated into prior period pricing rates at a balance sheet date will be included as an asset in capital employed.
- j. The net balance sheet figure for trade receivables is included in capital employed.

15.6 Further general adjustments will then be applied in addition to creditors' figures captured in the financial statements.

- a. Finance lease creditors will be treated as a source of capital and therefore not deducted.

- b. All loans (including bank overdrafts) are treated as a source of capital, and therefore not deducted.
- c. Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed moneys such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.
- d. Current tax liabilities or assets and deferred taxation are treated as a source of capital, and therefore not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.
- e. Declared dividends are treated as a source of capital, and therefore not deducted.
- f. Non-current liabilities, including pension liabilities, should be excluded.

15.7 Provided no further adjustment has taken place in the group accounts, a contractor's total capital employed is taken as being the average of its total net assets as shown in the relevant opening and closing balance sheets for the entity for the period under review.

Fixed and Working Capital

15.8 For these purposes, in order to calculate the split of total capital employed between fixed and working capital (positive or negative), consideration needs to be given to identify those costs that are obviously 'fixed' in nature from the balance sheet. This

figure is then subtracted from the total capital employed figure (as described above) and the balance is then determined as being 'working capital'.

16. Calculation of Cost of Production

16.1 The information required for the calculation of cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as the financial or management accounts. It will normally include all of the material, labour and overhead costs of the business unit subject to adjustment for certain items outlined in the paragraphs below.

16.2 Costs of production, annualised where appropriate, is computed for the same relevant unit for which capital employed is computed. Among other items, it should include:

- a. direct costs; and
- b. indirect costs, with the exception of those items set out below.

16.3 However, it should exclude :

- a. capital expenditure;
- b. the cost of raising and servicing loan capital;
- c. distribution of profits;
- d. notional transactions;
- e. costs related to assets excluded from capital employed;
- f. discounts allowed on external sales;
- g. any loss arising from either an excess or deductible provision of a purchased insurance that arises from a MOD claim;
- h. the cost of premiums and payments for insurance which cover:
 - i. that element of consequential loss insurance that relates to loss of profit; and
 - ii. the contractor's own defects in materials or workmanship incident to the normal course

of construction, such as the costs to repair defects in materials or workmanship, and for breach of contract;

- i. compensation payments of an abnormal nature to the extent that they are excluded from overheads;
- j. lump sum additions to pension schemes to the extent that they are excluded from overheads;
- k. subscriptions and donations of a political or charitable nature;
- l. credits, grants or refunds deducted from overheads; and
- m. any other costs not considered Allowable under the guidance published by the SSRO.

Calculation of capital services adjustment

16.4 Having followed the processes outlined above, the information available should then be sufficient to allow the four computations to be completed.

16.5 Appendix B to this document sets out a worked example of the calculations required having determined the key information.

Opinions and Determinations

17. Overview

- 17.1 The Act and Regulations require the SSRO to give an opinion or make a determination on the appropriateness of a cost risk adjustment (or group cost risk adjustment), profit on cost once adjustment (or group profit on cost once adjustment), or capital services adjustment (or group capital services adjustment) in the circumstances set out below.
- 17.2 In making any determination under the Act or Regulations (in addition to any other matter set out below), the SSRO must have regard to:
- (a) Any regulations or statutory guidance in force at any time material to the matters under consideration.
 - (b) The extent to which the statutory guidance has been followed (and any justification for not following).
 - (c) The extent to which any person has fulfilled its obligations under Part 2 of the Act and the Regulations.
 - (d) Any relevant previous decisions of the SSRO.
 - (e) Representations made by the parties to the contract (or persons who would be party to a proposed contract) and (where not such a party or person) the Secretary of State.
- 17.3 The following sections are not designed to replicate or replace the Act or Regulations. They are

included to provide assistance to users for when an opinion or determination may be sought.

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

18. Opinions

- 18.1 The SSRO must give an opinion on the appropriate amount of a cost risk adjustment (or group cost risk adjustment), POCO adjustment (or group POCO adjustment) or capital servicing adjustment (or group capital servicing adjustment) for a qualifying defence contract (if the contract price were to be redetermined) or proposed qualifying defence contract or qualifying sub-contract or proposed qualifying sub-contract on referral from, as the case may be:
- (a) the Secretary of State;
 - (b) an authorised person;
 - (c) the primary contractor (or person who proposes to enter into a contract with the Secretary of State); or
 - (d) contracting authority (or the person who proposes to enter into a qualifying sub-contract).
- 18.2 The SSRO may give an opinion on any matter in relation to a qualifying defence contract or proposed qualifying defence contract on joint referral from:

- (a) the Secretary of State and the primary contractor (or in the case of a proposed qualifying defence contract, the other proposed party to the contract);
- (b) the Secretary of State and a proposed sub-contractor, in the case of a proposed sub-contract,

19. Determinations

- 19.1 The SSRO may determine whether the amount of an agreed cost risk adjustment, POCO adjustment or capital servicing adjustment is appropriate on referral from:
- (a) the Secretary of State;
 - (b) an authorised person;
 - (c) the primary contractor; or
 - (d) in the case of a qualifying sub-contract, by virtue of section 29(1) of the Act only.
- 19.2 In making a determination, the SSRO must have regard to the following at the time of the agreement:
- (a) the information that was available to each party; and
 - (b) the statutory guidance that was in place.
- 19.3 In making a determination in relation to the cost risk adjustment, the SSRO must also have regard to the terms of the contract.
- 19.4 If the SSRO determines the amount of the adjustment was not appropriate, it may determine the contract price is to be adjusted by a specified amount.

Appendix A: Glossary of terms

Group sub-contract

Group sub-contract means a contract:

- (a) the price payable under which includes an amount of profit;
- (b) which is made between the primary contractor and any person associated with the primary contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of the qualifying defence contract.

Further Group sub-contract

Further group sub-contract means a contract:

- (a) the price payable under which includes an amount of profit;
- (b) which is made between two or more persons, each of which is associated with the primary contractor or a group sub-contractor;
- (c) the value of which is no less than £100,000;
- (d) the award of which was not the result of a competitive process (as defined in regulation 59 or 60); and
- (e) where the goods, works or services to be provided under the contract are necessary to enable the performance of a group sub-contract or further group sub-contract.

Attributable Profit

The attributable profit is:

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

- (b) where only part of the output of a group sub-contract or further group sub-contract is necessary to enable the performance of the qualifying defence contract, that part of the profit element in the price payable under that group sub-contract or further group sub-contract which relates to the output necessary for that performance.

Attributable profit does not include:

- (a) any capital servicing adjustment made under step 6 of regulation 11;
- (b) any profit which is received by a person which is not associated with the primary contractor.

Group Sub-contractor

A group sub-contractor means a person with which the primary contractor makes a group sub-contract.

Applicable Costs

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

Appendix B: Worked Example of POCO adjustment

What the price should be (profit applied once according to Section 15 of the DRA)

Key: Input
 Calculation

Prime contractor

Allowable costs P	546
Price SC1 (w/o Prft)	391
Total allowable costs	937
Profit (steps 1,2,4,5)	93.7
CSAs Prime	20
Price (no pr on pr)	1050.7

Subcontractor 1

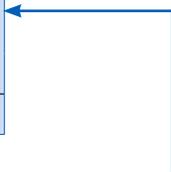
Allowable costs SC1	230
Price SC2 (w/o Prft)	104
Price SC3 (w/o Prft)	51
Total allowable costs	385
Profit applied to SC1)	0
CSAs SC1	6
SC1 Price W/O profit	391

Subcontractor 2

Allowable costs SC2	100
Profit applied to SC2	0
CSAs (SC2)	4
SC2 Price W/O profit	104

Subcontractor 3

Allowable costs SC3	50
Profit applied to SC3	0
CSAs (SC3)	1
SC3 Price W/O profit	51



Worked example of the methodology to determine the POCO adjustment

Stage 1-4 before POCO (with profit added on at each step at supplier's rates)

Key: Input
 Calculation

Profit and CSA rate inputs

	CSAs	Profit rate applied
Prime (steps 1,2,4&5)	2%	10%
Subcontractor 1 profit used	1.5%	12%
Subcontractor 2 profit used	4%	8%
Subcontractor 3 profit used	2%	14%

Prime contractor

Allowable costs P	546
Price SC1 (with Prft)	454
Total allowable costs	1000
Profit (steps 1,2,4,5)	100
CSAs Prime	20
Price (incl pr on pr)	1120

Subcontractor 1

Allowable costs SC1	230
Price SC2 (with Prft)	112
Price SC3 (with Prft)	58
Total allowable costs	400
Profit applied to SC1)	48
CSAs SC1	6
Price including profit	454

Subcontractor 2

Allowable costs SC2	100
Profit applied to SC2	8
CSAs (SC2)	4
Price SC2	112

Subcontractor 3

Allowable costs SC3	50
Profit applied to SC3	7
CSAs (SC3)	1
Price SC3	58



Step 5 - Total costs attributable to the QDC (incl. lower tier CSAs)

Prime (not incl. CSA)	546
SC 1 (AC1 + CSA)	236
SC 2 (AC2 + CSA)	104
SC 3 (AC3 + CSA)	51
$\Sigma A = \text{Total}$	937

Step 6 - Prime Contract Profit Rate net of steps 3 and 6

$\pi = \text{Steps 1,2,4,5 only}$	10%
-----------------------------------	-----

Step 7 - Profit the group should get (net of Prime CSAs)

$\Sigma A \times \pi = \text{Total target profit net of Prime CSA}$	93.7
---	------

Step 8 - Total attributable profit (net of step 3 and CSAs on the Prime QDC)

Profit (steps 1,2,4,5)	1120
Profit applied to SC1	454
Profit applied to SC2	112
Profit applied to SC3	58
$\Sigma P = \text{Total profit incl.}$	1744

Step 9 - Reduction in price to ensure profit only arises once

$\Sigma A \times \pi = \text{Total target profit net of CSAs}$	93.7
$\Sigma P = \text{Total profit incl.}$	163.0
$\text{POCO reduction} = \Sigma A \times \pi - \Sigma P$	-69.3

Step 10 - Allowable costs included in the pricing formula

Prime Allowable Costs used in section 15 pricing formula	1000
--	------

Step 11 - Calculate the Step 3 POCO adjustment

POCO reduction (step 9)	-69.3
Allowable Costs (step 10)	1000

POCO adjustment (POCO red/AC)	-6.93%
--------------------------------------	---------------

Cross-check to confirm that it works

Prime Allowable Costs	1000
Profit for steps 1,2,4 and 5	10%
Step 3 adjustment (POCO)	-6.93%
Step 6 adjustment (CSAs)	2.0%
Contract Profit Rate	5.07%
Price (AC+AC*CPR)	1050.7
Check against price as it should be	1050.7

Appendix C: Worked Example for Capital Servicing Adjustment

The worked example shown below incorporates the four main computations that need to be followed in order to determine the capital services adjustment in step 6 of the CPR.

To aid the worked example shown below we have provided the following illustrative information:

1. Total Capital Employed:
 - Example a): £4,000,000;
 - Example b): £4,500,000; and
 - Example c): £2,500,000.
2. Fixed Capital: £3,000,000 (in all three examples)..
3. Working Capital (by way of calculation i.e. total capital employed less fixed working capital):
 - Example a): £1,000,000;
 - Example b): £1,500,000; and
 - Example c): (£500,000).
4. Cost of Production: £6,000,000 (in all three examples).

This therefore allows “Computation 1” to be completed, although it will be based on actual figures for individual contractors.

This worked example uses the following recently-published capital servicing rates for 2015:

- Fixed Capital Servicing Allowance: 5.94%;
- Working Capital Servicing Allowance for positive working capital: 1.72%; and
- Working Capital Servicing Allowance for negative working capital: 1.03%.

These rates, published annually, are as provided in the SSRO 2015 Contract Profit Rate document.

	Example (a)	Example (b)	Example (c)
CP:CE ratio calculation:			
(a) Fixed capital	£3,000,000	£3,000,000	£3,000,000
(b) Working capital	£1,000,000	£1,500,000	(£500,000)
(c) Total capital employed	£4,000,000	£4,500,000	£2,500,000
(d) Total cost of production	£6,000,000	£6,000,000	£6,000,000
(e) CP:CE ratio (D/C)	1.50	1.33	2.4
This completes Computation 1			
Computation 2			
(f) Fixed Capital as a proportion of Capital Employed (a / c)	0.75	0.66	1.20
(g) Positive Working Capital as a proportion of Capital Employed (b / c)	0.25	0.34	-
(h) Negative Working Capital as a proportion of Capital Employed (b / c)	-	-	(0.20)
Capital Servicing Rates (published annually but given in this worked example)			
(i) Fixed Capital Servicing Rate	5.94%	5.94%	5.94%
(ii) Working Capital Servicing Rate (positive)	1.72%	1.72%	1.72%
(iii) Working Capital Servicing Rate (negative)	1.03%	1.03%	1.03%
Computation 3			
Fixed Capital Servicing Allowance (f x i)	4.46%	3.92%	7.13%
Positive Working Capital Servicing Allowance (g x ii)	0.43%	0.58%	-
Negative Working Capital Servicing Allowance (h x iii)	-	-	(0.20%)
Capital Servicing Allowance "x"	4.89%	4.50%	6.93%
Computation 4			
Capital Servicing Adjustment for step 6 ("x" / e)	3.26%	3.38%	2.89%

