SSRO

Single Source
Regulations Office

Assuring value, building confidence

Guidance on adjustments to the baseline profit rate 2017/18

Illustrative example

Contents

Introduction

1. About this Guidance

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

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

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

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

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

2. Application of this Guidance

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

2.2 It is a legal requirement to have regard to this guidance. This document provides guidance on the adjustments to make to the baseline profit rate when determining the contract profit rate for all qualifying defence contracts and qualifying sub-contracts.

3. Statutory Reports

3.1 In relation to any qualifying defence contract, or qualifying sub-contract, the primary contractor (or sub-contractor) must provide statutory reports as described in Part 5 of the Regulations.

3.2 Regulation 23(1) requires a contract pricing statement be provided for the qualifying defence contract within one month of the initial reporting date. Additional information can be found in the user guide for the contract pricing statement.

3.3 As stated in Regulation 23(2)(d) the contract pricing statement has to describe the calculation made under Regulation 11 to determine the contract profit rate. This includes all adjustments that were made under steps 1 to 6 as detailed in this guidance document. The calculation is detailed in the profit worksheet of the report template.

Baseline profit rate (Step 1)

4. Basis of Baseline Profit Rate

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

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

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

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

4.4 The methodology is used to calculate six baseline profit rates. The rates relate to four separate activity types, a composite activity category and a zero rate:

- develop and make;
- provide and maintain;
- ancillary services;
- construction;
- a composite rate for 'develop and make' and 'provide and maintain'; and
- a zero rate category for contracts with organisations which are not permitted or do not wish to make a profit and/or when the MOD and contractor agree that a zero rate is appropriate.

4.5 The application of the appropriate baseline profit rate to contracts is principles rather than rules based.

5. Principles of application of appropriate baseline profit rate

5.1 Contractors and the MOD must have regard to the following approach and principles when selecting the appropriate profit rate for a contract. The following paragraphs provide guidance on selecting the baseline profit rate that should be used.

Single activity type contract

5.2 The MOD and the contractor should choose an appropriate baseline profit rate which best applies to the contract requirements:

- develop and make;
- provide and maintain;
- ancillary services;
- construction; and
- zero rate.

5.3 In doing this the MOD and the contractor should have regard to the descriptions of typical work activities in Table 1 below.

5.4 In principle, one method of determining the appropriate baseline profit rate should be on the basis of the main contract activity, according to the Allowable Costs. For example, the main contract activity type could be determined by assigning the contractor's obligations to each activity type category and apportioning the total Allowable Costs associated with these to each category. The main contract activity is the category with the greatest proportion of Allowable Costs. Where there is an equal apportionment across activity types other than 'develop and make' and 'provide and maintain', where the composite rate would apply, the MOD and contractor should agree the single activity type which best applies to the contract requirements.

5.5 The SSRO acknowledges that a number of functions will need to be performed in contracts where there is one main activity type. However, the baseline profit rate for the main activity, rather than for all input activities, should be selected for the whole contract.

Composite rate for 'develop and make' and 'provide and maintain'

5.6 It is recognised that it may not always be possible to establish a single rate where the programme covers both 'develop and make' and 'provide and maintain'. Therefore, a composite rate has been calculated. The composite profit rate is calculated by taking a simple average of the two profit rates for the 'develop and make' activity type and the 'provide and maintain' activity type.

5.7 As a guide, if the proportion of the activities ('develop and make' and 'provide and maintain') are both in excess of one third of the total contract costs then consideration should be given to using this composite rate.

5.8 Where the MOD and contractor agree that there is more than one activity type, the MOD and the contractor can also agree to use separate contracts for each activity and apply the appropriate baseline profit rate to each contract.

5.9 The contract pricing method used does not affect the selection of a baseline profit rate.

Zero profit rate contracts

5.10 There may be circumstances in which the MOD desires to enter into a contract with an organisation which is not permitted or does not wish to make a profit. In these circumstances the MOD and contractor should agree to apply a zero rate. A consequence of using this zero rate should be that the Step 2 cost risk adjustment will also be zero.

6. Baseline profit rates

6.1 The SSRO has set out six baseline profit rates. Table 1 shows example contract activities relating to each activity type and the circumstances in which they should apply. The list of contract activities is presented as a guide and is not exhaustive.

Table 1: Baseline profit rates and example contract activities within each category

Rate	Description of category
1. Develop and make	This category includes manufacturing or assembly of goods or equipment to order based on designs or specifications provided. It also covers the disposal of equipment, the purchase of long-lead items for manufacture, prime contracting and systems integration and upgrade activities. It also includes research, design and development of technical intellectual property for goods, equipment, engineering or software performed to order, typically in line with any agreed design brief or specification. Activities within concept, assessment, demonstration, manufacture and disposal phase contracts should fall within this category.
2. Provide and maintain	This category includes any work undertaken that either provides the MOD with a capability where the contractor owns the assets, or where the contract covers work on in-service equipment. It includes servicing and upkeep for the MOD owned equipment, including ongoing engineering and maintenance and includes training related to the introduction and operation of equipment. Activities within 'in-service' phase contracts and contracts for the provision of availability of equipment should typically fall within this category. Provision of asset hours (for example flying hours for an aircraft) through hiring out or leasing equipment to the MOD should also be included.
3. Ancillary services	This category includes back office and routine support services, for example clerical work or upkeep of grounds and facilities. Typical activities include IT support services (for example data processing, network hosting, IT repairs and maintenance, IT security services); facilities support services (for example property cleaning, property repairs and maintenance, gardening, security services); and administrative support services (for example business outsourcing such as data management, bookkeeping).
4. Construction	This category applies to contracts for construction or related activities which include architectural, engineering and/or building services. The buildings or sites being constructed, designed or planned would include, for example, those that are industrial or commercial in nature i.e. factories, warehouses, docks, plants, metal structures and office accommodation.
5. Composite rate for 'develop and make' and 'provide and maintain'	This category should include a combination of 'develop and make' and 'provide and maintain' activities. This rate should be used when both proportions of 'develop and make' and 'provide and maintain' activities are in excess of one third of the total contract costs.
6. Zero rate	This category should apply to a contract with a supplier which is not permitted or does not wish to make a profit and/or when the MOD and contractor agree that a zero rate is appropriate.

Cost risk adjustment (Step 2)

7. Basis of cost risk adjustment

7.1 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".

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

8. Regulated pricing methods

8.1 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)).

8.2 There are six regulated pricing methods that the parties to a qualifying defence contract may decide to use, as set out in Regulation 10(4) to 10(11). All regulated pricing methods use either an estimate or actual Allowable Cost base.

9. Principles of risk adjustment

General approach

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

9.2 The purpose of the cost risk adjustment is to incorporate into the contract profit rate an additive to reflect the risk that the contractor's actual Allowable Costs in delivering the requirement will differ from the estimated Allowable Costs included in the contract price. While one factor will be the proportion of actual versus estimated costs included in the pricing method, other factors also drive risk. The adjustment should be agreed by considering the principles stated at paragraph 9.11.

9.3 For qualifying defence contracts that are based on the cost-plus or estimate-based fee pricing methods, the cost risk adjustment should be minus 25 per cent, because actual Allowable Costs are used to determine the costs to be paid, although the MOD and the contractor should always have regard to the principles at paragraph 9.11.

9.4 For all other pricing methods, the adjustment may vary from minus 25 per cent to plus 25 per cent, depending on the risk of actual Allowable Costs differing from estimated Allowable Costs, using the following guidance and the principles stated at paragraph 9.11.

9.5 Subject to the considerations of the regulated pricing method, the starting point for the appropriate cost risk adjustment is that none should apply. A positive or negative cost risk adjustment should apply where it can be reasonably justified and evidenced.

Negative adjustment

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

9.7 For example, this may be justified where there are risks that are well understood and for the large part mitigated.

9.8 The SSRO recognises that for some defence contracts most of the cost risk associated with one or more sub-contracts is held by, or assigned to, the Secretary of State. It is appropriate to recognise these circumstances when agreeing a cost risk adjustment. The cost risk adjustment should reflect the reduced risk of the primary contractor's actual Allowable Costs under the contract differing from its estimated Allowable Costs, thus recognising the reduced risk held by the prime contractor associated with the sub-contract(s).

Positive adjustment

9.9 A positive adjustment should be made where the MOD and the contractor agree there are higher risks of actual Allowable Costs differing from estimated Allowable Costs.

9.10 For example, this may be justified where the risk is held by the contractor, and not the MOD, and where the risks are not well understood and/or cannot managed in the Allowable Costs because they are not in the control of the contractor and therefore cannot be mitigated.

Principles to consider

9.11 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. give consideration to the contract pricing method (refer to 9.3 and 9.4);

c. not take into account risk that should be managed in estimated Allowable Costs;

d. be based upon an assessment of the extent to which actual Allowable Costs may vary from estimated Allowable Costs, both positively and negatively;

e. take into account the relative likelihood of actual Allowable Costs being over or under estimated Allowable Costs;

f. take into account the extent to which the probability and expected impact of cost risk has been mitigated, eliminated or transferred to another party, for example through insurance or where sub-contract risk is 'passed through' to a party other than the prime contractor;

g. take into account the extent to which cost risk should be covered through Allowable Costs;

h. reflect and draw upon the overall approach to risk assessment such as risk allocation, management, and risk registers (and be recorded in the risk register);

i. not take into account uncertainty resulting from force majeure, for example an unforeseeable natural disaster; and

j. be based on reasonable documented assumptions and/or evidence.

Profit on cost once adjustment (POCO) (Step 3)

10. Basis of POCO adjustment

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

10.2 "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)".

10.3 This adjustment ensures that if a party to a qualifying defence contract enters into a single source sub-contract with another group member, and this group sub-contract is necessary to enable the performance of the qualifying defence contract, then profit arises only once in relation to Allowable Costs included in the group sub-contract price.

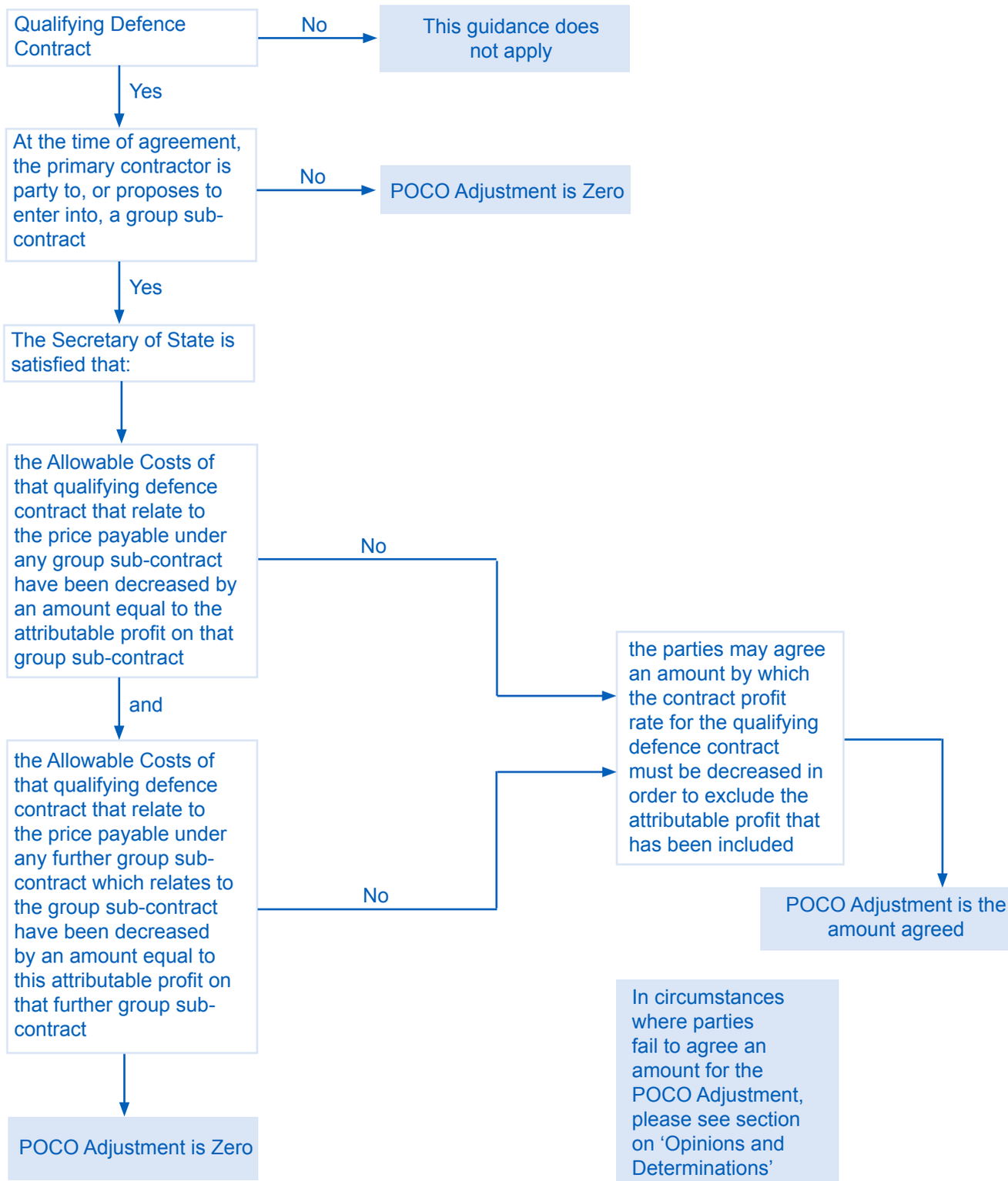
11. Application of POCO adjustment

11.1 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.

a. The purpose of this guidance is to provide a consistent methodology for contractors and the MOD to follow when agreeing a POCO adjustment amount.

b. The POCO adjustment does not apply:
   i. to non-competitive sub-contracts with a value less than £100,000;
   ii. to any profit included in sub-contracts to non-group members;
   iii. to any profit included in sub-contracts to group members if these sub-contracts were awarded competitively; or
   iv. to any profit included in the price of the sub-contractor outside the delivery of the qualifying defence contract.

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


Qualifying Defence Contract
No
This guidance does not apply
Yes
At the time of agreement, the primary contractor is party to, or proposes to enter into, a group sub-contract
No
POCO Adjustment is Zero
Yes
The Secretary of State is satisfied that:
the Allowable Costs of that qualifying defence contract that relate to the price payable under any group sub-contract have been decreased by an amount equal to the attributable profit on that group sub-contract
No
and
the Allowable Costs of that qualifying defence contract that relate to the price payable under any further group sub-contract which relates to the group sub-contract have been decreased by an amount equal to this attributable profit on that further group sub-contract
No
POCO Adjustment is Zero
the parties may agree an amount by which the contract profit rate for the qualifying defence contract must be decreased in order to exclude the attributable profit that has been included
POCO Adjustment is the amount agreed
In circumstances where parties fail to agree an amount for the POCO Adjustment, please see section on 'Opinions and Determinations'

12. Methodology to determine the POCO adjustment

12.1 The information upon which the POCO calculation is constructed is likely to be held by the prime contractor and their group sub-contractors and not the MOD. In such cases, in order for the parties to reach an informed agreement as to the POCO adjustment:

a. the prime contractor should propose the POCO adjustment to the MOD, supported by the facts, assumptions and calculations relied upon; and

b. the MOD should scrutinise those matters and request any further information required to form a view as to the amount by which the contract profit rate must be decreased in order to exclude attributable profit that has been included.

12.2 The table below demonstrates the 12 stage process that contractors and the MOD must have regard to when agreeing the POCO adjustment amount.

12.3 Please refer to Appendix A for a glossary of the terms used below. Please refer to Appendix B for a high level worked example of the process to aid users

Stage	Ref	Process
For the primary contract:		
1	-	Document the expected contract supply chain, identifying all the group sub-contracts and further group sub-contracts.
2	-	Identify the group sub-contracts and further group sub-contracts which are not the result of a competitive process.
For the primary contract and each group single source sub-contract identified at Stage 2:		
3	AC	Identify the allowable costs for the prime contractor and the applicable costs of each group sub-contract.
4	P	Calculate the contract profit rate for the primary contractor (before the application of Step 3 (POCO) and Step 6 (CSA)) multiplied by the allowable costs of the prime contractor and calculate the attributable profit applied to each group sub-contract.
For the primary contract POCO adjustment:		
5	∑AC	Sum the total allowable costs in the primary contract and the applicable costs of the group sub-contracts.
6	π	Calculate the contract profit rate for the primary contract before the application of Step 3 (POCO) and Step 6 (CSA). This will be: Step 1 (BPR) +/- Step 2 (risk adj.) - Step 4 (SSRO funding adj.) + Step 5 (incentive adj.).
7	∑AC x π	Multiply the total of the allowable costs of the prime contractor and the applicable costs of the group sub-contracts (∑AC) by the profit rate (π).This gives the target profit that the group should receive from the qualifying defence contract (net of primary contract CSA).
8	∑P	Sum the contract profit for the primary contractor (before the application of Step 3 (POCO) and Step 6 (CSA)) and the total attributable profit of the group sub-contracts at each level.
9	$POCO_R$ = (∑AC x π) -∑P	To calculate the POCO reduction, subtract the total of the contract profit rate for the primary contract (before the application of Step 3 (POCO) and Step 6 (CSA)) and the total attributable profit of the group sub-contracts (∑P) from the target profit (∑AC x π). This is the reduction to the price that will result from the Step 3 POCO adjustment.
10	∑A	Determine the Allowable Costs included in the primary contract (including group sub-contractor prices) for the purposes of the pricing formula.
11	POCO adj	The POCO adjustment is the POCO reduction ($POCO_R$) divided by the Allowable Costs for the primary contract (IA). This is the Step 3 adjustment, which will result in a reduction to the profit (or zero if no profit has been charged at lower levels).
12	(∑A + (∑A*CPR))	Apply all adjustments (Steps 1 to 6) to calculate the contract profit rate (CPR) which is applied to the allowable costs associated with the primary contract (∑A) using the formula (∑A+(∑A*CPR)). Cross check the calculated contract price to expectations.

SSRO funding adjustment (Step 4)

13. Basis of the funding adjustment

13.1 Section 19(2) of the Act, and Regulation 11(5), set out the requirement for the funding adjustment:

> "For the purpose of assisting the Secretary of State in determining for a financial year each of the rates mentioned in subsection (1) and the SSRO funding adjustment, the SSRO must provide the Secretary of State with its assessment of what is the appropriate rate or funding adjustment for that year."

14. Application of the funding adjustment

14.1 Subtract from the amount resulting from Step 3 the SSRO funding adjustment in force at the time of the agreement, which is from the amount resulting from Step 3:

a. until 31 March 2017, zero; and

b. on or after 1 April 2017, the rate published in the London Gazette in accordance with section 19(4) of the Act.

Incentive adjustment (Step 5)

15. Basis of incentive adjustment

15.1 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."

15.2 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 adjustment between zero and 2 percentage points.

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

16. When to apply incentive adjustment

16.1 It may be desirable for the Secretary of State to include a positive incentive in certain circumstances.

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

17. Principles of applying incentive adjustment

17.1 The inclusion of an incentive adjustment is at the Secretary of State's discretion. When considering whether to apply an incentive adjustment the Secretary of State should have regard to the following principles:

a. The incentive adjustment can be applied to any qualifying defence contract, or qualifying sub-contract using any regulated pricing method. The incentive adjustment must relate to the performance of the contract to which it applies.

b. The incentive adjustment must be used for delivering performance on a contracted performance metric. The contract should be priced on the basis that a contractor will deliver the performance specified in the contract.

c. 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.

d. The incentive adjustment must be within a range of up to 2 percentage points. A positive incentive adjustment will not be applied to all qualifying defence contracts and is not an entitlement.

e. The link between the incentive adjustment and performance must be simple and measureable. The criteria for achievement must be measurable and set objectively.

f. The link between the incentive adjustment and performance, and 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.

g. 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 legislative obligations.

h. The incentive adjustments should not be linked to a reduction in the Allowable Costs of the contract. Reducing Allowable Costs of a contract should be rewarded via the chosen regulated pricing method.

17.2 Subject only to this guidance and the maximum incentive adjustment of 2 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)

18. Basis of capital servicing adjustment

18.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment:

"Take the amount resulting from step 5 and add to or subtract from it an agreed amount ("the capital servicing adjustment"), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract."

18.2 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."

19. Importance of Step 6 adjustment

19.1 The capital servicing adjustment ensures that a contractor receives an appropriate and reasonable return on their investment in fixed and working capital.

19.2 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.

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

20. Calculating the capital servicing adjustment

20.1 The Capital Servicing Adjustment (CSA) calculation requires input of three pieces of data that are likely to be held by the prime contractor and their group sub-contractors and not the MOD – the fixed capital, working capital and cost of production. The prime contractor should propose the CSA adjustment to the MOD, supported by the facts, assumptions and calculations relied upon; the MOD should scrutinise those matters and request any further information required to agree the final adjustment.

20.2 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'.

20.3 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.

20.4 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.

20.5 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.

20.6 The following section guidance sets out the principles to be followed in order to assess the level of capital employed and the total cost of production.

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

21. Calculation of capital employed

21.1 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 a subsidiary company, division or site location. The contractor should apply the most relevant unit of their business based upon their professional judgement.

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

21.3 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.

21.4 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. land and buildings not in occupation;
   ii. plant and machinery demonstrably not in use;
   iii. where held for speculative purposes or for long term expansion not yet planned; or
   iv. where there has been unreasonable delay in disposal of surplus assets.

g. certificates of tax deposit; and

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

21.5 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 any inventory in the balance sheet, provided it is accompanied by Auditor Attestation. If a contractor has not already done so in its balance sheet then interim payments on account of work in progress are to be deducted.

d. Patents and trade-marks, may be included to the extent that a company can demonstrate that they are registered in the name of the contractor and have not lapsed (or the contractor has a valid licence to use) and they actively or defensively contribute to the conduct of the business, even if they are not shown in the contractor's balance sheet.

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

f. Where a customer has paid an amount due in respect of the contract prior to the performance of part or all of the obligations under the contract (for example where there is a contract liability) the advance payment or payments received is treated as a 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 MOD on single source 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 an 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.

21.6 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.

21.7 Provided no further adjustment has taken place in the group accounts, a contractor's total capital employed in the business unit 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

21.8 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'.

21.9 Adequate justification should be provided to support the calculation of both fixed and working capital.

22. Calculation of cost of production

22.1 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.

22.2 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.

22.3 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 servicing adjustment

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

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

Opinions and determinations

23. Overview

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

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

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

24. Opinions

24.1 The SSRO must give an opinion on the appropriate amount of a cost risk adjustment (or group cost risk adjustment), POCO adjustment (or group POCO adjustment) or capital servicing adjustment (or group capital servicing adjustment) for a qualifying defence contract (if the contract price were to be re-determined) or a proposed qualifying defence contract, or a qualifying sub-contract (if the contract price were to be re-determined) or a 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 (in the case of a qualifying defence contract);

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

e. the contracting authority (in the case of a qualifying sub-contract); or

f. the person who proposes to enter into the qualifying sub-contract.

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

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

b. the Secretary of State and the sub-contractor in the case of a qualifying sub-contract, or the Secretary of State and the proposed sub-contractor, in the case of a proposed qualifying sub-contract.

25. Determinations

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

a. the Secretary of State;

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

c. the sub-contractor (in the case of a qualifying sub-contract).

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

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

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

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

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

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

Appendix A: Glossary of terms

Group sub-contract

Group sub-contract means a contract:

a. where 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. where the value of which is no less than £100,000;

d. where 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. where 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. where the value of which is no less than £100,000;

d. where 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.

Fixed Capital

Tangible fixed assets

Working Capital

Current assets, less cash, less current liabilities, plus short term debt

Capital employed

Fixed capital plus working capital.

Appendix B: Worked example of POCO adjustment

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

Expected contract price

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

Key:

Input:

Calculation:

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

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

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

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

Methodology to determine the POCO adjustment

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

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

Key:

Input:

Calculation:

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

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

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

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

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

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

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

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

Stage 8 - Total attributable profit (net of step 3 and CSAs on the Primary QDC)	
Profit (steps 1,2,4,5) Profit applied to SC1 Profit applied to SC2 Profit applied to SC3	100 48 8 7
∑P = Total profit at all levels	163

Stage 9 - Reduction in price to ensure profit only arises once	
Total target profit (∑AC x π) *deduct* Total profit at all levels (∑P)	93.7 163.0
$POCO_R$ = POCO reduction	-69.3

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

Stage 11 - Calculate the Step 3 POCO adjustment	
$POCO_R$ *divided by* Allowable Costs (∑A) (Stage 10)	-69.3 1000
POCO adjustment	**-6.93%**

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

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

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

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

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

- Fixed capital servicing allowance: 5.94%;
- Working capital servicing allowance for positive working capital: 1.72%; and
- Working capital servicing allowance for negative working capital: 1.03%.

These rates, published annually, are as provided in the SSRO *Single source baseline profit rate, funding adjustment and capital servicing methodology* document.

	Example (a)	Example (b)	Example (c)
Computation 1			
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 14/15 rates for this worked example only)			
(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%