

SSRO

Single Source
Regulations Office

Guidance on the baseline profit rate and its adjustment 2019/20

Version 5

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Versions of this guidance

This is version 5 of the guidance on the baseline profit rate and its adjustment which applies to contracts agreed on or after 1 April 2019. It is a legal requirement to have regard to this guidance, which supersedes all previous versions.

The table in Appendix A highlights changes that have been made from the previous version of the guidance.

The publication and application dates of versions of this guidance are shown below.

Version number	Date published	Applies to contracts agreed on or after
5	18 March 2019	1 April 2019
4	15 March 2018	15 March 2018
3	15 March 2017	15 March 2017
2	24 March 2016	24 March 2016
1	26 March 2015	27 March 2015

1. Introduction

About this guidance

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



- 1.2 In accordance with Section 30 of the Act, Part 2 of the Act and the Regulations “apply to qualifying 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 contract 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.

Application of this guidance

- 1.5 This is statutory guidance issued by the SSRO under Section 18(1) of the Act. It applies to all qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). This document updates the version published in March 2018 to include:
- a. the baseline profit rate, SSRO funding adjustment and capital servicing rates that apply for the financial year commencing 1 April 2019;
 - b. revised guidance on the application of the Step 6 capital servicing adjustment; and
 - c. revised section and paragraph numbering.¹
- 1.6 It is a legal requirement to have regard to this guidance when applying the six steps. This document provides guidance on the adjustments to make to the baseline profit rate when determining the contract profit rate for all QDCs and QSCs in respect of which the time of agreement (as defined in Regulation 2(1)) is on or after the date this guidance takes effect. The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.²

Statutory reports

- 1.7 In relation to any QDC, or QSC, the primary contractor (or sub-contractor) must provide statutory reports as described in Part 5 of the Regulations.
- 1.8 Regulation 23(1) requires a contract pricing statement be provided for the QDC within one month of the initial reporting date.
- 1.9 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.

Relevant records

- 1.10 In relation to a QDC, Regulation 20 requires the primary contractor to keep 'relevant records'. In the case of a QSC, it is the sub-contractor who is so required. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor, as the case may be, 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State for specific purposes, such as verifying certain matters relating to the price payable under a QDC or QSC. Such matters may include the calculation of the contract profit rate.

¹ A guide to the changes which have occurred from the previous version is provided in Appendix A.

² SSRO (2018) *DefCARS Reporting Guidance and System User Guide for Defence Contractors - Version 5*. Paragraphs 4.8 to 4.31.

Key terms and definitions

Allowable Costs	A term used for the costs incurred to deliver a QDC or QSC. Costs must be appropriate, attributable to the contract and reasonable in the circumstances to be considered Allowable.
Baseline profit rate (BPR)	Section 17(2) of the Act and Regulation 11 require that the contract profit rate for any qualifying defence contract must be calculated by applying six steps. The first step requires taking the baseline profit rate which has been determined by the Secretary of State.
Capital employed (CE)	The total amount of capital used for the acquisition of profits or the capital investment necessary for a business to function. The SSRO defines this as the sum of fixed and working capital.
Capital servicing adjustment	A term used to refer to fixed capital servicing adjustment and positive or negative working capital servicing adjustments collectively.
Cash and cash equivalents	A term used for current assets comprising receivables from other sources, short-term investment of money, and cash at hand and at bank.
Cost of production (CP)	A cost incurred by a business when manufacturing a good or providing a service before financing charges (interest). It is calculated as: cost of production = operating revenue (turnover) – operating profit/loss [EBIT].
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio can be used at the company level or can be used to attribute a proportion of the contractor's capital employed to individual contracts.
Current assets	A company's balance sheet items that represent the value of all assets that can reasonably expect to be converted into cash within one year.
Current liabilities	A company's balance sheet items that represent debts or obligations that are due within one year.
Defence Reform Act 2014	The primary legislation applicable to QDCs.
Fixed capital	The total capital outlay that is invested in fixed assets, that stay in the business almost permanently – or at the very least, for more than one accounting period. The assets are considered fixed in that they are not used up in the actual production of a good or service but have a reusable value. Fixed capital investments are typically depreciated over a number of years.
Fixed capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in fixed capital.

Fixed capital servicing rate	The cost of servicing medium-term to long-term (i.e. more than one year) debts.
Negative working capital	A term used when the working capital number is negative. It results when a company holds less current assets than its current liabilities.
Negative working capital servicing adjustment	An adjustment that accounts for the rate of return (interest earned) which is attributed to investment in negative working capital (i.e. depositing creditors' cash on fixed-deposit accounts).
Negative working capital servicing rate	The rate of return (interest earned) on short-term (i.e. up to one year) bank deposits.
Positive working capital	A term used when the working capital number is positive. It results when a company holds more current assets than its current liabilities.
Positive working capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in positive working capital.
Positive working capital servicing rate	The cost of servicing short-term (i.e. up to one year) debts.
Qualifying defence contract (QDC)	Those contracts that fall within the scope of the Act and the Regulations, and that the MOD has not exempted from being a QDC. In such contracts an allowance for profit is calculated by reference to the baseline profit rate applicable at the time of pricing.
Qualifying sub-contract (QSC)	A QSC is a contract between a primary contractor and another contractor or between a sub-contractor and another contractor where it meets the definition laid down in Section 28 of the Act and has been assessed and notified as a QSC pursuant to the procedure under Section 29 of the Act.
Single Source Contract Regulations (SSCRs)	Secondary legislation in the form of a Statutory Instrument, enabled by the Act.
Single Source Regulations Office (SSRO)	The independent non-departmental public body established under the Act, with wider powers and remit than the Review Board.
Working capital	A measure of both a company's efficiency and current/short-term (up to one year) financial health. It indicates how much capital a company uses in its day-to-day activities.

2. Baseline profit rate (Step 1)

Basis of Baseline Profit Rate

- 2.1 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”.
- 2.2 The relevant time should be the time of agreement, as defined in Regulation 2(1). The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.³
- 2.3 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 QDCs.
- 2.4 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. The baseline profit rate in force for the financial year commencing 1 April 2019 is:⁴

2019/20 baseline profit rate
7.63%

³ SSRO (2018) *DefCARS Reporting Guidance and System User Guide for Defence Contractors - Version 5*. Paragraphs 4.8 to 4.31.

⁴ Figures for earlier years are available in the *London Gazette*.

3. Cost risk adjustment (Step 2)

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-based rather than rules-based.

Regulated pricing methods

- 3.3 Regulation 10(2) states that the parties to a QDC 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)).
- 3.4 There are six regulated pricing methods that the parties to a QDC 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.

Principles of risk adjustment

General approach

- 3.5 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.
- 3.6 The purpose of the cost risk adjustment is to incorporate into the contract profit rate an additive or deduction 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 3.15.
- 3.7 For QDCs 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 3.15.
- 3.8 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 3.15.
- 3.9 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

- 3.10 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.
- 3.11 For example, this may be justified where there are risks that are well understood and for the large part mitigated.

- 3.12 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

- 3.13 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.
- 3.14 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 be managed in the Allowable Costs because they are not in the control of the contractor and therefore cannot be mitigated.

Principles to consider

- 3.15 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 3.7 and 3.8);
 - 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.

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

Basis of POCO adjustment

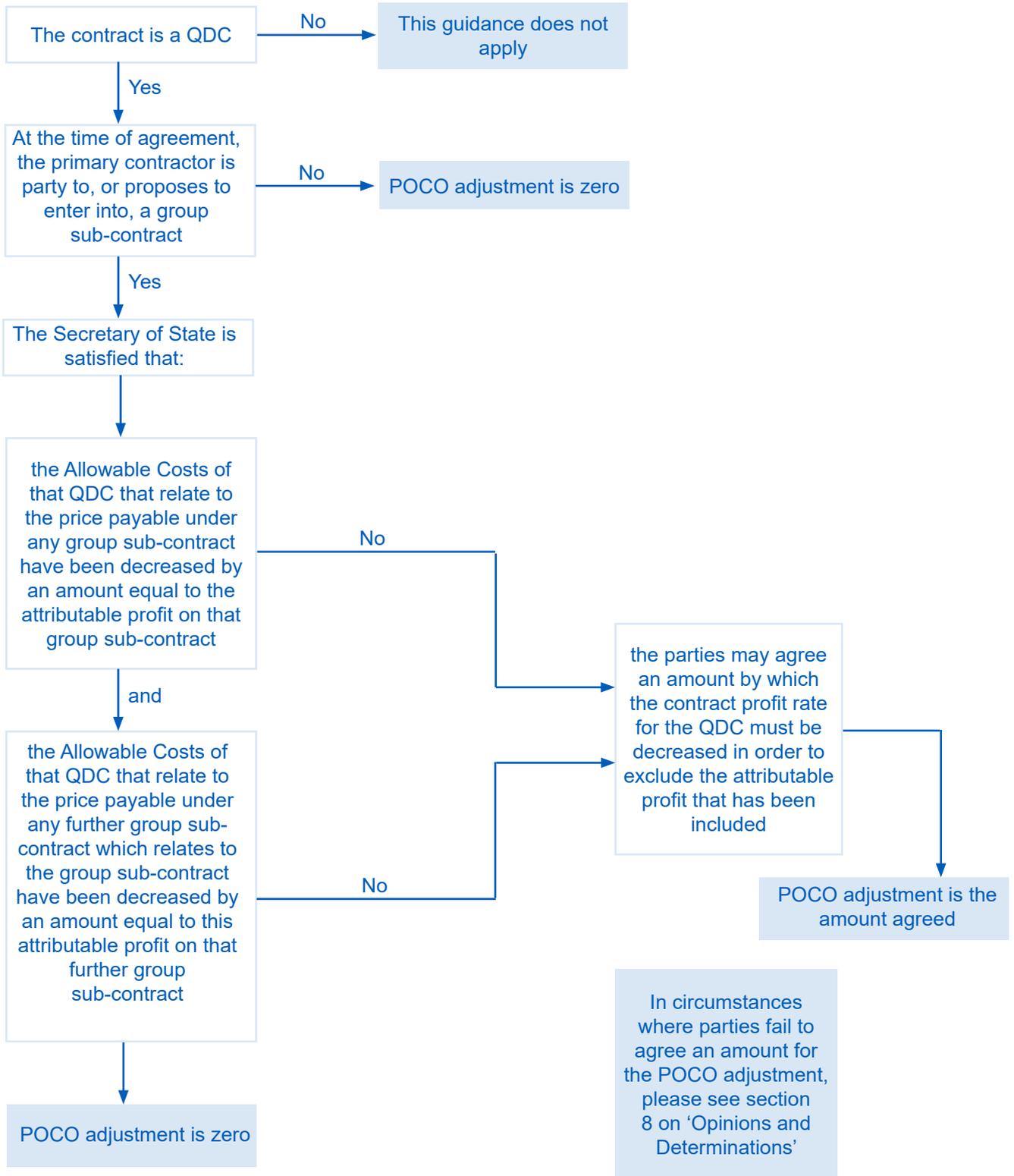
- 4.1 Section 17(2) of the Act and Regulation 11(4) set out the requirement for the POCO adjustment:

“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).”

- 4.2 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.

Application of POCO adjustment

- 4.3 The POCO adjustment applies to a QDC 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 QDC.
- 4.4 The diagram on the next page demonstrates when a POCO adjustment should be made.



Methodology to determine the POCO adjustment

- 4.5 The information upon which the POCO adjustment calculation is constructed is likely to be held by the prime contractor and its 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.
- 4.6 The table below demonstrates the process that contractors and the MOD must have regard to when agreeing the POCO adjustment amount.
- 4.7 Please refer to Appendix B for a glossary of the terms used below. Please refer to Appendix C for a high-level worked example of the process to aid users.

Stage	Process	Calculation (see Appendix B)
1	Document the expected contract supply chain, identifying all the group subcontracts and further group subcontracts (see 4.3) to which the POCO adjustment applies. Note the total Allowable Costs (used for the purposes of the pricing formula) for each contract.	
2	Calculate the contract profit rate (before the application of Step 3 (POCO) and Step 6 (CSA)) for the primary contract (CPR_p) and each group sub-contract (and further group sub-contracts) (CPR_{Si}) identified at stage one.	CPR_p CPR_{S1} CPR_{S2} CPR_{Si}
3	Multiply total Allowable Costs identified at stage one for the primary contract (AC_p) and each the group (and further group) sub-contracts (AC_{Si}) by their respective contract profit rates calculated at stage two. The result is the profit for the primary contractor (π_p) and the attributable profits of each group sub-contractor (π_{Si}) (net of POCO adjustment and CSA).	$AC_p \times CPR_p = \pi_p$ $AC_{S1} \times CPR_{S1} = \pi_{S1}$ $AC_{S2} \times CPR_{S2} = \pi_{S2}$ $AC_{Si} \times CPR_{Si} = \pi_{Si}$
4	Sum the profits calculated at stage three to determine the total group profit (net of POCO adjustment and CSA). This comprises the profits of the primary contractor (π_p) and the sum of all attributable profits for all group sub-contractors ($\sum \pi_s$).	$\pi_p + \pi_{S1} + \pi_{S2} + \pi_{S3} \dots$ = $\pi_p + \sum \pi_s = \sum \pi$
5	Note the total Allowable Costs of the primary contract (AC_p) and subtract from it the sum of the attributable profits for all group sub-contract ($\sum \pi_s$) calculated at stage two.	$AC_p - \sum \pi_s = AC^*$
6	Multiply the value calculated at stage five by the primary contract profit rate (CPR_p) derived at stage two. This gives the target profit that the group should receive from the QDC (net of primary contract CSA).	$AC^* \times CPR_p = \pi_T$
7	Subtract the total group profit from stage four (before the application of Step 3 (POCO)) and Step 6 (CSA)) from the target profit from stage six. This is the reduction to the price that will result from the Step 3 POCO adjustment.	$\pi_T - \sum \pi$ = $POCO_R$
8	The POCO adjustment is the POCO reduction ($POCO_R$) divided by the total Allowable Costs for the primary contract identified at stage five. 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).	$POCO_{adj}$ = $POCO_R / AC_p$
9	Apply all adjustments (Steps 1 to 6) to calculate the contract profit rate (CPR) which is applied to the total Allowable Costs associated with the primary contract. Cross check the calculated price to expectations.	$AC_p + (AC_p \times CPR)$

5. SSRO funding adjustment (Step 4)

Basis of the funding adjustment

- 5.1 Section 17(2) of the Act, and Regulation 11(5), set out the requirement for the funding adjustment.

Application of the funding adjustment

- 5.2 Subtract from the amount resulting from Step 3 the SSRO funding adjustment in force at the time of the agreement as defined in Regulation 2(1), which is –
- until 31 March 2017, zero; and
 - on or after 1 April 2017, the rate published in the *London Gazette* in accordance with section 19(4) of the Act.
- 5.3 The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.⁵
- 5.4 The SSRO funding adjustment in force for the financial year commencing 1 April 2019 is:⁶

2019/20 SSRO funding adjustment

0.042%

⁵ SSRO (2018) *DefCARS Reporting Guidance and System User Guide for Defence Contractors - Version 5*. Paragraphs 4.8 to 4.31.

⁶ Figures for earlier years are available in the *London Gazette*.

6. Incentive adjustment (Step 5)

Basis of incentive adjustment

- 6.1 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.”

- 6.2 This document provides guidance for the Secretary of State to use when determining when to apply the incentive adjustment to a QDC and what to consider when setting the adjustment between zero and two percentage points.
- 6.3 The incentive adjustment guidance is principles-based rather than rules-based.

When to apply incentive adjustment

- 6.4 It may be desirable for the Secretary of State to include a positive incentive in certain circumstances.
- 6.5 The incentive adjustment is not automatic and will be applied exceptionally for QDCs.

Principles of applying incentive adjustment

- 6.6 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 QDC or QSC 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 two percentage points. A positive incentive adjustment will not be applied to all QDCs and is not an entitlement.
 - e. The link between the incentive adjustment and performance must be simple and measurable. 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.

- 6.7 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.
- 6.8 The incentive adjustment 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.
- 6.9 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 QDC.

7. Capital servicing adjustment (Step 6)

Basis of capital servicing adjustment

- 7.1 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.”

- 7.2 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.”

- 7.3 The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.⁷

- 7.4 Section 30 of the Act sets out that “[the Act] and single source contract regulations apply to qualifying subcontracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)”

- 7.5 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2019 are:⁸

Item	Rate
Fixed capital	3.98%
Positive working capital	1.18%
Negative working capital	0.53%

- 7.6 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2019) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.

⁷ SSRO (2018) *DefCARS Reporting Guidance and System User Guide for Defence Contractors - Version 5*. Paragraphs 4.8 to 4.31.

⁸ Figures for earlier years are available in the *London Gazette*.

Calculating the capital servicing adjustment

- 7.7 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor's obligations under the contract (the CSA calculation).
- 7.8 The next sections of the guidance set out the calculations of capital employed and of cost of production, which are required for the CSA calculation. The diagrams after that guidance set out the four computations to be performed. A simple worked example is described at Appendix D to this guidance.
- 7.9 The CSA calculation ensures the contractor receives an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purposes of enabling it to perform the contract. On this basis borrowing costs should not form part of Allowable Costs.
- 7.10 The CSA calculation assumes that the capital intensity of the unit of business (that is the ratios of its fixed and working capital to its cost of production for a given period) is equivalent to the capital intensity of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.
- 7.11 The contractor and the Secretary of State must use the information of the unit of business which they agree is most relevant to the contract. This may be a subsidiary company, division, business unit, or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.
- 7.12 The calculation has two components: the capital employed and the cost of production. Both components should be derived from the same financial records or should be adjusted to ensure they are on the same basis. For example, if cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as financial or management accounts, then components of capital employed, for example manufactured inventory, may need adjustment to ensure they are valued on the same cost basis.
- 7.13 Regardless of which financial periods are described in the records from which data is drawn to determine the capital employed and cost of production, the capital servicing rates to which the relevant parties must have regard are those in force at the time of the agreement (see paragraph 7.3), not those relating to any other period.

Calculation of capital employed

- 7.14 Capital employed is the debt and equity necessary for a unit of business to function. Directly calculating this may be difficult because a unit of business may not separately report the debt and equity necessary for a business to function from other debt and equity. Capital employed is instead indirectly calculated with reference to the equal and opposite balance sheet items for which more granular information is available.
- 7.15 Capital employed should be computed as the total assets less total liabilities, excluding interest-bearing liabilities, of the business unit.
- 7.16 Capital employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.

- 7.17 The capital employed is adjusted to remove elements that are not part of normal operations, are equivalent to debt, or would not result in an appropriate result if included in the calculation. These adjustments seek to achieve a result that, when taken with the cost of production as a ratio, approximates the capital intensity of the contract as closely as is practicable.
- 7.18 The initial definition of capital employed is total assets less total liabilities, except for interest-bearing liabilities. The following items should then generally be excluded:
- a. items not representing capital employed in normal operations, for example:
 - i. goodwill, brands and customer lists acquired in a business combination;
 - ii. fair value adjustments that did not require additional input of capital, for example, the upward revaluation of tangible and intangible assets;
 - iii. investments in shares and securities;
 - iv. loans to or from other companies, including non-trading balances with group entities;
 - v. assets held for sale and idle assets not required for the normal operation of the business; or
 - vi. cash that exceeds the amount required for normal operations. Normal operational requirements might include holding cash for the purpose of meeting liabilities included in the calculation of capital employed;
 - b. items that are indirect ways of raising capital that should be treated as debt equivalents, for example:
 - i. deferred tax assets or liabilities; or
 - ii. retirement benefit surpluses or obligations; and
 - c. other items whose inclusion would not result in an appropriate Step 6 adjustment.
- 7.19 Where cash is held in a group pooling arrangement outside the balance sheet of the unit of business used for the calculation, a value of cash required for normal operations of the business unit may be included as an element of capital employed.
- 7.20 Exceptional further adjustments may be agreed with the Secretary of State if they can be reliably estimated and have a material impact on the result. Any adjustment will depend on the information available and the specific circumstances of the contract being delivered. Examples of such situations are:
- a. where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or
 - b. where considering the timing of a significant transaction during the period will give a more precise average.

Fixed and working capital

- 7.21 To calculate the split of capital employed between fixed and working capital employed a contractor should identify balance sheet items that are fixed in nature; this will generally include items that are held for more than one year. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive or negative.

- 7.22 Adequate justification should be provided to support the calculation of both fixed and working capital. In determining what type and standard of information is required, the relevant parties should take a proportionate approach considering:
- a. the specific requirements and circumstances of the contract;
 - b. the materiality of particular components of the calculation; and
 - c. what it is reasonable to expect would be available.

Calculation of cost of production

- 7.23 Cost of production is the cost incurred by the functioning of a business before financing charges.
- 7.24 Where the period to which the cost of production relates is not one year, an equivalent annual value should be computed because the capital servicing rates to which the CP:CE ratio is applied are an annual rate of return.
- 7.25 The initial definition of cost of production is operating revenue less operating profit/loss. The following items should then generally be excluded:
- a. borrowing costs;
 - b. costs related to items excluded from capital employed; and
 - c. costs whose inclusion would not result in an appropriate Step 6 adjustment.
- 7.26 Where exceptional adjustments have been made to capital employed in accordance with paragraph 7.20, a corresponding adjustment to cost of production may be required.

Computation 1
Determine ratio of capital employed to cost of production
Fixed capital value
Plus
Working capital value
<u>EQUALS</u>
Capital employed
Divide into
Cost of production
<u>EQUALS</u>
Cost of production as a proportion of capital employed (CP:CE)

Computation 3
Apply capital servicing rates
Fixed capital as a proportion of capital employed
Multiplied by
Fixed capital servicing rate
PLUS
Working capital (positive) as a proportion of capital employed
Multiplied by
Positive working capital servicing rate
<u>OR (if working capital is negative)</u>
Working capital (negative) as a proportion of capital employed
Multiplied by
Negative working capital servicing rate
<u>EQUALS</u>
Capital servicing rate ⁹

Computation 2
Determine the individual proportions of capital employed
Fixed capital value
Divided by
Capital employed
<u>EQUALS</u>
Fixed capital as a proportion of capital employed
Working capital value
Divided by
Capital employed
<u>EQUALS</u>
Working capital as a proportion of capital employed

Computation 4
Calculate the capital servicing adjustment for Step 6
Capital servicing rate
Divided by
Cost of production as a proportion of capital employed (CP:CE)
<u>EQUALS</u>
Capital servicing adjustment to be used in Step 6 of CPR

⁹ The capital servicing rate can be positive or negative.

8. Opinions and determinations

Overview

- 8.1 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 servicing adjustment (or group capital servicing adjustment) in the circumstances set out below.
- 8.2 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.
- 8.3 For further information, please refer to the SSRO's guidance on referrals.¹⁰

Opinions

- 8.4 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 QDC (if the contract price were to be re-determined) or a proposed QDC, or a QSC (if the contract price were to be re-determined) or a proposed QSC 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 QDC);
 - d. the person who proposes to enter into a contract with the Secretary of State (in the case of a proposed QDC);
 - e. the contracting authority (in the case of a QSC); or
 - f. the person who proposes to enter into the QSC.
- 8.5 The SSRO may give an opinion on any matter in relation to a QDC or proposed QDC, or a QSC or proposed QSC, on joint referral from:
 - a. the Secretary of State and the primary contractor in the case of a QDC, or the Secretary of State and any other proposed party to the contract in the case of a proposed QDC; or
 - b. the Secretary of State and the sub-contractor in the case of a QSC, or the Secretary of State and the proposed sub-contractor, in the case of a proposed QSC.

¹⁰ SSRO (2016) *Guidance on the SSRO's Referrals Procedures for Opinions under the Defence Reform Act 2014*. SSRO (2016) *Guidance on the SSRO's Referrals Procedures for Determinations under the Defence Reform Act 2014*. Updated referrals guidance is due for publication on 1 April 2019.

Determinations

- 8.6 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 QDC); or
 - c. the sub-contractor (in the case of a QSC).
- 8.7 In the case of a QDC, the SSRO may also determine whether the amount of an adjustment agreed on a group basis is appropriate.
- 8.8 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.
- 8.9 In making a determination in relation to the cost risk adjustment, the SSRO must also have regard to the terms of the contract.
- 8.10 If the SSRO determines the amount of an adjustment was not appropriate, it may determine the contract price for a QDC is to be adjusted by a specified amount. In the case of a QSC, the SSRO may determine that a payment of a specified amount must be made to or by the Secretary of State.

Appendix A: Changes from previous version

A.1 The table below highlights changes from version 4 of the guidance to this version. Revised section and paragraph numbers are not highlighted as changes.

Key to changes:

No change
Deleted
Revised/moved
Added

Section/paragraph v4	Section/paragraph v5
Introduction	1. Introduction
1 About this guidance	About this guidance
1.1	1.1
1.2	1.2
1.3	1.3
1.4	1.4
2 Application of this guidance	Application of this guidance
2.1	1.5
2.2	1.6
3 Statutory reports	Statutory reports
3.1	1.7
3.2	1.8
3.3	1.9
	Relevant records
	1.10
4 Key terms and definitions	Key terms and definitions
Baseline profit rate (Step 1)	2. Baseline profit rate (Step 1)
5 Basis of Baseline Profit Rate	Basis of Baseline Profit Rate
5.1	2.1
5.2	2.2
5.2	2.3
5.4	2.4

Section/paragraph v4	Section/paragraph v5
Cost risk adjustment (Step 2)	3. Cost risk adjustment (Step 2)
6 Basis of cost risk adjustment	Basis of cost risk adjustment
6.1	3.1
6.3	3.2
7 Regulated pricing methods	Regulated pricing methods
7.1	3.3
7.2	3.4
8 Principles of risk adjustment	Principles of risk adjustment
General approach	General approach
8.1	3.5
8.2	3.6
8.3	3.7
8.4	3.8
8.5	3.9
Negative adjustment	Negative adjustment
8.6	3.10
8.7	3.11
8.8	3.12
Positive adjustment	Positive adjustment
8.9	3.13
8.10	3.14
Principles to consider	Principles to consider
8.11	3.15
Profit on cost once adjustment (POC) (Step 3)	4. Profit on cost once adjustment (POCO) (Step 3)
9 Basis of POCO adjustment	Basis of POCO adjustment
9.1	4.1
9.2	4.2
10 Application of POCO adjustment	Application of POCO adjustment
10.1	4.3
10.2	4.4
11 Methodology to determine the POCO adjustment	Methodology to determine the POCO adjustment
11.1	4.5
11.2	4.6
11.3	4.7

Section/paragraph v4	Section/paragraph v5
SSRO funding adjustment (Step 4)	5. SSRO funding adjustment (Step 4)
12 Basis of the funding adjustment	Basis of the funding adjustment
12.1	5.1
13 Application of the funding adjustment	Application of the funding adjustment
13.1	5.2
	5.3
13.2	5.4
Incentive adjustment (Step 5)	6. Incentive adjustment (Step 5)
14 Basis of incentive adjustment	Basis of incentive adjustment
14.1	6.1
14.2	6.2
14.3	6.3
15 When to apply incentive adjustment	When to apply incentive adjustment
15.1	6.4
15.2	6.5
16 Principles of applying incentive adjustment	Principles of applying incentive adjustment
16.1	6.6
16.2	6.7
16.3	6.8
16.4	6.9
Capital servicing adjustment (Step 6)	7. Capital servicing adjustment (Step 6)
17 Basis of capital servicing adjustment	Basis of capital servicing adjustment
17.1	7.1
17.2	7.2
18 Importance of Step 6 adjustment	
18.1	(See 7.6)
	7.3
	7.4
18.2	7.5
18.3	
	7.6
19 Calculating the capital servicing adjustment	Calculating the capital servicing adjustment
19.1	
19.2	
19.3	7.7
19.4	

Section/paragraph v4	Section/paragraph v5
19.5	7.8
19.6	
	7.9
	7.10
	7.11
	7.12
	7.13
20 Calculation of capital employed	Calculation of capital employed
20.1	(See 7.11)
20.2	(See 7.11)
	7.14
20.3	7.15 (See also 7.17)
	7.16
	7.17
20.4	7.18
20.5	(See 7.15)
20.6	(See 7.15)
20.7	(See 7.16)
	7.19
	7.20
21 Fixed and working capital	Fixed and working capital
21.1	7.21
21.2	7.22
22 Calculation of cost of production	Calculation of cost of production
22.1	
	7.23
22.2	7.24 (See also 7.12)
22.3	7.25
	7.26
23 Calculation of capital servicing adjustment	
23.1	
23.2	
Opinions and Determinations	8. Opinions and Determinations
24 Overview	Overview
24.1	8.1
24.2	8.2

Section/paragraph v4	Section/paragraph v5
24.3	8.3
25 Opinions	Opinions
25.1	8.4
25.2	8.5
26 Determinations	Determinations
26.1	8.6
26.2	8.7
26.3	8.8
26.4	8.9
26.5	8.10
	Appendix A: Changes from previous version
Appendix A: Glossary of POCO terms	Appendix B: Glossary of POCO terms
27 Group sub-contract	Group sub-contract
Group sub-contract means a contract	B.1
28 Further group sub-contract	Further group sub-contract
Further group sub-contract means a contract	B.2
29 Attributable profit	Attributable profit
The attributable profit is	B.3
Attributable profit does not include	B.4
30 Group sub-contractor	Group sub-contractor
-	B.5
Appendix B: Worked example of POCO adjustment	Appendix C: Worked example of POCO adjustment
-	C.1
-	C.2
Expected Contract Price	Expected Contract Price
-	C.3
Appendix C: Worked example for capital servicing adjustment	Appendix D: Worked example for capital servicing adjustment
-	D.1
-	D.2

Appendix B: Glossary of POCO terms

Group sub-contract

B.1 Group sub-contract means a contract:

- a. where the price payable under which includes an amount of profit (as is);
- 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 QDC.

Further group sub-contract

B.2 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

B.3 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 QDC, all the profit element in the price payable under that group sub-contract or further group sub-contract; or
- 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 QDC, 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.

B.4 Attributable profit does not include:

- a. any capital servicing adjustment made under Step 6 of Regulation 11; and
- b. any profit which is received by a person which is not associated with the primary contractor.

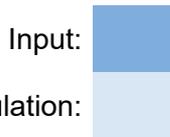
Group sub-contractor

B.5 A group sub-contractor means a person with which the primary contractor makes a group sub-contract.

Appendix C: Worked example of POCO adjustment

- C.1 To calculate what the POCO adjustment is, apply the stages that have been described in the main body of this document.
- C.2 The diagram below reflects Stage 1 of the methodology, with profit applied at the supplier's rates at each level. These figures are used in the calculations that follow.

Key:



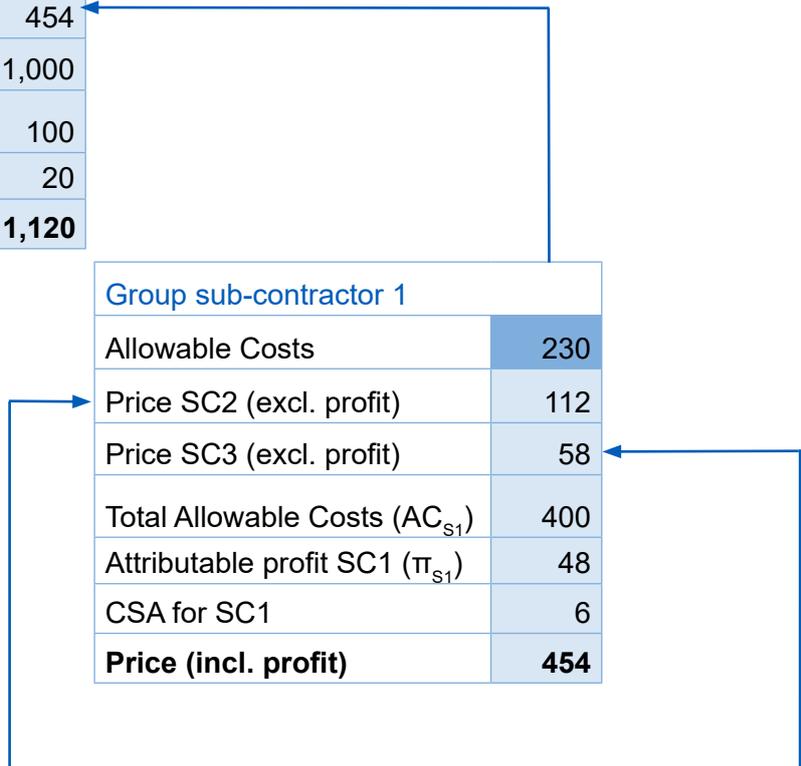
Profit and CSA rate inputs		
	CSA	Profit rate (steps 1, 2, 4 & 5)
Primary contractor	2%	10%
Group Sub-contractor 1	1.5%	12%
Group Sub-contractor 2	4%	8%
Group Sub-contractor 3	2%	14%

Primary contractor	
Allowable Costs	546
Price SC1 (excl. profit)	454
Total Allowable Costs (AC_p)	1,000
Profit (steps 1,2,4,5) (π_p)	100
CSA for Prime (CSA_p)	20
Price (incl. profit on profit)	1,120

Group sub-contractor 1	
Allowable Costs	230
Price SC2 (excl. profit)	112
Price SC3 (excl. profit)	58
Total Allowable Costs (AC_{s1})	400
Attributable profit SC1 (π_{s1})	48
CSA for SC1	6
Price (incl. profit)	454

Group sub-contractor 2	
Total Allowable Costs (AC_{s2})	100
Attributable profit SC2 (π_{s2})	8
CSA for SC2	4
Price	112

Group sub-contractor 3	
Total Allowable Costs (AC_{s3})	50
Attributable profit SC3 (π_{s3})	7
CSA for SC3	1
Price	58



Stage 2 - Contract profit rates (net of steps 3 and 6)	
CPR_P	10%
CPR_{S1}	12%
CPR_{S2}	8%
CPR_{S3}	14%

Stage 3 - Contract profit at each level (net of steps 3 and 6)	
Profit applied to PC (π_P)	100
Attributable profit SC1 (π_{S1})	48
Attributable profit SC2 (π_{S2})	8
Attributable profit SC3 (π_{S3})	7

Stage 4 - Total group profit (net of steps 3 and 6)	
Sum of profit at all levels (net of steps 3 and 6)	163
$\pi_P + \pi_{S1} + \pi_{S2} + \pi_{S3} = \Sigma\pi$	

Stage 5 - Group Allowable Costs	
Allowable Costs of prime	1,000
less group sub-contract attributable profits	-48 -8 -7
$AC_P - (\pi_{S1} + \pi_{S2} + \pi_{S3}) = AC^*$	937

Stage 6 - Target profit that the group should receive (net of Primary CSA)	
Total target profit net of Primary contract CSA	$937 \times 10\%$
$(AC^* \times CPR_P) = \pi_T$	93.7

Stage 7 - Reduction in price to ensure profit only arises once	
Reduction in price to ensure profit arises only once	93.7 -163
$\pi_T - \Sigma\pi = POCO_R$	-69.3

Stage 8 - Calculate the Step 3 POCO adjustment	
$POCO_R$ divided by prime contractor Allowable Costs	-69.3/1,000
$POCO_R/AC_P = POCO_{adj}$	-6.93%

Stage 9 – Apply to prime Allowable Costs and cross check to expected price	
Prime Allowable Costs (AC_P)	1,000
Profit for steps 1,2,4 and 5	10%
Step 3 adjustment ($POCO_{adj}$)	-6.93%
Step 6 adjustment (CSA_P)	2%
Contract profit rate (CPR)	5.07%
$AC_P + (AC_P \times CPR)$ Check this price against the expected price (see below)	1,050.7

Expected contract price

C.3 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 Act.

Key:



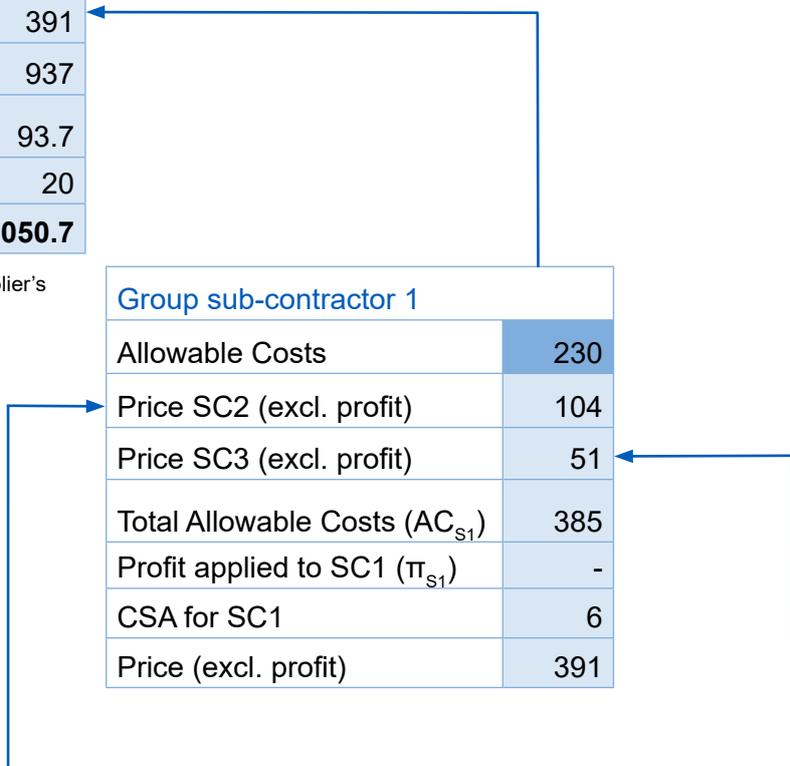
Primary contractor	
Allowable Costs	546
Price SC1 (excl. profit)	391
Total Allowable Costs (AC_p)	937
Profit (steps 1,2,4,5) (π_p)	93.7
CSA for Prime (CSA_p)	20
Price (excl. profit on profit)	1,050.7

* calculated reflecting profit applied at the supplier's rates at each level

Group sub-contractor 1	
Allowable Costs	230
Price SC2 (excl. profit)	104
Price SC3 (excl. profit)	51
Total Allowable Costs (AC_{s1})	385
Profit applied to SC1 (π_{s1})	-
CSA for SC1	6
Price (excl. profit)	391

Group sub-contractor 2	
Total Allowable Costs (AC_{s2})	100
Profit applied to SC1 (π_{s2})	-
CSA for SC2	4
Price (excl. profit)	104

Group sub-contractor 3	
Total Allowable Costs (AC_{s3})	50
Profit applied to SC1 (π_{s3})	-
CSA for SC3	1
Price (excl. profit)	51



Appendix D: Worked example for capital servicing adjustment

D.1 The worked example shown below incorporates the four main computations that need to be followed in order to determine the capital servicing adjustment in Step 6 of the contract profit rate formula.

D.2 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;
- Example c): £2,500,000; and
- Example d): (£1,000,000).

2. Fixed capital:

- Examples a), b), and c): £3,000,000; and
- Example d): £1,500,000.

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;
- Example c): (£500,000); and
- Example d): (£2,500,000).

4. Cost of production: £6,000,000 (in all four 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 2015/16:

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

	Example (a)	Example (b)	Example (c)	Example (d)
Computation 1				
CP: CE ratio calculation:				
(a) Fixed capital	£3,000,000	£3,000,000	£3,000,000	£1,500,000
(b) Working capital	£1,000,000	£1,500,000	-£500,000	-£2,500,000
(c) Total capital employed	£4,000,000	£4,500,000	£2,500,000	-£1,000,000
(d) Total cost of production	£6,000,000	£6,000,000	£6,000,000	£6,000,000
(e) CP:CE ratio (d/c)	1.5	1.3	2.4	-6.0
Computation 2				
(f) Fixed capital as a proportion of capital employed (a/c)	0.75	0.67	1.20	-1.50
(g) Positive Working Capital as a proportion of capital employed (b/c)	0.25	0.33	-	-
(h) Negative working capital as a proportion of capital employed (b/c)	-	-	-0.20	2.50
Capital servicing rates (published annually but 2015/16 rates for this worked example only)				
(i) Fixed capital servicing rate	5.94%	5.94%	5.94%	5.94%
(ii) Positive working capital servicing rate	1.72%	1.72%	1.72%	1.72%
(iii) Negative working capital servicing rate	1.03%	1.03%	1.03%	1.03%
Computation 3				
Fixed capital servicing allowance (f x i)	4.46%	3.92%	7.13%	-8.91%
Positive working capital servicing allowance (g x ii)	0.43%	0.58%	-	-
Negative working capital servicing allowance (h x iii)	-	-	-0.21%	2.58%
Capital servicing allowance "x"	4.89%	4.50%	6.92%	-6.34%
Computation 4				
Capital servicing adjustment for Step 6 ("x"/e)	3.26%	3.38%	2.88%	1.06%

