

# **ADS Group Limited**

## **Your details**

Name:

Organisation:

ADS Group Limited

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

Paragraph 1.2: Suggest the reference to non-statutory functions is deleted or explanation of what these are and how they affect the Guidance is provided.

Paragraph 2.1: Suggest the drafting is adjusted to reflect that the GPFAA will continue to apply to extant single source contracts, and that the Guidance will apply only to adjusting the Baseline Profit Rate for Qualifying Defence Contracts and Qualifying Subcontracts.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

ADS supports using a principles rather than rule Guidance as this will result in a more user friendly document and help the parties reach s based approach to producing the outcomes that are practical and pragmatic.

Application of the principles will inevitably lead to rules being established. It is Cost Risk Adjustment important that these are consistent and are visible to companies.

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

Subject to clarification of paragraph 5.3(4)(b). The circumstances in which the contract can be used to amend the Regulations are unclear.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

The overarching principles begin the discussion on risk, however, further detail and clarification are required, particularly with respect to statements made about the target pricing method.

Further principles requiring inclusion/discussion are:

- Integration risk for prime contractors
- Target pricing method as above, and further developed with maximum prices, complex sharelines, shareline slopes
- Revenue risks where income varies with KPIs
- The concept of profit 'clawback' where overruns requires further development (MoD causing overrun and underruns)

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Application of the principles will inevitably lead to rules being established. It is important that these are consistent and are visible to companies.

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The diagram presents the requirements in a graphical format without adding anything extra. As a result, it has limited usefulness and little effect on understanding.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

The process is over complex and would benefit from being simplified. Removing some steps should make the CSA computation easier and more direct.

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

Regulation 17(2) Step 5 allows the award of an incentive adjustment at the sole discretion of the Secretary of State. It is unclear why this right should be bounded or conditioned by Guidance.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

Further guidance and examples are required to clarify understanding in a number of areas e.g.:

- How does a Subcontractor performing a QSC access the Incentive Adjustment when the Contractor is responsible for agreeing the sub contract price?
- Can the Contractor reflect the Subcontractor’s Incentive Adjustment in its own pricing?
- What would happen if the performance required to secure the Incentive Adjustment was achieved but there was a subsequent breach of contract e.g. the criteria were fulfilled, however, the contract was late because GFE did not arrive on time or did not work when installed?
- Paragraphs 11.2 and 12(h) appear to be contradictory. It is difficult to envisage circumstances where MOD would pay an incentive adjustment where the supplier’s performance could not be measured against a clearly identified contractual requirement.

ADS believes that as use of the Incentive Adjustment is at the sole discretion of the Secretary of State it should be left to the SoS and the Contractor/Subcontractor(?) to determine its application.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

It appears counter intuitive to exclude cost performance from incentivisation, this and schedule are the most frequently incentivised outputs. Linking the incentive to any form of stretch target will inevitably require it to be recorded in the contract.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

It should be left to the SoS and the Contractor/Subcontractor(?) to determine application of the Incentive Adjustment, subject to its use being at the SoS's sole discretion.

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Application of the principles will inevitably lead to rules being established. It is important that these are consistent and are visible to companies.

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

Box 'Computation 3' requires adjustment to replace the second 'PLUS' with 'OR (if negative)'.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

Under this guidance there is an opportunity to update and simplify the rules, which could be clarified with a worked example.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

As for Question 15

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

As for question 15

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

# Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

Some adjustments are required to align the Guidance with the Defence Reform Act (DRA) and Single Source Contract Regulations. The DRA only allows the SSRO to make determinations when determining the amount of a Penalty.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

It is important that opinions and determinations made by the SSRO are published as soon as possible after they are concluded so that other contractors and subcontractors are able to reflect the outcomes in their own work and situations.

# **BAE Systems**

## **Your details**

Name:

Organisation:

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

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Yes

No

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

The use of rules based guidance would be too restrictive and is unlikely to cover all possible situations.

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

Further clarity is required with regard to the wording relating to Target Cost Incentive Fee type contracts as it is currently confusing

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

See response to question 3

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The diagram is a representation of the legislation

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

The methodology is extremely difficult to follow which could present problems in its application.

Our interpretation is that the methodology as stated will apply the prime contractor's profit rate to all costs in the group which we do not consider to be appropriate. Capital Servicing Allowances between the prime and the group subcontractor may be different and the pricing methods for the prime and the group subcontractor may also be different.

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

The adjustment should be used to incentivise specific, exceptional performance. We agree that the adjustment should not be routine and should be used sparingly but don't believe this equates to "exceptional circumstances". The Secretary of State should be free to determine whether the use of an incentive adjustment is appropriate in any particular circumstance.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

In general, the guidance suggests that the incentive adjustment should be considered to incentivise a contractor to meet a stretch target not associated with the cost of performing the contract.

We would welcome the guidance including more examples of what performance levels might indicate an incentive adjustment should be considered.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

No additional comment

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

Please however refer to our response to question 9

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

See response to question 3

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 15** – Is it clear from the section entitled 'Calculation of Capital Employed' which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

Generally yes however there are some exceptions.

- The meaning of the terms capital employed and net assets are not fully consistent in all parts of this section.
- In relation to paragraph 16.4 (b), should not the whole of retained earnings be excluded from capital employed?
- Paragraph 16.4 lists items that will be excluded from capital employed, but item (h) on MOD advance payments calls for such balances to be deducted from assets which means it is included in capital employed (as a credit)
- We do not understand the inclusion of paragraph 16.6 (c)
- Our practice is to compute average capital employed based on a thirteen point average which we believe gives a more precise representation of capital employed over the period than a two point average as set out in paragraph 16.7 of the guidance.

**Single Source Cost Standards**  
**(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 17** – Is it clear from the section entitled 'Calculation of Costs of Production' which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

No additional comment

**Single Source Cost Standards  
(Draft) Statutory Guidance on adjustments to the Baseline Profit Rate**

**Consultation Response Form**

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

No additional comment

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

# The Boeing Company

## Your details

Name:

Organisation:

Position:

## Consultation questions

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

Yes, but see below for detailed areas and opportunities for improvement – especially the flow-diagrams.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

However, for better understanding, the following may help?

Title: Currently this seems to jump into the middle of the process and it may be better to call the document something like “Guidance on the Steps to be Considered in Establishing a Contract Profit Rate for QDCs and QSCs”?

In respect of para 2.1; I don’t think the Guidance does replace the Government Profit Formula and Associated arrangements.

In respect of para 2.2; the use of the term ‘currently’ will lead to confusion and it would be better to speak of contracts awarded prior to 18 December 2014.

In respect of para 3.1; the words in parentheses appear unnecessary.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

I think that principles rather than rules are the correct direction of travel, which will allow parties sensible latitude in negotiation in respect of matters of determination.

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

In respect of para 5.1 and elsewhere; 'qualifying defence contract' the guidance needs to make clear that it covers QDCs and QSCs. That being the case 'SoS' should be changed to 'contracting authority'.

In respect of para 5.3 (4) (b); the statement is made that 'although not in the regulations...'. In which case this paragraph should be deleted from the guidance.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes

No

Please add comments to support your answer:

The principles are not sufficiently clear nor unambiguous.

In respect of para 6.2; '...as whether or not' does not make sense, but in any case there should be reference to actual out-turn costs in respect of 'estimate based' costs.

In respect of para 6.3; if risk is shared *equally* then the aim would be to have zero adjustment, otherwise it is entirely appropriate to have a positive or negative adjustment.

In respect of para 6.3(i); the contract terms and conditions should be the prevailing vehicle for these matters.

In respect of para 6.4 (i); the statement in parentheses is at odds with the principle being described.

In respect of para 6.4 (ii); should this not be included in section 5.3?

In respect of para 6.5; the intent is not clear and it would seem perfectly reasonable to permit the cost-risk adjustment to be used in such circumstances?

In respect of para 6.6; there are a number of bullets (at least 6) related in some form to contract terms and conditions. Perhaps these could be grouped together as a comprehensive section that deals with matters that are, or should be, included in Ts and Cs. It follows on, therefore, that the contract terms and conditions should be the prevailing vehicle for such matters and, with respect, the SSRO should then allow agreed TS&Cs and their impact to prevail.

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

I think that principles rather than rules are the correct direction of travel, which will allow parties sensible latitude in negotiation in respect of matters of determination.

# Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

I don't think the flow-diagram actually aids understanding but, if it stays, the guidance (and diagram) needs to make clear that it covers QDCs and QSCs. That being the case 'SoS' should be changed to 'contracting authority'.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

The methodology for calculating POCO adjustment is too elaborate and obscure. In any case step 1 is inconsistent with Regulation 61, where the contractor is not required to look beyond the first tier sub-contractor.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

The terms of the application of an available incentive adjustment must be covered in the individual QDC (and QSC) terms and the award should be at the sole discretion of the contracting authority. Following on from this, paras 12.1 ( h ) –(j) and para 12.2 should be contained either in narrative form in a QDC /QSC or in the form of new 800 series DEFCONS.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

In general yes, but see the answer to Q9, namely that the matters articulated in paras 12.1 ( h ) –(j) and para 12.2 should be contained either in narrative form in a QDC /QSC or in the form of new 800 series DEFCONS.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

I think that principles rather than rules are the correct direction of travel, which will allow parties sensible latitude in negotiation in respect of matters of determination.

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

I don't think diagram aids understanding. I think a better methodology would be to spell out the steps wholly in words and then link to Appendix B.

**QUESTION 15** – Is it clear from the section entitled 'Calculation of Capital Employed' which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

However, in respect of para 16.4, the list needs to be related, where appropriate, to "Business Unit".

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes

No

Please add comments to support your answer:

In respect of para 16.8; after 'total capital employed' should be the statement "in the Business Unit".

**QUESTION 17** – Is it clear from the section entitled 'Calculation of Costs of Production' which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes

No

Please add comments to support your answer:

# Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

In respect of para 18.1; the list should include the contracting authority for a QDC.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

This is an important data-set that will guide future approaches on both sides.

# FinExperts

## Your details

Name:

Organisation:

Position:

## Consultation questions

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Yes  No

# Introduction

Please note, Yusani Limited has shared its response with FinExperts Ltd, and FinExperts Ltd is in agreement with the issues raised by Yusani Limited.

These comments are therefore additive to Yusani's and have not duplicated points already made.

Please see the mark-up of the guidance for detailed comments.

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes   No

Please add comments to support your answer:

Yes, however the description in 5.4 (4) (b) is not understood, and does not agree with the law.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

6.3 (i) is not understood. Contracts must be priced in accordance with the law. TCIF contracts will be priced using the estimated allowable costs, that on average should achieve the contract profit rate as priced. To include more/less costs would not be in accordance with the law. Other risk indicators would be the inclusion of maximum prices, or the shape/slope of the shareline

6.4 (i) The opposite is true for cost plus/estimate based fee contracts and should be included.

6.4 (ii) is inadequately explored, for instance if the overrun is the cause of the MoD, if this concept is to stand then underruns should also be addressed.

6.6 The parties ‘must’ not follow the guidance but must have regard to it.

6.6 Integration risk is key for prime contractors and needs to be included.

6.6 Pricing will be performed before the contract is let, this may predate a maturity of the project approach to risk

6.6 The level of contingency in a price is not the deterrent of the level of risk, risk relates to the Only more than 50% if a QSC. Does a lower threshold apply if a commercial subcontract **variability** of the cost outturn

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

## Profit on Cost Once

**QUESTION 7 –** Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The diagram does not add to the law/regulations/ It needs to include QSCs, and references to the SSRO

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

The solution is overly complex and does not add to the law/regulations

1. The first stage is not required, stage 2 needs to make clear that only contracts with an unbroken chain are in scope
2. The solution for CSAs is complex and confusing

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

It should be used to reward contractors for delivering results that drive utility to the MoD through schedule/specification or cost performance.

This should be for delivering stretch targets, not usual performance.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

The guidance is confusing:

Fulfilling the contract, is fulfilling the legal requirements, it appears that the incentive requirement cannot be written into the contract.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

Cost performance should not be excluded to drive the incentive. For many circumstances and some pricing methods it would be entirely appropriate and is at the core of what the MoD seek to incentivise.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

# Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

Please see the mark-up for corrections.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

No. The language used is largely an import from the GACs, which are confusing and in archaic language.

This is an opportunity for a re-write in plain, modern English. This would be enhanced with a worked example balance sheet.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

Again, a clear statement using modern language per IFRS GAAP would help, with an example.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

Again, a clear statement using modern language per IFRS GAAP would help, with an example.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

# Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

# **Finmeccanica UK**

## **Your details**

Name:

Organisation:

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

Seen from the perspective of a contractor, this guidance would benefit from more work to create a workable set of rules. Generic terms such as 'appropriate maturity' in para 6.6 is an example. In terms of a suitable test, who and how is it going to be judged? The issue of contingencies and risk registers (again 6.6) are not clear in terms of how they are to be used and the values associated with them.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

4.1 'Incentive' should be replaced by 'cost risk'

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

5.0 Section 5 is seen as unnecessary as the Act and/or the regulations make clear the allowed pricing methods. Where the SSRO make additional comments, they are often at variance with the regulations such as those at para 5.3

5.2 The wording is ambiguous in that the target price method does not adjust estimated costs but rather adjusts the fee for any difference to the actual costs incurred.

5.3 (4) While the target allowable costs will be those estimated at the time of the agreement (as stated in the regulations), the actual fee in the final price will be established by reference to comparison of the actual costs incurred in the performance of the contract compared with the target cost.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

Not until the SSRO has gained demonstrable expertise and experience in operating in a post-DRA world.

6.2 We can understand a full -25% adjustment for cost plus where the cost risk is wholly with the MoD. Under an estimated-based fee arrangement the contract profit is set with regard to the estimated cost and then applied to the actual costs. So, cost overruns result in a reduced profit percentage. Para 6.3 states that where there is a maximum price to the target cost sharing arrangement, the MoD's exposure is not only protected by the share line but may also be limited to a maximum price: there should be some recognition of the risk to the contractor by applying a (reduced) positive adjustment. It is noted that at para 6.4 (i) there is recognition that the full +25% for firm or fixed price contracts may not be appropriate in all circumstances; should there not be similar provision against a full -25% adjustment.

6.5 This para is unclear as to the application eg revenue risks as set in TCIF maximum price contracts.

# Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

Sections 7, 8 and 9 are unnecessarily complex and only detract from the quality of the primary and secondary legislation. The SSRO analysis appears to be at variance with the statutory requirement and may create misunderstandings.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

Para 8.1 confirms that POCO applies to group subcontracts that are not competitive, irrespective of whether they are QSCs (QSCs are only determined where they are entered into for a QDC; if they pre-date the QDC then they are not QSCs. POCO should not apply retrospectively to existing subcontracts.

On Step 4, the **SSRO funding adjustment** (which is not yet to be enacted), it would be important to know what the SSRO intends to use as the denominator and how it will be derived.

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

**Incentive adjustment:** SSRO have to consider application to QSCs; the guidance is silent to this effect.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

The SSRO ought to consider application to QSCs; the guidance is silent to this effect.

On **Capital servicing allowance**, the flow chart contains errors (eg a PLUS should be OR).

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

11.0 This aligns with the comments that the MOD have made at various reviews, ie incentives are exceptional; limited to either incentive for early delivery ahead of the contracted schedule (accelerated programme?) and/or over achievement of KPIs; are limited to 2%. However, in 11.2 (a) we consider the wording in brackets “(but not including this as a contractual requirement)” should be deleted, as appropriate wording would need to be included in the contract to define the incentive as stated in 12.1 (h).

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Not until the associated guidance is articulated with absolute clarity.

# Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

The flowchart contains errors (eg a PLUS should be OR).

**QUESTION 15** – Is it clear from the section entitled 'Calculation of Capital Employed' which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

15.0 A number of tighter definitions will be required, such as in 15.3 CE ratio should be referenced and 15.5 'divided by' should be 'divided into'

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

16.0	Use of the term capital employed should be consistently segregated from source of capital. In a number of instances the use of capital employed is used for both eg 16.4(h). In addition, there are a number of accounting references and terminology that are now obsolete.
16.8	Should refer to property, plant and equipment, and intangible assets that did not arise as a consequence of a business combination.
16.6 g	Should be applied to all non-current liabilities.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

17.1	Should be rephrased to address (1) those items in the income statement that should be excluded eg fair value hedging gains or losses, (2) movement in inventory, and (3) treatment applicable to creation/amortisation/impairment of capitalized development costs within intangible assets.
17.3 h.ii	Is unclear eg is rework to be excluded.
17.3 i and j	Why would such costs be excluded from overheads? It may be that they are agreed to be excluded from costing or pricing rates.
17.4 l	If overheads have been decremented by a grant or refund, the credit in the income statement should remain as a credit to the cost of production.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes

No

Please add comments to support your answer:

18.1 The SSRO should recognise that the guidance applies to QSCs and that this is the responsibility of the contracting authority.

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes

No

Please add comments to support your answer:

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

**And, in addition on Appendix A**

The discussion on contracts appears to add confusion rather than clarity. As an example – is the second (b) under Attributable Profit referring to non-controlling interests of a group subsidiary? Applicable Costs section needs to incorporate that CSAs are allowed at each level in the group contracting chain.

QSC's also need to be referenced/included when appropriate throughout

# **General Dynamics**

## **Your details**

Name:

Organisation:

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

Overall the guidance has been structured effectively however more worked examples would be beneficial.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

Subject to clarity as to what constitutes "Baseline profit"

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

A rules based approach would remove freedom to negotiate on a case by case basis

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

Further clarity is required in respect of the impact/treatment of cross border transactions and how these will be viewed by HMRC and where liability in this respect will lie.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

Clarity is required as to how this would be managed in respect of amendments to contract as these may have different levels of group company involvement

It is considered that this aspect may be better managed as an allowable cost adjustment rather than a profit rate adjustment.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

However, issues can be foreseen with regards to determining when exceptional circumstances exist – it may well be best managed as an adjustment (post contract) to the “below the line” profit rate or as an absolute “£” value.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes

No

Please add comments to support your answer:

But see answer to Q9

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes

No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

See answer to Q6

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes

No

Please add comments to support your answer:

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes

No

Please add comments to support your answer:

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes

No

Please add comments to support your answer:

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

# Lockheed Martin

## Your details

Name:

Organisation:

Position:

## Consultation questions

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

Section 1.2 refers to 'non statutory functions' – what is this?

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes

No

Please add comments to support your answer:

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes

No

Please add comments to support your answer:

Additional considerations should be given when making a negative adjustment. There seems to be more principles to consider when making a positive adjustment but nothing on the negative adjustment.

Section 6.4(i) mentions that it is possible that less than full +25% adjustments could be applied if it is generally deemed a low risk contract – who does the deeming?

Section 6.6 bullet 5 – who agrees the approach to risk is of appropriate maturity? The adjustment is made at time of pricing when the project is not mature so this conflicts with the principle that we have to consider.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

## Profit on Cost Once

**QUESTION 7 –** Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes

No

Please add comments to support your answer:

The diagram does not show what happens if the contractor and the MOD do not agree a POCO adjustment amount. This is needed for completeness.

The methodology needs to be simplified.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes

No

Please add comments to support your answer:

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes

No

Please add comments to support your answer:

We need an example on how the incentive adjustment will be applied. Is this indicating a stretched target in the contract? If so, this conflicts with some of the principles. Incentive adjustments must not be linked to legal obligations (j) but incentive adjustments must be used for delivering performance above the contractually required level.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes

No

Please add comments to support your answer:

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes

No

Please add comments to support your answer:

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes

No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes

No

Please add comments to support your answer:

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes

No

Please add comments to support your answer:

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes

No

Please add comments to support your answer:

# Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes

No

Please add comments to support your answer:

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

# Marshall Aerospace and Defence Group

## Your details

Name:

Organisation:

Marshall Aerospace and Defence Group, The Airport, Cambridge

Position:

## Consultation questions

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

It would be better still if the list of bullet points in section 6.6 were given numbers (ie (i) etc). This would make it easier to refer to these paragraphs.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

I think it would be clearer still if the title of the guidance were "Calculating the contract profit rate" as this is the purpose behind making the adjustments to the baseline profit rate. This is explained in para 1.1 of the introduction. This change to the title could make the document easier to find for those wanting to understand how to construct a full price for a qualifying contract.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes

No

Please add comments to support your answer:

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes

No

Please add comments to support your answer:

I believe that some further consideration is needed on some of the principles in the paper. In 6.4 (i) I feel it should be spelled out that the negative adjustment must still be in the range of -25% to +25% just to make it clear that it did not mean an unbounded negative.

In 6.6 I believe it would be better to replace the word “applied” to “considered”. If they always have to be applied then under bullet point 5 some urgent projects may not be able to commence if the risks are not of “appropriate maturity” whereas if they need to be considered, the parties could agree to comments the programme if that were the best way to meet a requirement in the necessary timescale.

In 6.6 bullet points seven and eight, the contractor still retains significant risk even if they have controlled elements of the cost through the supply chain, which is good practice. In addition if the subcontractor were to fail to carry out all of its duties then the responsibility would fall squarely on the contractor. I do not feel that this section properly recognises this.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

If the rules made the overall process clearer or more effective then yes

## Profit on Cost Once

**QUESTION 7 –** Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

I think that POCO is a simple concept that should not require the diagram or the methodology in section 9. Adding this level of detail for something that should be relatively simple risks making it more complex than it needs to be, which in turn increases the likelihood of one or more parties making an error or misunderstanding the requirement.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes

No

Please add comments to support your answer:

I think it is unnecessary to show it in this way. Please see comment under Question 7

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes

No

Please add comments to support your answer:

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes

No

Please add comments to support your answer:

Partially. Para 11.2a is somewhat confusing. If the SoS wishes to incentivise a certain level of performance that is in excess of the priced level of performance, then I believe that this should be documented in the contract as part of the final negotiation before the contract is signed. This would provide maximum clarity for both parties and the maximum ability for the contractor to deliver the desired outcome, armed with the knowledge of what reward will be available. By not including it as a contractual requirement, there is a risk that it is not properly understood. It could also be that I haven't quite understood what is meant in para 11.2a.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

I believe that the performance level above contracted performance that would attract the incentive needs to be clearly delineated in the contract.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

If the SoS desired something else of value from the contract, it should be possible to use the incentive mechanism for that. It would be difficult today to draft an exhaustive list of what that may be.

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

If the rules made the overall process clearer or more effective

# Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

I think the worked example at Appendix B is better as it uses numbers and demonstrates the computations rather than just explaining them. However the diagram is useful although it may contain one or two errors:

In computation 1, “divided by” should be “divided into” and would be consistent with the worked example at Appendix B

In computation 3 the second “PLUS” should be “OR”

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

It is broadly clear but it would be helpful to provide clarity on what is meant by a “unit of their business”.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

It might be useful to include a section on when such opinions or determinations may be called upon and whether these are binding or not, or if not binding what weight they carry

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

Any such information would prove very useful for any organisation pricing contracts under this new regime

# **MBDA UK Ltd**

## **Your details**

Name:

Organisation:

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

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Comments on style and formatting are not required.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

We are unclear of the relevance of the “non-statutory” functions of the SSRO.

This guidance does not replace the GPFAA – these remain for extant contracts and, presumably, for new, non-qualifying contracts.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

Clearly established principles are fundamental.

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

The statement at 6.2 needs to be clear that this reference to “estimate based” pricing means a price established by actual costs. Additionally, whilst a difference between actual and estimated costs may not affect risk, it does affect price.

6.3 (i) should also address variable share lines in target pricing.

Under 6.4 (ii) the statement made appears to ignore the possibility that an overrun could be caused by an act or omission of the contracting authority, late or defective GFE being a potential example.

6.5 is not entirely clear.

Under 6.6 the fifth bullet implies agree post contract award and, therefore, after the price has been set. The eleventh bullet suggests that UK MoD contracts recognise “force majeure” which, strictly speaking they do not. Where the circumstances are appropriate, an excusable delay clause is negotiable but, typically, this will only allow for an extension in time. With regard to the twelfth bullet, we would take the view that “auditable assumptions” would be more geared to outcomes of risk, not to the initial assessment of risk.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Ultimately, yes.

We note the response form does not include a question on the SSRO Funding Adjustment. Although it is some time before this would be applied, we would be

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

We believe that the POCO approach outlined in this guidance could be significantly simplified and that the more complex construction is likely to create greater room for innocent error from all parties.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

See response to “7” above.

In addition, a re-iteration of the meaning given in the Defence Reform Act to “group” might be helpful.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

The incentive adjustment envisaged should be available for exceptional performance.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

We do understand the examples given, but further examples might be useful.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

There appears to be a contradiction between 11.2 (b) and 12.1 (h), or at least the scope for misunderstanding.

12.1 (j) could be amended to read “legislative” rather than “legal” obligations – the contract will be a legal obligation.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes

No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes

No

Please add comments to support your answer:

Ultimately, yes.

# Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

In Computation 3 the word “plus” above the negative assessments appears incorrect.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

Section 16.5 f and g appear less clear than the current wording of the GACs – “Advance payments received from customers prior to the company’s performance of the sales contract are treated as capital employed, i.e. not deducted from assets, subject to an appropriate transfer being made from advance payments to progress payments, in accordance with the billing arrangements of the contract wherever possible, or failing that, pro-rata to the value of work-in-progress in the same proportion as the total advance payments bear to the contract price”. If the intent is the same, we are not clear why the wording should vary.

16.6 raises “launch aid” – we are unaware that UK Defence contracts have benefited from “launch aid” previously.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes

No

Please add comments to support your answer:

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes

No

Please add comments to support your answer:

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes

No

Please add comments to support your answer:

This section of the guidance does not appear to distinguish between the nature of opinions and that of determinations – only the latter are binding.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

Such supplementary guidance could be beneficial for all concerned, particularly in relation to determinations.

## Ministry of Defence

### Your details

Name:

Organisation:

Position:

### Consultation questions

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below. Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

The MOD consider the guidance to be structured effectively.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

Paragraph 2.1 – The reference to adjustments to the Baseline Profit Rate of the Yellow Book may cause confusion as it is a different thing to the baseline profit rate of the Orange Book, and different adjustments apply. Perhaps it might be better to state that this guidance determines how the contract profit rate that applies to qualifying defence contracts (hereinafter referred to as QDCs) and qualifying sub-contracts (hereinafter referred to as QSCs) must be determined, and it replaces the methodology in the Yellow Book used to determine the Total Contract Profit Allowance, which has no relevance to QDCs/QSCs.

Paragraph 2.2 – The application of the previous guidance to “contracts currently in force” is not legally straightforward. We suggest that the intent of section 2 would be better served by making the statement in the positive, e.g. “This guidance only applies to Qualifying Defence Contracts (QDCs) and Qualifying Subcontracts (QSCs) and has no legal status to contracts that are not QDCs or QSCs.”

Paragraph 3.1 – There are no restrictions to the application of this guidance to QDCs/QSCs... it applies to all QDCs and QSCs, so this proviso should be removed (it suggests that there are some). The restrictions (e.g. SofS exemption power) determine whether a contract is a QDC or QSC, however once a contract is a QDC/QSC, then both parties must have regard to this guidance in all cases.

Paragraph 3.1 – Although it states here that the guidance applies to all QSCs, there are numerous points throughout the document where it would be clearer to spell out that it applies to QSCs, such as paragraphs 5.1, 7.1, 8.1, and in the diagram following 8.4.

Question 2 continued...

Paragraph 3.1 – Although stated elsewhere in the document, it might be helpful to spell out that it is a legal requirement to have regard to this guidance in this section (Application of this Guidance), for example as per paragraph 1.2 of the Single Source Cost Standards (SSCS).

Possible new paragraph - There are numerous references to the Secretary of State (SofS) in the document. Although the Act and SSCRs use the term SofS, this is a legal artefact. The vast majority of powers and duties conferred onto the SofS will be delegated to MOD officials. As written, the guidance suggests to the lay reader that SofS may have to be personally involved, which will not be the case. We suggest a paragraph is added to make this clear and recognise that it will be for MOD to ultimately decide which officials have which delegated powers.

Possible new paragraph - As with all aspects of the price, the MOD consider that the onus is on the supplier to estimate a fair and reasonable contract profit rate, including all the adjustments. The supplier should be able to evidence their assumptions, and needs to set this out in the Contract Pricing Statement (see Regulation 23(d) which requires the supplier to “describe the calculation that was made under regulation 11 [Steps in determining contract profit rate] to determine the contract profit rate, including all adjustments that were made under steps 1 to 6;”). The MOD consider that it would be helpful if this were made clear in the statutory guidance.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes

No

Please add comments to support your answer:

We support the approach the SSRO has taken in the draft consultation document, which is principles-based for step 2 (risk) and step 5 (incentives), and more rules-based for step 3 (POCO) and step 6 (capital servicing adjustment).

It may be that the risk adjustment will benefit from a more rules-based approach to ensure consistency, however the MOD is comfortable with a principle-based approach in the first instance. As a general point, internal piloting suggests that more senior staff prefer a more principle-based approach, whereas more junior staff prefer a more rules-based approach. It may be that a rules-based approach has more advantages for lower value contracts.

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes

No

Please add comments to support your answer:

The MOD strongly disagree with the proposal that the cost risk adjustment should be primarily determined by the pricing method. MOD understands the intent of the step 2 adjustment is to ensure that risk and reward are suitably matched. Specifically that the supplier's reward (profit) should relate to the supplier's cost risk. The regulated pricing method does not determine how much cost risk a supplier is subject to... it is merely a partial measure (and a very crude one at that) of the **proportion** of the risk a supplier takes – not the **level** of risk. A high proportion of a low risk still equates to a low risk, and, conversely, a low proportion of a huge risk may still be a high risk (relative to an averagely risky contract). By linking the step 2 adjustment to one measure of the proportion of risk, and not to the level of risk, the MOD believes many undesirable outcomes are very likely to occur. Some issues with this suggested approach are outlined below:

- Fixed/Firm priced arrangements are used for low-risk contracts. For medium to high risk contracts, supplier are not prepared to agree firm/fixed price contracts, so target pricing is used. The SSRO's draft approach offers the highest profit rate to the lowest risk contracts.
- The proportion of risk a supplier takes on is only loosely determined by the regulated pricing method. Many (if not most) of the most significant risks are dealt with using specific contract terms and conditions. For example agreeing warranties, the inclusion of insurance premiums, indemnities, etc. A supplier may be prepared to use a fixed/firm price only if MOD takes on all the most significant risks, however MOD's proportion of risk would not be captured in the choice of regulated pricing method.
- Approximately 60% of the value of MOD contracts are firm/fixed. Offering the highest profit rate to these contracts, most of which are low risk and routine in nature, will have a major impact on the price of single source contracts, and will (in MOD's opinion) have a negative impact on value for money in single source procurement. It may also incentivise the MOD to use target cost approaches simply to get better value for money, which will reduce a supplier's incentive to become more efficient.

The MOD have no issue with higher risk contracts receiving a higher return (and vice-versa), indeed we welcome this approach. However supplier cost risk is determined primarily by the overall risk of the project, post any mitigation. Mitigation can come in many ways, such as: contractual terms, choice of regulated pricing method, flowing risk down to sub-contractors etc. The MOD view is that the principles have absolute primacy, and the regulated pricing method is merely one way a supplier's cost risk is mitigated.

Question 4 continued...

#### Use of a +25% or 0% starting point

The MOD do not support the suggestion of using a starting point of +25% or 0% of the BPR in any case. Use of any starting point will require MOD to negotiate any reduction in profit from the starting point. As previously stated, MOD would recommend the inclusion of paragraph on the requirement for the supplier to “describe the calculation that was made under regulation 11 [Steps in determining contract profit rate] to determine the contract profit rate, including all adjustments that were made under steps 1 to 6;”).

If the SSRO view is that a starting point is required, then, and only then, the MOD’s suggestion is that the onus is on the supplier to justify any movement from the risk free rate, as per Lord Currie’s, Key Recommendation 5 (page 32) in his 2011 Review of Single Source Pricing Regulations:

*“The implicit starting point for the contract profit allowance should be a ‘risk free’ profit rate. Commercial leads should have to justify any movement away from the ‘risk free’ rate using an assessment of the contractor’s risk. The MOD should develop guidance for commercial negotiators to follow in assessing the extent of the allowance that should be added for risk in the profit allowance.”*

#### Consistency with the SSCSs

In the recently published Single Source Cost Standards (SSCSs), the SSRO stated that

*“Provision for cost contingencies and cost risk are not Allowable as contractors are expected to manage actual costs and cost estimates as part of contract delivery. This is separate from, and does not apply to price risk in relation to a risk based contract where the contractor accepts risks on behalf of the MOD and where both parties accept this as being a necessary component of the contract. These and any other exceptional or abnormal costs will be assessed under Section 12 of this guidance.”*

MOD’s reading of this suggests that inclusion of contingency in the price is abnormal or exceptional. There is a direct relationship between the step 2 risk adjustment and the treatment of risk in allowable costs. For example the inclusion of contingency in the allowable costs can reduce the supplier’s exposure to cost risk. Without greater clarity of the treatment of risk in allowable costs, it is difficult to comment definitively on the proposed approach to the step 2 adjustment for Risk. This relationship is recognised in the 9<sup>th</sup> bullet point of paragraph 6.6 of the draft guidance on the contract profit rate, which states that the step 2 adjustment should “take into account any allowance for contingency that may have been included in particular elements of the allowable costs”.

Question 4 continued...

#### Detailed issues with sections 5 and 6

Paragraph 5.3 – The description of the six pricing methods has been largely taken from Regulation 10... the MOD considers that some of the wording is complex, and the regulated pricing methods would benefit from a more ‘plain English’ description. This is particularly the case for the estimate-based fee method and the target pricing method. 5.3(4)(b) states that “Although not in the Regulations, depending on the terms of the qualifying defence contract, target pricing costs might not be wholly estimated or wholly actual allowable costs”. MOD readers found this confusing. The price in target priced contracts is initially set using estimated costs, as per Regulation 10, and is then adjusted, as set out in Section 16 of the Act, based on the difference between the actual and estimated costs. It is perhaps better to say that the total price payable under the contract (rather than target pricing costs) depends in part on actual and in part on estimated costs. On a separate note it may be worth pointing out that ‘time of agreement’ is legally defined in Regulation 2.

Paragraph 6.2 – MOD readers found the following expression confusing ‘..., the cost risk adjustment should be -25% *as whether or not actual costs are different to the estimated cost has no effect on the contract price*’. For cost plus contract there may be no estimated costs (just actuals). Perhaps it would be better to say that because a supplier takes on no cost risk in cost plus or estimate based fee contracts, they should only receive the risk-free rate, i.e. a -25% of BPR adjustment for step 2.

Paragraph 6.3 – One reading of this is that the share line should be set such that the contract is only averagely risky to the supplier (and thus attract a 0% adjustment). The MOD is not clear why this should be a policy aim over and above value for money which could result in a contract that was more or less risky than average. MOD readers also found 6.3(i) confusing. It refers to the ‘number’ of costs, which is hard to quantify. Perhaps it would be clearer to state, as a principle, that the greater the proportion of cost risk that a supplier has transferred to the MOD, the lower the profit rate should be (perhaps as an extension to bullet 8 of paragraph 6.6).

Paragraph 6.4 – This states that “When firm, fixed or volume-driven pricing methods are used then the cost risk adjustment should be +25%, because the contractor bares all the risk”. As stated above, this is not true as contractual terms and conditions (e.g. indemnities, warranties) impact on risk sharing. Also, as worded, this strongly suggests that +25% is both the starting and ending point.

Paragraph 6.4(i) refers to ‘taking into account the overarching principles above’, however since 6.4(i) *is* the overarching principle, MOD readers were not sure what principles were being referred to.

Question 4 continued...

Paragraph 6.5 – MOD readers were not entirely sure what this meant. Is it saying that the step 2 adjustment should only relate to the level of cost risk a supplier is exposed to (on the allowable costs included in the price), and cannot be used for any other purpose, such as compensating either party? If so, the MOD is comfortable with this, but perhaps it could be re-worded to be clearer.

Table beneath paragraph 6.6 – As the MOD strongly object to the approach being suggested, we also find the table far too simplistic and liable to produce poor value for money outcomes.

General – Throughout this section, the adjustment is often referred to as a percentage between  $\pm 25\%$ . This is not correct, the step 2 adjustment is a value between  $\pm 25\%$  of the *baseline profit rate*. This may seem obvious, however MOD considers that it is worth making this absolutely clear.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes

No

Please add comments to support your answer:

No – see above response to question 4.

Paragraph 6.6 - The MOD consider the 'Additional Principles to consider' to be very helpful, although it is hard to reconcile bullet point 9 with the SSCs. If these were taken as the overarching principles, with no starting point, the MOD would be supportive of the guidance on step 2.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

The MOD is open to a move towards a more rules based approach, however we are also comfortable with a principles based approach. The question might best be revisited once the new regime has been applied for a time.

## Profit on Cost Once

**QUESTION 7 –** Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The MOD considers the diagram to be very helpful (it could be amended to highlight that it also applies to QSCs).

The MOD consider that it would be very helpful to reference the definitions in Appendix A early in the chapter on POCO as not all readers realised that 'group subcontract', 'further group subcontract', and 'attributable profit' etc. were defined and thus found it difficult to follow. It may also be worth defining 'single source subcontracts' as this term is used in paragraphs 7.2 and 8.3.

Paragraph 8.3 – forth bullet point makes reference to 'any profit made' – it should refer to any profit included in the price of the subcontractor, not their outturn profit (their profit made).

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes

No

Please add comments to support your answer:

The MOD consider the inclusion of a rules-based approach for the calculation of POCO to be very helpful, and support the proposed methodology.

The MOD also feel that a worked example, along the lines of Appendix B for CSAs, would be very helpful.

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes

No

Please add comments to support your answer:

Yes. However there is one issue that needs to be clarified in the guidance, namely the application of the incentive adjustment to subcontractors.

Paragraph 10.2 states that the SofS can determine the incentive adjustment to apply to QSCs. This is not correct. It is up to the contracting parties to agree the incentive adjustment... SofS is only involved at the prime level. This was done deliberately as, just as there may be a good reason for the MOD to provide a positive incentive to prime contractors, the same may apply at any level, and we did not want to rule out positive KPIs down the supply chain. Note that both suppliers involved in a QSC must also have regard to this guidance.

However this raises the strong possibility that a prime contractor (or indeed anyone further down the chain) will offer their subcontractor the 2% and charge this to the MOD as an allowable cost – for the supplier there is nothing to lose by doing this. However this would not, in MOD's view, represent value for money. This risk can be mitigated by disallowing subcontractor incentive adjustments as an allowable cost. This limits a supplier from offering more incentive adjustment than they themselves receive (e.g. 2% at prime level on £1bn is a possible £20m incentive, of which they choose to allocate half to their subcontractor as they are instrumental in helping them achieve the higher performance level), unless they are prepared to fund it out of their own profit.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

The MOD understand the examples, however they should be illustrative, and there may be more. The principles effectively limit the circumstances when the incentive adjustment should be used, so the MOD does not see the need to limit the circumstances to the two examples given.

Paragraph 11.2(a) states that the date would not be included as a contractual requirement. As stated in 12.1(h), the link between higher performance and receipt of the incentive adjustment will be set out in the contract, which may be construed as a 'requirement'. Perhaps "as a reward for delivering equipment early", "or over and above the basic contractual requirement" or similar.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

The MOD consider the principles to be very helpful.

Paragraph 12.1(i) states that a contractor '[is] not entitled to any incentive adjustments related to that breach of contract'. It is highly unlikely that any incentive adjustments will be related to a breach of contract! Perhaps "not entitled to any incentive adjustments already received on that contract"?

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

The MOD consider that there are likely to be additional circumstances when it is appropriate and desirable, however the principles appear sufficient. This could, of course, be reviewed once the regime is more embedded.

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

The MOD does not consider it likely that a rules-based approach could ever be effective at deciding when it was appropriate to incentivise a particular level of performance above the contract base-line and how big this incentive should be. This will depend entirely on the specifics of the case. It would be no more possible to do this than it would be to generate rules effective at determining contract requirements in the first place.

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

The diagram is helpful, apart from one error – namely in computation 1 where the ‘Total Capital Employed’ is divided by the ‘Cost of production’ to give the ‘Cost of Production as a Proportion of Capital Employed (CP:CE)’. In fact this would give the CE:CP ratio. The CP:CE ratio is the ‘Cost of production’ divided by the ‘Total Capital Employed’. This is correct in the worked example, but not here.

Some additional minor changes are suggested:

- Computation 3 – change ‘Allowances’ to ‘Rates’ in the title, middle section, and final box at the bottom (‘allowance’ suggests a monetary amount, whereas a ‘rate’ is a rate of return per unit time such as an annual rate or interest rate).
- Computation 4 – change ‘allowance’ to ‘adjustment’ in the title and final box, as this is what we are aiming to calculate. Change the Capital Servicing Allowance in the middle to ‘rate’ as per computation 3 described above.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

The MOD considers that this is clear.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes

No

Please add comments to support your answer:

The MOD considers that this is clear.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

Yes, however paragraph 17.3(f) should be consistent with the SSCSs which state that only the discount on external sales should be excluded.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

The MOD found the worked example very helpful.

Some amendments are suggested below.

- Row 13: replace ‘Allowances’ with ‘Rates’
- Rows 14,15 and 16: replace ‘Allowance’ with ‘Rate’
- Row 19, fourth column. (0.20%) should be in the row below
- Row 23: replace ‘Allowance’ with ‘Adjustment’

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes

No

Please add comments to support your answer:

The legal basis of SSRO opinions and determinations is scattered about the Act and Regulations. Section 35(1) gives SofS the power to set out in the Regulations matters which the SSRO must give an opinion or determination on over and above those set out explicitly in the Act. It does not apply to all opinions and determinations. The Regulations do this in Regulation 51 and 52. R51(1) lists opinions required pre-contract, and R51(2) the opinions required when agreeing the price of an amendment to an existing contract, and adds the ability for the SSRO to say MOD have acted unreasonably in asking for an 'on demand' report ('on demand' reports are only specified in the Regulations, so the opinion related to them must also be specified in the Regulations).

The cast list of who can ask for an opinion or determination is correct, but under Section 30(1) of the Act, 'primary contractor' also means sub-contractor. This is legally correct, but probably confusing to the lay reader. It is probably better to say that anyone in a QDC/QSC, or proposing to enter a QDC/QSC, may refer a matter to the SSRO.

Section 35(3) adds still further to the opinions and determinations set out in the Act and Regulations, by giving the SSRO the power (but not the duty) to give an opinion on any matter that is not specified in the Act or Regulations, provided both parties ask for the opinion together. The SSRO may refuse to give this opinion, but does have the power to do so if wished.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

The MOD considers that this would be very helpful.

**QinetiQ**

## Your details

Name:

Organisation:

Position:

## Consultation questions

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

No comment.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

No comment.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

No comment.

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

Pricing methods (5) and (6) have required, in practice, the establishment of a Limit of Liability and this will be founded upon estimated costs. This could expose the contractor to an unrewarded element of risk depending on the commercial terms for limits of liability.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Some additional clarification in certain areas will be beneficial;

6.3.(i) In respect of target pricing, the risk adjustment for actual and estimated costs should be based on the range of possible outcomes rather than as absolute values of estimated and actual costs.

Consideration should be given to the gradient of the share lines above and below the Target Price to assess movement from the zero profit adjustment assumption.

6.4.(i) Contracts that are routine projects will be subject to risk assessment before the risk adjustment can be agreed at the appropriate level. There cannot be an automatic assumption that a routine project is 'deemed' to be low risk.

6.4.(ii) This point appears to be addressing a contract renegotiation matter and does not seem relevant for Statutory Guidance.

6.5 There can be situations that a contractor could take on risk without contingency or contractual cover and some risk adjustment should be considered appropriate. E.g. unforeseen events not covered by force majeure conditions and unknown unknowns.

6.6 Numbering of the 12 sub paragraphs listing the additional principles will be useful for referencing: bullet 1&2 implies that a risk is only a risk if it affects allowable costs, contractors are exposed to a range of risks not all of which are quantifiable as financial risks. E.g. reputational and change in law.

bullet 5&6 appears to assume that the price is agreed when the approach to risk is appropriately mature. Risk mitigation and maturity normally occurs throughout the duration of a project and is not in existence pre contract award.

bullet 8 risk transfer to a subcontractor can be an effective risk mitigation strategy, but does not insulate the contractor from all risks e.g. Integration and dependency risk.

bullet 9 should recognise that the inclusion of contingency does not eliminate all elements of possible risk.

bullet 11. If force majeure is not fully covered in the contract conditions, then the contractor's potential risk exposure should be considered in the risk adjustment.

bullet 12. the auditability of the risk assumptions is only possible with the outcome.

**QUESTION 6-** Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

A rules based approach has the potential to prescribe / influence contractual and risk transfer conditions which may not be appropriate to the commercial arrangements that best suite both parties to the transaction. The principles approach should be capable of being applied to all contractual arrangements without undue interference and adverse impact on contract delivery.

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

For completeness – the exclusion of single source sub-contracts, with a value of less than £100,000 and subcontracts that are the result of competition, could be incorporated into the diagram.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

Understanding of methodology would be enhanced with the inclusion of a worked example as an Appendix to the Guidance.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

For an incentive adjustment to drive the desired behaviours, setting an expectation that awards will only be applied exceptionally, could have the effect of producing an outcome that is suboptimal for the customer. As raised in the Currie Review, the profit element is a small fraction of the total spends.

Any incentive to provide value above the contracted terms should be encouraged to occur on a frequent basis. If the incentive is perceived to be an exceptional event and requires the Secretary of State's intervention, which could be for very low values on small QDCs, this could be considered as unlikely, making any occurrences even more exceptional.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

If the circumstances for applying the incentive are less specific, then both MoD and Industry will be more encouraged to consider this as a reward in the wider context of superior performance. As stated in 11.2 (a) and (b) the potential application is limited and is unlikely to create the desired behaviours.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

The principle in 12.(e) and (k) that excludes incentive adjustments for ‘reductions in allowable costs’ appears to fail to recognise the opportunity that may exist under certain regulated pricing methods to identify additional cost savings over and above the values expected in the initial pricing.

The requirement to have the link between the incentive adjustment and the performance stated in the contract appears to attempt to formalise conditions on performance that could not be foreseen at the time of entering into the contract. If this is the case, the terms are likely to be too limiting to cover the spectrum of opportunity that may exist.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

Please see our responses to Question 11 and the incentive to drive down allowable costs where this is not covered in the regulated pricing method.

The concept of trying to define all the possible principles that may be appropriate seems impossible; this could be accommodated with the application of discretionary awards where appropriate, this would provide some incentive and acknowledgment for the unexpected performance / conditions.

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Please see our responses in Questions 11 and 12.

# Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

The diagram is helpful, but there is an error in Computation 1.  
Cost of Production as a Proportion of Capital Employed is derived from:  
Total Capital Employed  
Divided **INTO** Cost of Production

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

No comment.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

The guidance does not attempt to make a definition of the split between fixed and working capital, but based on current practice this is largely self-explanatory.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

For the purposes of consistency all disallowable costs (to the extent it is included within the direct / indirect costs) should be excluded from the cost of production.

E.g. the excluded categories do not include Entertaining and Sales & Marketing expenses, which as per Statutory Guidance may not be an allowable expense.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

Drafting point only:

Appendix B – The numbered paragraph 2 includes the phrase ‘Fixed Working Capital’ which conflicts with the first bullet of 4 and in the table which refer to ‘Fixed Capital’. We presume that the usage ‘Fixed Capital’ is correct and should be used throughout.

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

No comment.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

This practice will provide useful clarification and assist with achieving a consistent and common standard for single source Contract Profit Rate calculation.

# Rolls Royce Holdings plc

## Your details

Name:

Organisation:

Position:

## Consultation questions

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

Note SSRO funding adjustment - (Step 4). This adjustment does not apply until 1 April 2017. Hence on contracts priced prior to that time but go beyond 1 April 2017, we would welcome guidance on what forward estimate to use and if there will be a mechanism to reopen the contract? Alternatively, clarification that all contracts priced prior to 1 April 2017 will not require a funding adjustment for the entire contract duration.

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

General points;

Para 1.2 It would be useful to understand what the SSRO non-statutory functions are in respect of?

Para 2.1perhaps it should say for new QDC/QSC Not sure this comment is necessary only?? If it has to remain in the guidance then

We understand that the GPFAA will remain for extant contracts and non QDC/QSC going forward, although it's likely that contractors may adopt a common set of rules so that as far as practicable there is standardisation, simplification, repeatability across all Government Customers, be it MOD, BIS, TSB, DoD, European Commission, BWB etc in respect of allowable costs and reward consistent with the contract T&Cs.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes   No

Please add comments to support your answer:

This seems very sensible but would welcome the opportunity to review the position after all parties have gained sufficient experience. In particular for instance how the DoD FARs work and also how the guidance on SSCS develops in respect of accounting for risk

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes   No

Please add comments to support your answer:

Para 4.1 ‘incentive’ should we believe read ‘cost risk’ Para 5.3(4)(b) We would welcome further clarification.

### (4) Target pricing method

(b) Although not in the Regulations, depending on the terms of the qualifying defence contract, target pricing costs might

**not be wholly estimated or wholly actual allowable costs.**

Para 6.6, bullet 9. Clarity would be welcomed between this and the SSRO guidance on allowable costs (para 11.1). Both refer to contingencies, but with apparently contradictory guidance (SSCS disallow, whereas profit rate allows).

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

- Consistent with the development of the guidance on SSCS we would welcome development of the profit rate guidance on the cost risk adjustment. This review and clarification such that the guidance does not drive the type of contract that can be offered to MOD. Rather that the customer (MOD) can drive the commercial / contractual arrangements without being constrained by the guidance on SSCS and profit rate.
- Over time it would be useful to take account of other factors such as type of work, contract duration, CADMIN cycle etc, to develop the 'reward for risk'.
- 6.4 *This says : "When firm, fixed or volume-driven pricing methods are used then the cost risk adjustment should be +25%, because the contractor bears all the risk"*
  - a. It would be helpful if the SSRO clarified the word 'all' in this context as the word 'majority' would better fit these type of arrangements.
- Para 6.4(ii). This says that for fixed contracts that overrun and where additional funds are requested from MOD then the "increase on profit should be deducted or clawed back from any additional funds agreed". We would request clarification on such situations as where MOD require contract variations, the contractor assumes more risk on existing deliverables etc.
- We would welcome clarification as to whether a sliding scale approach to the +/- 25% is acceptable and if so the principles regarding how this would apply?
- Para 6.6 We would welcome the opportunity to develop the guidance on the additional principles to consider. This could be by for example reference to typical risk registers such that the appropriate reward for risks assumed can be agreed separate from the cost base.
  - o These could be developed in conjunction with the SSCS guidance such that risks can be apportioned between MOD and the contractor in line with how MOD wishes the contract to be discharged. The objective being that the MOD should be able to drive the type of contract to be let, rather than the principles dictate the type of contract that can be taken on by the contractor. Particular emphasis on integration risk, availability contracts and revenue risks.
  - o Para 6.6, bullet 9 Clarity would be welcomed between this and the SSRO guidance on allowable costs (para 11.1). Both refer to contingencies, but with apparently contradictory guidance (SSCS disallow, whereas profit rate allows).

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

However we recommend that more experience of application of the SCS and Profit rate is gained before making a final decision.

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

However it would be helpful if the SSRO also gave guidance in respect of:

- Appendix A Group subcontract & Further Group subcontract, subparts (b), which refers to *‘two or more persons, each of which is associated with the primary contractor’* Does this cover situations of associated companies, JVs, and essentially any that are partially owned by the contractor? What are the situations and the level of POCO adjustment, if any, that is required? We do not believe it was the intent of the regulations to include anything other than wholly owned group subcontract units?
- We would welcome worked examples of all scenarios (internal subcontract at varying levels, also within the external supply chain, what happens on an acquisition and a divestment etc).
- Confirmation that the key principle is to earn the profit intended by the SSRO which includes matching the capital employed with the appropriate costs of production.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

However clarification is sought in respect of Regulation 61 where the requirement is for each ‘contractor’ (first tier subcontracts only). Worked examples would be useful.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

One of the aims of the SSRO (and MOD) is to ensure value for money to the tax payer. The commercial construct is a key way of achieving this aim and hence use of the incentive adjustment for exceptional performance is seen as a key enabler, hence its use should be encouraged not just used in exceptional circumstances.

Noted that regulation 17(2) (5) allows the award of an incentive at the discretion of the Secretary of State.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

- The examples are helpful, but further practical examples would increase understanding, both what should and should not be included.
- Under 11.2b the incentive arrangement may be appropriate if “exceeds all its set Key Performance Indicators” yet under 12.1b it states it cannot be paid for “performance that is not specified as a contractual requirement”.  
  
These statements appear to conflict resulting in the incentive payment not being paid, please can the SSRO clarify?

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

We would ask for further guidance from the SSRO as to why cost performance is excluded from the incentivisation adjustment? Cost and schedule performance are normally considered together? This is important for instance in respect of service availability arrangements.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

We would recommend that it is sensible for MOD to have the ability to incentivise contractors for such circumstances as innovative contracting arrangements at their discretion.

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

However there should be flexibility for MOD to reward contractors for such circumstances as innovative contracting arrangements at their discretion.

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

However it is recommended that the SSRO issue a simple mechanistic excel spreadsheet to make the process easier to understand for those not familiar with the calculation. This could be dovetailed with the relevant reporting template formats for capital and cost

The box, computation 3, includes a 'plus', where this should read 'or (if negative)'.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

This section would benefit from an overhaul to bring it up-to-date. In the timescales for the consultation it was not possible to review.

It is recommended that MOD and SSRO work jointly on this in facilitated workshops.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

See 15 above.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

See 15 above.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

This is effective for this stage of the process and joint working between SSRO/MOD and Industry will improve this over time.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

We fully support the need to establish a body of knowledge so that we can better understand and interpret the principles and guidance, as they arise.

## **Serco Limited**

### **Your details**

Name:

Organisation:

Position:

### **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

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Yes

No

# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

Would suggest a change to the draft to reflect the fact that GPFAA will continue to apply to extant single source contracts

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

Would encourage a move to rules based approach as soon as practical to facilitate clarity.

# Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

The intention of different pricing methods should reflect the different allocations of risk between parties. The contractor should have a return from profit that reflects the risk.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes  No

Please add comments to support your answer:

Further detail is required on the statements on target pricing i.e. specific elements of 6.4 (ii) overrun contracts and clawback profits where impacted by MOD; definition of a low risk contract, who defines; revenue risk where it varies by KPI regime. The concern here is that the lack of clarity will cause uncertainty.

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Rules will add clarity and remove and potential inconsistent application of guidelines.

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The flow diagram facilitates the understanding of the steps within the process of the decision. It can help the overall appreciation of the sequence of things.

It would also help having a diagram reflecting when to refer the matter to the SSRO if the parties cannot agree on the adjustment to be made.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

The process appears to be overly complex and introduces confusion to the calculation. It needs to be simplified to be much more user friendly, especially for SME's, if this is to be adopted by all in a fair manner; as not many companies will have the luxury of the additional resources that will be required to process these new process requirements.

# Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes

No

Please add comments to support your answer:

Agreed that it should be used sparingly but it should not be just a judgement call to when it is applied. The key is consistent application so everyone is aware of the applicable criteria.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes

No

Please add comments to support your answer:

It would be beneficial to have more examples to help the understanding of the use of this feature.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes

No

Please add comments to support your answer:

Unclear why cost performance is excluded from the incentive as this drives VFM and is generally the focus of project's success.

Re. Incentive for exceeds ALL KPI's - This would suggest the need for KPI's to be set in a way to reflect exceeding when currently most don't provide for overachievement once maximum performance is achieved.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

Rules increased the clarity and remove uncertainty.

## Capital Servicing Adjustment

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes  No

Please add comments to support your answer:

Diagram does aid the overall understanding.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

The lists under sections 16.4 and 16.5 appear to lay this out, although it would be aided by examples on any contentious issues referenced in 16.6.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes

No

Please add comments to support your answer:

The definition is vague and unclear and probably could be helped by reference to relevant accounting standards we would suggest. A company’s definition of ‘fixed’ can vary, depending upon the main industry they are based in.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes

No

Please add comments to support your answer:

Section 17.2/3 explain the general principles. Simplification of this would be reduce any confusion.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

Probably needs to consider a more complex company's balance sheet as well, in terms of examples.

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

Effectively communicated but brings out the need to align this with DRA and Single Source Contract Regulations.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes  No

Please add comments to support your answer:

Yes this is a significant change with a large impact and it is important all determinations are published as soon as possible to allow contractors/sub-contractors to adapt and work through practical implications.

# **Yusani Limited**

## **Your details**

Name:

Organisation:

Position:

## **Consultation questions**

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail, particularly on areas where you disagree. This will help us to understand the basis for your answer and inform our finalisation of the Guidance. As a minimum, please include the paragraph number your comment refers to.

Please do not feel that you need to respond to all of the consultation questions set out in the document: we welcome brief or partial responses addressing only those issues where you wish to put forward a view.

Comments on style and formatting are not required.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by ticking one of the boxes below.

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# Introduction

**QUESTION 1** - Do you agree the guidance has been structured effectively?

Yes  No

Please add comments to support your answer:

**QUESTION 2** - Does the introduction provide a clear description of the status and the purpose of this guidance?

Yes  No

Please add comments to support your answer:

However, there are some corrections and clarifications necessary:

1. The title of the document is somewhat misleading. It would be clearer to entitle it “Guidance on the Steps to establish the Contract Profit Rate”.
2. In para 1.2, it is not clear what the SSRO’s non-statutory functions are and why it is necessary to refer to them. Furthermore, §18(1) of the Act does not give authority to issue the guidance as such, but only refers to it. It would be more correct to say: “For the purposes of Section 18(1) of the Act, the SSRO issues this guidance in relation to the steps set out in Section 17(2) for the calculation of the contract profit rate.”
3. Para 2.1 should be deleted, this guidance does not “replace” the GPFAA. The GPFAA has no effect on QDCs and QSCs, so it cannot be replaced as such.
4. In para 2.1, the use of the expression “currently” is ambiguous. It would be clearer to say: “For those non-qualifying defence contracts or non-qualifying sub-contracts in force on 1 April 2015 the previous methodology established by the ‘Government Profit Formula and its Associated Arrangements’ remains in place.”
5. Para 3.1, as mentioned in the comment on para 1.2, §18(1) of the Act does not give authority to issue the guidance as such, but only refers to it. It would therefore be more correct to delete “under” and replace it with “for the purposes of”.

**QUESTION 3** – With the exception of profit on cost once, do you agree that this guidance should be principles rather than rules based?

Yes  No

Please add comments to support your answer:

It is important that all parties have clarity in this matter. If clarity is improved by moving to a rules based approach then it will receive support.

## Cost Risk Adjustment

**QUESTION 4** - Do you agree with the principle that the Regulated Pricing Method should be the primary consideration to determine the cost risk adjustment?

Yes  No

Please add comments to support your answer:

The differing pricing methods are intended to reflect different allocations of risk between the parties. The contractor should have a return from profit that is proportionate to that risk.

However, it is not clear why it is necessary to repeat the description of the differing pricing methods in the guidance, particularly when there is some further elaboration that is not covered in the legislation. In particular, para 5.3(4)(b) is unnecessary and adds confusion; if it is necessary to say anything it would be clearer to say:

“Although not in the Regulations, the target profit allowance will be set at the contract profit rate and the target price will comprise the sum of allowable estimated costs and the contract profit rate. However, in contrast to a firm or fixed price method, the final contract price under this method will be determined by the sum of the actual allowable costs and the profit allowance as varied from the target profit allowance by the formula set out in the terms of the contract.”

This was an issue raised at the Seventh Delegated Legislation Committee on 10 December 2014 to which the Parliamentary Under-Secretary of State for Defence (Mr Philip Dunne) gave an explanation.

**QUESTION 5** - Do you agree with the overarching principles to consider when determining the cost risk adjustment?

Yes

No

Please add comments to support your answer:

The principles given are not clear enough and will cause uncertainty:

1. In this section, and throughout the document, “qualifying defence contracts” should be replaced with “contracts” as the guidance is needed to apply to both QDCs and QSCs. Where the word “MOD” or “Secretary of State” is used as a contracting authority it should be replaced by “contracting authority” as the guidance is needed to apply to both QDCs and QSCs.
2. In 6.2, after “estimate-based” add “where the price is based on out-turn actual costs”, for clarification.
3. In 6.3(i), it is not clear whether this refers only to the target pricing method or to other methods, or to all methods. It is not clear to what “terms” this refers.
4. In 6.4(i), a parenthetical statement (which undermines the principle) without justification is unhelpful. In what circumstances could a negative adjustment be made? The expression “generally deemed” is too vague; “deemed” by whom? an objective standard must be used. This over-simplistic approach needs to be developed more fully with the following features taken into account: the nature and type of the work, the value at risk, the length of the contract, and other performance factors reflecting increased or decreased risk.
5. In 6.4(ii), this has nothing to do with profit adjustments in Step 2. It is also unclear as to what principle it is addressing. If it has any merit then it should be elsewhere in the guidance and more clearly stated.
6. In 6.5, does the converse apply: ie when a risk has been covered in either allowable cost base or the terms and conditions of the contract for a qualifying defence contract, the cost risk adjustment should not be used as a compensatory method for either party. This would seem to be equally fair. Both positive and negative aspects of a principle need to be stated.
7. In 6.6, the use of bullet points is poor professional practice for a legal document, which should use a numbering convention; otherwise we are having to quote the number of the bullet sequence when making a reference to the principle.
  - Second bullet, the expression “how” seem inappropriate and should be replaced with “the extent to which”.
  - Third bullet, delete “and the contractor’s proposed solution to deliver them”, the cost risk adjustment should reflect the risk in the contract requirements alone.
  - Fourth bullet, amend “consistent” to read “not inconsistent”, this is an unnecessary restriction. The adjustment shouldn’t be inconsistent with ..., for example, it may be complementary to ...
  - Fifth bullet, delete. If this implies that pricing is delayed until the project approach to risk is of an “appropriate” maturity, then it can’t be right. In any event, what is “appropriate maturity”? The parties make an assessment of the risk at the time of pricing; however, it could be that the selected method of pricing may be different depending on the maturity of risk assessments, but that is a different issue.
  - Sixth bullet, who is going to judge “good business practice” and against what benchmarks in the industry? It seems particularly vague. Isn’t it the same as the tenth bullet? In relation to “insurance”, if the cost risk has been mitigated by insurance then the risk relates to the extent of the excess or deductible on the policy and the cost of claiming under the policy.
  - Seventh bullet, delete. This is unnecessary as it is covered by the third bullet: “contract requirements” includes “contractual terms”.

7. In 6.6, continued

- Eighth bullet, what terms could these be? This is a spurious concept since if the third party fails then the risk is still held by the contractor. If it is not a third party but the other party to the contract then to the extent that the risk is not in the contract it doesn't have to be assessed
- Ninth bullet, why? Contingency is merely a subset of the estimate of the actual cost that is expected on average to be incurred - why give it special significance?
- Eleventh bullet, delete. MoD contracts do not provide an indemnity from these circumstances, so they must still be a risk. If the contract contains a special term that provides some protection for these circumstances then that will be taken into account as a result of the third (and seventh) bullet; however, it is not MoD practice to give a full force majeure provision and even then the cost risk is not mitigated, as there is no price adjustment for those events, only a timescale adjustment.
- Twelfth bullet, delete, this is unachievable if it is to link to the risk register. The risk register and risk management relates to the management of causes of risk. Auditable assumptions will be tied to the consequences. They will not match.

**QUESTION 6**- Would you support moving towards a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

It is important that all parties have clarity in this matter. If clarity is improved by moving to a rules based approach then it will receive support.

## Profit on Cost Once

**QUESTION 7** – Does the diagram aid your understanding of when a profit on cost once adjustment should be made?

Yes  No

Please add comments to support your answer:

The diagram does not address QCs, which is necessary to have a full understanding of the issue. See comment 1 against Question 5 for a possible solution. Also, there needs to be illustrated the option of referring the matter to the SSRO if the parties cannot agree on the adjustment to be made.

It's not clear what the diagram is adding to what is said in the legislation.

**QUESTION 8** – Do you agree with the methodology for calculating profit on cost once?

Yes  No

Please add comments to support your answer:

1. Creating an 11 stage process seems an over-elaborate way of addressing the issue, without any added value from what is said in the legislation. We expect the Guidance to add value.
2. The Methodology should be applicable to QSCs as well as QDCs.
3. Stage 1 is wholly inconsistent with Regulation 61. The requirement is a first tier requirement only for each “contractor” ie the Regulations only require the contractor to look at his first tier subcontracts.
4. Stage 4, says net of Step 6 (CSA), which is not correct unless the CSA is to be applied later - if CSAs are applied later, after a POCO adjustment, why mention them here? CSAs are to be applied to each and every level in the supply chain including contractors in the same group. A separate comment needs to be made in the guidance on CSAs to avoid confusion.
5. Stage 5, omits a reference to “contract” after “primary” (in two places), which causes confusion.
6. Stage 10, the parenthetical phrase should read “including applicable group sub-contract costs”.
7. The Appendix A is unhelpful in defining a “group sub-contract. Much guidance is needed in interpreting the phrase “person associated with the primary contractor” for the different corporate groupings and associations encountered in the industry.

## SSRO Funding Adjustment

It would be helpful to know now how this adjustment is to be calculated, and what the adjustment would be if it did apply now - even if it does not apply until 2017. This would help contractors gauge the effect of this adjustment and to have an awareness of how the SSRO will calculate it.

## Incentive adjustment

**QUESTION 9** – Do you agree that an incentive adjustment should only be used in exceptional circumstances?

Yes  No

Please add comments to support your answer:

The incentive adjustment should be used for exceptional performance, which is different from “in exceptional circumstances”. It should be used sparingly, but again that doesn’t mean “in exceptional circumstances”. It is another tool for the contracting authority to use in appropriate circumstances.

**QUESTION 10** – Do you understand the examples for when a positive incentive might be used, or would more examples aid your understanding?

Yes  No

Please add comments to support your answer:

1. The parenthetical phrase in para 11.2(a) is not understood; how does this align with para 12.1(b) if not specified as a contract requirement?
2. More examples would aid understanding of the use of this feature, including both when it is inappropriate and when it may be appropriate.

**QUESTION 11** – Do you agree with the principles of applying the incentive adjustment?

Yes  No

Please add comments to support your answer:

1. The principles should be applicable to QSCs as well as QDCs.
2. In para 12.1(i), when the contractor is in breach of contract the guidance states that the contractor is not entitled to any incentive adjustments related to that breach of contract - it is not clear how this might work. For example, what is the situation if an incentive is attributed to the speed of a vessel (which is achieved) but the delivery of the vessel is late (resulting in a breach of contract)? Or would the principle apply only to incentives related to delivery in the example given?
3. In para 12.1(j), after “legal obligations” insert “imposed by legislation” and in the second sentence, replace “legal” with “legislative”. The contract is a legal obligation, so a distinction needs to be made.

**QUESTION 12** – Are there any additional principles or circumstances where you think an incentive adjustment should apply?

Yes  No

Please add comments to support your answer:

**QUESTION 13** – Would you support moving to a more rules based approach in the future?

Yes  No

Please add comments to support your answer:

It is important that all parties have clarity in this matter. If clarity is improved by moving to a rules based approach then it will receive support.

## Capital Servicing Adjustment

### Calculating the Capital Servicing Adjustment

1. Regulation 11(8)(a) needs some guidance from the SSRO. It is assumed that this refers to direct costs under the contract, as indirect cost will include depreciation, as referred to in para 14.1.
2. This section needs to say the period that is to be used for the calculation. For fixed, firm and target pricing methods either the guidance should say that the CSAs should be based on –
  - a. ratios that existed for a given previous period, or
  - b. a forecast of the ratios that will exist during the performance of the contract (although this would be speculative).If a. then should this be the closing figures at the end of the period, or an average of a given prior period?
3. CSAs are to be applied to each and every level in the supply chain including contractors in the same group.
4. As referred to in Comment 4 in Question 8, a separate statement needs to be made in the guidance on the application of CSAs to avoid confusion in the process of computing the contract profit rate. The guidance for Step 6 only states how to calculate the CSAs and not how they are applied.

**QUESTION 14** – Does the diagram aid your understanding of how to undertake the four computations to be followed in order to determine the capital servicing adjustment?

Yes

No

Please add comments to support your answer:

Computation 3 includes a “PLUS”, this should read “OR (if negative)”.

**QUESTION 15** – Is it clear from the section entitled ‘Calculation of Capital Employed’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

1. In para 16.1, the phrase “most relevant” presumably refers to circumstances when more than one business unit within a legal entity is involved in the contract performance - it would be helpful if this was clearer. The involvement of a business unit in another legal entity will have its own capital employed calculation.
2. In para 16.4, add at the end “for the business unit” to clarify.
3. In para 16.4.a, delete and replace with “all balances in total equity”, to clarify.
4. In para 16.4.d, delete “being capital not employed in the business of the parent company”, as it is unnecessary.
5. In para 16.4.f, replace “capital” with non-current assets”.  
In para 16.4.f.i, delete “in” at the beginning.  
In para 16.4.f.iv, add at the end “, but not including those recorded as actively seeking a purchaser”.  
In para 16.4.h., delete “which should be deducted from assets and not included in capital employed”, this principle is already covered in the preamble to 16.4.
6. In para 16.5, the use of language is often not up-to-date with current standards and predates changes introduced in the late 20<sup>th</sup> century by IASB and its predecessors. After “can generally be included in assets” insert “in determining the total capital employed in the business unit”, for clarity.
7. In para 16.5.c, in line 1 delete “which”; after “statutory accounts” insert “inclusive of an appropriate” and delete “. This is subject to any”; at the end replace “work in progress” with “inventory”.
8. In para 16.5.d, in line 1 delete “which”; delete “capital employed”; after “to the extent that a company can demonstrate that they are” insert “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” and delete “‘live’ and contribute to its earnings”. A patent and trade mark portfolio may not be actively used in a business, but may be necessary to defend the business if claims are made against it, and to maintain exclusivity.
9. In para 16.5.e, in line 1 delete “which”; delete “capital employed”; replace “provisions” with “amortisation and impairment”; in the second sentence after “product” insert “developed or”. Provisions are an element of creditors and not intangible assets.
10. In para 16.5.f, replace “capital employed” with “a source of capital”; replace “and is not deducted from assets” with “and is therefore not deducted from assets used in determining the total capital employed in the business unit”. For clarity.
11. In para 16.5.g, add at the end “in the business unit”. The wording could be improved by reference to IFRS language rather than language from SSAPs.
12. In para 16.5.h, replace “non-competitive” with “single source”. With regard to the phrase “except where otherwise agreed”, with whom and under what circumstances can an agreement be reached?
13. In para 16.5.i, amend to read “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 in the business unit.” For clarity.
14. In para 16.5.j, replace “debtors” with “trade receivables”. For clarity.

*Question 15, continued:*

15. In para 16.6.a, amend to read “Finance lease creditors will be treated as a source of capital, and therefore not deducted.” IFRS makes this requirement.
16. Delete para 16.6.c, which contains unnecessary detail.
17. In para 16.6.d, delete “Mainstream corporation tax” and insert “Current tax liabilities or assets”.
18. Delete para 16.6.e - Why is this necessary. If included in the statement of financial position it is a source of capital and not capital employed in the business unit.
19. In para 16.6.g, Replace text with “Non-current liabilities, including pension liabilities, should be excluded.
20. In para 16.7, after “capital employed” insert “in the business unit”.

Generally, there is confusion on the distinction between “capital employed” and a “source of capital” which needs to be resolved.

**QUESTION 16** – Is it clear how to distinguish the split between fixed and working capital?

Yes  No

Please add comments to support your answer:

In para 16.8, delete “consideration needs to be given to identify those costs that are obviously”, which is confusing and unhelpful, and replace with “property, plant and equipment, and intangible assets that did not arise as a direct consequence of a business combination are considered”.

In the second sentence, after “total capital employed” insert “in the business unit”.

**QUESTION 17** – Is it clear from the section entitled ‘Calculation of Costs of Production’ which items should generally be excluded or included?

Yes  No

Please add comments to support your answer:

1. In para 17.1, delete “all of the material, labour and overhead costs of the business unit” and replace with “revenue less PBIT, plus or minus movement in inventory, and adjustments for treatment of amortisation, impairment of intangible assets and fair value hedges,”. For clarity.
2. In para 17.3.h.ii, after “construction” insert “after delivery”. For clarity.
3. In para 17.3.i, the use of the phrase “to the extent that” presumably covers the timing and spread - it would be helpful to clarify this.
4. In para 17.3.l, it is not clear why these items should be deducted.

**QUESTION 18**– Does the inclusion of a worked example aid your understanding of the adjustment?

Yes  No

Please add comments to support your answer:

## Opinions and Determinations

**QUESTION 19** - Do you agree that the role of the SSRO with regards to opinions and determinations for the Contract Profit Rate adjustment has been effectively communicated?

Yes  No

Please add comments to support your answer:

There is a significant mis-statement of the legislation, which needs to be corrected; a distinction needs to be made between the authority for giving opinions and the authority for making determinations:

1. In para 18.1, after “Act” insert “and regulation 51”, and delete “or make a determination”; after “capital services adjustment” insert “under a proposed contract or where a contract price is to be redetermined under regulation 14”. The specified purposes for the making of a determination under §35(1)(b) are governed by Regulation 52 and are limited to the DPS and output metrics used for reporting. A determination on these matters is governed by §18(3).
2. In para 18.1.(c), delete “or” at the end and after subpara (d) and add subparas:  
(e) the contracting authority (in the case of a qualifying sub-contract); or  
(f) the person who proposes to enter into the qualifying subcontract.  
See regulation 64(7).
3. Insert a new paragraph 18.2 and renumber previous 18.2 to be 18.3:  

18.2 Section 18(3) of the Act and regulation 18(2) enables the SSRO to make a determination whether any adjustment agreed under Steps 2, 3 or 6 is appropriate on an application by:

  - (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).

## Appendix A: Glossary of terms

1. The definition of “Group Sub-contract” needs to be developed to give guidance on the meaning of “person associated with the primary contractor” with examples for the different corporate groupings and associations encountered in the industry.
2. The definitions needs to be adapted for QSCs as well as QDCs.
3. “Applicable Costs” needs to be amended to read: “For the purpose of the POCO adjustment calculations, Applicable Costs includes allowable costs and CSAs but excludes the attributable profit (excluding CSAs).”
4. There needs to be further guidance on the meaning of “business unit” and on QBU, with examples for the different corporate groupings and associations encountered in the industry.

**QUESTION 20** - Do you agree that supplementary guidance should be issued setting out examples of opinions and/or determinations made by the SSRO, as they arise?

Yes

No

Please add comments to support your answer:

It is important that all parties are aware of examples of opinions and determinations by the SSRO as soon as possible after they are made so that any necessary adjustment to behaviour can be made in the light of the examples.