SSRO

Single Source
Regulations Office

Assuring value, building confidence

Review of single source contract profit rate methodology 2015

Response to consultation

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Background

1. Introduction

1.1 Under the Defence Reform Act 2014 (the Act), the Single Source Regulations Office (SSRO) is required annually to review the figures used to determine the contract profit rate for pricing qualifying defence contracts (QDCs) and qualifying subcontracts (QSCs).

1.2 Section 19(2) of the Act requires that for each financial year, the SSRO must provide its assessment of the appropriate baseline profit rate and capital servicing rates for QDCs[1] to the Secretary of State for Defence. Section 19(1) of the Act requires the Secretary of State to publish the baseline profit rate and capital servicing rates for each financial year.

1.3 In recommending the 2015/16 baseline profit rate and capital servicing rates, the SSRO carried out due diligence of the work undertaken by the Review Board for Government Contracts under the previous 'Yellow Book' regime. During this review the SSRO signalled its intent to develop a new approach to calculating the baseline profit rate in future.

1.4 The SSRO carried out a review of the previous methodology to assess its limitations and determine its own credible method to deliver a fair and reasonable return for industry while ensuring value for money for the taxpayer.

1 Where QDCs are referred to in this document, this also applies to QSCs.

2. Our Approach

2.1 The SSRO's review focused on the issue of comparability and how to benchmark profits on QDCs against profits achieved by wider industry.

2.2 The SSRO concluded that a single baseline profit rate did not allow for the diversity of products and services covered in single source contracts and proposed a new approach based on setting multiple baseline profit rates with reference to six types of contract activity (contract manufacture; contract design and development; ancillary support services; equipment upkeep, maintenance and support; IT; and capacity provision).

2.3 The proposed methodology was based on transfer pricing principles to analyse company data and calculate the level of return for companies carrying out similar work to that in single source defence contracts. Changes to the treatment of capital servicing were also proposed; as the new range of baseline profit rates were understood to better reflect capital servicing it was suggested that capital servicing rates should be set to zero.

The Consultation

1. The process

1.1 On 25 September 2015, the SSRO issued its proposed baseline profit methodology and launched an eight week public consultation.

1.2 In carrying out this consultation the SSRO sought to ensure that as many people and groups as possible had the opportunity to contribute views. The consultation was published on the SSRO's website[2] and directly emailed to our stakeholder contacts. A consultation response form was provided, including specific questions on the approach.

1.3 In total, we invited 74 stakeholders to respond to the consultation, including government bodies, defence industry contractors, academics, professional associations, think tanks and regulatory bodies.

2 https://www.gov.uk/government/consultations/review-of-single-source-contract-profit-rate-methodology-2015.

1.4 The consultation closed on 20 November 2015. This document summarises the feedback we received and explains the decisions we have taken as a result.

1.5 The final methodology was published on the SSRO's website on 21 January 2016.

2. Breakdown of responses

2.1 We are grateful to all stakeholders who responded to the consultation. In total we received 19 responses and the breakdown of respondents can be seen in Table 1. We have considered all feedback received.

2.2 The SSRO obtained a good understanding of individuals' and organisations' views on the proposed baseline profit methodology from the detailed feedback received.

2.3 Full responses from stakeholders can be found on the SSRO's website, where there was agreement to publish these.

Table 1: Breakdown of respondents

	Government	Industry	Regulators/ other Government Bodies	Trade and Professional Associations and Think Tanks	Research/ Academics	Consultants	Media	**Total**
Number of stakeholders invited to comment	1	30	19	11	5	5	3	**74**
Number of Responses received	1	14	0	1	0	3	0	**19**
Percentage of responses received	100	47	0	9	0	60	0	**26**

3 Overall response and decisions to feedback

3.1 The SSRO has carefully considered the responses provided by stakeholders and believes a methodology based on multiple baseline profit rates by contract activity is credible and will deliver good value for money for the taxpayer and a fair and reasonable return for industry. The SSRO was encouraged that the majority of respondents also agreed the proposals were consistent with achieving these aims. The majority of stakeholders also showed support for a method based on the principle of comparability and a shift towards multiple baseline profit rates. Almost all respondents agreed that the comparator reference groups should be expanded to include companies with activities overseas.

3.2 However, two main areas of concern were highlighted. Few stakeholders agreed with the six proposed contract activity types, on the basis that they did not accurately reflect the categories of work undertaken on single source defence contracts, and that applying these activity types to QDCs may be difficult in practice.

3.3 No respondents agreed with setting capital servicing rates to zero, as it was felt that the comparator companies could not reflect the diversity of capital structures among companies undertaking similar work on QDCs.

3.4 In deciding whether to amend the baseline profit methodology proposals, the SSRO considered the intentions behind the Defence Reform Act 2014, Single Source Contract Regulations 2014 and the SSRO's aim to ensure the methodology strikes the right balance between delivering a fair and reasonable return for industry while ensuring value for money for the taxpayer.

3.5 The SSRO was intending to recommend a number of baseline profit rates. In particular, the SSRO recognised that there should be two main activity types, 'develop and make' and 'provide and maintain', each of which would incorporate a broader range of activities than in the initially proposed categories. This would simplify the categorisation of contracts and also increase the number of comparator companies within each reference group. Consideration was also being given to having rates for specific categories of work that would not fall into these two broad categories, such as ancillary services. It was also intended to recommend a composite rate for 'develop and make' and 'provide and maintain' to address contracts that had significant elements of both activity types.

3.6 However, before the finalisation of the SSRO's proposals we received a letter from the Secretary of State stating:

"For financial year 2016/2017, the methodology used to determine contract profit rates for UK single source government defence contracts should be such that it would result in the setting of a single baseline profit rate."

3.7 The letter from the Secretary of State is statutory guidance, which the SSRO must have regard to when providing the Secretary of State with its assessment of the appropriate rates, to assist him in making his determination (Defence Reform Act, section 19(3)).

3.8 The SSRO's proposed approach was driven by its objective of ensuring good value for money is obtained in government expenditure on qualifying defence contracts and that contractors are paid a fair and reasonable price. The SSRO also gave due consideration to the results of consultation. However, the statutory guidance contains a clear instruction as to what the Secretary of State considers will assist him in setting the rates for 2016/2017.

3.9 Accordingly, the SSRO will be recommending only one baseline profit rate. This will be the composite rate for 'develop and make' and 'provide and maintain' as the combination of these two categories is the best comparator, given there is no single group of comparable companies that covers all aspects of work done under single source contracts. A combination of these two categories represents in excess of 95 per cent of the expected work to be done under single source contracts. The SSRO is confident that this is an appropriate comparator group and is a significantly better comparator group than under the previous 'Yellow Book' approach.

3.10 The letter indicated that the Department supports the principle that multiple baseline profit rates better reflect the risk and reward balance in defence single source contracts but requires more time to understand the implications of the proposal.

3.11 We note that the MOD has indicated that we should work towards having multiple profit rates and that the statutory guidance from the Secretary of State should be regarded as seeking to delay the implementation of multiple rates for one year. Accordingly, we hope to be able to develop a proposal with multiple rates for adoption in 2017/18.

3.12 The SSRO has examined the consultation responses regarding setting capital servicing rates to zero and is satisfied that the right approach is to deliver a return on capital through the baseline profit rate.

3.13 However, given the responses to the consultation, and given that the variation in capital employed within the comparator companies may differ from that of single source defence contractors, the SSRO has decided that capital servicing rates will not be set to zero in 2016/17. As the SSRO may recommend a greater number of baseline profit rates associated with specific activities in future, this could allow capital servicing rates to be set to zero in the longer term.

3.14 Accordingly, the SSRO will calculate and recommend the capital servicing rates following a similar methodology to that used in the previous 'Yellow Book' regime. The requirements in step 6 for determining the capital servicing adjustment will remain unchanged.

3.15 The 'Single Source Baseline Profit and Capital Servicing Rates Methodology' (Baseline Profit Rate Methodology) published on 21 January 2016 provides full details of the final methodology for determining the baseline profit rate. The SSRO has also updated the 'Contract Profit Rate Guidance' on the adjustments to the baseline profit rate and will launch a public consultation on these changes.

3.16 Given the instruction from the Secretary of State and the consequent decision of the SSRO to recommend a single baseline profit rate we have not summarised the feedback received for every consultation question. The paragraphs below summarise the feedback received on those questions that remain relevant and the SSRO's response.

Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

3.17 The majority of respondents agreed with using the principle of comparability to set baseline profit rates (15 out of 19 respondents). Over half of respondents also stated that the companies selected for benchmarking need to be appropriate comparators in order to achieve fair and meaningful comparisons (11 out of 19).

3.18 *The SSRO is satisfied that the transfer pricing principles used in the methodology will ensure a fair and reasonable return for industry and value for money for the taxpayer. Appropriate comparator companies are selected on the basis that they share similar risks, assets and characteristics to work undertaken on QDCs. The process for selecting comparator companies is documented in the Baseline Profit Rate Methodology publication.*

Do you agree the profit level indicators should always be 'net cost plus'?

3.19 Around two thirds of respondents agreed that net cost plus should be the profit level indicator (PLI) for all activity types (13 out of 19 respondents).

3.20 The SSRO agrees it is simpler and more consistent to use net cost plus as the PLI for the two activity types used to determine the baseline profit rate. This PLI is the same as the 'return on total cost' PLI used in the previous 'Yellow Book' regime.

Do you agree that having multiple baseline profit rates which reflect the type of contract activity means that capital servicing allowances can be set at zero?

3.21 No respondents agreed that capital servicing should be set to zero as a result of introducing multiple baseline profit rates by activity. Reasons given for this included that: a bespoke reward for capital servicing is needed due to the variation in company capital structures; the baseline profit rates would not be able to account for the diversity of capital structures among companies performing the same activity; and the approach could discourage companies to invest in asset or site purchases.

3.22 A few respondents suggested that including capital servicing as an Allowable Cost would be a credible alternative (3 out of 19).

3.23 The SSRO is satisfied that the right approach is to deliver a return on capital through the baseline profit rate.

3.24 However, in response to views expressed on this issue, the SSRO has decided that capital servicing rates will not be set to zero in 2016/17. Therefore the SSRO will calculate and recommend capital servicing rates to the Secretary of State following a similar methodology to that used in the previous 'Yellow Book' regime. These include rates for fixed capital, positive working capital and negative working capital. The requirements in step 6 for determining the capital servicing adjustment will remain unchanged.

3.25 Some changes have been made to the previous 'Yellow Book' methodology for calculating capital servicing rates. For example, instead of using a BBB- credit rating in the calculation, the credit ratings of the top defence suppliers to MOD by expenditure were analysed. The appropriate credit rating for these suppliers was assessed as BBB using December 2015 data and will be used in the calculations as it is believed to be the right proxy for credit ratings of contractors with QDCs. For working capital (negative) the methodology is to use a three year rolling average of the Bank of England statistics on interest for short term deposits. The previous approach used a three year rolling average of the London

Interbank Offer Rate (LIBOR), less 0.125 percentage points to reflect the difference between LIBOR and London Interbank Bid Rate (LIBID). The change to use the Bank of England data without an adjustment will provide greater simplicity and transparency, as opposed to using a LIBOR rate with an adjustment.

3.26 As in the previous methodology, the baseline profit rate will be adjusted to remove capital servicing from the comparator company data, as each contractor will receive an appropriate return for this through the capital servicing adjustment.

3.27 As part of its review of Part 2 of the Defence Reform Act 2014 and the Single Source Contract Regulations 2014, the SSRO will explore options for making the cost of servicing capital an Allowable Cost and setting capital servicing rates to zero to deliver a return on capital through baseline rates associated with more specific activities.

Do you agree with the proposal to continue to use three year rolling averages?

3.28 The majority of respondents agreed with continuing to use three year rolling averages (17 out of 19 respondents). Over half of respondents stated this would help to maintain stable baseline profit rates over time and smooth fluctuations in the data (11 out of 19).

3.29 The SSRO will continue to use three year rolling averages in the baseline profit methodology. As discussed above, the baseline profit rates used in the three year average will exclude capital servicing. For the next two years, the three year rolling average will include the underlying baseline profit rates from the previous 'Yellow Book' regime, which also exclude capital servicing.

3.30 Under the new methodology, the SSRO will also publish the baseline profit rate without the adjustment for a return on capital. This is currently for information only but may be used in future if a greater number of baseline profit rates associated with more specific activities are recommended in future, which could allow capital servicing rates to be set to zero.

Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

3.31 Almost all respondents agreed that UK based companies with activities predominantly overseas should be included in the comparator reference groups (18 out of 19).

3.32 The SSRO will include UK companies with activities predominantly overseas in the calculations for the baseline profit rate.

Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

3.33 The majority of stakeholders who responded to the consultation agreed that overseas companies operating in Western Europe and North America should be included in the calculations (16 out of 19). Over half of respondents also mentioned the need for the international data and companies assessed to be comparable to those in the UK (11 out of 19).

3.34 The SSRO will include overseas companies operating in Western Europe and North America in the baseline profit rate methodology. The data used in the calculations originates from an international database of publicly filed financial information. A detailed review of accounts, business descriptions and company websites is undertaken to ensure the nature and location of each business' activities is understood.

4 Additional issues raised by respondents

4.1 The table below shows the key additional comments made by respondents.

Issue	Description of issue	Response
Transparency	Over half of respondents requested that the comparator companies used, the criteria for their selection and the calculations used to determine the baseline profit rates should be published (10 out of 19).	The SSRO will publish the list of companies in the comparator reference group. The process for selecting companies and calculations used are provided in the SSRO's Baseline Profit Rate Methodology publication.
Comparing international data	A few respondents enquired whether international data would be standardised prior to benchmarking and if only companies using International Financial Reporting Standards will be included (3 out of 19).	The potential impact of accounts being filed by comparable companies under different accounting standards, such as IFRS or their local country's Generally Accepted Accounting Principles (GAAP), was considered as part of this review. The analysis of company data focuses on profit and loss account data. The requirements of local GAAP in the relevant countries and IFRS are not considered to create material differences which would distort the operating profit results in the samples. Restricting companies to those which file under a particular accounting standard (such as IFRS) could restrict the size of the sample unduly and may bias the sample towards larger companies. For example, this would exclude companies in the US who remain on local US GAAP.
Adjustments for Allowable Costs	A few respondents requested details about whether comparable company profit data would be adjusted to account for the Allowable Cost regime (3 out of 19).	The consultation document explained that the SSRO would make adjustments to the methodology for Allowable Costs. However, after further consideration of the methodology, the SSRO believes these adjustments should not take place. The SSRO's Allowable Costs guidance explains some forms of amortisation can be treated as Allowable Costs and therefore the cost of production data for comparable companies should not be adjusted. As company accounts do not generally separate out selling and marketing costs, it would not be possible to adjust for these.

Next Steps

5.1 The SSRO will follow the methodology published on 21 January 2016 and analyse the comparable company data used to produce the baseline profit rate, and calculate the capital servicing rates.

5.2 The SSRO will make its recommendation on the baseline profit rate and capital servicing rates for QDCs for 2016/17 to the Secretary of State for Defence before 31 January 2016.

5.3 The Secretary of State is expected to publish the rates for 2016/17 by 15 March 2016.

5.4 The SSRO has amended the ‘Contract Profit Rate Guidance’ on the adjustments to the baseline profit rate. A five week consultation on this guidance will be launched on 25 January 2016. Further details on the consultation can be found on the SSRO’s website.

5.5 Following a review of consultation responses, the SSRO will finalise and publish the guidance on the adjustments to the baseline profit rate, prior to the introduction of the 2016/17 rates on 1 April 2016.