



SSRO

Single Source
Regulations Office

Review of single source contract profit rate
methodology 2015
Consultation paper

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Executive Summary

The SSRO is required to recommend to the Secretary of State for Defence appropriate rates of profit that contractors should receive for work procured by the MOD on a non-competitive basis

- The SSRO is the recently established independent regulator of the procurement of 'single source' military equipment and services by the MOD.
- Section 19(2) of the Defence Reform Act (2014), requires the SSRO to provide its assessment of the appropriate rate to the Secretary of State for Defence for qualifying defence contracts (QDCs).¹

A credible method to set profit rates is needed to ensure public confidence in MOD single source procurement

- Single source procurement represented around 53 per cent of new MOD contracts in 2014/15. The MOD spent approximately £8.3 billion on single source contracts in 2014/15.
- Competition may not be possible because of a lack of or limited numbers of competitors, for national security reasons, or for urgent military requirements.
- In the absence of market forces, a credible framework is needed to oversee single source procurement.

To be credible, the framework needs to deliver value for money for the taxpayer and a fair and reasonable return for industry

- Profits for companies need to reflect the risk they take in carrying out work.
- Profits need to reflect the diversity of equipment and services delivered and therefore the type of work undertaken.
- The regime needs to be transparent about profit rates expected and achieved.

The SSRO has carried out a review of the way profit rates were set previously, from which it has learned lessons about how to ensure its new methodology is fit for purpose

- Profit rates were set from 1968 until 2015 using the principle that contractors should earn a return comparable to the average of British industry.
- As the SSRO is a new independent regulator it needs to set its methodology for assessing appropriate profit rates, and ensure the methodology is robust.
- The SSRO has therefore reviewed the approach taken until now, and particularly focused on the issue of comparability.

¹ Where qualifying defence contracts are referred to in this document, this also applies to qualifying subcontracts (QSCs).

Comparability should remain an important principle in setting profit rates, but the approach adopted in the past was too blunt

- Delivering value for money for the taxpayer, and ensuring a fair and reasonable return for industry, requires comparison against others doing similar work.
- However, the range of companies included in the past comparisons was too broad. Companies carrying out completely different work, for example in the retail, pharmaceuticals, tobacco and food and drink sectors, were included in calculations to set profit levels.
- The single rate did not allow for the diversity of products and services covered by MOD single source procurement. The single baseline profit rate, based on the average profits of British industry, could be varied according to risk, but was not varied by type of work.

The SSRO is proposing to set profit rates in future based on comparable work

- The SSRO will analyse company data, using the methodologies commonly used for 'transfer pricing'² purposes, and calculate the level of return for companies carrying out similar work.
- The SSRO proposes to recommend baseline profit rates associated with six types of work (contract manufacture; contract design and development; ancillary support services; equipment upkeep, maintenance and support; IT; and capacity provision).
- This approach will ensure credibility, providing more appropriate returns that are demonstrably fair and reasonable, as well as representing value for money for the taxpayer.

²Transfer pricing is a concept which seeks to ensure that companies operating in a number of territories receive appropriate income and profit in each, as if each territory were operating at arm's length as a third party would do. Transfer pricing prevents companies from manipulating their pricing between territories to locate profit in territories with lower tax rates.

The baseline profit rates will provide a return on capital

- The approach in the past was to provide separate allowances to companies based on the level of capital employed by each contractor. This was necessary because a single baseline profit rate could not reflect the diversity of work.
- The level of capital employed in similar types of work for non-MOD customers should be comparable. For example, building a large ship for a private sector firm should require proportionally similar levels of capital as building a large ship for MOD.
- The proposal is therefore that the new range of baseline profit rates will better reflect capital servicing, and so the capital servicing allowances will usually be set to zero.
- An alternative approach, which the SSRO is consulting on, would be to make capital servicing an allowable cost.

Implementation will be kept simple

- The baseline profit rate applicable for a particular contract will be an objective matter (based on type of work).
- Where there are two or more types of work, the baseline profit rate will be an average across the relevant rates, weighted according to the cost in each type.
- The range of risks in a contract do vary, and so the MOD and a contractor will continue to negotiate the risk adjustment, up to +/-25 per cent of the baseline profit rate. The SSRO will issue updated guidance on this before April 2016.
- Where a contract is extremely high in value, the SSRO could be asked to provide an opinion on the contract profit rate to be applied.

The SSRO will ensure transparency on profit rates

- To monitor how the new approach is working, the SSRO will review the profit rates set (or expected), and the actual profits achieved. The SSRO is collecting, for the first time in the UK, a full set of data on expected and achieved profit rates, in single source defence contracts.
- The SSRO will ensure transparency on profits, by publishing each year (in aggregate form) information on the level of profit agreed in contracts and the level of profit actually achieved.

The SSRO is consulting on the proposed new approach, and will finalise the methodology and recommend profit rates by 31 January 2016

- This consultation runs for eight weeks from 25 September 2015. A consultation feedback form is available at: <https://www.gov.uk/government/organisations/single-source-regulations-office>
- Following consultation, the SSRO will finalise the methodology and then make its recommendations to the Secretary of State for Defence, by 31 January 2016, on the baseline profit rates for 2016/17.

Background

1. Introduction

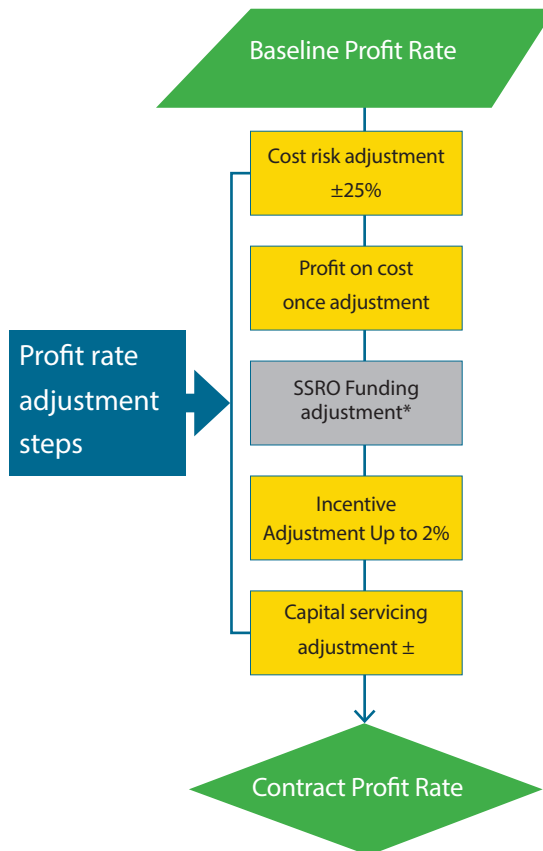
- 1.1 Under the Defence Reform Act 2014 (the Act), the Single Source Regulations Office (SSRO) is required annually to review the figures used to determine the contract profit rate for pricing single source contracts. Section 19(2) of the Defence Reform Act 2014 requires that, for each financial year, the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate and capital servicing rates.
- 1.2 Under the previous Yellow Book regime, the baseline profit rate and capital servicing allowances were calculated by the Review Board for Government Contracts (the Review Board), an advisory non departmental public board sponsored by the Ministry of Defence (MOD). The Review Board developed these rates for the final time for the 2015/16 financial year.
- 1.3 In recommending the 2015/16 baseline profit rate and capital servicing allowances, the SSRO carried out due diligence of the work undertaken by the Review Board. During this review the SSRO signalled its intent to develop a new approach to calculating the baseline profit rate in future.
- 1.4 As the new independent expert regulator, the SSRO needs to determine its methodology for calculating the profit rate and ensure it is credible. In line with its overarching aim under Section 13(2) of the Defence Reform Act, one of the SSRO's key objectives is to recommend an appropriate profit rate which strikes the right balance between delivering a fair and reasonable return for industry while ensuring value for money for the taxpayer.

1.5 This paper sets out the results of the single source contract profit methodology review and presents the proposed new approach from 2016/17.

2. Contract profit rate steps

2.1 Section 17(2) of the Act and Regulation 11 of the Single Source Contract Regulations 2014 (the 'Regulations') sets out the six steps for determining the contract profit rate for qualifying defence contracts. These steps provide for adjustments to be made based on the rate and funding adjustment described in Section 19(1) of the Act. Step 1 uses the baseline profit rate as the starting point and Step 6 includes an adjustment for capital servicing (see Figure 1 and Figure 2). Both of these steps require an effective methodology to determine the resulting rate and adjustment.

Figure 1: Contract profit rate formula flow chart



* Not applicable until 2017

Figure 2: Steps required in applying the adjustments to the baseline profit rate to determine the contract profit rate

Step 1

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

Step 2

Adjust that rate by an agreed amount, being an amount falling within specified parameters above or below the baseline profit rate, so as to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs.

Step 3

Deduct an agreed amount from the amount resulting from step 2, so as to ensure that profit arises only once in relation to those allowable costs under the contract in respect of which Regulations provide that a deduction may be made.

Step 4

Deduct the SSRO funding adjustment which is in force at the time mentioned in step 1 from the amount resulting from step 3. This step will not apply until 1 April 2017.

Step 5

Where the Secretary of State determines that the amount resulting from step 4 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount specified by the Secretary of State. Any increase must not exceed the maximum increase of 2 per cent.

Step 6

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

This adjustment:

- (a) is to be made having regard to the capital servicing rates determined under section 19(1) of the Act; but
- (b) does not apply to the extent that the costs of the fixed and working capital employed by the primary contractor are already allowable costs under the contract.

The contract profit rate is:

- (a) the amount found at the end of step 6; or
- (b) in a case where step 6 is disapplied under section 18(2)(a) of the Act, the amount found at the end of the last of the steps in subsection 18(2) that apply in that case.

The Secretary of State or an authorised person, and the primary contractor, must have regard to guidance issued by the SSRO in relation to any of the steps set out above.

See 'SSRO Contract Profit Rate - Guidance on adjustments to the baseline profit rate' for more information: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417883/SSRO_Guide_Adjustments_to_baseline_profit_rate_reduced-size-web.pdf

3. Previous methodology to calculate the baseline profit rate and capital servicing allowances

3.1 The Review Board previously set the baseline profit rate based on the principle of comparability, where it was assumed that defence contractors involved in non-competitive contracts should receive “a return equal on average to the overall return earned by British industry, having regard to both capital employed and cost of production”¹.

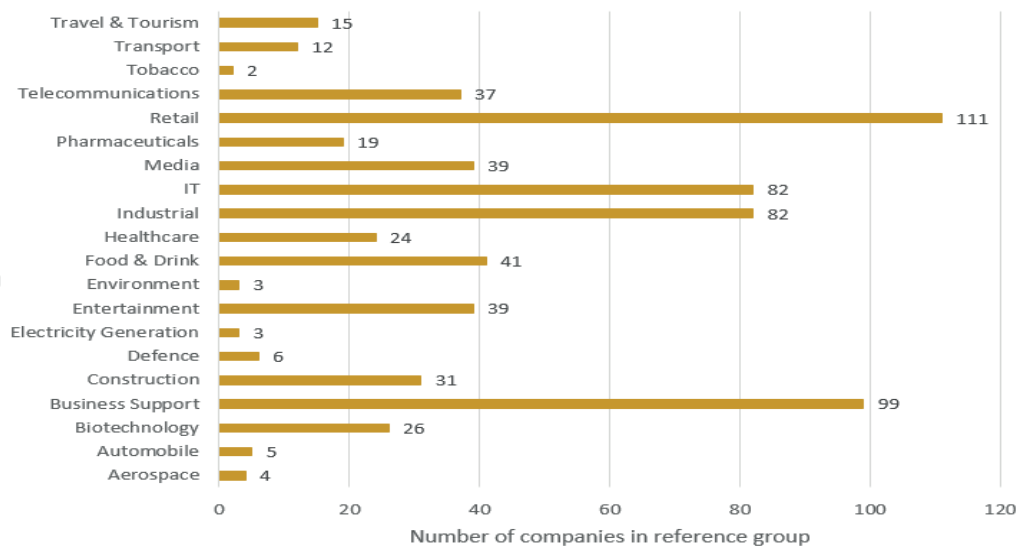
3.2 This approach used a reference group of over 600 UK companies from the FTSE and AIM stock exchanges to examine wider industry profits. Within this group, a small number of companies (around 70) drove about 80 per cent of the reference group profit figure.

3.3 The following industry sectors were not included in the reference group as the Review Board believed they could have compromised the comparability principle:

- Primary industry sectors – agriculture, mining and oil & gas.
- Financial industry sectors - banking, insurance and investment.
- Regulated utility sectors - water and multi-utilities.

3.4 However, the reference group still included companies from a wide range of industries. For example, companies in the retail sector comprised 16 per cent of the 680 companies used in the comparator reference group in the 2015 baseline profit rate review. A third of companies in the reference group were from the retail, media, food and drink and entertainment sectors (see Figure 3).

Figure 3: Reference group by industry sector in 2015 baseline profit rate review



¹ See Review Board for Government Contracts ‘Report on the 2014 annual review of the profit formula for non-competitive government contracts’ February 2014.

- 3.5 In addition, the percentage profit (return on cost of production), cost of production and earnings before interest and tax (EBIT) of the different industry sectors incorporated within the reference group vary greatly (see Figure 4).
- 3.8 The fixed capital servicing allowance (FCSA) and the working capital servicing allowances (WCSA) were determined by the Review Board using rolling averages of corporate bonds and London Interbank Offered Rates historical data.
- 3.9 The Review Board downloaded publicly filed company financial

Figure 4: Cost of production, return on cost of production and earnings before interest and tax for industry sectors included in 2015 baseline profit rate review reference group



- 3.6 The baseline profit rate was derived from calculating EBIT minus the cost of servicing capital and then the value was expressed as a percentage of cost of production. It is therefore a measure of profit made on cost of production when the cost of servicing capital has been removed. Capital servicing was then added back in through the capital servicing adjustment (Step 6) of the contract profit rate formula.
- 3.10 Each year, the underlying baseline profit as a percentage of cost of production was calculated using data from the reference group in the most recent financial year for which data was available. The exact composition of the companies within the reference group varied each year.
- 3.7 The capital servicing allowances are in three parts:
 - fixed capital servicing allowance;
 - working capital servicing allowance (positive); and
 - working capital servicing allowance (negative).
- 3.11 A simple three year average was used to calculate the recommended baseline profit rate in order to smooth out changes in the annual figure.

4. Trends in baseline profit rates and capital servicing allowances

4.1 Baseline profit rates set (using a three year rolling average) ranged between 7.27 per cent to 10.7 per cent over the past ten years². Table 1 shows the baseline profit rates and capital servicing allowances set using the previous methodology between 2006 and 2015.

4.2 The overall contract profit rate will differ from these baseline profit rate(s), as subsequent adjustments are made when setting the rate, for example to adjust for contract risks (see Figure 1). There is limited evidence to demonstrate what the overall contract profit rates set have typically been, as well as the outturn profits achieved when contracts are completed.

Table 1: Baseline profit rates and capital servicing allowances set during 2006 - 2015

Review year	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
FCSA	6.79%	6.71%	6.71%	6.69%	6.71%	6.65%	6.54%	6.39%	6.20%	5.94%
WCSA	5.74%	6.23%	6.23%	6.85%	5.80%	4.28%	2.86%	n/a	n/a	n/a
WCSA (positive)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	2.43%	2.07%	1.72%
WCSA (negative)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	1.42%	1.25%	1.03%
Underlying BPR	9.53%	10.83%	10.04%	9.56%	8.27%	9.29%	10.19%	10.99%	10.92%	9.88%
3 year rolling average BPR	7.27%	9.74%	10.13%	10.14%	9.29%	9.04%	9.25%	10.16%	10.70%	10.60%

* The 2008 Review Board's annual review of the profit formula was not published due to a delay in the publication of the 2007 review. Rates for 2008 were included in the 2009 Review Board annual publication.

Note: The Review Board used a single CSA rate which it applied to both positive and negative working capital up to the 2012 annual review of the profit formula. In the 2013 annual review the Review Board concluded 'it would be appropriate to recognise a separate rate for a contractor with negative working capital' and accordingly calculated separate WCSA rates.

²See SSRO 2015 Contract Profit Rate publication: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

See also Review Board for Government Contracts 'Report on the annual review of the profit formula for non-competitive government contracts' for 2009, 2011 and 2013.

5. Scope of the review

- 5.1 We have conducted a full review of the principles and methodology previously used by the Review Board to calculate the baseline profit rate and capital servicing allowances. In proposing changes to the methodology, we have also highlighted that guidance on applying the cost risk adjustment will be amended.
- 5.2 The main focus has been to explore how to benchmark defence contract profits against the profits in wider industry. The review also examined the following specific issues which were highlighted in the SSRO's '2015 Contract Profit Rate' publication:
1. the principle of comparability;
 2. the exclusion of companies under price regulation;
 3. the inclusion of companies which are UK-based but whose activities are predominately overseas;
 4. the treatment of Research and Development (R&D) tax credits; and
 5. the use of simple rolling averages.

6. Consultation timeline

- 6.1 The SSRO is consulting on the proposed new approach, and will finalise the methodology and recommend profits rates by 31 January 2016.
- 6.2 The consultation runs for eight weeks from 25 September 2015 until 20 November 2015. A consultation feedback form is available at: <https://www.gov.uk/government/organisations/single-source-regulations-office>
- 6.3 Following consultation, the SSRO will finalise the methodology and recommend the baseline profit rate and capital servicing allowances for 2016/17 to the Secretary of State by 31 January 2016. The Secretary of State is to publish the rates by 15 March 2016.

Policy Assessment

In this section, we set out our views on why we believe a new approach is required

1. The principle of comparability and its implementation

Overview

1.1 We conclude that the determination of an approach to comparability, through which we identify relevant benchmarks as an input to determining the baseline profit rate, will remain an essential part of the methodology. However we believe the Review Board set of companies for making comparisons as well as the adoption of a single profit rate are no longer appropriate. We therefore propose a new approach which incorporates the principle of comparability in the methodology.

The principle of comparability

1.2 Currently the mechanism for setting the contract profit rate on single source defence contracts is based on a series of adjustments to the baseline profit rate.

1.3 To date the baseline profit rates recommended by the SSRO and the Review Board have been set using “the principle of comparability”, where it is assumed that the defence contractors involved in non-competitive contracts should receive “a return equal on average to the overall return earned by British industry, having regard to both capital employed and cost of production”¹.

1.4 The SSRO’s initial consideration is whether or not, as a principle, comparability should be retained for the purpose of setting baseline profit rates. The answer to this question is positive. It is not possible to directly observe a ‘fair’ level of profit. Such a judgement can only be reached with reference to comparative data, where profits are determined through arms’ length or market-based processes, so that the level of profit attained can be held up as objective evidence of what constitutes a fair profit. Precisely because by definition no market-based data on profit emerges from single source contracting, we need to look externally for relevant benchmarks. A contract price, for example, might be considered as fair and reasonable if the contractor could generally expect to be paid a similar price in a competitive market for providing the equivalent services with the same levels of cost and risk.

1.5 The use of a competitive market as a basis for comparison in assessing whether prices are reasonable is common in analysis undertaken by competition authorities. In this example, a judgement about whether or not a price is excessive in a market where competition is not effective might be made by comparing that price with the price that is judged to be achievable in an equivalent competitive market.

1.6 Comparisons are therefore likely to be inherent in any method for setting the baseline profit rate. The key issues are how those comparisons are made and what the benchmarks for comparison are.

Is the comparative data appropriate and relevant?

1.7 The company profit data that is used to provide the benchmark in the calculation of the baseline profit data needs to be drawn from companies and functional activities, where the cost structures and market risks borne by the companies are similar to those in defence companies contracting with the MOD. In addition the data needs to be appropriate to provide

¹ See Review Board for Government Contracts ‘Report on the 2014 annual review of the profit formula for non-competitive government contracts’ February 2014.

- a benchmark for different types of defence contracts (for instance, those that involve deployment of company capital assets in the service of MOD as well as those that do not). This is important because the baseline profit rate seeks to replicate what the profit rate for the relevant defence contracts might be had they been exposed to a competitive procurement process. Therefore it is logical to look for adjacent market sectors and companies with similar economic characteristics.
- 1.8 The challenge of finding relevant economic data to use as a proxy in the absence of directly observable, market-based data is a common issue in economic regulation and other economic contexts. One example is the determination of transfer pricing. Transfer pricing methodologies are used to ensure that multinational enterprises do not manipulate prices between their component entities to divert income and profit to lower-tax jurisdictions. The methodologies identify instances where market competition cannot influence pricing to ensure a 'fair' outcome to both parties, for example where entities under common ownership agree a price on the sale of a product to best suit the overall tax position of their corporate group rather than the price which would best reflect both parties' commercial interest on a standalone basis.
- 1.9 Transfer pricing rules require the application of an arm's length standard - the setting of prices on rates and terms to which unconnected parties would agree if they were negotiating with each other independently at arm's length. This is analogous to the SSRO's duty to recommend a baseline profit rate, where we are required to independently determine the profit rate in the absence of a market process (for example a competitive tender) to determine the outcome.
- 1.10 In addition, transfer pricing rules require that in determining comparable companies, they should be selected based on the type of functions and market in question and that the comparator companies should be limited to a set of close comparators.
- 1.11 Given these considerations, we challenge whether the existing methodology is the best approach to generate a comparable return. The methodology sought to generate a return comparable to the average return earned by the rest of British industry. This is by definition a very broad industry base of comparators. The methodology was developed in 1968 when the basket of companies was likely to have been less varied and included a higher proportion of manufacturing companies. The existing basket includes a wide range of industry sectors and would be considered too large and functionally diverse if it were used as support for taxation and it would not withstand scrutiny for transfer pricing purposes. Nor would such an approach be used in the determination of the cost of capital in regulated monopoly sectors, such as energy and rail networks.
- Is it appropriate to maintain a single baseline profit rate to cover all single source contracts?**
- 1.12 A feature of the MOD's single source procurement is that it covers a wide variety of functionally diverse contracts. These can include for example the development of capital assets for transfer to MOD and the leasing of existing privately-owned capital for use by MOD, through to contracts requiring the contractor to incur operating costs only, and facility maintenance.
- 1.13 Given the importance of the comparative data being appropriate and relevant, a single baseline profit rate covering all MOD procurement is no longer the right approach. This rate is based on a comparator sample that is not sufficiently aligned to the contracts in question to be considered 'like-for-like'. A single rate fails to properly recognise the full diversity of contract types and contract deliverables and the risks that are, or are not, associated with them.

1.14 Partly to address this issue, the Yellow Book methodology remunerates capital separately through specified capital servicing allowances. However this creates more complexity in the regime. Furthermore if the comparator sample is representative of the costs and risks faced by the defence contract in question, then an appropriate remuneration of capital should implicitly already be factored in to the baseline profit rate. This suggests that capital need not be separately remunerated through the profit formula.

general has risks that do not apply to the same degree in single source contracts, for example the risk in bringing new concepts to market.

1.15 We have reviewed international methodologies for defence procurement to see how the UK compares to practices in other countries. We note that in none of the following countries is the contract profit rate set with reference to a single fixed rate for all types of defence contracts: the USA, Canada, Germany, France, Netherlands and Australia.

Does the existing methodology set a rate at the right level for MOD contracts?

1.16 The existing comparator set may produce a profit rate that is inappropriate for some MOD contracts. Contracts entered into by the MOD tend to have specific characteristics. Typically:

- the risk for the contracting company can differ on each contract, for example from providing contract manufacturing or services capability to the MOD;
- capital requirements may be lower, as the MOD will contribute to or fully fund buildings or plants; and
- speculative development of products to take to market is rare, as the MOD will fund and specify this development. Where the MOD does not, the development will likely have been similarly funded by another government and should not lead to an additional return for the business.

1.17 In contrast, broader industry in

2. Should companies under price regulation be included in the comparable set?

Overview

- 2.1 We conclude that companies involved in regulated markets will not be specifically excluded and, where arising, a review of the materiality of their regulated activities will be performed on a case-by-case basis.

Review findings

- 2.2 There is an argument that price regulation could influence the output of a set of comparable companies by regulated prices moving it away from a 'true' arm's length range.
- 2.3 In principle, the SSRO sees no reason for a blanket exclusion of regulated industries from the range of comparable companies.
- 2.4 However, as noted above, the SSRO proposes to move to more focused and relevant comparable businesses. In practice, therefore, by using comparables focused closely on the activities involved, the likelihood of regulated companies falling within a set reduces (for example it is unlikely that water companies would be identified in the set of comparable companies).
- 2.5 However some companies returned in the comparable set may be primarily in markets where the pricing between third parties is regulated or otherwise influenced.
- 2.6 The SSRO will address this on a case-by-case basis and will consider exclusion where it is apparent that the extent and influence of the regulated pricing conditions are sufficient to cause an unacceptable level of distortion.

3. Should UK-based companies with significant overseas activities be excluded from the comparable set?

Overview

- 3.1 The SSRO will be using company data from Western Europe (including the UK) and North America in the set of comparable companies.

Review findings

- 3.2 The historic set of comparable companies is based on companies listed in the UK and with a UK headquarters and does not distinguish where companies earn some or all of their income and profits. Equally it does not include companies that are not listed or headquartered in the UK but whose business activities are comparable and which would have been included had they been UK headquartered/ listed.
- 3.3 The review has considered whether to exclude companies which are UK based but whose activities are predominately overseas, and found no reason to necessarily exclude such companies. Unless specifically excluded, the comparables set will include consolidated financial data which will incorporate overseas costs and sales.
- 3.4 Only companies operating in non-comparable markets should be excluded as these may have materially different levels of profit and so distort the resulting range. Therefore the comparators should be chosen from companies operating in Western Europe and North America, where the operation of the economy is similar to that in the UK.
- 3.5 Following transfer pricing principles, where possible the new process will contain a more detailed review to assess whether a material amount of income or profit, which could potentially impact the business' overall results, is made in a non-comparable market.

4. How should Research and Development tax credits be treated in establishing the rate?

Overview

- 4.1 The review finds that no adjustment should be made to the comparable set of companies on the grounds of practicality and, Research and Development (R&D) tax credits should continue to be dealt with within the Allowable Costs regime.

Review findings

- 4.2 Under UK tax rules, spending on qualifying R&D activity can attract a tax credit which is payable 'above the line'. This could alter the profit of the contracting entity, potentially duplicating reward from the government for an R&D process it effectively funds through the contract.
- 4.3 The nature of third party information means that it is very difficult to isolate and extract any R&D tax credits received by companies. This is not information which is typically disclosed in public filings of financial information.
- 4.4 As such, adjusting a comparables set for the impact of R&D tax credits is likely to be either based on broad assumptions, which would reduce robustness of the outcome, or be impractically time consuming. Furthermore, R&D tax credits are already covered in the SSRO's [Single Source Cost Standards -Statutory Guidance on Allowable Costs](#) and so should not be covered in the Baseline Profit Rate or elsewhere in the Contract Profit Rate, thus preventing any duplication of reward.

5. Should simple rolling averages be used in the calculations?

Overview

- 5.1 We conclude that the use of simple averages over a period of time is suitable, and indeed is already used in other similar work in transfer pricing. The use of three year rolling averages should continue, using profit rates based on a single year of data.

Review findings

- 5.2 Rolling averages take into account results over a set period of years - a 'window' that rolls forward as time progresses. The current methodology uses simple rolling averages to smooth changes in the baseline profit rate and capital servicing allowances over time. A three year rolling average is currently used for the baseline profit rate.
- 5.3 The review found that the use of simple averages over a period of time is suitable and the use of three year rolling averages should continue in order to smooth changes in the annual figures.

6. International approaches

Overview

- 6.1 The review also considered international approaches. Of the countries reviewed, the UK is the only one that has a single baseline profit rate.

Review findings

- 6.2 Methodologies to determine profit on single source contracts vary by country. In the USA, Canada, France, Germany, the Netherlands and Australia all elements of the profit methodologies are applied on a case-by-case basis. Profits in Australia, France, Germany and the Netherlands also involve negotiations on each profit element and all assess the risk involved in the contract.
- 6.3 The USA has a prescriptive approach and the application of these rules, rates and costs are reviewed by auditors within the Defence Contract Audit Agency (DCAA).
- 6.4 Canada, France, Germany and Australia also have laws enforcing pricing audits, although the Netherlands do not.

Overview of proposed model

1. Overview

1.1 This section summarises the operation of the proposed revised methodology and the way in which the SSRO intends to approach the steps involved.

1.2 In overview, the revised methodology will identify comparable companies tailored specifically to the activities, including assets and contract risks, involved in qualifying defence contracts and qualifying subcontracts. It will achieve this by:

- identifying characteristics of activities typically covered by single source defence contracts;
- setting appropriate profit level indicators;
- determining appropriate and robust comparable company financial data using third party company databases;
- reviewing this comparable data in the context of contract types seen by the SSRO and the activities of the comparable companies;
- using this data to set the baseline profit rate for each contract activity; and
- ensuring that this data is maintained year-on-year.

2. Activity characterisation

2.1 To ensure that the analysis of comparable companies is robust it must be tailored as specifically as possible to the functions, assets and risks of the activities involved in different types of qualifying defence contracts (QDCs).

2.2 Typical and expected contract requirements will be reviewed by the SSRO to understand these factors, for example including:

- whether the activities are speculative - involving development for sale - or routine;
- the level of independently developed intellectual property required, such as patents, trademarks or know-how;
- the assets involved, for example is the activity reliant on a capital-intensive production line or primarily a people business;
- the risks involved in performing the activities, for example stock risk, warranty risk or the need to maintain levels of innovation. Wider market risk should also be considered; and
- the management of these functions, assets and risks.

2.3 It is important to consider factors which govern the level of risk in a business, as this will drive the potential profit levels of that business, and the likely volatility of that profit.

2.4 For example, speculative activities such as the up-front funding and development of intellectual property will typically be expected to involve higher levels of capital and risk. Entities displaying these characteristics would be expected to command a higher level of return when making sales in a competitive market, but are expected to be prone to more volatile levels of profit as they have greater capacity for good years and bad years. Given the impact on profit levels, it is important that comparable companies are focused on similar levels of risk, including requirements for up-front speculative development, to be appropriate and effective.

2.5 The review of comparable companies will identify the companies which

best fit the activities in question by examining what is required in the delivery of the product or service, and how this is managed. It will also place this in the context of the contract requirements of QDCs/QSCs.

- 2.6 The output of this review will be the ability to characterise the core activities typically covered by single source contracts. These may be contracts with one activity or combining more than one activity characterisation.
- 2.7 While ideally the mapping of contracts to activity types would be at as detailed and granular level as possible, the SSRO is mindful of the need for practicality and ease of application of the new model.
- 2.8 The SSRO anticipates six activity

Table 2: Activity characterisations

Activity characterisation	Example
1. Contract manufacture	Manufacturing / assembly to specification and order
2. Contract design and development	Research and development of intellectual property to order
3. Ancillary support services	Back office and routine support services, for example clerical work or upkeep of grounds and facilities
4. Equipment upkeep, maintenance and support (including training)	Servicing and training contracts for MOD equipment, spare parts including high tech maintenance
5. Capacity provision	Provision of asset hours (eg flying hours for an aircraft) to MOD requirements
6. IT	Provision of IT related services

characterisations (see Table 2):

3. Setting appropriate profit level indicators

3.1 To determine a robust baseline profit rate for each activity characterisation, the most appropriate profit level indicator (PLI) must be selected. A profit level indicator refers to the margin or measure used relative to an appropriate base (e.g. costs, sales or assets) that is realised from a transaction.

3.2 For example, activities which are routine (i.e. performed to order rather than based on up-front speculative investment) typically earn a reward based on the cost of performing that activity. A profit based on these costs, a cost plus margin, is appropriate as it is linked to this cost base. A cost plus margin is calculated as:

$$\text{Return on total cost} = \frac{\text{Operating Profit}}{\text{Total Expenses}}$$

3.3 'Net cost plus', one of the suggested PLIs, is the ratio of recent years of operating profit to total cost. The net cost plus margin is a measure of return on costs using the total operational expenses of the company. The ratio can allow for differences in functions by assuming that they are reflected in the level of total operating expenses, with many items able to be included in either cost of goods sold or other operating expenses.

3.4 Businesses which take more risk in the delivery of products or services for a set fee often target a certain level of profit. This operating margin, as seen in the results of these companies, may be the most appropriate PLI in this case. An operating margin is calculated as:

$$\text{Operating margin} = \frac{\text{Operating Profit}}{\text{Net sales}}$$

3.5 Activities based on the effective utilisation of assets, by maximising the value of these assets while managing their cost may be best measured by the profit made from these capital assets. This is the return on capital employed. A return on capital employed is calculated as:

$$\text{Return on capital employed} = \frac{\text{Operating Profit}}{\text{Total assets - current liabilities}}$$

3.6 For each activity characterisation an appropriate PLI will be selected. This should be the most appropriate PLI for the activity in question. Suggested PLIs for the six activity groups are shown below:

Table 3: Suggested profit level indicators for each activity characterisation

Activity characterisation	Suggested profit level indicator
1. Contract manufacture	Operating margin / Net cost plus
2. Contract design and development	Net cost plus
3. Ancillary support services	Net cost plus
4. Upkeep, maintenance and support	Net cost plus
5. Capacity provision	Return on capital employed / Net cost plus
6. IT	Return on Capital Employed/ Net cost plus

3.7 In overview, activity characterisations 1-4 are essentially routine services activities, focused on the delivery of functions or products rather than the results of up-front speculative investment. As set out above, a reward based on these costs of performing the activity, incorporating a margin, is considered appropriate.

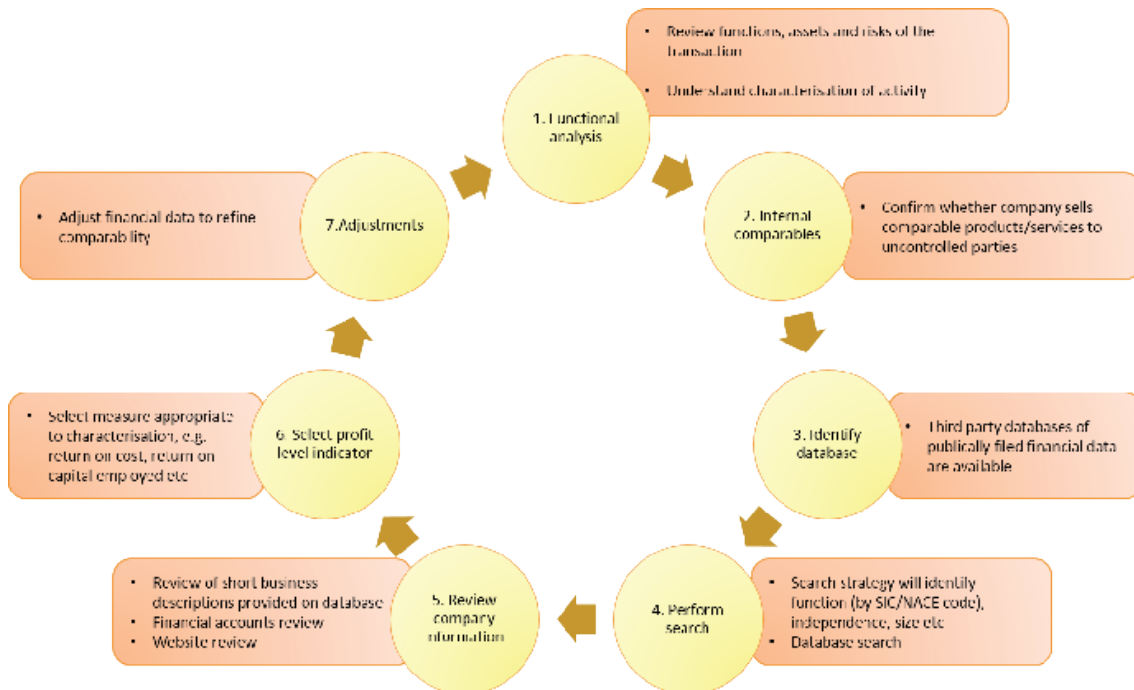
- 3.8 For activity characterisations 5-6, (Capacity provision and IT), the effective use of owned assets will be the key measure and so a return on capital employed, i.e. those assets, is considered appropriate. If consistency of PLIs across all activity characterisations is sought, the level of return could be expressed as a net cost plus (with the identification of appropriate asset-related costs).
- 3.9 For a single contract that includes elements of two or more different contract pricing types, a weighted average rate of the baseline profit rate for each type should be calculated and applied.
- 3.10 The weighted average rate would be weighted with reference to the relevant indicator, such as the costs for each element of the contract aligned to a different activity type.

4. Determining appropriate comparable data

- 4.1 An analysis of comparable companies will be performed to identify and gather the data required to set the baseline profit rate, for each activity characterisation.
- 4.2 Publicly filed company financial results compiled in a database, for example by Bureau van Dijk, will be used for this analysis and data will be scrutinised for quality assurance purposes. This financial data will be supplemented where necessary by other publicly available information on these potentially comparable businesses.
- 4.3 The comparable search process will follow transfer pricing principles and the best practice approach set out by the OECD and supported by HMRC. This is summarised below in Figure 5. The use of the OECD and tax authority accepted practices mean that the comparable benchmarking process has been widely tested and should be familiar to business.

- 4.4 Where steps in the search process involve an element of subjective judgement, specifically the manual review of company data, the assumptions and parameters guiding these assessments will be determined and clearly demonstrated. The classification of companies by activity type will be carried out using data such as Standard Industrial Classification (SIC) codes.
- 4.5 The outcome of the comparables search will be a range of financial data using the relevant profit level indicator.

Figure 5: Best practice approach to transfer pricing



5. Reviewing the comparable data

- 5.1 The comparable profit ranges for each activity type may need further adjustment to be consistent with the requirements of single source contracts.
- 5.2 Each range will be adjusted to reflect specific considerations of the SSRO's allowable costs regime and the nature of the contracts. For example, there may be an adjustment to exclude amortisation from comparable company data to reflect the absence of material intellectual property (that is funded in-house) in the contracting companies.
- 5.3 The profits earned by the comparable companies will be derived wholly or principally from the types of business model and activities seen on the competitive market. This will take account of:
- the capital employed in the business;
 - the levels of risk undertaken, for example ranging from routine 'work for hire' based on cost incurred, through fixed fee projects to a reward for speculative, upfront development of products for sale; and
 - the effective management of these factors by business management.
- 5.4 As such, profit data provided by the comparable companies will incorporate the capital involved in earning that profit.
- 5.5 Under the previous methodology, the question of an appropriate return on the capital involved in a contract was addressed through the removal of relevant measures in the calculation of contract profit and the subsequent reward of capital employed through the capital allowance provisions of the legislation. This was considered a necessary step to address the variation in capital employed by the historic set of comparable companies,

and the capital allowance provisions were an effective solution to this issue.

- 5.6 Under the revised methodology proposed, the sample of comparable companies will be specific to each activity characterisation. This will remove the wide variation in capital employed and make the baseline profit rate appropriate for the level of capital employed in each activity. As such no further adjustment is proposed in respect of capital employed and capital allowances will be set to zero. The revised model is considered appropriate and is expected to set a baseline profit rate which gives a proportionate return on capital to be achieved under single source contracts, aligning MOD with the return on contracts seen in the competitive market without the need for a further step in the calculation process. This will also contribute to greater transparency under the revised model.
- 5.7 Different contract types will give rise to varying levels of risk under single source contracts. This risk may relate to initial price setting or the treatment of cost variances under each pricing method. The MOD and contractors will continue to need to negotiate the cost risk adjustment, which will remain at +/-25 per cent as set out in legislation. The SSRO will issue updated guidance on its appropriate application.

6. Setting baseline profit rates

- 6.1 The profit range for each set of comparable companies will be used to recommend a baseline profit rate for each activity characterisation. These baseline profit rates will be set out in a table.
- 6.2 Each rate will be identified from the comparable profit ranges, using the median value.
- 6.4 The SSRO recognises that contracts can incorporate multiple types of activity. Where contracts contain more than one activity type, a weighted average profit rate should be applied. The SSRO will update its guidance on the contract profit rate to reflect this.
- 6.5 The allocation of contracts to an activity type and associated baseline profit rate should be objective. However, although we anticipate this would be a rare occurrence, if the MOD or the contractor could not agree on which of the proposed baseline rates would apply to a contract, it would remain possible to seek the SSRO's opinion.
- 6.6 Currently, if the MOD or contractors do not agree on the proposed adjustments within the contract profit rate methodology they are already able to ask the SSRO for an opinion. Guidance on the contract profit rate will be updated to reflect that the SSRO's opinion could be sought on the adjustments being made and which of the proposed baseline profit rates to use in exceptionally high value contracts.

7. Ensuring that data is maintained year-on-year

- 7.1 To remain current, the profit data will be updated annually to reflect the latest available financial data. The comparable companies in the existing set will be reviewed to ensure that they remain appropriate to the activities in question.
- 7.2 A full revision of the search is anticipated every three years, which will involve rerunning the full comparables search process to determine if any additional companies should be incorporated within the comparable set.
- 7.3 This updated programme is consistent with the best practice set out in the OECD Guidelines.

Implementation

This section sets out some of the key considerations for the implementation of the revised contract profit methodology in order to facilitate an efficient and well-communicated transition to the new model.

At this stage in the consultation process, the points discussed below do not provide an exhaustive list of considerations for implementation but do offer an overview of some of the main principles behind applying the new methodology in practice.

1. Introduction of the revised methodology

- 1.1 The introduction of the revised profit model discussed in previous sections would see a shift away from the previous profit methodology which has been in place for many years.
- 1.2 As it is proposed that three year rolling averages will be used to produce the baseline profit rates each year, the impact of the new methodology will be phased in over the following three years. Over the next two years, the SSRO will use the previously agreed underlying profit rates (the baseline profit rate as a percentage of cost of production) in constructing the three year average baseline profit rate for all contract activity types. For example, the 2015/16 profit rate figure used in this calculation will be 9.88 per cent, using the baseline profit rate as a percentage of cost of production.

2. Risk level

- 2.1 As a result of changing the baseline line profit rate methodology, guidance on the wider contract profit rate process will need to be amended.
- 2.2 The comparable company data used to determine appropriate baseline profit rates will draw on financial data from a broad range of companies undertaking a range of risk in their business activities.
- 2.3 However, the SSRO accepts that a wide range of risks beyond what is captured by this proposed model could exist for contracts. Accordingly, the historic +/- 25 per cent cost risk adjustment will remain to address varying risk levels.
- 2.4 The SSRO will issue updated guidance for applying this cost risk adjustment.

3. Transparency on profit rates

- 3.1 To monitor how the new approach is working, the SSRO will review the profit rates set (or expected), and the actual profits achieved. The SSRO is collecting, for the first time in the UK, a full set of data on expected and achieved profit rates in single source defence contracts.
- 3.2 The SSRO will ensure transparency on profits, by publishing each year (in aggregate form) information on the level of profit agreed in contracts and the level of profit actually achieved.

