



Single Source
Regulations Office

Assuring value, building confidence

Key questions and answers regarding the SSRO's baseline profit rate methodology

1. How did the SSRO ensure the comparator companies reflect the complexity of work undertaken on single source contracts?

The SSRO is confident that the companies selected through this process are valid comparators to the work undertaken on single source contracts and that the reference group is appropriate. The SSRO considered the nature of the functions, assets and risks involved in QDCs and QSCs to determine the activity characterisations. Detailed search criteria were then derived to select appropriate companies of a comparable nature. For example criteria relating to profit, turnover, geography, legal form and independence were applied to the financial database to extract comparable companies (see Section 4 of the published methodology).

To extract companies with relevant functions, industry NACE codes (which classify companies by type of economic activity) as well as analysis of company business descriptions were used, using specific text search terms.

To confirm the companies selected were actually undertaking comparable activities, company data, accounts and other information for the selected companies were systematically reviewed in detail. This review contains some subjective elements but every effort is made to assess these consistently, using financial indicators where possible.

This approach follows transfer pricing principles, as set out by the OECD and supported by HMRC.

The result of the review is a robust comparator set that is relevant to the activities undertaken by defence companies. The previous methodology included companies carrying out completely different work to that in the defence sector, for example in the retail, pharmaceuticals and tobacco sectors.

For transparency the SSRO has published the list of criteria used to select comparable companies, including the NACE industry codes and text search terms used (see Section 4 and Appendix B of the published methodology). The SSRO has also published the list of comparable companies used in the reference group, an approach which was not used under the 'Yellow Book' methodology (see Appendix C).

2. Are the comparator groups weighted towards smaller suppliers?

Smaller companies are excluded as only companies with a minimum turnover of £5 million in the most recent year were used in the calculation of the profit rate.

The methodology uses transfer pricing principles to calculate the level of return for a wider group of companies carrying out similar work to that in single source defence contracts. It is not designed to create a comparator group that as a whole is completely representative of all the defence contractors in the UK, for example in terms of turnover. As long as a company meets the set criteria, it is selected as a potential comparator. Company data and information is then reviewed in detail in order to confirm whether it meets the comparable criteria and should remain in the reference group.

The SSRO is confident that the companies selected through this process are valid comparators to the work undertaken on single source contracts and that the reference group is appropriate. The functions, risks and assets of single source contracts were considered and then detailed criteria were derived to select appropriate companies of a comparable nature.

The minimum threshold for a Qualifying Defence Contract is £5 million.

3. Are all prime defence contractors included in the comparator groups?

Defence sector companies from the UK, Western Europe and North America are included in the comparator reference groups. However, companies are only included if they meet all of the search and review criteria, for example relating to legal form, turnover, independence and data availability, and if they were confirmed as appropriate comparators for each activity type. It was also important to exclude those companies making a loss in the calculation year.

This means the group does not for example include all international companies with UK defence contracts.

4. Why are some companies in both activity type lists?

The search process for selecting comparable companies with relevant functions uses industry NACE codes and text search terms of company business descriptions. This means it is possible for companies to be picked up in either activity type category. Company accounts and other information is then reviewed in more detail to confirm they are appropriate comparators for each activity type.

In the majority of cases companies feature in one reference group, as their principal activities were identified as either 'develop and make' or 'provide and maintain' activities. However, where companies are viewed as carrying out main functions relating to both 'develop and make' and 'provide and maintain' activities, they can feature in both comparable company sets.

5. What is the reason to use the median as the choice of average?

The median is widely recognised as an appropriate measure to use according to transfer pricing principles, and is referred to in the best practice approach set out by the OECD and supported by HMRC.

Some respondents to our consultation on the methodology highlighted concerns about the volatility of the baseline profit rate over time and that stability in rates was needed to aid long term planning. Using the median will help to reduce volatility over time and the SSRO will also continue to use three year rolling averages in the baseline profit methodology which has the effect of smoothing changes in the annual figures.

The previous methodology was calculated using a 'mean' average and therefore larger companies had a higher weighting in the final results, and the overall results were more sensitive to the profitability of a small number of these companies.

6. Is the SSRO open to the possibility of profit rates needing to increase in the future or is it more likely that they will continue to be reduced?

The SSRO must ensure value for money for the taxpayer with a fair and reasonable return for industry.

The SSRO has not made any assessment of its recommended profit rates for any years beyond 2016/17. However, if the profits of these comparable companies increase over time, the baseline profit rate would also increase in line with this. The SSRO intends to develop a proposal for multiple baseline profit rates for adoption in 2017/18.

The new methodology uses an appropriate and international reference group of comparator companies and is relevant to the activities involved in undertaking defence contracts. The baseline profit rate is also calculated using a three year rolling average in order to smooth annual changes in the result.

During the SSRO's consultation on the review of the methodology, the majority of stakeholders showed support for a method to produce baseline profit rates based on the principle of comparability.

7. Why did the SSRO not make adjustments to the company profit data for non-Allowable Costs?

The SSRO did not make any adjustments to the comparable company profit data to take into account costs that would generally not be Allowable. The SSRO does not believe that an adjustment should be made to account, for example, for amortisation or sales and marketing costs as the methodology is not dependent on whether costs in individual contracts are Allowable. Any calculation that derived a profit margin before non-Allowable Costs would effectively make them Allowable.

The Single Source Cost Standards state that some forms of amortisation can be treated as Allowable Costs and that sales and marketing costs can be Allowable if they are demonstrably linked to a qualifying defence contract (see section 10 of the Single Source Cost Standards).

On a practical level, there are also data constraints. For example, data on amortisation may not be available for every company in the financial database.

8. What is the impact of the new baseline profit rate on defence contractors?

The baseline profit rate is the starting point for agreeing the profit rate for each contract and is not the actual contract profit rate which will be achieved. For each individual contract, adjustments can be made to take account of factors such as risk, performance incentives and capital servicing rates. Across the contracts examined by the Single Source Regulations Office (SSRO) by 16 March 2016 the average profit rate agreed when a contract was signed was 12.48 per cent, compared with the 10.60 per cent baseline rate for 2015/16.

It is possible to achieve a higher percentage profit than was agreed at contract signing, by reducing costs through increased efficiency.

The methodology provides a fair and reasonable return to industry because it is now based on a comparison to the activities involved in undertaking defence contracts. Previous profit rates that were based on comparison with industry and activity that had little in comparison with fulfilling defence contracts.

A three year rolling average is applied to the baseline profit rate. This will also ensure there will be less volatility year on year in the baseline profit rate.