

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:
consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

London
EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Charly Wason

Organisation:

Ministry of Defence

Position:

Head of SSAT

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

In principle, we support the retention of 'comparability' as an underpinning principle of setting the profit rate. It would be difficult to assess whether our suppliers are being paid a fair return on single source work without such a principle. We also agree that the absence of market-based data on single source profit work means that the SSRO will need to look at other sectors to find relevant benchmarks.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

This system is substantially more complex than the current one. The characterisation of the contract into one of the proposed categories will inevitably frequently be open to interpretation, and the setting of differential rates will strongly incentivise both parties to classify contracts in a way that is advantageous to them. Where we are contracting for more than one type of activity, separate risk adjustments will need to be negotiated for each of the BPRs. The combined effect risks a significant lengthening of the negotiation process, and a slower uptake of QDCs.

We believe that there may also be problems in collecting the data for comparators. Although the activity type may be obvious for some contracts, obtaining a sufficiently detailed dataset for this purpose may be very difficult. Dividing the data into six groups may give rise to two further issues: first, the smaller the activity group, the more chance there is that one or more companies may disproportionately drive the profit rate; secondly, it may be difficult to gather data from. To deal with this complexity, there should be fewer categories as well as comprehensive accompanying guidance by the SSRO on the types of contract activities that would determine which category a contract would fall within.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

As stated above, we believe that there should be fewer categories, with well-defined boundaries between them. We suggest:

- Zero profit rate, for not-for profit organisations
- Pass-through for items where the MOD has taken on the majority of price or performance risk on sub-contracts.
- Facilities and commodities. This would include provision things such as IT, back office and routine support services, commodities (fuel, tyres, batteries etc.) and construction. A comprehensive list of goods or services that fall into this category would need to be drawn up.
- The manufacture and support of specialised military equipment. This would include bespoke IT and communications equipment and possibly certain categories of construction such as specialist nuclear facilities. Again, a comprehensive list of goods or services that fall into this category would need to be drawn up.

We would be happy to work with the SSRO to firm up these categories to ensure that they are defined in a way that minimises the room for disagreement, and to further consider whether any additional or further distinction within the categories might be desirable.

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

We do not understand how a rate based on capital can be applied in a pricing formula based on a return on cost. In principle we could apply a ROCE to the capital employed on a given QDC/QSC, and then divide this by the allowable costs to get a contract specific BPR. But this would be contrary to the Act, which states that the contract profit rate needs to be based on the baseline profit rate published by the Secretary of State and there is no provision for making a contract-specific based on a new methodology. Our view is therefore that the only PLI consistent with the primary legislation is 'Net cost plus'.

Question 5. 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?

Yes No

Please add comments to support your answer:

In principle, we recognise the benefits of multiple precise Baseline Profit Rates. However, given that the calculation of the CSA is one of the six steps prescribed in Section 17(2) of the Defence Reform Act, we would need to ensure that any would not make any of these steps redundant. We would like to work with the SSRO to formulate a proposal that does not have this effect.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

While we support the proposal, we would like to understand better how it could be calculated if the CSA was incorporated into the baseline profit rate

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

Provided that the categories are amended as set out above.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Implications on 'step 2' risk adjustment - We believe that moving from to a choice of multiple BPRs will have a significant impact on the 'step 2' risk adjustment. We welcome the SSRO statement that updated guidance on the adjustment will be issued before April 2016.

The legislation is very clear that the 'step 2' risk adjustment is to "reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs". The pricing method and contract terms and conditions will remain an important consideration in assessing this risk but 'type of work' is also a major factor when agreeing an appropriate adjustment. The move to a choice of multiple BPR's based on type of work will therefore take a significant element out of this process.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Paul Everitt

Organisation:

ADS Group Limited

Position:

Chief Executive

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

The Regulations will govern the pricing and reporting largest, most complex contracts placed by MOD, some of which may have contract durations exceeding 25 years. Many of these high value, long duration contracts underpin long term businesses and for whom stability is critical, particularly when making investment decisions.

From a practical perspective, stability is the critical factor. Comparability is one of a number of methods that can be used to determine the base line profit rate and will be viable provided it delivers the certainty required to allow contractors to invest, a fair return for the contractor, and value for money for MOD. It also needs to be at a level that will attract new entrants to the market and retain existing suppliers. Whatever methodology is used to determine the baseline profit rate, ADS believes the data used should be compiled objectively and used in a transparent manner. An adequate volume of data will be required make meaningful comparisons.

Defence is a global business and all the major defence suppliers operate on a worldwide basis. The new methodology should deliver levels of profit similar to those obtained for performing comparable work on single source contract in other advance economies.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

ADS agrees that there should be multiple baseline profit rates by reference to type of contract activity, providing that the conditions set out in Question 1 are met.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes

No

Please add comments to support your answer:

While ADS understands the SSRO's objective in delineating contract activity into six categories, none correlate closely or reflect the nature of the work and the inherent risks, undertaken by single-source contractors. It remains unclear as to how the new methodology will determine appropriate profit and allocate it when a contract includes a blend of activities.

For example, the SSRO has proposed 'contract manufacture' as one of the six categories of contract activity. However, it may be that in practice, very little or the 'manufacturing' content is performed by the prime contractor itself. Instead, this may be carried out by subcontractors because of the complex or specialised nature of the manufacturing activity. As the nature of defence equipment and associated services has become more complex over time, the role of the Prime Contractor has evolved and the main tasks and roles are now often final assembly, test and commissioning; overall high level system design and integration; programme management; and risk management and ultimate holder of the risk.

Further information will be required regarding the classification and application of the proposed categories. It is unclear, for example, whether a bespoke, small-volume avionics developer/manufacturer should earn profit by reference to a manufacturer of pumps. Similarly, despite the similarities in steel/hull/propulsion, it is unclear whether a military vessel can be compared to a commercial ship given the complex integration of systems that will be required of the former.

Clarification will also be required as to the definition of each of the categories. It can be argued, for example, that there exists considerable overlap between activities that can be classified as 'ancillary support', 'upkeep, maintenance and support' and 'capacity provision'. Furthermore, within each of these categories, activities can vary hugely, with 'upkeep, maintenance and support' activities ranging from building maintenance to nuclear asset maintenance. Whilst recognising that there are some extant contracts for the provision of IT services that have been placed on a single source basis, the need for a separate activity characterisation may be questionable given the ease with which future work could be competed.

If contract activity is to be the basis upon which distinctions are made, ADS believes it should be made clear that this will focus on the components of the output, rather than the context of the types of input cost to the contract. Further information and training for industry will be necessary to ensure that activities across the life of contracts are correctly captured and that their classification is consistent.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

ADS believes that 'net cost plus' is a simple and workable profit level indicator. It's similarity to the profit level indicator used in the current system also makes it easier for industry to understand.

In order to ensure the SSRO are adopting the most appropriate and effective PLIs for each activity characterisation, however, industry would benefit from clear examples of its practical application.

Question 5. 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?

Yes No

Please add comments to support your answer:

The SSRO states in its consultation document that 'the level of capital employed in similar types of work for non-MoD customers should be comparable.' While this seeks to connect a type of work with a capital structure that is optimal and efficient, there is not necessarily always causal link. Business models can vary significantly from company to company, even when the product or service supplied is similar. To illustrate, while EasyJet and BA both supply seats on aircraft, one has adopted a capital structure of leased assets and the other of ownership.

Indeed, for many contractors the capital structure is one inherited from prior MOD ownership, or driven by MoD requirements/contracts. The site/business sale agreements from the MOD pre-suppose CSAs as a method of remunerating contractors for their investment and care will be required to ensure that these agreements are not disturbed by setting CSAs to zero.

There is a direct link between CSAs and the Capital Employed in a business. It will be important to understand the likely effects of setting the former to zero will have on investment, efficiency and make/buy decisions.

It may be necessary to ring fence capital to parts of a business when distinct investment has taken place e.g. PPP/PFI, leased assets etc.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

The importance of stability and certainty for companies when making investment decisions has been highlighted in the response to question 1. If the method achieves this then using a three year rolling average will smooth out any unexpected anomalies. If, however, it fails to achieve stability then a using a three year rolling average will be little more than a 'sticking plaster' and there may still be unwelcome fluctuations. Stability is crucial to enabling contractors to enter, invest and remain in the sector.

ADS would also welcome a review as to whether a longer period rolling average, or a US-style weighted profit guidelines system, would be feasible or desirable. The later has an established track record over a long period of delivering stability.

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

ADS believes it will be possible to include IFRS compliant data, subject to its availability in sufficiently granular format, and that it is used in an open and transparent manner.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

ADS believes it will be possible to include IFRS compliant data, subject to its availability in sufficiently granular format and that it is used in an open and transparent manner.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

ADS believes the proposed methodology will be consistent with the above aims, providing that SSRO takes action to ensure:

- activity characterisations are aligned with the requirements of QDC/QSCs;
- the classification of activities is easy to agree between parties;
- a sufficient volume of robust and objective data is available to allow for meaningful comparisons and stability in the baseline profit rate; and
- the policy adopted for CSAs will reward investment appropriately.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Overview of the Proposed Model (Page 18 et seq)

ADS believes that the availability (or lack thereof) of data may prove to be a significant obstacle to the implementation of the SSROs proposals. For example:

- Transfer pricing data is not publicly available information.
- The activities undertaken by companies rarely fit squarely into one of the SSRO's proposed activity characterisations.
 - Many companies only provide geographical analysis; and
 - Analysis that is disclosed rarely matches the SSRO's categories.
- While SIC codes are for the dominant output of a company (which may have many activities), such codes are often a poor description of the actual output and complexity of an entity. SIC codes can be misleading, especially given they are sometimes managed to minimise Pension Protection Fund levies.

ADS recommends that the SSRO undertakes testing to ensure that the data required for the successful implementation of its proposals is available in the format required. In doing so, it is worth highlighting that few companies aside from defence companies undertake similar activities. Should defence companies alone be sampled, this may result in the US weighted profit guidelines by proxy as most will to some extent be performing contracts under this regime and thereby creating circularity.

Section 2: Should companies under price regulation be included in the comparable set? (Page 15)

This section discusses excluding companies under price regulation, however, the Consultation Response Form omits questions on this issue. Aspects of businesses of a number of ADS member companies are subject to price regulation. In general, ADS believes that the inclusion or otherwise in a Reference Group of a company whose prices

Review of single source contract profit rate methodology 2015

Consultation Response Form

are subject to these controls should be made on the basis of the proportion of its total business subject to the controls. A separate decision would be required in each instance, based on individual circumstances. In addition, the level and form of price regulation and the nature of the Regulator are also issues.

Further information regarding the rationale for including/excluding companies in Reference Groups, and details of how criteria would be applied are required before a firm view on this issue can be provided.

Cost Risk Adjustment Sections 5.1 (p11), 5.7 (p23) and 2.3 and 2.4 (p25)

The interaction between the baseline profit rate and the cost risk adjustment needs to be recognised when setting the former to ensure that overall the SSCRs are working as envisaged. A consistent approach to both is required as treating them separately may result in the SSCRs failing to deliver either value for money for the MOD or a fair and reasonable price for the contractor.

Speculative Development, Section 1.16, Bullet 3 (page 14) and Section 2.4 (page 18)

The statement at 1.16, bullet 3 that the:

'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'

is not entirely supported by the data. Most UK defence contractors have annual PV R&D budgets and statistics issued by BIS² indicates that in aggregate, companies spent approximately £1.7Bn on R&D in 2013, up 7% on the previous year. This data should, however, be treated carefully as:

1. Whilst the BIS data has been compiled using Frascati principles, companies may not classify R&D spend consistently
2. It may include an element of financial support from Government (not necessarily from MOD)
3. The defence R&D cycle is complex. A contractor may fund some low Technology Readiness Level (TRL)³ work from its internal resources and reveal the results to MOD who may then fund (wholly or partly) the next phase. As the work proceeds to the higher TRLs it would be expected that MOD would wholly fund the work as it would be likely be the sole customer for the output.
4. It is common for companies to invest in equipment upgrade programmes
5. R&D can be applied to processes as well as products and services.

This also needs to be taken into account when considering selection of comparable companies as envisaged by Section 2.4.

² See http://www.ons.gov.uk/ons/dcp171778_385959.pdf

³ See https://www.aof.mod.uk/aofcontent/tactical/techman/content/trl_applying.htm?zoom_highlight=trl for an explanation of TRLs

Review of single source contract profit rate methodology 2015

Consultation Response Form

Use of Median Values, Section 6, page 24

ADS believes weighted averages should be used as this will give a better reflection reality and scope of the market.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Martin Williams

Organisation:

Babcock International Group

Position:

Head of Finance - MOD Accounting

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

Provided that it was explained how the information will be sourced and analysed in order to ensure an open and honest consultation and demonstration of consistency of measurement for true like-for-like comparability (we note in the sections below some of our key comparability concerns).

We would also emphasise the issue of size of the sample population for each of the categories, as this will need to be sufficiently large to ensure that profitability comparisons are not subject to statistical anomalies or specific company risk.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

We believe that it should be the output of the contract and the purpose of the business rather than the inputs to the contract which should drive the classification.

When we enter into a contract it is primarily based around the delivery of an output, for example, maintenance or refit of a warship. As such we believe it would be inequitable and arbitrary to split out the inputs to the contract, such as the provision of a facility to house the vessel or the provision of services in support of work undertaken on the vessel, which can be every bit as critical as the engineering delivery, and assign a profit rate to them as all aspects of delivery are required to meet the output requirement.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

We do not believe the categories adequately cover the complexity and risks associated with some services. For example, the refitting of a nuclear submarine is infinitely more complex than provision of training or spare parts, and the management of facilities or provision of maintenance regimes associated with nuclear technologies within a dockyard purchased from the MoD with maintenance obligations on the contractor, is considerably different to facilities maintenance of an office block.

Notwithstanding our comments in Q2, we would suggest that there should be either a greater number of categories, or further disaggregation into sub-categories, in order to reflect the different complexities of contracts. One further category we would suggest is the provision of nuclear related services, due to the unique risks and costs associated with such work.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

We are concerned that disallowed costs (e.g. selling and marketing) would be included as a cost for the reference group in setting the profit rate but would be a charge against profits for MoD contractors. We need to understand how this issue will be dealt with in setting the profit rates.

Question 5. 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?

Yes No

Please add comments to support your answer:

We have certain obligations and legacy agreements with the MOD which predate and span the DRA. These obligations and agreements require us to maintain, update and replace major assets at considerable cost which is then reflected in our capital servicing allowance under current arrangements for calculation of the profit rate. If the SSRO remove capital servicing allowances we will require specific guidance as to how these legacy obligations and agreements will be accommodated in the new methodology.

Furthermore, the capital intensity of a nuclear submarine refitting company is likely to be vastly different to the capital requirements of a non-nuclear business and having too few categories of contract may not enable a fair and reasonable return for businesses of a capital intensive nature.

Alternatively, treating capital servicing as an allowable cost might be a more appropriate arrangement as it would enable the more consistent application of a baseline profit rate, giving consideration to a business' specific financing structure.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

Subject to further guidance on the criteria used to identify a comparable market, company and country. This should include the methodology used to adjust for any differences in accounting policies, systematic market risk, taxation policies, financing costs, FX changes etc.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

As per the comment to Question 7, this is subject to further guidance on the criteria used to identify a comparable country. We are concerned that companies operating in different countries will be subject to different costs of employment and legislative burdens, which could impact their profitability. In addition, a company's strategy for international expansion may impact the level of profit that company is prepared to accept.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

We disagree due to the key points made in our answers to the previous questions, in summary:-

- We believe it should be the output of the contract which determines the profit rate to be applied, not the component parts (inputs) to the delivery of the contract.
- We do not understand how the SSRO will be able to source and analyse appropriate data to enable profit rates to be generated for the proposed categories to enable equitable comparability with MoD contracts.
- We are concerned how the SSRO will deal with the treatment of costs of the reference groups differing from the costs of MoD contractors, with a key example being the costs which are disallowed on MoD contracts under the SSCR's.
- We do not agree that capital servicing should be set at zero as there are too many differences in the capital structures of Companies (an some legacy agreements which require companies to undertake significant capital investment) to adequately reflect it within a comparable profit rate and ensure a fair return to industry.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Pg 22, Section 4 - Companies generally do a range of activities and we don't understand how the use of SIC codes will enable the SSRO to identify comparable profit levels for different types of contracts. Furthermore, in the event that the SSRO could align SIC codes to contracts, is the Bureau van Dijk information internally consistent, for example being categorised in line with SIC codes and all under International Accounting Standards? Will the data be reliant on segmental analysis from publically available accounts in order to provide more relevant profitability comparisons, and if so how would comparisons be made between public and private companies with different disclosure requirements?

Pg 23, Section 5.1-5.3 - we should like further guidance on how the profitability of comparable companies will be adjusted in consideration of accounting policies such as revenue recognition, depreciation, operating cost recognition. Similarly, we should like to understand how adjustments will be made for the timing of transitions that companies may make from time to time between accounting regimes. We are concerned how this will be applied in an objective way.

Pg 25, Section 2.3 - we would like confirmation that it is not intended for the cost risk adjustment to be used to compensate for the inability to appropriately align a contract to a category. The cost risk adjustment is independent of the profit rate and should reflect the risk inherent within the agreed estimate of the contract, regardless of the type of contract. If the cost risk adjustment is intended to be used as a compensatory mechanism, it suggests that the proposed methodology is flawed at the outset.

For almost 50 years, industry has been consulted on the constituent parts of the reference group, so not to do so under new methodology would seem inconsistent with the aim of a fair and reasonable return for industry.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to "conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:

- the principle of comparability;
- the exclusion of companies under price regulation;
- the inclusion of companies which are UK based but whose activities are predominately overseas;
- the treatment of R&D tax credits; and
- the use of simple rolling averages."

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:
consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

David Green

Organisation:

BAE Systems PLC

Position:

Finance Director, Shared Services

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

We support the retention of the principle of comparability as it ensures that contractors are rewarded at a fair and equitable level consistent with a suitable reference group.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

We support the principle that contractors should be rewarded for the type of activity that they undertake.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

The defence industry is characterised by various factors namely:

- Prime contracting and systems integration capabilities;
- The design and development of complex products within exacting timescales to meet customers' operational requirements; and
- Low volume production runs with planned embodiment points for engineering change.

To reflect these factors we suggest an additional activity class to specifically cover prime contracting and systems integration is included in the methodology.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

Question 5. 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?

Yes No

Please add comments to support your answer:

Your suggestion is for fixed and working Capital Servicing Allowances (CSAs) to be subsumed into the baseline profit for each activity class. Implicit in this is the assumption that the capital structures of the reference group are, on average, suitably representative of the capital structures of defence contractors involved in single source contracting. We do not believe that this assumption can be substantiated.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Note that the transition process from the previous methodology to the new methodology would need careful consideration, particularly if CSAs are subsumed into the baseline profit rates.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

The proposed methodology has the capability of meeting these twin objectives, but it must be applied with sufficient insight into the activities undertaken by the UK defence industry for it to succeed.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Michael Hayes

Organisation:

Boeing Defence UK Ltd

Position:

Commercial Director

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

Boeing agrees that the use of comparability is acceptable in principle. Any data-set needs to be statistically significant and relevant to the Defence sector.

For Suppliers to have confidence in the process and the data-sets the SSRO approach should be one of transparency and consistency.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

Boeing believes that the basic profit rate needs to be simple and meaningful, which in turn will simplify and potentially shorten contract negotiations between MoD and its supply chain, by removing the potential for debate and argument surrounding particular categorisation of work by activity characterisation.

In addition; for each the six proposed activity areas it will be more difficult to maintain a statistically significant data-set and, in any case, if the difference between the rates for most or all activity areas is small, then the effort in dealing with these small differences will be disproportionately time consuming and expensive.

Maintaining a single profit rate will aid consistency between Suppliers and MoD and thereby simplify the work of the SSRO in this area.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

Please see the comments for question 2 above.

Notwithstanding the Boeing preference to have one profit rate, observation of the six proposed activity characterisations indicates;

- a potential for confusion and therefore argument in respect of any differential profit rate proposed between Equipment Upkeep (4) and Capacity Provision (5) on Performance Based Logistics provision contracts,
- systems (and systems of systems) integration is (are) not included. There is case that this is different to Contract Manufacture (1) and should be treated entirely separately.

Furthermore, Boeing observes that if there are to be multiple profit rates then determination of rates should be based upon output product rather than input capability or infrastructure.

s'?

Review of single source contract profit rate methodology 2015

Consultation Response Form

Yes No

Please add comments to support your answer:

Boeing agrees that the 'nett-cost plus' PLI would be the most appropriate for a single profit rate regime, or if multiple rates are to be used for activity characterisation, then 'nett-cost plus' should also be used for each margin calculation.

Question 5. 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?

Yes No

Please add comments to support your answer:

Notwithstanding that Boeing believes that there should only be one profit rate, it believes that capital servicing allowances should continue to be provided.

In many cases the capital structure of Suppliers is driven by either legacy or strategy, more often than not, in providing MoD with 'strategic' capability. To potentially penalise Suppliers for supporting MoD would seem perverse and a disincentive to future investment that may thereby erode capability at a time when MoD needs this most?

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Boeing agrees that a three-year rolling average has worked in the past and sees no reason to propose a change.

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Review of single source contract profit rate methodology 2015

Consultation Response Form

Yes

No

Please add comments to support your answer:

Boeing agrees with this approach to potentially increase the data-sets, provided the data can be collected, analysed and interpreted in a consistent manner to those data collected in the UK.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes

No

Please add comments to support your answer:

Boeing agrees with this approach to potentially increase the data-sets, provided the markets are comparable and if the data can be collected, analysed and interpreted in a consistent manner to those data collected in the UK.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes

No

Please add comments to support your answer:

Boeing believes that the proposed methodology will be consistent with the aims of providing a fair return for Suppliers, whilst maintaining value for money if SSRO;

- has a statistically significant comparative base from which to derive a satisfactory profit rate or set of rates,
- can, if multiple profit rates are the direction of travel, provide an unambiguous set of guidelines for activity characterisations (see comments to Q3),
- maintains a capital servicing allowance regime,
- maintains a pragmatic view on risk and incentivisation,
- keeps simplicity at the core of its deliberations.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Paragraphs 4&5: Boeing believes that the availability of consistent comparative information may prove to be a significant issue and, in particular, a data-set in relation to interco transfer pricing rates and methodologies, which frequently are not in the public domain, will be difficult to obtain. In addition 'adjustments' for relevance and comparison need to be unambiguous and transparent in order for confidence in the process to be maintained.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

London
EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Nick Prior

Organisation:

Deloitte LLP

Position:

MOD Lead Client Service Partner

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

We have no particular preference for or against comparability. The issue is whether any proposed alternative can be shown to be better than the current comparability based system.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

We agree that there could be advantages to multiple baseline profit rates, but the challenge is to be able to structure the rates to be fair and transparent and consistent. In our response to question 10 we have provided a fairly detailed consideration of the SSRO's BPR proposals, which includes comments on the SSRO's proposals relating contract activity. The cost element of the price will always be much larger and more important than the profit element, and we have some concern that undue complexity in profit calculation may distract from the task of ensuring that costs are appropriate.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

It is not clear that these six types of activity are appropriate. Please see our response to the SSRO's proposals included at question 10.

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Review of single source contract profit rate methodology 2015

Consultation Response Form

Please add comments to support your answer:

We have no particular preference for or against 'net cost plus', but it has the benefit of being straightforward and any alternative would need to be demonstrably better. Use of multiple profit level indicators would raise the level of complexity. Again, in our response to question 10 we have commented on the SSRO's proposals on this matter.

Question 5. 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?

Yes No

Please add comments to support your answer:

It is not clear that companies undertaking similar activities will, necessarily, have similar capital structures. We have responded to the SSRO's specific proposals in question 10.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

A volatile BPR would be unsuitable for use in pricing single source contracts, introducing additional uncertainty. Averaging is a useful tool to improve stability.

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

We agree providing the companies' activities can be shown to be comparable.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Review of single source contract profit rate methodology 2015

Consultation Response Form

Please add comments to support your answer:

We agree providing the companies' activities can be shown to be comparable. However, the SSRO may find it difficult to identify objective criteria for including companies. Extraction of data on a consistent and transparent basis may also pose additional problems. We have responded to the SSRO's specific proposals in question 10.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

At this point the proposals do not contain enough information or certainty to be able to make a judgement.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Comments on the proposed model and implementation:

Paragraph 2.2, page 18: Characterising the activities and risks involved in a "typical" QDC could be a major task.

The bullet points are described as examples, but presumably the SSRO will also consider the implications of QDC's often being at the forefront of technology, where costs are likely to be difficult to predict with accuracy.

The bullets list factors that are, to an extent, susceptible to subjectivity and manipulation.

The bullets list factors that will either:

- Require a relatively narrow group of contractors which results in each activity characterisation being more susceptible to individual company or sector volatility; or
- Contain a group of contractors that lack homogeneity of capital structure meaning that the resulting profit rates might not be best suited to all contracts that are priced using such activity characterisation.

Under the current regime, the BPR is derived on a "top down" basis, whereby profitability is assessed against a reference group which includes all companies within two populations, being components of the FTSE All Share Index and the AIM All Share Index, unless they are excluded for an agreed reason. The new proposal is suggesting that BPR's should be derived on a "bottom up" basis, whereby profit rates on single source contracts are derived from the profitability of comparable arm's length transactions. I.E., other transactions or companies will have to be selected for inclusion

Review of single source contract profit rate methodology 2015

Consultation Response Form

in the BPR derivation calculation. This selection process seems likely to be subjective and difficult to agree.

Table 2, page 19: The table appears to contain three broad industrial categories (contract manufacture / contract design and development / IT) and three activities that will often be secondary to a principal activity (ancillary support services / equipment upkeep, maintenance and support (including training) / capacity provision).

Presumably these activity characterisations will have been derived from analysis of existing single source contracts. However, without knowing the provenance it is not clear that these are natural classifications for different types of QDC activity. Nor is it clear that the returns expected from each of these activities are so distinct that they cannot be catered for within the +/- 25% cost risk adjustment.

The following might be considered:

- If the SSRO is pursuing this route, shouldn't manufacturing be broken down into the manufacture of different types of equipment, eg should aircraft manufacture attract the same return as submarine production?
- Risk can vary greatly depending on whether the equipment is "first of type" as opposed to steady state production. The six activity characterisations appear to provide for a set of discrete types of contract with associated levels of risk whereas, in practice, the risk associated with any one contract varies on a continuous basis across the whole life of a product from design to steady state manufacture. It is not clear that this granularity is captured within the proposed activity characterisations, or whether it would be captured in the Cost Risk Adjustment.
- It is not clear how more unusual contracts, such as capability provision contracts, might be treated. For example, MOD might pay a contractor to maintain the capability to produce a particular product, and place separate contracts when/if it decides it needs more of the product.
- "IT" is a very broad activity. Does it include activities such as developing software, providing hardware and IT support, all of which have very different cost structures and risk profiles. Are they all intended to attract the same rate of return?
- Benchmarking the secondary activities is likely to be complex. For example, it will be very difficult to identify an "activity characterisation" group of companies with returns that reflect a benchmark profitability for the provision of asset hours.

Paragraph 3.3, page 20: "Net cost plus" is phraseology borrowed from transfer pricing and appears to be largely the same as the SSRO's current ROCP methodology.

Paragraph 3.4, page 20: "Operating margin" is another technique used in transfer pricing, also known as the "resale minus" methodology.

With reference to transfer pricing, HM Revenue and Customs states²:

"Resale minus is most commonly used to consider the arm's length price of goods purchased by an affiliated distributor in a connected transaction, by

² See <http://www.hmrc.gov.uk/manuals/intmanual/INTM484070.htm>

Review of single source contract profit rate methodology 2015

Consultation Response Form

identifying the gross margin achieved by comparable independent distributors. A detailed explanation is available at [INTM421050](#).

“The most common difficulty with this method is the availability of reliable financial information on the comparable entities.”

It is not clear that this technique would be appropriate for the pricing of QDCs.

Paragraph 3.5, page 20: Return on capital employed (ROCE) also needs to be used with care. Issues associated with assessing appropriate CE include:

- How will property plant and equipment (PPE) be valued, eg:
 - Are PPE valued at historic cost?
 - Are PPE revaluations allowed (nb US GAAP does not allow revaluations)?
 - What happens (if anything) when companies are acquired and PPE get revalued through a fair value adjustment?
- Should economic values be used?

Table 3, page 20: Notwithstanding the previous point, it is not clear that suggested PLIs are optimal. For example, many “contract manufacture” and “contract design and development” contracts will be reliant on significant capital assets provided by the contractor. It would seem appropriate to compensate the contractor for the provision of those assets.

It is not clear whether the PLIs in the table are suggested as combinations or alternatives, e.g. would capacity provision be rewarded with either ROCE or net cost plus, or some combination of the two?

The SSRO is to assess which PLI(s) is(are) most appropriate for each activity characterisation. This makes the profit calculation inherently more opaque and susceptible to subjectivity.

Paragraphs 4.1-4.5, page 22: As noted earlier, the process for identifying comparable data appears to be complex.

It is likely that comparable companies will be part of a wider corporate group of companies. Intra-group trading might not be on an arm's length basis and subsidiaries sometimes rely on parent company funding or guarantees in order to function. Such companies should not be considered in isolation and should only be considered in the context of the wider corporate group. In selecting the comparable companies for each activity characterisation the SSRO should consider whether it is appropriate to use the accounts of individual companies that belong to corporate groups, or whether it would be more appropriate to use consolidated accounts. The use of group accounts would have the disadvantage of possibly including a broader range of activities than the activity characterisations.

The proposed model is based on transfer pricing principles, whereby the overriding requirement is that transactions must use terms (price etc.) as if the transaction was at arm's length, between unrelated parties.

Review of single source contract profit rate methodology 2015

Consultation Response Form

HMRC makes it clear that application of the arm's length principle can be highly complex. Its website states³:

"The complexities of applying the arm's length principle in practice should not be underestimated. Because of the closeness of the relationship between the parties there can be genuine difficulties in determining what arm's length terms would have been - especially where it is not possible to find wholly comparable transactions between unconnected parties. There are many factors to take into account."

MOD single source pricing is characterised by monopoly/monopsony relationships, whereby the single source contractor is the only possible supplier and the MOD is generally the only possible buyer. It is inevitable that in an environment where there is only one buyer and only one seller, there will be very few truly comparable transactions. This is likely to mean, either that the SSRO's calculation will have to be extremely complex, or that the SSRO will need to simplify its calculations using broad estimates and proxy calculations.

A further point to note is the significant issues that have been identified with the current transfer pricing regime whereby, for example, companies have been accused of widespread manipulation of reported results by moving profit to low tax jurisdictions. The OECD/G20 Base Erosion and Profit Shifting (BEPS) project recently unveiled wide-ranging proposals for improvements and estimates that between USD 100 to 240 billion⁴ of tax revenue is lost each year owing to this issue. It is not clear when or whether the OECD's proposals will be adopted.

Paragraph 4.4, page 22: UK SIC codes are included in company annual returns (Form AR01) and their use does seem appealing, but they do have limitations, for example:

- Companies select their own SIC classifications for entry on their annual returns. The coding system can be confusing and there is little incentive to classify a company accurately, leading many to be incorrect. For example, at least three subsidiaries of one of the largest single source contractors state that their SIC code is 84220, which is a code intended for use by the public sector.
- Most companies undertake a range of activities but are only required to list one SIC code on their annual return. Most companies do list just one SIC code, although they can list up to four.
- The US uses a coding system called NAICS and there is also a European coding system called NACE. These systems are similar to the UK SIC system, but they are not the same.

Paragraph 5.1, page 23: It is not clear whether the SSRO is proposing to have a range of profit rates for each activity characterisation, say through various PLIs, or whether it is intended that each activity characterisation attracts only one profit figure.

³ See <http://www.hmrc.gov.uk/manuals/intmanual/INTM412040.htm>

⁴ See, for example: <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>

Review of single source contract profit rate methodology 2015

Consultation Response Form

Paragraph 5.2, page 23: It is not clear whether there will be a process involving any further adjustments that might be applied to profit rates. Full disclosure of any such adjustments would be beneficial to demonstrate transparency and promote trust in the calculations.

Paragraph 5.6, page 23: The consultation paper states:

“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 appropriate for the level of capital employed in each activity.”

However, with activity characterisations as broad “Contract manufacture” it would be extremely surprising if the companies within it had some standardised capital employed requirement. Please also see the comments on Paragraph 1.14, above.

Paragraph 5.7, page 23: This paragraph suggests that further risk related adjustments are to be made to each activity characterisation. We note that the separation of contracts into the six activity characterisations already takes account of some level of pricing adjustment for risk and that care will need to be taken to avoid the possibility of duplicating adjustments for the same risk.

Paragraph 1.2, page 25: If the logic for removing the CSAs is that the new methodology already incorporates compensation for capital employed into the profitability figure, then one would expect that during the three year averaging period the previously agreed BPRs would also be uplifted to include compensation for capital employed. This would require a simple calculation using the EBIT and cost of production figures shown in the table on page 11 the Review Board's report on the 2015AR. The 2015/16 profit rate figure would be $90,385 / 758,470 = 11.92\%$ and the 2014/15 profit rate would be $93,647 / 716,653 = 13.07\%$.

Paragraph 2.2, page 25: The paragraph states:

“The comparable company data used to determine appropriate baseline profit rates will draw on financial data from a **broad range** [emphasis added] of companies undertaking a range of risk in their business activities.”

This does not appear to be consistent with paragraph 1.2 (page 18), which states:

“In overview, the revised methodology will identify comparable companies **tailored specifically** [emphasis added] to the activities, including assets and contract risks, involved in qualifying defence contracts and qualifying subcontracts.”

It is unclear how broad, or how tailored, the activity characterisation groups are intended to be. If these groups are broad, and include large numbers of North American and European companies, then there will be considerable cost and complexity in preparing the data. Narrow activity characterisation groups are likely to be even more problematic:

- It will be difficult to justify the inclusion or exclusion of individual companies. Further, the larger companies that really influence the results tend to

Review of single source contract profit rate methodology 2015

Consultation Response Form

undertake a range of activities and be vertically integrated – making it more difficult to classify them.

- Small sectors are often dominated by a few very large companies, which are big enough for their individual results to have a significant impact on sector profitability. Calculations could become circular, as extreme levels of profitability (high or low) would feed into the profit formula and affect future profitability.
- There is a risk that the profitability of a small activity characterisation groups will be highly volatile and therefore unsuitable for application to single source contracts.

Paragraph 3.2, page 25: It is not clear which profit rates the SSRO is intending to publish, whether those for contracts in progress or just those completed. It is noted that, to date, only a small number of contracts have been placed using the regime. This suggests that there could be a risk to anonymity if the SSRO publishes data, even in aggregate form, particularly in its early years. The SSRO may wish to consider prioritising the preservation of anonymity above its commitment to publish the data.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to "conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:

- the principle of comparability;
- the exclusion of companies under price regulation;
- the inclusion of companies which are UK based but whose activities are predominately overseas;
- the treatment of R&D tax credits; and
- the use of simple rolling averages."

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Sir Brian Burridge

Organisation:

Finmeccanica UK Ltd

Position:

Senior Vice President UK Corporate

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

Comparability has to be regarded as the central tenet in setting contract profit rates for QDCs. In applying this principle, the comparator data must be relevant, objective and transparent. However, the process that surrounds the application of comparability has also to be suitably pragmatic so as not to add complexity to contract negotiations to the extent that timelines are extended and outcomes become unpredictable. In addition, the comparability principle should be seen as setting a 'stable and long term' position, something which other defence regulators (notably the US) take into account. It also needs to deliver a reasonable rate of return for industry whilst demonstrating value for money for the taxpayer.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

Again, the theory of multiple profit rates segmented to reflect the activity inherent in defence contracts is sound but the application is more complex. The proposed characterisations outlined at para 2.8 of the Consultation Document (CD) rarely occur as a single facet in a contract: rather, they appear in combination. Equally, they do not lend themselves to hard-edged definitions. In addition, the level of risk inherent in each of the categories will vary markedly according to the context of the contract concerned. Taken together, these facets are likely to add an additional layer of complex contract negotiation which again will increase complexity and add time and cost.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes

No

Please add comments to support your answer:

As defined in the CD, the classifications do not accurately convey the nature of activity undertaken by an original equipment manufacturer. Here the end-to-end process in producing a platform or weapon system consists of design and development (of which systems integration is a major part) with a significant element of the manufacturing cost-base arising from a combination of sub-contracted work and materials. Usually, only those components which represent core intellectual property are manufactured in-house. The process then continues with assembly, commissioning, testing and certification. Success depends on the application of key specialist and functional expertise in aspects such as production engineering, project management and risk management.

In addition, the design, development and production of a complex system-level assembly such as a radar or other sensors cannot be compared with the process of creating more standard types of mechanical components. The former tends to involve relatively low quantity production runs and the embodiment of leading-edge technology, which is inherently high-risk, and has major software content: this combination is not mirrored in build-to-print mechanical component manufacture.

Overall, in these circumstances, the application of the US DFARS Weighted Profit Guidelines is a more effective tool and should be considered further for its applicability to UK QDCs.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

In principle, the application 'net cost plus' is a relevant and simple approach. However, the underpinning activity analysis would have to be sufficiently granular to ensure that varying levels of risk or optimum asset utilisation did not become 'smoothed-out' through averaging.

Question 5. 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?

Yes No

Please add comments to support your answer:

The basis of this premise to set capital servicing allowance at zero is described in the CD (at para 5.4) as, '*... profit data provided by the comparable companies will incorporate the capital involved in earning that profit.*' However, the link between similar types of work and the associated capital structure is not necessarily uniform across the supply base, particularly for on-shore OEMs and higher tier suppliers. This would need to be reflected in a granular approach to comparator selection and grouping. It could also be incorporated on a case by case basis, to ensure a suitable return to contractors is achieved.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Given the duration of the time horizons inherent in the development and delivery of the UK's defence equipment, suppliers value a system that delivers stability and levels-out market anomalies. While the three-year rolling average has proved reasonably effective in the past, there is much to favour the US DFARs Weighted Profit Guidelines where the profit allowance framework is set as a matter of policy which, in turn, creates stability and allows contractors to plan accordingly.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

In line with the answer to question 1, comparability has to be at heart of the basis of setting contract profit rates for qualifying contracts. While there are a number of plausible potential approaches (not least a variation on the current 'UK basket'), given the international nature of the defence business, the use of a reference such as the USA DFAR Weighted Profit Guidelines would be more appropriate.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

Same reasoning as for Question 7

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

The key will be in the conversion of theory into practice. In terms of providing an accurate and objective assessment of the value for money for the taxpayer and in providing a demonstrably fair and reasonable return for industry, a number of implementation issues will have to be addressed. In particular:

- the comparator cohort selected must be relevant, objective and transparent;
- industrial activity categories and the supporting definitions must be straightforward to apply so as to avoid adding increased complexity and additional transaction costs;
- the resulting system must deliver stability with a profit rate that provides a reasonable return for industry and minimizes the impact of market anomalies.

Without these features there will be an increasing disincentive for industry to take-on single-source work.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Whilst we agree that the use of comparability is acceptable in principle, as indicated in our response to Question 1 above, we are concerned that there is insufficient time available within the consultation timeline for industry to gain sufficient understanding of any "comparability data" and proposals for the profit figure to be used by the SSRO in calculating and recommending any new profit rates by 31 January 2016. We consider that a further consultation period should be allowed after this initial consultation to enable industry to provide feedback on the ultimate approach proposed by the SSRO. This would help to ensure that we have a reasonable, workable solution in practice for all parties involved and also help to avoid unintended consequences.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Rebecca Richards

Organisation:

General Dynamics UK Limited

Position:

Head of Commercial

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

Comparability is acceptable in principle, however, that comparable data should be compiled objectively and transparently by the SSRO, with sufficient volume of data collected to allow for a meaningful comparison. We acknowledge, however the SSRO decide to calculate the average contract profit it will likely be an imperfect solution mostly due to the shortage of comparable data available in the public (and government) domain. As such, an average profit should be taken from the 600 UK Companies, but the baseline average should be weighted for risk.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

The industry members that service government contracts usually take a greater risk in-order to service the contract requirements for the government. Additionally, due to the sensitivity of the projects the industry member will be unable to sell bespoke products within a civil environment, so the commercial market is limited and consequently the return is also limited. Often IP that is created cannot be utilised for any other purpose. The return on the industry member's investment is limited and it is reasonable that a weight should be added to baseline profit for this risk and limitation of merchantability.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

Further information will be required regarding the classification and application of these categories.

Clarification will also be required as to the definition of each of the categories.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

This is a workable profit level indicator. However, industry would benefit from clear examples of its practical application.

Question 5. 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?

Yes No

Please add comments to support your answer:

Business models can vary significantly from supplier to supplier, even when the product or service supplied is largely similar.
Setting the CSAs to zero likely lead contractors to move to a lower production/ or less efficient model and will not incentivise lower capital businesses.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

This seems a reasonable period for collecting data and to allow some stability.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

Subject to sufficient, reliable data being available.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

See q7 above

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

Subject to the clarifications and availability of data set out in answers 1 – 6 above

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Further to our answers detailed at q 1 and 2 above, the SSRO may respond that Step 2 of the process is responsible for the risk element, however this is risk associated with allowable costs, Step 2 does not account for the risk that the contractor takes to service the contract as explained above. It is accepted that Step 5 makes allowance for return on capital employed, however in some circumstances the risk is not just in the capital employed.

In view of the foregoing, the contract profit should reflect the increased risk and lack of merchantability and this can be done by adding a proportionate weight to the average contract profit when calculating the Baseline profit rate.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to “conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:

- the principle of comparability;
- the exclusion of companies under price regulation;
- the inclusion of companies which are UK based but whose activities are predominately overseas;
- the treatment of R&D tax credits; and
- the use of simple rolling averages.”

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO’s website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO’s website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street

¹ SSRO ‘2015 Contract Profit Rate’ January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

London
EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Neil Goulding

Organisation:

Marshall Aerospace and Defence Group

Position:

Head of Commercial, Support Solutions

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

As the aim is to replicate the outcomes of a competitive environment in an environment where there is no competition, some form of comparison with the outturns achieved in an appropriately selected wider marketplace seems a sensible approach.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

I think there are likely to be a number of aspects not captured by the six categories. For example, contracting for availability, a key contract type used in long term defence contracts, is absent. This is not the same as equipment support yet also not capacity provision as the flying assets belong to the MoD.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes

No

Please add comments to support your answer:

This is a simple way of calculating the profit and involves little change from the previous system, reducing the impact of change on the staff concerned.

Question 5. 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?

Yes

No

Please add comments to support your answer:

I am unsure on this one. I can see the logic behind this rationale but am not sure that it would automatically be suitable. I think a number of points were raised at the ADS workshop about asset / site purchases that may be impacted by this change so it needs careful consideration.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes

No

Please add comments to support your answer:

I think stability is important and the use of rolling averages will serve to reduce the impact of any sudden changes.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

If the group of comparable organisations is sufficiently large to ensure that this does not skew the overall result then I would say yes.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

If the group of comparable organisations is sufficiently large to ensure that this does not skew the overall result then I would say yes.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

I believe that it could as long as the categories are appropriate and sufficient comparable data is found. I do have a concern that the use of multiple categories and the process needed to evaluate them could be both expensive and time consuming and might bring about a conflict with both of the aims repeated above. I cannot see within the consultation document any plan to measure cost versus benefit such that this system is not permitted to subvert the aims.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

We would appreciate as much transparency as possible around the calculation of new rates, including the composition of the organisations used for comparability purposes. This will aid our understanding of the new methodology, which will be key to gaining broad acceptance of the changes. I understand that acceptance is not necessary yet believe it would still be useful and beneficial for all parties involved.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Martin Greenwood

Organisation:

Serco Group

Position:

Senior Finance & Commercial Manager

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

The principle of comparability is a desirable requirement in setting profit rates baseline. Equally transparency of the information used to achieve this is critical to ensure comparability is not distorted.

We would hope the comparability stretched beyond the UK given the Defence industry is global and most companies who support the industry have a global presence.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

Serco supports the principle of multiple profit rates, the key is how you actual distinguish between the different rates and how they become applicable. They key in that would be transparency of how the multiple rates were reached in terms of the information used to calculate and the understanding of the differences.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

The main concern is that the categories proposed necessarily correlate with the nature of the work, and its inherent risks, undertaken by single-source contractors. It remains unclear as to how the new methodology will determine appropriate profit and allocate it when a contract includes a blend of multiple activities which is the case for a significant amount of contracts for MOD. For Serco (and its competitors) it certainly could be viewed that part of the value provided to the customer is the integration of multiple activities as well as the delivery of the service. The integration includes risk mitigation/management across a portfolio of activities not just one of the activity areas of the proposed profit rates. I can certainly see examples of current contracts that sit across 3/4 of the classifications.

Further information will be required regarding the classification and application of these categories. Once this is provided significant training for industry and MOD will be

Review of single source contract profit rate methodology 2015

Consultation Response Form

necessary to ensure that activities across the life of contracts are correctly captured and that their classification is consistent.

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

It is similar to the profit level indicator used in the current process which will aid the transition. It would be helpful to see clear worked examples to ensure the most effective profit level indicators are being used for each type of activity.

Question 5. 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?

Yes No

Please add comments to support your answer:

The consultation document suggests that 'the level of capital employed in similar types of work for non-MoD customers should be comparable.' While this seeks to connect a type of work with a capital structure that is optimal and efficient, in practice it is not this simple. For many companies its capital structure is one inherited from prior MOD ownership, or driven by MoD requirements/contracts. The key here is that the removal of CSA does not have the impact of de-incentivising higher capital employed companies and driving industry to back away from investments that improve the service delivery elements of a contract due to the impact of CSA's

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Comfortable with the 3 year average to avoid spikes, obviously the longer the period of rolling average allow a more smooth the movement.

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Review of single source contract profit rate methodology 2015

Consultation Response Form

Yes No

Please add comments to support your answer:

As stated the Defence Industry is global market and therefore where possible I would include overseas companies

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

Yes as per question 7.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

It could delivering these aims, but critically the activity associated to the various profit needs to be aligned to single source contract work and these are agreed with MOD and industry. Additionally, as highlighted above changes to the CSAs do not impact the balance of companies.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

The biggest challenge to this proposal being implemented is the availability of the data to calculate the profit rates. This links directly to transparency and without this industry will struggle to easily adopt this and achieve the objectives. The main concern is that companies do not provide analysis in the same way the profit rates would require the data.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Review of single source contract profit rate methodology 2015

Consultation Response Form

Overview

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. It is also required to publish the review and make an annual recommendation to the Secretary of State for Defence (SofS) on whether the profit rate should be adjusted.

In recommendations to the SofS in January 2015¹, the SSRO set out its intention to *“conduct a full review of the principles and methodology used by the Review Board to calculate the baseline profit rate. The SSRO will also develop a potentially new approach to calculating the baseline profit rate in future. The SSRO will review a number of areas including:*

- *the principle of comparability;*
- *the exclusion of companies under price regulation;*
- *the inclusion of companies which are UK based but whose activities are predominately overseas;*
- *the treatment of R&D tax credits; and*
- *the use of simple rolling averages.”*

The results of the review, and the proposed new methodology, were published on 25 September 2015 and are available on the SSRO's website:

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

Following consultation, we will publish the final methodology, and our recommendations to the SofS on the profit rate adjustments, by the end of January 2016.

This is a public consultation held over an eight week period. It is open to anyone with an interest in defence single source procurement.

Please respond by 20 November 2015.

Copies of this response form are available on the SSRO's website. The response form can be completed electronically or printed and completed by hand.

Please email your response to the following address:

consultations@singlesourceregulationsoffice.gov.uk

You can also post responses to us at:

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London

¹ SSRO '2015 Contract Profit Rate' January 2015

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/401719/20150205-SSRO_Contract_Profit_Rate_6.pdf

Review of single source contract profit rate methodology 2015

Consultation Response Form

EC4A 1AB

If you require paper copies of any of the draft documents or the response form, please contact us (using the email or correspondence address above to provide us with your contact details). We will be happy to post copies to you.

Your details

Name:

Ewen McCrorie

Organisation:

Thales UK Ltd

Position:

VP Finance UK

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

We believe the use of comparability is acceptable in principle, as long as there is sufficient volume of comparable data and calibration thereof. The data output should be made available to industry and compiled objectively and transparently by the SSRO. Our concern is the availability in the public domain of such comparable data and that many Companies just report externally by geographic segment.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

We agree that the profit needs to reflect the type of work but the principle of transparency is key. In principle there should be multiple baseline profit rates by reference to type of contract activity, but in practice large contracts will fall into a variety of activities and this could prove a problem in agreeing precisely those activities which are relevant and their proportions, therefore; how we would proceed with multiple activities within the one contract is unclear.

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

Thales does appreciate the SSRO's objective in delineating contract activity into six categories, however as we state above not all of the categories proposed necessarily correlate with the nature of the work undertaken by single-source contractors and there is considerable overlap between activities.

For example, two contracts each with elements of outsourced or in house 'manufacture' that vary significantly by proportion. The outsourced manufacture may require much closer integration and management. A further example – availability contracting; upkeep maintenance and support can also include design development and manufacture. Activity is a question of judgement and also subject to subjective assessment

Review of single source contract profit rate methodology 2015

Consultation Response Form

Further information and training would be required in order to understand the classification and application of these categories and a lot of effort and negotiation may be expended on an area, which has a small impact on the end contract value. This time could be better spent on other elements of the procurement process.

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

Thales believes that 'net cost plus' is a simple and workable profit level indicator and consistency of content; cost vs profit is key.

Question 5. 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?

Yes No

Please add comments to support your answer:

We consider all companies aim to have an optimal and efficient capital structure, however, the level of capital employed does vary by contractor and is often a result of history, mergers or acquisition, geography or potentially group policy – for example property could reside in a separate company, or one company in the group could purchase all IT assets. We do not agree therefore the level of capital employed by different organisations, in similar types of work is necessarily comparable.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

Stability is crucial and ensuring data is collected over a longer period (at least three years) with rolling averages will lead to less anomalies. A methodology for excluding outliers would avoid spurious spikes.

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Review of single source contract profit rate methodology 2015

Consultation Response Form

Yes No

Please add comments to support your answer:

Thales believes this is a good approach providing we have the data and that this data is understood and comparable- under IFRS this should be achievable. There may need to be some calibration of data to ensure it is comparable.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

Defence is a global business and it is important to ensure we ultimately receive in the UK a similar level of profit as other major defence suppliers which work outside the UK on comparable work

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

Thales consider this methodology may achieve this objective but have to ensure the agreement of activity classifications between parties, trust that a sufficient volume of data is available to allow for meaningful comparisons in the baselines by category. We also need surety of recovery of our costs. The baseline profit rate is just one step in agreement of the contract value. Value for money perhaps could have been explored by having one baseline profit rate (easily calculated by Contractor) and adjusting carefully for the cost risk adjustment to reflect each 'activity' by contract.

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Thales believes that the fundamental issue will be the availability (or lack thereof) of calibrated data and determining the applicable activity(ies) which rarely fit squarely into one of the SSRO's proposed activity characterisations. SSRO will potentially be using elements of non-allowable cost within determined profit percentages. We would appreciate transparency and an understanding of the calculations that determine the baseline profit rates and the profit level indicators that drive them.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Thales disagrees with the reference Sec 1.16 (page 14) and section 2.4 (page 18) that the speculative development of product development is rare and we feel that we are in common with many industries to ensure that we are at the forefront of technology and MOD does indeed benefit from industry investment .

The relationship between the cost risk adjustment and the baseline profit rate does need to be explored to ensure that the regulations are working as envisaged and not purely overcomplicating the procurement process (sec 5.1 (p11) and sec 2.3 and 2.4 (p25)

The use of median values (sec 6.2) is we feel unusual and weighted averages could be a better measure,

Review of single source contract profit rate methodology 2015

Consultation Response Form

Your details

Name:

David Scillitoe

Organisation:

Yusani Limited

Position:

Director

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 methodology. 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

Review of single source contract profit rate methodology 2015

Consultation Response Form

Introduction

Question 1. Do you agree that it is right to continue to use the principle of comparability to set baseline profit rates?

Yes No

Please add comments to support your answer:

The principle of comparability is sound. It has been supported by Parliament since it was introduced in 1968. Successive Committees of Public Accounts have endorsed the Treasury/MoD approach that the principle of comparability should be decisive in determining the target rate of profit. However, there is now a question with what the comparison should be made:

- Should the comparison be made with the out-turn profit of companies in a competitive market? If so, which companies should be included in the comparison?
- Should the comparison be made with the rates of profit used by international government agencies procuring on a non-competitive basis?

It is considered that the comparison described at option b. should be used rather than option a. for the following reasons:

- The UK pricing methodology is setting a baseline profit rate for the purpose of arriving at a negotiated price. The use of comparable out-turn profits gives no reflection of what the target profit was by those companies at the time of pricing - there is not an equivalent basis to use as the comparison.
- International government agencies have a methodology for arriving at a baseline profit rate for the purpose of pricing. A comparison with their profit rates would be on a more equivalent basis for use under the UK pricing methodology.
- Out-turn profits should not be used as the comparator, as they are influenced by the contract outcomes, which can vary for many reasons unconnected with market forces. The baseline profit rate should be based on a comparable expectation of earned profit at the time of pricing.

What is essential is that the methodology is simple, transparent and reproducible by independent third parties. It is also essential that there is a degree of predictability in the setting of the rate so that companies have a reasonably stable economic environment in which to consider their future investment strategies.

A weighted average should be used and not a median, which is likely to distort the outcome.

Question 2. Do you agree that there should be multiple baseline profit rates by reference to type of contract activity?

Yes No

Please add comments to support your answer:

This proposition sounds credible but is not plausible or practical on the basis of the current proposals. It adds unnecessary complexity and contention to an aspect of pricing that should be kept simple. It is the risk in the activity that should be used to flex the profit rate and not the mere nature of the activity itself.

If applied, the different types of contract activity need to be fully defined: there are no definitions in the current proposals. Even when defined, there will be disputes about what activity falls into what description, which will delay the negotiations. There needs to be a calculated profit rate for each item that is priced, based on the nature of the activity rather than applying an average for the contract. It is likely that significantly more categories would be needed to give the granularity required to allow meaningful analysis to be performed. This would have practical implications for negotiating and reporting contracts.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 3. Do you agree with the six types of activity for which baseline profit rates will be provided?

Yes No

Please add comments to support your answer:

See response to Question 2.

The different types of contract activity need to be fully defined: there are no definitions in the current proposals. Better alignment is required between the activities performed by contractors and the proposed Activity Characterisations.

Many contracts include more than one characterisation. There can be considerable overlap between Ancillary Support Services, Equipment Upkeep, Maintenance and Support, and Capacity Provision and the proportions can vary during the course of the contract.

It is likely that significantly more categories would be required to give the granularity needed to allow meaningful analysis to be performed - which will increase complexity and the likelihood of contention.

Case studies/examples should be used to illustrate how complex and overlapping activities can be classified to arrive at a profit rate for a contract item to be priced.

Question 4. Do you agree the profit level indicators should always be 'net cost plus'?

Yes No

Please add comments to support your answer:

If out-turn profit level indicators are to be used then "net cost plus" is a suitable basis. However, case studies/examples should be used to illustrate how this calculation would be done for the different activity characterisations, showing the source and reliability of the data.

It is questionable whether it is practical to identify reliable source data for each activity characterisation that will be needed to give the granularity required to allow meaningful analysis to be performed.

Question 5. 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?

Yes No

Please add comments to support your answer:

There is no consistency in capital structures used by contractors for the same or similar activity, therefore the capital servicing allowance should not be set to zero.

Question 6. Do you agree with the proposal to continue to use three year rolling averages?

Yes No

Please add comments to support your answer:

A three year rolling average should give stability and smoothing of some fluctuations. However, a longer period may be needed if there are significant fluctuations. A weighted average should be used and not a median, which is likely to distort the outcome.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 7. Do you agree that UK based companies with activities predominantly overseas, but in comparable markets, should be included in the calculations?

Yes No

Please add comments to support your answer:

If companies' out-turn profit is to be used as a basis for comparison then Yes. The data should be IFRS compliant. It is questionable whether it is practical to identify reliable source data for each activity characterisation that will be needed to give the granularity required to allow meaningful analysis to be performed.

The data used should be identified and capable of independent analysis by third parties.

Question 8. Do you agree that overseas companies operating in Western Europe and North America should be included in the calculations?

Yes No

Please add comments to support your answer:

If companies' out-turn profit is to be used as a basis for comparison then Yes. The data should be IFRS compliant. It is questionable whether it is practical to identify reliable source data for each activity characterisation that will be needed to give the granularity required to allow meaningful analysis to be performed.

The data used should be identified and capable of independent analysis by third parties.

Question 9. Do you agree that the proposed methodology is consistent with the aim of delivering value for money for taxpayers and a fair and reasonable return for industry?

Yes No

Please add comments to support your answer:

The proposed methodology is over complex and contentious, leading to greater analysis and negotiation by the parties with the potential for disputes. A simpler solution should be proposed.

The requirement is for a fair return. This should be established by comparison with other methodologies used by other international state procurement agencies. The new methodology must result in contractors receiving a level of profit comparable to that for performing similar work under single source contracts in other advanced countries.

It is not unreasonable to establish a single rate for all types of activity eg 10%, which is then flexed on the basis of risk in the contract. This approach should certainly apply to contracts priced below £25M.

As there is no credible information to support the proposed methodology, it would be irresponsible to introduce it without evidence and examples of its application. There should be a period of shadow running of the proposed methodology, with the current arrangements continuing to apply say, for three years, to build up evidence and practice in the proposed arrangements.

Review of single source contract profit rate methodology 2015

Consultation Response Form

Question 10. Please add any additional comments below, stating the paragraph and page numbers in the consultation document which your comments refer to.

Executive Summary, page 3: There is reference to “a credible method to set profit rates is needed ... in MOD single source procurement.” There is no evidence that the proposals are credible, they posit an approach that is theoretical with no practical experience over time; furthermore, the SSRO’s remit covers only QDCs and QSCs not all single source procurement by MOD. Finalising the methodology by 31 January 2016 appears unrealistic to give any confidence in the outcome or utility of the methodology.

Paragraphs 1.8-1.10, page 13: Companies do not normally publish transfer pricing data for their businesses. How will it be obtained? (It has also been criticised by the OECD.) This is the cornerstone of the proposals and yet it is not evident how reliable information will be obtained in the granularity needed to be useful.

Paragraph 2, page 15: All companies operating in comparable markets are likely to be undertaking single source contracts from a state agency, which will be regulated - are these to be excluded? The methodology makes no reference to any adjustments to the financial results before being used in the computation - what adjustments, if any, will be made?