SSRO

Single Source Regulations Office

Single source baseline profit rate methodology

Consultation on changes for the 2020/21 rates assessment

July 2019

Contents

1. Introduction

1.1 Section 19(2) of the Defence Reform Act 2014 (the Act) requires that the Single Source Regulations Office (SSRO) provides the Secretary of State with its assessment of the appropriate baseline profit rate, capital servicing rates, and SSRO funding adjustment ("rates") by 31 January each year for the purpose of assisting the Secretary of State in determining what those rates are for the subsequent financial year.

1.2 The SSRO's approach to calculating its assessment is set out in its *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology* ("the methodology")[1].

1.3 The SSRO, in consultation with stakeholders, prioritised detailed work in 2019/20 to further refine the methodology by reviewing the activity, company size and data quality criteria used to select comparator group companies used in the baseline profit rate assessment.

1.4 To achieve this the SSRO considered stakeholder representations and carried out detailed analysis. Amendments are proposed to the baseline profit rate methodology that:

a. remove 'small' companies from the result by introducing a more sophisticated company-size criteria, aligned to those used by other organisations, to further improve stability of the comparator group and to enhance that aspect of the methodology;

b. calibrate the automatic filters that identify a company's activities to further reduce the need for manual intervention; and

c. clarify or codify existing practice in the activity characterisations to provide additional transparency and give further assurance that the methodology is applied in a consistent way.

1.5 Further details of the proposals are set out in this consultation document.

1.6 Details of the consultation period and how you can respond to the consultation are contained in Section 5 of this document.

1 https://www.gov.uk/government/publications/2019-contract-profit-rate

2. Company size and data quality

Introduction

2.1 In the first stage of the methodology the SSRO uses the Orbis database to search for companies that might be potential comparators. The database includes details of 200-300 million companies globally and allows complex search queries to be constructed based on the company's characteristics or financial results.

2.2 One of the criteria used to select potential comparable companies is turnover. A company must have had turnover of at least £5 million for each of the last five years (the 'turnover threshold') to be admitted to a comparator group.

2.3 Some stakeholders have challenged the £5 million turnover threshold on the basis that it results in companies being included in the comparator groups that are not of a similar size to the MOD's single source contractors and, therefore, not sufficiently comparable for the purpose of determining the Baseline profit rate (BPR).

2.4 In Autumn 2018, the SSRO committed to considering the publication of material in relation to the turnover threshold that is included as part of the evidence base provided to the Secretary of State with the rates recommendation. This information was published in March 2019[2]. Subsequently the SSRO, in consultation with stakeholders, prioritised further work in 2019/20 to examine company size and data quality criteria used to select comparator group companies used in the baseline profit rate assessment.

Rationale for existing threshold

2.5 For the 2019/20 assessment recommended to the Secretary of State in January 2019 the SSRO Board's decision was to retain the current turnover threshold under the current methodology. In coming to that decision, the Board considered that the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD guidelines") suggest that company size is a commonly observed quantitative criteria for comparability.[3] To date, however, the SSRO has not sought to link the turnover threshold to comparability and has not considered the potential for a size differential to exist between the populations of companies requires a change to the BPR methodology. This is because:

a. there is a diversity of QDCs and QSCs, both in terms of the type and scale of work;

b. the OECD guidelines[4] allow for comparability differences where they could not materially affect the condition being examined (in this case, profit) and the SSRO has not found turnover to be a systematic determinant of profitability; and

c. it is possible to apply adjustments in arriving at the contract profit rate for a QDC or QSC to take account of the factors set out in legislation in order to ensure good value for money and fair and reasonable prices are achieved.

Additional analysis of company size

2.6 The SSRO has further investigated how other organisations define company size and consider that a measure of size that considers turnover, assets, and number of employees would be more robust than the current turnover-only approach, and would align the methodology to approaches taken by other internationally recognised organisations.

2 https://www.gov.uk/government/publications/2019-contract-profit-rate
3 *OECD Transfer Pricing Guidelines (2017)* Chapter III paragraph 3.43.
4 *OECD Transfer Pricing Guidelines (2017)* Chapter III paragraph 3.47.

2.7 To analyse company size the SSRO has used recognised definitions[5] to consider the size characteristics of:

a. the companies used to determine the baseline profit rate: the 2019/20 Develop and Make (D&M) and Provide and Maintain (P&M) comparator groups;

b. QDC/QSC contractors drawn from the SSRO's *Quarterly qualifying defence contract statistics: Q2 2018/19*;[6] and

c. organisations paid £5 million or more during 2017/18 by the Ministry of Defence (MOD).[7] 349 organisations are included in the MOD's supplier list, of which 276 can be identified as companies (others predominantly being government entities).

2.8 The SSRO considered the size characteristics of contracting companies and their corresponding global ultimate owners (GUOs) (Figure 1 and Figure 2). Conclusions on the data are that:

a. the single source defence procurement market is more concentrated than the MOD's supplier list supply base and the comparator group on the basis that it is composed of fewer, large suppliers;

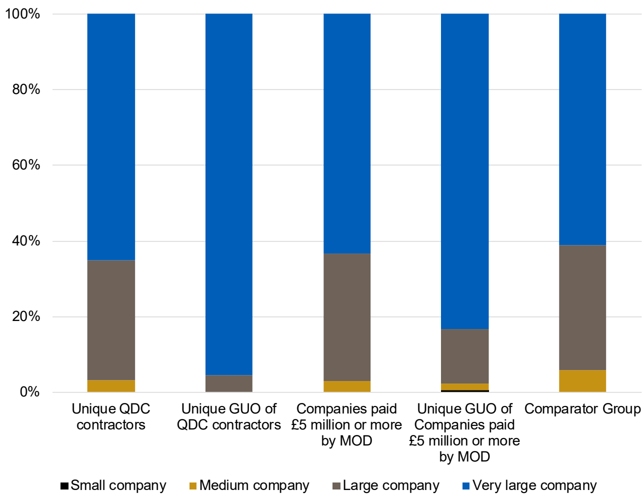
b. direct comparison of contracting companies or GUOs of contracting companies to the comparator group requires careful consideration because:

- the size characteristics of QDC and QSC contractor GUOs are likely a result of a non-competitive market, which the comparator group is specifically designed not to emulate; and
- contractors will likely have support from their wider group and so might be expected to be smaller than equivalent companies in the comparator group, which are selected on the basis of being independent; however,

c. each group of companies examined contained a broadly similar distribution of size of contracting entity, the majority of which are classified as large or very large. The companies in the QDC/QSC supplier group had the fewest number of small or medium companies and the comparator group the most.

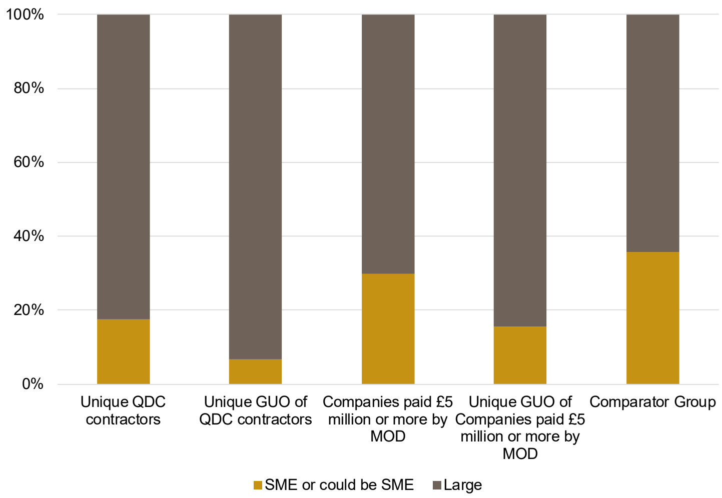
2.9 The SSRO do not consider that these differences give rise to a requirement to change in the methodology The comparator group should not exactly mimic companies that hold QDC/QSCs because this would become a measure of profit in a non-competitive market, rather than an external benchmark of a fair and reasonable profit.

Figure 1: Proportion of contractors/companies: EU definition of Large



5 See Appendix 1 for definitions.
6 https://www.gov.uk/government/publications/quarterly-qualifying-defence-contract-statistics-q2-201819
7 https://www.gov.uk/government/statistics/mod-trade-industry-and-contracts-2018

Figure 2: Proportion of contractors/companies: Orbis definition of company size[8]



Application of transfer pricing principles

2.10 The SSRO has considered the application of the OECD Guidelines to the methodology and:

a. the guidelines imply that size is a criteria that should be taken into account when searching for companies undertaking comparable activities to those in QDCs and QSCs.[9] However, taking into account the six steps as a means of further accounting for size differences and the aim to avoid replicating the features of a non-competitive market, the SSRO continues to consider the current approach to be reasonable; and

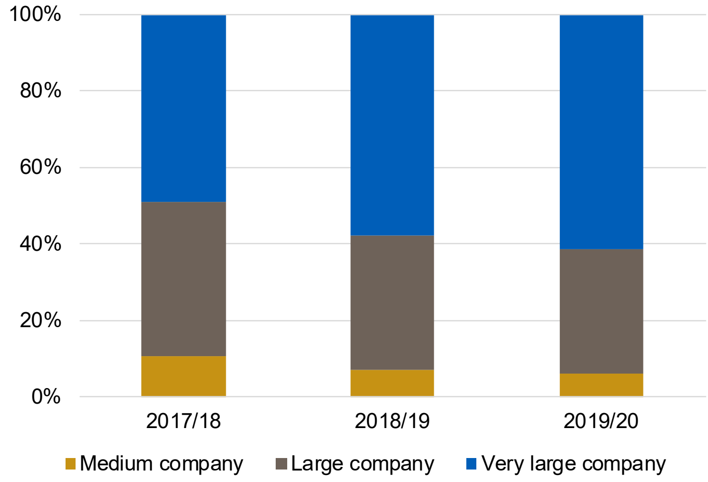
b. OECD guidelines promote quality over quantity; no significant data quality issue has been identified; however, whilst existing search criteria help enhance data quality they are not designed for that purpose.

- The presence of smaller companies creates a data availability issue, in that the size distribution of the comparator group fluctuates as a result of smaller companies dropping out the comparator groups during the three-year cycle, as shown in Figure 3 below; this issue would be improved if the company size criteria were linked to regulatory reporting thresholds
- The SSRO considers that independent financial audit process adds credibility to the reported financial position and performance of a business and that financial information that is audited is better quality than information that is not audited; linking the methodology's size threshold to an objective regulatory threshold might further enhance data quality.

8 See Appendix 1 for definitions.

9 *OECD Transfer Pricing Guidelines (2017)* Chapter III paragraph 3.47

Figure 3: Size characteristics (Orbis definition[10]) of the comparator group over time



Conclusions and proposal

2.11 An appropriate turnover threshold is one which results in a comparator group which meets the objective of the methodology as an open-market profit benchmark.[11] Our assessment is that this is achieved by the current turnover threshold. The SSRO has investigated the relationship between turnover and profitability of comparator group companies during each of the last four BPR assessments and did not establish evidence of any systematic relationship between the two. The SSRO has carried out additional analysis, as set out above, and we do not consider that differences in the size characteristics of the comparator group compared to QDC/QSC contractors or to their GUOs gives rise to a requirement to change in the methodology.

2.12 However, achieving the aims of the methodology is not unique to the current threshold; alternatives in the region of the current threshold can also achieve similarly acceptable results, which we have considered in respect of representations on data issues for small companies.

2.13 The SSRO considers that the presence of smaller companies creates a data availability issue in that the size distribution of the comparator group fluctuates, albeit within reasonable bounds, as a result of smaller companies dropping out the comparator groups during the three-year cycle. The SSRO also considers that independent financial audit adds credibility to the reported financial position and performance of a business and that financial information that is audited is better quality than information that is not audited. Linking the methodology's size threshold to an objective regulatory and reporting threshold would help address both these matters.

2.14 In order to achieve this in a consistent and efficient manner the SSRO propose that the turnover threshold be replaced with conditions based on the UK implementation of EU regulations for assessing if a company is 'medium' or 'large', consequently excluding 'small' companies from the result.[12] These thresholds are used in the UK to help determine if a company is eligible for an audit exemption or for submitting abridged accounts to Companies House, among other matters.

10 See Appendix 1 for definitions.

11 by "open-market benchmark" the SSRO means a representative measure of profit resulting from the interactions of buyers and sellers, constrained only to the extent that local conditions dictate (for example in respect of tariffs, taxes, and other regulatory restrictions that may affect those transactions and other distortions resulting from market failure, such a monopoly)

12 £10.2 million turnover; £5.1 million total assets; 50 employees

2.15 The qualifying condition proposed is:

- an annual turnover of more than £10.2 million; and either one of the following
  - » total assets worth more than £5.1 million; or
  - » 50 or more employees on average.

2.16 The qualifying condition in UK legislation is that a company must satisfy two or more of the three requirements. However, the SSRO would not seek to include companies that only meet the total assets and employee requirements on the basis that the methodology is to benchmark profit and therefore requires companies have sufficient turnover to ensure the resulting profit calculation is meaningful and not distorted by small timing differences in cost recognition.

2.17 The proposal is an objective measure, not substantially different from the existing approach and still small in the context of comparator companies with turnover ranging up to £69 billion. The change will maintain comparability, consistent with the objectives of the methodology, whilst also enhancing the stability of the comparator group year-on-year, alongside maintaining the existing purpose of the threshold. The change may also further mitigating data quality risks by ensuring companies meet EU thresholds for requiring an independent financial audit.

2.18 The SSRO believes that the introduction of a turnover threshold higher than the one proposed, perhaps resulting in only very large companies being present, would exclude from the assessment many companies of similar size to those which the MOD contracts with on both a single-source and competitive basis and would undermine the diversity of firms which contribute to the integrity of the BPR as an open-market profit benchmark. To the extent there are any remaining size differences between the MOD's largest single source contractors and the comparator group we consider these are consistent with the construction of a reasonable starting point for the application of the six-steps to arrive at a contract profit rate which supports value for money and fair and reasonable prices.

2.19 We consider the proposal to be sound evidence-based proposal to a change in the company size requirements. The existing criteria and the proposed replacement are set out below:

Existing condition

Operating Revenue (Turnover)

9.14 Companies are only included in the search if they meet a minimum turnover level of £5,000,000 for all the last five years. This requires companies to have turnover data for all years subject to this criteria. This level of turnover returns a sufficient number of companies to make the process viable.

Proposed condition

Company Size

9.14 The search criteria are designed to collect data for companies which publish good quality financial information, and to return a sufficient number of companies to make the process viable. This requires companies to have data that demonstrates they meet the following criteria for all of the last five years:

a. an annual turnover of more than £10.2 million; and either one of the following
   - total assets worth more than £5.1 million; or
   - 50 or more employees on average.

Response to specific representations

2.20 In arriving at its consultation proposals the SSRO has considered stakeholder representations on company size and the methodology, as set out in the table below

Table 1: Stakeholder representations on company size and the methodology

Representation	Response
That the methodology is fundamentally sound.	The SSRO considers that keeping the methodology under review and considering stakeholder representations ensures the approach has broad support.
The benchmark companies are typically smaller than the MOD's largest single source suppliers	There is a wide distribution of company sizes in MOD contracting, both in single source and otherwise and this diversity is captured in the comparator group. It is important that large companies with dominant market positions are not overly represented as this would undermine the integrity of a competitive benchmark.
The inclusion of smaller companies means the profit rate is too low	The underlying profit of the comparator group is similar to the MOD's largest single source suppliers on average (see *Key questions and answers regarding the methodology 2019/20*, Question 4[13]) and the six steps can result in a range of contract profit rates similar to the profits earned by those suppliers across their wider business, based on profit rates reported by contractors.
Removing smaller companies from the comparator group increases the profit rate, so that means the turnover threshold is wrong	Removing a significant number of companies with shared characteristics (such as their size) from the comparator groups will change the underlying profit rate – it may go up or down. This does not suggest, however, that those companies were not valid comparators in terms of their activities and should be removed by altering the parameters of the methodology. Removing companies because they have a certain effect on the rate would undermine the credibility of the assessment.
Smaller companies could not deliver QDCs/QSCs	All companies in the benchmark are active going concerns delivering commercial activities to business customers akin to those activities undertaken in QDCs/QSCs. Whether those activities are contracted for on a basis that would meet the legal threshold for classification as a QDC or QSC, or the MOD's contracting policies is not a determinant of whether a company undertakes those activities.
The data of smaller companies is unreliable and distorted	The SSRO recognises companies of all sizes have an element of discretion as to how they manage and report their finances, although we have not identified any specific issues. Additional data quality controls may provide further confidence that the aggregate effect of any such discretion does not have a distortionary effect on the benchmark. We have set out proposals to further mitigate the risk of data quality issues with some smaller companies.

13 https://www.gov.uk/government/publications/2019-contract-profit-rate

3. Activity characterisations and search criteria

Introduction

3.1 The SSRO has developed four activity characterisations to describe the activities undertaken in QDCs and QSCs. A comparable company is one that predominantly undertakes economic activities that match one of the activity characterisations. Financial data for the companies that form these 'comparator groups' are then used to calculate the baseline profit rate. The groups are:

a. Develop and Make (D&M);

b. Provide and Maintain (P&M);

c. Ancillary Services (AS); and

d. Construction (Con).

3.2 The SSRO is not proposing to introduce new activity types at this time. However, we welcome input on this issue and will consider if the introduction of new or amended activity types should form part of a future SSRO work programme.

3.3 Selecting companies for the comparator groups is a multi-stage process. First, the SSRO uses the Orbis database to search for potential comparators. Secondly, the SSRO manually reviews the activities and geography of each company to determine if they meet the specified criteria.

3.4 The existing Orbis search criteria are set out in Section 9 and Appendix B and C of the methodology. The process for the manual review is set out in Section 10 of the methodology and the activity characterisations are set out in Appendix A.[14]

3.5 The SSRO has now performed the manual review of comparator companies for three BPR assessments, supported by external independent transfer pricing experts and is experienced in the detail of how the process works and the kinds of companies that are appropriate. The requirement for a full manual review this year provides an opportunity to codify existing practice, to further ensure companies are selected in a consistent way.

3.6 Amendments are proposed to the methodology document that predominantly codify existing practice in the existing activity characterisations and seek to respond to feedback from stakeholders on appropriate comparators. These amendments seek to refine the boundaries of what is or is not to be considered comparable, rather than reverse decisions for any companies that have previously passed the manual review.

3.7 The following is an example of how the consultation proposals are set out. Text is highlighted to indicate whether we propose that it is to be deleted or added:

> 2.3 This is an example of text in the existing methodology document that will not change. It is proposed that the following text in the existing methodology will be deleted. This is more text that will remain unchanged. This is text that it is proposed will be added.

Assessing whether a product is commoditised in the D&M activity characterisation

3.8 If the product produced by a company is commoditised that company is likely to be excluded from the D&M comparator group. The D&M activity characterisation gives some examples of commoditised products and non-commoditised products. Applying these examples in practice achieves the desired result, but the SSRO considers that the nature of the examples of non-commoditised products could be clearer and that the examples of comparable and non-comparable products should be extended to include electronic products as well as mechanical products.

14 https://www.gov.uk/government/publications/2019-contract-profit-rate

3.9 The proposal is that this is addressed by amending the activity characterisation as follows:

> Appendix B 1.2 …If the product is a commoditised unit or processed raw manufacturing input, for example ~~a screw, bulb,~~ generic electrical or mechanical components, sheet metal, shaped plastic, or ancillary items such as basic tools, then this may not be sufficiently complex and the company is likely to be excluded. Electronic or mechanical assemblies or subsystems ~~components such as pumps, actuators and motors~~ that are complex and not of a commoditised nature are more likely to be considered the output of a comparable manufacturing process.

Assessing the complexity of the research and development activities in the D&M activity characterisation

3.10 Certain types of D&M activity, although employing both design and manufacturing, are not ‘developing’ to the extent required to be comparable. For example, where the design activity is limited to applying ideas developed elsewhere under the companies’ own brand. Such complexity has been an issue raised by stakeholders and the SSRO considers that it would be beneficial if the activity characterisation was clearer.

3.11 In order for a company to get research and development (R&D) tax relief from HM Revenue & Customs in the UK, the company needs to meet certain criteria. A qualifying R&D project would be one that:

a. looked for an advance in science and technology;

b. had to overcome uncertainty;

c. tried to overcome this uncertainty; and

d. could not be easily worked out by a professional in the field.

3.12 These kinds of considerations have merit when thinking about the complexity required in the development activities carried out by a comparable D&M company. We propose that this issue is addressed by adding the following text to the D&M activity characterisation:

> Appendix B 2.1. Companies undertaking comparable activities considered as ‘Develop and Make’ are expected to engage in manufacturing and the design and development contributing to that process. This would therefore not include manufacturing on behalf of a hiring firm that supplies the design, or those solely undertaking research or design work with no associated manufacturing. Where development activities do not seek to result in a novel or differentiated product the company is less likely to be considered comparable.

Assessing companies in the P&M activity type that perform loosely comparable activities

3.13 It may be acceptable for comparable companies to engage in some loosely comparable activities. The P&M activity characterisation lists examples of such activities. The SSRO has observed that a number of comparable P&M companies engage in the sale of their ex-hire fleet and considers that giving this as a specific example in the activity characterisation would be useful.

3.14 We propose that this issue is addressed by adding the following text to the P&M activity characterisation:

> Appendix B 2.4 ...It may be acceptable for comparable firms to engage in some loosely comparable activities as part of normal business (for example parts procurement, warehousing, logistics, installation, or the sale of the company’s ex-hire fleet)…

Assessing companies that provide equipment inside facilities

3.15 The P&M activity characterisation focuses on describing the type of equipment that a comparable company may provide. The SSRO has observed that a number of comparable P&M companies could be more likened to the provision of complex facilities, for example, dockyards or training simulators. The SSRO considers it would be helpful to be clear that providing facilities that embody or integrate the equipment is permitted.

3.16 We propose that this issue is addressed by adding the following text to the P&M activity characterisation:

> Appendix B 2.2 …Comparable activities would typically be of the type which can be likened to those involved in the support and provision of equipment used for military or defence purposes. This could cover a broad range of products such as structural metal goods, machinery, electronic and mechanical subsystems, vessels, containers, general machinery, ships, aircraft, and wheeled or tracked vehicles or other means of transportation and other items of machinery of an industrial nature. Comparable companies may also provide the facilities embodying or integrating the equipment and the training necessary to operate or maintain these assets.

Assessing the construction of residential blocks of flats

3.17 The Construction activity characterisation is clear that land-banking activity is grounds for exclusion. However, the examples could better reflect the nature of the industry. In particular, the construction of residential property is not always an indicator of land-banking; for example, a company might construct residential property under contract by the land owner.

3.18 We propose that this is addressed by removing this exclusion in the third paragraph of the Construction activity characterisation:

> Appendix B 3.3 …Comparable companies are not expected to hold land for long-term appreciation purposes and as such those who engage primarily in real estate development or the construction of residential property would typically be excluded.

3.19 It should be noted that companies that predominantly construct individual houses will continue to be likely to be excluded because these are not typically of steel-frame or concrete construction, as suggested by the second paragraph (3.1) of the activity characterisation.

The assessment of tunnelling under the construction activity

3.20 The structure of the Construction activity characterisation implies it is more restrictive with regards to tunnelling, highways maintenance or rivers and coastal work than other loosely comparable activities. The SSRO considers that tunnelling at a fixed location could be considered as a loosely comparable activity if it is for the purpose of the construction of a building.

3.21 We propose that this is addressed by redrafting the paragraph to be more similar to how other loosely comparable activities are dealt with in the fourth paragraph of the Construction activity characterisation:

> 3.2 …To the extent that civil engineering works relates to the assembly of a structure at a fixed location (for example it is not tunnelling, highways maintenance or rivers and coastal work) then it is more likely to be considered as 'Construction'. To the extent that companies engage in tunnelling, pipe-laying, highways maintenance or river and coastal work, these activities are not expected to extend beyond what might reasonably be required to support the delivery of a structure.

The wording of the exclusion of "specialised nature" in the Ancillary Services characterisation

3.22 The Ancillary Services activity characterisation is simultaneously broad, in that it suggests accountancy and legal advice is likely non-comparable, and restrictive, in that it limits the consideration of 'professional services' to just those industries.

3.23 The SSRO considers that the provision of professional services is more nuanced in practice. For example, it observes that companies providing ancillary HR services might also provide some higher-value-adding, but still routine, services (simple personal tax advice, recruiting, and the like) on the side of more basic support services. The recommendation is to allow routine tax and legal advice as Ancillary Services.

3.24 The description of non-comparable professional services does not necessary explicitly exclude professional services usually considered non-comparable, for example architecture, engineering consultancy services, and the like.

3.25 We propose that this is addressed by redrafting the paragraph to allow some routine tax or legal advice, as well as expanding the description of 'professional services' to include more industries. The words "chartered professionals" are proposed on the basis that this has a particular meaning in English.

> Appendix B 4.2 …Administrative support relates to outsourced business services such as payroll processing, call centres, HR, basic book-keeping, routine tax or legal advice and other clerical work…
>
> Appendix B 4.3 …Companies that engage in support services loosely connected to those described above, but which are of a specialised nature would not typically be considered comparable. Such non-comparable services would include provision of security services in prisons, the design and procurement of IT infrastructure, the services of chartered professionals professional services such as accountancy or legal advice, or the supply of clinical staff to hospitals. Companies that do not undertake activities akin to ancillary support services (for example, recruitment, construction, software development, management consultancy, engineering consultancy) are not considered comparable.

Assessing a globalised company's operational markets

3.26 A company that is incorporated in a comparable market may operate globally, in both comparable and non-comparable markets. The methodology says (paragraph 10.2) that a company must operate in Western Europe and North America but does not give a great deal of additional detail on how this requirement might be applied in practice.

3.27 Appendix A of the methodology document currently describes in detail how to assess a company's activities. The proposal is that a similar 'comparable market' characterisation is incorporated as Appendix B to codify existing SSRO practice into the methodology document:

> Appendix B Companies undertaking comparable activities in any activity group are expected to operate in markets that would typically include Western Europe and North America.
>
> Where a company undertakes global operations consideration should be given to the nature of the activities occurring in different geographic areas. The comparable activities of the business are expected to meet the relevant activity characterisation and be undertaken in comparable geographic areas.
>
> The determination of where a company's activities are undertaken might be by reference to the amount of cost incurred, the number of employees, the value of assets employed, or other measures depending on the nature of the activities undertaken.
>
> It may be acceptable for comparable firms to undertake some activities in non-comparable geographic areas. However, these activities are not expected to extend beyond what might reasonably be required to deliver the company's principal business.
>
> The end customers for the outputs generated by comparable companies may be located in any geographic area. For example, a company that exports goods or services from a comparable market to a non-comparable market is unlikely to be excluded on that basis.

Financial criteria: Tangible fixed assets greater than zero

3.28 A company's lack of tangible fixed assets is a strong indicator of subsequent rejection from the review but is not a criteria currently considered by the Orbis search.

3.29 In order to reflect the expectation that comparable companies will own or control assets for use in their commercial activities the SSRO propose that the following search criteria is added to the methodology.

> Tangible Fixed Assets
>
> 9.18 Companies must have a tangible fixed assets value greater than nil for the most recent two years. This is to reflect the expectation that companies performing comparable activities will own or control assets for use in their commercial activities.

Geography criteria: overseas territories

3.30 A company's incorporation in an overseas territory is a strong indicator of subsequent rejection from the review but is not a criteria currently considered by the Orbis search.

3.31 In order to reflect the expectation that comparable companies operate in Western Europe and North America we propose that the existing 'Geographic location' criteria in the methodology is amended to state that overseas territories are not included.

> 9.11 Companies located in the following regions, not including overseas territories, were included in the search:
>
> - Western Europe
> - North America

Reviewing company information on functions

3.32 The Orbis database includes information collated by Bureau van Dijk (BvD) about company activities. Using a uniform and unique form, the idea is to establish, for each company, a structured notice (or "overview"), in two parts:

a. a "full overview", an exhaustive summary of the activities of a company; and

b. detail of 18 specific topics.

3.33 The methodology already identifies two fields for review, 'primary business line' and 'main production sites'. The field 'Main activity' describes if a company operates in one or more of Manufacturing, Services, Wholesale or Retail. The SSRO has found this to be a strong indicator of subsequent rejection from the comparator groups: 'retail' and 'wholesale' companies tend to be rejected.

3.34 It is not possible to use this field as a search filter in the Orbis database and, in any case, the SSRO considers that the value of this field is in its potential to improve the efficiency of the manual review. It is proposed that the methodology is amended to introduce a review of this additional field to ensure that the SSRO utilises the information available in the Orbis database to make its review process effective and efficient.

> 10.3 At the first stage, the Orbis 'main activity', 'primary business line' and 'main production sites' are reviewed. This is used as a triage to reject companies that are non-comparable.…

Option to retain existing comparator companies

3.35 The proposed changes described above might result in companies currently included in the comparator groups failing to continue to meet the financial and functional search criteria for inclusion in the comparator groups.

3.36 In order to ensure the SSRO can continue to regard those companies as comparable companies, if appropriate, we propose that the existing description in the methodology of the process to quality assure the comparator groups is amended to be clear that the companies included in previous comparator groups can be used to inform the process in a given year.

> 10.7 Decisions are subject to a further round of reviews for quality assurance purposes, including examining the presence or otherwise of the MOD's suppliers or of companies included in previous comparator groups. This entire process is supported by independent transfer pricing experts.

Proposed amendments to NACE Rev 2 codes and text search terms

3.37 We are proposing changes to the automated Orbis search criteria which relate to the activities a company undertakes. These are the NACE codes and text search terms. The aim is to refine these criteria in order to improve the overall efficiency of the automation through reducing the number of non-comparable companies picked up by the search and subsequently having to be removed as part of the manual review.

3.38 We are proposing to add the term "militar*" to the text search of all activity types which will identify companies which report the word military (or similar) in relation to their activities. This is intended to further enhance defence sector representation in the result.

3.39 Details on the proposed changes in relation to NACE codes are outlined below.

The 'Develop and Make' activity type NACE Rev 2 codes and text search terms

Sub-activity	NACE Rev 2 code	Description	Text search terms
Manufacturing	251	Manufacture of structural metal products	(manuf*, produc*, fabric*, build*, defense*, defence*, militar*)[15]
	2511	Manufacture of metal structures and parts of structures	
	252	Manufacture of tanks, reservoirs and containers of metal	
	2529	Manufacture of other tanks, reservoirs and containers of metal	
	253	Manufacture of steam generators, except central heating hot water boilers	
	254	Manufacture of weapons and ammunition	
	259	Manufacture of other fabricated metal products	
	2599	Manufacture of other fabricated metal products n.e.c.	
	2630	Manufacture of communication equipment	
	2651	Manufacture of instruments and appliances for measuring, testing and navigation	
	28	Manufacture of machinery and equipment nec	
	29	Manufacture of motor vehicles, trailers and semi-trailers	
	30	Manufacture of other transport equipment	
	301	Building of ships and boats	
	302	Manufacture of railway locomotives and rolling stock	
	303	Manufacture of air and spacecraft and related machinery	
	304	Manufacture of military fighting vehicles	
	3099	Manufacture of other transport equipment n.e.c.	
Research and development (R&D)	749	Other professional, scientific and technical activities nec	(research*, develop*, design*) **AND** (test*, equip*, machin* , militar* , vehic* , defense* , defence*)
	72	Scientific research and development	
	721	Research and experimental development on natural sciences and engineering	
	712	Technical testing and analysis	
	741	Specialised design activities	

15 * denotes a part word. For example, "develop*" includes "develop", "develops", "developed", "developing", "developer" and "development".

3.40 Replacing '251*: Manufacture of structural metal products' has the effect of removing the following level 4 code that is always unsuccessful in delivering companies that pass the manual review: '2512 Manufacture of doors and windows of metal'.

3.41 Replacing '252*: Manufacture of tanks, reservoirs and containers of metal' has the effect of removing the following level 4 code that is always unsuccessful in delivering companies that pass the manual review: '2521: Manufacture of central heating radiators and boilers'.

3.42 Replacing '259*: Manufacture of other fabricated metal products' has the effect of removing the following level 4 codes that are predominantly used by companies producing commoditised metal components and are usually unsuccessful in delivering companies that pass the manual review:

a. '2591: Manufacture of steel drums and similar containers';

b. '2592: Manufacture of light metal packaging';

c. '2593: Manufacture of wire products, chain and springs'; and

d. '2594: Manufacture of fasteners and screw machine products'.

3.43 Replacing '30*: Manufacture of other transport equipment' with a number of level 3 and 4 codes has the effect of removing the following level 4 codes that are always unsuccessful in delivering companies that pass the manual review:

a. '3091: Manufacture of motorcycles'; and

b. '3092: Manufacture of bicycles and invalid carriages'.

3.44 Replacing '72*: Scientific research and development' has the effect of removing the following level 4 code that is always unsuccessful in delivering companies that pass the manual review: '7220: Research and experimental development on social sciences and humanities'.

3.45 It is proposed to add NACE code '2630: Manufacture of communication equipment' to the search on the basis that it occurs regularly in both the existing D&M comparator group and the companies added through the defence cross-check. The code may deliver additional companies to the search result that are appropriate comparators.

The 'Provide and Maintain' activity type NACE Rev 2 codes and text search terms

Sub-activity	NACE Rev 2 code	Description	Text search terms
Capacity provisioning	7712	Renting and leasing of trucks	(rent*, leas*, hir*, capacity*) AND (container*, truck*, tank*, trailer*, aircr*, aviation*, plane*, industrial*, defence*, defense*, militar*)
	7732	Renting and leasing of construction and civil engineering machinery and equipment	
	7734	Renting and leasing of water transport equipment	
	7735	Renting and leasing of air transport equipment	
	7739	Renting and leasing of other machinery, equipment and tangible goods nec	
Upkeep and maintenance	33	Repair and installation of machinery and equipment	(repair*, maint*, upkeep*, update*, training*) AND (equip*, vehic*, aircr*, defense*, defence*, militar*)
	452	Maintenance and repair of motor vehicles	
	712	Technical testing and analysis	
	749	Other professional, scientific and technical activities nec	

3.46 Add '7731: Renting and leasing of agricultural machinery and equipment'. This NACE code occurs 12 times in companies that are included in the existing comparator group and may deliver additional appropriate comparators to the search result.

3.47 Remove '452*: Maintenance and repair of motor vehicles' because this code overwhelming delivers consumer car operations, not the industrial vehicles the SSRO are seeking.

3.48 Remove '712*: Technical testing and analysis' because this NACE code is always unsuccessful in delivering companies that pass the manual review.

3.49 Remove the text search 'plane*' because it is not generally a word that is used to refer to aircraft, as was intended, and instead identifies companies wholly unrelated to our activity types (planetariums, planers, etc).

3.50 Remove the search term 'capacity*' because companies reporting this word are primarily discussing their own capacity to produce or manufacture something, rather than an ability to provide capacity to others. For example, power generation companies: "43,000 megawatts of generating capacity". Such companies are usually unsuccessful in passing the manual review

3.51 Replace the search term 'train*' with 'training' because companies delivering training predominantly use the term 'training' to describe their activities. The term 'train' delivers other irrelevant companies in the rail (train) or automotive (drive-train, power-train) or footwear (trainers) industries.

The 'Ancillary Services' activity type NACE Rev 2 codes and text search terms

NACE Rev 2 code	Description	Text search terms
631	Data processing, hosting and related activities; web portals	(outsourc*, support*, maint*) **AND** ((clean*, maint*' facil*, industr*, upkeep*) **OR** (cleric*, IT![16], office*, data*, admin*, defence*, defense*, militar*))
6311	Data processing, hosting and related activities	
802	Security systems service activities	
811	Combined facilities support activities	
8121	General cleaning of buildings	
8122	Other building and industrial cleaning activities	
8129	Other cleaning activities	
821	Office administrative and support activities	
829	Business support activities	
8299	Other business support service activities n.e.c.	

16 ! Denotes where the search is case-sensitive.

3.52 It is proposed to replace two level-three NACE codes with one of their subsidiary level-four codes in order to exclude the following codes that are always unsuccessful in delivering companies that pass the manual review:

a. '6312: Web portals';

b. '8291: Activities of collection agencies and credit bureaus'; and

c. '8292: Packaging activities'.

The ‘Construction’ activity type NACE Rev 2 codes and text search terms

NACE Rev 2 code	Description	Text search terms
2511	Manufacture of metal structures	(construct*, build*, engineer*, architect*, defense*, defence*, militar*)
2599	Manufacture of other fabricated metal products	
2891	Manufacture of machinery for metallurgy	
2892	Manufacture of machinery for mining, quarrying and construction	
2899	Manufacturing of other special-purpose machinery	
41	Construction of buildings	
411	Development of building projects	
4120	Construction of residential and non-residential buildings	
42	Civil engineering	
4211	Construction of roads and motorways	
4213	Construction of bridges and tunnels	
4291	Construction of water projects	
4299	Construction of other civil engineering projects	
43	Specialised construction activity	

3.53 It is proposed to remove the NACE codes that describe the manufacture of metal structures and some machinery because these NACE codes bring in a large number of manufacturing companies making smaller metal products, rather than large metal structures as was intended by the search. Together, these codes are usually unsuccessful in delivering companies that pass the manual review, with a 1 per cent success rate from 291 companies.

3.54 The net effect of replacing the existing level-four NACE codes with the corresponding level-two codes of 41* and 42* will be to incorporate the following level-four codes in addition to those already included in the existing search:

a. ‘4212: Construction of railways and underground railways’;

b. ‘4221: Construction of utility projects for fluids’; and

c. ‘4222: Construction of utility projects for electricity and telecommunications’.

3.55 4221 and 4222 occur regularly in companies that are already within the comparator groups and so may deliver additional appropriate comparators to the search result, along with 4212.

3.56 Presenting 411* and 4120* with the corresponding level 4 code of 41* will not have any practical effect because no additional codes are introduced, it is just a summarisation of the lower levels that are already used.

4. Application of the revised methodology

4.1 Following due consideration of any points raised in response to this public consultation, and approval by the SSRO's Board, the SSRO intends to publish a summary of consultation responses by 3 October 2019.

4.2 The SSRO proposes that the revised methodology will apply to the baseline profit rate, capital servicing rates and SSRO funding adjustment recommended to the Secretary of State in January 2020, and thereafter.

4.3 There is a short amount of time between the consultation closing and the SSRO Board reviewing and approving the methodology for the 2020/21 recommendation. The SSRO intends to accommodate any points raised in response to this public consultation but it may be that some points will need to be considered in more detail and resource constraints may require these to be deferred until subsequent years.

4.4 The proposed timetable for concluding methodology changes for 2020/21 is summarised below.

Activity	Organisation	Date
Submission of responses to consultation	Stakeholders	1 Jul 2019 to 26 Aug 2019
Consider consultation responses and prepare methodology	SSRO	Aug 2019 to Sep 2019
SSRO Board reviews and approves methodology to be applied for 2020/21	SSRO	26 Sep 2019
Response to consultation published	SSRO	3 Oct 2019
Baseline profit rate, capital servicing rates and SSRO funding adjustment to be applied for 2020/21 recommended to the Secretary of State	SSRO	31 Jan 2020
The rates, together with the reasons for any difference to the SSRO's recommendation, published by the Secretary of State	Secretary of State	Mar 2020
Publication of recommendation documents	SSRO	Mar 2020

4.6 The SSRO welcomes views on the proposed timetable for publication and application of the revised methodology as part of this consultation.

5. Consultation questions

5.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on the following consultation questions:

a. Do the proposed amendments to the methodology enhance the identification of companies whose economic activities are included in whole or in part in the activity types that contribute to the delivery of QDCs and QSCs?

b. Is the proposed methodology consistent with the aim that good value for money is obtained in government expenditure on qualifying defence contracts and that persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts?

c. Are there any material issues in the topic areas covered in this consultation that have not been adequately addressed in the proposed changes?

d. What, if any, aspects of the SSRO's methodology should the SSRO prioritise for review in the future?

5.2 A consultation response form containing these questions has been published alongside this consultation document on the SSRO's website. Completed response forms should be sent:

a. by email to consultations@ssro.gov.uk (preferred); or

b. by post to SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.

5.3 Responses to the consultation should be received by 26 August 2019. Responses received after this date will not be taken into account in finalising the methodology for 2020/21 but will inform subsequent consideration of methodology changes.

5.4 The SSRO also welcomes the opportunity to meet with stakeholders to discuss the proposals during the consultation period. If you wish to arrange such a meeting, please contact us at the earliest opportunity via consultations@ssro.gov.uk.

5.5 In the interests of transparency for all stakeholders, the SSRO's preferred practice is to publish responses to its consultations, in full or in summary form. Respondents are asked to confirm in the response form whether they consent to their response being published and to the attribution of comments made. Where consent is not provided comments will only be published in an anonymised form.

5.6 Stakeholders' attention is drawn to the following SSRO policy statements, available on its website,[17] setting out how it handles the confidential, commercially sensitive and personal information it receives and how it meets its obligations under the Defence Reform Act 2014, the Freedom of Information Act 2000, the General Data Protection Regulation and the Data Protection Act 2018.

a. The Single Source Regulations Office: Handling of Commercially Sensitive Information; and

b. The Single Source Regulations Office: Our Personal Information Charter.

17 https://www.gov.uk/government/organisations/single-source-regulations-office/about/personalinformation-charter

Appendix 1: Definitions of company size

European Union

Small and medium-sized enterprises (SMEs) are defined in EU recommendation 2003/361. The main factors determining whether an enterprise is an SME are:

a. staff headcount; and

b. either turnover or balance sheet total.

Table 2: EU recommendation 2003/361

Company category	Staff headcount	Turnover	or Balance sheet total[18]
Medium-sized	< 250	≤ €50m	≤ €43m
Small	< 50	≤ €10m	≤ €10m
Micro	< 10	≤ €2m	≤ €2m

Orbis

Orbis reports a field called ‘Company Size’ based on the following criteria:

Very large company:

At least one of Operating revenue >= 100 million EUR, Total assets >= 200 million EUR, Employees >= 1,000, Listed.

Companies with ratios operating revenue per employee or total assets per employee below 100 EUR (130 USD) are excluded from this category.

Companies for which operating revenue, total assets and employees are unknown but have a level of capital over 5 million EUR (6.5 million USD) are also included in the category.

Large company:

At least one of Operating revenue >= 10 million EUR, Total assets >= 20 million EUR, Employees >= 150, not Very Large

Companies with ratios operating revenue per employee or total assets per employee below 100 EUR (130 USD) are excluded from this category.

Companies for which operating revenue, total assets and employees are unknown but have a level of capital comprised between 500 thousand EUR (650 thousand USD) and 5 million EUR (6.5 million USD) are also included in the category.

Medium company:

At least one of Operating revenue >= 1 million EUR, Total assets >= 2 million EUR, Employees >= 15, Not very large or large

Companies for which operating revenue, total assets and employees are unknown but have a level of capital comprised between 50 thousand EUR (65 thousand USD) and 500 thousand EUR (650 thousand USD) are also included in the category.

Small company:

Not very large, large, or medium.

18 ‘Balance sheet total’ consists of the assets in A to E under "Assets" in the layout prescribed in Article 9 of 78/660/EC or those in A to E in the layout prescribed in Article 10 of 78/660/EC.