

**Baseline Profit Rate methodology**  
**Responses to the consultation**  
**July 2019**

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# 1. ADS Group



23 August 2019

**Single Source Baseline Profit Rate Methodology  
Consultation for Changes 2020/21**

I am pleased to enclose ADS's response to the SSRO's consultation 'Single Source Baseline Profit Rate Methodology'. You will see it is in two parts: the Response Form completed as requested and a copy of the consultation paper marked up with comments in track change.

The consultation paper was reviewed by a group of industry experts and the recurring themes of their comments were to ensure that:

1. The comparator group consisted of companies whose economic activities were included in whole or in part in the activity types that contribute to the delivery of QDCs and QSCs. The expert group concluded that whilst this was being achieved, companies performing QDCs and QSCs performed additional economic activities that were absent in comparator group companies. These activities were mainly associated with integrating sophisticated equipment into complex systems and complex systems into advanced, complex platforms. Some commentators also noted that the economic activities performed by MOD's contractors were generally to higher or more complex standards than those performed by comparator group companies. The need for MOD's contractors to deliver complex equipment that capable of operating satisfactorily in harsh environments including shock, vibration, humidity, electro-magnetic compatibility, etc. was not replicated in comparator group companies. These additional economic activities, skills and capabilities were not being rewarded appropriately via the Baseline Profit Rate.
2. Financial comparisons were made on a like-for-like basis. In this respect, the expert group believed that the financial results of comparator group companies should be adjusted to remove the costs of amortisation or impairment of intangible assets and the amortisation of goodwill. These costs are not Allowable Costs in QDCs and QSCs and the current position results in comparisons being made on dissimilar basis which disadvantages contractors.

ADS and its members will be pleased to provide any further information you may require or to clarify any of the points made in this response.



### 3. Consultation responses

3.1 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?

~~Yes~~/ No / ~~Don't know~~ (Delete as appropriate)

#### Comments

Defence is a unique market because of its high initial cost, extremely long development/production/support cycles, single in-country customers (MOD) who happen to also be regulators, exports advocates and funders of R&D. The sector requires long term investments with modest returns in a currently relatively flat market. In the current world where rapid development and mass production is becoming the norm (e.g. iPhone upgrades every 12 months), delivering infrequent new products and services and supporting them throughout their 40 year life cycles requires companies with unique characteristics.

Coupled with this is the nature of single source contracts and the work carried out during their performance. Whilst the *'proposed amendments to the methodology [enhance] identification of companies whose economic activities are included in whole or in part of the activity types that contribute to the delivery of QDCs and QSCs'* they are incomplete. In practice, comparator companies are simple component or equipment suppliers. By contrast, companies that perform QDCs and QSCs are integrating many equipment into complex systems and then integrating many complex systems into platforms. Comparator group companies lack the skills, facilities and other resources to perform these more complex tasks. They cannot be said to be a grouping of prime contractors and equally, their size of many would not support a prime contracting environment.

Review of the websites for 10% of the comparator group companies revealed that although they appear to perform similar economic activities to those performed by defence contractors holding single source contracts, they are in practice dissimilar. The reason for this are that the technical requirements for equipment produced under single source contracts are generally more demanding. Comparator group companies do not design for shock survivability, low electronic signature, ability to withstand harsh vibration environments, continued operation after flooding etc. or the myriad of other technical standards unique to defence Contracts for services also have significant differences particularly in supportability and management of obsolescence. As a result, whilst companies that perform QDCs and QSCs can be said to perform economic activities that are the same as or similar to companies in the comparator group, they also perform additional high grade economic activities that comparator group companies do not perform.

Review of companies in the comparator group also identified that the ICT sector is under represented. Many single source contracts have substantial ICT content, and this should be reflected by inclusion of this sector in the comparator group.

- b) Is the proposed methodology consistent with the aims that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts?

Yes / No / ~~Don't know~~ (Delete as appropriate)

Comments

The current methodology does not adjust comparator group company data for the cost of impairment and amortisation of intangibles. MOD CAAS officers do not recognise these costs as being Appropriate, Attributable or Reasonable and exclude them and other assets arising from business combinations from the calculation of the Capital Servicing Allowance.

However, these costs are not removed from the comparator group financial data during calculation of the Baseline Profit Rate and the outcome is a distorted comparison which disadvantages the contractor who as a result does not receive a 'fair and reasonable price'.

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

Yes / ~~No~~ / ~~Don't know~~ (Delete as appropriate)

Comments

1. The ICT sector companies needs to be included in the comparator group. Members who operate in other market areas as well as defence and which use the same software skill sets e.g. banking, advise that customers in these sectors generally have bigger budgets and prices are generally higher. The skill sets required are in short supply and they have to pay a premium in order to secure them which creates challenges when trying to achieve profit comparable with suppliers who focus on commercial markets.

2. Amortisation of intangibles needs to become an Allowable Cost or conversely, comparator group company data should be adjusted to achieve a like-for-like comparison.

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

Comments

The SSRO should reconsider the benefit obtained from having four activity characterisations. The nature of defence contracting means that it is often difficult to separate Develop and Make from Provide and Maintain activities and the two categories could easily be merged.

The reasons for having separate categories for Ancillary Services and Construction is unclear unless the intention is to 'slice and dice' contracts to achieve different profit rates for different types of activity within the same contract. If this is the reason then ADS urges MOD and the SSRO to take a cautious approach as it is likely to result in contractors adjusting their corporate structures, ways of working and staff gradings to maximise the benefit they can obtain.

## **2. BAE Systems Ltd**



19<sup>th</sup> August 2019

[REDACTED]

Dear [REDACTED]

### **Baseline Profit Rate Methodology Consultation Response**

Many thanks for Matthew Rees' letter of 1<sup>st</sup> July 2019, inviting views on the SSRO's proposed changes to the Baseline Profit Rate Methodology and the associated implementation timetable. As with previous consultations, BAE Systems are submitting the Consultation Response Form, to assist in the analysis of all responses, and this letter as supplementary information to provide what we feel is a more comprehensive response.

#### **Comparator Group changes**

The removal of smaller companies from the Comparator Group is a step in the right direction as industry has always considered them wholly unrepresentative of the makeup of the UK defence market and the companies that are in a position to take on QDC / QSCs.

However, we remain of the view that the Comparator Group will still be unrepresentative as it contains too many companies that are not similar enough to defence contractors. We disagree with the underlying premise that the Comparator Group should not resemble a group of companies that hold QDCs because this would 'become a measure of profit in a non-competitive market, rather than an external benchmark of a fair and reasonable profit'. The profit generated through QDCs should be reflective of the characteristics and risk profile of the work performed under them. The fact that the MoD cannot compete the work they are contracting under the SSCRs, when it would, by policy, be their preference to competitively select suppliers, should be a clear indicator that this work is inherently different to the work it can compete. The work performed under QDCs / QSCs is usually more specialised, complex and risky. QDC / QSC profit rates should be comparable those earned by contractors performing single source and competed work of similar characteristics, and in similar economic circumstances, in defence markets at home and elsewhere in the world. To achieve fair and reasonable prices, a comparison with returns for similar work (i.e. defence contracts) in other developed, Western economies (primarily the US, as this represents the closest to a truly competitive defence market) would be a better measure of comparability.

[REDACTED]

## **Problem with current methodology**

We also believe that there are inherent flaws in the current methodology as it uses published company outturn profits to set input contract profit rates. We do not believe that using published company financial results will deliver a fair and reasonable baseline profit rate. The ultimate published company profits will have been impacted by accounting rules potentially skewing profit recognition over time, by risks that have impacted in the delivery of business and by costs not directly associated with the delivery of contracts.

## **Going forward**

BAE Systems suggests that SSRO undertaking a wholesale and comprehensive review of the methodology applied, drawing experience and views from all stakeholders, would be an appropriate and beneficial activity, rather than looking to introduce minor amendments to the existing methodology in terms of descriptors and definitions. This review should also consider the appropriateness of the comparability group and the measure or concept of comparability. We have referred to this in our response to the Profit Principles Working Paper submitted to SSRO previously.

However, if the extant methodology is retained, we would propose SSRO considering:

- Why retail and wholesale companies “tend” to be rejected from the Comparator Group when these companies should always be rejected given the total dissimilarity to the activities defence companies undertake;
- Whether the construction and ancillary services categories are appropriate or required. Whilst we accept that some major defence programmes may contain elements of such activities, these programmes have specialist considerations not generally experienced in the outside world, such as operation on MoD / List X sites, stringent regulations and requirements (e.g. nuclear safety) or unique MoD contract terms which in themselves bring complexity, cost, risk and ultimately threat to profitability of contracts. Additionally, we would question why any programme that is exclusively for construction and / or ancillary services would be contracted single-source given there is a vibrant competitive market for such activities.

## **Conclusion**

The baseline profit rate has been a cause of disagreement since the introduction of the Defence Reform Act and associated Single Source Contract Regulations in 2014. Having five years of experience of the new regime and the BPR methodology, BAE Systems feels the time is right for a full consideration of the methodology to construct QDC/QSC profit rates. We have set out above some of our major points in response to this specific consultation but would welcome a broader engagement on the whole matter of QDC / QSC profit rates. As highlighted in our response to the Profit Principles Working Paper, generating appropriate returns that allow a business to compensate its shareholders adequately for their investment is vital to preserve the sovereign defence capability of the UK and freedom of action for the UK Armed Forces and therefore is an important cornerstone of the regime. We are also mindful that any review should seek to simplify the regime, whether in relation to how baseline rates are derived (if indeed the idea of a “baseline” rate is retained) or in how contract profit rates are constructed and applied, to allow a shift in focus onto contract costs which are overwhelmingly the largest element of contract prices.

I trust you find this informative and useful. BAE Systems welcomes any dialogue on this or related matters and is more than willing to meet with SSRO to discuss further. I would be happy to provide any clarifications relating to the above should you so require.

Yours sincerely

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# **SSRO**

Single Source  
Regulations Office

## **Single source baseline profit rate methodology**

Consultation on changes for 2020/21

Response form

July 2019

### 3. Consultation responses

3.1 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?

Yes

Comments

The move to remove smaller companies from the comparator group is a step in the right direction as industry has always considered them to be wholly unrepresentative of the makeup of the UK defence market and the companies that are in a position to take on QDC / QSCs.

The other proposed changes do not significantly impact our view of the methodology

- b) Is the proposed methodology consistent with the aims that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts?

No

Comments

We remain of the view that (a) the comparator group will still be unrepresentative as it contains too many companies that are not similar enough to defence contractors and (b) the methodology is inherently flawed as it uses published company outturn profits to set input contract profit rates.

We disagree with the underlying premise that the Comparator Group should not resemble a group of companies that hold QDCs because this would 'become a measure of profit in a non-competitive market, rather than an external benchmark of a fair and reasonable profit'. The profit generated through QDCs should be reflective of the characteristics and risk profile of the work performed under them – the fact that the MoD cannot compete the work they are contracting for under SSCRs, when it would, by policy, be their preference to competitively select suppliers, should be a clear indicator that this work is inherently different to the work it can compete – it is usually more specialised, complex and risky. The principle should be that QDC Contract Profit Rates should be comparable those earned by contractors performing single source contracts and competed work of similar characteristics and in similar economic circumstances in defence markets at home and elsewhere in the world. To achieve fair and reasonable prices, a comparison with returns for similar work (i.e. defence contracts) in other developed, Western economies (primarily the US) would be a better measure of comparability.

We do not believe that using published company financial results will deliver a fair and reasonable baseline profit rate. The ultimate published company profits will have been impacted by accounting rules potentially skewing profit recognition over time, by risks that have impacted in the delivery of business and by costs not directly associated with the delivery of 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?

Yes

Comments

The points raised under the previous question require a wholesale review of the methodology, rather than minor amendments to it in terms of descriptors and definitions.

However, should the SSRO continue with this extant methodology we would propose looking into:

- Why retail and wholesale companies tend to be rejected from the Comparator Group when these companies should always be given the total dissimilarity to the activities defence companies undertake;
- Whether the construction and ancillary services categories are appropriate or required. Whilst we accept that some major defence programmes may contain elements of these activities, these programmes have specialist considerations not generally experienced in the outside world, such as operation on MoD / List X sites, stringent regulations and requirements (e.g. nuclear safety) and MoD contract terms which in themselves bring complexity, cost, risk and ultimately threat to profitability of contracts. Additionally, we would question why any programme that is exclusively for construction and / or ancillary services would be contracted single-source given there is a vibrant competitive market for such activities.

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

Comments

The overall concept of 'comparability'

### **3. Leonardo MW Ltd**

# **SSRO**

Single Source  
Regulations Office

## **Single source baseline profit rate methodology**

Consultation on changes for 2020/21

Response form

July 2019



### 3. Consultation responses

3.1 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?

~~Yes~~ / ~~No~~ / Don't know (Delete as appropriate)

#### Comments

We welcome making changes to the definition of the reference group but believe further changes should be considered if the reference group is to provide a “fair and reasonable” profit to businesses conducting single source contracts with the MOD.

- Steps 1 (BPR) and 6 (CSA) of the profit rate account for over 90% of the contract profit rate. The SSRO’s approach to determining the rates for steps 1 and 6 are therefore critical to meeting the requirements section 13 of the Act.
- The SSRO’s chosen approach differs to the previous regime in that it looks to define a reference group of companies who conduct comparable economic activities to those under QDC’s/QSC’s, but in a competitive environment (previous regime looked to determine a profit rate that may be achieved by alternate use of the investors capital in UK based businesses whose returns were directly linked to cost of production and capital employed).
- SSRO’s approach, being comparable businesses, means the reference group needs to align to the dynamics of the defence market and its contractors, such as:
  - Activity type
  - Complexity:
    - Development and delivery of new complex product
    - Support to sustaining customer capability
    - Supply chain
    - Regulatory
    - Contractual terms
    - Risk
  - Investment in highly skilled people and complex technologies.
  - Contractual terms
  - Product and in service risk
  - Working for a customer with bespoke, sometimes iterating requirements, often at low volumes.

In LMWL’s view the typical company, in the market(s) the MOD is engaging, is:

- much larger, and
- capable of managing greater complexity (on behalf of the customer)

than the existing, or proposed, thresholds and filters provide.

In support of the above position:

From papers issued by the SSRO (elements thereof summarised in table 1 below):

- 95% of QDC/QSC's are placed with contractors that are classified as large according to the EU definition 2003/361/EC (as adopted by the SSRO for SME reporting).
- The median Global Ultimate Owner (GUO) is circa. £2.8b (*SSRO graph 2/7/19*).
- The median QDC/QSC contractor is circa. £0.3b (*SSRO graph 2/7/19*).
- The median comparator company is circa. £0.2b (*SSRO graph 2/7/19*).
- The average QDC/QSC let is £133m with average annual revenue of £30m (average contract duration 4.4 years). Contractors are not typically single contract businesses so would likely be much larger than £30m pa revenues. Recognising this point is made on an average, this is additional emphasis to the first bullet that explains 95% of QDC/QSC businesses are greater than €50m pa revenue.

The above suggests the type of activity the MOD is contracting, requires complex businesses of greater size than the proposed minimum £10.2m revenue threshold.

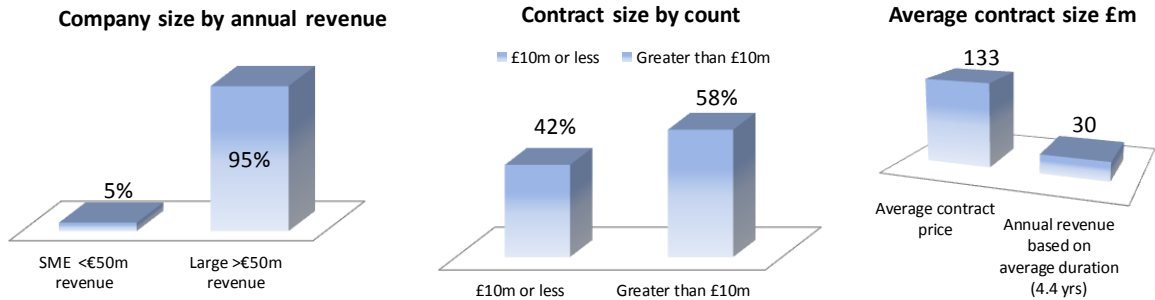
Size is not the only determinant and the SSRO incorporate the use of NACE codes as filters. However, these codes are not filtering out smaller less complex companies. We recognise the SSRO are proposing changes to the use of NACE codes, but do not think NACE codes on their own will resolve all the comparability issues.

To the concern that the SSRO does not want to reflect the market as single source only, we agree, but see the SSRO analysis as providing comfort in this regard rather than concern:

- The SSRO's working paper on "profit principles" explains MOD revenues are less than 20% of total revenues for 8 of their top 10 suppliers and not all of those MOD revenues were non-competitive. Indeed, GUO's and most MOD contractors operate in a mixed market environment: competitive, non-competitive, UK and overseas.

**Table 1**  
**SSRO - Annual qualifying defence contract statistics: 2018/19**

**Contracts placed and reported on 1st April 2015 to 31st March 2019**



95% of QDC/QSC are placed with companies >€50m annual revenue

Average QDC/QSC price is £133m

Median GUO of QDC/QSC contractors circa £2.8b annual revenue

Capital servicing adjustment - reference group 1.35%, defence contractor average 0.85%  
*(SSRO recommendation fact sheet 2019 and SSRO presentation pack January 2019)*

Capital servicing adjustment - reference group 1.46%, defence contractor average 0.73%  
*(SSRO slides 10/7/19 - median)*

Average duration of QDC/QSC	Years	4.4	Sum total contract prices 2015/16 to 2018/19	£m	26,755
Number of QDC/QSC	No.	201	Average contract price	£m	133
Number of QDC/QSC that are SME (SME <€50m revenue, 250 people, €43m balance sheet - 2003/361/EC)	No.	11	Annual revenue based on average duration (4.4 yrs)	£m	30
			Contract size by count		
			£10m or less		42%
			Greater than £10m		58%
SME <€50m revenue		5%			
Large >€50m revenue		95%			

Further consideration regarding comparability, of the reference group with businesses engaged in the defence markets, is capital structure. The current reference group has a Capital Servicing Adjustment (CSA) twice that of QDC/QSC businesses which suggests the group as a whole is quite different to defence contractors.

Whilst we do not have detail from Orbis, or the workings behind SSRO's analysis, based on SSRO information we:

- Think the minimum size of company ought to be significantly higher than proposed and would welcome understanding the size and spread of companies contracting with the MOD.
- Would welcome better comparability in terms of the issues listed above (in the fourth bullet), which we do not think can be achieved solely through NACE codes.
- Think a further test of any defined reference group might also be the comparability of capital structure and the CSA (this is also important as the CSA of the reference group is a deduction from the reference group profit in determining the underlying profit rate in constructing the BPR).

Finally, we do not see construction and ancillary as being typically comparable with single source defence contracting. Such activities should be competed or single source by exception.

- b) Is the proposed methodology consistent with the aims that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts?

~~Yes~~/ No / ~~Don't know~~ (Delete as appropriate)

Comments

We think the intent of the proposal is compliant with section 13.

However, based on the information provided we cannot tell whether the intent will be achieved and, for the reasons explained in answer to question a), we think further steps are required to improve comparability and “fair and reasonable pricing”.

Regarding achievement of “good value for money” this is a complex judgement that warrants exploring beyond the discussions in the working paper and may require changes in approach in the MOD and other Government departments depending on the outcome.

By means of example.

The term “good value for money” would require definition. It includes both monetary and qualitative aspects:

One definition might be:

- Monetary
  - What is the “real” cost to the tax payer/government?
    - Purchase cost net of direct and indirect tax recoverable (CT, PAYE, NI throughout the supply chain)
    - Potential for benefits to UK prosperity through export
- Qualitative
  - How well the product or service meets the customer’s requirements?
  - Sustainability of capabilities the MOD requires?

Another may be much narrower

- Did I get the requirement for the lowest “sticker price” possible?

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

Yes / ~~No~~ / ~~Don't know~~ (Delete as appropriate)

Comments

As explained above:

Demonstrating the: size, complexity, capital structure and nature of, businesses included in the comparator group fairly represents the defence market.

Value for money definition from "total government" (a definition that meets all government requirements)

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

Comments

- Depending on the outcome of this review, and assuming the approach remains that of comparability of similar activities, it may still be necessary to build on the approach and tools used, placing further emphasis on understanding the dynamics of single source defence market to construct a comparator group that delivers comparability.
- Not with-standing the above, the single source regime does not have a true competitive equivalent so “true” comparability is probably not possible and demonstration/agreement of a fair and reasonable profit will remain illusive. Short of returning to logic similar to the previous regime (returns made through alternate use of capital), then other approaches used in international defence contracting might be considered?
- A definition, by government (Treasury?) of “value for money to the tax payer” considering the achievement of:
  - How well the product or service meets the customers need
  - How the purchase sustains required capabilities
  - What is the real “net cost” to the tax payer (purchase cost net of direct and indirect tax recoverable – CT, PAYE, NI etc.)
  - Potential benefits to UK prosperity

## 4. Metasums

# **SSRO**

Single Source  
Regulations Office

## **Single source baseline profit rate methodology**

Consultation on changes for 2020/21

Response form

July 2019



### **3. Consultation responses**

- 3.1 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?

No

Comments

SSRO's report dated 12 June 2019 shows that there were only 11 out of the 201 qualifying contracts were contracted to SMEs.

For the 5 years between 2008 and 2013 I was Technical Advisor to the JRBC and responsible for ensuring that Annual Returns were submitted on time for consideration by the Review Board for Government Contracts. In 2008 there were 35 contractors (entities/BUs) who were asked to submit these returns (contractors whom MoD advised that in the previous year had MoD single source contract revenues of >£10m); many were subsidiary undertakings that shared the same parent undertaking (SSRO refers to as GUO) and I don't believe any would have classified as an SME. By 2012 this number had increased to 52 entities/BUs (25 GOUs); of these there was I believe just 1, a registered charity, was an SME. The average annual revenue of these 25 GOUs would have placed the average at a significant multiple of the Orbus definition of 'Very large company'. The relevant size of companies should therefore be placed in the comparison group where revenues are at least at this threshold or higher.

As the SSRO is aware The Review Board for Government Contracts calculated the reference group from companies listed on the London Stock Exchange headquartered in the UK. In the 2013 review this comprised 639 companies with sales of £805 billion (you will quickly see that the Review Board 2013 was an overall arithmetic mean revenue of £1.26 billion whilst SSRO's 2019 was arithmetic mean revenue was 2.62 billion). The SSRO, unlike their predecessor The Review Board for Government Contracts, uses the median operating profit and cost of production rather than the sum of the whole comparator group. SSRO does not give transparency to enable the extent of the distortion to be established. I can see from my analysis of listed companies I researched for the 2013 review that the pareto effect the largest companies have on ranked distribution is significant. Furthermore I saw during 2008 through 2013 a good correlation between higher market cap and higher profitability (market cap : PBIT/CoP) and by deduction from Review Board published reports that companies with smaller market cap had lower PBIT:CoP. I have numbers to support but I believe that SSRO has access to Review Board files that should evidence the same.

Nearly all defence contractors undertaking qualifying contracts are large and are either UK or US owned (GOU is based in UK or USA) as shown in table on page 19 of SSRO's January 19 supporting analysis to the 2019/20 rates. The pie chart at page 24 of the same report shows c20% of companies as Italian and comprises c25% of Develop and Make. The distribution of the comparator group should be representative of that of the contractor group. Currently this does not look to be achieved.

I could not find in the SSRO paper a statement that subsidiary undertakings were excluded from the comparator group. I may have missed it. It would have assisted if this was clearly stated. If it no longer a condition of selection, then it should be.

- b) Is the proposed methodology consistent with the aims that good value for money is obtained in government expenditure on qualifying defence contracts, and that persons who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts?

No

Comments

I believe that an analysis of parent undertakings that are performing qualifying contracts (the contractor group) have higher than typical levels of know-how and intellectual property. Indicators of this are market value multiple to book value (excluding intangible assets), PBIT (excluding impairment and amortisation of intangibles) over Non-Current Assets (excluding investments and intangibles). Defence contractors tend to be system integrators rather than volume manufacturers. Volume manufacturers typically form the first tier of sub-contractors. The contractor group for develop and make should reflect the same.

As expressed in my paragraph 3 of a) above the profit allowance should be informed by the aggregate values of the comparator group and not the median. The pareto impact of the skewed distribution towards smaller companies places the median materially to the left of the arithmetic mean. SSRO has access to Review Board data for the periods to which I refer as well as their own data for later periods. My data is available if wanted.

I see little if any value in segregating the comparator between D&M and P&M. The segregation of AS and Con may be more distinct but suffers from a low comparator base.

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

Yes

Comments

The Review Board for Government Contracts excluded intangible assets from reference group capital employed and similarly excluded amortisation and impairment of the same from PBIT. SSRO in not excluding the same in its calculation of baseline profit rate and from allowable costs has taken an irrational approach. SSRO allowable cost guidance does not confirm the costs as allowable and AAR and are allowable for inclusion in calculation of CSAs. It is currently understood to be MoD CAAS policy to interpret SSRO's statutory guidance on allowable costs and calculation of CSAs such that these costs are wholly excluded i.e. MoD regard amortisation and or impairment as not AAR and exclude the carrying value of goodwill and business combination assets from calculation of CSAs. I'm happy to discuss this a lot further and give fuller substance to arguments and alignment with broader government policy.

I've reviewed my numbers of largest 130 reference group companies for annual accounts ending in year to March 2013 and March 2014 and find that the adjustment for amortisation and impairment of non-current intangible assets equated to 3.2% and 3.5% of profit respectively. In this adjustment the Review Board added back to profits costs of goodwill impairment and non-current intangible asset amortisation and impairment such that the profit allowance was on a basis consistent with guidance on allowable costs (Government Accounting Conventions). SSRO has access to the Review Board files to verify these values. Non alignment of SSRO's allowable cost guidance and calculation of baseline profit rate has caused a significant distortion and needs to be corrected.

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

Comments

The collective relationship and cohesion between impact on business combinations, POCO, and inclusion costs of non-current intangible assets recognised on a business combination within contract prices of qualifying contracts.

## **5. MOD**

The MOD have looked at the SSRO's consultation paper on the Baseline Profit Rate and we think that the changes proposed are sensible and will make improvements to the existing methodology. However, we recognise that the wider issue of what constitutes a fair profit is being considered in other work you are doing, and that this may have an impact on the BPR methodology in future.