SSRO

Single Source
Regulations Office

# The baseline profit rate and its adjustment

Consultation

March 2021

# Contents

# 1. Introduction

1.1 The regulatory framework established by Part 2 of the Defence Reform Act 2014 (the Act) requires that the price payable under a qualifying contract be determined in accordance with the formula—

$$(\text{Contract profit rate} \times \text{Allowable Costs}) + \text{Allowable Costs}$$

1.2 Section 17(2) of the Act sets out six steps for the calculation of the contract profit rate (CPR) for a qualifying contract. The inputs needed to apply the six step calculation include the baseline profit rate, capital servicing rates and the SSRO funding adjustment (the rates).

1.3 The SSRO supports the calculation of CPRs in the following ways:

- We provide the MOD with our assessment of the appropriate rates by 31 January each year, to assist the Secretary of State to determine those rates for the subsequent financial year.
- We issue statutory guidance in relation to the six steps, which the contracting parties must have regard to when calculating the CPR for a qualifying contract.

1.4 The SSRO's approach to assessing the appropriate rates is set out in its *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology* ("the methodology"). Its recommendation to the Secretary of State for the rates that will apply from 1 April 2021 were made in accordance with the methodology.

1.5 On 15 March 2021 the Secretary of State announced that he had determined two baseline profit rates (BPRs) for 2021/22:

- a rate of 8.31% as recommended by the SSRO; and
- an additional rate of 0.057%, which had not been recommended by the SSRO.

1.6 In announcing the rates the Secretary of State, in respect of the additional rate, stated "The intention is that this rate can be used to set Contract Profit Rates at a rate that does not result in such companies making a profit, should it not be appropriate for them to do so." In making his determination the Secretary of State stated that the additional rate "will only apply to Qualifying Defence Contracts where:

- the contract is between Secretary of State and a company incorporated under the Companies Act that is wholly owned by the UK Government; and
- both parties to the contract agree that it should apply."

1.7 This consultation refers to the additional rate as the "net zero BPR", as its application is intended to result in a zero percent CPR.

1.8 On 15 March 2021 the SSRO published version 7 of its statutory guidance on the baseline profit rate and its adjustment ("profit rate guidance"). In accordance with the SSRO's practice, version 7 of the profit rate guidance updates version 6 to include the rates determined by the Secretary of State for 2021/2022. The additional words are set out in Appendix 1 to this consultation document. Version 7 also includes some unrelated changes to the previous version that the SSRO considers to be minor and uncontroversial. Version 7 of the profit rate guidance comes into force from 1 April 2021.

1.9 The setting of the net zero BPR gives rise to two further considerations by the SSRO, which are the subject of this consultation:

- Whether the profit rate guidance requires further updating (version 7.1) to reflect any implications of the net zero BPR for application of the six steps.
- If there is a continuing need for a net zero BPR, how the SSRO should incorporate a net zero BPR into its annual rates assessment, alongside the rate we recommend using our existing methodology.

1.10 At the same time, the SSRO is continuing to consider the impact of the COVID-19 pandemic. Under the current methodology, the financial information used for the 2022/23 BPR recommendation will be extracted from annual company financial statements for the year ending on or before 31 March 2021. This data will be impacted by the COVID-19 pandemic. This consultation seeks evidence from stakeholders of the impact of COVID-19 which they would like the SSRO to consider in arriving at the 2022/23 rates assessment.

1.11 This consultation document is structured as follows:

- Section 2 sets out a proposed timetable for publication and application of updated profit rate guidance.
- Section 3 considers the six steps required to calculate a CPR and the impact of setting a net zero BPR on each of those steps.
- Section 4 looks ahead to consider the assessment of multiple BPRs, including a net zero BPR for 2022/23 and beyond.
- Section 5 addresses the SSRO's plans for assessing the impact of COVID-19 related issues.
- Section 6 contains the consultation questions, details of the consultation period and explains how stakeholders can respond to the consultation.
- Section 7 contains an appendix that duplicates the changes made to version 7 of the profit rate guidance to reflect the Secretary of State's determination; and an appendix which presents an illustration of the six steps and the range of CPRs available using the net zero BPR before the impact of contractor performance.

1.12 The SSRO invites all interested parties to respond to the consultation by 21 May 2021, in accordance with section 6 of this document.

# 2. Application of the revised guidance

2.1 Following due consideration of any points raised in response to this public consultation, and approval by the SSRO's Regulatory Committee, the SSRO intends to publish a summary of consultation responses and an updated profit rate guidance by 30 July 2021. If necessary, we would expect to update the contract reporting guidance with the outcome of the consultation in September 2021.

2.2 The proposed timetable for concluding guidance changes on the topics in this consultation is summarised below.

| Activity | Organisation | Date |
|---|---|---|
| Version 7 profit rate guidance publication | SSRO | 15 March 2021 |
| Consultation published | SSRO | 26 March 2021 |
| Version 7 profit rate guidance comes into force | SSRO | 01 April 2021 |
| Deadline for submission of responses to consultation | Stakeholders | 21 May 2021 |
| Publication of consultation response summary and version 7.1 profit rate guidance | SSRO | 30 July 2021 |
| Version 7.1 profit rate guidance comes into force | Stakeholders | 01 Aug 2021 |

2.3 We intend for the revised profit rate guidance to come into force as quickly as possible. We have proposed only limited changes which would not affect the majority of contracts and so there may be a lesser requirement for stakeholder familiarisation than usual. This is reflected in the timetable above. However, we welcome views on the new guidance coming into force at a later date if it is considered this would give stakeholders more time to raise awareness of changes.

# 3. Guidance relating to a zero contract profit rate

### The price formula and the six steps

3.1 Section 15 of the Defence Reform Act 2014 (the Act) and regulation 10 of the Single Source Contract Regulations 2014 (the "Regulations") require that the price payable under a qualifying contract be determined in accordance with the formula—

$$(\text{Contract profit rate} \times \text{Allowable Costs}) + \text{Allowable Costs}$$

3.2 Section 17(2) of the Act sets out six steps for the calculation of the CPR. Section 18 of the Act provides for the SSRO to issue guidance in relation to the steps set out in section 17(2).

3.3 This section considers the impact on the six steps of the Secretary of State's determination of a net zero BPR for use with wholly owned government companies who agree it should apply to their contracts. An illustrative calculation of how a zero CPR may be arrived at using the rates determined by the Secretary of State for 2021/22 is presented in Table 1.

### Table 1: Illustrative calculation of a zero contract profit rate

| Contract profit rate step | | Value/Adjustment |
|---|---|---|
| **Step 1** | Baseline profit rate | 0.057% |
| **Step 2** | Cost risk adjustment | 0 |
| **Step 3** | POCO adjustment | 0 |
| **Step 4** | SSRO funding adjustment | -0.057% |
| **Step 5** | Incentive adjustment | 0 |
| **Step 6** | Capital servicing adjustment | 0 |
| | Illustrative CPR | 0 |

3.4 The illustration in Table 1 is consistent with the provisions of the Act and the Regulations. It is achievable having regard to the following assumptions and requirements:

- there is a wholly owned government contractor and agreement at step 1 that the net zero BPR should apply;
- application of the SSRO funding adjustment at step 4 is mandatory (section 17(2));
- the arrangements are not in scope of the requirement to agree a POCO adjustment (regulation 12);
- the Secretary of State has not specified an incentive adjustment amount (section 17(2)); and
- steps 2 and 6 have been set to zero which is permissible under the legislation (section 17(4)(b)).

3.5 These assumptions which inform Table 1 will not necessarily hold for a contract that is priced using the net zero BPR.

3.6 Section 18 of the Act provides for the SSRO to issue guidance in relation to the steps set out in section 17(2). Version 6 of the SSRO's profit rate guidance did not envisage the application of two BPRs, nor a circumstance in which parties might seek to arrive at a zero CPR. Version 7 of the profit rate guidance incorporates the two BPRs set by the Secretary of State and states that the guidance pertaining to Steps 2 to 6 applies irrespective of which BPR is taken (see Appendix 1). Consideration is given below to whether any additional guidance is required and Table 2 summarises the consultation proposals.

### Table 2: SSRO's consultation topics and proposals

| Profit rate step | SSRO's proposal for version 7.1 |
|---|---|
| Step 1: Baseline Profit Rate | No change |
| Step 2: Cost risk adjustment | No change |
| Step 3: POCO adjustment | No change |
| Step 4: SSRO funding adjustment | No change |
| Step 5: Incentive adjustment | Include the BPR selected in consideration in application of Step 5. |
| Step 6: Capital servicing adjustment | Potential approaches presented for comment |

### Step 1 - Baseline profit rate

3.7 Section 17(2) of the Act and Regulation 11(2) set out the first step in determining the contract profit rate as follows:

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

3.8 The Secretary of State determined two BPRs for 2021/22. Paragraph 2.6 of version 7 of the profit rate guidance sets out the two BPRs that are in force from 1 April 2021 and is duplicated in Appendix 1.

3.9 As two BPRs have been determined, the contracting parties need to select the appropriate BPR to apply to their contract after considering the Secretary of State's determination of the circumstances in which each applies. The Secretary of State has specified in his determination that the net zero BPR applies only to QDCs with wholly owned government companies and where both parties to the contract agree that it should apply. The guidance issued as part of version 7 of the profit rate guidance sets out those conditions.

3.10 Our view is that the new guidance in version 7 is sufficient to explain how to apply the baseline profit rate and we do not propose further amendments to the guidance on step 1 at this time.

### Step 2 - Cost risk adjustment

3.11 Section 17(2) of the Act and Regulation 11(3) set out the requirement for the cost risk adjustment (CRA):

"Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25% of the baseline profit rate, so as to reflect the risk of the primary contractor's actual allowable costs under the contract differing from its estimated allowable costs."

3.12 If the net zero BPR is applied the CRA may be within the range of plus 0.01425 percentage points and minus 0.01425 percentage points for the financial year 2021/22 (see Appendix 2).

3.13 The SSRO's profit rate guidance currently provides that there should be a minus 25 percent CRA for contracts with a cost-plus pricing method. For contracts using other pricing methods, it sets out principles that the contracting parties should apply to incorporate an addition or deduction to the CPR to reflect the risk that the contractor's actual Allowable Costs in delivering the requirement will differ from the estimated Allowable Costs included in the contract price.

3.14 Our view is that the same guidance should apply to contracts that apply the net zero BPR. This is on the basis that the value of the BPR in force does not alter the risk of the contractor's actual Allowable Costs under the contract differing from its estimated Allowable Costs. If the BPR is very small the scope for the parties to reflect that risk in monetary terms in the contract price is limited, but the SSRO's profit rate guidance must align with the available adjustment range set out in the legislation.

### Step 3 – Profit On Cost Once (POCO) adjustment

3.15 Section 17(2) of the Act and Regulation 11(4) set out the requirement for the POCO adjustment:

"Deduct from the amount resulting in Step 2 the adjustment determined in accordance with regulation 12 ("the POCO adjustment"), so as to ensure that profit arises only once in relation to those Allowable Costs under the contract that relate to the price payable under any group sub-contract (including any further group sub-contract)."

3.16 A wholly government owned company with a QDC may have associated companies for which it is the ultimate parent undertaking.[1] This gives rise to the possibility that at the time of agreement the company may be party to, or propose to enter into, "group sub-contracts" in relation to the QDC, and there may be "further group sub-contracts" within the meaning of Regulation 12. If there is attributable profit in the prices of those sub-contracts, then either the Allowable Costs of the QDC may be decreased to remove the attributable profit, or there must be a POCO adjustment to reduce the CPR for the QDC.

1 One person is "associated" with another if they are group undertakings in relation to each other and "group undertaking" has the meaning given by s.1161 of the Companies Act 2006. This definition involves a legal test that focuses on whether one undertaking controls another. Note that the Secretary of State is not an undertaking within the meaning of the Companies Act 2006.

3.17 The SSRO's profit rate guidance explains the circumstances in which the POCO adjustment applies. It sets out the process that should be followed to calculate the adjustment.

3.18 The legislative requirement of the POCO adjustment, as set out in regulation 11(4), is to ensure that profit arises only once in relation to those Allowable Costs that relate to the group and further group sub-contracts. If the application of the net zero BPR results in a zero CPR for a QDC, then no QDC profit would arise in relation to the costs of sub-contracts in addition to profit already applied in the sub-contract price. However, the calculation of the POCO adjustment set out in regulation 12 requires that the attributable profit of the group and further group sub-contracts is removed, and this applies even in the case where the CPR of the QDC is zero. The POCO adjustment may therefore result in profit being deducted, even though the legislative requirement for profit to arise only once is already met. There is no scope for the process which the legislation sets out for a POCO adjustment to be changed through the SSRO's profit rate guidance.

3.19 The net zero BPR for 2021/22 can only apply to contractors wholly owned by the UK Government and any group or further group sub-contractor would be associated with the prime contractor. We would expect government owned companies to enter into any sub-contracts understanding the legislative requirement for a POCO adjustment when calculating the CPR of a QDC. It would be open to the prime contractor to structure its contracts in a way that does not impact negatively on the CPR by avoiding entering into group sub-contracts.

3.20 The SSRO's view is that the same guidance must apply to contracts that apply the net zero BPR. This is on the basis that the profit rate guidance reflects the requirements of regulation 12, which applies to all QDCs, and we consider that it can be reasonably applied in respect of a QDC with a wholly government owned contractor.

3.21 The SSRO has reviewed the operation of the POCO adjustment as part of its review of legislation work. Findings from its consultation on the review were published in June 2020.

### Step 4 – SSRO funding adjustment

3.22 Section 17(2) of the Act and regulation 11(5) set out the requirement for the funding adjustment as follows:

"Deduct from the amount resulting from Step 3 the SSRO funding adjustment which is in force at the relevant time…".

3.23 Step 4 is a mandatory step and must be applied when calculating the CPR of any qualifying contract. The profit rate guidance at Step 4 explains this requirement and sets out the rate. The SSRO funding adjustment for 2021/22 is 0.057 per cent.

3.24 Our view is that Step 4 continues to operate in the same way for a QDC with a wholly government owned contractor. The SSRO's guidance on step 4 is straightforward and we do not propose to amend its application in light of the net zero BPR.

### Step 5 – Incentive adjustment

3.25 Section 17(2) of the Act and Regulation 11(6) set out the requirement for the incentive adjustment:

"Where the Secretary of State determines that the amount resulting from Step 4 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract specified by the Secretary of State, increase that amount by an amount ("the incentive adjustment") specified by the Secretary of State, that amount not to exceed two percentage points."

3.26 The guidance on the application of Step 5 provides that it may be desirable for the Secretary of State to include a positive incentive in certain circumstances and explains the principles that the parties should have regard to when considering whether to apply such an adjustment.

3.27 Table 1 illustrates what the SSRO understands to be the MOD's intended approach to the application of the six steps to arrive at a zero CPR. Under this approach, an incentive adjustment is not applied. Depending on the application of Steps 2, 3 and 6 it would still be possible to arrive at a zero CPR with an adjustment at Step 5. It is also possible that the Secretary of State may wish to use the step 5 adjustment to incentivise performance in a UK government owned entity.

3.28 We do not propose to limit the application of Step 5 in the profit rate guidance in relation to which BPR is applied. However, the BPR that is applied may be a relevant consideration in the application of Step 5 and we propose to reflect this in the profit rate guidance by adding "the baseline profit rate applied at step 1" to the list at paragraph 6.6.

### Step 6 – Capital servicing adjustment

3.29 Section 17(2) of the Act and Regulation 11(7) set out the requirement for the capital servicing adjustment:

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

3.30 The SSRO makes an adjustment in the calculation of its BPR recommendation to normalise the data in respect of the capital servicing of each comparator company. This is to ensure that the BPR is an appropriate baseline upon which to apply the SSRO's profit rate guidance for Step 6. A CPR that uses the SSRO's recommended BPR therefore incorporates two adjustments to take into account the different levels of fixed capital and working capital employed by the companies in the comparator group and the performance of a contract:

- an adjustment in the calculation of the BPR; and
- an adjustment agreed between the contracting parties at step 6 to reflect the circumstances of the contract.

3.31 The SSRO's profit rate guidance sets out the relevant capital servicing rates and explains how the parties should calculate the two other components of the CSA: the 'capital employed' and the 'cost of production'. Guidance and examples are provided on how to calculate the CSA using these components.

3.32 We understand that the MOD intends that the net zero BPR is to be applied in circumstances where there should be no profit on the QDC. The approach to the CSA is underpinned by the assumption that parties engaging in a QDC or QSC will be required to earn a positive return on capital employed, as they have private capital financing needs. The approach in the profit rate guidance, and the legislative requirement to have regard to capital servicing rates in force, would not typically result in a capital servicing adjustment of zero.

3.33 Table 1 illustrates what the SSRO understands to be the MOD's intended approach to the application of the six steps to arrive at a zero CPR. Under this approach no adjustment is made at step 6, although it would still be possible to arrive at a zero CPR with an adjustment at Step 6, depending on the application of Steps 2, 3 and 5.

3.34 The SSRO's profit rate guidance for Step 6 can facilitate different choices of BPRs. We can see two potential approaches for giving guidance on step 6:

- unified guidance that is applied to any qualifying contract; or
- separate step 6 guidance to apply when the net zero baseline profit rate is used.

### Unified step 6 guidance

3.35 The SSRO's guidance explains how to calculate a CSA based on the capital employed and the cost of production. Paragraphs 7.19 and 7.21 of the profit rate guidance set out a list of general exclusions to remove elements of capital whose inclusion would not produce an appropriate result at step 6. This capital is excluded from the adjustment so that the capital servicing rates are not applied to it. A contract that earns no profit, as is the intent when the net zero BPR applies, also earns no return on capital and so it is appropriate for the outcome after the application of step 6 to be zero. Amending the guidance to add capital owned by government to the list of general exclusions on capital employed would provide for a zero CSA for contracts with companies wholly owned by UK Government, thus achieving the appropriate outcome. It would also result in lower capital servicing adjustments for partially UK Government owned companies.

3.36 The SSRO is mindful, however, that it may not always be the case that wholly government owned contractors do not have capital return requirements. We are cautious about introducing a change that could significantly alter the result of Step 6 for some government owned contractors without sufficient input on the matter.

### Different step 6 guidance for the net zero baseline profit rate

3.37 An alternative approach would be to develop specific step 6 guidance to apply in circumstances where the net zero baseline profit rate has been applied. This might require the following options:

- contracts to which the net zero BPR is applied to set the CSA such that the CPR equals a return consistent with HM Treasury guidance on the cost of capital for inter or intra departmental services[2]; or
- contracts to which the net zero BPR is applied being directed to include any financing costs as Allowable Costs and apply a CSA that delivers a CPR of zero, on the basis there would be no need for a further return on capital employed to be provided for by the contract profit rate.

3.38 The SSRO seeks feedback from stakeholders on the potential approaches above, or any other proposals, for dealing with step 6 for contracts applying the net zero BPR. This input may assist in determining if either of these approaches are suitable and if one is preferable to the other.

### Preparation and submission of contract reports

3.39 Contractors must report the information on the six-step contract profit rate calculation in the Contract Pricing Statement Report under Regulation 23 (CPS). The reporting guidance on preparation and submission of contract reports ("contract reporting guidance") explains how to do this in paragraphs 4.12 to 4.13 and Tables 9 and 10. The SSRO does not see a need to make any amendments to that guidance to support the application of a net zero BPR.

3.40 The existing CSA calculation is provided by fields in the Defence Contract Analysis and Reporting System (DefCARS) and aims to make it easier for contractors to demonstrate that they have had regard to the calculation set out in profit rate guidance. Guidance on this is set out in paragraphs 4.14 to 4.16 and Table 11 of the contract reporting guidance. There are also validation warnings and errors that are flagged by DefCARS if the calculator has not been completed. If different CSA guidance is applied for contracts applying the net zero BPR the SSRO may need to change DefCARS and the contract reporting guidance to support this, at a minimum to remove some validation errors if the existing calculation is not applied. We will consider the extent of any changes pending input from stakeholders on our Step 6 guidance.

2 For example, see paragraph 11.16 to 11.29 of Consolidated budgeting guidance 2020 to 2021 or paragraph 6.3.7 and 7.7.2 of Managing Public Money

# 4. Future baseline profit rates and SSRO funding adjustment assessment

4.1 The net zero BPR was determined by the Secretary of State for 2021/22 with the express purpose of enabling a CPR on a QDC entered into with a wholly government owned company that results in the company not making a profit from the QDC. The SSRO expects there to be a continuing need for a net zero BPR, if only to enable amendments in future years to a QDC entered into in 2021/2022, such that a zero CPR would continue to apply for the duration of the contract.

4.2 The SSRO consulted on multiple BPRs in 2015 and 2016. We have not pursued the recommendation of multiple BPRs since that time, following guidance from the Secretary of State that the implications needed further consideration. Some legislative change may be helpful in due course to facilitate the determination of multiple BPRs and their subsequent application to qualifying contracts. One change that we recommended in 2017 was to enable referrals to the SSRO in relation to all profit rate steps, including the BPR.

4.3 The SSRO is now considering whether it should recommend to the Secretary of State a net zero BPR for 2022/23 and beyond, alongside the BPR we recommend for contracts that are intended to make profits.

### Achieving the SSRO's aims of value for money, and fair and reasonable price

4.4 The SSRO must consider whether assessing a net zero BPR would be consistent with its statutory aims of ensuring that government achieves good value for money in its expenditure on QDCs and that contractors are paid a fair and reasonable return. Our initial consideration of these requirements is that:

- In the normal course of business, paying profit is consistent with our aim of ensuring contractors are paid a fair and reasonable price, and this would encompass almost all circumstances under the regime.
- There may be circumstances in which the aims of value for money and fair and reasonable prices may be better served by a zero CPR, and it would therefore be consistent with our aims to recommend a net zero BPR to the Secretary of State for use in those cases. Those circumstances might include where the purpose of the contract is to enable the Secretary of State to make payments to another part of the UK government and where a contract's purpose is not to make profit for the contractor, its members, or its shareholders.

### Setting a zero contract profit rate

4.5 The Secretary of State has determined a net zero BPR equal to the SSRO funding adjustment, so that the application of Step 4 in the calculation results in a zero CPR, for a contract to which that BPR applies. The net zero BPR for 2021/22 is set at the level of the SSRO funding adjustment recommended by the SSRO.

4.6 If the SSRO were to adjust its methodology to include recommendation of a net zero BPR, then one option is to continue assessing that rate at the level of the SSRO funding adjustment. This would enable a calculation of the kind illustrated at Table 1 to arrive at a zero CPR.

4.7 Assuming the SSRO incorporates a net zero BPR into its methodology, stakeholders are asked to comment on whether the SSRO should continue to set the rate at the level of the SSRO funding adjustment.

### Implications for our assessment of the SSRO funding adjustment

4.8 The SSRO funding adjustment calculation is based on the total Allowable Costs of contracts entered into, not the price of those contracts, and is therefore unaffected by the Secretary of State's determination of two BPRs for 2021/22. Our view is that contracts using the net zero BPR, and therefore owned wholly by UK Government, should contribute to the SSRO's running costs in the same manner as other contracts because all contractors have equal access to the services the SSRO provides. We do not propose any changes to the SSRO funding adjustment methodology.

### Implications for our assessment of the capital servicing rates

4.9 Each year the SSRO calculates the following three capital servicing rates based on averages of interest rate data published by Bloomberg or the Bank of England:

- Fixed capital
- Positive working capital
- Negative working capital

4.10 These rates are calculated as rolling averages of three debt benchmark rates and our view is that this aspect of the methodology can continue to operate as before. We do not propose to change the capital servicing rate methodology.

# 5. COVID-19 related issues

5.1 Under the current methodology, the financial information used for the 2022/23 BPR recommendation will be extracted from annual company financial statements for the year ending on or before 31 March 2021. These data will be impacted by the COVID-19 pandemic.

5.2 The SSRO is committed to engaging with its stakeholders on its approach to delivering its 2022/23 rates recommendation. As more data on the impact of the pandemic starts to become known we will be able to establish if and how we may need to adapt our comparability analysis in our rates assessment.

5.3 The SSRO's methodology adopts a comparable company search process that follows transfer pricing principles to identify comparable companies. The approach is set out in section 4 of the methodology.

5.4 The OECD published "Guidance on the transfer pricing implications of the COVID-19 pandemic" in December 2020. The guidance represents the consensus view of the 137 members of the OECD/G20 Inclusive Framework on base erosion and profit shifting (BEPS) regarding the application of the arm's length principle and the OECD Transfer Pricing Guidelines to issues that may arise or be exacerbated in the context of the COVID-19 pandemic. That guidance states that:

"The arm's length principle has been found to work effectively in the vast majority of cases, and this principle-based approach to assessing intercompany prices is equally robust for evaluating controlled transactions in the face of the COVID-19 pandemic. The OECD TPG [transfer pricing guidelines] are intended to help tax administrations and MNEs [multinational enterprises] find mutually satisfactory solutions to transfer pricing cases and should be relied upon when performing a transfer pricing analysis under the possibly unique circumstances introduced by the pandemic."

5.5 The SSRO's view is that transfer pricing principles can continue to be relied upon as the basis of the SSRO's BPR assessment.

5.6 We invite stakeholders to submit evidence of the impact of COVID-19 which the SSRO should consider in arriving at the 2022/23 rates assessment. This information will help us to establish if and how we may need to adapt our comparability analysis in our rates assessment. In particular we are interested in:

- understanding the extent and timing of business disruption and altered working practices on both qualifying contracts and on other operations, which might inform a comparability analysis; and
- information on the metrics that contractors may be using to quantify and compare the impact of the pandemic on different activities (for example, on work carried out in different geographies or for different customers), especially if these metrics can be recreated with data that is publicly available or available in Orbis.

# 6. Consultation questions

6.1 The SSRO invites stakeholder views, together with supporting evidence where appropriate, on matters raised above and specifically on the following consultation questions:

1. Please provide any evidence in relation to the impact of COVID-19 you believe is relevant to the SSRO assessment of the rates for 2022/23.
2. The SSRO issued update guidance on the application of the six steps on 15 March 2021 that incorporated the Secretary of State's announcement of a net zero BPR. Are any further changes to the guidance necessary as a result of the determination of the net zero BPR?
3. Assuming the SSRO incorporates a net zero BPR into its methodology, should the SSRO continue to set the rate at the level of the SSRO funding adjustment?
4. Do you have further comments on the assessment and application of a net zero BPR?

6.2 Consultees do not need to answer all the questions if they are only interested in some aspects of the consultation.

6.3 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:

- by email, including arranging an appointment to speak to the SSRO about the consultation to: **consultations@ssro.gov.uk** (preferred).
- by post to: Baseline profit rate consultation, SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB.
- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767.

6.4 Responses to the consultation should be received by 5.00pm on Friday 21 May 2021. Responses received after this date will not be taken into account in updating the guidance, but may be used to inform future guidance and assessments.

6.5 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 using the email or correspondence address above.

6.6 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.

6.7 Stakeholders' attention is drawn to the following SSRO policy statements, available on its website, 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 UK General Data Protection Regulation and the Data Protection Act 2018.

- The Single Source Regulations Office: Handling of Commercially Sensitive Information; and
- The Single Source Regulations Office: Our Personal Information Charter.

# 7. Appendices

## Appendix 1: Extract from version 7 of the Guidance on the baseline profit rate and its adjustment

7.1 The box presents paragraph 2.6 of version 7 of the profit rate guidance, which sets out two baseline profit rates in force from 1 April 2021.

**Existing guidance**

2.6 Section 19(4) of the Act states that the Secretary of State must publish the baseline profit rate for each financial year in the London Gazette, no later than 15 March in the preceding financial year. The baseline profit rates in force for the financial year commencing 1 April 2021 are:

| Category | 2021/22 baseline profit rates |
|---|---|
| Baseline profit rate | 8.31% |
| Baseline profit rate to apply to contracts between the Secretary of State and a company wholly owned by the UK Government and where both parties agree | 0.057% |

2.7 The Secretary of State's determination for the financial year commencing 1 April 2021 included a second baseline profit rate in addition to the SSRO's recommended rate. As required by section 19(6) of the Act the Secretary of State has explained the reasons for the difference in the London Gazette notice, which is available at: https://www.thegazette.co.uk/notice/3760612

2.8 That notice explains that the second baseline profit rate will only apply to qualifying defence contracts where:

a. the contract is between Secretary of State and a company incorporated under the Companies Act that is wholly owned by the UK Government; and

b. both parties to the contract agree that it should apply.

2.9 The guidance in this document pertaining to steps 2 to 6 applies irrespective of which baseline profit rate is taken. The SSRO intends to consult on whether any further revisions are required to its guidance and will publish an update in due course.

## Appendix 2: Illustration of the six steps and the range of CPRs available using the net zero baseline profit rate before the impact of contractor performance

7.2 The table below shows the range of contract profit rates available for the financial year 2021/22 at the time of agreement when the net zero baseline profit rate is used, applying the existing SSRO guidance.

| Contract profit rate step | | Value/Adjustment |
|---|---|---|
| **Step 1** | Baseline profit rate | 0.057% |
| **Step 2** | Cost risk adjustment * | -0.01425pp to +0.01425pp |
| **Step 3** | POCO adjustment ** | |
| **Step 4** | SSRO funding adjustment | -0.057pp |
| **Step 5** | Incentive adjustment *** | up to +2.00 pp |
| **Step 6** | Capital servicing adjustment (CSA) **** | Minimum: 0.0%<br>Lower quartile: 0.6%<br>Upper quartile: 1.6%<br>Maximum: 4.4% |

| | |
|---|---|
| Illustrative minimum CPR, based on:<br>-25% step 2, +0pp step 5 and +0.0pp step 6 | **-0.01425%** |
| Illustrative low CPR, based on:<br>-25% step 2, +0pp step 5 and +0.6pp step 6 | **0.64275%** |
| Illustrative high CPR, based on:<br>+25% step 2, +2pp step 5 and +1.6pp step 6 | **3.64275%** |
| Illustrative maximum CPR, based on:<br>+25% step 2, +2pp step 5 and +4.4pp step 6 | **6.44275%** |

* An adjustment of between +/- 25 per cent of the BPR.

** A POCO adjustment may be applied to ensure that profit arises only once in relation to some intra-group sub-contracts. The adjustment is nil for the majority of contracts, as shown here.

*** A positive adjustment of up to two percentage points may apply to incentivise the achievement of enhanced performance.

**** Estimated using actual values for contracts priced in 2019/20. The actual adjustment may be higher, lower or negative. Source: SSRO (2020) *Annual Qualifying Defence Contract Statistics: 2019/20*