The baseline profit rate and its adjustment

Consultation response form

Overview

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The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

Single Source Advisory Team (SSAT)

Organisation:

Ministry of Defence (MOD)

Position:

Pol & Regs

Consultation questions

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The baseline profit rate and its adjustment

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Question 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.

MOD is content that the Baseline Profit Rate is a reasonable proxy for a fair return. We do not expect the rates for 2022/23 to be substantially different from the 2021/22 rates due to the 3-year rolling average, but we would like to consider this once the data has been received. If as a result of COVID-19 the number of companies in the comparator group falls to the point where statistically valid conclusions cannot be drawn, we would encourage the SSRO to revisit the method.

The baseline profit rate and its adjustment

Consultation response form

Question 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 result of the determination of the net zero BPR?

Please add comments to support your answer:

MOD is broadly content with the explanation on application of the six-step process when using the net zero rate.

Consultation response form

Question 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?

Please add comments to support your answer:

The MOD is content with the arrangements currently in place.

The baseline profit rate and its adjustment

Consultation response form

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

Please add comments to support your answer:

No further comments.

The baseline profit rate and its adjustment

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The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

Alison Hexter

Organisation:

Thales UK Ltd
350 Longwater Avenue, Green Park, Reading, Berkshire RG2 6GF

Position:

Finance Director Government

Consultation questions

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The baseline profit rate and its adjustment

Consultation response form

Question 1: Please provide any evidence in relation to the impact of COVID-19 you believe is relevant to the assessment of the BPR for 2022.23

The global economy, including the Thales Group has, and continues to be profoundly affected by the Covid-19 public health crisis. Whilst the more rapid vaccine rollout in the UK may lead to a shorter period of impact for UK based companies, overseas (and for some companies in the comparator group) the impact is less certain at this time.

Notwithstanding the potentially more favourable position the UK finds itself in, we do remain in the midst of a pandemic. During this time, Defence has remained a priority for the UK Government and whilst companies in this field have continued to operate they have incurred additional costs as a result. Some, but not all, of these costs may be recoverable, but at the time of writing, it is not yet confirmed if or how these will be reimbursed.

It is inevitable that other companies in the comparator groups whether in the UK or overseas will be experiencing similar uncertainties around Covid costs, and the impact on their level of profitability may still be unknown. Consequently, and notwithstanding Industry's extant concerns about the composition of the comparator group, it is Thales' view that to use this group to assess BPR for 2022.23 will be even more unrepresentative.

Any adverse change to the BRP for 2022.23 will not only affect that particular financial year, but due to the 3 year averaging mechanism used in calculating the profit used for the BPR assessment will affect future yearsBPR rates.
Some of the companies in the BPR comparator group publish Consolidated accounts and include a median profit rate indicator (rather than just UK results), and as such it will be difficult to fully understand the Covid impact on profitability. . The comparator group will show the impact but not identify specifically (so specific evidence will not be readily available) in their P&L statements **all costs (current and any future provisions)** incurred as a result of the pandemic, and not just those costs that are deemed AAR.

It is also debatable whether a simple review of the statutory accounts will answer the question of impact. For example, Thales SA statutory accounts (year end Dec 2020) indicate the complexity of this question and the disclosures are qualitative rather than quantitative. See extract from the Thales SA accounts below (italicised).

Consequently, whilst we remain in the midst of this period of uncertainty, the SSRO might consider the use of a minimum baseline profit rate acceptable to industry, that will help provide contractors the opportunity to make a fair and reasonable return (astated Government objective). For 2022.23, the SSRO might consider the use of a minimum baseline profit rate at least at the rate of 2021.22 BPR.

For Thales this crisis has affected demand across the Group's markets, with a major impact on the civil aeronautics activities reported within the operational segment "Aerospace".

The baseline profit rate and its adjustment

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On the other hand, the measures implemented to limit the spread of Covid-19 had an impact on the Group's production, project execution, supply chain and customers' ability to take delivery of products and systems. That impact was particularly significant on the results at June 30th, 2020.
In this context, and while keeping as number one priority the health and safety of its employees, Thales has implemented a global adaptation plan in order to (1) maintain its productive capacities at the service of its customers, (2) limit the financial and industrial impacts of this crisis and (3) strengthen its funding capacity in the event that the crisis persists or worsens.

Revenue recognition
A significant share of Group revenues is generated by contracts to design and deliver complex products and service contracts. According to IFRS 15, the corresponding revenue is accounted for based on the costs incurred to date. The sanitary crisis has generated inefficiencies (under-activity, reorganizations, planning delays...) and over costs (purchase of protective equipment, expenses related to the extension of work from home).
*Under IFRS 15, these costs must be excluded from the measurement of progress towards completion, and consequently do not generate revenue. They are accounted for within the income from operations as soon as they are incurred. (*The impact therefore is likely to reduce profit achievements as a result of reduced revenue from under activity)
Governmental support measures
State support measures (short-time working, incentives to maintain employment, etc.) are recorded as a reduction in the costs concerned, as soon as they are guaranteed. (Any Furlough credits received have in effect reduced overhead cost -
Other assets
The Group reviewed the other assets: inventories, set up costs, capitalized development costs, deferred tax assets. This analysis did not trigger any significant impairment in 2020.
Pensions and other long-term employee benefits
At the end of December 2020, the corresponding commitments have been updated to take into account changing market conditions. The service cost will generally increase if interest rates have decreased due to pandemic

Re the comments on Transfer pricing, Transfer prices ensure transparency and agreement for tax purposes of the price that one operating entity may charge another. However,for the Comparator group, using a set of consolidated accounts which eliminate Inter Co transactions, it is difficult to understand the relevance of the connection. Consolidated accounts are considered to give a fair reflection of arm's length transactions between the group and third parties so transfer pricing itself is not relevant.

The baseline profit rate and its adjustment

Consultation response form

Question 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 result of the determination of the net zero BPR?

Please add comments to support your answer:

None

The baseline profit rate and its adjustment

Consultation response form

Question 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?

Please add comments to support your answer:

None

The baseline profit rate and its adjustment

Consultation response form

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

Please add comments to support your answer:

None

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The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

Janine Crocker

Organisation:

BAE Systems plc

Position:

Financial Controller – Maritime + Land Sector

Consultation questions

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The baseline profit rate and its adjustment

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Question 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.

Discussions between the company and the MoD about COVID impacts and relief thereof are ongoing and Commercial-in-Confidence. We therefore cannot share with the SSRO the specific impacts experienced by us on either QDC contracts or on our other operations.

It appears that the SSRO is seeking this data to establish the impact COVID may have on the Baseline Profit Rate calculation for the coming three year period. We fundamentally doubt that the impact of the pandemic on the in-year accounts of one business can be metricated or indeed extrapolated from that company's results to the entire Comparator Group, which is what you'd need to be able to do in order to eliminate COVID impacts out of the baseline profit rate calculation.

While Defence may have been fairly protected from immediate impacts of the pandemic as budgets are agreed and major defence contracts let many years in advance, the Comparator Group, as industry has pointed out many a time, does not consist of a majority of Defence Contractors. The Comparator Group is compiled of a very diverse list of companies, both in terms of geography, ownership structure and industries they service. The analysis conducted by Industry last year for the 'Think Paper' suggested only 12% of the Comparator Group companies are Defence firms, with the remainder spread very widely into general equipment providers, leasing, rentals etc. It would be implausible to believe that using a small sample of evidence provided by a small Group of companies likely to respond to this consultation would provide a basis from which to estimate the impact of COVID on each of these varied comparator company industries and geographies.

The legislation requires a fair price to be paid to contractors and including data which has been materially, negatively impacted by the COVID pandemic into the calculation of future available profits, does not in our opinion provide a fair return. Through the 3-year-rolling average calculation, this impact would not only provide a single year hit to industry, but will suppress profit levels for at least a three year period. In addition, as the BPR determines the contract profit rates used on long-term contracts, this impact could be unfairly carried by contractors for many years to come.

As a result of this, we wholeheartedly support a suspension of the extant BPR methodology and a freezing of the BPR % at the current value. We do not believe that there is any obvious reason why 2020 financial results would have resulted in significantly different profit rates than 2019, had it not been for COVID. This suspension would allow time to complete the work being conducted between MoD, Industry and the SSRO to reassess the Contract Profit Rate calculation process and the BPR methodology respectively. Alternatively, if the methodology was to be retained for the coming year, a floor at the current BPR % could be introduced to ensure fair returns to contractors through this unprecedented crisis.

The baseline profit rate and its adjustment

Consultation response form

Question 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 result of the determination of the net zero BPR?

None.

The baseline profit rate and its adjustment

Consultation response form

Question 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?

None.

The baseline profit rate and its adjustment

Consultation response form

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

None.

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The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

Scott Cattaneo

Organisation:

ADS Group Ltd

Position:

Head of Defence Commercial

Consultation questions

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General comment

COVID-19's impacts on the BPR will be of the most material nature, and therefore ADS believe it should have featured more predominately within this consultation. For instance:

1. The pandemic effects on the comparator group's profitability will last many years and will be highly significant.

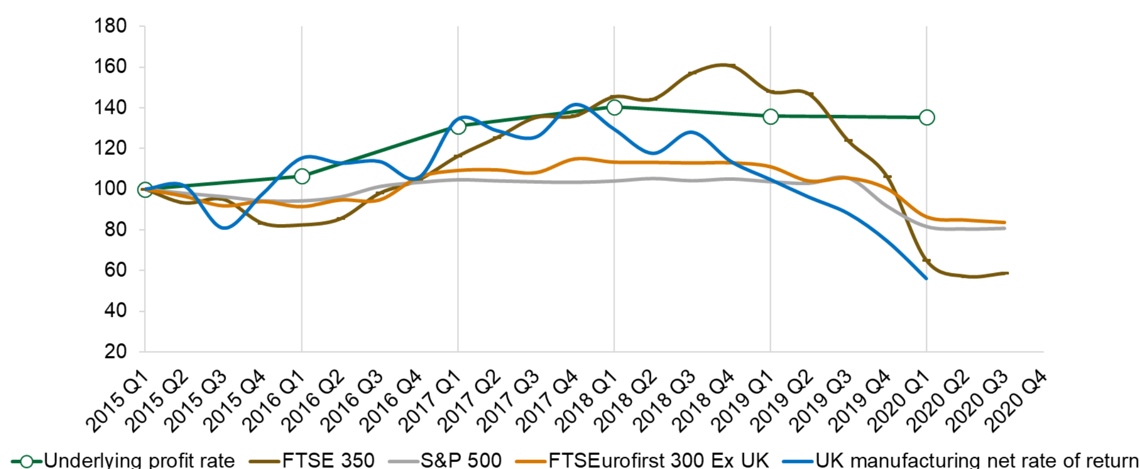
2. Due to the data extraction methodology, much of the data is well over a year old when used to price a QDC/QSC. Indeed, when the SSRO extract data in November 2021, the earliest results will be from April 2020. Therefore, optimistically the 24/5 data will be the first comparator group free of this bias (24/25 data extracted Nov 23, being at earliest April 22 data).

3. The three-year averaging means that the BPR will be potentially impacted up to 26/7. With an average contract duration of 4.5 years, a contract priced in March 2027 will be impacted until its completion in approx. September 2031.

Question 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.

The SSRO is required to set a BPR that gives contractors a fair and reasonable price. The impact on corporate performance should not need to be evidenced, it is a known impact. Further the SSRO presentation 'Supporting Analysis' to the 21/22 profit rate provided the following chart (page 18)', demonstrates the early impact on markets as they anticipate the future dividend streams (profits).

The SSRO are required to set a profit rate that gives the fair and reasonable return on costs that meet the Appropriate, Attributable, and Reasonable (AAR) criterion. Contractors' pricing, will be based on costs that are costs to **perform contracts, not costs that are at a productive under-capacity. The MoD will not price at inefficient (unreasonable) cost performance as industries in the Comparator Group have incurred due to COVID-19. The comparator group will show low profits/losses often based on non-performance, market collapse, curtailment and significant under-capacity.**



The SSRO must find a way to ensure the COVID-19 impact is removed and that contractors are recompensed for their **performance**. MoD contractors have generally been less affected by the COVID-19 pandemic, they operate in key areas and often cannot stop outputs (nuclear refuelling for example). The comparator group (CG) will be much more heavily influenced by consumer and general economic activity, the CG therefore becomes even less relevant.

Logically, if the SSRO were to simply use the current CG data unamended and profit rates fall, contractors should be allowing (in estimates and (impossibly) in actuals) costs that represent the inefficiency, under-utilisation in that CG, for the duration of the impact of the disturbance to the BPR. That is logical, but impossible to implement. One solution is to keep the BPR static at current levels (corrected for items that ADS are raising separately), until the effects of the pandemic are worked through financial results. Further, industry would support moving to fixed profit rates (an arrangement like the US/Canadian system that would avoid this issue and the structural issues of compiling an appropriate CG

Transfer Pricing

ADS note the reference to the OECD document 'Guidance on the transfer pricing implications of the COVID-19 pandemic'. Industry requests that the SSRO explain how they use Transfer Pricing (TP) principles in the compilation of the BPR.

TP principles seek to ensure fair taxation treatments between tax jurisdictions of transactions made between associated entities. It therefore analyses an actual company transaction profit chain (e.g. coffee sales) and uses the TP comparability data to allocate the elements of profit (brand value vs shop value added) to companies. The actual company profits in question (e.g. Starbucks) are split using reference criteria from TP. The TP principles are therefore for a very specific use, sentencing a groups taxable profits on their transactions between tax jurisdictions.

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Industry believes that the TP principles are inappropriate for a comparator group as a whole, additionally we believe that the SSRO BPR does not currently adhere to TP principles, as it uses group accounts, which contain transactions that are most distant from the underlying transaction. TP guidance states that you must 'identify the transaction' as closely as possible. Group financial statements profitability are a remote measure to a transaction and are therefore often inappropriate (especially for goodwill and business combination intangible assets impairment and amortisation).

The introduction to 'Guidance on the transfer pricing implications of the COVID-19 pandemic, para 5 states: 'It is important not to lose sight of the objective to find a reasonable estimate of an arm's length outcome, which requires an exercise of judgment on the part of taxpayers and tax administrations'. Clearly this is to analyse actual (COVID-19 impacted results of market collapse/curtailment/non-performance), for tax administrators, at a transaction between group members.

'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'.

This appears to mean that the SSRO will overlook the impact of COVID-19 on the comparator group. We believe this is inappropriate and would unacceptable to industry, coupled with the long-term impact, this may place the MoD at severe risk of not being able to obtain the equipment/support they require and lead to divestment, exit and an erosion of UK capability for years to come. The TP rules are the SSRO use are both inappropriate and not adhered to when calculating the BPR.

Question 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 result of the determination of the net zero BPR?

Please add comments to support your answer:

No comments on the draft. The SSRO however are trying to remedy a position, through 6 steps to achieve zero that would be better made by changing the Act/Regulations. This would resolve all the complexity the SSRO have demonstrated.

Question 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?

Please add comments to support your answer:

Yes, however please refer to above comment at Q3.

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

Please add comments to support your answer:

No.

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The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

Terry Hersey

Organisation:

Metasums Ltd

Position:

Director

Consultation questions

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Question 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.

Introduction

Paragraph 5.7 SSRO seeks, from stakeholders, "evidence of the impact of COVID-19" such that it can establish if and how the methodology for comparability analysis may need to be adapted for the assessment of rates for 2022/23. I believe that adaptation of SSRO's current methodology is not what is required but rather a fundamental reset.

Before I talk to the actions I see as necessary in a fundamental reset I should firstly clear my input on the question asked i.e. 'evidence of the impact of COVID-19'.

- I have no knowledge of, nor evidence (other than which is already in the public domain) of the extent and timing of business disruption and altered working practices.
- I have no knowledge on the metrics that contractors are using to quantify and compare the impact on different activities.
- Given the range of companies that comprise SSRO's reference group and the range of companies that comprise the industry group (companies with qualifying defence contracts) I have no evidence to say that such metrics could not be recreated for the reference group with data that is publicly available but and I truly doubt that it could.
- News information shows that the impact of COVID-19 differs greatly between nations and between phases of the pandemic e.g. Finland Vs Italy and Sweden 2020 Vs 2021. Impact to-date within a geography differs greatly as a consequence of government action (e.g. lockdowns) and government support (e.g. loans, grant aid and other stimulus measures). Extent and duration of economic recovery for any geography is completely uncertain as is the distribution across business sectors and products
- The impact on individual ultimate holding companies differs greatly (e.g. Amazon vs ICHG) as a consequence of a large number of factors which remain largely unknown or unknowable.

The narrowness of SSRO's question in the response above and in paragraph 5.7 to cause utility of the question to be constricted to the point of being expunged.

In paragraph 5.7 and in Question 1 above SSRO should, I believe, have requested input on what changes to methodology the SSRO should consider adopting in arriving at recommendations of BPR rates for 2022/23 and later periods. It is this question that I have answered.

A fundamental reset of methodology is needed

It is as difficult to argue against the principle of comparability as it would be to argue against a warm sunny day. However the choice by SSRO to use OECD transfer pricing framework as the operable model is somewhat odd. OECD's guidance on transfer pricing was '*established on the arm's length principle underlying Article 9 of both the OECD Model Tax Convention on Income and on Capital ("the OECD Model") and the United Nations Model Double Taxation Convention between Developed and Developing Countries ("the UN Model"), as that principle is elaborated in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("the OECD Transfer Pricing Guidelines").*[1] The aim of the OECD Guidance is to provide a framework that can be used to establish prices between related parties that simulates

[1] OECD Paper June 2011 Transfer pricing legislation – A suggested approach

the price that would have existed between unrelated parties '*The Arm's Length Principle*' such that taxation due to each nation can be properly assessed. The OECD methodologies available to parties to establish the arms-length price for transactions between related parties are varied and set out over 612 pages. The consistent feature of the framework, regardless of which methodology is adopted, is to ensure that comparability compares 'apples with apples'. Further thoughts on SSRO's use of the OECD paper are contained in 'OECD and COVID-19' section below.

SSRO does not make and has never made sufficient efforts to ensure that 'like' is compared with 'like' or that differences are minor. Pre COVID-19 the errors I'm concerned about have always been significant. They are caused by the selection criteria of the comparison group and failures in processing comparison group financial data relating to investments by ultimate parent undertakings in business acquisitions. These errors result in a soundly thought through basis for comparability not being achieved. Furthermore, even if SSRO were to have a damascene awakening and establish a profit rate it would recommend to the Secretary of State would still be based upon events of many years past.

To be clear, I believe that SSRO has always failed to compare 'apples with apples' in two significant areas and therefore even before COVID-19 the basis of comparability was significantly flawed, and methodology needs to be corrected.

Flawed areas that require modification are:

a. Setting a baseline profit rate (BPR) for a pricing period where the BPR is based upon historic extraordinary world events that have passed i.e. COVID-19. SSRO's basis of calculation is reliant upon today's comparison looking just like it was 5 years ago (it is the one from 5 years previous that is being used). See COVID-19 section below.
b. Setting a baseline profit rate (BPR) for a pricing period where the BPR is based upon the financial performance of a comparison group of ultimate holding companies whose average key financials differ widely from average key financials of ultimate holding companies for the 340 qualifying contracts awarded to end Q3 2020/20 (key financials to be considered in establishing a representative comparison group of ultimate holding companies should include market capitalisation, capital goods products or service base, and annual revenue).
    - I see no basis for the exclusion of loss-making companies from the comparison group (two wrongs do not make a right whereby error of not excluding amortisation and impairment of goodwill and intangible assets recognised as a consequence of a business combination is set against excluding loss-making companies where losses are often caused by impairment of such assets which should have been excluded)
c. Setting a baseline profit rate (BPR) for a pricing period where the BPR is based upon the financial performance of a comparison group of ultimate holding companies whose key financials have not been adjusted to (1) exclude intangible assets from capital employed, nor (2) exclude amortisation and/or impairment of intangible assets. I remain unclear whether SSRO's failure to properly exclude amortisation and/or impairment charge in the income statement for intangible assets recognised as a consequence of a business combination results from (a) a failure of understanding, (b) an unwillingness to evaluate the amount from annual reports or databases, or (c) an unwillingness to correct a long-standing error. Similar exclusions should take place from capital employed. See business combinations and Annual reports section below.

- The process requirement is clear. Intangible assets in the balance sheets of ultimate holding companies largely comprise goodwill and other intangible assets initially recognised as a consequence of a business combination. Similarly amortisation and/or impairment of intangible assets recorded in the income statement largely result from goodwill and other intangible assets initially recognised as a consequence of a business combination. Notes to the accounts typically show (but not always) the split between assets and charges to the income statement of arising on goodwill and business combinations and other intangibles. If the information is not available on the database that SSRO uses to extract data used to calculate the BPR then SSRO should look to the published annual reports and extract the data manually. These are material values and impact significantly upon the quality of the resultant values. If intangible assets and write-downs are not segregated in the annual report then either SSRO should proportion to those that are or classify all intangible assets as arising as a consequence of a business combination.

Options for change are:

d. Comparability by reference to the profits rates paid by other free major nations, e.g. USA, Canada, Germany.
    - Once set the rates would require little update other than adjustments occasioned by changes to interest rates as would apply to FCSA and WCSA step 6.
    - I am unaware of any other major nation that annually establishes the profit rate to be included in contract prices of a single source contracts by comparability to a reference group of companies undertaking a broad range of industrial activities.
    - The methodology generally used by major nations is to set the criteria and range of establishing a contract profit rates where the criteria and range are fixed as long-term policy.
    - A very significant proportion of the work undertaken on qualifying contracts is with very large multi-national enterprises (global workforce and global revenues).
    - If the framework adopted by nations leads to a different contract profit rates being offered for similar work with similar risk and similar capital requirements, then the arms-length value of contract will be distorted and propensity an MNE’s propensity to invest or engage in work undertaken for a nation will be affected.
    - Comparability may be complex to evaluate but once soundly established the framework and evaluation methodologies to be used by buyers and sellers should remain undisturbed. Defence contracting is a long-term business
    - The UK legal framework requires that cost risk and capital requirements are addressed outside of the baseline profit rate whilst other risk types are uniformly prosecuted within the baseline profit rate e.g., management risk, breach/default risk.
    - Similarly, the UK framework includes the fixed capital servicing allowance as an element whilst other nations include this as an allowable cost e.g., USA FCCM

e. Comparability by reference to the longer-term performance of a reference group of ultimate holding companies that excludes data from time periods impacted by

extraordinary world events (e.g. COVID-19) and where corrections are made for b. and c. above. See also section on comparability below.

- The period for assessment of comparison group profitability should be published annual reports for financial periods ending between 1st January 2010 and 1st January 2020 (the decade before the pandemic). The results calculated for 2022/23 recommendation should therefore be used for all future periods i.e. excepting for corrections the 2022/23 SSRO's recommendation of baseline profit rate should only be varied as a consequence of changes that capital servicing allowance rates has on the comparator group underlying profits.
- Defence industry, particularly that comprising activity undertaken on single source qualifying contracts, is a long-term business sector; If the defence sector was FMCG then there would be no large single source contracts.
- The average (mean) size of qualifying contract at £141.9m[2] is extremely high as is the mean contract duration of 4.3 years. Long term business activity should be matched by rewards that are fixed over the long term.
- Volatility in the baseline profit rate is to be avoided as this increases sector market risk to shareholders (β) and consequential risk to Government.

COVID-19

COVID-19 makes a significant distortion to the relevance of the time period used for comparison. I am far from certain that the taxation authorities looking to OECD guidelines would be easily convinced that the arms-length price for a transaction in 2030/31 between related parties should be based on the simple average of profit rates earned by companies whose financial year end fell in the fiscal years 2019/20, 2020/21 and 2021/22. I am certain that for pricing of qualifying single source contracts that extraordinary events of COVID-19 during 20/21 should not be used in the pricing of contracts some 5 years later. The lack of synchronicity is too great.

Financial year end	Date of average profit	Comparator Group Year	First use in BPR	Last use in BPR	Final year average contract pricing date	Average contract completion
Sept 2019	March 2019	2019/20	2020/21	2022/23	Sept 2022	April 2027
Sept 2020	March 2020	2020/21	2021/22	2023/24	Sept 2023	April 2028
Sept 2021	March 2021	2021/22	2022/23	2024/25	Sept 2024	April 2029
Sept 2022	March 2022	2022/23	2023/24	2025/26	Sept 2025	April 2030

[2] SSRO Quarterly defence contract statistics: Q£ 2020/21

The baseline profit rate and its adjustment

Consultation response form

OECD and COVID-19

The OECD report published in December 2020 on 'transfer pricing implications of the COVID-19 pandemic' and referenced by SSRO in paragraph 5.4 is (a) far more nuanced than the section quoted by the SSRO could be seen to imply, and (b) relate to "evaluating controlled transactions" between associated undertakings and "BEPS" avoidance. Furthermore:

Chapter 1 of the OECD report addresses the impact of COVID on comparability analysis needed support of transfer pricing between associated undertakings of Multi-National Enterprises (*MNE*)) for the purpose of establishing transfer prices between related parties across international borders during a period such that tax liability can be properly assessed and be seen by tax authorities in each nation as a fair proportioning of profits between entities under common control.[3]

OECD require the principle of comparability to be used to good effect in guidance on transfer pricing; it would be difficult to think of an alternative route to getting a fair and reasonable distribution of taxable profits between nations where economic activity in support of a transaction had been undertaken between related parties (associated undertakings) in different nations. The OECD paper addressed the additional difficulties caused by COVID-19 of attaining appropriate data and discussed options. Arguably, for transactions between related parties, comparability to 'something' was and remains the only option by which international double taxation treaties could be established.

Comparability

The SSRO's two statutory aims of obtaining good value for taxpayers' money and fair and reasonable prices for industry. This requires, amongst other actions, that the SSRO '*provide the Secretary of state with its assessment of what is the appropriate rate …. for that year*.' Implied but not stated in the Act is that the assessment and recommendation by the SSRO of that rate should be made on the basis of comparability. The quality of the resultant recommendation is dependent upon (a) the selection of a relevant basis of comparability, (b) timely and relevant data upon which the assessment is informed, and (b) the adoption of sound methodologies to calculate the baseline profit rate to be proposed to the Secretary of State for the year ahead. The choice of the basis to be used for comparability and the detail of the computation is of immense importance.

Sound methodologies anchored in a jointly agreed understanding of accounting for business combinations and consequential treatment of intangible assets in the balance sheet and all consequential amortisation/impairment in the income statement

Characteristics of a sound basis of comparability

- Needs to be timely or it needs to be enduring
- It needs to be reasonable.
- If it is based on a comparison group, the comparison group needs to have common characteristics beyond NACE code. Mean or median size of companies in the comparison group should be similar to the same mean or median size of the group accounts of the ultimate holding company of actual qualifying defence contracts let.

[3] E.g. Section 4 and 5 talks to timing issues and that 'uncontrolled transactions undertaken during the same period as the controlled transaction ("contemporaneous uncontrolled transactions") is the most reliable information to use in a comparability analysis'.

The baseline profit rate and its adjustment

Consultation response form

<u>Business combinations and Annual reports.</u>

I'll try to very simply address why intangible assets recognised as a consequence of a business combination (takeover or acquisition) and consequential charges to the income statement needs to be removed in order that a valid basis of comparability is established.

- A company is worth to its shareholders what it considers to be the current value of all its net future cash flows. This value has nothing to do with the net assets of the corporation. By way of example I have chosen an FT250 company IMI PLC. IMI at 31-12-2020 had shareholders equity in its balance sheet of £799m and these shares had a market value of £3,337m (today, as a consequence of an improved outlook the market capitalisation value of these shares is £4,561m). If another group wanted to acquire IMI PLC, then, all other things being equal, it would need to pay more than today's market price for the shares. If it had to pay existing IMI PLC shareholders £5,000m to acquire their shares the difference between the balance sheet value of the net assets acquired (non-current assets, plus current assets, less current liabilities, less non-current liabilities) would be recorded as a mixture of goodwill or intangible assets acquired as a consequence of a business combination.
- The value of goodwill or intangible assets acquired as a consequence of a business combination is the current (discounted) value of expected future cash flows that are expected as a consequence of the business combination. It is in effect the current value of future profit stream acquired. If contracts are half complete, then the profits anticipated from that contract are capitalised on day 1 (the contract is now an asset of the acquiring company). If existing customers are expected to place further contracts, then profits anticipated from such customer relationships are capitalised on day 1 (that customer relationship is now an asset), if the company name and trademarks are expected to deliver customers then profits arising are capitalised on day 1 (the trade mark and company name are now owned by the acquirer and an asset). The know how of the staff is not an asset because the acquiring company has no control over how long they will be employed so profits made from this knowhow cannot be capitalised and are classed as goodwill. Processes and procedures are however owned by the acquirer and future profits can be capitalised on day 1.
- Goodwill is just the current value of those future profits that do not arise as a consequence of the company acquiring the means to secure future business of discharge current contracts; it is the balancing number. No one knows what it comprises.
- Goodwill is subject to an annual impairment review. The current value future cash flows of the acquired business are evaluated and if they are less than the carrying value of the business combination intangible assets the carrying value is reduced to the sum calculated and the difference is written off to the income statement as goodwill impairment.
- Other assets recognised on a business combination are written down over their useful lives. These assets would not ever have featured as assets in the books of IMI PLC as profits are only ever recognised when realised and losses taken as foreseen. As shown above this is not the case in a business combination where assets are created on business combination else the difference between the market price paid for the company and the net assets acquired would need to show as an immediate loss in the consolidated accounts of the ultimate parent undertaking.

The baseline profit rate and its adjustment

Consultation response form

- IMI company accounts will never show intangible assets recognised as a consequence of a business combination. The acquiring company will show a £5,000m investment in a subsidiary undertaking. The intangible assets and goodwill recognised as consequence of the business combination will only show in the consolidated accounts (by way of a consolidation adjustment).
- To not write back amortisation/ impairment of business combination intangible assets and goodwill is to massively understate profits on a comparable basis to that employed by trading entities. Even if the trading entity were the ultimate group holding company, then amortisation/ impairment of business combination intangible assets and goodwill would still need to be added back to show the actual profits made.

<u>More detail on acquisition of a listed company for cash consideration</u>

- If price paid by the acquiring company is greater than the market capitalisation before the offer, then the shareholders of the acquired company have realised a profit
- Profit to shareholders resulting from an increase in the market value of their shares is not addressed in statutory accounts. The market value of share is the value assessed by shareholders (whether they know they are doing it or not) of the current value of future cash flows discounted at a rate that reflects the risk of that investment.
- If price paid the acquiring company is greater than the shareholder funds reported in statutory accounts, it is because the market value of the acquired company is greater than its net assets
- This difference is the expected current value of future profits purchased through the business combination i.e. profits foreseen
- This purchase of profit is recognised as intangible assets arising as a consequence of business combination and any balance as goodwill
- Intangible assets arising recognised as a consequence of a business combination are not costs incurred but rather costs that have been avoided. Such classes of assets are not able to be capitalised other than on a business combination e.g. future profits on contracted work or profits expected to arise on work yet to be contracted by existing customers
- The only alternative accounting requirement available to accounting regulators was for that portion of the acquisition price that was future profits to be recognised as an immediate loss and for profits to be recognised as they were realised.
- If price paid the acquiring company is less than the shareholder funds reported in statutory accounts, it is because the market value of the acquired company is less than its net assets
- This difference is the expected current value of future losses assumed in the business combination i.e. the current value of future losses foreseen by the shareholders of the acquired company

<u>Same for acquisition of listed company for non-cash consideration e.g. shares</u>

- Shares in the acquiring company are listed and therefore the market value of new shares issued to acquire the target is known. This value is then processed as per cash acquisition set out above

The baseline profit rate and its adjustment

Consultation response form

Extracts from IMI PLC Annual report 2020 Note 11 Intangible Assets

Accounting policy

Intangible assets are disclosed as acquired intangible assets and non-acquired intangible assets. Amortisation of acquired intangible assets is treated as an adjusting item as described in Note 3 of these accounting policies, because of its inherent volatility.

i. Goodwill
Goodwill is initially measured at cost being the excess of the aggregate of the acquisition-date fair value of the consideration transferred over the net identifiable amounts of the assets acquired and the liabilities assumed for the business combination. After initial recognition, goodwill is measured at cost less any accumulated impairment losses. The value of the goodwill can arise from a number of sources, but in relation to our more recent acquisitions, it has been represented by post-acquisition synergies and the skills and knowledge of the workforce.

ii. Research and Development
Expenditure on research activities, undertaken with the prospect of gaining new scientific or technical knowledge and understanding, is recognised in the income statement as an expense as incurred. Expenditure on development activities, whereby research findings are applied to a plan or design for the production of new or substantially improved products and processes, is capitalised provided benefits are probable, cost can be reliably measured and if, and only if, the product or process is technically and commercially feasible and the Group has sufficient resources and intention to complete development. The expenditure capitalised includes the cost of materials, direct labour and directly attributable overheads. Other development expenditure is recognised in the income statement as an expense as incurred. Capitalised development expenditure is stated at cost less accumulated amortisation (see below) and impairment losses (see accounting policy 'Impairment') and is included in the other acquired or other non-acquired category of intangible assets depending on its origin.

iii. Software development costs
Software applications and systems that are not an integral part of their host computer equipment are capitalised on initial recognition as intangible assets at cost. Cost comprises the purchase price plus directly attributable costs incurred on development of the asset to bring it into use. Following initial recognition, software development costs are carried at cost less any accumulated amortisation (see below) and accumulated impairment losses (see accounting policy 'Impairment') and are included in the other acquired or other non-acquired category of intangible assets depending on their origin.

iv. Customer relationships and other acquired intangible assets
Customer relationships and other intangible assets that are acquired by the Group as part of a business combination are stated at their fair value calculated by reference to the net present value of future benefits accruing to the Group from utilisation of the asset, discounted at an appropriate discount rate. Expenditure on other internally generated intangible assets is recognised in the income statement as an expense as incurred.

v. Amortisation of intangible assets other than goodwill

Amortisation is charged to the income statement on a straight-line basis (other than for customer relationships and order book, which are charged on a sum of digits basis) over the estimated useful lives of the intangible assets. Amortisation commences from the date the intangible asset becomes available for use. The estimated useful lives are:

- Capitalised development costs are the life of the intangible asset (usually a maximum of 15 years)
- Software development costs are the life of the intangible asset (up to 10 years)
- Customer relationships are the life of the intangible asset (up to 10 years)
- Other intangible assets (including order books, brands and software) are the life of the intangible asset (up to 10 years)

The Group splits its intangible assets between those arising on acquisitions and those which do not, because the amortisation of acquired intangibles is recognised as an adjusting item in the income statement.

Goodwill Impairment testing

Accounting policy.

For the purpose of impairment testing goodwill acquired in a business combination is, from the acquisition date, allocated to each of the Group's cash-generating units (or groups of 'CGUs'). The composition of CGUs reflects both the way in which cash inflows are generated and the internal reporting structure. Where our businesses operate closely with each other we will continue to review whether they should be treated as a single CGU. Each unit or group of units to which goodwill is allocated represents the lowest level within the entity at which the goodwill is monitored for internal management purposes and shall not be larger than an operating segment before aggregation.

Where goodwill forms part of a CGU and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in this circumstance is measured based on the relative values of the operation disposed of and the portion of the CGU retained.

Impairment – the carrying values of the Group's non-financial assets other than inventories and deferred tax assets, are reviewed at each balance sheet date to determine whether impairment indicators exist.

If indicators exist, the recoverable amount of the asset or all assets within its CGU is estimated. An impairment loss is recognised whenever the carrying amount of an asset or its CGU unit exceeds its recoverable amount. Impairment losses are recognised in the income statement.

For goodwill and assets that are not yet available for use, the recoverable amount is evaluated at each balance sheet date.

The recoverable amount of non-financial assets is the greater of their fair value less costs to sell and value in use. In assessing value in use, an individual assessment is made of the estimated future cash flows generated for each CGU derived from the Group's long-term forecasts for the next five years. These are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Management believe that this approach, including the use of the indefinite cash flow projection, is appropriate based upon both historical experience and because it is one

of of the bases management utilise to evaluate the fair value of investment opportunities. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the smallest cash generating unit to which the asset belongs.

Reversals of impairment

Impairments of goodwill or available for sale financial assets are non-reversible. In respect of other assets, an impairment loss is reversed if at the balance sheet date there are indications that the loss has decreased or no longer exists following a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised. **Key estimate**

The value in use is based on a discounted cash flow model. The principal key estimate reflects the combination of assumptions used in these calculations, including the long-term growth rates and the discount rate applied to forecast cash flows in addition to the achievement of the forecasts themselves. The assessments performed were materially insensitive to changes in the underlying growth and discount rate assumptions which were not significantly revised in the current year. Further information on the assumptions adopted for material cash generating units and the assets affected is included below.

The Group has 12 (2019: 19) cash generating units to which goodwill is allocated. Following management's assessment during the year, the grouping of the CGUs, as defined for the purpose of goodwill testing, has been changed to reflect the re-organisation of the divisional structures as shown in Note 4, principally in IMI Precision Engineering with the new Motion Control, Fluid Technologies & Commercial Vehicles sectors and in IMI Critical Engineering with a new regional structure.

The recoverable amount of a CGU is the higher of its fair value less costs to sell and its value in use. Value in use is determined using cash flow projections from financial budgets, forecasts and plans approved by the Board covering a five-year period and include a terminal value multiple. The projected cash flows reflect the latest expectation of demand for products and services.

The key assumptions in these calculations are the long-term growth rates and the discount rates applied to forecast cash flows in addition to the achievement of the forecasts themselves. Long-term growth rates are based on long-term economic forecasts for growth in the manufacturing sector in the geographical regions in which the cash generating unit operates. Pre-tax discount rates specific to each cash generating unit are calculated by adjusting the Group post-tax weighted average cost of capital ('WACC') of 7% (2019: 7%) for the tax rate relevant to the jurisdiction before adding risk premia for the size of the unit, the characteristics of the segment in which it resides, and the geographical regions from which the cash flows are derived.

The baseline profit rate and its adjustment

Consultation response form

This exercise resulted in the use of the following ranges of values for the key assumptions:

	2020 %	**2019 %**
Pre-tax, pre-risk adjusted discount rate	9.2 – 10.7	8.3 – 11.0
Long-term growth rate	1.3 – 2.1	0.7 – 2.0

For the purpose of assessing the significance of CGUs, the Group uses a threshold of 10% of the total goodwill balance. The recoverable amount of the CGUs is determined from a value in use calculation and the key assumptions used in this calculation are the discount rate, growth rate and operating cashflows.

These estimates are determined using the methodology discussed above and for those CGUs considered to be significant, outlined in the table below

2020	**Goodwill £m**	**Discount rate %**	**Growth rate %**
IMI Critical – Petrochemical & Isolation	117.1	10.9	2.1
IMI Critical – Control Valves	94.0	10.9	2.1
IMI Precision Americas – Fluid Technologies	58.1	12.2	1.8
2019			
IMI Critical – Petrochemical & Isolation	113.3	9.4	2.0
IMI Critical – Control Valves	90.2	9.4	2.0
IMI Precision Americas – Fluid Technologies	60.4	10.5	1.6

The baseline profit rate and its adjustment

Consultation response form

Sensitivity to changes in assumptions

The principal key estimate reflects the combination of assumptions used, including the long-term growth rates and the discount rate applied to forecast cash flows in addition to the achievement of the forecasts themselves.

The Directors do not consider that any reasonably possible changes to the key assumptions would cause the carrying amount to exceed the recoverable amount of the CGU.

Forecast cash flows – decreased demand can lead to a decline in the forecast cash flows used to assess goodwill impairment. A decrease of 33% in the forecast cash flows of Petrochemical & Isolation would result in impairment. A decrease of 79% in the forecast cash flows of Control Valves would result in impairment. A decrease of 48% in the forecast cash flows of Precision Americas – Fluid Technologies would result in impairment.

Discount rates – a rise in the pre-tax discount rate to 15.3% (i.e. +4.4%) in Petrochemical & Isolation would result in impairment. A rise in the pre-tax discount rate to 46.0% (i.e. +35.1%) in Control Valves would result in impairment. A rise in the pre-tax discount rate to 21.8% (i.e. +9.6%) in Precision Americas – Fluid Technologies would result in impairment.

Growth rates – a decline in the growth rate to -4.7% (i.e. -6.8%) in Petrochemical & Isolation would result in impairment. A decline in the growth rate to -19.1% (i.e. -20.9%) in Precision Americas – Fluid Technologies would result in impairment. A significant decline in the growth rate would be required before Control Valves goodwill would require an impairment.

No other CGUs have goodwill that is considered significant in the context of the Group's total goodwill balance, nor do any CGUs use the same key assumptions for the purposes of impairment testing in either this year or the last.

The aggregate amount of goodwill arising from acquisitions prior to 1 January 2004 which had been deducted from the profit and loss reserves and incorporated into the IFRS transitional balance sheet as at 1 January 2004, amounted to £364m. The cumulative impairment recognised in relation to goodwill is £41m (2019: £41m).

The baseline profit rate and its adjustment

Consultation response form

Question 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 result of the determination of the net zero BPR?

Please add comments to support your answer:

If the Secretary of State wishes to have an additional baseline profit rate that *"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."* then this should be implemented with minimal disruption to statutory guidance.

The devise of a baseline profit rate that is equal to the SSRO's funding adjustment looks to be just a book-keeping devise. Industry at large should not be overly concerned with a process that is internal between the Secretary of State and companies wholly owned by the UK Government.

SSRO should take care to use 'Government or UK Government' when referring to the UK Government and not 'government' as the later suggests any government of any country or state. An issue with FARs and DFARs.

Not for inclusion within SSRO's statutory guidance on establishing contract profit rate applicable to new contracts or contract changes but I would wish SSRO to make clear in its reporting guidance that a *company incorporated under the Companies Act* that is wholly owned by the UK Government is not 'the Secretary of State or an authorised person' within the meaning of the Act. Whereby such a company will not have access to reports (qualifying contracts, and reports on overheads and forward planning etc) that are made available by its qualifying subcontractors to SSRO and the Secretary of State, or an authorised person.

The baseline profit rate and its adjustment

Consultation response form

Question 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?

Please add comments to support your answer:

I’d ask the Secretary of State. SSRO should ask directly; using a public consultation to address this question looks out of place and therefore risks being interpreted as somewhat churlish.

The baseline profit rate and its adjustment

Consultation response form

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

Please add comments to support your answer:

Just to be clear, setting a zero-profit rate for a contract does not mean that such contracts will not make a profit or a loss. Unless the secretary of State sets aside all of SSRO's statutory guidance on allowable costs, losses will arise as a consequence of costs that do not comply with AAR test e.g. not attributable to the contract, defined benefit pension shortfalls, public relations events. Unless contract pricing type is cost plus differences between the estimate and the actual cost will fall to become profits or losses.

The Secretary of State is already able to exempt a contract between the Secretary of State and a company incorporated under the Companies Act that is wholly owned by the UK Government. The only disbenefit to the Secretary of State in using exemption as the method to exclude profit from the price paid to the prime contractor company (incorporated under the Companies Act) where that company is wholly owned by the UK Government is that to provide such an exemption would mean that any sub-contracts placed by that company would never be QSCs.

Similarly, were sub-contracts placed by a typical prime contractor to a *company incorporated under the Companies Act that is wholly owned by the UK Government* exemption by the Secretary of State would render further sub-contracts placed by that government owned contracting authority to never be QSCs.

The inclusion of such contracts as qualifying defence contracts rather than exclusion as exempted contracts has a micro benefit to contractors of diluting the step 4 SSRO funding adjustment.

I assume that the entities that have brought this into play is (1) AWE Management Ltd which will become 'a company incorporated under the Companies Act that is wholly owned by the UK Government' in a few months' time, and (2) potentially Sheffield Forgemasters Limited.

The baseline profit rate and its adjustment

Consultation response form

Overview

This response form should be read in conjunction with the consultation document.

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of obtaining good value for taxpayers' money and a fair and reasonable prices for industry. We also welcome comments from people or organisations with a particular interest in defence (non-competitive) procurement. The consultation will close on 21 May 2021. Following our consideration of responses to the consultation, we will publish an updated profit rate guidance by the end of July 2021.

Please respond by 5.00pm on Friday 21 May 2021.

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

- by email to: **consultations@ssro.gov.uk** (preferred)
- by post to: Baseline profit rate consultation responses, 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

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

The baseline profit rate and its adjustment

Consultation response form

Your details

Name:

James Schofield

Organisation:

Leonardo UK Limited

Position:

VP Finance

Consultation questions

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

When answering the consultation questions, it would be very helpful if you could support your responses with additional explanation and detail. This will help us to understand the basis for your answer and inform our finalisation of the guidance. As a minimum, please include the paragraph number(s) your comment refers to.

In the interests of transparency, it is our intention to publish responses to this consultation on the SSRO website upon completion of the consultation. Please indicate whether or not you consent to publication of your response by marking one of the boxes below.

Yes [X] No [ ]

Please note, if you do not consent to publication, we will treat your response as confidential to the extent of any disclosure that is required by law. In the event we are required by law to make a disclosure of your consultation response, to the extent we are legally permitted to do so, we will give you as much notice as possible prior to such a disclosure and will take into account all reasonable requests made by you in relation to the content of such a disclosure.

The baseline profit rate and its adjustment

Consultation response form

Question 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.

1. To understand the impact of COVID-19 on the BPR, your question will need to be asked, and understood, of all the companies in the BPR comparator groups, not just of the contractors engaged in this consultation.
    a. The SSRO's BPR methodology explains the comparator groups are companies performing similar activities to SSCR contractors. However, analysis suggests many of the companies are in fact performing differing activities, in quite different markets, therefore the impact of COVID-19 may be different to that of contractors responding to this consultation.

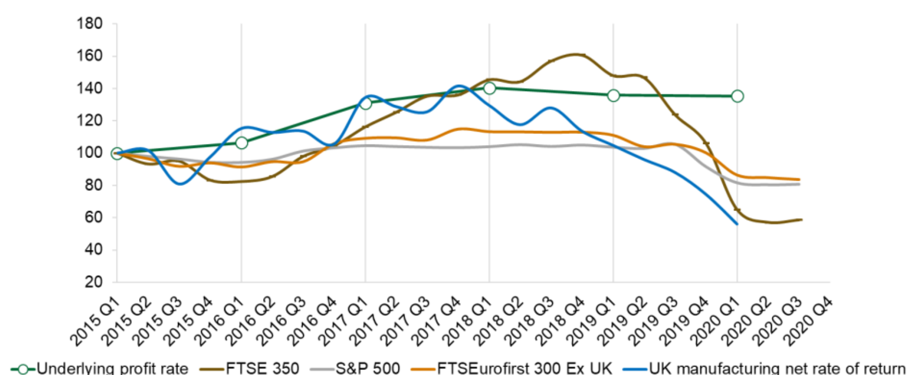
2. Your enquiry will not only have to deal with the actual impact of COVID-19 to date, on demand, supply chain, indirect costs, utilisation, efficiencies and performance but also to what extent businesses have anticipated the impact on future performance by means of financial provisions or through changes to forecast contract profit margins.

3. Your enquiry would also need to understand the nature of contracting methods in the comparator group.
    a. Notwithstanding changes to demand/market, the impact of changes to performance/utilisation and costs will manifest differently if contracting is ascertained cost (cost plus) as compared to; fixed, firm, or competitive. The former (cost plus) primarily seeing changes through costs and revenues, the latter (fixed, firm, competitive) in margins.

4. Your enquiry would also need to understand what impacts are temporary (and for how long) and what are permanent, as future methods of safe business execution may differ to those pre-COVID-19. Any new methods of operating would need to be accommodated in Allowable cost guidance and future contract pricing, but what is the approach to existing contracts?

5. Understanding the issues raised in points 2 to 4 will require information additional to that included in the comparator group companies' statutory accounts. Will the comparator group companies provide information beyond that already in the public domain?

6. The regime requires a fair price to be paid to the contractor. If pricing includes the estimated Allowable costs based on a "reasonable" level of performance (i.e. not assuming a permanent pandemic) then the profit must also be set on the same basis (i.e. profit should not be based on a year impacted by the pandemic). For the reasons mentioned in points 1 to 5 we do not see a practical route for the SSRO to assess the comparator group and make adjustments to remove the impact of the pandemic. Indeed, the 2021/22 rate, as shown on the SSRO chart issued with the BPR, is already showing the BPR for 2021/22 is affected by COVID:



7. We therefore recommend that the BPR is:
    a. Firstly, reviewed for improvements to methodology as proposed by DSAG, then
    b. The BPR is fixed for a period of time based on the current three year rolling average as adjusted for 7.a.

    A BPR impacted by COVID-19, if not corrected, will mean pricing will not meet Section 13 requirements for circa 4 years in setting a BPR (depending on how many years the underlying PLI is affected) and for many more years than that for long term contracts priced using the COVID-19 impacted BPR.

8. Transfer pricing
    a. We would welcome SSRO explanation of how Transfer Pricing principles support the construction of the BPR as stated in this consultation and the papers issued with the BPR.
        i. Transfer pricing principles ensure intra-group transactions are valued at arms-length in order that profits are correctly attributed and taxes appropriately paid, in each tax regime. The SSRO BPR methodology uses the aggregate profit recorded at group company level, not the profits of individual trading entities.
    b. We also comment that transfer pricing does not mitigate the impact of COVID-19 on subsidiary or group profits.

The baseline profit rate and its adjustment

Consultation response form

Question 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 result of the determination of the net zero BPR?

Please add comments to support your answer:

1. As this situation is unique to Companies wholly owned by the UK Government we suggest there is specific legislation introduced to accommodate this circumstance and deliver the desired profit rate.

2. If the wholly owned Government Company subcontracts work, on a single source basis, to "industry" (non-Government wholly owned companies) then those subcontract companies would refer to the "normal" SSCR and guidance in the construct of price and operation of the regime.

3. SSRO reporting of QDC profitability would need to separate the activities of wholly owned UK Government companies to avoid distortion of results.

The baseline profit rate and its adjustment

Consultation response form

Question 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?

Please add comments to support your answer:

1. See above comments

Consultation response form

Question 4: Do you have further comments on the assessment and application of a net zero BPR?

Please add comments to support your answer:

1. No