

**SSRO**

Single Source  
Regulations Office

# The baseline profit rate and its adjustment

Consultation responses

August 2021

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# 1. Introduction and summary

## Background

- 1.1 The regulatory framework established by Part 2 of 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 appropriate 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:
- a. We provide the MOD with our assessment of the appropriate rates by 31 January each year, pursuant to section 19(2) of the Defence Reform Act 2014 (the Act), to assist the Secretary of State to determine those rates for the subsequent financial year.
  - b. We issue statutory guidance in relation to the six steps, to which the contracting parties must have regard 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 apply from 1 April 2021 was made in accordance with the methodology.
- 1.5 The [Secretary of State announced on 15 March 2021](#)<sup>1</sup> that he had determined two baseline profit rates (BPRs) for 2021/22:
- a. a rate of 8.31% as recommended by the SSRO; and
  - b. an additional rate of 0.057%, which had not been recommended by the SSRO, hereafter referred to as the “government owned contractor rate (GOCR)”.
- 1.6 In announcing the rates, the Secretary of State stated the following in relation to the GOCR:
- “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.”
- “[The additional 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.”

<sup>1</sup> <https://www.thegazette.co.uk/notice/3760612>

- 1.7 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. Version 7 of the profit rate guidance came into force from 1 April 2021.
- 1.8 The setting of the GOCR gave rise to two further considerations by the SSRO, upon which it conducted an [eight-week public consultation from 26 March to 21 May 2021](#)<sup>2</sup>:
- Whether the profit rate guidance requires further updating (version 7.1) to reflect any implications of the GOCR for application of the six steps.
  - If there is a continuing need for the GOCR, how the SSRO should incorporate a GOCR into its annual rates assessment, alongside the rate we recommend using our existing methodology.
- 1.9 The consultation also sought evidence of the impact of COVID-19 which stakeholders would like the SSRO to consider in arriving at the 2022/23 rates assessment. 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.

### Consultation summary

- 1.10 During the consultation period, the SSRO:
- held group and individual discussions with stakeholders<sup>3</sup>; and
  - received 8 written responses (see Table 1).

**Table 1: Breakdown of respondents**

	Government	Industry	Trade association	Industry consultant
Number of responses	1	5	1	1

- 1.11 Overall, respondents welcomed the opportunity to engage with the SSRO on the BPR and its adjustment. We thank those who responded to the consultation for sharing their views. Six respondents gave permission for their responses to be published and these are available in [SSRO \(2021\) The baseline profit rate and its adjustment: consultation responses](#).

<sup>2</sup> <https://www.gov.uk/government/consultations/the-baseline-profit-rate-and-its-adjustment>

<sup>3</sup> Comprising the Ministry of Defence (MOD), ADS Group Ltd (ADS), the Defence Single Source Advisory Group (DSAG) and individual defence contractors.

## Next steps

- 1.12 As a result of feedback, we will:
  - a. Update version 7 of the [statutory guidance on the baseline profit rate and its adjustment](#) (“profit rate guidance”) and publish version 7.1 containing the changes which will come into force in August 2021;
  - b. Finalise our approach for assessing an appropriate, baseline profit rate, capital servicing rates, and SSRO funding adjustment for 2022/23 in September 2021, addressing potential inclusion of a GOCR set at the level of the SSRO funding our adjustment;
  - c. Conduct our assessment and make a recommendation to the Secretary of State in January 2022.
- 1.13 The following sections of this paper summarise the views and evidence provided by the consultation respondents, together with the SSRO’s commentary on how these responses have informed the final decision in the areas on which we consulted.

## 2. Impact of COVID-19

- 2.1 We requested that stakeholders provide evidence relating to the impact of COVID-19 that they believed was relevant to the SSRO's assessment of the rates for 2022/23. Eight respondents provided feedback.
- 2.2 The MOD stated that it was content that the BPR is a reasonable proxy for a fair return and noted that it didn't expect the 2022/23 rate to differ substantially from the 2021/22 rate due to the 3-year rolling average. The MOD reserved its final consideration to when the latest data becomes available and stated that it would encourage the SSRO to revisit the method 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.
- 2.3 Industry respondents presented feedback which we have grouped into:
- descriptions of COVID-19 effects on operations of suppliers and on the comparator group; and
  - views against the SSRO using the current methodology to make a BPR recommendation for 2022/23.

### Descriptions of COVID-19 effects on operations of suppliers and on the comparator group

- 2.4 Industry feedback on the impact of COVID-19 was varied. Some noted that MOD contractors may have been shielded in part from the effects of COVID-19 as a result of ongoing, long-term delivery of defence contracts. One respondent reported evidence of no material immediate impact on profit due to this protection. Some respondents provided evidence on how COVID-19 has impacted their operations despite the protection provided by ongoing MOD contracts. The impacts include increased costs, reduced profitability and reduced demand in global markets. Additional costs were driven by several factors including new ways of working, antigen testing, extra PPE, shift working and increased cleanliness. They anticipated a reduction in their profits to be driven by reduced revenue from under-activity, reduced efficiency and reduced productivity. One respondent identified investment in digitisation as prerequisite for the foreseeable future, which may only be a partially recoverable cost. Another respondent argued that there was no need to evidence the impact of COVID-19 on corporate performance as it is already demonstrated by the [SSRO's 2021/22 profit recommendation supporting analysis](#), which they claimed shows the early impact on markets.<sup>4</sup>
- 2.5 Industry anticipated that the impact of COVID-19 on the comparator group companies would vary due to different geopolitical and economic conditions, and across individual companies, markets and sectors. Some respondents attributed the anticipated varied impact to differences in government interventions, including differences in lockdown measures and industry support measures. They envisaged the comparator group companies to be more heavily influenced by consumer and general economic activity than the defence contractors. They expected the comparator group to show low profits or losses resulting from non-performance, market collapse, curtailment and significant under-capacity.

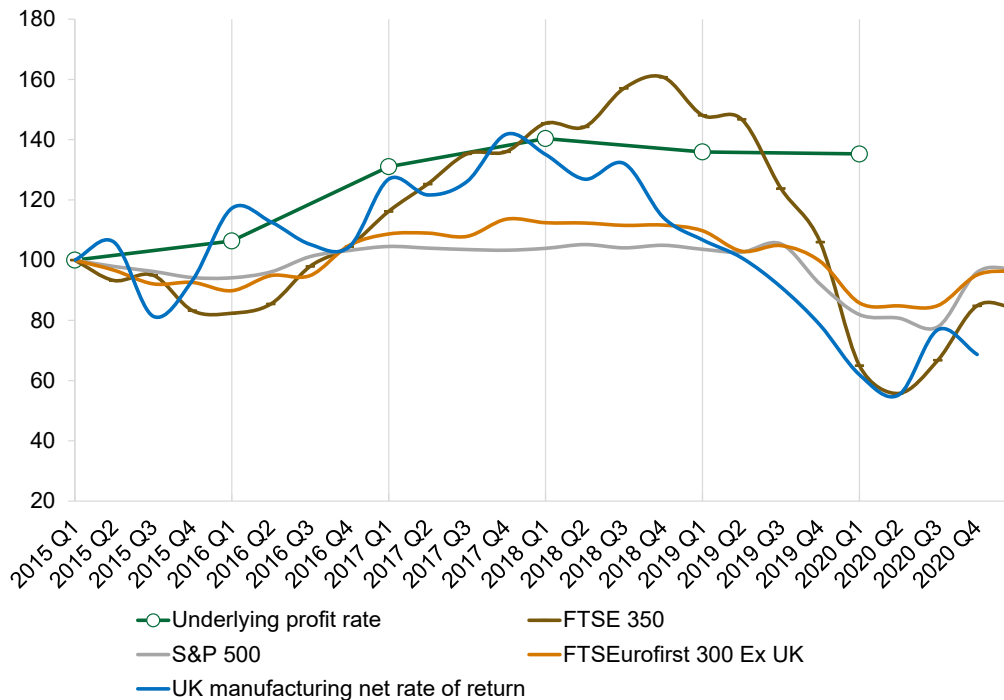
<sup>4</sup> Slide 18 [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/962715/Supporting\\_Analysis\\_Pack\\_1-OSCA.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/962715/Supporting_Analysis_Pack_1-OSCA.pdf)

- 2.6 Two respondents provided feedback on the furlough measures. One respondent suggested that furlough may not have been available for many parts of the defence industry due to potential loss of capacity. The other respondent noted that state support measures can be recorded as a reduction in costs and furlough credits which in effect reduce overhead costs.

*Response*

- 2.7 Industry respondents submitted that the COVID-19 pandemic has affected the costs of contractors that hold qualifying contracts in respect of operating their businesses, investing in capabilities to enable new ways of working and the extent to which those may be recoverable from the MOD as Allowable Costs. As we understand it, industry respondents question the extent to which companies operating in the broader economy, who are represented in the comparator group, have been able to:
- a. undertake the economic activities the methodology relies on; or
  - b. maintain profit margins by offsetting any increased costs due to the impact of COVID-19 through cost reductions elsewhere, or by increasing revenue.
- 2.8 As the relevant data becomes available, the SSRO proposes to assess the activities of comparator companies and the reasons for changes in rates of profits earned.
- 2.9 Experiences are likely to differ across companies. The geographic regions included in the search are Western Europe and North America, which have been affected by COVID-19. We accept that economic circumstances differ between countries, and we acknowledge that the impact of COVID-19 may vary from country to country. However, we do not consider the impact of, or response to, the pandemic has been so significantly different as to justify blanket exclusion of one or more of the countries from the comparable geographic regions. The review process is carried out at a company level and will consider the impact of COVID-19 on each individual company.
- 2.10 As part of the 2021/22 profit rate recommendation the SSRO published metrics comparing the trend in the underlying profit rate to the trend in profitability of companies included in major UK, US, and European share indices; and in the UK manufacturing sector. An updated version of the chart is presented in Figure 1 showing more recent data. Industry submissions drew attention to data in Figure 1 as showing what they considered was the impact of the COVID-19 pandemic. The SSRO does not use this data to determine the appropriate arm's-length rate of profit, and note that it has fluctuated over a number of years.

**Figure 1: trend in the underlying profit rate to the trend in profitability of companies included in major UK, US, and European share indices; and in the UK manufacturing sector**



- 2.11 We agree that the way schemes to subsidise employee salaries (such as the Coronavirus Job Retention Scheme in the UK) are typically accounted for, as an offset against costs, helps to maintain consistency of revenue and cost. We accept, however, that some workers are being paid but are not generating any revenue, and that the grant received may not fully offset the costs.

### Views against the SSRO using the current methodology to make a BPR recommendation for 2022/23

- 2.12 Industry respondents compared the anecdotal evidence of the impact of COVID-19 on their operations with their views on its purported impact on the comparator group companies. They urged the SSRO not to use the current methodology to make BPR recommendations for 2022/23. We have grouped industry views into the following sub-topics:
- suggested unrepresentativeness of the comparator group;
  - implications of using the 3-year rolling average and of using data impacted by COVID-19;
  - excluding loss makers;
  - challenges associated with the assessment of the impact of COVID-19; and
  - proposals for the BPR assessment.



### ***Suggested unrepresentativeness of the comparator group***

- 2.13 Five respondents expressed concerns that the comparator group will be unrepresentative due to the anticipated impact of COVID-19 across different geopolitical and economic attributes. They submitted that the comparator group companies are undertaking different activities and operating in different markets and so the impact will be different. They asserted that the comparator group companies have experienced a more serious impact from COVID-19 than defence contractors, driven by curtailed operations leading to lower profitability. One respondent questioned whether a BPR derived from a diverse comparator group, following the COVID-19 pandemic, will comply with the requirement for a fair return to industry.

#### ***Response***

- 2.14 We agree that the current circumstances of comparator companies need to be explored to check whether they remain appropriate benchmarks. Our aim for the BPR assessment is to confirm that comparator companies are undertaking comparable economic activities and can be used in the assessment of a suitable starting point for the application of the six steps. As usual, this assessment will be guided by our ability to identify an arm's-length profit rate for comparable economic activities, using the most recent and reliable data we can obtain.
- 2.15 We do not accept that it is necessarily the case that companies with qualifying contracts continued to operate normally, but comparator group companies did not and are therefore less relevant for benchmarking. Defence companies are diverse in nature as are comparator group companies; and the effects of COVID-19 on their revenue, costs and profits depend on their individual circumstances. We need to examine the available data for comparators before reaching conclusions regarding their economic activities. As stated, our aim for the BPR assessment is to update our view on an arm's-length profit rate for comparable economic activities using the most recent and reliable data.
- 2.16 Our aim of assessing an arm's-length rate of profit is consistent with our statutory aims of value for money and fair and reasonable profits. We accept that we must undertake such an assessment on a reliable basis, but our view is that it would be premature to conclude now that it is unachievable. Additional checks will be necessary to ensure that profits of each benchmark company can be considered reliable to inform future profits. If we have insufficient data from the most recent complete financial year, we may look to the previous year.

#### ***Implications of using the 3-year rolling average and of using data impacted by COVID-19***

- 2.17 Most respondents from industry were concerned about the medium- to long-term effects of data that has been impacted by COVID-19 on the BPR and on the pricing of QDCs/QSCs. Five respondents pointed out that the data used in the 2022/23 BPR calculation and the application of the 3-year rolling average will impact the BPR for at least three years. One respondent pointed out that the 3-year averaging means that the BPR will potentially be impacted up to 2026/27 and that with an average contract duration of 4.5 years, a contract priced in March 2027 will be impacted until its completion in approximately September 2031.

- 2.18 Five respondents presented views on the potential consequences of using data impacted by COVID-19. Two respondents argued that including data which has been materially, negatively impacted by COVID-19 into the calculation of future profits, if not corrected, will mean that the pricing of contracts will not meet the SSRO's statutory aims.<sup>5</sup> Three respondents cautioned against basing any BPR recommendation and the pricing of contracts on data that is impacted by COVID-19. They urged the SSRO to exclude the distortionary effect of COVID-19 from the comparator group's results.
- 2.19 One respondent thought that the SSRO's statement that "...transfer pricing principles can continue to be relied upon as the basis of the SSRO's BPR assessment..." meant that the SSRO would overlook the impact of COVID-19 on the comparator group, and that this would be inappropriate.

### *Response*

- 2.20 The SSRO is required to provide the Secretary of State each January with its assessment of the appropriate BPR for contracts entered into in the next financial year. It is correct to observe that the underlying rate assessed by the SSRO each year may have an impact over several future years. The underlying rate will be included in the three-year average that comprises the BPR recommended to the Secretary of State and, if accepted, contract profit rates will be derived from the BPR.
- 2.21 The three-year averaging process promotes stability in the BPR relative to wider economic fluctuations, whether positive or negative. In any assessment year, such fluctuations may surpass the stability mechanism to impact the BPR and there is potential for COVID-19 to have such an effect.
- 2.22 To the extent that any effects of COVID-19 are long-lasting, or even permanent, the economic data from companies in the comparator group will reflect this in time. Future BPRs may be characterised by higher, lower, or similar rates of profit to the pre-pandemic period. We think that profits on QDCs should continue to be based on returns earned from comparable activities, which reflect the cumulative effect of positive and negative economic shocks of the past.
- 2.23 We continue to believe that it is valuable to assess a BPR which is based on identifying companies undertaking comparable economic activities, consistent with the aims of our methodology. We do not support concluding on the BPR recommendation for 2022/23 (including freezing it at 8.31%) without having assessed the evidence on company profits using the most up to date data. We aim to appropriately apply the arm's length principle set out in the OECD's transfer pricing guidelines and conduct a comparability analysis that takes account of the effects of COVID-19.
- 2.24 The MOD's response supports the SSRO's position on these matters, stating that it was content that the BPR is a reasonable proxy for a fair return and that it didn't expect the 2022/23 rate to differ substantially from the 2021/22 rate due to the 3-year rolling average.

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<sup>5</sup> Section 13 of the Act states that: "The SSRO must aim to ensure (a) that good value for money is obtained in government expenditure on qualifying defence contracts, and (b) that persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts."

### ***Excluding loss makers***

- 2.25 One respondent was concerned that the SSRO's approach of excluding loss makers from the BPR calculation will not address their expectation of a significant deterioration due to COVID-19 in the profit of many large to medium sized companies in the comparator group.

### ***Response***

- 2.26 Loss-making companies are removed to reflect the expectation of positive profit on estimated Allowable Costs in QDCs. This maintains consistency with the construct of the profit formula as a mark-up on estimated Allowable Costs and removes the possibility of a negative BPR resulting from the assessment. We are not seeking to benchmark the losses of companies due to COVID-19 or any other reason and have no plans to change this aspect of the methodology.
- 2.27 As set out above, we will examine the most recent data about comparators to understand whether their profits can reliably be used, going forward, as an indicator of fair profits for companies with qualifying defence contracts. The fact that the profits of companies in the comparator group may have deteriorated (or improved) is not itself a reason to conclude that they cannot be used as a benchmark.
- 2.28 We have commenced comparator company data analysis and have observed examples of companies reporting a significant reduction in profit compared to the past, while remaining profit-making. We consider that the proper approach to determine whether a company should be included in the BPR calculation is to assess whether it undertook comparable activities.

### ***Challenges associated with assessing the impact of COVID-19***

- 2.29 Respondents from industry anticipated challenges with assessing the impact of COVID-19. One respondent argued that to understand the impact of COVID-19 on the BPR, it is necessary to identify the impact on all comparator group companies, not just the contractors engaged in this consultation. Two respondents thought that understanding the impact of COVID-19 requires additional information to that included in the comparator group companies' statutory accounts and questioned how the SSRO will access that information. Another respondent cited clause 28 of the [OECD COVID guidance on Transfer Pricing](https://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm)<sup>6</sup>, which suggests two options for dealing with the effects of government interventions when carrying out a benchmarking exercise:
- verify that comparable enterprises faced similar restrictions; or
  - determine on a case-by-case basis the extent to which adjustments (exclusion of economic data) are necessary for each comparable enterprise over the impacted period.

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<sup>6</sup> <https://www.oecd.org/tax/transfer-pricing/guidance-on-the-transfer-pricing-implications-of-the-covid-19-pandemic.htm>

- 2.30 Two respondents expressed concerns about using results from a small sample. One respondent doubted that a small sample of evidence provided through this consultation could provide a basis from which to estimate the impact of COVID-19 on each of the varied comparator company industries and geographies. Another respondent expressed doubt that the impact of the pandemic on the in-year accounts of a single business could be metricated or extrapolated across the entire comparator group and asserted this would be necessary to eliminate COVID impacts from the BPR calculation.

#### *Response*

- 2.31 We sought evidence to help understand the impacts of COVID-19 and inform our approach to the SSRO's annual assessment. We are not seeking to extrapolate the results to the comparator group, but to identify any indicators suggesting that, as a result of COVID-19, economic activities of the comparator group are incomparable to the activities contributing to QDCs and QSCs. We have begun to develop our approach to assessing the relevance of comparators, which will include consideration of whether companies have not been operating for substantial periods of time, or have customers who have been unable to transact with them.
- 2.32 The aim of our methodology is to establish an arm's-length rate of profit which is a product of comparable economic activities and markets in order to inform a suitable starting point for the application of the six steps. We accept the need to verify that the required analysis can be conducted on a reliable basis. The information provided by contractors will allow the SSRO to better understand the circumstances prevailing at the time the profit data was generated and therefore have greater confidence that the analytical exercise has been conducted appropriately. We have commenced our analysis and consider it is premature to reach conclusions regarding the extent of information required on each comparator and the sources from which information will need to be obtained.

#### *Proposals for the BPR assessment*

- 2.33 Industry respondents used the above observations as a basis for making three proposals about the approach the SSRO should take to the BPR assessment:
- a. **Freeze the BPR:** Four respondents recommended freezing the BPR at the 2021/22 level of 8.31%. One respondent recommended keeping the BPR static at current levels and at the same time correcting for items that the ADS Group are raising separately, until the effects of the pandemic on the financial results diminish. Three respondents agreed with this view, with one of them suggesting setting a BPR floor of at least the 2021/22 BPR.
  - b. **Fixed BPRs:** One respondent proposed moving to fixed profit rates (an arrangement like the US or Canadian system) that they claimed would avoid the impact of COVID-19 issue and the structural issues of compiling an appropriate comparator group.
  - c. **Recover impact through Allowance Costs:** One respondent argued that if the SSRO uses the current comparator group data unamended and profit rates fall, contractors should be able to recover costs that represent the inefficiency and under-utilisation in the comparator group, for the duration of the impact of the disturbance to the BPR. The respondent noted that implementation of this suggestion poses significant challenges.

### *Response*

- 2.34 We have a statutory obligation to recommend rates to the Secretary of State every year. As in past years, the SSRO will apply an evidence-based approach to inform its assessment. We continue to see merit in setting profits earned with reference to real world economic data and reflecting the dynamics of the economy in which prices and profits are determined by active trade in goods and services. This approach is in line with our statutory aims.
- 2.35 We do not support the idea of concluding on the BPR assessment for 2022/23 (including freezing it at 8.31%) without having assessed the evidence on company profits. Analysis is required to gain an up-to-date picture of company profits and capital servicing rates. Information may come to light which suggests the BPR should rise or fall.
- 2.36 We remain open to the possibility that the pandemic requires us to alter how we perform our assessment. We will consider whether there is a need to account for disruptions in economic activity, for example by excluding or adjusting data, or using data which is not the most recently available.
- 2.37 We cannot accept the suggestion of fixed BPRs. The UK does not operate a Canadian or US-type system and to move to one would require legislative change. We do not recommend such a change, as the case for change has yet to be made.
- 2.38 We do not agree that contractors should be able to claim costs derived in some way from the comparator group. The SSRO's view is that profit and Allowable Costs should not be used to cross-subsidise one another, as this would not be in the interests of the regime. The legislation is clear that for costs to be allowable in a qualifying contract, the contractor must be in a position to demonstrate that the costs are appropriate, attributable to the contract and reasonable in the circumstances.

### **Conclusion on the impact of COVID-19**

- 2.39 We agree that the COVID-19 pandemic has had an impact on the comparator group companies, and that the effect of an underlying rate in a particular year has an impact over several future years. We continue to believe, however, that it is valuable to recommend a BPR which is based on comparability analysis. We do not support concluding on the BPR assessment for 2022/23 (including freezing it at 8.31%) without having assessed the evidence on company profits. Defence contractors are diverse in nature as are comparator group companies, so we cannot conclude that defence contracts have continued to operate normally while the comparator group companies have not. We are analysing the available company data and considering the appropriate actions to take. Our aim is to make a recommendation to the SSRO Board in September 2021 on the best approach to the 2022/23 assessment.



## 3. Updates to the statutory guidance

- 3.1 We requested that stakeholders provide feedback on the question of whether any further changes to the guidance are necessary as a result of the determination of the government owned contractor rate (GOCR). Five stakeholders provided feedback. The MOD stated that it was content with how the six-step calculation works to deliver the GOCR. The remaining four respondents presented varying views which we have grouped into three broad categories: the impact on the guidance and its application; legislative change; and other issues. No respondent provided feedback specifically addressing our proposals for steps 5 and 6.

### **The impact on the guidance and its application**

- 3.2 One respondent proposed that there should be separate guidance for wholly government owned contractors. They were concerned about the lack of clarity on the number of companies and contracts the GOCR will affect, and how the GOCR will be achieved through the six-step process. Another respondent suggested the need to implement the GOCR with minimal disruption to the guidance, but noted that industry should not be overly concerned with the operation of the GOCR given it applies only to government owned contractors. Another respondent noted that they would have serious concerns if the GOCR were to be expanded beyond wholly government owned contractors.
- 3.3 One respondent expected that if a contractor with a QDC that uses the GOCR enters into sub-contracts with companies that are not wholly government owned then the “normal” legislation and guidance should apply to that sub-contract.

### *Response*

- 3.4 We agree that any disruption to the guidance from the introduction of the GOCR for wholly government owned contractors should be minimised. We prefer to have one set of guidance and we consider that the approach to applying the GOCR can be incorporated into the existing pricing guidance without causing undue disruption to the vast majority of cases to which the GOCR will not apply. We therefore shall continue to issue only one guidance document on the application of the six steps.
- 3.5 The Secretary of State’s 15 March 2021 announcement stated that for 2021/22 the GOCR applies to QDCs with wholly government owned contractors and where both parties to the contract agree. It does not apply to QSCs. We have no plans at this time to recommend that the circumstances in which the GOCR applies should change.

### **Legislative change**

- 3.6 Two respondents proposed amending the primary legislation to achieve the GOCR for wholly government owned contractors in preference to applying it through the six-step calculation.
- 3.7 Another respondent queried whether the legislation should apply differently to wholly government owned contractors, for example in respect of reporting, the requirements of Allowable Costs, the capital servicing adjustment, and the cost risk adjustment.

### *Response*

- 3.8 The SSRO considers that the legislation does not frustrate the Secretary of State's intent to determine the GOCR for a wholly government owned contractor. We have, however, recently made a recommendation for legislative change so that the legislation better supports the determination of multiple baseline profit rates. We are also confident that updating the current guidance will better support the Secretary of State's intent when determining the GOCR to be implemented within the existing legislative framework.
- 3.9 Where a qualifying contract is awarded, the requirements of the legislation apply equally to government owned contractors as they do to non-government owned contractors. In announcing the GOCR, the Secretary of State expressly referenced that it would enable the pricing and transparency provisions of the regulatory framework to be applied in these circumstances.

### **Other issues**

- 3.10 One respondent observed that inclusion of wholly government owned contractors in the regime benefits contractors by reducing the SSRO funding adjustment.
- 3.11 The same respondent proposed that the SSRO should clarify in the 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, and as such will not have access to reports that are made available by its qualifying sub-contractors to the SSRO and the Secretary of State, or an authorised person.

### *Response*

- 3.12 We are sympathetic to the view that contracts using the GOCR should contribute to the calculation of the SSRO funding adjustment in the same manner as other contracts. We do not propose any changes to the SSRO funding adjustment methodology. The SSRO Board will be asked to agree the methodology for assessing the 2022/2023 funding adjustment in September 2021.
- 3.13 The requested clarification in the reporting guidance does not seem necessary. The Act provides for contractors to submit statutory reports to the MOD and the SSRO. The SSRO operates the Defence Contracts Analysis and Reporting System securely, so that only the MOD and the SSRO have access to reports submitted by contractors. The Secretary of State may authorise any person to exercise specified functions under the Act and we do not see anything preventing a government owned contractor being designated as an authorised person. The SSRO is not empowered to issue guidance about how that power may be exercised. It would be a matter for the MOD whether it wishes to share information in statutory reports with an authorised person.

## Guidance

- 3.14 Our decisions on each of the six steps are summarised in Table 2. We have taken a decision to implement the proposals for the guidance on steps 1 to 5 as set out in the consultation. For step 6, the development of the final guidance is set out below.

**Table 2: SSRO's consultation topics and decisions**

Profit rate step	SSRO's decision 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 at step 1 in consideration in application of step 5.
Step 6: Capital servicing adjustment	Provide separate provision, within the pricing guidance document on the application of step 6 where the BPR for a wholly government owned contractor has been selected.

- 3.15 The decisions are based on our considerations that version 7 of the guidance can be applied to steps 1 to 4 without amendment:
- **Step 1: Baseline profit rate** – The guidance sufficiently explains how to apply the baseline profit rate.
  - **Step 2: Cost risk adjustment** – 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.
  - **Step 3: POCO adjustment** – The 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.
  - **Step 4: SSRO funding adjustment** – The guidance sufficiently explains how to apply the SSRO funding adjustment.



### Step 5

- 3.16 Our decision for step 5 is to include the BPR selected at step 1 in consideration of its application. We do not propose to limit the application of step 5 in the 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 will reflect this in the guidance as shown in Box 1.

#### **Box 1 – Additional guidance on the incentive adjustment**

6.6

- g. The incentive adjustment applied may be set to reflect the baseline profit rate selected at step 1.

### Step 6

- 3.17 We balanced the following factors before deciding how to update the guidance in relation to step 6:
- a. the legislative requirements on step 6;
  - b. having a single guidance document with minimal disruption due to the GOCR; and
  - c. the policy intent that the GOCR can be used to set a contract profit rate that does not result in companies making a profit.
- 3.18 We concluded that the following changes should be made to step 6 guidance:
- a. maintain the guidance for contracts applying the standard baseline profit rate unchanged in its current form; and
  - b. incorporate within the document separate provision for contracts applying the GOCR.
- 3.19 We believe this will help ensure that contractors are clear on how step 6 should apply, whichever BPR they select, and help all parties comply with their legislative obligation in respect of setting contract profit rates.
- 3.20 Section 17(2) of the Act and regulation 11(7) require the parties to 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. In addition, the legislation requires that the parties:
- must have regard to the capital serving rates in force at the time of agreement;
  - must not further recover costs of capital which are Allowable Costs under the contract; and
  - may use capital figures for any business unit which is likely to be performing the primary contractor’s obligations under the contract.

- 3.21 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. Such an adjustment is not made in the determination of the GOCR therefore the 'standard' step 6 guidance would not be suitable to apply. The updated guidance explains that the parties will need to determine what an appropriate and reasonable rate of return on capital is for the contract, in order to set the contract profit rate in accordance with the requirements of Section 17 and Regulation 11. To assist the parties, two potential scenarios are outlined in order to illustrate how they might seek to agree step 6.
- 3.22 The first scenario is where the parties agree that the application of the GOCR is with the intent that the contract should not make a profit. Then step 6 would be applied such that the adjustment to the amount resulting from step 5 produces a contract profit rate of zero. This is on the basis that making no profit on a contract includes making no return on capital employed for the performance of the contract.
- 3.23 The second scenario recognises that there may be circumstances in which a wholly government owned contractor seeks to pass on a capital charge to the MOD, even where the GOCR is selected.<sup>7</sup> In these circumstances, the guidance suggests that the cost of capital may either be agreed at:
- a. an amount estimated by applying the usual approach to step 6, but using a set of appropriate input parameters<sup>8</sup> specified and agreed between the parties; or
  - b. an amount established through other reasonable means agreed by the parties to reflect the actual cost of capital, which may either be recovered through a step 6 adjustment or as an Allowable Cost. The Allowable Cost guidance makes clear that borrowing costs are generally not allowable because they are dealt with at step 6. The capital servicing rates reflect debts yields of private corporations and step 6 is designed with this in mind. The parties may therefore conclude that in seeking to ensure that the cost of capital is recovered appropriately it is preferable for an amount to be included in the cost base. In the circumstances where the cost of capital employed is recovered through Allowable Costs, regulation 11(8)(b) does not allow any further adjustment at step 6 to reflect these costs.
- 3.24 Regulation 11(8)(a) requires that regard must be made to the capital servicing rates in force at the time of agreement and so there must be clear reasons to depart from incorporating those rates into the determination of the contract profit rate. One such reason may be that the capital servicing rates reflect the cost of debt to privately financed corporations, which may not be appropriate to apply in the context of a wholly government owned entity. Annex 6.1 of [Managing Public Money](#)<sup>9</sup> provides guidance on the choice of appropriate rates.

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<sup>7</sup> For example, it is a requirement of *Managing Public Money* that charges within and among central government organisations should normally also be at full cost, including the standard cost of capital (currently at 3.5%)

<sup>8</sup> Capital employed, cost of production, fixed capital, positive working capital, negative working capital and the capital servicing rates.

<sup>9</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/994902/MPM\\_Spring\\_21\\_with\\_annexes\\_180621.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/994902/MPM_Spring_21_with_annexes_180621.pdf)

- 3.25 To assist the MOD and industry with the application of step 6, we have introduced the following labelling in paragraph 2.6 of the guidance:
- The GOCR to indicate the baseline profit rate that applies to contracts between the Secretary of State and a contractor wholly owned by the UK Government and where both parties agree that it should apply.
  - The 'standard baseline profit rate' to indicate the baseline profit rate that should apply in all other circumstances.
- 3.26 We will replace the current profit rate guidance with the new guidance set out in Appendix A. Subsequent paragraphs have been renumbered.

## 4. The approach to setting the GOOCR

- 4.1 We sought feedback on the question of whether, assuming that the SSRO incorporates a GOOCR into its methodology, the SSRO should continue to set the rate at the level of the SSRO funding adjustment. Four stakeholders provided feedback. The MOD agreed for the GOOCR to form part of the SSRO recommendation in future, if the SSRO is content that it provides value for money and fair and reasonable return. The MOD also stated that it was content for the rate to be set at the level of the SSRO funding adjustment. Two of the three industry respondents agreed for the GOOCR to be set at the level of the SSRO funding adjustment. The third industry respondent provided comments without expressing a view on how the GOOCR should be set.
- 4.2 Industry respondents provided additional feedback in relation to the determination of the GOOCR. One respondent raised three issues. First, suggesting that the SSRO should directly ask the Secretary of State about their requirement for a GOOCR. Secondly, pointing out that calculating a GOOCR for a contract does not ensure that the contract would not be profitable (or loss-making). Thirdly, suggesting that exempting a wholly government owned contractor from becoming a QDC could be an alternative to setting a GOOCR, but recognising the drawback that doing so would also prevent sub-contracts being QSCs. Another respondent questioned whether alternatives have been considered to determining a second BPR, and whether the Act and Regulations are applicable or suitable given the aims of its use.

### *Response*

- 4.3 In announcing the rates for 2021/22 the Secretary of State explained the intention that the GOOCR 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. The MOD explained in response to this consultation that it was content with the current approach. The SSRO does not see any further need to enquire from the Secretary of State as to the requirement for the rate.
- 4.4 We agree that the application of a GOOCR to a QDC will not necessarily result in it making a zero profit. This was acknowledged in the [Secretary of State's announcement](#)<sup>10</sup> on the determination of the rates. The profit outcome will depend on the chosen pricing method and any associated target cost incentive fee (TCIF) or final price adjustment, and on any revenue or costs incurred outside the scope of the QDC, for example corporation tax or other costs that are not Allowable Costs. The MOD may need to consider other arrangements in addition to the QDC if a wholly government owned contractor is to completely achieve a profit outcome of zero.

<sup>10</sup> <https://www.thegazette.co.uk/notice/3760612>

- 4.5 We are aware that the Secretary of State may exempt contracts from the regulatory framework and we agree that this would be a way of dealing with contracts with wholly government owned contractors. We nevertheless welcome plans to make the regime amenable to contracts where otherwise they may have been exempted. In announcing the GOCR, the Secretary of State noted that it would enable the pricing and transparency provisions of the regulatory framework to be applied to contracts and relevant sub-contracts, which are intended to assist the government to obtain value for money and contractors to be paid fair and reasonable prices.
- 4.6 We will make a final decision in September 2021 as to whether the SSRO will include a GOCR in its future annual rates recommendation to the Secretary of State and whether it will continue to be set at the level of the SSRO funding adjustment. The feedback received will help to inform that decision.

## 5. Other feedback from the consultation

- 5.1 We requested stakeholders to provide additional comments on the assessment and application of a GOOCR. Five stakeholders provided feedback. The feedback comprised the GOOCR related issues, which we have integrated into the COVID-19, guidance and GOOCR sections. It also included views that were outside the scope of the topics which we address in Section 6. In addition, these two issues were raised:
- a. One respondent proposed the exclusion of companies that have QDCs/QSCs that are GOOCR from the comparator group to avoid the negative impact on the BPR calculation.
  - b. Three respondents urged the SSRO to report/publish separate analysis and statistics for standard QDCs/QSCs statistics and for wholly owned UK Government companies to avoid distorting the results.

### *Response*

- 5.2 We do not intend to include companies that have QDCs/QSCs that use the GOOCR in our BPR calculation. They would fail the “independence” search criteria (see [section 9 of the methodology](#)<sup>11</sup>) because they are more than 50 per cent owned by a single ‘person’.
- 5.3 The SSRO recognises that a GOOCR applies to contracts with specific criteria. Depending on the purpose of the analysis, there will be circumstances where these contracts warrant being presented separately from other contracts. The SSRO will carefully consider the most appropriate treatment and presentation of these contracts in analysis or statistics, and make it clear how they have been handled.

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<sup>11</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/967442/Single\\_source\\_baseline\\_profit\\_rate\\_\\_capital\\_servicing\\_rates\\_and\\_funding\\_adjustment\\_methodology\\_March\\_2021AP.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/967442/Single_source_baseline_profit_rate__capital_servicing_rates_and_funding_adjustment_methodology_March_2021AP.pdf)

## 6. Matters on which the SSRO did not consult

6.1 A number of industry respondents to the consultation provided feedback on aspects of the SSRO's BPR methodology which were not in scope of the specific aspects we consulted upon. The SSRO received input from defence industry representatives<sup>12</sup> regarding the methodology and held meetings to discuss those representations. We are taking the opportunity in this document to respond to the issues that have been raised. A detailed account of the input that was provided to the SSRO is at Appendix B, together with our responses.

6.2 An overarching theme of the input we received from industry was a desire for the BPR assessment to be targeted towards the MOD's largest single source contractors and contracts. Proposed changes to the methodology in this regard focused on two areas:

- changes to the approach to comparator company selection to favour the inclusion of larger companies and exclude smaller ones; and
- changes to analytical methods to emphasise the data belonging to larger companies and de-emphasise the data of smaller companies.

### *Response*

6.3 Figure 2 illustrates that the majority of the MOD's total single source spend is on large contracts, but in terms of numbers, most qualifying contracts are small in value. Arguments may be made that the SSRO's approach should focus on:

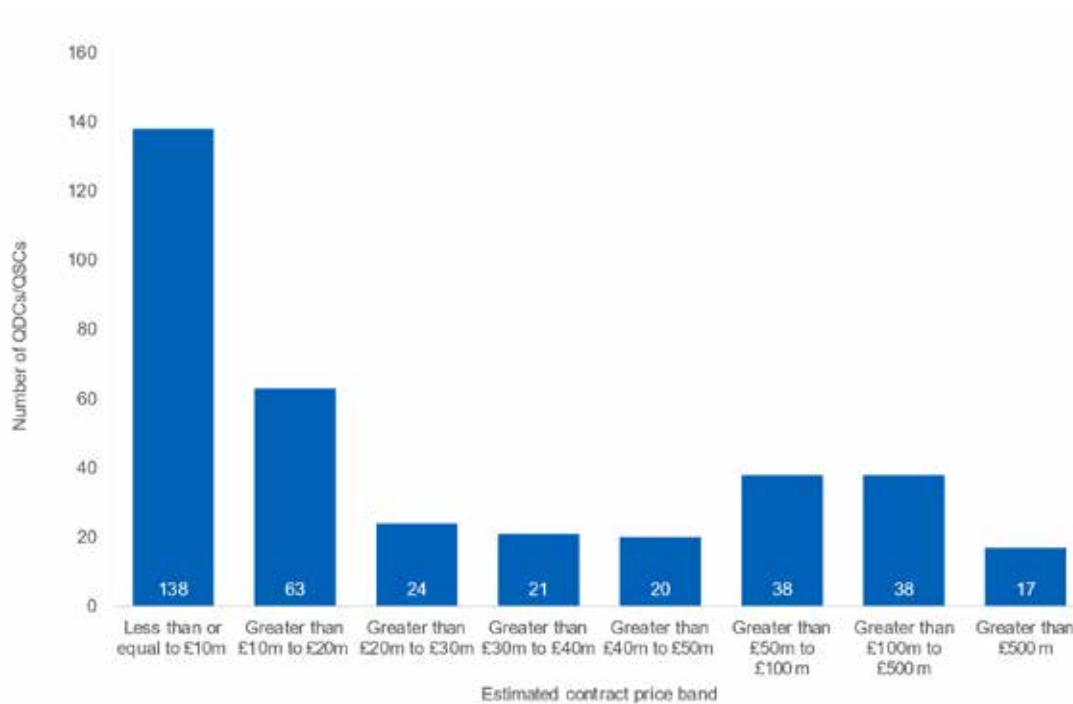
- where the largest proportion of taxpayer money goes – a smaller group of larger contracts; or
- circumstances that are akin to most single source contracts – a larger group of smaller contracts.

6.4 Consistent with the regulatory framework, the SSRO's methodology produces a BPR which is a reasonable starting point for all defence contracts regardless of size.

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<sup>12</sup> Comprising members of the Defence Single Source Advisory Group (DSAG) and the Association of Defence Suppliers (ADS)

**Figure 2: Number of QDCs/QSCs by estimated contract price for all QDCs/QSCs**



Source: [SSRO Annual qualifying defence contract statistics: 2020/21](#)

6.5 The SSRO benchmarks profit rates based on activities and, relevant to this, industry have asserted differences between the activities of larger and smaller single source contracts. We believe the case for separation remains unproven at this time and draw attention to the following matters:

- The regulatory framework does not draw a distinction between larger and smaller contractors.
- We have not seen evidence that this unreasonably favours or disadvantages one or the other of these groups in terms of the profits they can earn on single source contracts.
- We have not yet established any points of economic substance differentiating larger and smaller contracts.
- We are concerned to avoid an approach which results in levels of granular separation that cannot clearly be shown to exist or enhance the regime.

6.6 We support refining our approach where that is consistent with enhancing value for money and fair and reasonable prices. We are interested in further exploring whether there are any activities that need separate analysis, in the same way that we currently capture develop and make, provide and maintain, ancillary services and construction activity types. If so, we would need to identify any economically relevant characteristics that clearly separate larger and smaller QDCs, so that they can be applied in a comparability exercise. We welcome the feedback from industry describing the work of larger defence contractors, which may assist further investigation. We will consider such a review as part of our future corporate planning.



- 6.7 Evidence from industry and our own analysis shows that changing the parameters of company selection and data analysis techniques would alter the BPR. It is not clear, however, that such changes would enhance the robustness of the arm's-length assessment. We do not believe that techniques which tend to place the greatest emphasis on the largest comparator companies' results enhance comparability. If size were to be considered a comparability factor (we have not accepted that it is) then comparability would not necessarily be achieved by such an exercise. We are not ruling out that there may be approaches to manipulating the data which produce a more reliable measure of an arm's-length profit rate. However, we are not persuaded that the alternatives presented so far fall into this category and we see significant problems with them. Our considerations on specific feedback are at Appendix B.

# Appendix A: Changes to guidance for step 6

## Key to changes:

No change
Revised
Added

**Table A1: changes to the current guidance**

Current guidance	New guidance from 30 July 2021
7.7 In the calculation of the baseline profit rate (step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2019) <i>Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology</i> .	7.7 In the calculation of the baseline profit rate (step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2019) <i>Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology</i> .
	7.8 Contracts which apply the standard baseline profit rate should follow the guidance in paragraphs 7.9 to 7.28 in determining the appropriate adjustment at step 6. Contracts which apply the GOCR should follow the guidance in paragraphs 7.29 to 7.32 in determining the appropriate step 6 adjustment.
<b>Determination of the capital servicing adjustment</b>	<b>Determination of the capital servicing adjustment for contracts applying the standard baseline profit rate</b>
7.8 to 7.26	7.9 to 7.27
7.27 Where exceptional adjustments have been made to Capital Employed in accordance with paragraph 7.21, a corresponding adjustment to cost of production may be required.	7.28 Where exceptional adjustments have been made to Capital Employed in accordance with paragraph 7.22, a corresponding adjustment to cost of production may be required.
	<b>Determination of the capital servicing adjustment for contracts applying the government owned contractor rate</b>

Current guidance	New guidance from 30 July 2021
	<p>7.29 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment when the GOCR has been applied at step 1.</p>
	<p>7.30 The intention is that the GOCR can be used to set contract profit rates at a rate that does not result in such companies making a profit. The parties may agree that the contract should make no return on capital because it is not intended that the contractor make a profit. In these circumstances, the parties should set the value at step 6 such that when applied to the result of step 5 the resulting amount is zero.</p>
	<p>7.31 There may be circumstances where the parties agree that the contract price should include a cost of capital employed. In these circumstances the parties must agree the appropriate charge and how it should be captured in the contract price. This may require the following in respect of a cost of capital charge:</p> <ol style="list-style-type: none"> <li>a. an amount estimated by applying the approach to step 6 set out in the 4 computations on page 28, using a set of values for the input parameters specified and agreed between the parties. The parties should apply the guidance in a way that reflects the financing structure of the wholly UK government owned contractor under consideration; or</li> <li>b. an amount established through other reasonable means agreed by the parties to reflect the actual cost of capital employed.</li> </ol>
	<p>7.32 The Allowable Cost guidance makes clear that borrowing costs (a cost of capital employed) are generally not allowable because they are dealt with at step 6. However, in the case where the GOCR is applied and the parties agree that the contract price should include a cost of capital employed the parties may consider it is preferable for the cost to be included in allowable costs. In the circumstances where the costs of capital employed are Allowable Costs no further adjustment should be made at step 6.</p>

# Appendix B: Considerations on matters on which the SSRO did not consult

- B.1 Industry respondents provided feedback on aspects of the SSRO's baseline profit rate (BPR) methodology which were not in scope of the specific aspects we consulted upon. The SSRO also received, outside of the consultation process, written representations from the Defence Single Source Advisory Group (DSAG) dated 30 March 2021 and 10 May 2021. We held meetings with members of ADS Group Limited (ADS) and DSAG (referred to collectively as 'industry representatives') to explore their views in relation to the SSRO's methodology.
- B.2 This section responds to the industry feedback, which we have grouped into themes shown in Table B-1.

**Table B-1: Profit discussion themes**

Theme	Topics
Alternative approaches to profit	<ul style="list-style-type: none"> <li>• The Yellow Book and the Currie Review</li> <li>• Other international approaches</li> <li>• Setting a number by agreement</li> <li>• Alternate investment</li> <li>• Transfer pricing</li> </ul>
Comparability	<ul style="list-style-type: none"> <li>• Relevance of comparators</li> <li>• Size threshold</li> <li>• Comparability of capital structure</li> </ul>
Data	<ul style="list-style-type: none"> <li>• Averaging and weighting of data</li> <li>• Treatment of outliers</li> <li>• Conjoining of data sets</li> </ul>
Measures of profit	<ul style="list-style-type: none"> <li>• Treatment of accounting entries related to acquisition</li> <li>• Gains and losses on disposal</li> <li>• Disallowed costs</li> </ul>

## Alternative approaches to profit

- B.3 Industry representatives suggested that the SSRO adopts a fundamentally different approach to profit. There were differing suggestions that involved:
- a. dispensing with the use of actual profit data and determining a BPR via other means (see B7 – B12); and
  - b. maintaining an approach using actual company profits to determine the BPR but altering the analytical approach (see B13 – B15).

- B.4 Some of the suggestions would require changes to the legislation that we are not aware are being considered. This includes suggestions to move away from a BPR that is recommended annually by the SSRO and determined by the Secretary of State.

*Lord Currie's review and the Yellow Book approach to comparability*

- B.5 Industry representatives referred to Lord Currie's review<sup>13</sup>, asserting that Lord Currie had found little merit in changing the approach to calculating a BPR based on the principle of comparability.
- B.6 Lord Currie stated that view in 2011. Lord Currie also recommended that the SSRO periodically review the approach and that in doing so it may wish to consider a range of alternatives. We have retained aspects of the methodology applied by the Review Board for Government Contracts where we considered these have merit, such as using actual company profits as a benchmark for contract profits. We have further developed the methodology where it was necessary, for example redefining the principle of comparability in respect of economic activity rather than membership of an equity market index. The SSRO's approach to comparability reflects internationally recognised transfer pricing principles for determining an arm's-length profit rate.

*Basing the BPR on approach taken or rates paid by other nations*

- B.7 One consultation respondent proposed that the BPR should be based on the profit rates paid by other nations (e.g. USA, Canada and Germany), updated annually for changes in foreign exchange rates and capital servicing rates. Industry representatives suggested that the SSRO adopts an approach similar to the US which focuses on four profit factors:
- a. Performance risk: this has two parts, reflecting both technical uncertainties and management effort, with "standard" and "technology incentive" ranges available.
  - b. Contract type risk: this reflects the pricing method and, for fixed price contacts with progress payments, the working capital requirements.
  - c. Facilities capital employed: imputed cost calculated by applying the applicable cost-of-money rate to the facilities (equipment) capital employed in contract performance.
  - d. Cost efficiency: this allows a special incentive for demonstrable cost reduction efforts that benefit the pending contract.
- B.8 The SSRO has a statutory duty to provide the Secretary of State with its assessment of what the appropriate BPR is for that year. In doing so we must have regard to our aims of value for money and fair and reasonable prices. Given the differing international systems, we have concerns as to whether the profits in other jurisdictions should guide the SSRO's own assessment of what is appropriate for the UK. As we understand it, the UK regime is the only one where profits are primarily determined with respect to a market-based benchmark in a transparent and replicable way. We are not persuaded of the merits of moving away from that approach.

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13 Review of the Single Source Pricing Regulations (2011)

- B.9 The adoption of a US-style system would be a matter to be dealt with through legislation rather than the BPR methodology because it would require altering all six steps. We do not think a case has been made for wholesale adoption of a US-style system, but we have identified some features which we consider may be desirable to incorporate into the six steps. These features are also applied in the US:
- a. being able to define multiple starting points for the determination of profit based on the nature of the work being contracted for; and
  - b. an explicit recognition of the pricing method.
- B.10 We have made these [recommendations to the Secretary of State](#)<sup>14</sup>. There will be opportunities to consider these matters further as the Secretary of State's review of legislation develops in the coming months.

*Setting a number by agreement*

- B.11 Another option presented by industry representatives was to set the BPR at an amount agreed by the MOD and industry.
- B.12 This is a matter that can only be dealt with through legislation. We do not see any merit in such an approach and we would not support it for the following reasons:
- a. We provide an objective and transparent benchmark based on profits actually earned and costs incurred that is not influenced by the relative bargaining power of the MOD or contractors;
  - b. Our approach applies best practice from internationally recognised transfer pricing principles, and provides a central starting point which can be adjusted via the other steps to account for the circumstances of each contract.
  - c. The existing approach is stable, predictable, and resilient to transitory external factors.

*Alternate investment*

- B.13 ADS suggest a BPR based on a return the investor could receive from "alternate" investment, as under the Yellow Book.
- B.14 We do not support the Yellow Book approach, which based the BPR on a weighted average of profits earned by a subset of companies from the FTSE 100. We do not see a basis to conclude that this represented genuine alternative investment choices faced by single source defence contractors, or that the FTSE 100's constituent companies are best placed to inform the profits on single source defence contracts.

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<sup>14</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/993792/Review\\_of\\_Legislation\\_Recommendations\\_June\\_2021A.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/993792/Review_of_Legislation_Recommendations_June_2021A.pdf)

- B.15 We can see merit in an approach that is properly based on the opportunity cost of investment, but do not consider it can be reliably implemented at this time. The opportunity cost of investment is a common underpinning concept in economic regulation and the SSRO has made reference to its potential value in guiding the band of the step 2 cost risk adjustment in its [Review of Legislation Recommendations 2021](#). However, it is an approach which determines profit with respect to return on capital, whereas the regulatory framework determines profit as a mark-up on cost.

#### *Transfer pricing*

- B.16 Respondents questioned the appropriateness of the transfer pricing principles used to underpin the BPR methodology. They argued that transfer pricing principles are meant to ensure that intra-group transactions are valued at arm's-length in order that profits are correctly attributed, and taxes appropriately paid. They suggested that application of transfer pricing in the BPR methodology is inappropriate because it uses the aggregate profit recorded at group company level and not the profits of individual trading entities.
- B.17 The application of the arm's-length principle, as set out in the OECD Transfer Pricing Guidelines, involves a comparison of a controlled transaction (e.g. an intra-group transaction) with a controlled transaction between independent enterprises. This is to that confirm the profit on which corporation tax is applied is recognised in the appropriate jurisdiction. Similar to the application of the arm's length principle in the context of international tax, the SSRO is seeking to establish an appropriate rate of profit for a transaction that is not carried out on an arm's-length basis. In our case this is because the nature of the transaction precludes a competitive tendering process rather than because the two parties are related enterprises. Although the underlying purpose of determining an arm's-length profit ultimately differs, we believe it provides a sound foundation upon which to recommend the BPR.
- B.18 We have adapted the typical comparability process for transfer pricing to compare the profits which should be earned on qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs) with profits earned by companies who carry out similar activities. The SSRO's BPR methodology describes the economically relevant characteristics with suitable granularity to appropriately define what constitutes comparability. We are of the view that aggregate company level data is suitable given the function of the BPR, which is a starting point for agreeing a profit rate applicable to a wide range of economic activities. Given that only one BPR is applied to government entities which undertake a range of economic activities, we do not consider it desirable, reliable or necessary to attempt to achieve transactional level comparability in the BPR. Our approach results in an appropriate BPR, which can then be subject to further contract specific adjustment.



## Comparability

### *Relevance of comparators*

- B.19 The SSRO publishes descriptions of company activities which are consistent with the company being engaged in economic activities comparable to those in qualifying contracts (the activity characterisations). Undertaking comparable economic activities is a key requirement for a company's financial results to form part of the BPR calculation. The characteristics of QDCs and QSCs are diverse and profit is determined through a six step process which allows for a range of contract profit rates to be agreed. The boundaries of comparability for the BPR are therefore broadly defined.
- B.20 Two respondents to the consultation noted the importance of ensuring the comparator group has common characteristics to QDCs and QSCs. The respondents questioned whether the SSRO was achieving this aim.
- B.21 Industry representatives supplied the SSRO with their analysis of the SSRO's 2021/22 comparator groups. The analysis assigned each company to a specified classification of:
- Defence contractor
  - Relevant to defence contract outputs/risk
  - Non-bespoke/configured equipment
  - Simple and entirely inconsistent
  - Leasing financing/rental – not relevant
  - Configured engineering but low complexity
  - Inappropriate industry
- B.22 Using this classification, industry sought to examine the effect on the underlying rate for 2021/22 by removing companies from the calculation in all groups other than defence contractors and those considered relevant to defence contract outputs or risk, and by taking a different approach to averaging. This analysis showed a lower rate of profit on average than when the remainder of the comparator group was included, but that using different averaging approaches would increase the value of the underlying rate (we address the issue of averaging in B44 – B52).
- B.23 Industry representatives also provided written feedback on the activity characterisations. They viewed the activity types as generally correct but thought the process of selecting companies performing those activity types needed improving. In common with other aspects of industry feedback, their comments focused on orientating the descriptions of comparable activities to those they said were representative of the MOD's single source suppliers with high value contracts, who account for the majority of MOD expenditure on qualifying contracts. They provided a list of characteristics of such defence contracts. We understand that some of these characteristics were developed by the MOD to differentiate between different levels of cost risk in defence contracts. According to industry representatives, these characteristics emphasise uniqueness and complexity in defence industrial activity, combined with a requirement for rare specialised labour in production inputs and challenging customer requirements.



- B.24 Industry representatives also argued that the SSRO needed to take account of the following matters:
- a. 'prime contractor' responsibilities, which they say often require complex project management, supplier management, and design responsibilities in order to provide oversight of an entire programme, instead of the MOD carrying out those activities in-house;
  - b. a lack of manufacturing processes in the broader economy that can be likened to those within the single source defence work;
  - c. single source defence work is often the original equipment manufacturer who tends to maintain the hardware they originally supplied;
  - d. the prevalence of work in the comparator group which they claimed is more routine and has a lower risk profile; and
  - e. the inclusion of companies in the comparator group which are said to be irrelevant to the defence sector.
- B.25 Specific feedback was also noted on the activity types themselves. This feedback:
- a. emphasised aspects of the descriptions which were thought to be particularly relevant;
  - b. highlighted elements that were not thought to be consistent with the delivery of QDCs; and
  - c. drew attention to what was claimed to be examples of activities included in the comparator group which did not fit the descriptions set out by the SSRO.
- B.26 Industry representatives believe the BPR approach should be targeted towards the characteristics of a small number of very high value contracts. We disagree and think that the BPR should provide a reasonable starting point for the wide range of economic activities carried out under qualifying contracts. The rest of the six-step process allows for a range of contract profit rates that reflect the characteristics of a particular contract to be agreed.
- B.27 Given there is one BPR that applies to all qualifying contracts, the SSRO has sought to capture the range of economic activities which contribute to the delivery of QDCs and QSCs and to construct the BPR around the main activities. We do not believe the feedback provides evidence which undermines the appropriateness of the BPR methodology. We accept that the activities of some major defence suppliers on some contracts can be characterised as unique and complex, with rare specialised labour in production inputs and challenging customer requirements. Other qualifying contracts are less complex, require less scarce labour and clear customer requirements. Even where parts of the contract activities are relatively unique in terms of their complexity or resourcing requirements, there will be other aspects which would not meet that description. We can see merit in continuing to develop the descriptions of the activities in qualifying contracts. This should be done by reference to the full set of activities, not just a subset of interest, in a way that allows distinctions to be drawn where it is economically relevant to do so.

- B.28 We are interested in exploring the prevalence or otherwise of the characteristics of defence contracts cited by industry. If they can assist in refining the delineation between comparable and non-comparable economic activities this may further improve the BPR as a fair starting point for pricing of all qualifying contracts. The analysis needs to be approached with care, for the following reasons:
- a. The current activity descriptors are sufficient to encompass the MOD's major single source suppliers and we consider they are undertaking the specified activities.
  - b. Emphasising or de-emphasising aspects of the activity characterisations in line with industry suggestions may lead to the exclusion of companies that we would expect to be present, including some defence suppliers.
  - c. The characterisations put forward by industry are based in part on a series of cost risk factors intended to assist in the pricing of contracts. A BPR which was constructed based on the presence of all these factors (reflecting the highest risk contract) would not necessarily be a suitable starting point for step 2, which starts at a neutral point position intended to allow for further upward or downward adjustment for risk.
  - d. We must balance the following competing evidence:
    - The profitability of the major defence contractors is hard to distinguish from both the comparator group and the range of profit rates available under the regime, which indicates the approach is working.
    - Claims from industry that the work of defence companies is more complex and risky than the comparator group and therefore that the BPR is understated.
    - Industry's own assessment of comparator companies which are relevant to defence sector shows that they tend to be less profitable on average than the remainder of the comparator group.
- B.29 The SSRO's current priorities in respect of profit are to:
- a. establish an appropriate response to COVID-19 for the purpose of the 2022/23 profit recommendation; and
  - b. facilitate the implementation of the changes to legislation arising from the Secretary of State's review.
- B.30 We will consider the priority to be given to further considering the descriptions of the activities in qualifying contracts as part of our corporate planning.
- Comparator company size threshold*
- B.31 The BPR methodology requires that a company must have data that demonstrates it meets the following criteria for all of the last five years to qualify as a comparable entity:
- a. an annual turnover of more than £10.2 million; and
  - b. either total assets worth more than £5.1 million or 50 or more employees on average.

- B.32 Industry representatives raised concerns that this threshold allows for the inclusion of companies that:
- a. are not consistent with the size and complexity of UK MOD single source work;
  - or
  - b. would not be of sufficient size to hold a qualifying contract with the MOD.
- B.33 The SSRO's aim is to create a BPR that can be used for all qualifying contracts irrespective of size. Approximately 40 per cent of qualifying contracts have an estimate price of £10 million or less, and the majority (approximately 70 per cent) no more than £40 million. Much larger contracts are less common, although they account for the majority of single source contracting by value. We see no good reason to exclude smaller companies from the comparator group to increase the relative representation of larger ones. We have also not seen any compelling evidence that suitable rates of profit cannot be achieved for larger contracts under the regulatory framework.
- B.34 Our main criteria for selecting a company for inclusion into a comparator group is whether it undertakes activities which can be likened to those that contribute to the delivery of qualifying contracts. We do not seek to judge whether or not the MOD may or may not choose to place a qualifying contract with the company due to its size, or for any other reason, because:
- a. company size has not been shown to be a reliable indicator of the activities we specify;
  - b. it would involve the SSRO making a judgement about how the MOD might choose to contract in hypothetical circumstances based on an arbitrary threshold; and
  - c. we can find no evidence that the MOD would be precluded from placing a qualifying contract with a company of any size, although we acknowledge it would consider the economic or financial standing of a contractor as part of the procurement process.
- B.35 Concerns were also raised about the presence of owner-managed entities that may pursue accounting approaches not suitable for our analytical purposes. We are confident that the SSRO's company search criteria excludes unsuitable owner-managed entities. We are happy to review any examples of concern brought to our attention.

### *Capital structure*

- B.36 The profit rate of each comparator company is adjusted in proportion to the ratio of fixed and working capital employed to costs of production. This is a measure of the capital intensity of each company. A corresponding adjustment is made in the pricing of individual contracts by an adjustment at step 6 of the contract profit rate to reflect the capital intensity of the contract. The SSRO issues guidance to establish the appropriate capital servicing adjustment (CSA) for each contract. This process is intended to ensure that the contract profit rate reflects an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purposes of enabling the contractor to perform the contract.

- B.37 Industry representatives noted that the average CSA for a qualifying contract is closer to the aggregate effect the CSA has on the D&M comparator group than on the P&M group. They expressed concerns that this difference indicated QDCs could be likened to D&M-type work more than to P&M-type work and this was a comparability issue.
- B.38 Table B-2 shows the reduction on the BPR and on the D&M and P&M activity types due to the application of the CSA. The bottom row shows the mean average and range of CSAs applied to qualifying contracts for each financial year, taken from the SSRO's statistical bulletins.

**Table B-2: Capital servicing adjustments in the calculation of the baseline profit rate and in qualifying contracts**

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
<b>Reduction in P&amp;M rate due to CSA</b>	-2.01pp	-2.67pp	-1.55pp	-1.79pp	-2.15pp	-1.65pp
<b>Reduction in D&amp;M rate due to CSA</b>	-0.91pp	-1.23pp	-1.03pp	-0.92pp	-0.98pp	-1.15pp
<b>Reduction in BPR due to CSA</b>	-1.46pp	-1.95pp	-1.28pp	-1.35pp	-1.57pp	-1.40pp
<b>Min/average/ MaxCSA in qualifying contracts</b>	0pp 1.18pp 4.3pp	0pp 0.80pp 2.6pp	0pp 1.03pp 4.4pp	-0.3pp 1.12pp 4.4pp	0pp 1.05pp 4.9pp	-

Sources: SSRO Activity type fact sheets, SSRO Annual qualifying defence contract statistics: 2020/21

Notes: The contract analysis reports on all contracts which became QDCs/QSCs between 1 April 2015 and 31 March 2021, and that have submitted reports on or before 30 April 2021. The contract profit rate data is sourced from the latest available Contract Pricing Statement. The mean average CSAs are an arithmetic mean of the reported amounts reported by QDCs/QSCs within that financial year.

- B.39 Table B-3 shows the CSA applied to the profit data for a range of defence suppliers and the median average adjustment for companies in each activity type. The median CSAs for each activity type in Table B-3 should not be confused with the difference between the median profit rate with and without the CSA applied, which is shown in Table B-2.

**Table B-3: Capital servicing adjustments of defence suppliers**

Name	Capital servicing adjustment in the 2021/22 underlying rate calculation
QinetiQ Group PLC	-1.10%
Rolls-Royce Holdings PLC	-0.99%
Babcock International Group PLC	-0.87%
Northrop Grumman Corporation	-0.83%
Raytheon Technologies Corporation	-0.73%
General Dynamics Corp	-0.67%
Airbus SE	-0.65%
Safran	-0.57%
Boeing Company (The)	-0.54%
Lockheed Martin Corp	-0.51%
Ultra Electronics Holdings PLC	-0.48%
Leonardo - Finmeccanica S.P.A.	-0.41%
Vinci	-0.41%
BAE Systems PLC	-0.37%
Thales	-0.28%
Serco Group PLC	-0.22%
Jacobs Engineering Group INC	-0.13%
Comparator group	Median CSA of comparators
Develop and make	-0.83%
Provide and maintain	-1.29%
Ancillary services	-0.26%
Construction	-0.16%

Source: Orbis, SSRO calculations

Notes: The comparator groups include profit-making companies in the 2021/22 comparator groups.

- B.40 We believe an appropriate way to establish comparability is to directly examine the activities that the companies undertake. Both single source defence contractors and the comparator group companies display a broad range of capital structures. We consider it is unreliable to infer comparability from this data, because of a lack of conformity in capital servicing for defence contractors and it is an approach we do not intend to pursue. The approach we take is to adjust the calculation of the BPR and provide guidance for the step 6 adjustment which allows for differences in the relative share of capital employed to cost of productions (capital intensity) to be reflected in the profit rate. The CSA mitigates against any concern that contracts will have inappropriate rates of profit where companies have diverse capital structures.

- B.41 We do not consider that the BPR methodology would be improved if the average CSA for QDCs tends toward the average for one comparator group or another. This is because:
- There is little conformity in the CSA's of defence contractors, nor do they closely associate with the activity type which is most relevant to their work. This suggests the CSA is a poor comparability indicator.
  - The range of CSAs of D&M and P&M companies' qualifying contracts overlap significantly, which is not captured when comparing aggregate effects.
  - Differences in the CSA deduction in the BPR and additions in contract profit rates demonstrate that the adjustment accounts for differences in capital intensity.
- B.42 We do not believe it would be beneficial to identify comparators by reference to CSAs achieved under qualifying contracts. Our preference is to accept different capital structures are present in the comparator group and to follow the current approach of removing an average amount for capital servicing, given that the CSA allows a contract-specific contribution to contract profit rates.

### Data

- B.43 The BPR is a composite rate derived from two separately defined activity types: P&M and D&M. Calculating the composite rate involves combining data on actual profits earned by companies assessed as performing the specified activities. The SSRO's approach is:
- The median of the set of capital servicing adjusted profit rates for each activity group (D&M and P&M) is calculated and used as an underlying rate for that activity group.
  - For each activity group, the mean of the current year's underlying rate and the underlying rates for the two prior years is calculated. This results in a three-year rolling average profit level indicator for D&M and another for P&M.
  - The composite rate, or BPR, is the mean average of the two three-year rolling averages.

### *Averaging and weighting of data*

- B.44 Industry have made representations to the SSRO that the profit data should be reweighted in proportion to the relative cost base associated with each company's rate of profit, and the mean average of the reweighted data calculated (referred to as the weighted average hereafter). They argued this was an appropriate measure of profit and challenged the SSRO's approach of calculating the median of the rates of profit of each comparator company identified in an activity type. They also noted the mean could be skewed by profit rate outliers.
- B.45 The reasons cited for the weighted mean being appropriate were:
- the size of a company is relevant to profitability and should be taken into account;
  - weighting company profits on the basis of company size gives more prominence to companies that can be likened to the MOD's major single source contractors, and less to others; and

- c. each pound sterling of cost should have equal weight in the calculation because it is representative of the return where much of the investment is made.
- B.46 Emphasising the profitability of the contracts with the largest cost base does not achieve size comparability with QDC suppliers. The MOD's single source suppliers are diverse in size and are often smaller than the non-defence companies in the comparator group. Further, suppliers for whom single source MOD work represents a material proportion of their revenue are not necessarily the largest.
- B.47 We do not accept the proposition that each pound sterling of profit should be given equal weighting for the following reasons:
- a. Mark-ups on cost do not measure the return achieved on an investment.
  - b. The SSRO's methodology measures profit by reference to the revenue and cost of aggregated activities of the comparator group. We consider this to be a more realistic representation of how profits are actually earned.
- B.48 We do not believe that weighting company data in proportion to the cost base is appropriate because:
- a. It would place the greatest emphasis on the profits of companies who are not similar in size to most single source defence contractors.
  - b. The relative size of the largest comparators would result in the BPR being significantly influenced year on year by circumstances of a small number of companies.
- B.49 It is worth considering whether company size influences comparability, beyond any contribution to the company's activities, such that companies of certain size should be emphasised over others in calculating the BPR. For example, the profits of company may be influenced by its size due to:
- a. Economies or diseconomies of scale – a company may experience relative cost advantages or disadvantages depending on its size.
  - b. market power – the extent to which a company may influence profit may be a function of its size, in so far as this may confer them a dominant market position.
- B.50 It is not apparent however that either of these considerations would lead to the conclusion that the calculation should be weighted towards the largest companies. Market power is something that should not be emphasised (and makes the case for the inclusion of smaller companies). Neither can it be the case that only the largest companies are those that are at or close to their minimum efficient scale.
- B.51 We agree with industry's assessment in respect of the mean average, to the extent that we consider the mean average to be a measure of central tendency that is not robust to the presence of outliers. We believe this provides a strong case to not use the mean irrespective of whether the data is re-weighted or not.



### *Treatment of outliers*

- B.52 In data analysis, an outlier is a data point that differs significantly from other observations in the dataset. In our BPR supporting analysis, we consider the effect of two types of potential outliers:
- a. Profit outliers – companies whose profit rates are distant from what is typically observed in the comparator group.
  - b. Size outliers – companies whose size is distant from what is typically observed in the comparator group.
- B.53 Outliers are of concern to the SSRO as they can influence the analysis in a way that gives a false representation of the character of the underlying data. In this instance the characteristic of interest is the central tendency of the range of profit rates of comparator companies.
- B.54 The profit methodology excludes loss-makers and places a lower threshold on company size but does not place an upper limit on profit or size, which may allow for outliers to be present in the data. The comparator group data includes:
- a. a relatively small number of companies with profit rates much higher than the remainder of the comparator group; and
  - b. a relatively small number of companies that are much larger than the remainder of the comparator group.
- B.55 These observations are consistent with the presence of outliers. For this reason, the SSRO favours adopting analytical approaches which are robust to outliers, rather than seeking to classify and treat them directly, for example by removing them.
- B.56 Industry representatives contended that:
- a. They did not see the relevance of including profit outliers, because calculation of the median rate of profit does not account for company size.
  - b. Large companies and highly profitable companies are not ‘outliers’ and it may be that their performance should be duly considered by using the weighted mean, which would: place less weight on profit rates of small companies; and place more weight on profit rates of large companies.
- B.57 The SSRO does not seek to take into account company size in its calculation of the profit level indicator of the comparator group. We have demonstrated in our previous analyses (which we have shared with industry) that company profitability and size are largely unrelated. We use the median as an indicator of central tendency and do not place an upper limit on profit. In so far as the median diminishes the influence of profit outliers on the result, this is consistent with our analytical aims.



- B.58 We are also not seeking to emphasise or de-emphasise the profits of companies based on size for the reasons set out above. Profit outliers are of concern to us irrespective of company size; analytical methods which amplify their effect should be avoided, and those that diminish their effects pursued. Our analysis of the comparator group data shows that:
- The companies with profits in the highest 1% have the effect of overstating the central tendency of profitability where the mean is used, but have little effect on the median and the weighted mean.
  - The companies within the highest 1% of size have the effect of understating the central tendency of the data where the weighted mean is used but have little effect on the mean and median.
  - The central tendency measured by the median is the least sensitive to the presence of the highest 1% most profitable and largest companies.
- B.59 These results are consistent with expectations given the characteristics of each statistic and the data. They support the median as the most appropriate measure of central tendency for the data we use for the BPR assessment.

#### *Conjoining of data sets*

- B.60 Industry representatives challenged the approach to conjoining the D&M and P&M data, considering that it gives both groups equal weight in the calculation, thereby giving the P&M group, which has fewer companies, more weight than the D&M group. They questioned if the SSRO considered that half the value of qualifying contracts are D&M and half are P&M. As an alternative, they suggested an approach whereby the data from both the P&M and D&M groups is pooled into a single data set prior to the averaging process. Table B-4 shows the SSRO's calculations for the 2021/22 rates.

**Table B-4 – Combination of activity groups to derive the composite rate**

	Underlying rates			3-year average
	2019/20	2020/21	2021/22	2021/22
Develop and make	7.86%	8.69%	8.13%	8.23%
Provide and maintain	9.14%	7.77%	8.25%	8.39%
				<b>Composite 8.31%</b>

- B.61 The SSRO's approach is based on the following considerations:
- the median is the most robust measure of central tendency of the data on company profits;
  - D&M and P&M exist as two distinct and separate activity types with different profitability characteristics;
  - the aim is to recommend a rate applicable to a range of contracts that have significant elements of the D&M and P&M activity types; and
  - calculating a single BPR should not be unduly affected by differences in the population of each activity type.
- B.62 The SSRO does not rely on D&M and P&M being found in equal measure, or any other proportion, on QDCs and QSC. We think that more granular weighting would not be meaningful. Our approach is to identify activity types which we believe are present in substantial amounts in QDCs and QSC and include them on an equal footing. If we observe that activities are not typically present, they are not included at all in our calculation (for example, ancillary services or construction activities). We consulted on the activity descriptions in 2015, 2016 and 2019 and considered feedback from stakeholders when developing the activity characterisations currently in use. Industry representatives have confirmed our D&M and P&M descriptions as being generally correct against the landscape of defence contracting. We consider the approach we take to be at the appropriate level of granularity given the reliability of judgements around weighting, the requirement for a single BPR for non-governments contracts and the ability to adjust for contract-specific differences via the 6 steps.
- B.63 In performing our company search we seek to identify all relevant companies operating in the specified geographic region. We know from our analysis that fewer companies engage in P&M type activities than D&M. Our concern with industry's suggestion of pooling data is that it would make the BPR sensitive to the prevalence of a particular activity in the wider economy, which we do not see as a factor which should be emphasised in determining a reasonable rate of profit for qualifying contracts. Table B-5 shows the calculation of a three-year average profit rate by pooling the D&M and P&M data used in the 2021/22 BPR assessment into a single group of companies. By pooling data, the effect of typically higher rates of profit in P&M companies (see the 2021/22 underlying rates presented in Table B-4) are offset by the lesser number of companies who tend to perform such work. We do not consider the prevalence of work in the wider economy as a comparability factor. It would not be consistent with our statutory aims of value for money and fair and reasonable profit to recommend a BPR which incorporated those effects.

**Table B-5 – profit rates of a pooled data set**

	Underlying rates			3 year average 2021/22
	2019/20	2020/21	2021/22	
Composite (Pool) (D&M; P&M)	7.88%	8.52%	8.19%	8.20%

## Measures of profit

### *Background*

- B.64 In transfer pricing, transactional margin methods examine the profit arising on controlled (e.g. intra-group) transactions and establishes if they are appropriate with reference to comparable uncontrolled transactions (e.g. comparable transactions made by independent enterprises). The SSRO applies these concepts to establish an appropriate rate of profit for a transaction, in our case a qualifying contract.
- B.65 The transactional net margin method examines a net profit indicator relative to an appropriate base. Selecting the appropriate net profit indicator and the appropriate base are important choices. The SSRO examines operating profit relative to operating costs. The choice aligns with the construct of the pricing formula, which is a mark-up on all costs appropriate, attributable to the contract, and reasonable in the circumstances.

### *Treatment of accounting entries relating to acquisitions*

- B.66 Industry representatives consider there are costs included in the operating costs of comparator companies that are not relevant for qualifying contracts, and submit the SSRO should identify a different net profit indicator that excludes those costs. The costs in question are those that arise in consolidated financial statements as a result of acquisition accounting:
- a. amortisation and depreciation of fair value adjustments made to the amortised historic cost of acquired assets at the time of acquisition; and
  - b. impairment and, where applicable, amortisation of goodwill assets that are recognised on acquisition.
- B.67 Industry representatives argue that:
- a. these amounts are abnormal accounting entries that represent an expectation of future profit rather than being costs incurred by the group;
  - b. the use of consolidated group accounts does not satisfy the requirements of the transfer pricing guidelines, which suggest transactional analysis;
  - c. acquiring other businesses is not within scope of the goods or services acquired by the MOD under qualifying contracts;
  - d. these accounting entries only appear in consolidated financial statements therefore they cannot be brought in as a cost on a qualifying contract, which is held by an individual legal entity; and
  - e. therefore, some costs associated with acquiring other businesses should be removed from the cost base of comparator companies when the SSRO is assessing the baseline profit rate.

*Response: Nature of the accounting entries*

- B.68 When a group acquires another company, the assets and liabilities acquired are initially recognised on the balance sheet at values that, in total, sum to the total consideration paid to acquire them. Some company valuation methods are based on expectations of future profit, but other methods take a different approach. Ultimately, the assets recognised and any subsequent costs when they are written down represent the actual amount that was incurred to purchase the assets. We do not accept the view that acquisition accounting entries are abnormal; rather, they represent the broad consensus of the accounting profession on how to best provide information about:
- a. the economic resources of the reporting entity (in this case a group of companies), claims against the entity and changes in those resources and claims; and
  - b. how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources.<sup>15</sup>
- B.69 Where a comparator company has subsidiaries, the consolidated financial statements are the appropriate financial information to use because they reflect the activities performed by the whole group. It is the whole group that is being assessed against the SSRO's activity characterisations.

*Response: OECD guidelines and transactional analysis*

- B.70 The OECD guidelines recognise that there are often insufficient public data to allow for net profit indicators to be determined at a transactional level.<sup>16</sup> In the case where the comparable uncontrolled transaction is company-level or group-level data the functions performed by the company or group in its total operations must be closely aligned. The financial data we use in respect of comparator companies that have subsidiaries is the accounting information of the entire corporate group, and it is the whole group that is being assessed against the SSRO's activity characterisations.

*Response: acquiring other businesses and the scope of goods or services acquired by the MOD under qualifying contracts*

- B.71 We disagree that acquiring other businesses is irrelevant in the context of qualifying contracts. Acquiring ownership, control or use of the assets required to deliver a qualifying contract is an essential component of enabling the performance of the contract. If the assets acquired are needed to perform the contract, then the costs and benefits of the acquisition should be considered.

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<sup>15</sup> For example, refer to the IFRS Conceptual Framework for Financial Reporting

<sup>16</sup> OECD TPG, Chapter II paragraph 2.109

- B.72 In carrying out a functional analysis the transactions to be tested (in our case qualifying contracts) must be understood and the component aspects identified and sought in comparable companies. Mergers and acquisitions are a widespread feature of the defence industry, of companies that hold qualifying contracts, and of activities carried out under qualifying contracts. We observe that:
- a. many contractors have been acquired by larger groups or have acquired other companies themselves;
  - b. many contractors operate within larger corporate groups and benefit from the synergy and other efficiencies that come with that approach to corporate growth; and
  - c. a contractor's group may provide a parent company guarantee for the work carried out by the contractor.

- B.73 It is important that the comparability analysis we are carrying out takes account of the assets used and risks assumed, including how those functions relate to the wider generation of value of the entity to which the contracting parties belong, the circumstances surrounding the transaction, the business strategies pursued by the parties, and industry practice. To exclude activities associated with acquiring other businesses would be to ignore an important feature of qualifying contracts.

*Response: Accounting entries that only appear in consolidated financial statements*

- B.74 SSRO guidance does not say that costs associated with acquisitions cannot be an Allowable Cost, nor do we require that accounting information used to determine Allowable Costs is reported in accordance with particular accounting standards. Our guidance says that "...contracting companies may adopt a variety of accounting policies and make judgements in the preparation of financial statements for statutory reporting purposes (for example, International Financial Reporting Standards and UK Generally Accepted Accounting Practice). Application of these policies to QDCs will not necessarily result in costs charged satisfying the AAR principles and contractors must have regard to this guidance".
- B.75 Costs associated with acquisitions should be considered as part of the assessment of the Allowable Costs of a contract, and not recovered through higher rates of profit. Failing to recognise operating costs incurred by a company as a cost in the BPR calculation (for example by using earnings before interest, taxes and amortisation (EBITA) as the profit level indicator) would increase contract prices without the need to consider if an acquisition had occurred that should be reflected in the allowable costs.
- B.76 Stakeholders have told us that costs associated with acquisitions are generally indirect, or overhead costs. We are investigating the application of the Allowable Costs guidance to the rates setting process as part of the overheads project and anticipate that this feedback will influence guidance changes that are being developed as part of that project.

*Response: costs associated with acquiring other businesses should be removed from the cost base of comparator companies when the SSRO is assessing the baseline profit rate*

- B.77 As set out above we disagree with the feedback raised by industry representatives. We also disagree with the remedy they propose, which is that the costs that arise in consolidated financial statements as a result of acquisition accounting are removed from the cost base of each comparator company.
- B.78 The costs highlighted are only part of the financial consequences of acquisition. When a company is acquired it becomes an integral part of a group's operations and the acquisition will have broad effects on the financial performance of the group. An acquisition will provide opportunities for revenue growth, diversification of risk, and economies of scale. Any assessment of the impact on financial performance as a result of mergers and acquisitions would need to consider all aspects of acquisition, not just a narrow aspect of the acquisition costs. We do not accept that it would be reasonable to assess the appropriate profit rate on the basis of the costs and revenues remaining after part of the costs of acquiring assets are deleted.

*Gains and losses on disposal*

- B.79 The SSRO uses operating costs as the basis for the calculation. Industry representatives have submitted that operating profit/loss (OPPL) from the Orbis database includes write-offs and impairment but excludes the sale of operations, and that this is inappropriate.
- B.80 The figures the SSRO uses for each company are:
- a. the "Operating Profit"; and
  - b. the "Operating Costs" = "Sales" – "Operating Profit"
- B.81 Both figures are taken as they are reported in the "global standard view" of the Orbis database, and the definitions of these figures are shown in Table B-6.

**Table B-6 – Definitions of financial fields in the Orbis database**

Profit and loss account			
OPRE	Operating Revenue (Turnover)		Total operating revenues (Net sales + Other operating revenues+ Stock variations). The figures do not include VAT. Local differences may occur regarding excises taxes and similar obligatory payments for specific market of tobacco and alcoholic beverage industries
TURN	Sales		Net sales
COST	Cost of Goods Sold		Cost of sold goods, production, services. Costs directly related to the production of the goods sold + depreciation of those costs
GROS	Gross Profit	OPRE - OST	Operating revenue - Cost of goods sold
OOPE	Other Operating Expenses		All costs not directly related to the production of goods sold such as commercial costs, administrative expenses, etc. + depreciation of those costs
OPPL	Operating P/L [=EBIT]	GROS - OOPE	EBIT. All operating revenues - all operating expenses (Gross profit-Other operating expenses)

- B.82 The data in Orbis is derived from many different sources, which collate information reported in company financial statements. Operating profit and operating costs are not universally defined by accounting standards, and so are not universally reported in company financial statements. Financial information is mapped to the headings shown in the 'global standard view' by the data provider.
- B.83 Industry representatives are correct that, in general, gains and losses recognised when assets are held for sale, and any further gains and losses on the date of disposal, are not included within OPPL, and so are not included in the profit measure the SSRO uses to determine the BPR.
- B.84 The SSRO is content that these amounts are not included in the analysis. The overarching purpose of our analysis is to find comparable companies carrying out comparable activities and to observe the profit rates of those activities. It is consistent with that aim that profits and losses associated with disposing of assets (which by definition are no longer used to carry out the activities we are measuring) are excluded from the assessment. We observe that these adjusting entries are generally small and consider that relying on the Orbis standardisation process to remove them is sufficient.



### *Disallowed costs*

- B.85 Acquisition accounting issues are discussed above, but industry representatives have also told us that they think similar issues arise with costs that are incurred in the performance of qualifying contracts but are “disallowed costs”<sup>17</sup>, and that the SSRO should examine a different net profit indicator that excludes those costs. Such costs include:
- a. costs the SSRO’s guidance explains are generally not allowable, for example the funding of defined benefit pension scheme deficits, redundancy costs in excess of the statutory levels, costs incurred on unsuccessful bids, some sales and marketing costs, entertainment costs, faulty workmanship, and damages for breach of contract; and
  - b. costs where it may be difficult to demonstrate the requirement to be attributable to the contract, for example some overhead costs.
- B.86 Industry representatives told us that disallowed costs were likely to have an immaterial impact on the BPR result, but that they demonstrate inconsistency in the SSRO’s approach.
- B.87 The legislation allows for any cost that meets the requirements of being appropriate, attributable to the contract and reasonable in the circumstances to be an Allowable Cost under a qualifying contract. The guidance explains that some costs are generally not allowable, on the presumption that they could only be demonstrated to be appropriate, attributable to the contract, and reasonable in the circumstances (AAR) in very limited circumstances. However, each cost should be assessed on its merits and the guidance does not state that costs which are generally not allowable are never allowable. If a cost does not meet those requirements, then it should not be (or have been, in the case of a contract priced using actual costs) incurred in the delivery of the qualifying contract. Challenges in respect of demonstrating certain costs meet the requirements of Allowable Costs should be addressed directly, and not circumvented by manipulating the BPR.
- B.88 We believe that our approach achieves fairness and consistency in that the costs of comparators and the costs of qualifying contracts may both be considered AAR in relation to their own particular circumstances. The SSRO uses operating costs the contract incurred that relate to the revenue each comparator company receives. The SSRO does not make any adjustments to the comparable company data to take into account costs that may hypothetically fail requirements of being Allowable Costs in a qualifying contract. We do not consider it possible to reliably make an assessment of those costs, or to make corresponding adjustments to comparator company’s other financial results (such as revenue and balance sheet items) to reflect the company’s position as if the specific cost which industry would like to see removed had not been incurred.

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<sup>17</sup> Our understanding of the terms “disallowed costs” is that it seeks to describe costs which a contractor claims meet the requirements of Allowable Costs, but that the MOD consider the claim unproven and therefore the cost claimed does not enter into the price of a qualifying contract.

