SSRO

Single Source
Regulations Office

Single source baseline profit rate methodology

Consultation on changes for the 2023/24 rates assessment

June 2022

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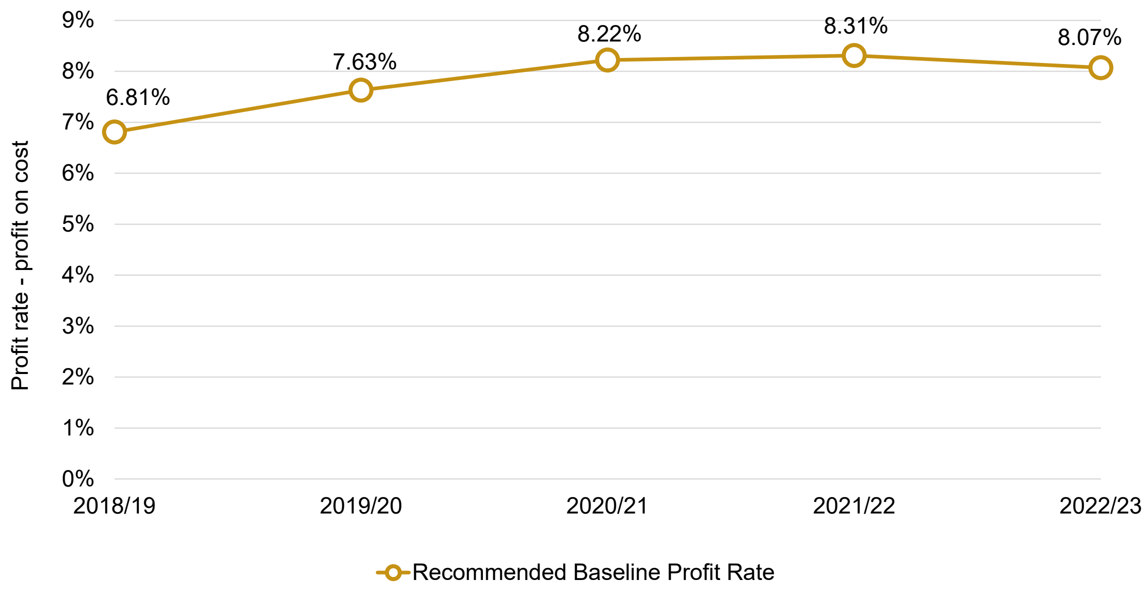
1. Introduction

1.1 Section 19(2) of the Defence Reform Act 2014 (the Act) requires the Single Source Regulations Office (SSRO) to provide the Secretary of State with its assessment of the appropriate baseline profit rate, capital servicing rates, and SSRO funding adjustment ("rates") by 31 January each year. The SSRO's approach to calculating its assessment is set out in its *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology* ("the methodology")[1].

1.2 The SSRO's methodology involves calculating a return on cost based on functional comparability in line with the OECD's transfer pricing principles. We first adopted such an approach for the 2016/17 rates recommendation and have maintained it in subsequent years, while keeping the methodology under review and making appropriate updates.

1.3 We applied the methodology for the 2022/23 rates assessment, giving particular attention to the effects of the COVID-19 pandemic. The 2022/23 baseline profit rate (BPR) recommendation used a four-year average of the underlying annual rates, rather than the usual three, with the aim of removing heightened variability in the underlying data which is used in the BPR assessment. Figure 1 shows the BPRs the SSRO has recommended since 2018/19. We stated our intention to consult on the averaging approach ahead of the Board making a decision on the approach for assessing the 2023/24 rates.

Figure 1 – Recommended baseline profit rates (2018/19 – 2022/23)



1 https://www.gov.uk/government/publications/2022-contract-profit-rate-recommendation

1.4 In determining the rates for 2022/23, the Secretary of State went further than the SSRO to remove the effects of COVID-19 by using the average of the three years prior to 2021 as the BPR. This resulted in the BPR at the same level as in 2021/22. In a written statement to Parliament, the Minister for Defence Procurement said:

"I have asked the SSRO to engage with industry and my officials in returning (next year) to a market based benchmark based on their established methodology that reflects my intention to remove the impact of Covid-19."[2]

1.5 The SSRO aims to reflect the Secretary of State's intent and consider other stakeholder views in developing proposals for delivering the 2023/24 rates assessment. The objective for the 2023/24 rates assessment is, as in past years, to recommend predictable stable rates that support value for money for the government in its expenditure on qualifying defence contracts and fair and reasonable prices for contractors.

1.6 This consultation aims to support delivery of the Secretary of State's intent, and seeks input on proposals for the 2023/24 rates assessment, which we will consider before deciding our approach. **The SSRO invites all interested parties to respond to the consultation by 16 August 2022.**

1.7 We will be consulting on the BPR from 20 June to 16 August 2022. Our Stakeholder Engagement Strategy contains five priorities, one of which is to improve the experience of stakeholders participating in our consultations. As part of this we said that "we will try to avoid consultations during the Summer and Christmas holiday periods or provide additional time for responses where that is not possible". The consultation period runs over the Summer. We are holding the consultation on the dates above because it is the earliest opportunity for it to be held, and allows sufficient time to respond to stakeholder views and deliver the recommendation by the statutory deadline. To mitigate this, we are holding a workshop on 30 June 2022, at which we will discuss the consultation; explain our thinking; and an opportunity for us to hear stakeholders' views. We are happy to arrange bilateral meeting(s) for those stakeholders who are unable to attend the workshop, or for those who are unable to provide a written response.

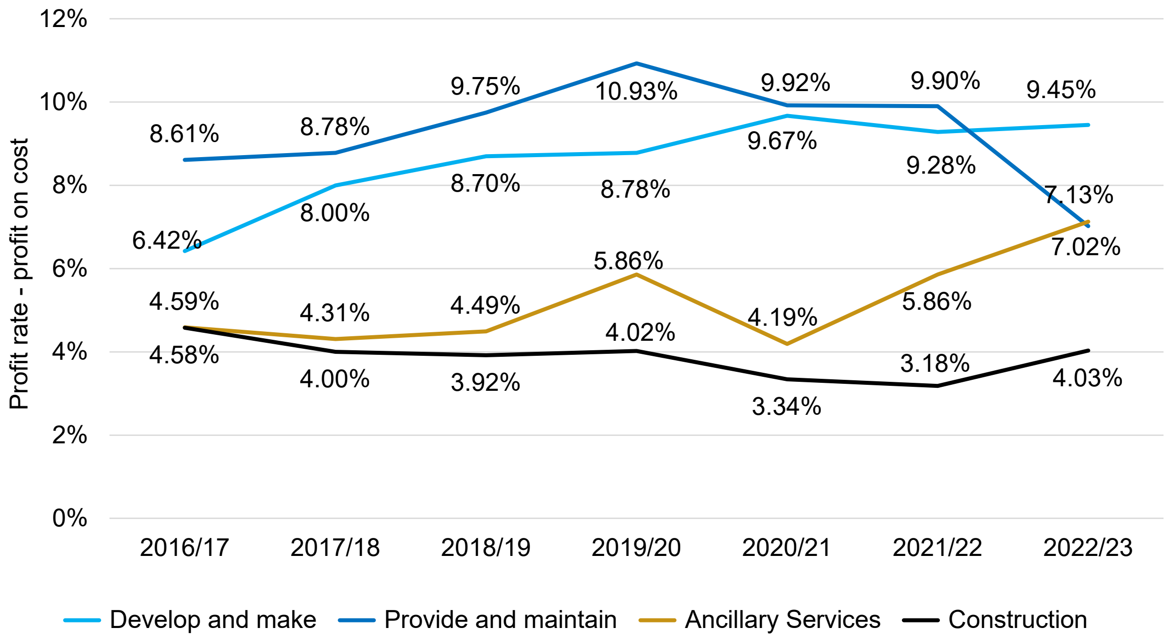
2 https://questions-statements.parliament.uk/written-statements/detail/2022-03-28/hcws726

2. The 2022/23 rates assessment, recommendation and determination

2.1 The BPR is an average of the profit rates of groups of companies carrying out the types of activities that contribute to the delivery of qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). The SSRO identifies comparable companies through a selection process that follows transfer pricing principles. The methodology has been applied since the 2016/17 rates recommendation, with some modifications in the assessment years that followed.

2.2 In carrying out the 2022/23 assessment, we recognised the potential for the COVID-19 pandemic to have an impact on company activities in the relevant year of data (FY2020).[3] Potential impacts from the pandemic included periods of inactivity, reductions in demand, and supply constraints. We supplemented our process for identifying comparator companies with additional data fields and financial indicators to ensure that the comparator groups constituted only companies that continued to undertake comparable activities. We identified and excluded companies that would normally have been suitable comparators but undertook non-comparable activities due to the pandemic. This included companies that suffered significant periods of inactivity or spent the period doing different activities from the work undertaken in QDCs or QSCs.

Figure 2: Activity type median profit rates (2017-2023) – unadjusted for capital servicing



3 FY2020 means the latest year ending on or before 31 March 2021 that is addressed by the financial statements of each comparator company. For most comparator companies this is the year ended 31 December 2020 but some company financial statements cover different time periods, for example the year ended 31 March 2021, or the year ended 30 June 2020.

2.3 Figure 2 shows the median profit rates of comparator companies for 2022/23 (based on FY2020 data) year compared with those from prior years. Aggregate changes in cost and revenue for each company result in the year-on-year movement in profit rates shown. Our use of the median, removal of loss makers, and time averaging all help remove variability in rates of profit in a single year, of which COVID-19 we believe was a driver for FY2020. For that year, around 60 per cent of the comparator companies in both the develop and make (D&M) and the provide and maintain (P&M) groups which make up the BPR, experienced reductions in revenue compared to the previous four-year average. Relatively fewer P&M companies also saw reduced costs compared to D&M companies. Consistent with this, we found that in FY2020, the median profit rate for the D&M group increased whereas that for P&M group declined. The median profit rates for the ancillary services and the construction groups also increased, although these are not used in the BPR calculation.

2.4 Before making its 2022/23 recommendation, the SSRO considered the appropriateness of the BPR in light of the data it had analysed. We considered the stabilising features of the methodology, which mitigate the impact of transient shocks or differential impacts on individual companies and allow for changes in profitability to be reflected in the BPR over time in a predictable and measured way.

2.5 The BPR that we recommended for 2022/23 was based on a four-year average of the underlying annual rates. Changing the averaging period from three to four years increased the influence of stable historical trends on the result while preserving the BPR’s ability to reflect new trends going forward. It allowed for the possibility that the 2022/23 assessment could be indicative of a longer-term deviation from the past. The result was a recommended BPR of 8.07%, compared to 8.31% in the prior year. We undertook to consult on the averaging approach for 2023/24.

2.6 The Secretary of State determined that FY2020 data should not feature in the calculation of the rates for 2022/23 and set the BPR and CSRs to remain at the level of the rates for 2021/22. As set out at paragraph 1.4 above, when announcing the rates the Secretary of State asked the SSRO to engage with stakeholders on a return to a market-based benchmark using the SSRO’s established methodology, while reflecting the intent to remove the impact of COVID-19.

3. The 2023/24 rates assessment

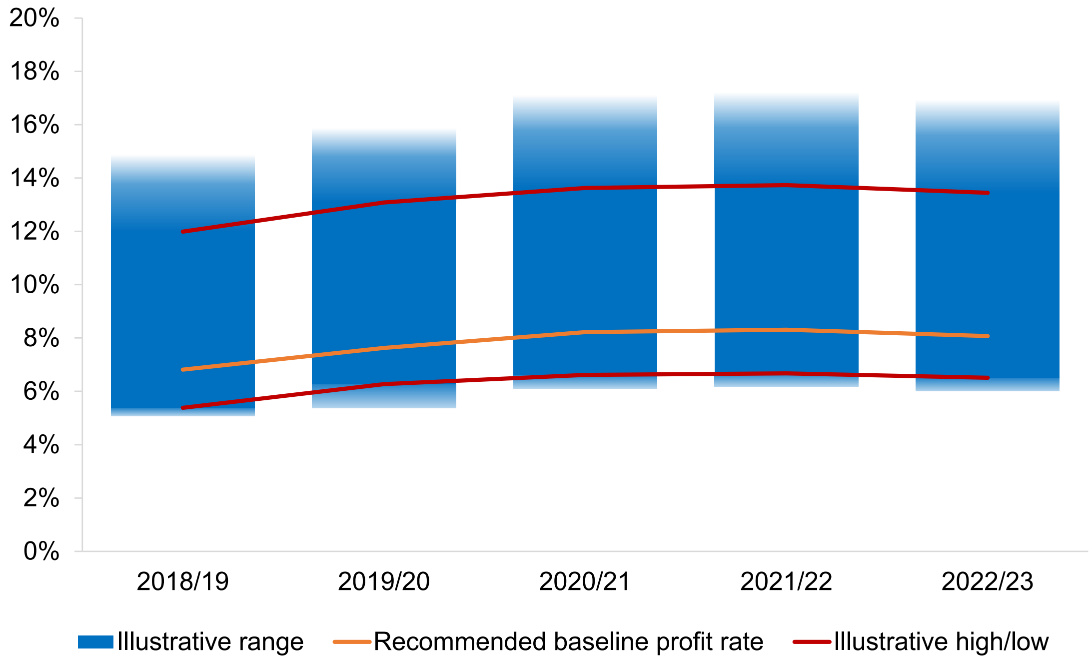
3.1 We have considered delivering the Secretary of State's intent in developing proposals for the 2023/24 rates assessment. The proposals do not depart from the fundamentals of our methodology, and consider the issues that will need to be addressed:

- The inclusion of individual company data in any one year
- The inclusion of all data over a specific period
- The approach to combining multiple years of data into a single rate

Time period and averaging

3.2 Our assessment of the appropriate BPR involves taking an average of the underlying rates across several years. We do not predict the market conditions in which the BPR will be applied, but by taking an average across years, we balance the risk of the BPR being out of step with fair market rates which can rise and fall over time. In practice, this is done by including the rate based on the most recent company data but also giving weight to previous years' underlying rates. The regime also provides for a range of adjustments to the BPR to ensure the parties can agree a fair rate of profit reflecting the circumstances of the contract. This is shown in Figure 3.

Figure 3 – Range of contract profit rates



3.3 The SSRO has, historically, applied a three-year average. In the 2022/23 rates recommendation, the SSRO applied a four-year average, which gave one-quarter weight to FY2020. This change increased the influence of stable historical profit trends relative to transitory effects (positive or negative). It preserved the SSRO's ability to reflect new trends going forward, for example if the 2022/23 assessment proved to be short-lived or indicative of a longer-term shift from the past.

3.4 We consider the averaging approach and the inclusion or exclusion of data can be suitable ways to remove the transitory effects of COVID-19. The approach applies alongside the other measures already built into the methodology (such as the review of company activities and removal of loss makers) which we have used in the past assessment years to filter out companies which do not meet specified criteria.

3.5 We have set out three examples of averaging period scenarios in Table 1 using the SSRO's methodology. The examples include the SSRO's pre-2022/23 rates assessment approach (Scenario 1), and the approach taken by the SSRO for the 2022/23 rates recommendation (Scenario 2) which are inclusive of FY2020 and FY2021 data, both of which may reflect the period of the pandemic. The pandemic period data is included on the basis that in the event FY2021 data shows a pandemic related spike in profit rates, averaging through 2020-21 may help remove a COVID-19 induced variability in the BPR.

3.6 Scenario 3 is included on the basis that the Secretary of State removed FY2020 from the 2022/23 rates determination. It would continue to exclude FY2020 in line with the Secretary of State's determination in 2022 but would return to the SSRO's methodology by using data from FY2021.

Table 1: Averaging scenarios for applying the SSRO's methodology

BPR averaging scenario	Number of averaging years	Reporting years included in the average				
		FY2017	FY2018	FY2019	FY2020	FY2021
1	Three			✓	✓	✓
2	Four		✓	✓	✓	✓
3	Three		✓	✓		✓

3.7 Each scenario in Table 1 has a different effect, which we summarise as follows:

- **Scenario 1**: This is the approach which was applied by the SSRO to the 2016/17 to 2021/22 rates assessments. It uses the most recent available data, including averaging out the period of the pandemic.
- **Scenario 2**: This is the approach the SSRO used for the 2022/23 rates recommendation to further enhance the stabilising effect of averaging in the BPR assessment. It averages out the period of the pandemic, but places more weight on older data than scenario 1.
- **Scenario 3**: This represents striking out FY2020 data consistent with the approach taken by the Secretary of State in the 2022/23 BPR determination. It uses FY2021 data as the most recent available.

3.8 We note that longer averaging periods are possible, but we have not included them given the length of lag between the data and the application of the rates.

3.9 Our methodology is to update the company data annually, to ensure the BPR keeps up with fair market rates of profit. We applied our methodology and used the most recent data for the 2022/23 recommended rates. It is too early, however, to know if FY2021 data will enable us to both return to our established methodology and remove the effects of COVID-19 from the BPR. An alternative to our approach of averaging out the positive and negative effects of COVID-19, alongside data outside of the pandemic, would be to exclude both FY2020 and FY2021 data from the assessment entirely. This is presented in Table 2. We take a cautious approach to this as removal of data would need to be justified on the basis that it supported fair and reasonable prices and value for money.

Table 2: Averaging company data for FY2017-19

Number of averaging years	Reporting years included in the average				
	FY2017	FY2018	FY2019	FY2020	FY2021
Three	✓	✓	✓		

3.10 We are seeking stakeholder views on the averaging period and the case for including or excluding periods of data from the 2023/24 rates assessment. We are seeking feedback on the scenarios presented, including your views of the merits or otherwise of the approaches the SSRO might take to using FY2020 and FY2021 data.

Question 1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate?

Question 2: What should be the approach in the assessment to reflect the Ministerial intent to remove the effects of COVID-19 from the benchmark?

Question 3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1, and do you favour one?

For each of the above questions, please provide the reasoning and evidence to support your view, an explanation of any benefits, and the potential for known or unintended consequences.

Capital servicing rates

3.11 In determining the capital servicing rates (CSRs) for 2022/23, the Secretary of State indicated intent to remove the effects of COVID-19 and fixed the capital serving rates at the same level as in 2021.

3.12 The current actual cost of capital servicing reflects actual past interest rates. We do not consider it would be appropriate to exclude interest rate data from the period of the pandemic on an ongoing basis. The pandemic temporarily increased the cost of debt (which determines capital servicing rates) and to exclude this would ignore an actual cost incurred by companies which has an ongoing effect on their profit rates. For this reason the established approach to the CSRs does not seek time period consistency between the company and bond data. On this basis, we propose that the capital servicing rates should continue to be calculated on their current basis. We are seeking your feedback on this proposal.

> **Question 4**: Should the approach to the capital servicing rates be retained? Please provide the reasoning and evidence to support your view, an explanation of any benefits and for the potential for known or unintended consequences.

Filtering companies to remove the effect of COVID-19

3.13 We are still of the view that it is not possible to adjust individual company profit rates to what they would have been had the pandemic not occurred. Filtering in and out individual companies based on the activities undertaken during the pandemic, measuring markups using profitable companies (i.e. removing loss makers) and applying suitable averaging techniques, filters out profit variance both within and between years. This helps ensure that the BPR is at a level consistent with non-pandemic rates, thereby reflecting the removal of COVID-19 induced variability in the BPR.

3.14 We developed additional COVID-19 assessment measures after considering feedback from last year's consultation. The measures comprised a review process for identifying comparator companies for the 2022/23 rates assessment which considered the explanations that companies provided on their websites or in their annual reports and accounts, addressing the impact that the COVID-19 pandemic had had on their operations. We supplemented our review process with some additional data fields and financial indicators. The purpose of this review was to ensure that the comparator groups constitute only those companies that continued to undertake comparable activities, irrespective of the impact of COVID-19.

3.15 We are interested in whether you have any further thoughts on ways we can use to mitigate the impact of COVID-19 in the data, in addition to the way we filter companies to remove the effect of COVID-19.

> **Question 5**: What additional steps could the SSRO take in analysing individual companies to remove the effects of COVID-19 from the baseline profit rate? We welcome suggestions together evidence to support your view, an explanation of any benefits, and for the potential for known or unintended consequences.

4. Future developments

4.1 The SSRO has committed to keeping the BPR methodology under review. We intend to consider how activities which occur under qualifying contracts are reflected in our baseline profit rate assessment. Our immediate priority is to respond to both the Secretary of State's 2022 rates determination and the review of legislation, with the activities review to follow. We will make a decision on a final timetable in the next round of corporate planning but it is planned to commence in April 2023.

4.2 An activities review would look at our existing groups relating to manufacturing and support and potential new groups for activities such as communication and information systems. We have taken an initial step by seeking to establish an Information Technology services group for inclusion in the SSRO's assessment methodology, subject to the Board's approval. A broader activity will be a substantial piece of work that includes consideration of activities conducted in qualifying contracts and associated activity characterisations. Any changes considered would need to improve the suitability of a recommended baseline profit rate and be introduced in a manner that maintained an appropriate degree of stability and predictability for contracting parties.

5. Application of the revised methodology

5.1 Following due consideration of any points raised in response to this public consultation, and approval by the SSRO's Board in September 2022, the SSRO intends to apply the approved methodology to the 2023/24 rates assessment and to publish a summary of consultation responses.

5.2 We will endeavour to respond to all points raised by stakeholders in response to this public consultation. Feedback on matters which the SSRO included in this consultation or that will need to be considered in more detail may be deferred to subsequent reviews.

6. Consultation questions

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

- **Question 1:** How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate?
- **Question 2:** What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark?
- **Question 3**: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1, and do you favour one?
- **Question 4**: Should the approach to the capital servicing rates be retained?
- **Question 5**: What additional steps could the SSRO take in analysing individual companies to remove the effects of COVID-19 from the baseline profit rate?

6.2 We welcome responses supported by the rationale and evidence, an explanation of any benefits and the potential for known or unintended consequences.

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

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

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

6.4 Responses to the consultation should be received by 16 August 2022. Responses received after this date will not be taken into account in finalising the methodology for 2023/24 but will inform subsequent consideration of methodology changes.

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

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

6.7 Stakeholders' attention is drawn to the following SSRO policy statements, available on its website,[4] setting out how it handles the confidential, commercially sensitive and personal information it receives and how it meets its obligations under the Defence Reform Act 2014, the Freedom of Information Act 2000, the General Data Protection Regulation and the Data Protection Act 2018:

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

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

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