BPR methodology consultation

Consultation response form

Overview

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

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on Tuesday 16th August 2022.

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

- by email to: **consultations@ssro.gov.uk** (preferred)

- by post to: Baseline profit rate consultation responses, SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB

- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

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

BPR methodology consultation

Consultation response form

Your details

Name:

Andrew Palmer

Organisation (if you are responding on behalf of an organisation):

Ministry of Defence

Position (if you are responding on behalf of an organisation):

Single Source Advisory Team – Deputy Head

Consultation questions

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

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

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

Yes [X] No [ ]

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

BPR methodology consultation

Consultation response form

Question 1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The MOD cannot support either Scenario 1 or 2 in Table 1 at paras 3.6 – 3.7 of the BPR Consultation paper (June 2022). These two scenarios both propose to include the extraordinary year FY2020 in the 2023/24 BPR calculation, when it was excluded by the Secretary of State in the 2022/23 BPR determination.

Scenario 3 is the only scenario listed that is consistent with the approach taken by the Secretary of State in the 2022/23 BPR determination. To clarify, the Ministerial intent to "remove the effects of COVID-19 from the benchmark" was to remove data relating to an extraordinarily unusual event. That event was not the pandemic itself but the impact it had on the economy, large swathes of which were closed for extended periods of lockdown in FY2020.

MOD accepts that COVID-19 will have also impacted FY2021 data (i.e. year ending on or before 31 March 2022) and likely beyond, but nothing like the extent to which FY2020 was impacted by the March – May 2020 lockdown, and subsequent national and local lockdowns in FY2020.

Accordingly, MOD supports Scenario 3 which excludes FY2020 data from, and includes FY2021 data in, the 2023/24 BPR calculation.

BPR methodology consultation

Consultation response form

Question 2: What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We have addressed this in our Question 1 response. We interpret the Ministerial intent to be to remove the impacts of COVID-19 in the one extraordinary year which was FY2020, when the pandemic commenced, several extended national lockdowns were imposed which shut down or severely impacted many sectors of the economy, and vaccines were unavailable until they began rolling-out in the closing months of the FY2020 period. FY2020 was extraordinarily impacted by COVID-19 in a way that subsequent years have not been.

The Ministerial intent is not to say that all impacts of COVID-19 should be removed from the BPR calculation for all time, because in any event it would not be possible to disentangle the impacts in each year, to achieve that result. The Government has moved to a Living with COVID strategy. The Ministerial intent in the 2022/23 BPR calculation was to exclude the extraordinary impacts of COVID-19 in the year that the pandemic hit and most impacted the economy, which was FY2020. This intent should be maintained in subsequent BPR calculations, by the continued exclusion of FY 2020 only. This is achieved by the SSRO’s Scenario 3 proposal made in the consultation paper, which is the approach supported by the MOD.

Consultation response form

Question 3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1 of the consultation document, and do you favour one? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The showstopper drawbacks of Options 1 and 2 for the MOD are that they re-introduce FY2020 into the BPR calculation, which runs counter to the Ministerial intent expressed in response to the 22/23 calculation. It would be inconsistent and against the Ministerial intent to now bring back FY2020 into the 2023/24 calculation, so we do not regard Options 1 & 2 as tenable options.

Conversely, the strength of Option 3 is that it is consistent with the Ministerial intent expressed in 2022, in that it removes the extraordinary year FY2020. The Ministerial statement also asked the SSRO “to engage with industry and my officials in returning (next year) to a market-based benchmark based on their established methodology”. In MOD’s opinion, this is achieved by continuing to exclude the most impacted year, but <u>not</u> excluding subsequent years, so moving to a position of gradually restoring the established methodology to the point in due course where FY2020 drops out of the averaging calculation. At that point we would also see some merit in looking again at the SSRO suggestion, embodied in Option 2 (and as proposed by SSRO last year for 2022/23), to move to a four-year averaging methodology.

As we have made clear, we very strongly favour and support Option 3.

BPR methodology consultation

Consultation response form

Question 4: Should the approach to the capital servicing rates be retained? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The MOD agrees with the SSRO proposal at para 3.12 of the consultation paper, that the capital servicing rates should continue to be calculated on their current basis. We did consider a different approach during the on-going review of the legislation and likewise concluded that no changes were needed to the existing approach.

BPR methodology consultation

Consultation response form

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

Please add comments to support your answer:

We agree with the SSRO view that it is not possible to adjust individual company profit rates to what they would have been had the pandemic not occurred. As we indicated in our response to Question 2, we likewise believe it would be impossible to disentangle the multiple factors impacting an individual company's profitability in any given year, to isolate only COVID-19 impacts, up or down.

We agree with the filtering measures taken by the SSRO to help ensure that the BPR is at a level consistent with non-pandemic rates, insofar as those filtering measures relate to COVID-19 impacted FYs other than FY2020. Because of the extraordinary impact in that particular year, we support the most appropriate filtering measure in that case, to exclude FY2020 altogether, to meet the Ministerial intent for the 2022/23 calculation. The MOD believes the exclusion of FY2020 from the BPR calculation should continue until the FY2020 data drops out of the 3-year averaging calculation.

We have no additional steps that we wish to suggest the SSRO adopts.

Response to the Single Source baseline profit rate methodology consultation

1. Introduction

   The SSRO issued a consultation paper in June 2022 to seek views on the baseline profit rate (BPR) methodology for 2023/24 period. DSAG has already submitted two papers on this topic: one in October 2021 and the more recent one submitted in June 2022. Both highlighted specific areas of concern that should be considered as part of the review of the methodology. Given that the more recent paper undertook an analysis of the c400 contracts let as either QDCs or QSCs since the SSCR regime came into effect, we now have a body of evidence that should influence the review of the methodology.

2. General comments

   a. Para 1.3:

      i. The SSRO have narrowed the focus of the review to the averaging approach but Objective 2 of the SSRO's Corporate plan stated a much broader focus – "*we will keep our baseline profit rate methodology under review. We want to consider how the activities which occur under QDCs are reflected in our baseline profit assessment*." DSAG is not sure why the focus has narrowed but believe that it is important to retain the broader focus especially as the challenge set by the Secretary of State was for "*an engagement with Industry in returning to a market based benchmark …that removes the impact of Covid-19*." The assessment requires a broader perspective focusing on comparability of activities (as it applies to the strategic shocks of extreme events such as Covid) as well as the simple impact of COVID-19 on company profitability.

      ii. DSAG has undertaken an analysis of the c400 QDCs/QSCs let since the regime came into effect. We need to re-emphasise the importance of reviewing the whole methodology in the light of that analysis (i.e. averaging is but one element of the methodology). The SSRO have explained that their review was unable to isolate and exclude the impact on profit of the pandemic. If we take the analysis we have done on the 400 QDCs/QSCs we can see that the majority of contracts let were with the larger companies with turnovers above £150M – in most cases these Defence companies were required to continue to operate as normal during the Covid-19 disruption. Other essential companies were also operating as close to business as usual as they could (such as utilities). It is therefore possible to highlight within the comparator group (CG) those companies that were more able to operate as normal than those that were not. For instance, leasing companies in the P&M category suffered a different impact to those companies in P&M operating in support of MoD.

iii. Focusing only on a rolling average does not remove the impact of Covid-19, instead it has the effect of spreading it over a number of years – even if the use of four years instead of three reduces the weighting of the 2020/21 underlying rate. And if the Covid effect were to last for more than a year (currently supply chains are predicted to normalise by 2024) the rolling average would just compound the shock across more years which when used to price long-term contracts means that contracts will bear the impact of Covid for over a decade.

iv. The 'heightened volatility' that has been seen in the setting of the BPR is a product of the decision to split the comparator group into Develop and Make (D&M) and Provide and Maintain (P&M), which we considered in our earlier papers on the topic and consider inappropriate and not possible with any fidelity (discussed later).

b. Para 1.4:

i. The quotation from the Secretary of State included the recognition that it is unfair to include the effects of an event as extraordinary as Covid. We agree with the Secretary of State. We note that there may be other extraordinary events that may arise and require exclusion in the future. And as MoD pricing policy is to exclude any costs of Covid, the profit rate should be set on the same basis. Therefore, any review must consider:
   1. How to remove the effect
   2. How to ensure a fair profit rate suitable for pricing
   3. S of S preference for a market-based approach (noting that is MoD policy to exclude Covid/significant events from within the cost base)

ii. To achieve these objectives, we need a fair PLI and recommend:
   1. A single comparator group (CG) (D&M+P&M as a single population) which is more comparable as discussed later and as examined in DSAG's Oct 2021 paper offers more stability.
   2. The BPR should exclude significant events
   3. The CG needs to be reviewed for comparability based on historic data.

c. Para 2.1:

i. Our historic analysis revealed that of the c400 QDCs/QSCs let to date there has been a significant portion let with GUOs that have a turnover in excess of £150M. DSAG has been observing for some time that a more representative CG should take account of the complex high value work being placed under single source. The use of averaging across D&M and P&M is an artificial split born out of the original context in which MoD wanted to represent the CADMID cycle and not in terms of comparable activities. The analysis shows that the CGs with QDCs/QSCs perform both

D&M and P&M activity making it difficult to demonstrate how segregating the two makes for comparability. It is time to revisit this artificial divide that creates a disproportionate outcome as per our paper published in October 2020, March 2021 and June 2022.

ii. Reference to transfer pricing is a topic that we covered in the March 2021 paper and which needs to be discussed in more detail at some point.

d. Para 2.2: The impact of Covid on some companies within the CG was quite different to the impact on Defence contractors – Defence contractors were required to continue to operate "as normal". While a few of the other GUOs in the CG may also have had to operate as normal for strategic reasons, it underlines the DSAG collective view that the comparability of the CG GUOs needs to be reassessed, especially as some GUO's in the CG saw demand change, including periods where the business closed down if activities were non-essential. This could have been a filter applied for the 2020/21 assessment rather than looking for changes in activity which is vaguer and more uncertain. It is not clear, for instance, what the degree was to which the SSRO were able to differentiate in terms of impact as implied in the last sentence of para 2.2. For instance, aero-engine leasing saw incomes fall as airlines stopped flying, while companies that provided for the sale, hire and leasing of fork lift trucks would also have suffered a reduction in activities. We do not believe that these typical examples represent comparability with activities under QDCs, and there is more to glean from further examination of the CG using this logic.

e. Para 2.3:

i. DSAG have queried the use of the median in previous papers. We do not see the use of median, removal of loss makers and time averaging removes the impact of Covid. The historic analysis has provided insight into the actual spread of the QDCs/QSCs being let and it is clear that there is a "bias" towards the upper quartile of the spread of GUOs with the majority of contracts let to companies with turnovers of £150M or more. The application of a median therefore gives much greater influence to the smaller companies, for which there is little single source business, making it less representative of the actual picture and questioning whether the method reflects the market.

ii. The observation we made in the October 2021 paper and subsequent dialogue in December demonstrated that there are two artificial adjustments being made that undermines the fairness and market driven basis of the BPR outcome. First, using an average between D&M and P&M when the GUOs are in reality one performing both activities, creates an artificial basis on which the median is applied. Second, applying a straight median ignores the actual spread of GUOs and gives too much emphasis to those quartiles that attract very few GUOs. With this background supported by historic data DSAG would query whether the current methodology meets the fair and reasonable objective of the regime.

iii. If we look at the data for 20/21 60% of the GUOs experienced reductions in revenue. As mentioned above, whilst Defence contractors may have seen a level of revenue decrease due to changes in the ways of working or supply constraints, generally business had to continue during the pandemic. So if 60% of the CG GUOs saw revenue reduction, suggesting a large portion of volatility in the CG, then it is clear the methodology needs an overhaul or at least a review. Certainly GUOs should now be considered one population and not arbitrarily split between D&M and P&M to reflect the CADMID cycle, which may not be representative of how these companies are operating within that spectrum.

f. Para 2.4: "Stabilising" features do not remove the actual impact of Covid. A rolling average does not solve the problem – it spreads it over more years and if Covid or any strategic shock continued over a number of years as well then the effect would be compounded across all years included in the rolling average. For instance, the shock decrease experience in the 2018/19 period when the BPR fell to little over 6% has only just worked its way through the system (although contracts let at that time that are still extant retain the impact) – and the reduction was due in part to the exclusion of relevant Defence companies (as stated by the SSRO in subsequent meetings). Had that been rolled over four years we would still be seeing a recovery curve.

g. Para 2.5:

i. It is not clear what the statement "…the 2022/23 assessment could be indicative of a longer-term deviation from the past" means. Perhaps the SSRO could clarify the term further?

ii. It is not clear why the SSRO have undertaken to consult only on the averaging approach for 2023/24 when that is but a small part of the methodology and does not directly answer S of S's direction, which requires a more deeper assessment of the methodology. We have stated above that averaging has inconsistencies and creates compounding of the impacts of any strategic shock.

h. Para 3.1: As stated at 2.5, we do not believe the proposals answer the Secretary of State's request for a "market based benchmark based on their established methodology that reflects my intention to remove the impact of Covid-19".

Figure 3 – Range of contract profit rates (CPR)
The graph shows the theoretical high and low CPR and the BPR itself.

The SSRO also recently issued their annual statistics which we think better demonstrates the importance of agreeing a fair BPR to overall contract profitability. The statistics (link and table below) show the average BPR along with the CSA forms 96% of the average CPR for all contracts let to 2021/22. https://www.gov.uk/government/publications/annual-qualifying-defence-contract-statistics-202122

	Step 1 Baseline Profit Rate (%)	Step 2 Cost risk adjustment (%)	Step 3 POCO adjustment (%)	Step 4 SSRO funding adjustment (%)	Step 5 Incentive adjustment (%)	Step 6 Capital Servicing adjustment (%)	Contract (%) profit rate
Overall	8.03	0.30	-0.25	-0.03	0.32	1.03	9.41
	85%	3%	-3%	0%	3%	11%	100%

i. Para 3.2: While the SSRO considered a four year rolling average to increase the influence of stable historical profit trends, we highlighted in our paper in Oct 2021 and subsequent dialogue in December that in actual fact the underlying historic profit rate was still volatile over the long term. The work we did last year set out evidence that a more stable baseline over the last three years is achieved by reflecting a more representative assessment of the weighted average (i.e. taking into account the quartile in which the majority of QDCs had been let since the SSCR regime had been introduced), which data now exists to inform that approach. In such a case the rolling average may not have had such an important influence on the outcome.

j. Para 3.3: To meet the requirements of Schedule 13 of the Act, the BPR needs to be on the same basis as the rest of the price construct. It must also be suitable for use on contacts that extend over many years. The MoD took the view that pricing of contracts should exclude the effect of Covid (that being dealt with separately as a risk free element attracting no profit) so the BPR needs to be on the same basis (i.e. should exclude the effect of Covid). The four year averaging does not achieve that, it merely compounds the impact for more years.

k. Para 3.4:

   i. As stated above the averaging effect does not remove the impact of Covid, it just spreads it further.
   ii. Exclusion of data has the potential to facilitate removal of the impact of Covid but we do not think the accurate information on the impact is available to the SSRO (or anyone) to correctly make such adjustments to the current SSRO methodology.
   iii. The CG should be reviewed with the intent to remove those companies that are outside of the Defence market and any other sector that was required to continue to operate as normal to create a comparator group that reflects the circumstances applicable to the Defence sector and avoid tainting the outcome by including GUOs that were in a different market dynamic. This would be one way to exclude the "Covid effect",

another might be to ignore the CG output for March 2020, 2021, 2022 and 2023.

l. Para 3.6: Table 1, Scenarios 1 and 2 are not appropriate as they include FY2020, which was specifically excluded by S of S. FY2021 is still likely to be significantly impacted by Covid. Notwithstanding the query over whether the current CG is truly comparable against the result of the historic data, a review of the companies in the CG would be required to see how significant such an effect has been in this period. If FY 2021 CG was found to be only slightly impacted we would expect to see a combined D&M/P&M (i.e. one community only, not two averaged) with a four year average (excluding FY2020) subject to a review of the GUOs included.

m. Para 3.9: To achieve the objectives of Schedule 13 of the Act the PLI/BPR needs to work in concert with the approach to allowable costs. MoD policy is to exclude the risk assessed costs for Covid in the cost base (treating them as a standalone cost outside of the contract baseline) and only apply the CPR to the baseline costs (i.e. excluding Covid). The approach suggested in table 2 may meet the requirement, subject to the issues DSAG have raised in the paper on comparability – submitted in June 2022.

n. Para 3.12: We agree that Step 6 of the CPR formula should reference the current market costs of funding fixed working capital. However, when determining the net PLI for use in the BPR, the CSA adjustment made to a particular year's PLI must remain consistent with that year's funding rates (not be changed to use the latest funding rates as those rates are not relevant to the year the profits were earned).

o. Para 3.13: we agree it is not possible to identify the impact of Covid on the current CG population. But we do not agree that looking at activities, excluding loss makers, and averaging removes the effect of Covid. We do not understand how the SSRO was able to reach the conclusion that the actions taken resulted in the removal of Covid and yielded a profit rate that was suitable and fair for pricing. We have suggested above that a better approach might be to assess the CG against those types of companies that were required to continue to operate as normal such as Defence, Utilities, etc. For reasons explained above pricing requires a profit rate exclusive of Covid and this is the only way we can see of being able to accommodate that.

p. Para 3.14: As the DSAG paper submitted recently on BPR comparability explained we believe that there are improvements we could jointly pursue. We believe some of those ideas and recommendations we put forward would have changed the composition of the CG to better align to GUOs with QDC/QSCs. However, whilst that may result in improved comparability it would not have dealt with the removal of Covid. There are in effect three problems to resolve:
    i. Comparability (as the chosen methodology)
    ii. Excluding the impact of Covid on profitability
    iii. Consistency in pricing approach of allowable costs and profit

q. Para 3.15: the action is to remove the impact of Covid (not mitigate), in order to meet the S of S's request and to be consistent with MoD pricing policy. Using a single population CG, review for comparability of GUOs in the CG and weighted average may help with the removal of Covid. This would afford detail analysis of a few very large companies to see if the impact of Covid could be understood and removed (a more manageable review than having to look into every company in the CG)

r. Para 4.1: DSAG welcomes the commitment to keeping the BPR methodology under review and is equally committed to establishing a fair and reasonable outcome that is representative of the market it is trying to operate within. We look forward to further engagements utilising the data analysis DSAG have submitted last year and this year in support of the anticipated dialogue over the issues raised in those papers. DSAG feels that the initial discussion held in December 2021 was not conclusive and dismissed many key observations without proper assessment and discussion and we were disappointed that the engagement lost momentum. We hope that we will be able to re-establish a forum for ongoing dialogue to cover the work DSAG has done to identify Industry concerns.

s. We hope that DSAG's paper on comparability and historic analysis (June 2022) contributes to this broader review. We believe that joint working can help improve understanding and, where relevant, identify improvements to the methodology.

3. DSAG Response to the specific questions:

   a. Question 1: If the impact of Covid is to be excluded – do not include FY2020 and probably not FY2021 (supply chains are predicted to normalise as late as 2024) – use the period to extend the discussion on the methodology. If FY2021 is to be used, then it should be subjected to a review to ensure comparable market based profit rates that exclude the impact of Covid. Assuming a successful review of FY2021 which filters out those companies that are not comparable, we would propose combining D&M and P&M CGs (i.e. one population not averaging across two) with a four year average covering FYs 2017, 2018, 2019 and 2021. But if the review is non conclusive in terms of filtering then FY2021 should not be used and the current BPR should be maintained for the time being.

   b. Question 2: As per answer to question 1 above, we propose:
      i. A review of the FY 2021 CG for comparability (see DSAG paper June 2022).
      ii. Combining D&M and P&M as one a population (see DSAG paper June 2022).

iii. A review of FY 2021 for the impact of COVID.

Subject to a successful review of FY2021 that achieves comparability and excludes COVID, we would propose a combined D&M/P&M CG (i.e. one population not two averaged) with a four year average including the years FY2017, 2018, 2019 and 2021.

If the review is unsuccessful then FY2021 should not be used and the current BPR should be maintained.

c. Question 3: Averaging does not remove the impact of Covid. It also represents three phases of "averaging" (D&M/P&M, median and rolling average) which implies that the outcome is somewhat artificially removed from the representative market, especially as the QDCs let represent the upper quartile of the spread of GUOs. We do not see averaging as a solution to removing the impact of COVID, unless the affected years are removed from the averaging process. The impact of COVID needs to be removed and comparability of the CG tested and realised. Reasons for this are provided above, in our comments on the consultation paper, including:
   i. Averaging does not remove the impact of COVID unless the average only contains years that were not impacted by COVID.
   ii. MOD policy is pricing excluding COVID
   iii. The methodology is based on comparability
   iv. The BPR is used in pricing long term contracts and so affects pricing for many years to come.
   v. The SSRO statistics show how important BPR (& CSA) are to the Contract Profit Rate (CPR), they form some 96% of the CPR for contracts let to date. So setting it fairly is key to meeting Section 13 requirements.
   vi. The impact of COVID is more significant than any other "new trends". Therefore, to meet MOD policy and S13 requirements, if COVID cannot be removed, from recent years results, the rolling average should be based on years not impacted by COVID.

d. Question 4: We agree that Step 6 of the CPR formula should reference the current market costs of funding fixed and working capital. However, when deriving the net PLI, for use in determining the BPR, the CSA adjustment made to a particular year's PLI must remain consistent with that year's funding rates (i.e. not be changed to use the latest funding rates as those rates are not relevant to the year the profits were earned).

e. Question 5: DSAG have offered several papers, and within this response, suggestions that may help. The BPR CG should be tested for comparability, following the suggestions in the June 2022 DSAG paper. This will:
   i. Improve comparability

ii. Likely reduce the number of GUOs to then be reviewed for the impact of COVID
iii. Combine the CGs of D&M and P&M to be one CG population, as GUOs conduct both activities for their offerings.
iv. Review the resultant population for the impact of COVID

Using median this requires all the CG population to be reviewed as each GUO irrespective of size has the same impact on the BPR.

If a weighted average is used this would reduce the number of CG GUOs that require review for the impact of COVID. Only the largest GUOs would require review and removal of any impact of COVID. In making this suggestion, we understand there are other concerns regarding the use of weighted average and the dominance of a few large companies on the BPR result. However, in part, countering this concern we also observe of the 400 qualifying contracts let, where the SSRO could provide information, 84% of those contracts were placed with GUO's whose annual revenues are £1b or more. The benefits would be a market based profit rate that excludes the impact of COVID and therefore meets MOD pricing policy and Secretary of State requirements. The outcome of the above suggestion or, if that is not realised, using years that exclude COVID is a way of meeting MOD policy more suitable to pricing long term contracts. We believe the impact of COVID is more dominant than any other movements ("new trends"). So if COVID cannot be removed from the more recent years then using years not impacted by COVID better meets MOD policy and S13 requirements.

BPR methodology consultation

Consultation response form

Overview

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

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on Tuesday 16th August 2022.

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

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

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

BPR methodology consultation

Consultation response form

Your details

Name:

James Schofield

Organisation (if you are responding on behalf of an organisation):

Leonardo UK Ltd

Position (if you are responding on behalf of an organisation):

VP Finance

Consultation questions

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

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

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

Yes [X] No [ ]

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

BPR methodology consultation

Consultation response form

To help explain our responses to the questions posed, the following comments are provided on the consultation paper, referenced to its paragraph numbering.

Whilst the scope of this consultation is more limited than a full review of the methodology, we believe DSAG's two papers on the BPR, submitted in October 2021 and more recently in June 2022, are of relevance to this consultation and to achieving the Secretary of State's request for a fair market profit rate.

1.3:
The SSRO explain, at 3.13, that it is not possible to adjust individual company profit rates to what they would have been, had the pandemic not occurred.
The consultation explains the SSRO's intention to consult on the averaging approach.
We do not believe an averaging approach, unless the average excludes the years impacted by COVID, will answer the Secretary of State's request to remove the impact of COVID.
If years impacted by COVID are included in SSRO's rolling average, the averaging process simply spreads the impact. Furthermore, if COVID continues (as it is) for a number of years it's impact could be in each of the years included in the rolling average, which coupled with its application to pricing of long term contracts, means it's effect could be very long lasting.
1.4:
We think it important to include the Secretary of States logic to his request as well as the request itself:
https://questions-statements.parliament.uk/written-statements/detail/2022-03-28/hcws726

" I believe it would be unfair to include in this rate the effects of an event that is as extraordinary as COVID-19…….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"

We agree with the Secretary of State, the impact of extraordinary events should be excluded from pricing and that in returning to a market based benchmark it should exclude the impact of COVID. Indeed, as the MOD pricing policy is to exclude any costs of COVID the profit rate should be set on the same basis.
We believe the review must consider:

1. How to remove the effect of COVID
2. How to ensure a fair profit rate (Section 13)
3. Secretary of States preference for a market based approach

To support these objectives we recommend:

   a. A single Comparator Group (CG) of D&M and P&M combined
   b. The CG needs review for comparability, learning from the historic data of companies with QDCs/QSCs and activities performed.
   c. Consistency in pricing approach of allowable costs and profit i.e. excluding the impact of COVID on profitability.

2.1:

We believe, irrespective of COVID, the current BPR CGs include some companies that are not comparable with companies who hold QDCs/QSCs or the activities that are performed on QDCs/QSCs. We also contend that companies conduct both D&M and P&M activities for their “offerings” and therefore there should be a single population CG. We understand the segregation of these two CGs is borne of a view of contracting in context of the CADMID cycle and not in terms of comparable activities.

2.2:

The impact of COVID, on some companies within the CG, was quite different to the impact on Defence contractors. Whilst defence contractors were required to continue “as normal”, some companies in the CG saw demand change, including business closure, for periods, if activities were non-essential. These differences require understanding to see if they are raising issues of incomparable activities being conducted.

Two examples from the P&M CG (anonymised):

A CG company suffered a 30% reduction in revenues in 2020 when compared to 2019. 50% of its business is leasing aero-engines to civil airlines. As many customers did not fly for periods of time, during the pandemic, it saw income fall and had to undertake restructuring of some of the leasing contracts in order to mitigate short term liquidity requirements. We do not think financing activities (in this case leasing of engines) is comparable with activities conducted in QDCs/QSCs and this company ought not be in the CG.

Another, quite small, company suffered a 34% reduction in revenues in 2020 when compared to 2019. On further investigation its primary activities are the sale, hire and maintenance of fork lift trucks. Again, we do not believe hiring and selling of forklift trucks as being comparable with the activities conducted by companies with qualifying contracts.

The above are just two examples, further commentary on comparability has been provided by DSAG, to the SSRO, in support of joint discussions towards collaborative work on areas of the methodology that might be improved (reflecting on that we can learn from the 400 + qualifying contracts now let). Reconsidering some of the NACE codes currently included in the CG’s might help with this process.

Figure 2

The analysis on comparability, provided to the SSRO by DSAG, suggests there should be a single CG population, that coupled with discussions at 2.2, above, may suggest the D&M profit rate is the more indicative rate.

2.3:
We do not see the use of median, removal of loss makers and time averaging removes the impact of COVID.
Further to the discussion at 2.2, the consultation paper explains that for the FY2020 60% of the companies experienced reductions in revenue whilst many in P&M did not see costs reduce. Defence contractors may have seen some decrease in revenues due to changes in the way of working, or supply constraints, but generally business had to continue during the pandemic. Therefore, the revenue reduction again raises questions of comparability, as does the observation that many of the P&M with revenue reductions did not also see cost reductions. We wonder if the two example companies at 2.2 (above) might be indicative of the CG comprising other companies engaged in non-comparable activities? Hopefully, a joint review will resolve these questions.

2.4:
Again, “Stabilising” features do not remove the impact of COVID. A rolling average does not solve the problem, it simply spreads any impact over a number of years. If COVID continued for a number of years the effect would be in all the years included in the rolling average and the effect then applied to pricing of Long Term Contracts.

Figure 3 – Range of contract profit rates (CPR)
The graph shows the theoretical high and low CPR and the BPR itself.
The SSRO also recently issued their annual statistics which we think better demonstrates the importance of agreeing a fair BPR to overall contract profitability. The statistics (link and table below) show the average BPR along with the CSA forms 96% of the average CPR for all contracts let to 2021/22.
https://www.gov.uk/government/publications/annual-qualifying-defence-contract-statistics-202122

	Step 1 Baseline Profit Rate (%)	Step 2 Cost risk adjustment (%)	Step 3 POCO adjustment (%)	Step 4 SSRO funding adjustment (%)	Step 5 Incentive adjustment (%)	Step 6 Capital Servicing adjustment (%)	Contract (%) profit rate
Overall	8.03	0.30	-0.25	-0.03	0.32	1.03	9.41
	85%	3%	-3%	0%	3%	11%	100%

3.3:
The BPR needs to be on a consistent basis with the rest of the price construct and suitable for use in pricing contracts that extend over many years. As MOD policy is to price contracts exclusive of COVID the BPR needs to be on the same basis.

3.6, 3.7:
Table 1, Scenarios 1 and 2 are not appropriate as they include FY2020, which was specifically excluded by Secretary of State.
FY2021 is also likely to be significantly impacted by COVID, but this would have to be reviewed.
A market based profit rate, that excludes the impact of COVID, requires comparability of activities performed by the CG companies with those activities conducted by companies who hold qualifying contracts as well as removing the impact of COVID.
If there is a successful 2023/24 review to: exclude COVID and improve comparability, we would propose a combined D&M/P&M CG with a four year average including the years FY2017, 2018, 2019 and 2021.
If it is not possible to remove the impact of COVID from FY2021, then neither FY2020, or FY2021 should be included in the BPR assessment.

3.9:
The approach suggested in table 2 may meet the Secretary of State's requirement, subject to the issues DSAG have raised in the paper on comparability (submitted in June 2022).

3.13, 3.14:
Again, we do not think the SSRO's actions, of looking at activities, removing loss makers and using averaging removes the impact of COVID.
To achieve a "fair" BPR there are a number of issues to resolve:

a. A single Comparator Group (CG) of D&M and P&M combined.
b. The CG needs review for comparability, learning from the historic data of companies with QDCs/QSCs and activities performed.
c. Consistency in pricing approach for allowable costs and profit.

4.1:
We welcome the commitment to keeping the BPR methodology under review and we, in support of DSAG, are committed to help establish a fair and reasonable outcome that is representative of the market.

4.2:
We hope DSAG's paper on comparability (June 2022) contributes to this broader review. We believe that joint working can help improve understanding and, where relevant, improve methodology.

BPR methodology consultation

Consultation response form

Question 1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

As COVID is to be excluded:

- FY2020 - should not be used.

- FY2021 - should be subjected to a review to ensure a comparable market based profit rate that excludes the impact of COVID (as discussed above).

  Subject to a successful review of FY2021 that achieves comparability and excludes COVID, we would propose a combined D&M/P&M CG (i.e. one population not two averaged) with a four year average including the years FY2017, 2018, 2019 and 2021.

  If the review is unsuccessful then neither FY2020 or FY2021 should be used.

Reasons for the approach have been explained in the comments on the consultation section above, but include:

- The Secretary of State's requirement and MOD policy to price excluding COVID. This requires both the allowable costs and profit rate to exclude COVID.
- The requirement, set by the SSRO choice of methodology, for a market based profit rate based on CG companies conducting comparable activities to those conducted on qualifying contracts.
- Four years average, subject to a successful review of FY2021, is proposed to include the more recent trends (as discussed by the SSRO) and improvements to methodology for FY2021, whilst maintaining the stability provided by the pre-COVID years.

BPR methodology consultation

Consultation response form

Question 2: What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

As per our answer to question 1, we propose:

a. A review of the FY 2021 CG for comparability (see DSAG paper June 2022).
b. Combining D&M and P&M s one a population CG (see DSAG paper June 2022).
c. A review of FY 2021 for the impact of COVID.

Subject to a successful review of FY2021 the BPR would comprise a four year average including : FY2017, 2018, 2019 and 2021.

If the review is unsuccessful then FY2021 should not be used and the current BPR should be maintained.

Consultation response form

Question 3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1 of the consultation document, and do you favour one? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We do not see averaging as a solution to removing the impact of COVID, unless the affected years are removed from the averaging process.
The impact of COVID needs to be removed and comparability of the CG tested.

Reasons for this have already been discussed above, but include:

- Averaging does not remove the impact of COVID unless the average only contains years that were not impacted by COVID.
- MOD policy is pricing excluding COVID
- The methodology is based on comparability
- The BPR is used in pricing long-term contracts and so affects pricing for many years to come.
- The SSRO statistics show how important BPR (& CSA) are to the Contract Profit Rate (CPR), they form some 96% of the CPR for contracts let to date. So setting the BPR is key to meeting Section 13 requirements.

BPR methodology consultation

Consultation response form

Question 4: Should the approach to the capital servicing rates be retained? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We agree that Step 6 of the CPR formula should reference the current market costs of funding fixed and working capital. However, when deriving the net PLI, for use in determining the BPR, the CSA adjustment made to a particular year's PLI must remain consistent with that year's funding rates (i.e. not be changed to use the latest funding rates as those rates are not relevant to the year the profits were earned).

Consultation response form

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

Please add comments to support your answer:

- We recommend employing the suggestions made in the June 2022 DSAG paper to improve comparability of the BPR CG. This will also likely reduce the number of companies requiring review for the impact of COVID.

- Combine the CGs of D&M and P&M to be one CG population, as companies conduct both activities for their offerings.

- Review the resultant population for the impact of COVID
    - Using median requires review of all the CG population, as each company irrespective of size has the same impact on the BPR.

      (We note:
      If a weighted average is used this would reduce the number of CG companies that require review for the impact of COVID. Only the largest companies would require review and removal of any impact of COVID.
        - *In making this observation, we understand there are other concerns regarding the use of weighted average and the dominance of a few large companies on the BPR result.*
        - *However, in part, countering this concern, we also observe of the 400 qualifying contracts let, where the SSRO could provide information, 84% of those contracts were placed with companies whose annual revenues are £1b or more).*

The benefits would be a market based profit rate that excludes the impact of COVID and therefore meets MOD pricing policy and Secretary of State's requirements.

The outcome of the above suggestion or, if that is not realised, using years that exclude COVID is a rate meeting MOD policy more suitable to pricing long term contracts.

BPR methodology consultation

Consultation response form

Overview

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

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on Tuesday 16th August 2022.

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

- by email to: **consultations@ssro.gov.uk** (preferred)

- by post to: Baseline profit rate consultation responses, SSRO, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB

- by telephone, including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

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

BPR methodology consultation

Consultation response form

Your details

Name:

Janine Crocker

Organisation (if you are responding on behalf of an organisation):

BAE Systems plc

Position (if you are responding on behalf of an organisation):

Financial Controller – Maritime & Land

Consultation questions

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

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

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

Yes	x	No	

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

BPR methodology consultation

Consultation response form

Question 1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We believe that the BPR methodology should provide stability to defence contractors and MoD alike. The idea underpinning the methodology is that a selection of companies contained in the comparator group should be a guide to financial performance within current market conditions. This only holds true however when the market and economic conditions the companies in the comparator group are experiencing are reflective of those experienced by the defence contractors delivering single source contracts. The COVID pandemic was a clear example of these conditions diverging.

While most commercial industries saw a collapse in demand and in response reduced production significantly, our contractual obligations remained, our industry was declared of strategic national importance, our workers were made key workers and we continued to deliver.

This came at a significant cost through additional cleaning, the implementation of COVID testing, workstation adjustments, increased IT costs to enable home working and changes to shift patterns to allow for social distancing. We incurred these costs from the start of the pandemic in Q1 2020 through to the end of Q1 2022 when we returned to operations without restrictions. We see no reason as to why the same would not be true for the companies in the comparator group that continued to operate during the pandemic. It is therefore our belief that their financial results would have been impacted by these additional costs over the same period of time. The profits we are able to earn in future should not be impacted by the reduced profitability of the comparator group caused by the economic shock to their industries in the wake of the COVID pandemic.

Without any other adjustments to the BPR methodology (as described in answers below), we maintain that both the FY2020 and FY2021 data sets should be excluded from the BPR calculation for 2023/24. Both of these years were heavily impacted by the COVID pandemic, with companies across the economy (and therefore the comparator group) continuing to have to deal with suppressed demand, additional health and safety requirements impacting optimal production processes and incurring additional costs to deliver their outputs.

The SSRO has stated that by removing companies that either ceased to deliver their activities or were loss making during this period they believe that they are adequately addressing the impact of COVID. Many companies did carry on delivering their activities, albeit sub-optimally and at significantly higher cost, without necessarily making a loss. This reduction in profitability is not addressed by the SSRO’s proposed approach.

The averaging of the underlying rate over a longer period of time (4 instead of 3 years) also does not eliminate the impact; it simply spreads it over a longer period. Spreading over 4 years ensures that the COVID-driven reduction in the BPR is indeed felt longer by contractors than it would have been otherwise.

In our view, without other changes to the methodology, the only way to eliminate the impact of COVID, as directed by SoS, is to remove the FY2020 and FY2021 data points from the calculation in their entirety and for all future periods. The 2023/24 BPR should therefore be calculated as a 3 year average using FY2017, FY 2018 and FY2019, in line with Table 2 in your consultation paper.

BPR methodology consultation

Consultation response form

Question 2: What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We believe that the intent behind the SoS' announcement to exclude the impact of COVID from the BPR was to ensure that defence contractors would be able to earn a fair and reasonable return, unconstrained by severe economic shocks impacting the comparator group. This raises the question, what are variations in profits made by the comparator group driven by 'normal' fluctuations in the wider economy, and what sort of impacts should the BPR be shielded from. SoS clearly saw the COVID pandemic in the latter category. What we are not clear about is, where does the impact of Brexit, the war in Ukraine and the cost of living crisis sit in that regard? All of them will have impacts on the financial results of the comparator group companies, none of which are identifiable or separable. If the intend of the BPR methodology is not only to deliver VfM and fair and reasonable prices, but indeed stability and predictability to both contractors and the MoD, then the current methodology does not allow for this adequately.

Through previous consultation responses and the work done by DSAG on behalf of industry, we have voiced our concerns about certain aspects of the current BPR methodology. While we accept that this is not part of this consultation, we urge the SSRO to look again at how the methodology can be improved.

In particular, we suggest that the following would offer a fairer and more stable outcome to all:

- the removal of companies from the comparator group that are very much unlike the contractors delivering QDCs (in nature of their activity or revenue generation), who will experience economic shocks driven by unprecedented events very much different to us, and whose financial results in these circumstances should not guide the profits earned by us;
- the use of a weighted average instead of a median value, which currently skews results of the calculation towards a large group of small companies not delivering complex Programmes of the nature that we'd expect to be single source defence contracts and typically making lower returns;
- the combination of the current D&M and P&M activity groups into a single group, in line with the fact that all major defence contractors typically deliver contracts across this artificial activity separation.

BPR methodology consultation

Consultation response form

Question 3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1 of the consultation document, and do you favour one? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The averaging period should only be a tool for tempering minor fluctuations in the underlying BPR calculated on a fair and reasonable basis. It is not a suitable tool for correcting possible shortfalls in the methodology or indeed the impact of major economic shocks on financial results of comparator group companies.

If, for whatever reason, the calculated underlying BPR rate is flawed, then averaging it over a longer period simply spreads that flaw over a longer period, with the result that more contracts are let using this rate. We therefore do not see any benefit in changing from the 3 year averaging period.

BPR methodology consultation

Consultation response form

Question 4: Should the approach to the capital servicing rates be retained? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The SSRO proposes that the capital servicing rates should continue to be calculated on their current basis - including the actual rates in the years of the pandemic - and not to seek time period consistency between the years of financial results used in the BPR calculation and the cost of debt experienced by companies during the pandemic. We agree with this approach.

BPR methodology consultation

Consultation response form

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

Please add comments to support your answer:

We believe that it is simply not possible to 'analyse out' the impact COVID has had on company financial results from publicly available data.

The options we see to meet the ministerial intent as we understand it are to either:

- drop the FY2020 and FY2021 from the BPR calculation permanently, or
- amend the methodology by removing companies that are likely to have experienced the impact of the pandemic very differently to major defence contractors (drop in demand, reduction in economic activity, significant unrecoverable additional costs,…) from the comparator group, and use a weighted average of the remaining companies in a single activity group.

We see the latter as the more advantageous solution, as it would allow a continual application of the resulting methodology without the need for exclusion of certain years and a judgement over what significant events should be excluded.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

Overview

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

This is a public consultation, which is open to anyone with an interest in the SSRO's two statutory aims of ensuring that good value for money is obtained in government expenditure on qualifying contracts, and that parties to those contracts are paid a fair and reasonable price. We also welcome comments from people or organisations with a particular interest in non-competitive defence procurement. The consultation will close on 16 August 2022.

Please respond by 5.00pm on Tuesday 16th August 2022.

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

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

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

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

Your details

Name:

Derek Jones

Organisation (if you are responding on behalf of an organisation):

Babcock International Group

Position (if you are responding on behalf of an organisation):

Corporate Services Director - Marine

Consultation questions

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

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

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

Yes [X] No [ ]

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

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

Question 1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

Data for FY2020 and FY2021 should not be used to inform the 2023/24 baseline profit rate. Our reasoning for this approach is that the Minister was explicit in wanting the impact of COVID-19 removed from the profit rate calculation. The MoD have expressed a desire for Industry to remove any impact of COVID-19 from their cost bases where appropriate. Costs that relate to modified working patterns will become 'baked in' going forward.

Much of COVID impact may have been in delayed sales, affecting profitability in the wider market, i.e. less travel, less maintenance. The PLI is meant to be a measure of performance, therefore we think that covid has masked both performance and delayed sales which have skewed the measures. Therefore, using a COVID impacted 2020 and 2021 data in which it is unclear what is performance and what is delayed sales, will result in the COVID effect being averaged in the BPR for many years to come.

Government restrictions still applied during FY2021 and only lifted late in the year. The impact on profitability will be less severe than FY2020 when lockdowns were in place.

At Babcock International Group we have the following QBUs:

1. Devonport Royal Dockyard Limited (DRDL)
2. Babcock Marine Clyde Limited (BMCL)
3. Babcock Marine Rosyth Limited (BMRL)
4. Babcock Integrated Technology Limited (BITL)
5. Babcock Aerospace Limited
6. Babcock Land Limited (BLL) and
7. Babcock Land Defence Limited (BLDL)

Operations at these companies were affected by the initial lockdown and activities interrupted. Priorities were agreed with MoD on how programmes would resume working. Different ways of working were explored, and increased shift patterns were introduced to alleviate barriers to project delivery where people work alongside each other in high numbers. These had a major impact on costs in FY2020. There is lesser impact on FY2021 but some costs are now absorbed into a new baseline. FY2022 will be considered a normal year which will include new ways of working adopted going forward.
The safety and welfare of our employees is our main priority.

We expect the 'in year' BPR to remain at FY19 levels for FY20 and FY21 and the three- year average to be calculated accordingly.

As the BPR is calculated with using D&M and P&M groups, these groups should be combined to make a single population as opposed to a simple average of the two.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

BPR methodology consultation

Consultation response form

Question 2: What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We support the ministerial intent to remove the effects of COVID-19 from the benchmark. This could mean up to two years being removed from the benchmark. Given that the average QDC is 4 to 5 years (SSRO Statistics), this can have affect new contracts going forward.

Having the effects of COVID-19 in the benchmark will mean that 2026/27 will be the earliest year that there will be a return to a consecutive three-year benchmark. This assumes that FY22 is treated as a normal year albeit on a new basis.

In the meantime, a total of 200+ new QDCs could be agreed in this timescale that could be impacted by a COVID-19 benchmark for profit calculation.

BPR methodology consultation

Consultation response form

Question 3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1 of the consultation document, and do you favour one? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

The minister clearly stated a desire to remove the impact of COVID-19 in its entirety. BPR scenarios 1 & 2 fail to reflect the wishes of the minister. FY2021 is still likely to be influenced by COVID-19 to a lesser degree but should still be excluded from the 2023/24 calculation. On this basis, scenario 3 is unlikely to be of any benefit.

The BPR should continue to be frozen for another year.

FY2022 is likely to be the next year that sees any attempt of a return to a normal environment, albeit one that reflects the modified way of conducting business.

The profit rate to be set for 2026/27 is likely to be the first year that will use a consecutive rolling forecast. Preceding years will have gaps to exclude the effect of COVID-19.

BPR methodology consultation

Consultation response form

Question 4: Should the approach to the capital servicing rates be retained? We welcome responses supported by the rationale and evidence, an explanation of any benefits and for the potential for known or unintended consequences.

Please add comments to support your answer:

We agree with the principle that CSA should reflect current funding costs of fixed and working capital. However, when deriving the net PLI, for use in determining the BPR, the CSA adjustment made to a particular year's PLI must remain consistent with that year's funding rates (i.e. not be changed to use the latest funding rates as those rates are not relevant to the year the profits were earned).

Is the SSRO proposing a modified approach using median profit rates adjusted for capital servicing with COVID-19 impact removed, and a more up to date separate calculation for the CSA?

The CSA for contractors is generally calculated at QBU level and will vary. Some companies will have multiple QBUs including Babcock and all have independent CSA calculations. We do not agree a CSA at GUO level. Are SSRO suggesting that such a policy could be adopted?

A number of Babcock QBU's have a CP:CE ration more line with the D&M group which runs counter to the P&M rates where the company currently sits. Consequently, Babcock would be at a disadvantage if there was to a change to the BPR methodology in favour of activity groups. We seek a more balanced approach of combining D&M and P&M to give a fairer outcome to industry.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

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

Please add comments to support your answer:

The SSRO should look at the activities of the GUOs of QDCs/QSCs. This should better inform the comparator group for comparability. Companies that are not relevant can be removed.
The D&M and P&M groups should be combined as nearly all companies conduct both activities. This would give a more balanced profit rate.

It is extremely difficult to make an accurate assessment of the impact of COVID-19 on company performance. This event has made companies review and alter their working practices to achieve a new way of working. A consequence will be increased costs that will slowly filter into prices in the long-term. Existing contracts will see cost pressures that are alleviated by claims where applicable.

We also concur with the comments made by the DSAG in their response to this consultation.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

BPR methodology consultation

Consultation response form

Supplementary Comments

Babcock International Group appreciate the meeting held on 8th August 2022 seeking further clarification and detail.

It was noted at this meeting that it is the SSRO's intention to conduct a full consultation of the BPR methodology in April 2023. This consultation should cover all aspects of the methodology and we list out items we expect to be covered:

- Review of comparator groups for relevance to defence markets.
- Consider combining Design & Make and Provide & Maintain as these two groups are blurred by companies conducting both activities.
- Movement away from median to mean where the majority of work is performed.
- Consider more in-depth analysis of companies holding QDCs/QSCs – by value the larger companies hold a larger proportion of contracts that support major equipment programmes.
- SSRO should note that GUOs may not be the Prime contractor but their QBUs will perform the work with pricing and CSA calculated at that level. SSRO should consider Reports and Accounts at QBU level which may give a different analysis.