SSRO

Single Source
Regulations Office

Single source baseline profit rate methodology

Response to consultation on changes for the 2023/24 rates assessment

October 2022

Contents

1. Introduction and summary

1.1 This paper sets out the SSRO's response to the consultation on the 2023/24 rates assessment. The SSRO will now proceed to make its annual assessment of the appropriate baseline profit rate, capital servicing rates, and SSRO funding adjustment ("rates") which it will recommend to the Secretary of State by the 31 January 2023. Our approach is informed by the responses to this consultation.

1.2 The BPR is the first of six steps that contribute to the Contract Profit Rate and support both value for money in government expenditure and fair and reasonable prices for contractors.

1.3 During the consultation period, the SSRO:

- held a workshop which was attended by members from the MOD, industry and the Defence Single Source Advisory Group (DSAG);
- held a meeting with members from the MOD Single Source Advisory Team (SSAT); and
- held bilateral meetings with members from individual companies and an industry consultant.

1.4 The consultation posed five 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?

1.5 We received six detailed written responses (see Table 1).

Table 1: Breakdown of respondents

	Government	Industry	Trade association
Number of responses	1	4	1

1.6 Respondents welcomed the opportunity to engage with the SSRO on developing the methodology for the 2023/24 rates assessment and suggested that there are future methodology improvements they could jointly pursue with the SSRO. We thank those who responded to the consultation for sharing their views and for their continued engagement. We look forward to working with stakeholders to further improve the methodology going forward. Five respondents gave permission for their responses to be published on the SSRO website.

Consultation feedback and the SSRO's response

1.7 All respondents expressed two common views:

a. the need to exclude financial year 2020 (FY2020) company financial data from the 2023/24 rates assessment[1] and considered this to be consistent with the Secretary of State's exclusion of this period in the 2022/23 rates determination; and

b. to keeping the current approach for calculating capital servicing rates.

1.8 The respondents expressed different views in response to the remaining consultation questions. Their primary views are summarised below (1.9 and 1.10) and the details are presented in Section 3.

1.9 The MOD noted that the exclusion of FY2020 was to account for the unprecedented FY2020 events, particularly the national lockdowns. They supported an averaging approach which uses FY2021 company financial data but excludes FY2020 company financial data, noting that in their view this would reflect Ministerial intent. They supported the use of FY2021 based on the measures applied by the SSRO to assess individual companies for the effects of COVID-19 during the BPR assessment.

1.10 Industry respondents did not favour the use of FY2021 company financial data or the SSRO's responses to the pandemic in making the BPR assessment. Their view is that COVID-19 continued to impact data from that time period and could not be considered suitable; and that to deliver the Secretary of State's intent must involve the entire exclusion of company financial data from both FY2020 and FY2021. Some industry respondents were open to exploring conditions for including data from FY2021, whilst others preferred excluding it entirely and retaining the BPR at the same level as in 2021/22. Industry also took the opportunity to again register wider issues about the methodology on which the SSRO did not consult.

1.11 The scope of the consultation was guided by the Secretary of State's announcement. We recognise industry stakeholders' expressions of interest in a broader review of the BPR methodology and note the SSRO's commitment to keeping the methodology under review. In 2021 we published a detailed response to industry feedback on the methodology, which covers many of the points raised in this consultation.[2] We have also met with industry representatives to listen to their feedback.

1 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 https://www.gov.uk/government/consultations/the-baseline-profit-rate-and-its-adjustment

1.12 Having considered carefully the views of stakeholders, the SSRO will, in line with the Secretary of State's announcement, return to a market-based benchmark based on our established methodology that reflects the intention to remove the impact of COVID-19. The available macroeconomic data shows an adverse COVID-19 impact in FY2020 and subsequent recovery in FY2021. This improvement in FY2021 is consistent with the profit data for comparator companies used in the 2022/23 rates assessment. The SSRO has not yet finalised collecting and assessing all FY2021 comparator group data. Stakeholders should note that based on this evidence to date the SSRO is currently minded to exclude FY2020 company financial data and to include FY2021 company financial data. If the SSRO proceeds on this basis, its assessment of the baseline profit rate would be calculated as a three year average of FY2021, FY2019 and FY2018. We will keep under review the FY2021 company information and the final decision will be made in January 2023. If FY2021 company financial data is not used the most recent data available to calculate a baseline profit rate as a three year average would be FY2019, FY2018 and FY2017.

1.13 Our immediate priority is to respond to both the Secretary of State's 2022 rates determination and the review of legislation. We intend to consider how activities which occur under qualifying contracts are reflected in our baseline profit rate assessment. We will make a decision on a final timetable and scope of work in our next corporate plan which is due to commence in April 2023.

2. The 2022/23 rates assessment

2.1 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")[3].

2.2 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.

2.3 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. Additional details on the SSRO's 2022/23 rates assessment approach are in Appendix 1.

2.4 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 FY2021 to determine the BPR. This resulted in the BPR remaining 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."[4]

2.5 The SSRO launched a consultation in June 2022[5] with the aim of reflecting the Secretary of State's intent and of considering other stakeholder views in developing an approach for assessing the 2023/24 rates.

3 https://www.gov.uk/government/publications/2022-contract-profit-rate-recommendation
4 https://questions-statements.parliament.uk/written-statements/detail/2022-03-28/hcws726
5 https://www.gov.uk/government/consultations/single-source-baseline-profit-rate-methodology

3. Consultation feedback

3.1 We considered the Secretary of State's intent in developing proposals for the 2023/24 rates assessment. The proposals did not depart from the fundamentals of our methodology and considered the issues that needed to be addressed:

a. The inclusion of individual company data in any one year

b. The inclusion of all data over a specific period

c. The approach to combining multiple years of data into a single rate

3.2 The consultation set out three examples of averaging period scenarios using the SSRO's methodology (see Table 2). The examples included the SSRO's pre-2022/23 rates assessment approach which uses data for the most recent three years (Scenario 1); and the approach applied by the SSRO for the 2022/23 rates recommendation which uses data for the most recent four years (Scenario 2).[6] Both scenarios include FY2020 and FY2021 data. Scenario 3 excludes FY2020 data in line with the Secretary of State's determination in 2022 but returns to the SSRO's methodology by using data from FY2021.

Table 2: Averaging scenarios for calculating the baseline profit rate

Scenario	Reporting years included in the average			
	FY2018	FY2019	FY 2020	FY2021
1		✓	✓	✓
2	✓	✓	✓	✓
3	✓	✓		✓

3.3 We recognised that an alternative, would be to exclude both FY2020 and FY2021 data from the assessment entirely. We expressed a cautious approach to this as removal of recent data means the resultant BPR is not being based on the most recent available data, and would need to be justified on the basis that it supported fair and reasonable prices and value for money.

3.4 We sought, through five questions, stakeholder views on the averaging period and the case for including or excluding periods of data from the 2023/24 rates assessment. All the six respondents provided feedback on all the consultation questions. The respondents presented common views in their responses to some consultation questions, and different views in response to other consultation questions. A summary of feedback for each question and the SSRO's response is presented below. We also comment in Appendix 2 on matters which the SSRO did not consult on.

6 See Table 1 at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1009057/Response_to_consultation_on_the_baseline_profit_rate_and_its_adjustment_August_2021A_.pdf

Q1: How should the FY2020 and FY2021 data of comparator companies be used to inform the 2023/24 baseline profit rate?

3.5 Both industry and the MOD supported the exclusion of FY2020 company financial data from the 2023/24 rates assessment. They considered this to be consistent with the Secretary of State's exclusion of this period in the 2022/23 rates determination.

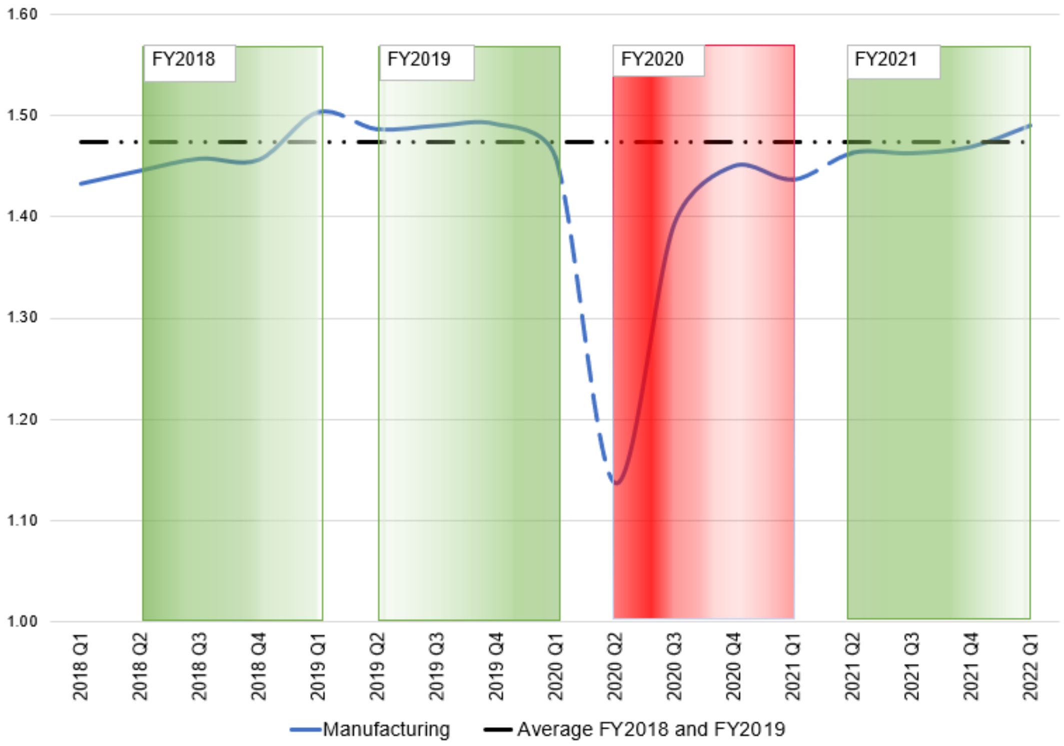
3.6 The respondents however expressed different views on how FY2021 company financial data should be used to inform the 2023/24 rates assessment. The MOD supported the inclusion of FY2021, acknowledging that whilst the pandemic was ongoing, it did not suffer the extraordinary lockdown events of FY2020. Two industry respondents thought FY2021 should be excluded, and the 2023/24 BPR retained at the same level as in 2021/22. They argued that governments' restrictions still applied during most of FY2021 and impacted on companies' operations, therefore exclusion of FY2021 data from the assessment would align with the Minister's statement of excluding the impact of COVID-19 from the BPR. The remaining three industry respondents considered FY2021 likely to be significantly impacted by COVID-19, noting that supply chains are predicted to normalise as late as 2024 and therefore proposing conditions for its use in the 2023/24 rates assessment:

- If FY2021 is used, it should be subjected to a review to ensure comparable market-based profit rates that exclude the impact of COVID-19.
- If FY2021 comparator group is found to be only slightly impacted by COVID-19 they would expect an assessment that combines the develop and make (D&M) and the provide and maintain (P&M) activity groups, and an application of a four-year average.
- If the review of the impact of COVID-19 is inconclusive then FY2021 should not be used and the BPR should be frozen at the same level as in 2021/22.

SSRO response

3.7 Having considered carefully the views of stakeholder, the SSRO has collated evidence on the macroeconomic performance of the UK economy during FY2021 compared to FY2020, and compared to the pre-pandemic period. Figure 1 shows trends for indexed Gross Value Added (GVA) data published by the Office of National Statistics (ONS) for the UK manufacturing sector. The index shows an adverse impact of COVID-19 on FY2020 and subsequent recovery in FY2021.

Figure 1: Indexed Gross Value Added for the UK manufacturing sector: 1997Q1 = 100



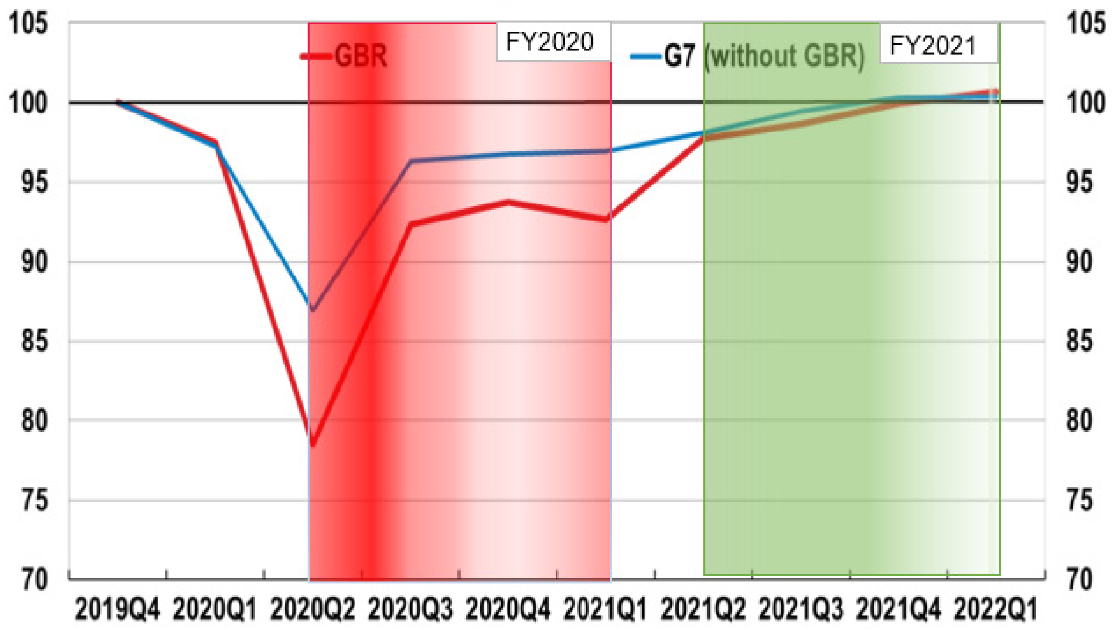
Source: ONS Statistics[7] and SSRO calculations

3.8 The UK's economic outlook provided by the OECD (see Figure 2) based on the real GDP index declines and then recovers. The OECD report considered FY2021 to be the period in which the G7 countries recovered from the impact of the pandemic[8].

7 https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/flashproductivitybysection

8 See page 4 at: https://www.oecd.org/economy/united-kingdom-economic-snapshot/

Figure 2: Indexed Real Gross Domestic Product for the G7: 2019Q4= 100



Note: Index for G7 (without GBR) is calculated as a simple average

GBR – Great Britain

G7 (without GBR) – USA, Japan, Germany, France, Italy, Canada

Source: OECD (2022), OECD Economic Outlook Statistics and Projections (database)[9]

3.9 The available macroeconomic data shows an adverse COVID-19 impact in FY2020 and subsequent recovery in FY2021. This improvement in FY2021 is consistent with the profit data for comparator companies used in the 2022/23 rates assessment. The SSRO has not yet finalised collecting and assessing all FY2021 comparator group data. Stakeholders should note that based on this evidence to date the SSRO is currently minded to exclude FY2020 company financial data and to include FY2021 company financial data. If the SSRO proceeds on this basis, its assessment of the baseline profit rate would be calculated as a three year average of FY2021, FY2019 and FY2018. We will keep under review the FY2021 company information and the final decision will be made in January 2023. If FY2021 company financial data is not used the most recent data available to calculate a baseline profit rate as a three year average would be FY2019, FY2018 and FY2017.

3.10 We note that three of the SSRO's four 2022/23 recommendation benchmarks remained at pre-pandemic levels during FY2020 period of lockdowns. Even where the broader effects of the pandemic are ongoing, it cannot be assumed this will necessarily manifest as an impact to the BPR that must be removed.

9 https://www.oecd.org/economy/united-kingdom-economic-snapshot/

Q2: What should be the approach in the assessment to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark?

3.11 The MOD observed FY2020 to have been an extraordinary year in which lockdowns were imposed and vaccines were unavailable at the beginning, thereby imparting severe knock-on effects on many sectors of the economy in a way that subsequent years have not been impacted. They noted that the exclusion of FY2020 was to account for the unprecedented events, and emphasised the need to continue excluding FY2020 from subsequent BPR calculations.

3.12 Industry expressed support for the Secretary of State's intent to exclude the COVID-19 effects from the analysis and to return to a market-based approach. Industry considered that the SSRO's consultation proposals, which they stated focused on the averaging approach, would not achieve the Secretary of State's request which they considered requires a deeper review of the methodology. They argued that it is the removal of the impact of COVID-19, and not its mitigation from the BPR, that fulfils the Secretary of State's request; and that is consistent with MOD policy of excluding COVID-19 related costs when pricing contracts. One respondent queried why, as an independent regulator, the SSRO is influenced and concerned by the Secretary of State's decision and intent.

3.13 Four industry respondents noted the possibility of other extraordinary events that may arise and require exclusion in the future. They gave the example of the war in Ukraine and the cost of living crisis. One of these respondents suggested that the Secretary of State's intent 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.

3.14 In addition to a proposal of applying a weighted average, industry repeated some of the proposals suggested in their response to Q1 (using a single population, reviewing for comparability and excluding COVID-19 affected years) as approaches that could be applied to reflect Ministerial intent to remove the effects of COVID-19 from the benchmark. One respondent noted, without identifying the specific elements, that DSAG's two papers on the BPR (shared with the SSRO in October 2021 and in June 2022) are also relevant to achieving the Secretary of State's request for a fair market profit rate.

SSRO response

3.15 The SSRO takes an evidence-based approach to delivering its functions, having regard to the views of our stakeholders. Considering the views of the Secretary of State when concluding the annual rates assessment approach is therefore appropriate. We have enquired with the MOD in respect of the industry feedback that there is a policy to exclude COVID-19 related costs when pricing contracts. Our understanding is that it is not policy to exclude these costs from the price of qualifying contracts. Any such cost would be subject to the requirements of Allowable Costs under Section 20 of the Act.

3.16 Economic circumstances are always the consequence of past economic shocks, which occur frequently, and the extent to which they appear extraordinary varies from event to event. The SSRO's approach includes features to stabilise the impact of economic shocks, and allows for further flexibility to adapt to extraordinary events in the future, should they arise in such a way that impacts the assessment of a fair BPR.

3.17 Several industry stakeholders have suggested that we should make methodological changes such as introducing weighted means or combining industry types. While we are giving consideration to these suggestions, our view is that they do not directly relate to the Ministerial intent to remove the effects of COVID-19 from the calculation. The underlying analytical merits of combining the D&M and P&M groups requires further investigation, while their effect (increasing the underlying rate in the short term) could change in future years and has produced lower rates in the past. We set out in detail[10] the rationale for our current approach to the composite of D&M and P&M in our response to the 2021 consultation. We will however keep this area under review, and intend to consider whether D&M and P&M should be replaced with a single activity type capturing the totality of design, development, manufacture and support in the planned activities review.

3.18 The SSRO uses the median which has stabilising properties. The weighted mean (the approach taken by the Review Board in calculating an "overall return") overemphasises the result of a few large companies in the comparator group, creating volatility and unpredictability for parties pricing contracts. For example, had the SSRO taken this approach for the 2022/23 rates assessment the effect of the performance of the largest few companies would have resulted in respective D&M and P&M underlying rates of 4.5 per cent and 3.5 per cent, compared to the SSRO's calculated 8.7 per cent and 6 per cent respectively. Using the weighted mean would have exacerbated rather than removed the effects of COVID-19. We remain of the view that our choice of average is appropriate for calculating a central markup which produces stable and predictable results.

Q3: What are your views on the strengths and drawbacks of the different averaging periods presented in Table 1 and do you favour one?

3.19 Industry respondents did not consider averaging as a solution to removing the impact of COVID-19, unless the affected years are removed from the averaging process. They argued that averaging does not remove the impact of COVID-19, but instead spreads and compounds the shock across many years.

10 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1009057/Response_to_consultation_on_the_baseline_profit_rate_and_its_adjustment_August_2021A_.pdf

3.20 The MOD and two industry respondents observed that SSRO's Scenarios 1 and 2 include FY2020 and fail to reflect the Minister's intent and are therefore not appropriate to be taken forward. The MOD supported the SSRO's Scenario 3, which they noted reflects Ministerial intent of excluding extraordinary years. The two industry respondents however said they thought that FY2021 is still likely to be influenced by COVID-19, albeit to a lesser degree, but that it should still be excluded from the 2023/24 calculation if the effects of COVID-19 cannot be isolated and removed from the data. One of these two respondents said that they did not see any benefit in changing from the three-year averaging period, and noted that the averaging period should only be a tool for correcting minor fluctuations in the underlying rate. The remaining three industry respondents suggested using a four-year average including FY2017, FY2018, FY2019 and FY2021, subject to exclusion of the impacts of COVID-19 from the data, improvement of comparability and combining the D&M and P&M activity groups.

3.21 One respondent noted that while the SSRO considered a four-year rolling average to increase the influence of stable historical profit trends, the respondent's earlier feedback pointed out that the underlying historic profit rate was still volatile over the long-term. They claimed that their analysis (which they shared with the SSRO) provided evidence that a more stable baseline over the last three years is achieved by reflecting a more representative assessment of the weighted average, which accounts for the comparator group quartile in which the majority of QDCs fall.

SSRO response

3.22 Averaging the underlying rates dampens the effect of short-term temporary increases or decreases in average profitability from one year to the next and allows for a phased transition when movements are more sustained. We do recognise that more extreme temporary year-on-year changes could limit the achievement of its desired effects. Industry's argument that averaging merely spreads the impact of a change in the BPR over a number of years may be a correct assessment if all contractors entered into identical qualifying contracts every year. In that case the year-on-year effect (positive or negative) would ultimately accumulate as if there had been no averaging at all. However, contracts are not entered into in this way. The BPR is the starting point for the application of the six steps which result in the contract profit rate, and small changes (such as those in the SSRO's previous recommendations) impart minimal effects on the year-on-year range of available contract rates. Our statistics show that changes in the BPR are typically accompanied by relatively smaller changes in average estimated contract profit rates.[11] From the perspective of a single contract and contractor, averaging reduces the impact of any one underlying rate on the price of a contract and the use of a year-on-year average is an important stabilising feature of the methodology.

11 See for example historical average estimated contract profit rates in Table 3 at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1100776/Q1_2022-23_Quarterly_statistical_bulletinA.pdf and historical BPRs on page 1 at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/967440/Recommendation_Factsheet_2021AP.pdf

3.23 We note DSAG's analysis from which we have observed that removing certain companies from the benchmark group enabled DSAG to calculate underlying rates which in some instances were higher than those from the SSRO's assessments. This excluded companies that the SSRO believed were suitable to include in the assessment. Further work will need to be done by the SSRO to confirm the reason for their removal and whether it is supported by evidence and should be subsequently adopted by the SSRO.

Q4: Capital Servicing Rates: Should the approach to the capital servicing rates be retained?

3.24 Both industry and the MOD agreed that Step 6 of the contract profit rate formula should reference the current market costs of funding fixed and working capital. Industry pointed out that when determining the net profit level indicator (PLI) for use in the BPR, the capital servicing adjustment made to a particular year's PLI must remain consistent with that year's capital servicing rates (CSRs).

SSRO response

3.25 We believe the current approach to the capital servicing rates is in line with stakeholders' views and will retain it. This involves including, in the CSRs calculation, interest rates data from the pandemic period to recognise the pandemic's temporary effect on the cost of debt.

Q5: What additional steps could the SSRO take in analysing individual companies to remove the effects of COVID-19 from the baseline profit rate?

3.26 Both the MOD and industry supported the SSRO's view that it is not possible to decompose the impacts of COVID-19 from other effects that may affect companies' operations. This would require adjusting company profits to what they would have been had the pandemic not occurred. The MOD supported 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 years other than FY2020.

3.27 Industry did not agree that reviewing activities, excluding loss makers, and averaging reflected the intent to remove the effect of COVID-19. Industry argued for the BPR to be calculated on the same basis as the rest of the price construct which requires excluding COVID-19 related costs when pricing contracts and hence a profit rate exclusive of COVID-19 effects. One industry respondent argued that the SSRO's approach of retaining companies that continued to undertake comparable activities does not adequately address the impact of COVID-19 as it does not account for reductions in profitability resulting from increased pandemic related costs.

3.28 Industry respondents repeated their view in favour of the weighted mean and that the removal of COVID-19 impacted years would be desirable. In additional they argued that benchmark companies should be drawn from sectors that were required to operate as "normal" during the pandemic, for which they suggested Defence and Utilities.

SSRO response

3.29 Our detailed 2022/23 rates assessment company review assessed the impact the pandemic had on the ability of companies to continue to operate as “normal” in so far that they were able to continue with their activities. We do not think any sector could be described as having continued operating as normal during the pandemic, including that of defence. Our understanding is that there were no requirements from the MOD for suppliers to continue to deliver as normal in FY2020 given the exceptional nature of the circumstances. We recognise that some strategically important sectors were afforded protections which lessened the operational impact of COVID-19. The provision of utilities is not an activity which the SSRO benchmarks in its BPR assessment. We will consider, in the planned 2023 activities review, evidence submitted on the provision of utilities as an activity which supports the delivery of qualifying contracts and their potential inclusion in the comparator group.

3.30 We note industry’s view that they do not agree with the measures the SSRO applied to mitigate the effect of COVID-19. We believe that the fact that the 2022/23 recommended rates assessment approach resulted in three of our four benchmarks remaining at pre-pandemic levels is indicative of the effectiveness of the measures we applied. The lower than pre-pandemic P&M group rate resulted from reduced rates of individual companies beyond which the stabilisation measures could address. These reductions were driven by companies operating both within and outside the defence sector. We found no evidence to support the suggestion that the profit rates of companies operating in the defence sector were differentially affected by COVID-19, compared to other companies in the comparator group.

Responses to issues not consulted on

3.31 Respondents provided feedback on aspects of the SSRO’s BPR methodology which were not in scope of the points we specifically consulted on. We note that while some of the issues raised are new, the majority have been raised previously and responded to by the SSRO. We have commented on this feedback under the different themes presented in Appendix 2.

4. Conclusion and next steps

4.1 There was an alignment of views that FY2020 company financial data should not be used in the 2023/24 rates assessment, but differing views on FY2021 and the appropriate averaging period.

4.2 In line with the Secretary of State’s announcement we will return to a market-based benchmark based on our established methodology that reflects the intention to remove the impact of COVID-19. The available macroeconomic data shows an adverse COVID-19 impact in FY2020 and subsequent recovery in FY2021. This improvement in FY2021 is consistent with the profit data for comparator companies used in the 2022/23 rates assessment. The SSRO has not yet finalised collecting and assessing all FY2021 comparator group data. Stakeholders should note that based on this evidence to date the SSRO is currently minded to exclude FY2020 company financial data and to include FY2021 company financial data. If the SSRO proceeds on this basis, its assessment of the baseline profit rate would be calculated as a three year average of FY2021, FY2019 and FY2018. We will keep under review the FY2021 company information and the final decision will be made in January 2023. If FY2021 company financial data is not used the most recent data available to calculate a baseline profit rate as a three year average would be FY2019, FY2018 and FY2017.

Appendix 1 : Background to the consultation

The 2022/23 rates assessment and determination

The BPR is an average of the profit rates of groups of companies carrying out the types of activities that contribute to the fulfilment 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 have followed.

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).[12] 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.

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.

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 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 determined for 2021/22. As set out at paragraph 2.4 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.

12 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.

Appendix 2 : Other matters

Respondents provided feedback on aspects of the SSRO's BPR methodology which were not in scope of the points we specifically consulted on this year. We note that while some of the issues raised are new, the majority of them have been raised previously and responded to by the SSRO. We have commented on this feedback under the different themes presented in Appendix Table 1.

Appendix Table 1: Comments on issues not consulted on

Topic	Stakeholder feedback	SSRO comment
Methodology review	Industry identified the following as the main elements that the review of the methodology should focus on: a. review of comparator groups for relevance to defence markets; b. combining D&M and P&M activity groups; c. move from median to weighted mean; and d. calculating capital servicing adjustments at Qualifying Business Unit (QBU) levels.	We note industry's suggestions and look forward to working with industry on the activities review project. The topics that may be covered will be subject to the scope of the activities project which is planned to commence in April 2023.
Combining D&M and P&M activity groups	One respondent asserted that 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 D&M and P&M.	Whilst there was heighted volatility in the underlying data, it is incorrect to say there was heightened volatility in setting the BPR. The SSRO recommended a BPR for 2022/23 only 0.24pp different from that for 2021/22, one of the smallest changes in recent years.

Topic	Stakeholder feedback	SSRO comment
Combining D&M and P&M activity groups	One respondent argued that 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. They argued that their analysis shows that companies with QDCs/QSCs perform both D&M and P&M activity, hence the need to revisit this artificial divide that creates a disproportionate outcome. The message was supported by the other industry respondents.	We responded to this point in paragraphs B60 to B63 of our response to the 2021 consultation[13]. We are open to reconsidering the separation of D&M and P&M. This will be considered in the activity review. We note that different approaches would have led to different underlying rate outcomes, both higher and lower than might otherwise be the case over the different years.
	One respondent argued that its QBUs have CP:CE ratios which are more aligned with the D&M group and would be disadvantaged by activities groups approach, so sought a more balanced approach of combining D&M and P&M to give a fairer outcome to industry.	We responded to this point in paragraphs B36 to B42 of our responses to the 2021 consultation[14].
Use of median Vs weighted average	One respondent noted that they have queried the use of the median in previous papers. They claimed that results from their analysis suggest that the majority companies with QDCs/QSCs have turnovers of £150M or more. They argued that the application of a median 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.	We have responded to this point in paragraphs B44 to B51 of our responses to the 2021 consultation[15]. We are working with stakeholders to review their analyses which we expect to inform our activities review. We have sought to better understand the approach that has been taken to company selection and this will require more work to determine if and how their approach might be incorporated into our annual assessment, if appropriate.

13 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1009057/Response_to_consultation_on_the_baseline_profit_rate_and_its_adjustment_August_2021A_.pdf
14 ibid
15 ibid

Topic	Stakeholder feedback	SSRO comment
Excluding leasing companies from the P&M activity group	One respondent asserted that the MOD cannot single source contracts for the provision of assets through leasing, and therefore companies undertaking leasing activities should not form part of the comparator group.	It was envisaged when the SSRO's BPR methodology was first developed that capacity provision would be an activity that may be relevant to the fulfilment of a QDC or QSC. There are examples where the MOD is granted the use of an asset or the right to operate it but does not own it. We have not ruled out that such an arrangement could be contracted for under the regime and think it is important to include them as they tend to generate higher rates for profit than more cost driven activities. As such our comparator group includes companies that lease aircraft, ships and other industrial hardware. It is right to consider, in light of the qualifying contracts that have been placed, if it remains appropriate to continue to reflect capacity provision in the BPR and we plan to do so as part of the activities review project which we have signalled in our Corporate Plan.

Topic	Stakeholder feedback	SSRO comment
CSA	One respondent argued for calculating a capital servicing adjustment (CSA) at a QBU and not global ultimate owner (GUO) level on the grounds that CSAs for contractors are generally calculated at QBU levels, so companies with multiple QBUs should have independent CSA calculations. They sought to know whether the SSRO is suggesting that such a policy could be adopted; and also whether the SSRO is proposing a modified approach using median profit rates adjusted for capital servicing with the COVID-19 impact removed.	We did not propose any changes to the approach to capital servicing adjustment and have no immediate plans to do so. The approach to capital servicing adjustment is set out in paragraphs 20 and 23 of the SSRO's Q and A document.[16] In the BPR we have to adjust the company level data for capital servicing, so we would need to understand why and how it is envisaged a QBU level adjustment would operate.
Transfer Pricing	The respondent requested a discussion on transfer pricing as a topic in more detail at some point.	We welcome a discussion on the transfer pricing topic.
Clarification	The respondent asked the SSRO to clarify the meaning of the statement "…the 2022/23 assessment could be indicative of a longer-term deviation from the past".	Following an economic shock, the overall system may settle to a position it was previously in or shift to different position. That might result in comparable, higher or lower average rates of profit over the longer term future compared to those observed in the past.

16 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1066587/Q_and_A_Briefing.pdf