

# SSRO

Single Source  
Regulations Office

## **BPR activities review consultation**

### Consultation responses

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## 1. Babcock

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

## The baseline profit rate activities review

### Consultation response form

#### Overview

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

This consultation is open to all interested persons. We particularly welcome comments from individuals or organisations with an interest in single source defence procurement and ensuring that good value for money is obtained in the government expenditure on qualifying contracts and the prices paid under those contracts are fair and reasonable. The consultation will close on 10 August 2023. Following our consideration of responses to the consultation, we will publish an updated profit rate guidance by the end of October 2023.

**Please respond by 5.00pm on Thursday 10 August 2023.**

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](mailto:consultations@ssro.gov.uk) (preferred)
- by post to: Baseline profit rate consultation responses, SSRO, G51/G52, 100 Parliament Street, London, SW1A 2BQ
- by telephone including arranging an appointment to speak to the SSRO about the consultation: 020 3771 4767

## The baseline profit rate activities review

### Consultation response form

#### Your details

Name:

Gerry McDonnell

Organisation:

Babcock International Group

Position:

Finance Manager

#### 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

No

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## The baseline profit rate activities review

### Consultation response form

**Question 1:** Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?

Babcock supports the arguments the DSAG have listed in their response. We also have our own observations:

Technical Support can cover many areas that cover both P&M and D&M activities. It is not necessarily appropriate to allocate into one area. In fact, in Appendix B the SSRO have duplicated the use of NACE Rev2 code 749 relating to Other Professional, scientific and technical activities. This supports the argument that P&M and D&M groups should be merged into a single comparator group. The BPR is calculated using data from both groups, so why not have one single group.

Technical support belongs to a combined D&M and P&M comparator group. Companies performing this work fall into both areas. This would be a fairer approach to adopt.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

## The baseline profit rate activities review

### Consultation response form

**Question 2;** Do you agree that the logistics activity complements the business as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?

Please add comments to support your answer:

Babcock supports the arguments the DSAG have listed in their response. We also have our own observations:

Given that there are very few contracts relating to logistics and given their value, it is not considered appropriate to include logistics to the P&M characterisations.

Classification: OFFICIAL

Handling Instructions: Commercial-in-Confidence

## The baseline profit rate activities review

### Consultation response form

**Question 3:** Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?

Please add comments to support your answer:

Babcock supports the arguments the DSAG have listed in their response. We also have our own observations:

Outsourcing activity can cover a range of activities in addition to those listed in Para 2.16 of the consultation. There may be some crossover with technical support as listed in question 1 above.

Given that such contracts are not material, why are SSRO seeking to add this activity at all?



## The baseline profit rate activities review

### Consultation response form

**Question 4:** To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?

Please add comments to support your answer:

Babcock supports the arguments the DSAG have listed in their response. We also have our own observations:

There is an aspiration by MoD to contract for availability and capability. The difficulty with agreeing such contracts is that MoD are often surprised at the cost. Contract negotiations generally revert to input costs when trying to agree an output price. MoD are not always reasonable in this respect and a lack of understanding exists.

The consultation paper references leasing but we are not aware if MoD leases assets direct. Contractors will use leasing arrangements to support delivering business outputs. The associated cost will be incorporated into the relevant pricing structure. Capacity provisioning extends beyond leasing, it extends to contractors employing and retaining the necessary qualified staff to achieve the MoD outcomes. MoD are quite keen on capacity planning to support their contract outputs. MoD will create a demand dependency with Industry when considering long term planning. This element appears to have been overlooked by SSRO in its analysis. Capacity provisioning will apply to the whole product lifecycle which is another reason to combine the two activity groups.

When considering the NACE Rev2 codes it appears inappropriate to include leasing as described in those codes. If these codes are removed, you are left with just two, one of which is duplicated in the D&M activity type. The remaining code is 33, repair and installation of machinery and equipment. It is difficult to see how Babcock is assigned to the P&M activity group as opposed to D&M.

NACE Group 301 covers building of ships and boats. It also covers the major overhaul of such vessels which is made clear in 3315. Both are a significant part of our business.

This provides additional support for the D&M and P&M groups to be combined. Both groups have over 75% by value of qualifying contracts and is likely to remain that way in future as the MoD require their leading partners to be suitably capitalised to deliver their programmes.

## 2. BAES

# The baseline profit rate activities review

## Consultation response form

### Your details

Name:

Janine Crocker

Organisation:

BAE Systems

Position:

Head of Government Contracting and Rates

### Consultation questions

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Yes

No

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## The baseline profit rate activities review

### Consultation response form

**Question 1:** Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?

In the absence of any other changes to the BPR Comparator Group selection methodology, it seems appropriate that Technical Support Activities should be included in the Provide and Maintain (P&M) activity group. Much of the technical support activity you describe does complement existing knowledge-based activities that may be contracted for under a QDC.

We would ask, however, that the SSRO consider the representations made by DSAG previously and again in response to this consultation, regarding the more fundamental aspects of how QDC-contract activity is viewed and benchmarked. It appears that many of the companies currently part of this comparator group may conduct a limited set of activities that may form a part of a more complex range of activities typically carried out under a qualifying defence contract, but not the whole range of activities we would expect such a contract would usually cover. We think equating the two by using one to feed into a benchmark for the other may be problematic.

## The baseline profit rate activities review

### Consultation response form

**Question 2;** Do you agree that the logistics activity complements the business as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?

Please add comments to support your answer:

'Logistics' activity is an example of an area where we can see the issue highlighted under Question 1 to manifest. We would expect that any contracts MoD lets for pure logistics services to be competed. In a single-sourced Qualifying Defence Contract we would expect logistics services only to be provided as a supplementary activity to a wider, more complex requirement. Therefore, we would not consider it appropriate to feed the returns generated by pure transport & logistics operators into this comparator group.

## The baseline profit rate activities review

### Consultation response form

**Question 3:** Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?

Please add comments to support your answer:

Ancillary Services Activity Group is not currently used to set the BPR, and therefore does not feed into pricing QDCs. Therefore, this question only becomes fully relevant to industry if you are suggesting this change with a view to, in future, including Ancillary Services in the setting of BPRs. We assume that if that was to be the case, you would consult on this change much more comprehensively.

As far as the SSRO define Ancillary Services, it seems on the face of it that labour outsourcing should be included in this grouping.

## The baseline profit rate activities review

### Consultation response form

**Question 4:** To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?

Please add comments to support your answer:

The wording of this question is difficult to follow. If it is asking whether Availability or Capability Contracts could be Qualifying Defence Contracts - then yes, we absolutely believe they fall into the realm of what we see MoD potentially contracting single source.

The second part of the question suggests to us the inclusion of companies potentially providing simple hire or leasing services in the P&M activity group. We would again question whether simple leasing arrangements should be contracted by the Authority non-competitively. If they were, we would contest that this type of activity is very different in nature and risk to an availability service provided for a complex range of military equipment, that may require highly specialised repair and maintenance regimes, often in combination with complex Engineering services. We would therefore argue that the returns made on the former should not form part of a benchmark set for the latter, as not representative.

### 3. DSAG



# The baseline profit rate activities review

## Consultation response form



c/o ADS, Salamanca Square,  
9 Albert Embankment,  
London, SE1 7SP

9<sup>th</sup> August 2023

**Subject: Open consultation. Baseline Profit Rate Activities Review**

Thank you for the opportunity to allow Industry to provide commentary and feedback in relation to the Baseline Profit Rate Activities Review Consultation.

We have consulted with the DSAG members and have aligned our position to represent the collated feedback of contractors. Industry members may also submit their own separate feedback as part of this consultation process.

Whilst DSAG has pleasure in submitting our combined response to the consultation paper on Part 1 of the BPR review, we were disappointed that the work submitted to the SSRO earlier in the year which also reviewed historic data has been largely ignored. We reiterate that the papers submitted are still relevant to the consultation and should be considered as part of this response in addition to the answers to specific questions raised. We have included as an appendix the paper submitted.

Please find enclosed the DSAG response to the consultation and our previous thoughts paper shared with the SSRO at Appendix A.

We look forward to receiving feedback on the consultation process and next steps in due course.

Yours sincerely,

Chair of DSAG

# The baseline profit rate activities review

## Consultation response form

### Overview

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

# The baseline profit rate activities review

## Consultation response form

### Your details

Name:

DSAG- Defence Single Source Advisory Group on behalf of Industry

Organisation:

ADS group

Position:

DSAG

### Consultation questions

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

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# The baseline profit rate activities review

## Consultation response form

**Question 1:** Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?

To explain our reasoning on activity groups and their membership: per 3.2 of the consultation paper, if comparability is the chosen methodology for setting a fair contract profit rate, we concur the “activity group is a group of companies that carry out activities that are similar, to an appropriate extent, to the activities we are seeking to benchmark”.

The key questions being:

- What is the activity we are seeking to benchmark?
- Are there companies who specifically conduct only those activities described in the activity type and can we therefore provide a comparable benchmark?

What activities are we seeking to benchmark?

In the pricing formula  $(CPR \times AC) + AC$ , CPR is the profit rate for the contracted obligation.

Fundamental to setting a fair **Contract Profit Rate** is the BPR as it, and the CSA (step 6), form 97% of the average CPR (SSRO statistics June 2023) for contracts let.

Therefore, using comparability as the method to determine a fair BPR (and CPR) means the activity we seek to benchmark is the type of contractual obligation the MOD is letting as a qualifying contract (it is not the input activities that contribute to qualifying contracts, but the obligation itself).

Are there companies who specifically conduct only those activities described in the activity type and can we therefore provide a comparable benchmark?

Comparability also obliges determining a reference group of companies that solely (or at least significantly) earn their profits from the defined activity type (contract type). We observe that many groups earn their profits from a range of contracting activities, with few solely dedicated to one contract activity type. Indeed, a review of the SSRO’s response to FOI request RF1058 and of the companies included in the SSRO comparator groups for D&M/P&M (for years 2021/22, 2023/2024) showed over 90% of those companies conducted both D&M and P&M contracts, not one or the other. Therefore it is not possible to provide unique benchmark profit rates for D&M and P&M as the companies in the comparator groups (D&M/P&M) actually conduct both activities. Industry has also conducted analysis (again shared with the SSRO), on the SSRO FOI request 058. This showed, of the SSCR D&M and P&M contracts, let 90% are held by GUOs who perform both activity types (i.e. those companies are deriving their profits by conducting both activities and therefore their profits are only suitable for use as a single population benchmark of D&M and P&M activity groups).

Therefore, to answer, “do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group...”

If the MOD place qualifying contracts specifically for technical support and if comparator companies can be identified, who significantly earn their profits from comparable contracts, then yes.

Conversely, if MOD are not placing qualifying contracts specifically for technical support, but technical support is always included in (say) an availability contract or a D&M contract, then our answer would be no as the comparable obligation, we are setting a profit rate for, is the P&M/D&M contract, not a technical support contract.

Indeed, members experiences are that technical support is an activity that forms part of D&M and P&M contracts rather than it is something contracted in its own right.

# The baseline profit rate activities review

## Consultation response form

**Question 2;** Do you agree that the logistics activity complements the business as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?

Please add comments to support your answer:

For reasons explained in response to Q1, if the MOD let very few contracts for logistics activities and if logistic activities are usually provided through other contract types (e.g. availability contracts), then no, they should not be included.

# The baseline profit rate activities review

## Consultation response form

**Question 3:** Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?

Please add comments to support your answer:

If “alternate” BPR activity types, such as ancillary, were to be proposed for use in pricing we would recommend there is much more study, analysis and consultation on the various SSRO activity types.

Ancillary services could comprises a broad range of contracting obligations from the provision of a resource with no committed outcome (e.g. simple labour provision) to contracts where there are committed outcomes.

We do not think a provision of labour, directed by MOD, with no committed outcome is the same type of contractual obligation as provision of administration/IT etc. where there is a committed outcome that may also involve capital investment (e.g. payroll, IT or accounting services that provide resource, sometimes facilities/software and due dates for service provision or service level targets).

# The baseline profit rate activities review

## Consultation response form

**Question 4:** To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?

Please add comments to support your answer:

The question asked is '(does it)...constitute an activity which enables the performance of qualifying contracts'. However, we believe that the question should be 'is this a comparable obligation or output that is contracted for by qualifying contracts'

We wonder if terminology is causing us a little confusion when responding to this question?

Our understanding of qualifying availability contracts is where the MOD own the asset, often previously purchased from the same contractor, and rather than contract for repair, overhaul and maintenance, on an as required basis, the MOD contract for a level of availability, of their asset. The contract providing the "guaranteed" level of availability will of course include conducting repair, overhaul, etc. but the obligation of "guaranteed" availability is quite different to an as required R&O contract.

We think the MOD have a number of availability type contracts, most of which will be significant in value, if not in number (count).

These availability contracts are quite different to asset leasing. In asset leasing contracts the lessor owns the asset, the asset is usually not bespoke, the arrangement may or may not include support and at the end of the lease period the asset returns to the lessor who will usually look to lease to another customer or sell the asset (hence the asset cannot be too bespoke as it has to be suitable for alternate, subsequent, users).

We are not aware lease contracting is used by the MOD under qualifying contracts. We also see asset leasing as quite different to P&M contracting conducted by the MOD. Therefore, we propose renting and leasing do not feature in the comparator group (NACE codes: 7735, 7739, 7712, 7732, 7734).

# The baseline profit rate activities review

## Consultation response form

### Further comments on the consultation paper

1.4

This methodology identifies companies undertaking **activities comparable** to those that **contribute to** the delivery of single source contracts through reviewing the characteristics, risks and assets of Qualifying Defence Contracts (QDCs) and Qualifying Sub-contracts (QSCs) (hereafter collectively referred to as qualifying contracts) and analysing company accounts, business descriptions and public information. This results in a methodology that, unlike the **previous regime, no longer uses companies that bear no relevance to those activities undertaken in the defence industry**, such as supermarket retailers, pharmaceutical and tobacco companies.

1.8

The methodology identifies companies whose economic activities are included in whole **or in part** in the activity types **that contribute to** the delivery of qualifying contracts. These comparable companies form the comparator groups for each activity type.

1.19

Phase 1 (Spring/Summer 2023) involved a detailed review of the DefCARS portfolio analysing how the contracts the MOD has entered into align with the SSRO's **current activity groups**

#### **Comparable activity. Or in part. That contribute to.**

As explained in response to Q1 the profit formula requires a fair profit is set for the contract promise made.

If comparability is the method for setting the BPR, the BPR must be set based on profits made from comparable promises. It should not be based on unrelated/incomparable contractual promises, that may be activities that contribute to a qualifying contract but are nothing like qualifying contract promises made (e.g. we do not believe the MOD place qualifying contracts for hand tool/plant hire and as such these are not representative contractual activities and therefore should not be included in the P&M profit rate. Likewise we do not think MOD place qualifying contracts to lease combat aircraft or their engines and therefore, again, companies leasing commercial aircraft are not comparable activities for P&M).

#### **Previous regime**

It is correct to say the previous regime did not choose comparability as the methodology for setting the BPR, instead it provided a benchmark based on the returns that could be made from "alternative uses that a contractor would have for its capital if its capital was not deployed on non-competitive contracts" (Report on the 2013 General Review of the profit formula for Non-Competitive Government contracts 2013. 303). Indeed, in his review and recommendations on single source procurement 2011 ("Review of the single source pricing regulations"), Lord Currie recommended the BPR methodology was a retained element of the old regime and commented at paragraph 164.c. "We have found little merit in changing the approach to calculating the baseline profit allowance based on the principle of comparability...".

#### **Activity group definitions**

We recommend Phase 1 includes a reconsideration of the activity group definitions to represent the contractual obligation let as qualifying contracts and not to include activities that **contribute** to such contracts, as these lower level obligations are not representative of the promise made for which the reward and price is to be set (see Q.1.), they are the allowable costs to the contract.



# The baseline profit rate activities review

## Consultation response form

1.20

Phase 2

..a division used in our activity groups which is not substantially reflected in the division of qualifying contracts activities (e.g. is developing and manufacturing (D&M) identifiable as a separable activity to maintaining and asset provision (P&M) activities as it is currently reflected in our approach)..

2.7

We identified some qualifying contracts that engaged in more than one activity type, which we labelled as 'combined groups' (e.g. P&M and ITS)

2.33

Industry asserted in its feedback to the 2022 consultation that its analysis shows that **companies with qualifying contracts perform both D&M and P&M activities**, hence the need to revisit this artificial divide that creates a disproportionate outcome<sup>10</sup>. **Our analysis has revealed that the MOD enters into qualifying contracts which undertake predominantly separate D&M and P&M activity group activities**, both in number and in contract price; while only nine qualifying contracts perform both D&M and P&M group activities.

2.34

We are open to reconsidering the separation of D&M and P&M in Phase 2 of the review if there is new evidence presented that justifies a case for doing so.

Comparability not only requires defining the “activity” with which you seek comparison but also determining whether there is comparable data available.

We welcome the SSRO’s analysis of qualifying contracts and would invite they conduct a review of those contracts, by activity type, by ultimate parent undertaking (or Global Ultimate Owner (GUO)) to understand how many and what value of contracts are held by the same GUOs across the differing activity types. We believe, from our analysis of the current comparator groups, already shared with the SSRO, that it is not possible to provide unique benchmark profit rates for D&M and P&M as over 90% of the companies in the comparator groups (D&M and P&M) actually conduct both activities.

Industry has also conducted analysis (again shared with the SSRO), on the SSRO FOI request 058. This showed, of the SSCR D&M and P&M contracts, let 90% are held by GUOs who perform both activity types (i.e. those companies are deriving their profits by conducting both activities and therefore their profits are only suitable for use as a single population benchmark of D&M and P&M activity groups).

2.33

The first sentence explains industry, as explained above, found most companies with D&M and/or P&M contracts and most companies included in the SSRO D&M and P&M comparator groups, conduct both contract activity types. Therefore, it is not possible to support separate benchmark D&M or P&M profit rates and instead a single comparator group should be used.

However, the SSRO’s statement, in the second sentence, does not deal with the issue raised by industry (i.e. can distinct D&M and P&M comparator groups be supported), instead it advises MOD significantly let distinct D&M and P&M contracts. Industry does not question the fact the MOD lets distinct D&M and P&M contracts. Industry is explaining separate comparator group benchmarks (for D&M and P&M) are not supportable as 90% of the companies conduct both activities.

2.34

We recommend the SSRO conduct the same simple analysis to test industries findings and request this should be considered in phase 1 .

# The baseline profit rate activities review

## Consultation response form

### 3.2

An activity group is a group of companies that carry out activities that are similar, to an appropriate extent, to the activities we are seeking to benchmark...

#### Appendix A

### 3.2

Please see our comments at Q.1 and at 1.8 and 1.9.

#### Appendix A

The activity we are seeking...

We make the following proposals in support of the BPR, as step 1 of setting a contract profit rate, should be based on profits made on comparable contracts (See our response to Q.1.)

#### D&M recommended wording:

Companies undertaking comparable activities considered as 'Develop and Make' are expected to significantly earn their profits from contracts for the design, development and manufacture of capabilities comparable to those contracted by the MOD.

#### P&M recommended wording:

Companies undertaking comparable activities considered as 'Provide and Maintain' are expected to significantly earn their profits from contracts for the delivery of services to ensure the availability of a customer's asset either through repair, servicing, logistics and technical support and maintenance, or a combination thereof.

Indeed we propose D&M and P&M should be a single population

Companies undertaking comparable activities considered as 'Develop and Make' and 'Provide & Maintain' are expected to significantly earn their profits from contracts for the design, development and manufacture of capabilities comparable to those contracted by the MOD and/or delivery of services to ensure the availability of a customer's asset either through repair, servicing, logistics and technical support and maintenance, or a combination thereof.

#### Ancillary services recommended wording:

Companies undertaking comparable activities considered as 'Ancillary Services' are expected to significantly earn their profits from contracts, with committed service outcomes, in either one of administrative, facilities or IT support activities, or a combination thereof.

#### Construction recommended wording:

Companies undertaking comparable activities considered as 'Construction' are expected to significantly earn their profits from contracts delivering services in relation to the construction of buildings or other structures at fixed locations.

#### IT recommended wording:

Companies undertaking comparable activities considered as 'Information Technology Services' are expected to significantly earn their profits from contracts involving the development, or operation and maintenance, of bespoke and complex IT systems; or the integration of off-the-shelf components or software to deliver a bespoke IT system/service.

Pending conclusion on the above proposals it may be the rest of annex A would require reconsideration. We would be happy to make proposals, if necessary, post agreement of what constitutes the comparable activity when setting a contract baseline profit rate.

# The baseline profit rate activities review

## Consultation response form



### Appendix A- Previously shared commentary around BPR by DSAG to SSRO.

#### DRA 2014 Pricing: The Contract Profit Rate (CPR) and the Baseline Profit Rate (BPR)

- A fair....price & VFM - DRA 2014 Section 13
- Pricing formula:  $(CPR \times AC) + AC$  - DRA 2014 Section 15
- Contract profit rate (CPR) - DRA Section 17

The Act's method for setting a fair price is to agree the contract's allowable costs and the Contract's Profit Rate. A contract being:

**A Promise:** Made by one party to another, in exchange for;  
**Consideration:** The value (price) exchanged for the promise made. Consideration includes;  
**Reward:** The return expected for the promise made (profit rate = CPR)

This paper focuses on setting a fair Contract Profit Rate as a reward for the promise made.

The Act's approach to setting a fair CPR is to determine a benchmark profit rate (Baseline Profit Rate (BPR)) suitable for use in pricing SSCR contracts and then to make adjustments, to that rate, to accommodate issues specific to the particular contract i.e.: risks, incentives, capital funding (Capital Servicing Adjustment (CSA)), plus to include a share of the SSRO running costs and an adjustment to ensure Profit On Cost is only paid Once (POCO).

Setting a fair BPR is critical to fair pricing as the **BPR, along with CSA, forms 96% of the CPR** (SSRO statistics - Contracts let June 2022).

#### Setting a fair BPR

##### History:

The regime prior to the DRA 2014 chose to set a "fair" BPR by reference to the returns of UK listed companies whose profits derived from **contracts** involving their own production of goods, works or services (i.e. it excluded businesses whose profits, or losses, were significantly derived from commodity price changes, banking, insurance, etc.).

##### SSRO methodology

##### Comparability:

The SSRO decided to change the basis of determining the BPR. Instead of the returns that might be made if alternate, unrelated, activities were invested in, they chose to set the BPR through comparability with that being contracted, by the MOD, under single source contracts. They also chose to broaden the geography of companies and included North America and Western Europe.

- **OECD**
  - In pursuing "comparability" the SSRO referred to the Organisation for Economic Co-operation and Development (**OECD**) transfer pricing guidelines for multinational enterprises and tax administrations.

# The baseline profit rate activities review

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- The OECD methodology employs an “arm’s length principle” to ensure a “controlled transaction” between two associated enterprises (with respect to each other) is as if it were an “uncontrolled transaction” between two independent enterprises (with respect to each other). The approach seeks to set fair pricing of “goods transferred or services provided and the condition of the transfer or provision” (the contract) by reference to the price of those same goods and services under an “uncontrolled transaction” (i.e. its seeks an uncontrolled, comparable, contract to set the price).
- **Following this methodology requires finding reference companies (the “uncontrolled transaction”) conducting contracts for “goods transferred or services provided and the condition of the transfer or provision” that are comparable with that contracted under qualifying contracts (the “controlled transaction”), in order that fair, comparable, consideration can be determined and the reward element of that consideration used to set the BPR.**
- **Market pricing**
  - MOD’s recent pre-consultation papers, proposing how market-based pricing might be introduced, also discusses comparability. **MOD explain, for the alternative price to be seen as fair and VFM, the price must be shown to have been determined through competition, or be a market price paid by others, and the “output” of goods, works or services, in terms of specification and T&Cs, must be the same as that for which the MOD are now contracting.**

**Comparability, under both OECD and MOD market pricing, requires comparable contractual promises, to those of qualifying contracts (contract: output, T&Cs and regulatory context) i.e. the comparable “activity” is the “contracted promise”.**

- **The SSRO’s comparability principle:**

*(SSRO “BPR, Capital Servicing Rates and funding adjustment methodology March 2023 Terms and definitions”, and SSRO Q&A’s)*

**“companies whose economic activities are included in whole *or in part in the activity types that contribute to the delivery of qualifying contracts”.***

We do not see the SSRO definition captures the reward is for the contacted promise made (as required by the OECD and MOD market pricing requirements). This has resulted in comparator groups (CG) including companies that are:

- Significantly different in capabilities, and who are;
- Conducting quite different contractual promises to those of companies who hold qualifying D&M/P&M contracts.

We propose the comparability definition should be:

- ***“companies whose contractual promises (and economic activities) are comparable to those of qualifying contracts, for D&M/P&M”.***
- **Comparability - Practical considerations with comparability as a methodology:**
  - It is difficult to identify companies who derive their profits from a single contracting “activity” type. Most ultimate parent undertakings (also termed global ultimate owner (GUO)) derive their profits from a range of contracting activities.
  - We do not see it is possible to have comparability in the same exacting manner as that required by the MOD when using market/competitive pricing.

# The baseline profit rate activities review

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- At best, **comparability could be: GUOs who substantially earn their profits from contract types that are comparable to qualifying defence contracts.**
- It is also likely, the greater the number of BPR activity groups, the harder it will be to find GUOs who perform only (or substantially) the specific comparable contracting “activity” type.
- Determining practical, contracting “activity” group definitions might be helped by exploring the range of contracting types GUOs with qualifying contracts actually perform?

For instance findings, discussed later in this paper, suggest there should be a combined D&M and P&M CG as very few GUOs perform only D&M or P&M:

- **90% of GUOs in the 2021/22 D&M and P&M CGs performed both D&M and P&M.**
  - **90% of the GUOs included in FOI request RFI058, that were also in the SSRO D&M or P&M CGs, perform both D&M and P&M.**
- CG dominant contracting method:  
Another complexity of using comparability, as a method of setting a fair BPR, is understanding the impact of any dominant contracting methods used by GUO’s included in the CG.  
Statutory guidance on the BPR and its adjustments, at 3.9, advises where the contract’s pricing methodology is cost-plus, or estimate-based fee, the Cost Risk Adjustment (CRA) is to be minus 25% of the BPR. Therefore, if the contracting method of GUOs included in the CG, is dominated by cost-plus, or estimate-based fee, their profits would require grossing up (by 33%) before their inclusion in the CG PLI, if the guidance at 3.9 of minus 25% of BPR is not to be double counted in pricing.

### Single or multiple BPR types in the future?

Currently the regime operates a single BPR using the D&M and P&M CGs. We support a single BPR and see it as supporting speed and simplicity. However, we propose the single BPR is constructed from a single comparator group, of D&M and P&M, instead of the current approach using two separate CGs combined by a simple average.

If multiple BPRs were ever to be considered (at step 1 or by adjustment at step 2) there should only be one BPR activity type, per SSCR contract, based on comparability of the contracted promise (i.e. if segmentation is introduced to the DRA, and those segments were not separable contractual promises, they would all use the same BPR type).

Each QDC or QSC would use the BPR contract type appropriate to its contracted promise (except where an alternative pricing methodology is used).

- A QSC, to a QDC, may use a different BPR contract type to its QDC if it is a different promise/contract type to the QDC.

However, we remain unconvinced the regime warrants multiple BPR types and whether ever granular comparator groups can be identified and demonstrated as providing fair rewards as part of a fair price. We also remain concerned multiple BPRs will cause complexity that detracts from “speed and simplicity” and hope the alternative pricing method, proposed under Schedule 10 of the Procurement Bill, removes the requirement for multiple BPRs.

### Comparability: Alignment

#### EBIT and POCO

The CG profits used to set the BPR are those reported in statutory accounts and therefore in compliance with: IFRS, US GAAP, or similar.

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The SSRO have aligned their Profit Level Indicator (PLI) with allowable costs guidance by using Earnings Before Interest and Tax (EBIT).

The SSRO's method for setting the BPR and the current approach to adjusting for Profit On Cost Once (POCO) are also in alignment (with statutory accounts, IFRS etc.) in that only group subcontracts, with controlled associates, are adjusted for POCO.

However, the MOD's proposals to change the scope of group subcontracts, that are subject to POCO, breaks this alignment and will result in unfair pricing, unless the MOD proposal is withdrawn or the SSRO change their BPR methodology to include profits from uncontrolled associates/investments. A separate paper has already been provided to the SSRO demonstrating this issue (copy is also attached here).



POCO example.xlsx

## ADS/DSAG review of comparability

DSAG undertook a review of the SSRO comparator groups in order to understand:

- How comparable are GUOs included in the SSRO CGs D&M and P&M with those GUOs who have qualifying defence contracts (at the time of analysis there were circa 400+ QDCs/QSCs)?
- Do the GUOs, included in each of the SSRO activity CGs, earn their profits substantially from contracts for those contracted “activity type” promises?
  - Are the GUOs included in the CGs performing comparable contractual promises to those of qualifying contracts?
  - Are GUOs performing more than one type of contract “activity type”? Is comparability better served by combining contracting “activity” type CGs?

The review included data provided by the SSRO under a data request RFI047.

- We also reviewed a similar, more recent, data request RFI058. We compared our findings for RFI058 with those for RFI047 to confirm whether the analysis in this paper remains valid. RFI047 & 058 are comparable (see Appendix 4).

This review was initially conducted against the CG for 2021/22.

- We have repeated the review for subsequent years CGs, including the most recent 2023/2024. The review of subsequent years confirmed the original findings.
  - Graphs illustrating comparability questions 1 and 3, are included for 2023/24 in Appendix 3.
  - The results of the reviews are included in appendix 1:
    - Comparability 2 for years 2020/2021 through to 2023/2024
    - Comparability 3 for years 2021/2022 through to 2023/2024

### **Comparability 1 - Are the GUOs with QDC/QSCs similar to GUOs in the SSRO's comparator groups DM/PM?**

The SSRO provided, for 398 QDC/QSCS let, details of the contract price and annual revenues of the GUO contracted (SSRO provided both sets of data in banded ranges to protect confidentiality).

Of the 398 contracts, 5 were placed with GUOs below their minimum annual revenue threshold (£10.2m) and in the case of 49 contracts, the SSRO could not provide GUO revenues (we are not sure why there is no data for 49 contracts, but wonder if this means these GUOs do not feature in the Orbis database and if so the SSRO CGs?).

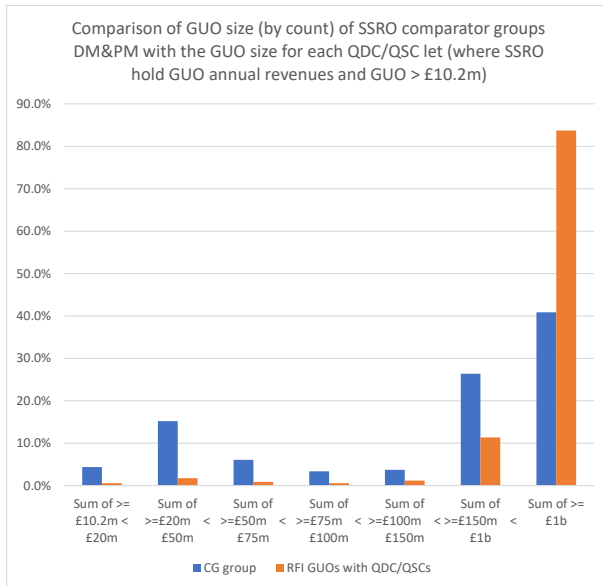
This resulted in a comparable population of 344 contracts (398 - 5 - 49).

To conduct a comparison, we have taken the SSRO 2021/22 CGs populations, for D&M and P&M, excluding any loss makers, after allowing for CSA. This resulted in a combined CG population (D/M & P/M) of 296 GUOs (n.b. SSRO 297 GUOs, one had no data available in our

# The baseline profit rate activities review

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check). We compared the GUO annual revenue size, in bands, of the 344 contracts let with the 296 GUOs in the CG.



The population distribution, by revenue band, for the GUO for each QDC/QSC let, is significantly larger than the distribution of GUOs included in the SSRO's comparator groups DM/PM.

By count, for the 344 contracts let **95%** were placed with a GUO  $\geq$ £150m annual revenue and **84%** with a GUO  $\geq$ £1b.

This compares with only **67%** of GUOs, in the SSRO 2021/22 CGs, having annual revenues  $\geq$ £150m.

When considering value, looking at the 344 contracts let, a similar result is also found.

The prices of contracts let, attributed to the contracted GUOs revenue band, sees **95%** of contract prices (COP to MOD) placed with GUOs  $\geq$  £150m annual revenue and **86%** with GUOs  $\geq$ £1b annual revenue.

### Conclusion:

A review of the size distribution of GUOs holding actual QDCs/QSCs suggest capabilities (e.g. technical, management of complexity, financial, etc.) required to discharge QDCs/QSCs are held by larger companies than the distribution in the SSRO CG. This suggests a number of the GUOs, in the SSRO CGs, may not be comparable in terms of capability and nature of contracts to GUOs who hold qualifying contracts.

**This is likely to be a result of the SSRO's definition of comparability not seeking companies conducting comparable contractual promises, but companies whose "...activities are included in whole or in part in the activity types that contribute to the delivery of QDC's...".**

We believe this has led to activity group definitions and use of NACE codes that allow the inclusion of companies whose contractual obligations are not comparable to those of qualifying contracts. For example the 77 NACE codes series are for activities we do not think the MOD would contract as single source.

### Recommendation:

A review of the:

- SSRO comparability principle towards ensuring a fair contractual reward is set.
- CG population towards better understanding of comparability with the contracted obligations placed under D&M/P&M qualifying contracts and the capabilities required, by the MOD, of the GUOs who hold these contracts.

**The following two comparability questions and actions begin this process.**

### Comparability 2 - Should the SSRO D&M and P&M CGs be two separate CGs or one?

The SSRO's BPR currently comprises two separate CGs, which are then, combined by a simple averaging of the two population's medians. The SSRO advise the request for two CGs came from the MOD, possibly deriving from its CADMID cycle (Concept, Assessment, Demonstration, Manufacture, In-Service and Disposal), but subsequently the Secretary of State requested a single BPR.

We therefore thought to review whether activities contracted by GUOs tended to include all the "through life" CADMID cycle for their supplied capability i.e. :

# The baseline profit rate activities review

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- Are their contracting activities limited to either D&M or P&M, or are they conducting both? Also;
- Are D&M and P&M the dominant contracting activity types that the regime should focus on, or are others equally significant?

We studied both of the existing comparator groups and also analysed the data provided by the SSRO in response to a FOI request No. RFI058.

### **Review of the GUOs comprising the D&M and P&M CGs**

We reviewed the GUOs' websites, company accounts, and looked to other sources such as Reuters to understand the "activities" conducted/contracted by the 296 GUOs in the two 2021/22 CGs. Of the 296 we excluded 25 as not classifiable (see below) and of the remaining 271 we found:

- **90% of GUOs conduct both D&M and P&M (243/271) for their products and capabilities**
  - 243 performed both D&M and P&M
  - 17 performed purely D&M
  - 11 performed purely P&M
- 25, it was decided, were not classifiable as either as their activities were such as: material suppliers, JV's/thin primes, plumbing, or rental/lessors, etc.

### **Review of the RFI058 request**

The response to a FOI request provided information on actual qualifying contracts let. The information included the contracting company name along with details of the contract (unless redacted). We sought to understand the contracting "activity" type (of the qualifying contract), who were the contracting companies' ultimate owners (GUO), whether those GUOs were in the existing SSRO CGs and what types of contracting "activities" were the GUOs involved in? We found:

- 77% of the contracts were with GUOs included in the SSRO CGs D&M or P&M.
  - 90% of those GUOs perform both D&M and P&M
- 1% were with GUOs in the SSRO Ancillary Services CG
- **Therefore, 99% of those contracts, where a GUO was in a current CG, were for D&M/P&M contracts.**
- 22% of contracts were let with GUOs not currently included in an SSRO CG

We analysed the 22% to understand their contract "activity type". Some contractors were not relevant to include in a comparator group (e.g. government owned), **but of those seen as relevant the majority were again D&M/P&M contract types.**

### **Conclusion:**

**Comparability would be better served if there was a single CG combining D&M and P&M CGs. There is a single BPR and logically there should be a single CG to determine the median.** This would also guard against the volatility of what is a small P&M CG population. The dominant contracting type we should focus on to ensure VFM and fair pricing is D&M/P&M

### **Recommendation:**

Improve comparability (and by outcome a more fair and reasonable outcome) by having a single population combining the D&M and P&M CGs.  
Place the main focus of a BPR methodology review on the single D&M/P&M Comparator Group

### **Comparability 3 - Are the contract activities of the GUOs in DM/PM CGs comparable to contracts let as DM/PM QDCs/QSCs?**

Whilst comparability issue 2 considered if the CG GUOs should be one or two populations, it did not test whether the CG GUOs significantly earned their profits from comparable contracts to those contracted as qualifying contracts (beyond the 25 it was felt were not performing D&M or P&M).



# The baseline profit rate activities review

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Comparability issue 3 sought to review the D&M and P&M CG GUOs to better understand the nature of the contracts they perform, how they achieve their profits and whether they are comparable.

We looked to assess whether they were:

- Significantly earning their profits from contractual obligations of a type that MOD would let under qualifying contracts, in comparable markets, with comparable regulatory requirements?
  - Involved in the defence market?
  - Involved in contracts for bespoke product development and support or simply the supply of standard products and services?
  - GUOs capable of complex programme integration?
- Significantly involved in other markets?
  - Making significant earnings from contracting activities MOD would not let through a qualifying contract (e.g. financial services, rent, leasing, etc.)?
- Influenced by other parameters?

Consideration was not as literal as to say if the GUO includes some earnings from financial services they would be excluded, or that only defence contractors, or only complex integrators, should be included. However, if significant earnings were seen to be from activities not associated with those contracted as D&M and P&M qualifying contracts then that GUO ought not be seen as relevant to that “activity type” CG.

As mentioned in the conclusion of comparability issue 1, the context of the contracted obligations let, through single source, also has to be considered to ensure comparability when setting the benchmark reward. Qualifying contracts tend to be: technical, complex, often involving integrations of capabilities towards a bespoke output. This is very different to the design, make and support of a standard product, that is sold to many customers (at a market or competed price), or a standard product with mild configuration or interface adjustments to meet customer specific installation requirements (e.g. plumbing, air-conditioning or elevator, provision and installation).

A review, for comparability of contract “activity” type, has been conducted on the 2021/22 CG, 2022/23 CG (N.B. the 2022/23 CG has not been used in setting the BPR) and 2023/24 CG. The assessment resulted in:

- GUOs removed from the CG: 2021/22 - 186, 2022/23 - 142, 2023/24 - 194 as they were seen as making earnings from contracts (activities) that are incomparable with that contracted under D&M and P&M qualifying contracts.
  - These companies were either significantly involved in:
    - Rental/leasing of: tools, equipment, fishing vessels
    - Dealerships
    - Suppliers of materials
    - Commercial vehicles set up as JV’s and acting as “thin primes”
    - Plumbing and heating contractors to domestic and other markets
    - Developing and providing standard product to multiple customers and not dealing with bespoke contractual requirements.

It was thought unlikely MOD would let qualifying contracts for these activities because an open market exists for them. At best some of these contracted activity types could be an input cost to a qualifying contract (a contractor may use a hired tool?) but comparability is sought to price the reward for the contracted D&M/P&M obligation, not a reward for individual input costs.

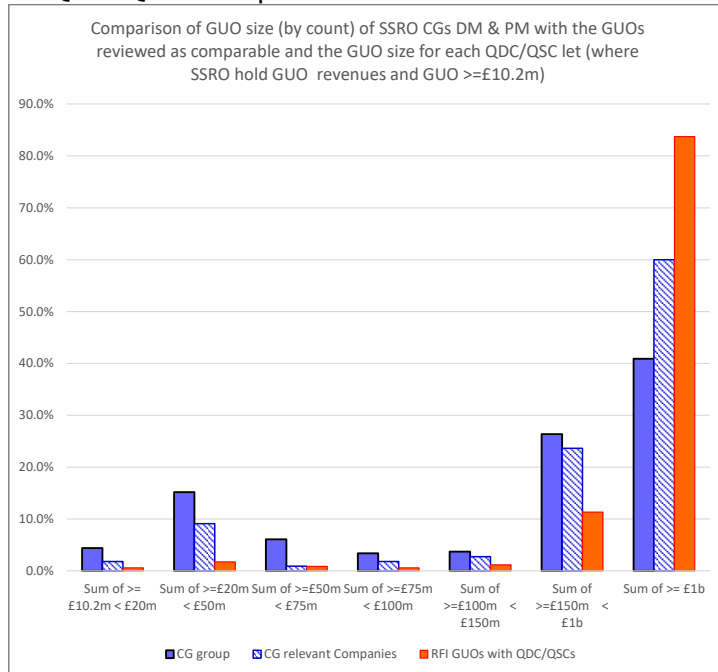
- GUOs remaining in the CG: 2021/22 - 110, 2022/23 - 83, 2023/24 - 102 were seen as comparable, although as explained above we could not categorically say their earnings are wholly the result of comparable promises to those let under qualifying D&M and P&M contracts (nor have we assessed whether the dominant contracting method is cost plus, etc.).

# The baseline profit rate activities review

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- To pursue pure contract “activity” type would require an even more in-depth review and, we think, likely yield a very small population.

The graph below shows the outcome of this review for 2021/22. It yielded a profile of GUOs that more closely matches the size of GUO that each of the 344 QDCs/QSCs were placed with.



The population size distribution, by revenue band, for the GUO for each QDC/QSC let, is more closely matched by the post review population of 110 GUOs (2021/22 CG), than it is by the SSRO’s comparator groups DM/PM. For a closer alignment, it is likely an even smaller population would result. Similar comment is made in information published by MOD and NAO, which explains the vast majority of MOD equipment expenditure is with a few key suppliers who are capable of managing MOD’s complex requirements. This statement is not to oblige only defence contractors to be included in the population, but to reflect on comparability and the complexity involved in single source contracts.

### Conclusions:

- The nature and context of the contracted “activities” and understanding the drivers that resulted in the MOD contracting with the chosen GUOs should be fully assessed to improve comparability assessment. A simple check might be, when considering comparability, could the contracting authority consider contracting with these “comparable” GUOs for the activity required? If not can we consider their contracts, profits and capabilities comparable?
- As mentioned above, GUOs are often a collection of businesses and hence the profits earned can be the result of a broad range of contracting activities. At the GUO level it is often not possible to attribute profits to a “single” contract/activity type. Hence, pursuit of comparability is probably better at an aggregate level rather than at an increasingly granular level.
- Assessment of comparability involves judgement. We realise differing parties may take differing views. To that end we believe this aspect of the SSRO’s methodology would benefit from collegiate working between the SSRO and stakeholders towards determining comparable GUOs.

### Recommendations:

- We propose the comparability definition should be: **“companies whose contractual promises (and economic activities) are comparable to those of qualifying contracts, for D&M/P&M”**.
- NACE codes should be reviewed to align with the changed definition of comparability.
- Comparability reviews should consider the nature of GUOs the MOD have let qualifying contracts with, in order to improve comparability assessment.
- As per comparability issue 2, the current CGs of D&M and P&M are made one CG.
- The manual review is increased to better filter for comparability to the contracted obligations let by the MOD under D&M and P&M qualifying contracts.

# The baseline profit rate activities review

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- D&M and P&M comparability is reviewed and lessons learned, before considering the introduction of other activity based profit rates.

We suggest a prioritised review of the BPR methodology is a joint process with all stakeholders.

### Appendix 1

The outcome of this review in terms of PLI and CSA.

		2020/21 SSRO D&M/P&M CG GUOs			2021/22 SSRO D&M/P&M CG GUOs			2022/23 SSRO D&M/P&M CG GUOs			2023/24 D&M/P&M CG GUOs as per SSRO 23/24 CG listing			
		YE to March 2019 profits			YE to March 2020 profits			YE to March 2021 profits			YE to March 2022 profits			
		Nos of GUOs	PLI net of CSA	CSA	Nos of GUOs	PLI net of CSA	CSA	Nos of GUOs	PLI net of CSA	CSA	Nos of GUOs	PLI	PLI net of CSA	CSA
<i>Excluding loss makers at the PLI net of CSA</i>														
<b>Average of 2 medians</b>														
SSRO Underlying Profit Rate	a	384	8.23%	1.57%	297	8.19%	1.40%	225	7.35%	0.89%	296	9.51%	8.45%	1.06%
ADS Recalculated Underlying Profit Rate	b	384	8.27%	1.55%	296	8.19%	1.43%	225	7.34%	0.87%	296	9.51%	8.45%	1.06%
D&M (*1)		323	8.78%	0.95%	246	8.19%	1.16%	189	8.67%	0.73%	239	9.80%	9.16%	0.64%
P&M (*2)		61	7.77%	2.15%	50	8.18%	1.72%	36	6.01%	1.01%	57	9.21%	7.73%	1.48%
<b>Single population - median</b>														
ADS Recalculated Underlying Profit Rate	c	384	8.54%	1.23%	296	8.19%	1.22%	225	8.46%	0.67%	296	9.80%	8.65%	1.15%
Average of 2 medians VS Single population (c-b)	d		0.28%	-0.32%		0.01%	-0.21%		1.13%	-0.20%		0.29%	0.20%	0.09%
<b>ADS review for relevant GUO, single population</b>														
ADS review for relevant GUOs (single population)	e				110	8.80%	0.89%	83	10.49%	0.75%	102	11.28%	10.24%	1.04%
ADS Recalc' Underlying Profit Rate Vs Relevant GUOs (e - b)					-186	0.61%	-0.54%	-142	3.15%	-0.12%	-194	1.77%	1.80%	-0.02%

### Notes:

- At implementation of the SSRO BPR methodology there was a 39% reduction in the net PLI (9.88% to 6.06%).
- The SSRO methodology, as operated, continues to consistently yield a lower profit rate. Why?
  - The yellow book BPRs averaged, over the 5 years 2011 to 2015, 9.95%
  - The SSRO BPRs averaged, over 5 years 2018 to 2021 + 2023 7.85%
  - The average SSRO BPR being 21.1% lower.
- (2022) The 2022/23 SSRO BPR recommendation has not been adopted. Its inclusion in the table above is for information of the relative impact of: single population, and relevant GUO analysis.

### A single population median:

#### Pre- DSAG review for comparability:

- Single population has differing affect by year but is consistently positive - In all four years the impact is positive: + 0.28%, + 0.01, + 1.13%, + 0.20%.

#### Post DSAG review for comparability:

- The review has just been of the SSRO CG and therefore our post review population would likely always be smaller than the original population (and never bigger)
- Comparability, for the reasons explained in "comparability issue 3", is likely to drive to fewer companies in a CG the more granular in activity type the CG seeks to be.
- The outcome of the review, whilst a smaller population, is closer to the size distribution of GUOs with actual QDCs/QSCs.
- The net PLI, in the range of 9% to 10.5% is closer to profit rates prior to SSRO derived PLIs.
- The review did not consider GUO dominant contracting method.

# The baseline profit rate activities review

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### Appendix 2

#### **Review approach:**

In assessing each GUO, of the D&M and P&M CGs, we considered:

1. Is the GUO offering only develop and make, or provide and maintain, for its products or services, or is it offering both activity types?
2. Is the GUO capable of delivering comparable “outputs”/conducting similar contracts to that contracted as QDCs/QSC’s by MOD?
3. Is the GUO involved and in markets and activities other than those comparable activities to D&M and P&M?
4. Is the GUO involved in the provision of financing to customers, are they significantly or wholly involved in leasing or rental of products (we do not see these activities as comparable to activities contracted by MOD on D&M or P&M QDCs/QSCs)?
5. Is the GUO involved in the defence market?
6. Is the GUO capable of discharging contracts involving complex integration?
7. Is the GUO involved in contracting activities and risks similar to single source - Longer term contracting for bespoke activities rather than delivery of standard products, or simple provision of labour?

Consideration of the answers to questions 1 to 7 is made, along the full narrative from the GUO website/Reuters, etc. to form an opinion on comparability.

The review did not considered the dominant contracting methodology of GUOs in the CG.

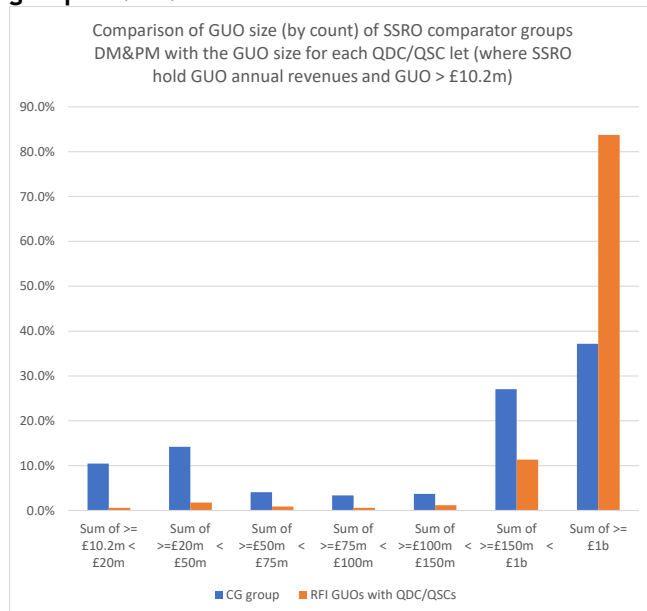
# The baseline profit rate activities review

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### Appendix 3

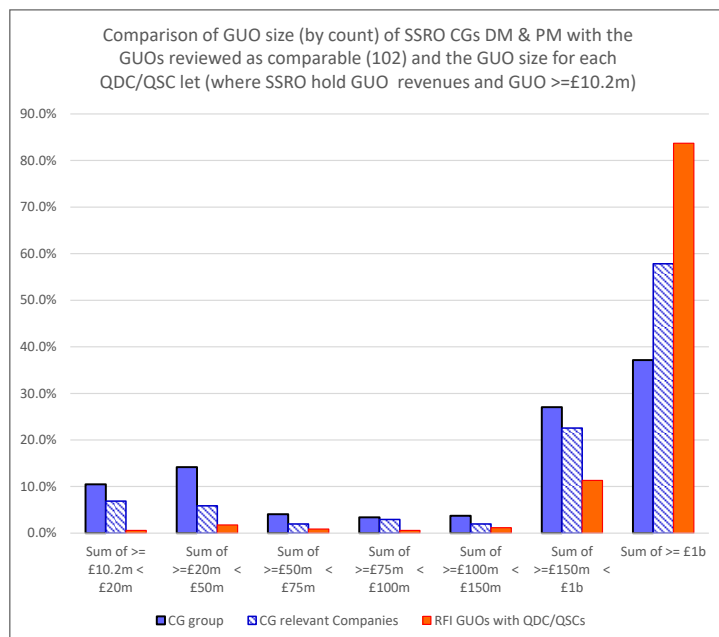
#### 2023/2024 D&M/P&M Comparator Group with GUOs with qualifying contracts per RFI047

#### Comparability 1 - Are the GUOs with QDC/QSCs similar to GUOs in the SSRO's comparator groups DM/PM?



The population distribution, by revenue band, for the GUO for each QDC/QSC let, is significantly larger than the distribution of GUOs included in the SSRO's comparator groups DM/PM. By count, for the 344 contracts let **95%** were placed with a GUO  $\geq$ £150m annual revenue and **84%** with a GUO  $\geq$ £1b. This compares with only **64%** of GUOs, in the 2023/24 SSRO CGs, having annual revenues  $\geq$ £150m.

#### Comparability 3 - Are the activities of the GUOs in DM/PM CGs comparable to activities conducted on DM/PM QDCs/QSCs?



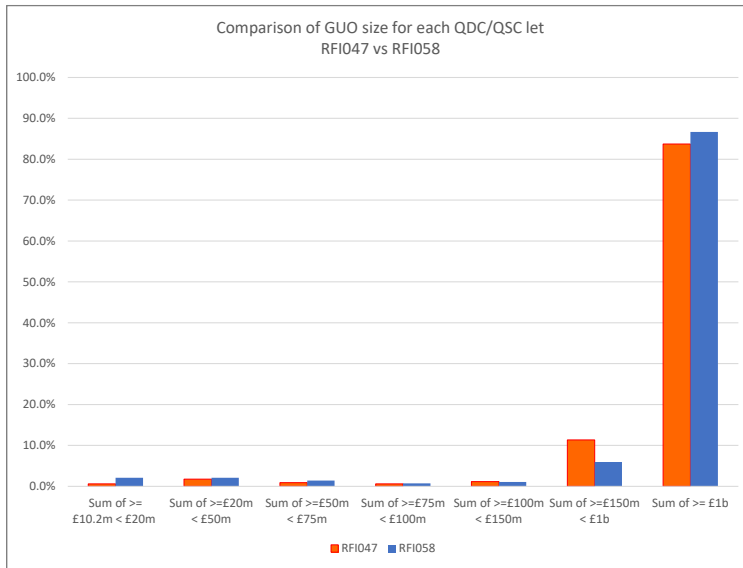
The population size distribution, by revenue band, for the GUO for each QDC/QSC let, is more closely matched by the post review population of 102 GUOs (2023/24 CG), than it is by the SSRO's comparator groups DM/PM.

### Appendix 4

# The baseline profit rate activities review

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### Comparison of RFI047 and RFI058



The size distribution of GUOs in both information requests is consistent. Therefore, the review and comparisons against RFI047 remains valid.

## The impact of including POCO of non-controlled associates

		Current POCO rules aligned with statutory accounts and the BPR	Expanded POCO to include non-controlled associates			
		Year 0 £000's	Year 1 £000's	Year 2 £000's	Year 3 £000's	Year 4 £000's
<b>GUO = BPR Comparator Group, all work is UK MOD SSCR</b>						
	<b>Revenue</b>	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
	Reduction in price for POCO of non-controlled associate		831	822	730	722
	Reduction in price for lower BPR on other supplier costs			8,499	16,282	17,037
<b>Used for BPR</b>	<b>Restated revenue</b>	<b>1,000,000</b>	<b>999,169</b>	<b>990,679</b>	<b>982,987</b>	<b>982,242</b>
	Other costs - assume fixed	906,900	906,900	906,900	906,900	906,900
	Non-controlled associate purchase cost	10,000	10,000	9,991	9,899	9,891
<b>Used for BPR</b>	<b>Total costs</b>	<b>916,900</b>	<b>916,900</b>	<b>916,891</b>	<b>916,799</b>	<b>916,791</b>
<b>Used for BPR</b>	<b>EBIT</b>	<b>83,100</b>	<b>82,269</b>	<b>73,788</b>	<b>72,966</b>	<b>72,235</b>
<b>Used for/as BPR</b>	<b>% on cost</b>	<b>8.31%</b>	<b>8.23%</b>	<b>7.38%</b>	<b>7.30%</b>	<b>7.22%</b>
<b>1 year contracts of the non controlled associate with the CG GUO</b>						
	Revenues	10,000	10,000	9,991	9,899	9,891
	COS	9,169	9,169	9,169	9,169	9,169
	EBIT	831	831	822	730	722
	% on cost	8.31%	8.31%	8.23%	7.38%	7.30%

### Notes on the example:

One GUO forms the Comparator Group and all its business is MOD SSCR

The non-controlled associate's contracts with the GUO and the GUO's own contracts, are 1 year contracts for this example

The non-controlled associates contract forms part of the COS/COP of the GUO

The non-controlled associates EBIT does not feature in the GUO EBIT in its statutory accounts, its share of its profits are below EBIT and therefore not in the BPR

The impact of reducing prices for non-controlled associates profit reduces the BPR which impacts on the profit of the GUO/comparator group and compounds year on year

The base profit rate is simply the current BPR rate with no other steps and no actual v estimated cost performance in order to show solely the impact of the change in POCO scope.

Comparable companies, performing comparable contracts, in alternate markets, would not have pricing affected in this way.

This change to POCO does not result in a fair price comparable with Section 13

## 4. Leonardo



# The baseline profit rate activities review

## Consultation response form

### Your details

Name:

James Schofield

Organisation:

Leonardo UK Limited

Position:

VP Finance

### Consultation questions

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

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

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

Yes

No

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

# The baseline profit rate activities review

## Consultation response form

We are pleased to have the opportunity to input to this BPR consultation. We support the submission made by DSAG. We believe the review would have benefited from a broader consideration of methodology and that there is benefit in amending the scope of Phase 1 to include consideration of:

1. Whether two separate populations (D&M and P&M) can be supported by distinct comparator groups or whether the group companies, involved in D&M and P&M contracts, actually perform both contract types (in which case only a single comparator group combining both can be supported).
2. Comparator group activity definitions: recognising the SSRO methodology seeks to use comparable profits when setting the baseline for the Contract Profit Rate, we propose comparability should seek profits made from similar contractual obligations as those let as qualifying contracts.

We believe the above two actions could be included in Phase 1, and indeed the next annual BPR recommendation, as they are simply changes in the application of the current methodology.

**Question 1:** Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?

We are in agreement with the response provided by DSAG, that is, if the MOD contract specifically for technical support and if companies earning their profits from performing comparable contracts can be identified, then technical support characteristics should be included.

However, if technical support is not specifically contracted, but only forms part of a broader D&M or P&M contractual obligation, then we would not agree technical support should be included in the P&M characteristics.

### Review of contracts under the regime

The SSRO's focus has been on the characteristics of activities that contribute towards qualifying contracts, rather than the characteristics of the contractual obligation itself. We maintain if we are to use comparability as the method of determining a fair baseline for the Contract Profit Rate we should be seeking companies whose profits derive from similar contractual obligations to those of qualifying D&M and P&M contracts, be those companies in the defence or other sectors. DSAG's response provides further explanation.

It is in this context, of the contractual obligation, we have made our above response.

To facilitate further consideration, we believe the review should include consideration of whether separate comparator groups, for each activity type, can be supported by finding companies whose profits derive wholly, or substantially, from the defined activity type.

We would welcome the SSRO conducting analysis that can be shared with stakeholders, of D&M and P&M qualifying contracts let:

- Where the global ultimate owner (GUO) (ultimate parent undertaking) has:
  - Both D&M and P&M qualifying contracts, the number of contracts and the aggregate value.
  - Just D&M contracts, the number of contracts and the aggregate value
  - Just P&M contracts the number of contracts and aggregate value
  - Have contracts that don't fall into any of the above

This would test the analysis already provided to the SSRO by DSAG, that suggest 90% of the comparator group companies for D&M and P&M conduct both D&M and P&M contracts for their products and therefore separate populations are not supportable and a single population D&M/P&M comparator group should be used.

We would also welcome Leonardo UK Ltd being provided with detail of our qualifying contracts, as classified by yourselves, into D&M or P&M categories.

# The baseline profit rate activities review

## Consultation response form

**Question 2;** Do you agree that the logistics activity complements the business as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?

Please add comments to support your answer:

We concur with the DSAG response, if the MOD let very few contracts for logistics activities and if logistic activities are usually provided through other contract types (e.g. availability contracts), then no, they should not be included.

**Question 3:** Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?

Please add comments to support your answer:

If the SSRO is considering using “alternate” BPR activity types, such as ancillary, we would recommend there is much more study, analysis and consultation on the various SSRO activity types.

Ancillary services could comprise a broad range of contracting obligations from the provision of a resource with no committed outcome (e.g. simple labour provision) to contracts where there are committed outcomes. The simple provision of labour, directed by MOD, with no committed outcome is not the same type of contractual obligation as provision of such as administration/IT etc. with a committed outcome (e.g. payroll, IT or accounting services that provide not just a resource but commitment to service levels and due dates).

We do not think simple labour provision should be included and imagine it infrequent such contracts are let as single source.

# The baseline profit rate activities review

## Consultation response form

**Question 4:** To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?

Please add comments to support your answer:

We are slightly confused by the term capacity provision in this context. The term often means contracting to reserve capacity such as a volume of: labour, machine time, or other output capability.

This section of the SSRO paper also discusses contracting for capability and we wonder if this discussion relates to D&M acquisition contracts, or is it referring to leasing capability? If the latter we do wonder how often/how likely qualifying contracts will be placed to lease bespoke products that may be at high risk?

Our experience of availability contracts and indeed contract types that preceded them (e.g. contracts for repair and overhaul) are these support a capability the MOD have previously acquired. Indeed, the original capability acquisition, through a D&M contract, was from ourselves. This evidences that we are conducting both D&M and P&M contracts, as do most capability providers in defence and other sectors. Therefore, Leonardo's profits would be suitable for use in a comparator group that is a single population of both D&M/P&M, but not in comparator groups that are solely D&M or P&M.

We agree with DSAG. We are not aware lease contracting is used, or significantly used, by the MOD under qualifying contracts. We see asset leasing as being quite different to qualifying P&M contracts and propose renting and leasing do not feature in the comparator group (NACE codes: 7735, 7739, 7712, 7732, 7734).

## 5. MOD

Thank you for consulting with us on this. Please find below our comments.

Question	Response
General Comments	<b>The MOD is supportive of the SSRO BPR methodology. We will be interested in the next stage of the review and would be happy to meet to discuss further once the scope of stage two is defined.</b>
Question 1: Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?	<b>Agree</b>
Question 2: Do you agree that the logistics activity complements the business[1]as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?	<b>Agree</b>
Consultation question 3: Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?	<b>We would appreciate some further clarification on what is included in the definition of 'labour outsourcing'.</b>
Consultation question 4: To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?	<b>We support the SSROs proposal to keep these arrangements as part of the comparator group. We note that this group tends to attract higher profits and would therefore be a beneficial inclusion for industry.</b>

**Claire Boylan**

**Head of Compliance**

Single Source Advisory Team

Ministry of Defence

## 6. QinetiQ

# The baseline profit rate activities review

## Consultation response form

### Your details

Name:

Malcolm Coffin

Organisation:

QinetiQ

Position:

Government Compliance Finance Director

### 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

No

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



# The baseline profit rate activities review

## Consultation response form

**Question 1:** Do you agree that the technical support activity complements existing knowledge-based activities and should be added to the provide and maintain (P&M) activity group? Do you have any reasoning why the P&M characterisations should not be expanded to include technical support services?

*Yes. From the analysis undertaken by SSRO, this category would appear to be a sizeable (10% of value) of qualifying contract activity. From our specific Company perspective this category would also be a sizeable proportion of our single-source activity. Hence, we do agree that it would be appropriate to include within the P&M category for BPR purposes.*

# The baseline profit rate activities review

## Consultation response form

**Question 2;** Do you agree that the logistics activity complements the business as-usual parts procurement and logistics activities already present in the P&M characterisations such that it should be included as a standalone activity in the P&M group? Do you have any reasoning why the P&M characterisations should not be expanded to include logistics services?

Please add comments to support your answer:

No. This is on the basis that the evidence provided indicates that logistics services account for <1 per cent (by price) of qualifying contracts. From our own specific Company perspective, this is also a negligible component of our services. Hence, including in P&M would not enhance (and would be detrimental to) comparability.

## The baseline profit rate activities review

### Consultation response form

**Question 3:** Do you agree that the labour outsourcing activity aligns with existing administrative activities and should be added to the ancillary services activity group? Do you have any reasoning why the ancillary services characterisations should not be expanded to include labour outsourcing?

Please add comments to support your answer:

As per our response to Question 2, the evidence suggests this is a negligible proportion of qualifying contract activity. Hence, it would be detrimental to comparability to include within either of the two activity groups (D&M and P&M) used for BPR purposes. Including within the ancillary services activity group seems appropriate. Though we are unclear as to what this activity group is used for (not impacting the BPR composite rate).

# The baseline profit rate activities review

## Consultation response form

**Question 4:** To what extent does the capacity provision, for example, through contracting for availability or capability, constitute an activity which enables the performance of qualifying contracts? Does it provide support or otherwise for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group characterisations, text search terms and NACE codes?

Please add comments to support your answer:

There is a key distinction here between QDCs that involve significant investment in bespoke assets that provide a bespoke capability to MOD and a generic provision of market-available assets. One of our largest QDCs provides aircraft and other assets that are 'used' by the customer (in as much it provides an output to them), hence it does seem to aid comparability by including 'capability provision' within the P&M activity type. However, the aircraft are accompanied by pilots and specialised courses to provide test-pilot training, so of a different nature to leasing an aircraft to MOD for MOD to use at their direction. Other assets 'provided' are also of a specialised nature (e.g. radars) and used by the contractor (with skilled operators) to provide wider services to the customer. Hence, not directly comparable to a leasing company, but does broadly relate to activities "involving the provision and/or operation of economic assets to a third party". This does provide some support for the inclusion of activities involving the provision and/or operation of economic assets to a third party in the P&M activity group. The definitions of the relevant activities will need to be very clear.

# The baseline profit rate activities review

## Consultation response form

### **Further comments on the consultation paper**

None of the questions are in respect of Information Technology Services. One of our two UK business sectors (UK Intelligence) provides expertise in cyber security and secure communication networks. This covers (as quoted in Appendix A of the consultation) the “design, integration or operation of networks and computer systems or services used for military or defence purposes”. As such, consideration should be given to including [some] IT Services companies in the comparator group. We are happy to provide more details of our QDCs in this area to aid SSRO’s understanding.

SSRO could directionally be heading toward distinct BPR’s for different activity types (as opposed to a single blended rate). We are of the view that many QDCs provide activities that cover a mix of activities and a blended rate is appropriate. Having multiple, discrete rates leads to complexity, subjectivity and dispute. This is best avoided by continuing with a blended rate, albeit with that blended rate potentially having additional companies within the comparator group.