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Dear Marcine,

Industry welcomes the opportunity to respond to the SSRO's Profit Rate 2017/18 consultation. As you will be aware, earlier this year ADS commissioned the economic consultancy, Oxera, to assist industry with assessing the SSRO's proposed move to multiple Baseline Profit Rates. Industry has met on a number of occasions in recent weeks to discuss the SSRO's consultation document (published in July 2016) and to assess Oxera's findings.

Industry does not wish to revisit the baseline profit rate for 2016/17 which was set by the Secretary of State for Defence in March 2016. In the context of the move to multiple rates, however, we believe it is appropriate to test whether the underpinning methodology is sufficiently reliable and robust. This is essential to secure the trust and confidence of industry.

Having carefully considered the SSRO's proposals, industry has identified a number of issues relating to the selection of companies in the comparator group, the financial data used for each company and the means by which this is translated into a baseline profit.

In order to ensure that companies receive a fair and reasonable price for the work undertaken in single source contracts, it is imperative that the identification, selection and use of the comparator companies and corresponding financial data is fit for purpose and does not lead to perverse outcomes. Given industry's concerns as to the robustness of the updated methodology, it does not support the move to multiple rates at this time. We consider that further work is needed before such proposals could be deemed to offer both good value for money for the UK taxpayer and a fair and reasonable price for industry.

Industry fully understands the Government's desire for reform in this area and we remain committed to working with both the SSRO and MOD to achieve this. Industry is fully prepared to engage and work closely with both the SSRO and MOD on these issues in order to find a way ahead that is mutually acceptable to all parties involved in single source procurement. ADS is willing to facilitate engagement with industry on the above matters through a series of workshops, roundtables or otherwise in the weeks and months ahead. In the immediate term, should you have any questions regarding any of the points raised, please do not hesitate to contact me directly.

Yours sincerely,


Paul Everitt,
Chief Executive, ADS Group

ADS SUBMISSION TO SSRO'S CONSULTATION ON 2017/18 PROFIT RATE

BACKGROUND

Contracts totalling in excess of £8 billion pounds were placed on a single source basis in 2014/15, representing over half of the Ministry of Defence's (MOD) expenditure on equipment and support in this year. A wide range of equipment and services are procured by the MOD in this way. These include major programmes, such as the Astute and Successor submarines, together with the contract for the management and operation of the Atomic Weapons Establishment sites, as well as a variety of proprietary equipment and support services.

Established under the terms of the Defence Reform Act 2014, the principal statutory aims of the Single Source Regulations Office (SSRO) are to ensure that good value for money is obtained in Government expenditure on regulated contracts, and that persons (other than the Secretary of State) who are parties to such contracts are paid a fair and reasonable price for the work undertaken. Industry fully supports these aims.

Provision of fair and reasonable prices for regulated contracts allows companies to invest in innovation, ensuring the UK remains at the forefront of research and development and that UK companies continue to be highly competitive in the global market. This in turn ensures that our Armed Forces maintain their pre-eminent reputation.

It is important that the Act and the Regulations provide for market conditions that give managers, shareholders and investors in domestic and international defence companies confidence in the value of the UK defence market and the attractiveness of the UK as a place for their defence activities. In the wake of the referendum on UK membership of the EU and the uncertainty that follows, the need for this confidence is even more acute.

BASELINE PROFIT RATE 2017/18

This consultation response follows our earlier submission in relation to the SSRO's consultation on the methodology for calculating the Baseline Profit Rate (published on 25 September 2015). This response examines the SSRO's specific proposals in relation to the implementation of multiple Baseline Profit Rates from 2017/18, as set out in the consultation paper published on 8 July 2016.

The SSRO has expressed an aspiration to move to a regime under which different profit rates are awarded to contracts on the basis of the primary activity undertaken and other contract-specific risk factors. Industry recognises the benefits that can be obtained by relating profit to the nature of its outputs and the risk taken. It offers the contractor an opportunity to earn more profit by accepting greater risk, while simultaneously delivering better value for money for the Authority by paying reduced profit for less risky work. However, while such an approach may seem viable in principle, industry has significant concerns that the methodology based on multiple Baseline Profit Rates (as set

out by the SSRO) will not achieve this in such a way that ensures the contractor will receive a fair and reasonable price.

In particular, under the SSRO's proposals, baseline profits on regulated contracts are benchmarked against average returns earned by a set of companies deemed by the SSRO to undertake activities comparable to those provided under regulated contracts. Whilst we recognise that benchmarking of profits against comparators is a well-established method for assessing the profitability of a company, the validity of the findings is heavily dependent on the relevance of the comparator group, the specific question being addressed and how the comparator statistics are manipulated.

In order to ensure that companies receive a fair and reasonable price for the work undertaken in single source contracts, it is imperative that the identification, selection and use of the comparator companies and corresponding financial data is fit for purpose and does not lead to perverse outcomes. Industry has identified a number of issues relating to the selection of companies in the comparator group, the financial data used for each company and the methodology for translating this into a baseline profit.

These issues are summarised below. Given industry's concerns as to the robustness of the methodology outlined for deriving the single baseline profit, it does not support the extension of the baseline into six different categories, as such a step will serve to further exacerbate many of the issues highlighted below.

1. Transparency in Comparator Selection Process

Industry appreciates the information which the SSRO has provided on the process undertaken to determine the Baseline Profit Rate and in particular the publication of the list of companies in the final comparator reference group, which is more information than has previously been made available. However, the level of information provided is insufficient to allow for a third party to verify the results derived by the SSRO. This is necessary in order to build confidence and trust in the approach taken by the SSRO.

In particular:

- The specific filters applied in the Orbis database are not entirely clear (e.g. use of consolidated accounts criteria and availability of data), which creates uncertainty and an inability to replicate the SSRO filtering process.
- It is not clear how the SSRO has manually filtered database results or how many companies have been filtered out by this part of the process. While the SSRO has stated that it reviews company websites to obtain more detail regarding the validity and location of each business' activities, it appears that this process that may have resulted in the filtering out of a material number of companies. An alternative to further detail on how the SSRO has undertaken this part of the process would be to publish a list of every company excluded through this part of the process together with a brief explanation for why each of these companies had been excluded.
- The SSRO has used the "most recent" financial results of each company. This means that the result of following the same process may be different one day to the next, meaning that even if the process was repeated exactly on a different date, the results would likely be different. This again prevents verification of the results by stakeholders. The sample should use results

for a defined financial year which would allow results to be replicated. Similarly, clarity as to the date when the Orbis database will be accessed each year would be beneficial.

- The specific inputs to and calculation of the final baseline profit figures have not been disclosed, making verification of the results by stakeholders impossible.

2. Appropriateness of Comparators

The SSRO has used industry NACE codes (which classify companies by type of economic activity) as the starting point in its process of extracting companies with relevant functions for inclusion within the comparator group. However, it appears that some potentially relevant NACE codes have been excluded from this process¹. These omissions appear to have led to the exclusion of some obvious comparator companies², leading industry to question the process by which the comparator companies were selected.

Similarly, some companies which would appear to be appropriate comparators have been omitted as the NACE code they have been assigned does not indicate that their activities include defence³. Industry would welcome a sense check on the comparator group to identify and explain any notable exclusions. This, in turn, would assist industry in determining where changes to their NACE code accreditation could be considered.

We also note that limited US disclosure requirements may have led to the systematic exclusion of all but the largest US companies in the comparator group, due to data availability. This may have led to a distortion in the results. Industry would welcome greater clarity on issues with the proposed methodology such as this.

3. Reconciliation of Orbis Data

The SSRO has used the Orbis database to extract financial information for each comparator company. However, the database contains only abbreviated data about each company. For many of the companies within the comparator group, it is not possible to reconcile the financial figures provided by the Orbis database with the source data in the company accounts. Indeed, a number of ADS members do not recognise their own company data cited by Orbis.

In order for industry to judge that these are the correct figures on which to base the future return on regulated contracts, we would welcome further information as to the extent of information the SSRO is able to obtain using Orbis.

¹ For example: *Security systems service activities* and *Public administration and defence; compulsory social security*

² For example: QinetiQ Group PLC and Raytheon Company

³ For example: Serco Group Ltd (*Combined office administrative service activities*); Carillion PLC (*Construction of residential and non-residential buildings*); Bombardier Inc (*Manufacture of other transport equipment*)

4. Profit-Level Indicator (PLI)

The SSRO's methodology assumes that *company* profitability is the correct benchmark for *contract* profitability.

Industry's understanding of the PLI use by the SSRO is as follows:

$$\text{Net cost plus} = \frac{\text{Operating Profit}}{\text{Total Expenses}}$$

where:

$$\text{Total Expenses} = \text{Revenue} - \text{Operating Profit}$$

This very simple calculation does not allow for adjustments to reflect the fact that a company is likely to have financial income and expenditure unrelated to its core operating activity and the pricing of its contracts. Such exceptional or non-core items can be a source of significant distortions to reported company profit numbers⁴. When properly conducting a comparator benchmarking exercise, it is necessary to make adjustments for such items in order to distil the results down to the return from the relevant business operation only. A failure to do so is very likely to generate inappropriate and misleading results.

Additionally, the profit of companies within the comparator group is expressed *after* costs equivalent to those that will have been disallowed in regulated contracts. This means that the comparator company profit reported *after* these costs is below the level which was earned *before* these costs; the latter of which is the truly comparable figure required for this exercise.

This further undermines the notion that the benchmark profit will deliver a return commensurate with that which would have been earned for performing similar work in a competitive environment. On this basis, the process is unlikely to result in a fair and reasonable price being achieved for regulated contracts.

5. Statistical Aggregation

Once the comparator group is confirmed and the financial data for these companies is obtained, it is necessary to aggregate the data into a single figure for use as a Baseline Profit Rate. Industry has concerns with the SSROs methodology for doing this.

When investors decide whether or not to invest in an industry, the return they expect to earn for a given level of risk is a crucial consideration. The SSRO's approach to setting the benchmark profit is effectively to estimate what investors expect companies conducting similar activities to those included in single source contracts to earn, but in a competitive environment.

This expected return at the industry level is measured by the mean, which takes account of the performance of every company in the industry. Therefore, to address the question of what an equivalent return to the comparator group would be is to ask what the *mean* return across those companies is.

⁴ For example, the impact of business combinations or financial instruments

On this basis, industry questions two elements of the SSRO's process of aggregation. Firstly, industry strongly believes it is the mean and not the median (which measures the return on one single company in the middle of the group) which should be used to aggregate the financial data and, secondly, we believe loss makers should not be excluded from the dataset. Loss makers are an important component of the comparator group – they represent valid outcomes of comparator companies and, therefore, they are an essential component of the expected outcome (which also requires use of the mean). We note that the approach advocated by industry is consistent with the approach taken by Ofgem in its energy retail benchmarking exercise⁵.

6. SSRO Funding Adjustment

Industry believes the complexity of the proposals for calculating the SSRO Funding Adjustment is disproportionate. Similarly, industry doubts that the proposal to reconcile the funding adjustment on contract completion will be easily manageable and feasible in practice. Industry would be supportive of a much simpler approach such as that described in the Financial Framework for the SSRO.

In addition to the points above, it is also worth highlighting the lack of clarity as to whether the SSRO's proposed approach is provided for under the legislation as it currently stands. A review of the Defence Reform Act and the Regulations, together with the Hansard record of the parliamentary debates preceding the Bill's Royal assent and statements made since by the Secretary of State for Defence, suggests that the legislation was only intended for a single Baseline Profit Rate for all single source contracts. It is unclear whether any move to multiple rates will require an amendment to the Act and the Regulations. If this is the case, legislative amendments will also be required for the introduction of blended or composite rates. Industry would welcome further clarity and legal advice on this issue.

Many of the issues detailed in this submission have been raised previously, either through the formal consultation process or at separate meetings with SSRO or MOD representatives. Given the persistence of these concerns and the additional issues raised in this response in relation to the proposals set out by the SSRO, industry cannot support the extension of the SSRO's approach to multiple Baseline Profit Rates at this time. Industry considers that further work is needed before such proposals could be deemed to offer both good value for money for the UK taxpayer and a fair and reasonable price to those taking on regulated contracts.

Industry understands the Government's desire for reform in this area and we remain committed to working with both the SSRO and MOD to achieve this. Industry is fully prepared to engage and work closely with both the SSRO and MOD on these issues in order to find a way ahead that is mutually acceptable to all parties involved in single source procurement.

⁵ <https://www.ofgem.gov.uk/ofgem-publications/39709/mrappendices.pdf>

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

Martin Williams

Organisation:

Babcock International Plc

Position:

Finance Director - Technology

Consultation questions

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

Comments on style and formatting are not required.

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 ticking 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.

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Question 1. Do you have any comments on the SSRO's intended approach to the calculation and application of the multiple baseline profit rates and SSRO funding adjustment (Step 4) for 2017/18?

Please add comments to support your answer:

Please see attached document with our comments.

1. INTRODUCTION

- 1.1 This consultation response follows our earlier submission in relation to the SSRO's consultation on the methodology for calculating the Baseline Profit Rate. Our response considers the SSRO's specific proposals in relation to the implementation of multiple Baseline Profit Rates from 2017/2018.
- 1.2 We understand the aspiration to move to a regime under which different profit rates are awarded to contracts on the basis of the primary activity undertaken and other contract-specific risk factors. We also agree in principle with the approach of using comparators to populate a data-set from which these rates can be derived. However, we disagree that the methodology set out by the SSRO will achieve this in such a way that contracts earn a fair and reasonable return for the industry. We have serious concerns about the methodology in its current form and in relation to future proposals.
- 1.3 The SSRO acknowledges at paragraph 1.3 of its consultation document that a feature of the MoD's single source procurement is that *"it covers a wide variety of functionally diverse contracts"*. In order to ensure that these *"functionally diverse contracts"* earn a fair and reasonable return, it is important to understand the nature and complexities of the work carried out by single source suppliers and to have a relevant group of comparators when calculating the appropriate Baseline Profit Rate.
- 1.4 The need for a reliable and reasonably accurate methodology to assess the Baseline Profit Rate is a product of the statutory duty upon the Secretary of State (as advised by the SSRO) to provide a rate that is fair and reasonable to the industry as well as representing good value to the tax-payer. In its current form, the Baseline Profit Rate methodology fails to meet the first criterion in any objective way, whilst the lack of transparency in the Baseline Profit Rate methodology has limited the effectiveness of the consultation process to date.
- 1.5 We explain below why we have serious concerns that the methodology currently proposed by the SSRO is not fit for purpose. We have raised a number of these concerns directly with the SSRO on previous occasions (in the context of the current methodology for deriving the single Baseline Profit Rate) through a previous consultation response, correspondence and meetings. Given that the establishment of six different categories on the basis of the SSRO's current methodology is likely to exacerbate the issues we have identified, we do not support the establishment of these different categories at this time.
- 1.6 The importance of ensuring the integrity of the Baseline Profit Rate methodology cannot be understated. It is vital to ensure that single source suppliers have confidence they will receive a fair and reasonable return for undertaking what is often complex and challenging work, so that they continue to invest their top talent and resources in performing that work. A methodology which deprives the industry of that fair and reasonable return could, in the long term, discourage innovation and investment and actually prove more costly to the tax payer.
- 1.7 Babcock International Group's annual revenue is around £5 billion and includes some £700 million of single source activity. The group's overall margin is around 11 per cent, and we anticipate that our single source contracts, representing some of the most complex engineering activities delivered by the group, should achieve a similar level of profitability, noting that our single source contracts include the distortionary impact of a significant level of free issue material estimated at around 10 per cent of revenue.
- 1.8 We summarise our concerns below under the headings of, respectively:
- Relevance and appropriateness of comparator set; and
 - Other methodological issues.

2. RELEVANCE AND APPROPRIATENESS OF COMPARATOR SET

- 2.1 We recognise that the SSRO has retained the principle of comparability in setting the Baseline Profit Rate, with the methodology relying heavily upon the use of benchmarking. We also recognise that the SSRO has determined that a fair return to the industry is better served by moving the comparator group away from an average UK industry return to establishing comparator groups more aligned to the nature of the activities carried out by single source suppliers. In so doing, the SSRO has broadened the UK dimension of the previous comparator group to incorporate European and North American companies in the "develop and make" and "provide and maintain" categories.
- 2.2 Benchmarking methodologies are employed in a range of regulatory settings to sense-check and/or derive rates of return. It is an obvious yet fundamental point that the usefulness of a benchmarking methodology will be directly correlated to the relevance of the comparator set from which the benchmark is derived. This being the case, in order to ensure that the industry receives a fair and reasonable return for the work undertaken in single source contracts, it is imperative that the identification, selection and manipulation of the comparator data is fit for purpose and does not lead to perverse outcomes. As a general rule, the inclusion of irrelevant comparator entities or irrelevant activities performed by relevant comparator entities in the comparator set will distort the benchmark. Whilst a question of fact and degree in each case, a benchmark derived in whole or part from an irrelevant comparator set will be misleading and not fit for purpose.
- 2.3 In this case, the SSRO's proposed benchmarking methodology suffers from a number of serious shortcomings. These are explained in further detail below. The analysis in the remaining sections of this note is based on Babcock's assessment of its own Orbis database dataset, as it has not had visibility of the dataset used by the SSRO (see Issue 4 below in relation to comments regarding transparency).

Issue 1: The focus on activities within the NACE codes is not fit for purpose

- 2.4 The SSRO has used industry NACE codes, which classify companies by type of economic activity, as the starting point for the process of identifying companies with relevant functions for inclusion within each comparator group. However, there are errors in the process adopted that will lead to a material distortion of the results obtained.
- 2.5 First, the activities included in many of the NACE codes that have been proposed are far too broad. This means that the categories identified by the SSRO include a range of fundamentally different activities with different risk profiles, different levels of complexity, and, more importantly, that are likely to generate different rates of return. For example:
- (a) in relation to "design and make", around 60 different NACE codes have been included producing 271 comparator companies. However, there is significant variation in the average operating profit between NACE codes (ranging from -7.34 per cent up to 44.96 per cent). This wide dispersion reflects the fundamentally different nature of the activities included within this category. It also highlights the implausibility of trying to calculate a meaningful average profit figure on this basis across such a wide range of different activities, many of which are irrelevant for the type of activities involved in single source contracts; and
 - (b) similarly, in relation to "provide and maintain", the dispersion in the operating profit between activities is even more pronounced. In particular, there are more than 45 different NACE codes included within this category, with the average operating profit ranging from -76.25 per cent (for the "Manufacture of steam generators, except central heating hot water boilers") to 120.76 per cent (for "Renting and leasing of air transport equipment"). Again, this highlights the

implausibility of calculating an average profit figure across such a broad range of different activities.

- 2.6 Second, the NACE codes proposed to establish the "develop and make" and "provide and maintain" categories have resulted in the inclusion of companies that do not engage in any activities similar to the type of complex defence single source supply which the methodology needs to address (such as, for example, the repair and capability upgrade of ballistic nuclear submarines, which represents some of the most complex work which Babcock undertakes). The consequence is that the methodology generates irrelevant and unreliable comparators. Examples include companies engaged in activities such as: retail car sales; van rental; dairy equipment provision; and tyre repair. A methodology based on such an irrelevant comparator set will inevitably fail to recognise and reflect the complexity of the work involved in integrating complex systems into a highly specialised military platform and, as a result, contribute to the provision of a Baseline Profit Rate that is unrepresentative and unfair.
- 2.7 Third, most of the contracts undertaken under the single source regulations are long term in nature and placed with companies of scale which are global in nature, able to deploy significant resources and strong balance sheets to ensure the delivery of critical defence outputs. We do not believe that the current group of comparator companies reflect these attributes.
- 2.8 Fourth, whilst there are some irrelevant NACE codes included within the SSRO's methodology, it also appears that some potentially relevant NACE codes have been excluded from the SSRO's selection. Surprisingly, this has, for example, resulted in the exclusion of five of the top 10 MoD suppliers by value. In this regard, entities such as QinetiQ Group plc, Raytheon, Lockheed Martin Corporation, Hewlett Packard and Boeing Corporation are all absent from the comparator groups. This is likely to be the result of the exclusion of NACE codes such as "security systems service activities" and "public administration and defence" which, unlike certain other NACE codes that have been included, are directly relevant to complex MoD work and represent a significant proportion of the value of MoD single source procurements.
- 2.9 These points demonstrate that the approach proposed by the SSRO is flawed at its most basic level and requires fundamental revision if it is ever to become fit for purpose.

Issue 2: the international scope of the SSRO's comparison is unreliable
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- 2.10 As noted above, the SSRO has broadened the UK dimension of the previous comparator group to incorporate European and North American companies in the "develop and make" and "provide and maintain" categories. However, the SSRO's methodology appears to give rise to results which compromise the reliability of the comparison sample.
- 2.11 For example, within the "develop and maintain" category, 271 companies are caught by the NACE codes; however, 122 companies (i.e. over 40 per cent of the total) are Italian, with just 40 companies from the UK, 17 from the US and 16 from Spain. This means that, for no objective reason, the Baseline Profit Rate comparison is heavily skewed towards the reported profitability of a sub-set of Italian companies. The rationale for this is unclear.
- 2.12 Further, we have concerns around the placing of reliance for comparison purposes on the stated performance of privately owned European companies, since the practice of actively managing operating profit to maximise tax efficiency is far more commonplace among such entities than it is for the industry participants supplying to MoD on a single-source basis.

- 2.13 We also note that there are very few US companies included as comparators (for example, just 6 per cent of all companies within the "develop and maintain" category). We acknowledge that this systemic shortcoming is likely to reflect a lack of available information in respect of US companies (which are subject to different reporting rules) rather than being due to any methodological adjustment. However, we contend that US companies are likely to provide a more reliable pool of comparator companies than European companies, as we consider their ownership structures to be more closely aligned to those of UK suppliers. Moreover, the US is the largest defence market in the world, with US arms manufacturers accounting for nearly a third of the global market, so they clearly should be an important part of the comparator group.
- 2.14 Accordingly, whilst we agree in principle with extending the scope of the comparator set to include overseas companies, the way in which the SSRO has implemented this decision has damaged the integrity of the comparison sample, rather than improved it.

Issue 3: the £5 million p.a. de minimis turnover threshold is too low

- 2.15 The SSRO also proposes that a de minimis turnover threshold of £5 million per annum should apply for companies to qualify as a comparator for the Baseline Profit Rate calculations.
- 2.16 Whilst it is unclear how the SSRO has arrived at this figure, the use of a £5 million p.a. turnover threshold is plainly inappropriate for present purposes. In particular, it results in the inclusion of a large number of small companies in comparator groups that do not (and patently could not) engage in activities of a similar nature or complexity to the types of activities that single source defence suppliers provide and the methodology needs to accommodate. By way of comparison, according to the National Statistics report on MoD procurement for 2015, the overwhelming majority of single source procurement spend is with companies with revenues in excess of £100 million per annum. Including such a large number of small companies performing functions of a fundamentally different nature will, again, obviously distort the results if a methodology based upon comparator benchmarking is to be employed.
- 2.17 Further, because the de minimis threshold for QDCs is also £5 million, the current approach appears to have resulted in the inclusion of companies whose annual turnover itself is equal to the minimum value of a QDC. It is of course the case that, a company with turnover of just £5 million is unlikely to be considered a realistic option for the MoD to award a QDC. Moreover, the SSRO's July 2016 Interim Compliance Statement notes that of the QDCs let in 2015/16, over 75 per cent were for a value in excess of £10 million (and further, half of that number were for a value in excess of £50 million).
- 2.18 If a de minimis turnover threshold of £50 million p.a. were used, then this would reduce the comparator group in the "develop and make" category from 271 companies to just 88. This, together with a more considered approach to comparator selection and assessment than is currently evidenced in the use of NACE codes, would seem to be urgently required.

Issue 4: transparency in comparator selection process

- 2.19 The ability for an entity to replicate the SSRO's methodology with respect to its own position is essential to instil confidence in the SSRO's approach by demonstrating that it has arrived at a methodology which is fit for its statutory purpose. Babcock has been unable to trace the SSRO's footsteps in order to identify its own numbers, so it is unclear what adjustments have been made, whether they make sense, and whether they have been done accurately. In particular:

- (a) the specific filters applied in the Orbis database used by the SSRO in establishing the comparator groups are not transparent. The SSRO has not disclosed how it manually filters the database, nor how many companies are excluded from the search as a result;
 - (b) Babcock understands that the SSRO employs text searches in order to supplement the result, but that such searches are run in an imprecise manner (e.g. use of word fragments), thus increasing the risk of including irrelevant and/or incomplete data;
 - (c) the SSRO has used the "most recent" financial results of each company. This means that the result of following the same process may be different one day to the next, meaning that even if the process was replicated exactly on a different date, the results would likely be different. This again prevents replication; and
 - (d) the SSRO has not disclosed the specific inputs to, and calculation of, the final Baseline Profit Rate figures, making audit of the output by a third party impossible.
- 2.20 The SSRO has used the Orbis database to extract financial information for each comparator company. However, the database contains only abbreviated data and, for many of the companies within the comparator group, it is not possible to reconcile the financial figures provided by the Orbis database with the source data in the company accounts. Indeed, Babcock does not recognise its own company data in the Orbis database.
- 2.21 It is clear from the points noted above that a great deal more information as to comparator selection and data manipulation methodology is required to be shown by the SSRO if the industry is to adequately understand the SSRO's approach to the Baseline Profit Rate methodology.

3. OTHER METHODOLOGICAL ISSUES

- 3.1 In addition to the concerns around how the comparator set is selected, we consider there to be several other methodological issues inherent in the SSRO's proposed approach to establishing the Baseline Profit Rates. These other issues are set out below.

Issue 5: company profitability may not be the correct benchmark for contract profitability

- 3.2 The SSRO's methodology incorrectly assumes that company profitability is the correct benchmark for contract profitability. In paragraph 4.2 of its illustrative example, the SSRO has proposed the following formula to calculate an appropriate profit level indicator:

$$\text{Net cost plus} = \frac{\text{Operating Profit}}{\text{Total Expenses}}$$

where: $\text{Total Expenses} = \text{Revenue} - \text{Operating Profit}$

- 3.3 The SSRO's approach to calculating the Baseline Profit Rate is, accordingly, heavily dependent on the operating profit of the providers included within the comparator set.
- 3.4 With regard to operating profit, where comparator companies are large, international companies, they are often diversified across a range of different markets/sectors and geographies (in order to mitigate the risks and exposure to any particular individual sector). This means that the returns from these diversified comparator companies are likely to vary between lines of business, and therefore the group operating profit may not reflect accurately the risks associated with a business line (or business lines) relevant for the purposes of comparison with a single source defence contract.

- 3.5 For example, Safran SA, a large multinational company active in a range of different sectors is included in the design and make comparator group. According to publicly available information, Safran's operating profit in 2015 ranged from between 5.3 per cent to 24.5 per cent depending on line of business, with a total consolidated profit (excluding one-off items) of 18.9 per cent.¹
- 3.6 In addition, there will be ways in which publicly listed and privately owned companies report their profitability (for example, as noted above, in the context of European private companies). Clearly, this could further distort the comparison process. It is of note that the approach previously adopted by the Review Board was to focus on around 650 listed companies, which largely avoided this potential bias. We explain above why the competitor set is far too wide and populated by irrelevant entities to provide the basis for a meaningful benchmark.
- 3.7 The calculation set out at paragraph 3.2 above does not allow for adjustments to reflect the fact that a company is likely to have financial income and expenditure unrelated to its core operating activity. Such exceptional or non-core items include gains or losses on disposal of businesses, impairment of goodwill and amortisation of acquired intangibles and these matters can be a source of significant distortions to reported company profits. In the context of the Safran example, reported operating profit in 2015 was 13 per cent. However, this figure increases to 18.9 per cent if certain one-off items that were included in the accounts (such as a write-down of goodwill) are excluded. Accordingly, when properly conducting a comparator benchmarking exercise, it is necessary to make adjustments for such one-off items, which are nothing more than accounting adjustments, in order to distil the results down to the return from the relevant business operation only. A failure to do so is very likely to generate inappropriate and misleading results.
- 3.8 In this regard, one of the most significant items that should be recognised in the context of the delivery of complex single source contracts if the benchmark is to be meaningful is the amortisation of intangible assets in relation to acquisitions. The amortisation of such intangible assets amounts to an accounting adjustment and has no relevance to underlying company profitability or to contract pricing and reported company profits should be adjusted to add back the amortisation in order to reflect underlying profitability. In the case of Babcock, amortisation of acquired intangibles in 2015 amounted to £94 million and unless account is taken of this the SSRO methodology will include a material misstatement of Babcock's profitability in the comparator group Baseline Profit Rate calculations.

<p>Issue 6: the median value is an inappropriate average for assessment of the Baseline Profit Rate</p>
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- 3.9 Once the comparator group is confirmed and reliable and relevant financial data for these companies is obtained, it is necessary to aggregate the data into a single figure for use as a Baseline Profit Rate.
- 3.10 In situations where there are relatively few comparators or there is significant variation between comparators in the rates of return, the mean and median can produce very different results. It is well established that care has to be given to the correct selection of the correct average measure where, for example, the use of a median when applied to a large unrepresentative comparator set will distort the results obtained in a radical fashion.

¹ When conducting a profitability analysis in a market wide investigation, the Competition and Markets Authority ("CMA") is mindful of the appropriateness of the comparison between firms, and therefore ensures that the analysis is tightly controlled so as to ensure the results are reliable. This is necessary to ensure that the measure to be derived is sufficiently connected to the activities in question.

- 3.11 In the present context, the variation between the mean and median value is clearly evident within the "design and make" and "provide and maintain" categories. For example, in relation to the "provide and maintain" category, the overall mean across all NACE codes is 18.8 per cent, compared to a median of just 9.9 per cent. Similarly, in relation to the "design and make" category, the overall mean is 9.2 per cent compared to a median of just 6.9 per cent. Such variation means that the choice between median and mean will have a material impact on the overall Baseline Profit Rate.
- 3.12 In this regard, the SSRO's proposed use of a median value is inconsistent with the statutory purpose it is seeking to achieve. In particular, its use compounds the misleading effect of the unrepresentative comparator set that has been selected.
- 3.13 The SSRO's approach to setting the Baseline Profit Rate is effectively to estimate what investors expect companies conducting similar activities to those included in single source contracts to earn, but in a competitive environment. However, it is an obvious point that any investor determining whether or not to invest in an industry will always carry out its assessment on the basis of an average return (a measurement inherently more representative of a diverse pool than a median value), which takes into account the performance of every company in that industry. With regard to this statutory objective, a mean value as applied to a more representative competitor set would obviously appear to be the more appropriate figure to be used.
- 3.14 The SSRO justifies its proposed use of a median value on the basis that (a) it is used in transfer pricing and (b) it reduces volatility in earnings in comparison to the mean. This is misguided on both counts:
- (a) first, we have found no evidence that either OECD or HMRC favour the use of the median in transfer pricing. Rather, we consider its application is as just one of a number of statistical measures (including mean, quartile ranges, etc) used to justify an assessment of comparator companies or transactions as evidence in support of a transfer pricing arrangement. This assessment is highly context-specific, and neither the OECD nor HMRC necessarily place higher relevance on the median over any other average. Even in this scenario, the overriding consideration remains the return anticipated by investors, which can only be accurately assessed by reference to a mean value; and
 - (b) second, the volatility of earnings is mitigated through the use of a three year rolling average in setting the Baseline Profit Rate. This being the case, there is no reason to use the more artificial median measures (and in any event, the SSRO has provided no justification as to why a median approach might produce more stable results).

Issue 7: the SSRO's methodology does not include loss-making contracts

- 3.15 As loss-making contracts provide a valid outcome of contract awards, Babcock considers that they are an essential component of the comparator group and therefore should not be excluded from the dataset, noting the requirement to adjust reported profitability for matters unrelated to core operating activity set out at 3.7 and 3.8. Babcock's view is consistent with, for example, the approach taken by Ofgem in its energy retail benchmarking exercise.

Issue 8: the SSRO funding adjustment appears incorrectly stated
--

- 3.16 We acknowledge the funding adjustment is in line with the previous guidance that the SSRO would be funded on an equal basis between the industry and the MoD from 2017/18 onwards.
- 3.17 That said, the calculation for the funding adjustment as described in the document does not appear correct. As it stands the formula in section 7.4 of the consultation document would seem to allocate all of the SSRO's costs (less additional tasks requested by the Secretary of State) to the industry. We would suggest the formula be corrected to:

$$\text{SSRO Funding Adjustment} = \frac{\frac{1}{2} \times (\text{SSRO} - \text{Costs of Additional Tasks Requested by the SoS})}{\text{Total Value of QDCs}}$$

- 3.18 We have previously highlighted that as the industry is expected to fund part of the SSRO's costs going forward, there should be appropriate changes to enable the industry to participate in the SSRO's governance. At a minimum, there should be an input into the budget setting for the SSRO to ensure that resources allocated are appropriate.

4. CONCLUSION

- 4.1 The flaws identified above are fundamental to the methodology the SSRO proposes. Many of the errors are obvious, in the sense they render the methodology incapable of identifying a base profitability rate that is fair and reasonable in the context of the type of work currently carried out through single source procurements.
- 4.2 In turn, these errors are principally the result of the use of a benchmark based methodology, but where the comparator set identified is unrepresentative of the activities with which the methodology needs to be concerned. These errors are compounded by the lack of interrogation and thus integrity of the figures obtained from the competitor set, the failure to recognise the need for important adjustments (such as amortisation of acquired intangibles) and the additional distortion arising from the use of a median average from which to derive a rate.
- 4.3 With regard to the above, Babcock considers it important to have responded to the consultation in a transparent manner and point out these deficiencies in so far as they have been possible to discern at this stage. In that regard, we have set out a list of recommendations to address these methodological flaws at [Annex 1](#) to this document.
- 4.4 As ever, Babcock remains willing to work with the SSRO in a constructive fashion to seek to remedy these concerns in so far as it is able and given their impact upon the future calculation of the Baseline Profit Rate. In that regard, we trust that this consultation response is of assistance and we look forward to further engagement in the immediate term with the SSRO on these important issues.

ANNEX 1

Babcock's Recommendations

- Conduct a review of the NACE codes and search criteria used to align them more directly to the nature of the activities carried out by sole source suppliers and to introduce a more balanced international dataset;
- Perform a sense-check on the output of the Orbis search results to identify any notable company exclusions, for example QinetiQ plc, Raytheon, Lockheed Martin Corporation, Hewlett Packard and Boeing Corporation;
- Implement a more detailed review of the Orbis search results to ensure that the nature of the activities carried out by the comparator companies is truly comparable;
- Increase the turnover threshold of £5 million to assist in ensuring the appropriateness of comparator companies;
- Introduce further transparency to the comparator company selection process to enable third party replication of the process;
- Use a weighted mean in order to include all of the comparator group in setting the Baseline Profit Rate;
- Establish the basis upon which company profitability is reported in the Orbis database (noting that Babcock does not recognise its own reported operating profit) and identify adjustments to reported profitability to ensure that exceptional non trading gains or losses and matters such as amortisation of acquired intangible assets are appropriately adjusted for in setting the Baseline Profit Rate for contracts; and
- From within the relevant dataset, use operating profit figures which focus more closely on relevant business lines.

Review of single source baseline profit rate methodology and adjustment guidance 2016**Consultation Response Form****Your details**

Name:

Steve Clifford

Organisation:

BAE SYSTEMS PLC

Position:

Director of Finance, Head Office

Consultation questions

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

Comments on style and formatting are not required.

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 ticking 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.

**Review of single source baseline profit rate methodology and adjustment
guidance 2016**

Consultation Response Form

Question 1. Do you have any comments on the SSRO's intended approach to the calculation and application of the multiple baseline profit rates and SSRO funding adjustment (Step 4) for 2017/18?

Please add comments to support your answer:

BAE SYSTEMS PLC response can be found on the attached letter.

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18th August 2016

Contract Profit Rate Consultation Responses
Single Source Regulations Office
Finlaison House
15-17 Furnival Street
London
EC4A 1AB

Dear Sirs,

2017/18 Profit Rate Consultation

BAE Systems has been involved in the industry discussions with ADS and at the CFO Steering Group on both Multiple Profit Rates and the SSRO Funding Adjustment. The company agrees and supports the points raised in the ADS letter to SSRO on 18th August 2016.

BAE Systems is supportive of the desire to move to multiple profit rates in the longer term when there is an appropriate methodology that provides industry with a fair and reasonable return, that is more transparent than is currently available and that reflects the scope, complexity and risk of non-competitive contracts it is asked to perform.

Yours faithfully,

Steve Clifford
Director of Finance
Head Office

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

Michael Hayes

Organisation:

The Boeing Company

Position:

Commercial Director, Boeing Defence UK Ltd

Consultation questions

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**Review of single source baseline profit rate methodology and adjustment
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Please add comments to support your answer:

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

In its response to the Consultation in 2015 on the 'Review of Single Source Contract Profit Rates Methodology' Boeing expressed a preference for one profit rate to avoid undue complexity and thereby retain agility in the contracting process. This opinion remains unchanged.

Over the passage of time there has been the opportunity for further analysis of proposals against the prevailing environment and Boeing wishes to make the following observations in support of a single Baseline Profit Rate (BPR).

1. Boeing has doubts that the Act or the Regulations allow for multiple or composite profit rates. In which case multiple rates should not be being considered until after necessary amendments to the legislation have been enacted. This would seem to be confirmed by the Secretary of State in his letter of 20 January 2016 to the SSRO chair; "...we require more time to understand the implications of the proposal [the principle multiple profit rates] and to make any necessary changes to the regulations in line with the planned 2017 review."
2. Further, Boeing considers that the methodology by which the current single BPR has been established is not robust, in that;
 - a. There is insufficient transparency in the process to permit accurate reproducibility and database 'filtering' has been subjective.
 - b. The comparator group is already small and has, surprisingly, excluded most large US Defence Prime Contractors. To make comparator groups even smaller to encompass four separate activity types will surely tend towards producing further statistical anomalies.
 - c. Financial information contained in the database is often unrecognisable compared with the same Company's data in company accounts, resulting in difficulties in interpretation and reconciliation. There are also concerns that in the SSRO analysis, company and contract profitability may have become conflated.
 - d. Arriving at a BPR has involved aggregation and the SSRO has used a median value, which skews the result towards a 'long tail' - either high or low. Because of the deficiencies highlighted above in 2 a-c, taking the median is always likely to produce anomalous results, therefore Boeing strongly supports the selection of a BPR based on a mean (not median) value analysis.
3. Because Boeing considers that the current methodology for setting a single BPR has serious weakness, accordingly it should not be used as a basis for setting multiple rates. The methodology must be addressed first with industry so that companies may have confidence in the approach. MoD had asked SSRO to undertake this review, as was minuted in the notes of the Defence Suppliers' Forum of 23 March 2016, chaired by the Secretary of State.

Finally, Boeing supports the analysis conducted as part of the ADS submission to the SSRO Consultation.

SSRO
Finlaison House
15-17 Furnival Street
London
EC4A 1AB

Date: 16th August 2016
Ref: Single Source BPR Methodology

Public Consultation – Review of single source baseline profit rate methodology and adjustment guidance 2016

Dear Sir or Madam,

Many thanks for inviting responses to the above consultation.

Marshall Aerospace and Defence Group has been fully supportive of the need for change and are committed to the new ways of working brought about by the Act.

I have attached our feedback in the format of your questionnaire and I hope that you will see that we have been largely supportive of the aims of the consultation whilst raising comments that we feel will give enhanced credibility to the system.

We would welcome the opportunity to explain any of our comments if they are unclear or if you wanted to be sure what has driven them. Please contact me in the first instance if you do have any questions.

Please be assured of our support for the SSRO in its role provided for under the Act.

Yours faithfully

On behalf of Marshall Aerospace and Defence Group

A handwritten signature in black ink, appearing to read "Ian Atkinson".

Ian Atkinson
Commercial and Purchasing Director

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

Neil Goulding

Organisation:

Marshall Aerospace and Defence Group

Position:

Head of Commercial, Military Aerospace

Consultation questions

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

Comments on style and formatting are not required.

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Yes

☒

No

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Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Question 1. Do you have any comments on the SSRO's intended approach to the calculation and application of the multiple baseline profit rates and SSRO funding adjustment (Step 4) for 2017/18?

Please add comments to support your answer:

We support the application of multiple baseline profit rates and fully appreciate the logic behind the need for multiple rates. We also fully understand that the SSRO has applied what it believes is a robust process to define the benchmarks and agree the methodology to be used. Our feeling is that this process has not been open to any real degree of challenge and therefore can lead to results that will not engender as much support for the methodology as would otherwise be possible. The detail behind the specific challenges is contained within the full response of ADS to this consultation and Marshall supports that response. In this regard, whilst we do support the introduction of multiple baseline profit rates, we believe it would be better to introduce these once all interested parties have a fuller understanding of the details behind the methodology and any perceived anomalies are fully explored, understood and addressed if this is found to be necessary.

On the SSRO funding adjustment, we believe it is right to leave this as included within the legislation rather than make a significant change. One alternative we have considered is whether this could become a subscription or fee-based service so that users would make specific contributions as they choose to use certain services. One risk with the current system is that one or more small users could exercise the SSRO's decision making bodies knowing that these will probably be paid for by the few very large companies that will in effect be paying for the industry element of the SSRO's costs, simply due to the scale of their single source contracts.

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

ADRIAN DOE

Organisation:

MBDA UK Ltd

Position:

HEAD OF PROGRAMMES COMMERCIAL OPERATIONS - UK

Consultation questions

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

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Yes

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No

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Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Question 1. Do you have any comments on the SSRO's intended approach to the calculation and application of the multiple baseline profit rates and SSRO funding adjustment (Step 4) for 2017/18?

Please add comments to support your answer:

This consultation response follows earlier submissions in relation to the SSRO's consultation on the methodology for calculating the Baseline Profit Rate (published on 25 September 2015). This response examines the SSRO's specific proposals in relation to the implementation of multiple baseline profit rates from 2017/18, as set out in the consultation paper published on 8 July 2016.

The SSRO has expressed an aspiration to move to a regime under which different profit rates are awarded to contracts on the basis of the primary activity undertaken and other contract-specific risk factors. We recognise the benefits that can be obtained by relating profit to the nature of its outputs and the risk taken. It offers the contractor an opportunity to earn more profit by accepting greater risk, while simultaneously delivering better value for money for the Authority by paying reduced profit for less risky work. However, while such an approach may seem viable in principle, there are significant concerns that the methodology based on multiple Baseline Profit Rates (as set out by the SSRO) will not achieve this in such a way that ensures the contractor will receive a fair and reasonable price.

In particular, under the SSRO's proposals, baseline profits on regulated contracts are benchmarked against average returns earned by a set of companies deemed by the SSRO to undertake activities comparable to those provided under regulated contracts. Whilst we recognise that benchmarking of profits against comparators is a well-established method for assessing the profitability of a company, the validity of the findings is heavily dependent on the relevance of the comparator group, the specific question being addressed and how the comparator statistics are assessed.

In order to ensure that companies receive a fair and reasonable price for the work undertaken in single source contracts, it is imperative that the identification, selection and use of the comparator companies and corresponding financial data is fit for purpose and does not lead to perverse outcomes. A number of issues have been identified relating to the selection of companies in the comparator group, the financial data used for each company and the methodology for translating this into a baseline profit.

These issues are summarised below. Given concerns as to the robustness of the methodology outlined for deriving the single baseline profit, we do not support the extension of the baseline into six different categories, as such a step will serve to further exacerbate many of the issues highlighted below.

1. Transparency in Comparator Selection Process

We appreciate the information which the SSRO has provided on the process undertaken to determine the baseline profit rate and in particular the publication of the list of companies in the final comparator reference group, which is more information than has previously been made available. However, the level of information provided is insufficient to allow for the process to be exactly replicated by a third party. This is necessary in order to build confidence and trust in the approach taken by the SSRO.

In particular:

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

- The specific filters applied in the Orbis database are not clear (e.g. use of consolidated accounts criteria and availability of data), which creates uncertainty and an inability to replicate the SSRO filtering process.
- It is not clear how the SSRO has manually filtered database results or how many companies have been filtered out by this part of the process. While the SSRO has stated that it reviews company websites to obtain more detail regarding the validity and location of each business' activities, it appears that this process that may have resulted in the filtering out of a material number of companies. An alternative to further specification of this part of the process would be to publish a list/number ex-post of every company excluded through this part of the process together with a brief explanation for why these companies had been excluded.
- The SSRO has used the "most recent" financial results of each company. This means that the result of following the same process may be different one day to the next, meaning that even if the process was repeated exactly on a different date, the results would likely be different. This again prevents replication. The sample should use results for a defined financial year which would allow results to be replicated. Similarly, clarity as to the date when the Orbis database will be accessed each year would be beneficial.
- The specific inputs to and calculation of the final baseline profit figures have not been disclosed, making audit of the output by a third party impossible.

2 . Appropriateness of Comparators

Exclusion of key companies in current comparator group

The SSRO has used industry NACE codes (which classify companies by type of economic activity) as the starting point in its process of extracting companies with relevant functions for inclusion within the comparator group. However, it appears that some potentially relevant NACE codes have been excluded from this process . These omissions appear to have led to the exclusion of some obvious comparator companies , leading to questions in relation to the process by which the comparator companies were selected.

Similarly, some companies which would appear to be appropriate comparators have been omitted as the NACE code they have been assigned does not indicate that their activities include defence . We would welcome a sense check on the comparator group to identify and explain any notable exclusions. This, in turn, would assist companies in determining where changes to their NACE code accreditation could be considered.

We also note that limited US disclosure requirements may have led to the systematic exclusion of all but the largest US companies in the comparator group, due to data availability. This may have led to a distortion in the results. Industry would welcome greater clarity on issues with the proposed methodology such as this.

3.Reconciliation of Orbis Data

The SSRO has used the Orbis database to extract financial information for each comparator company. However, the database contains only abbreviated data about each company. For many of the companies within the comparator group, it is not possible to reconcile the financial figures provided by the Orbis database with the source data in the company accounts. Indeed, we understand that a number of ADS members do not recognise their own company data cited by Orbis.

In order to judge that these are the correct figures on which to base the future return on regulated contracts, we would welcome further information as to the extent of information the SSRO is able to obtain using Orbis.

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

4. Profit-Level Indicator (PLI)

The SSRO's methodology assumes that company profitability is the correct benchmark for contract profitability.

Our understanding of the PLI use by the SSRO is as follows:

Net cost plus= (Operating Profit)/(Total Expenses)
where:

Total Expenses=Revenue-Operating Profit

This calculation does not allow for adjustments to reflect the fact that a company is likely to have financial income and expenditure unrelated to its core operating activity and the pricing of its contracts. Such exceptional or non-core items can be a source of significant distortions to reported company profit numbers. When properly conducting a comparator benchmarking exercise, it is necessary to make adjustments for such items in order to distil the results down to the return from the relevant business operation only. A failure to do so is very likely to generate inappropriate and misleading results.

Additionally, the profit of companies within the comparator group is expressed after costs equivalent to those that will have been disallowed in regulated contracts. This means that the comparator company profit reported after these costs is below the level which was earned before these costs; the latter of which is the truly comparable figure required for this exercise.

This further undermines the notion that the benchmark profit will deliver a return commensurate with that which would have been earned for performing similar work in a competitive environment. On this basis, the process is unlikely to result in a fair and reasonable price being achieved for regulated contracts.

5. Statistical Aggregation

Once the comparator group is confirmed and the financial data for these companies is obtained, it is necessary to aggregate the data into a single figure for use as a baseline profit rate.

When investors decide whether or not to invest in an industry, the return they expect to earn for a given level of risk is a crucial consideration. The SSRO's approach to setting the benchmark profit is effectively to estimate what investors expect companies conducting similar activities to those included in single source contracts to earn, but in a competitive environment.

This expected return at the industry level is measured by the mean, which takes account of the performance of every company in the industry. Therefore, to address the question of what an equivalent return to the comparator group would be is to ask what the mean return across those companies is.

On this basis, we would question the process of aggregation. We strongly believe it is the mean and not the median (which measures the return on one single company in the middle of the group) which should be used to aggregate the financial data. We understand that this approach is consistent with the approach taken by Ofgem in its energy retail benchmarking exercise.

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

6. SSRO Funding Adjustment

We believe the complexity of the proposals for calculating the SSRO Funding Adjustment is disproportionate. Similarly, we doubt that the proposal to reconcile the funding adjustment on contract completion will be easily manageable and feasible in practice. We would be supportive of a much simpler approach such as that described in the Financial Framework for the SSRO. In addition, we note that your worked example could be taken to indicate that the totality of SSRO's costs would be recoverable from industry

7. General

Many of the issues above have been raised previously, either through the formal consultation process or at separate meetings with SSRO or MOD representatives. Given the persistence of these concerns and the additional issues raised in this response in relation to the proposals set out by the SSRO, industry cannot support the extension of the SSRO's approach to multiple baseline rates at this time. Industry considers that further work is needed before such proposals could be deemed to offer both good value for money for the UK taxpayer and a fair and reasonable price to those taking on regulated contracts.

We understand the Government's desire for reform in this area and we remain committed to working with both the SSRO and MOD to achieve this. We are fully prepared to engage and work closely with both the SSRO and MOD on these issues in order to find a way ahead that is mutually acceptable to all parties involved in single source procurement

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

Terry Hersey

Organisation:

Metasums Ltd

Position:

Director

Consultation questions

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Yes

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No

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Please add comments to support your answer:

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

I believe that the approach taken by the SSRO is inappropriate. I strongly suspect that the SSRO is correct in paragraph 1.5 that no other country sets a single profit rate for all types of defence contract but it is, I believe equally true to say that no other country has a methodology where the allowance is based upon the financial performance of companies, for example the US uses a structure of weighted profit guidelines where the profit allowance, similar arrangements apply in Canada.

- (1) Looking back over the average financial performance of a collection business over the previous 3 years to apply to pricing of contracts that on average last for 4 years means that contractors should expect the rate to significantly lag the economic cycle
- (2) The profit allowance methodology should provide stability were similar contracts in similar circumstances to be priced in different periods (i.e. if risk, skill, expertise, financing, etc are the same then the profit allowance should be the same. Defence requires a long term relationship between industry and Government and that requires stability in application of both the scope and structure of allowable cost and fee.
- (3) A reference group of companies should not be used as they will never be representative of the work undertaken by contractors in fulfilling single source defence contracts. The structure should be set as a matter of government policy and be applied to all single source contracts regardless of the location or ownership of the contractor. For this to be consistently applied the allowance included in contract prices needs to be comparable with the allowance offered by other nations in its single source pricing arrangements (allowable costs need also to be similar). The methodology for establishing the profit allowance applicable to individual contracts should be based on policy established from looking to the rates available to similar contracts under the USA, Canada, France and Germany frameworks.

The SSRO is proposing the wrong answer to the wrong question.

Paragraph 3.10 looks to be illogical. Why pick 0% as a baseline profit allowance that the parties can agree to when no other arbitrary number is permitted. A zero percentage profit allowance will not give the contractor a zero percentage profit on the contract e.g. SSRO funding adjustment will still apply, some costs will not be allowable, the contractor has cost risk so not only is the end cost uncertain but the risk adjustment of plus or minus 25% is left mute as 25% of 0 is zero. If the parties can agree 0% then why not any other %. Surely it is better to exclude such contracts from the framework as the contract is not being performed for reward. I have always believed that contracts between the secretary of state and other UK government departments should be excluded from the scope of the regulations; similar exclusions should also apply to sub-contracts between contracting authority and a sub-contractor who is a branch of the UK government (these conditions apply within the US FAR).

The SSRO funding adjustment (can't see why any is needed) should be based upon a reduction in the price payable and should be simply established as a fixed amount based upon 50% of SSRO's (10 year) average annual running costs (net of any payments for extra tasks commissioned by the Secretary of State) divided by the average value of qualifying contracts and sub-contracts that are expected to be awarded in an average year. No truing up it's just a reduction in the price the contractor gets.

A couple of extra points.

Paragraph 9.11 is still unclear to me.

In 'a' is the set 'uncertainties' the same as the set 'risks' or has it a different meaning or scope

'c' All allowable costs need to be managed and all allowable costs estimates contain some uncertainty else they are not an estimate. I therefore don't understand

'd' and 'e' I can understand why overspend is included in the text as this is consistent with the legislation. I don't understand why underspend is included. If the cost are estimated at the mean expected outcome then the probability of each outcome multiplied by its impact is the same for overspends and underspend. The risk adjustment is to vary the profit for the shape of the distribution

'g' Surely the allowable cost guidance should say that estimates need to reflect the mean expected cost outcome. Pricing outside of the mean should be fixed there and not here

'j' unclear of what

The SSRO press release accompanying the consultation documentation looks to have been drafted to excite an understanding that either (1) defence contractors are ripping off the tax payer and the tax payer needs SSRO as a superhero as Gotham needs Batman; or (2) the management of the framework has been mishandled by government whereby contractors are paid too high a price. A better sense of balance and impartiality should have been achieved rather than the impression again of the SSRO playing to the gallery

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Your details

Name:

Neil Hamilton

Organisation:

Ministry of Defence

Position:

Deputy Head Single Source Advisory Team

Consultation questions

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

Comments on style and formatting are not required.

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 ticking 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.

Review of single source baseline profit rate methodology and adjustment guidance 2016

Consultation Response Form

Question 1. Do you have any comments on the SSRO's intended approach to the calculation and application of the multiple baseline profit rates and SSRO funding adjustment (Step 4) for 2017/18?

Please add comments to support your answer:

Thank you for the opportunity to comment on your paper on "Review of single source baseline profit and capital servicing rates methodology and adjustment guidance 2016". MOD Director General Finance wrote on 12th August 2016 to the Chief Executive of the SSRO noting that MOD is considering its position with regards to a number of key issues relating to Baseline Profit Rates, notably with regards to 'pass-through' and to how a multiple BPR might operate. It is important for the Department to understand fully all the implications arising from any proposed change to the BPR. Unfortunately, this work is not fully complete - we will engage with the SSRO on these major issues as soon as we can on this but in the meantime we are unable to provide a fully substantive response to this consultation.

On a purely technical aspect, the MOD's position remains consistent with our response to the previous consultation carried out in October-November 2016. The remaining concerns include; the reference groups for each type of contract activity, the implications of Multiple BPRs on the Capital Servicing Adjustment, the implications on the profit formula and whether the activity types are appropriate and sufficient. If MOD were to pursue the proposal of multiple rates, it would also like to explore the use of blended rates and a pass-through rate.

SSRO funding adjustment

The SSRO funding adjustment as embodied in the legislation was designed to be simple and to avoid the requirement to issue invoices to individual contractors, with all of the associated administrative and VAT overhead. It was not intended that some form of reconciliation of contract values would take place that would be used to adjust the percentages subtracted as Step 3 of the profit calculation. Given that Step 3 has not yet come into force, MOD position is that proposed scheme is overly complex and there is no evidence to support a change from the calculation scheme originally proposed.