

SSRO

Single Source
Regulations Office

Pricing guidance review 2018
Changes for 2019/20
January 2019

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1. Introduction

- 1.1 Section 18 of the Defence Reform Act 2014 (the Act) requires that the Secretary of State, or an authorised person, and primary contractors have regard to guidance issued by the SSRO in relation to any of the six steps for determining the contract profit rate for a qualifying defence contract (QDC) or qualifying sub-contract (QSC). Section 20 of the Act states that the SSRO must issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs. The SSRO aims to keep its guidance on these matters current and relevant and consult, as required, with stakeholders to provide additional clarity and certainty for those involved in single source defence contracting.
- 1.2 The current pricing guidance was published in spring 2018. It includes guidance on:
 - a. Allowable Costs¹ (Allowable Costs guidance); and
 - b. the application of the six-step process to calculate the contract profit rate² (profit rate guidance).
- 1.3 Following engagement with key stakeholders during summer 2018, the SSRO conducted an eight-week public consultation³ on proposed changes to its pricing guidance in three areas:
 - a. the requirements of Allowable Costs (the AAR test);
 - b. research and development costs (R&D); and
 - c. capital servicing adjustment (CSA).
- 1.4 During the consultation period, the SSRO:
 - a. held group and individual meetings with members of the SSRO's Operational Working Group⁴ and other interested parties;
 - b. received written responses to the working papers from 13 stakeholders, including the MOD, ADS, ten defence contractors and one consultant.⁵
- 1.5 The SSRO would like to take this opportunity to thank all those who responded to the consultation for sharing their views with us. The majority of respondents gave permission for their responses to be published and these are available in SSRO (2019) *Pricing Guidance Review 2018: Consultation Responses*. A summary of the views and evidence provided by consultation respondents, together with the SSRO's commentary on how these responses have informed the final guidance in the areas on which we consulted is available in SSRO (2019) *Pricing Guidance Review 2018: Summary of Consultation Responses*.
- 1.6 Having considered the feedback provided on the proposed guidance, this document presents the changes to the SSRO's pricing guidance that will apply from 1 April 2019. The SSRO will republish its pricing guidance documents in full in March 2019, incorporating the changes set out in this document.
- 1.7 Any queries relating to the revised pricing guidance for 2019/20 should be addressed to the SSRO's helpdesk (020 3771 4785 or helpdesk@ssro.gov.uk).

¹ SSRO (2018) *Allowable Costs Guidance*.

² SSRO (2018) *Guidance on the Baseline Profit Rate and its Adjustment 2018/19*.

³ From 15 October to 7 December 2018. See SSRO (2018) *Pricing Guidance Review 2018: Consultation on Changes for 2019/20*.

⁴ Comprising the Ministry of Defence (MOD), ADS Group Ltd (ADS) and individual defence contractors.

⁵ The ADS response was explicitly supported by four of the defence contractors that responded to the consultation.

2. Requirements of Allowable Costs (the AAR test)

We will replace paragraph 2.2 in the current Allowable Costs guidance with the guidance below. Subsequent paragraphs will be re-numbered.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>2.2 For the purpose of pricing QDCs and QSCs the Act requires both the parties to be satisfied that particular costs meet the requirements of Allowable Costs, having regard to this guidance. To facilitate this, the Secretary of State may require the contractor to show that the requirements are met (with reference to this guidance or otherwise). In such cases, the burden of proof rests with the contractor. Whether or not the Secretary of State requires the contractor to show that the requirements of Allowable Costs are met, the Secretary of State and the contractor must be able to verify, to their satisfaction, that the costs are Allowable Costs.</p>	<p>2.2 For the purpose of pricing a QDC, the Act requires the Secretary of State and the primary contractor to be satisfied that particular costs meet the requirements of Allowable Costs under Section 20(2)(a) to (c) of the Act, having regard to SSRO guidance. In the case of a QSC, it is the Secretary of State and the sub-contractor who must be so satisfied. To be satisfied, the Secretary of State may require the primary contractor (in the case of a QDC) or the sub-contractor (in the case of a QSC) to show that the requirements are met (with reference to SSRO guidance or otherwise). In such cases, the burden of proof rests with the contractor or sub-contractor, as the case may be. Whether or not the Secretary of State requires the contractor or sub-contractor to show that the requirements of Allowable Costs are met, the Secretary of State and the contractor or sub-contractor must be satisfied that the costs are Allowable Costs.</p>	<ul style="list-style-type: none"> • To provide clarity regarding QDCs and QSCs. • Removing unnecessary reference to verification.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>2.3 In relation to a QDC or QSC, and associated reports required under Part 5 of the Regulations, Regulation 20 places a duty on the primary contractor or sub-contractor to keep 'relevant records'. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State or an authorised person for verifying certain matters relating to the price payable under a QDC or QSC, including whether a cost is an Allowable Cost.</p>	<p>2.3 In relation to a QDC, Regulation 20 requires the primary contractor to keep 'relevant records'. In the case of a QSC, it is the sub-contractor who is so required. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor, as the case may be, 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State for specific purposes, such as verifying certain matters relating to the price payable under a QDC or QSC, including whether a cost is an Allowable Cost.</p>	<ul style="list-style-type: none"> To provide clarity regarding QDCs and QSCs.
<p>2.4 The Act and Regulations do not specify what, if any, other information related to facts, assumptions or calculations is to be provided by a contractor (if required by the Secretary of State), or what standard of information is needed, to show that a cost in a QDC or QSC is an Allowable Cost to the satisfaction of both parties. In determining what type and standard of information is required, the parties should take a proportionate approach considering:</p> <ol style="list-style-type: none"> the specific requirements and circumstances of the contract; the materiality of particular costs; and what it is reasonable to expect would be available. 	<p>2.4 The Act and Regulations do not specify what information is required in order to be satisfied that a cost is an Allowable Cost. In determining what type and standard of information is required, the relevant parties identified in paragraph 2.2 should take a proportionate approach considering:</p> <ol style="list-style-type: none"> the specific requirements and circumstances of the contract; the materiality of particular costs; and what it is reasonable to expect would be available. <p>2.5 Transparency between the parties as to what type and standard of information each considers is required to be satisfied that a cost is an Allowable Cost will facilitate the achievement of a proportionate approach.</p>	<ul style="list-style-type: none"> To enhance brevity. To provide clarity regarding QDCs and QSCs. To note that transparency between the parties will facilitate the achievement of a proportionate approach.
<p>2.5 The information used to show that costs are Allowable Costs should make sufficiently clear how the costs meet the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<p>2.6 The information used to show that costs are Allowable Costs should make sufficiently clear to both the Secretary of State and the primary contractor (in a QDC) or sub-contractor (in a QSC) how the costs meet the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> To provide clarity regarding QDCs and QSCs.

We will replace paragraphs 3.1 to 3.10 in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.1 Costs are Allowable to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. These three requirements apply to all costs of a QDC or QSC, whether estimated or actual, and whether incurred directly or indirectly to enable the performance of the contract.</p>	<p>3.1 Costs incurred by a contractor (which includes those already incurred and those which are anticipated) are Allowable Costs in a QDC or QSC to the extent they are appropriate, attributable to the contract and reasonable in the circumstances. These three requirements apply whether the contractor's costs are estimated or actual, and whether they are applied to the contract as a direct cost or as an indirect cost.</p>	<ul style="list-style-type: none"> • To clarify that 'costs incurred' refers to both those already incurred and those which are anticipated. • To more clearly explain that costs are incurred and then applied to contracts as direct or indirect costs.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.2 This guidance sets out the principles underpinning each requirement and a non-exhaustive list of related factors that the parties should consider when assessing whether particular costs meet the requirements and are, therefore, Allowable Costs. Assessing whether the factors are true requires judgement to be applied by the parties. The relative importance of each factor to the particular costs under consideration, and the level of information required by the parties to be satisfied that the factors are true, are matters for the parties to decide taking account of the circumstances of the case. However, it is unlikely that a requirement will be met where the parties judge none of the underpinning factors to be true.</p>	<p>3.2 The guidance in this section sets out the typical characteristics of costs that meet the requirements of Allowable Costs. The relevant parties should consider the characteristics when evaluating whether a particular cost incurred by the contractor meets each requirement.</p> <p>3.3 Determining whether each requirement of Allowable Costs is met calls for judgement to be applied by the Secretary of State and the contractor or sub-contractor, as the case may be. This includes judgement regarding:</p> <ul style="list-style-type: none"> the relative importance of the characteristics identified in the guidance to the particular cost under consideration, taking account of the circumstances of the case; and the type and standard of information required to be satisfied that the particular cost demonstrates the characteristics identified in the guidance. <p>3.4 In determining whether each requirement is met, the relevant parties may place differing emphasis on the characteristics described in the guidance and require different information to be satisfied that the cost demonstrates the characteristics. It is unlikely, however, that a requirement will be met where the relevant parties cannot conclude positively that the particular cost possesses at least one of the related characteristics.</p>	<ul style="list-style-type: none"> To more clearly explain the format of the guidance and how it should be applied. To clarify that the relevant parties may be satisfied that costs are Allowable Costs in different ways.
	<p>3.5 Section 5 of this document provides additional guidance related to the evaluation of specific categories of cost including, in some cases, the types of evidence that should be considered.</p>	<ul style="list-style-type: none"> To explain the purpose of the guidance on specific categories of cost.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.3 The overarching principle is that for costs to be determined Allowable Costs they must support a contract price that delivers good value for money in government expenditure and is fair and reasonable to the contractor.</p>	<p>3.6 This guidance is intended to assist the parties to determine the Allowable Costs for a QDC or QSC in a way that supports the SSRO's statutory aims of ensuring that:</p> <ol style="list-style-type: none"> good value for money is obtained in government expenditure on qualifying defence contracts, and persons (other than the Secretary of State) who are parties to qualifying defence contracts are paid a fair and reasonable price under those contracts. <p>3.7 The relevant parties should have regard to these aims when applying the guidance and considering whether costs meet the requirements to be appropriate, attributable to the contract and reasonable in the circumstances.</p>	<ul style="list-style-type: none"> To better indicate the need for the relevant parties to have regard to the aims of ensuring good value for money in government expenditure and fair and reasonable contract prices when applying the guidance.
	<p>3.8 References in this guidance to costs that 'enable the performance of the contract' include those suitably and necessarily incurred by the contractor to:</p> <ol style="list-style-type: none"> deliver the contract in question; or deliver multiple contracts including the contract in question and equitably apportioned to those contracts. <p>Delivering the contract in question may require sustaining an essential or desirable capability.</p>	<ul style="list-style-type: none"> To clarify the meaning of 'enable the performance of the contract'.
	<p>3.9 References in this guidance to costs which 'would withstand public scrutiny' include those which meet high standards of regularity, propriety and prudence, such that the relevant standards expected by Parliament of the Ministry of Defence can be met.</p>	<ul style="list-style-type: none"> To clarify the meaning of 'withstand public scrutiny'.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>Appropriate</p> <p>3.4 A cost is appropriate if, by its character, it is a cost that a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.</p>	<p>Appropriate</p> <p>3.10 A cost is appropriate if it is of a type and arising from an activity that:</p> <ol style="list-style-type: none"> a reasonable person informed of the facts would consider enables the performance of the QDC or QSC in question; and would withstand public scrutiny. 	<ul style="list-style-type: none"> Merged with subsequent paragraph to avoid duplication. To clarify that the requirement relates both to types of cost and the activities from which costs arise. Item a): The meaning of 'enables the performance' is given at 3.8. Item b): The meaning of 'withstand public scrutiny' is given at 3.9.
<p>3.5 In order to assess whether a cost is appropriate, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether a reasonable person, informed of the facts, would consider the cost suitable and necessary to enable the performance of the contract; and whether the cost is of a type that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence. 	<p>(See 3.10)</p>	<ul style="list-style-type: none"> Merged with preceding paragraph to avoid duplication.
<p>Attributable to the contract</p> <p>3.6 A cost is attributable to the contract if it is incurred by the contractor directly or indirectly to enable the performance of the QDC or QSC in question and is applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. Costs which are attributable to the contract should not be recovered in any way from another contract, whether past, existing or proposed.</p>	<p>Attributable to the contract</p> <p>3.11 A cost is attributable to the contract if it:</p> <ol style="list-style-type: none"> is incurred by the contractor; enables the performance of the QDC or QSC in question; is applied directly or indirectly to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and has not been and is not anticipated to be recovered, directly or indirectly, from another source, as Allowable Costs must only be recovered once. 	<ul style="list-style-type: none"> Merged with subsequent paragraph to avoid duplication. Item c): To more clearly explain that costs are incurred and then applied to contracts as direct or indirect costs. Item d): To identify the principle that Allowable Costs must only be recovered once and acknowledge that costs may be recovered from a range of other sources, not just other contracts.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.7 In order to assess whether a cost is attributable to the contract, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether the cost has been or is anticipated to be incurred by the contractor; whether the cost has a causal relationship with the performance of the contract; whether the allocation and apportionment of the cost to the contract is consistent with the contractor's overarching cost accounting practices or uses a methodology that is agreed with the Secretary of State; and whether the contractor has effective controls in place to ensure that costs are only recovered once. 	<p>(See 3.11)</p>	<ul style="list-style-type: none"> Merged with preceding paragraph to avoid duplication.
<p>Reasonable in the circumstances</p> <p>3.8 A cost is reasonable in the circumstances if it is of an amount that is consistent with what a reasonable person would consider ought to be or have been incurred to enable the performance of the QDC or QSC in question and which would withstand public scrutiny.</p>	<p>Reasonable in the circumstances</p> <p>3.12 A cost is reasonable in the circumstances if it is of an amount that:</p> <ol style="list-style-type: none"> a reasonable person informed of the facts would consider consistent with enabling the performance of the QDC or QSC in question; would withstand public scrutiny; is consistent with costs incurred by the contractor in similar circumstances; and demonstrates due regard for economy and efficiency in the use of resources. 	<ul style="list-style-type: none"> Merged with subsequent paragraph to avoid duplication. Item a): The meaning of 'enables the performance' is given at 3.8. Item b): The meaning of 'withstand public scrutiny' is given at 3.9. Item c): To remove reference to performance of third parties as relevant data is rarely likely to be available.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.9 In order to assess whether a cost is reasonable in the circumstances, consideration should be given to the following:</p> <ol style="list-style-type: none"> whether a reasonable person, informed of the facts, would consider the cost congruent with the performance of the contract; whether the cost is of an amount that is consistent with the standards of regularity, propriety and prudence expected by Parliament of the Ministry of Defence; whether the cost is supported by relevant empirical evidence, where it is reasonable to expect this would be available; whether the cost is consistent with costs of a similar nature that were or are anticipated to be incurred by the contractor in the performance of other contracts or by third parties in similar circumstances; and whether the contractor has taken adequate steps to enhance economy and efficiency in the use of resources. 	(See 3.12)	<ul style="list-style-type: none"> Merged with preceding paragraph to avoid duplication. Item c): Removed as the requirement is more fully described in paragraphs 2.2 to 2.5.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>3.10 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs and which may, therefore, be considered when determining if a cost is reasonable in the circumstances include, but are not limited to:</p> <ul style="list-style-type: none"> a. the level of competitiveness and/or market testing undertaken in the supply chain; b. the particular specification and performance requirements of the contract; c. uncertainty and risk affecting costs; d. events which were not anticipated at the time of agreement; e. the economic environment; f. the statutory provisions in place at the time of contracting; and g. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'. 	<p>3.13 Consideration must be given to the circumstances of the case when determining whether costs are reasonable. Circumstances which may influence costs, and which may, therefore, be considered when determining if a cost is reasonable in the circumstances, include, but are not limited to:</p> <ul style="list-style-type: none"> a. the level of competitiveness and/or market testing undertaken in the supply chain; b. the particular specification and performance requirements of the contract; c. the capability necessary to perform the contract; d. uncertainty and risk affecting estimated costs; e. the impact on actual costs of events which were not anticipated at the time of agreement; f. the economic environment; g. the statutory provisions in place at the time of contracting; and h. any alternative options available, for example, to justify decisions as to whether to sub-contract or undertake work 'in-house'. 	<ul style="list-style-type: none"> • Item c): Introduced to provide consistency with the guidance at 3.8 on costs which enable the performance of the contract. • Item d): To reflect that this is a consideration for costs which are anticipated to be incurred. • Item e) To reflect that this is a consideration concerning costs already incurred.

3. Research and development

We will replace Part D – Research and development costs in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
D.1 Research D.1.1 Research means original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. (And D.2.1)	D.1 Research and development D.1.1 Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. D.1.2 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.	<ul style="list-style-type: none"> To bring definitions of research and development together.
D.1.2 The costs of research undertaken before or during the contract that directly or indirectly enables its performance may be Allowable costs.	D.1.3 The costs of research and development incurred, whether applied directly or indirectly to a QDC or QSC, may be Allowable Costs.	<ul style="list-style-type: none"> To bring guidance on research and development together. To more clearly explain that costs are incurred and then applied to contracts as direct or indirect costs.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>D.1.3 Where the contractor's method for allocating and apportioning research costs means it is not possible or cost effective to show what amount of historic indirect research costs meet the requirements of Allowable Costs, indirect research costs incurred during the period of the contract may be used to determine the historic indirect research costs that are Allowable Costs provided that:</p> <ol style="list-style-type: none"> the research costs incurred during the period of the contract are consistent with historic levels; the parties agree that the indirect research undertaken during the period of the contract is of potential interest to the Secretary of State when considering the specific circumstances of the contract being delivered; indirect research costs are applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State; and costs are only recovered once. 	<p>D.2 Research applied indirectly</p> <p>D.2.1 A proportion of the costs of research undertaken during the period of the contract that are applied indirectly to contracts may be attributable to the QDC or QSC in question where the research to which the costs relate enables the performance of the contract.</p> <p>D.2.2 In determining whether the research enables the performance of the contract, the parties should consider the requirements of the contract and whether these necessitate the research, either expressly or by implication. Some research may be necessary if it is required to maintain capability to perform the contract.</p>	<ul style="list-style-type: none"> To replace the guidance related to historic indirect costs with guidance related to costs incurred during the period of the contract and applied indirectly to it. To clarify considerations to inform the assessment of whether the costs meet the requirement to be attributable to the contract. Item a): To remove the requirement to consider consistency with historic levels as costs will need to satisfy the requirement to be reasonable in the circumstances. Items c) and d): Removed to avoid duplication with paragraph 3.11.
<p>D.2 Development</p> <p>D.2.1 Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.</p>	<p>D.3 Development</p> <p>(See D.1.2)</p>	<ul style="list-style-type: none"> See comment at D.1.2.
<p>D.2.2 Development costs that directly or indirectly enable the performance of the contract may be Allowable Costs.</p>	<p>(See D.1.3)</p>	<ul style="list-style-type: none"> See comment at D.1.3.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>D.2.3 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Development costs may be Allowable Costs under either approach and the treatment already established for the contractor's own purposes should normally be adopted.</p>	<p>D.3.1 Accounting standards allow contractors to account for development costs in different ways. They will either recognise an intangible asset arising from development expenditure and amortise this over time or will write off the costs as they are incurred. Either approach may be used in determining the level of development costs that are Allowable Costs.</p>	<ul style="list-style-type: none"> To enhance clarity. To avoid duplication with paragraph 3.11.
<p>D.2.4 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.</p>	<p>D.3.2 Development costs that are recognised as an intangible asset and amortised are dealt with in section G.1 of this guidance.</p>	<ul style="list-style-type: none"> No change.
<p>D.2.5 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State.</p>	<p>D.3.3 Development costs that are written off as they are incurred should be applied to the contract on a basis that is consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State.</p>	<ul style="list-style-type: none"> No change.
<p>D.3 Other matters</p> <p>D.3.1 Abortive research or development expenditure should be treated in the same way as any other research and development and may be an Allowable Cost. This recognises that trial and error is normal and inevitable given the nature of such work. The assessment of what is a reasonable level of aborted work will depend on the information available and the specific circumstances of the contract being delivered, similar to the guidance on reworks, wastage and faulty workmanship (E.2).</p>	<p>D.4 Other matters</p> <p>D.4.1 The costs of research or development that did not achieve its planned objectives may be Allowable Costs and should be evaluated in the same way as any other research or development costs.</p>	<ul style="list-style-type: none"> To enhance brevity and clarity. To remove the additional guidance on assessing what is reasonable in the circumstances as this is adequately covered in paragraphs 3.12 to 3.13 and, in the case of research, the additional specific guidance at D.2.2.
<p>D.3.2 Costs should only be recovered once. Any costs recovered as a direct cost of any contract should not also be allocated and apportioned as an indirect cost.</p>		<ul style="list-style-type: none"> Removed to avoid duplication with paragraph 3.11.

We will replace Part E.4 in the current Allowable Costs guidance with the guidance below.

This is not part of the *Research and Development* specific Allowable Costs guidance, but the change is introduced here because previous specific guidance on benefits and credits gained by contractors through the taxation system as a result of research and development expenditure have been merged with the specific guidance on *Refunds, penalties and notional transactions*.

Key to changes: Text deleted Text revised/moved Text added

<p>E.4 Reimbursements, notional transactions and penalties</p> <p>E.4.1 Allowable Costs should be net of any reimbursements, credits, grants or refunds received by contractors that directly reduce a particular cost for the contractor.</p>	<p>E.4 Credits, notional transactions and penalties</p> <p>E.4.1 Allowable Costs should be net of any credits received by contractors that reduce a particular cost for the contractor. Credits may include, but are not limited to, reimbursements, grants, discounts or refunds.</p>	<ul style="list-style-type: none"> To clarify that the guidance relates to credits, of which reimbursements are one example.
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<p>E.4.2 Grants that are not ring-fenced and adjustments made through company income tax regimes are not relevant to the determination of Allowable Costs because they are not given with a view to directly reduce particular costs.</p>	<p>E.4.2 Credits that do not reduce a particular cost are not relevant to the determination of Allowable Costs.</p> <p>E.4.3 The treatment of a particular credit should be consistent with the contractor's overarching cost accounting practices or using a methodology agreed with the Secretary of State. In determining whether the treatment for a particular credit is appropriate, the relevant parties should consider:</p> <ol style="list-style-type: none"> a. the legal basis of the credit and whether this indicates it reduces costs or not; b. the economic substance of the credit, which may indicate that it reduces costs if: <ol style="list-style-type: none"> i. there is a requirement, intent, or common practice for the credit to be used to reduce costs; ii. the credit is calculated with direct reference to costs; iii. the credit is received from the same entity with which the costs were incurred; and iv. transactions are settled net of the credit; and c. the credit is received as a result of a particular requirement of the contract, which may indicate that it reduces costs. 	<ul style="list-style-type: none"> • To provide more general guidance concerning credits that do not reduce a particular cost. • To provide principles-based guidance to assist the relevant parties to determine the appropriate treatment for a particular credit.
<p>E.4.3 Notional transactions are generally not Allowable Costs.</p>	<p>E.4.4 Notional transactions are generally not Allowable Costs.</p>	<ul style="list-style-type: none"> • No change
<p>E.4.4 Costs arising from civil penalties and fines are not Allowable Costs. Such costs result from charges imposed by third parties on contractors to penalise them for wrongdoing or to derive compensation for harm done. As such, they do not satisfy the requirements of Allowable Costs.</p>	<p>E.4.5 Costs arising from civil penalties and fines are not Allowable Costs. Such costs result from charges imposed by third parties on contractors to penalise them for wrongdoing or to derive compensation for harm done. As such, they do not satisfy the requirements of Allowable Costs.</p>	<ul style="list-style-type: none"> • No change

4. Guidance on the baseline profit rate and its adjustment: Introduction

We will insert the following after paragraph 3.3 of the current Introduction. Subsequent paragraphs will be re-numbered.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
(2.3 of Allowable Costs guidance)	<p>Relevant Records</p> <p>3.4 In relation to a QDC, Regulation 20 requires the primary contractor to keep 'relevant records'. In the case of a QSC, it is the sub-contractor who is so required. Section 23 of the Act defines relevant records as accounting and other records (whether in hard or electronic form) which the primary contractor or sub-contractor, as the case may be, 'may reasonably be expected to keep' and 'which are sufficiently up-to-date and accurate' for use by the Secretary of State for specific purposes, such as verifying certain matters relating to the price payable under a QDC or QSC. Such matters may include the calculation of the contract profit rate.</p>	<ul style="list-style-type: none"> To remind contractors and subcontractors of their obligations to keep relevant records for the purpose of verifying certain matters relating to the price payable under a QDC or QSC; reflecting the Allowable Costs guidance.

5. Capital servicing adjustment: Allowable Costs guidance

We will replace Part G.2 – Financing costs in the current Allowable Costs guidance with the guidance below.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
G.2.1 Costs associated with the raising and servicing of capital are not Allowable Costs. The approach to calculating the step 6 capital servicing adjustment compensates for these costs. The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital they employ to enable the performance of a QDC or QSC.	G.2.1 Borrowing costs are generally not Allowable Costs. The approach to calculating the step 6 capital servicing adjustment compensates contractors for these costs. The SSRO publishes separate guidance on how the step 6 capital servicing adjustment ensures the contractor receives an appropriate and reasonable return on the fixed and working capital it employs for the purpose of enabling it to perform the contract.	<ul style="list-style-type: none"> To clarify the guidance.

6. Capital servicing adjustment: Profit rate guidance

We will replace sections 17 to 23 in the current profit rate guidance with the guidance below. Subsequent paragraphs will be re-numbered.

Key to changes: Text deleted Text revised/moved Text added

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>17 Basis of the capital servicing adjustment</p> <p>17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment:</p> <p>“Take the amount resulting from step 5 and add to or subtract from it an agreed amount (“the capital servicing adjustment”), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.”</p>	<p>17 Basis of the capital servicing adjustment</p> <p>17.1 Section 17(2) of the Act, and Regulation 11(7), set out the requirement for the capital servicing adjustment:</p> <p>“Take the amount resulting from step 5 and add to or subtract from it an agreed amount (“the capital servicing adjustment”), so as to ensure that the primary contractor receives an appropriate and reasonable return on the fixed and working capital employed by the primary contractor for the purposes of enabling the primary contractor to perform the contract.”</p>	<ul style="list-style-type: none"> • No change.
<p>17.2 Regulation 11(8) requires that: “In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:</p> <p>a. must have regard to the capital servicing rates in force at the time of the agreement;</p> <p>b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and</p> <p>c. may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor’s obligations under the contract.”</p>	<p>17.2 Regulation 11(8) requires that: “In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:</p> <p>a. must have regard to the capital servicing rates in force at the time of the agreement;</p> <p>b. must not apply any adjustment in respect to any costs of the fixed and working capital employed by the primary contractor which are Allowable Costs under the contract; and</p> <p>c. may use an average fixed and working capital for any business unit which is likely to be performing the primary contractor’s obligations under the contract.”</p>	<ul style="list-style-type: none"> • No change.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation																
17.3 Section 30 of the Act sets out that “[the Act] and single source contract regulations apply to qualifying subcontracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)”.	17.3 Section 30 of the Act sets out that “[the Act] and single source contract regulations apply to qualifying subcontracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors)”.	<ul style="list-style-type: none">No change.																
17.4 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2019 are: <table><tr><th>Item</th><th>Rate</th></tr><tr><td>Fixed capital</td><td>X</td></tr><tr><td>Positive working capital</td><td>X</td></tr><tr><td>Negative working capital</td><td>X</td></tr></table>	Item	Rate	Fixed capital	X	Positive working capital	X	Negative working capital	X	17.4 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2019 are: <table><tr><th>Item</th><th>Rate</th></tr><tr><td>Fixed capital</td><td>X</td></tr><tr><td>Positive working capital</td><td>X</td></tr><tr><td>Negative working capital</td><td>X</td></tr></table>	Item	Rate	Fixed capital	X	Positive working capital	X	Negative working capital	X	<ul style="list-style-type: none">No change.The guidance will be updated in March 2019 following the announcement by the Secretary of State of the relevant rates to apply from 1 April 2019.
Item	Rate																	
Fixed capital	X																	
Positive working capital	X																	
Negative working capital	X																	
Item	Rate																	
Fixed capital	X																	
Positive working capital	X																	
Negative working capital	X																	
17.5 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2018) <i>Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology</i> .	17.5 In the calculation of the baseline profit rate (Step 1) the comparator company data is adjusted to remove the effect of capital servicing and so sets a baseline upon which Step 6 can be applied for a contract. This process is set out in SSRO (2018) <i>Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology</i> .	<ul style="list-style-type: none">No change.																
18 Calculating the capital servicing adjustment 18.1 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor’s obligations under the contract (the “CSA calculation”).	18 Calculating the capital servicing adjustment 18.1 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment using a ratio of capital employed to the total cost of production (CP:CE ratio) of a relevant unit of business which is likely to be performing the contractor’s obligations under the contract (the “CSA calculation”).	<ul style="list-style-type: none">No change.																
18.2 The next sections of the guidance set out the calculation of capital employed and of cost of production, which are required for the calculation. The diagrams after that guidance set out the four computations to be performed. A simple worked example is described at Appendix C to this guidance.	18.2 The next sections of the guidance set out the calculations of capital employed and of cost of production, which are required for the CSA calculation. The diagrams after that guidance set out the four computations to be performed. A simple worked example is described at Appendix C to this guidance.	<ul style="list-style-type: none">No change.																

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>18.3 The CSA calculation compensates for an appropriate and reasonable return on all capital employed by the contractor for the purposes of enabling the contractor to perform the contract. On this basis financing costs should not form part of Allowable Costs.</p>	<p>18.3 The CSA calculation ensures the contractor receives an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purposes of enabling it to perform the contract. On this basis borrowing costs should not form part of Allowable Costs.</p>	<ul style="list-style-type: none"> • To enhance clarity.
<p>18.4 The CSA calculation assumes that the capital intensity of the unit of business is equivalent to the capital intensity of the performance of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.</p>	<p>18.4 The CSA calculation assumes that the capital intensity of the unit of business (that is the ratios of its fixed and working capital to its cost of production for a given period) is equivalent to the capital intensity of the contract. This assumption is a reasonable estimate because a unit of business will normally perform many contracts of a similar nature under similar conditions and it is therefore reasonable to expect that the QDC or QSC will be performed on the same basis with equivalent capital requirements.</p>	<ul style="list-style-type: none"> • To define the meaning of 'capital intensity'.
<p>18.5 The contractor must use the information of the unit of business most relevant to the contract, which may be a subsidiary company, division, Qualifying Business Unit (QBU), or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.</p>	<p>18.5 The contractor and the Secretary of State must use the information of the unit of business which they agree is most relevant to the contract. This may be a subsidiary company, division, business unit, or site location, and is selected based upon professional judgement. If reliable information cannot reasonably be isolated to a unit of business the information of the contractor's business as a whole may be used.</p>	<ul style="list-style-type: none"> • To clarify to whom the guidance applies. • To require the parties to agree which unit of business is most relevant for the CSA calculation.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
[See 21.2]	18.6 The calculation has two components: the capital employed and the cost of production. Both components should be derived from the same financial records or should be adjusted to ensure they are on the same basis. For example, if cost of production is derived from the information supplied during the course of the assessment of cost recovery rate claims, such as financial or management accounts, then components of capital employed, for example manufactured inventory, may need adjustment to ensure they are valued on the same cost basis.	<ul style="list-style-type: none"> To clarify the need for information used in the calculations of capital employed and cost of production to be on the same basis.
19 Calculation of capital employed 19.1 Capital employed is the debt and equity investment necessary for a unit of business to function. Directly calculating this may be difficult because a unit of business may not separately report the debt and equity necessary for a business to function from other debt and equity investment. Capital employed is instead indirectly calculated with reference to the equal and opposite balance sheet items for which more granular information is available.	19 Calculation of capital employed 19.1 Capital employed is the debt and equity necessary for a unit of business to function. Directly calculating this may be difficult because a unit of business may not separately report the debt and equity necessary for a business to function from other debt and equity. Capital employed is instead indirectly calculated with reference to the equal and opposite balance sheet items for which more granular information is available.	<ul style="list-style-type: none"> To enhance brevity.
19.2 Capital employed should be computed as the total assets less total liabilities, excluding interest bearing liabilities, of the business unit.	19.2 Capital employed should be computed as the total assets less total liabilities, excluding interest bearing liabilities, of the business unit.	<ul style="list-style-type: none"> No change
19.3 Capital Employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.	19.3 Capital Employed is the average capital employed over the same period used to determine cost of production. At a minimum this is the average of the opening and closing position.	<ul style="list-style-type: none"> No change

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>19.4 The capital employed is adjusted to remove elements that are not part of normal operations, are equivalent to debt, or irrelevant for single source procurement. These adjustments seek to achieve a result that, when taken with the cost of production as a ratio, approximates the capital intensity of the performance of the contract as closely as is practicable.</p>	<p>19.4 The capital employed is adjusted to remove elements that are not part of normal operations, are equivalent to debt, or would not result in an appropriate result if included in the calculation. These adjustments seek to achieve a result that, when taken with the cost of production as a ratio, approximates the capital intensity of the contract as closely as is practicable.</p>	<ul style="list-style-type: none"> To clarify elements that are to be excluded from the calculation of capital employed.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>19.5 The following items should generally be excluded from the general definition of total assets less total liabilities, except for interest bearing liabilities:</p> <ul style="list-style-type: none"> a. items not representing capital employed in normal operations, for example: <ul style="list-style-type: none"> i. intangible assets with an indefinite useful life; ii. fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets; iii. investments in shares and securities; iv. loans to or from other companies, including non-trading balances with group entities; v. assets held for sale and idle assets not required for the normal operation of the business; or vi. cash in excess of the amount required for normal operations; b. items that are indirect ways of raising money that should be treated as debt equivalents, for example: <ul style="list-style-type: none"> i. deferred tax assets or liabilities; or ii. retirement benefit surpluses or obligations; and c. items generally not relevant for single source MOD contracting. 	<p>19.5 The initial definition of capital employed is total assets less total liabilities, except for interest bearing liabilities. The following items should then generally be excluded:</p> <ul style="list-style-type: none"> a. items not representing capital employed in normal operations, for example: <ul style="list-style-type: none"> i. goodwill, brands and customer lists acquired in a business combination; ii. fair value adjustments that did not require additional input of capital, for example the upward revaluation of tangible and intangible assets; iii. investments in shares and securities; iv. loans to or from other companies, including non-trading balances with group entities; v. assets held for sale and idle assets not required for the normal operation of the business; or vi. cash that exceeds the amount required for normal operations. Normal operational requirements might include holding cash for the purpose of meeting liabilities included in the calculation of capital employed; b. items that are indirect ways of raising capital that should be treated as debt equivalents, for example: <ul style="list-style-type: none"> i. deferred tax assets or liabilities; or ii. retirement benefit surpluses or obligations; and c. other items whose inclusion would not result in an appropriate Step 6 adjustment. 	<ul style="list-style-type: none"> • To enhance clarity. • Item 19.5a)i): To clarify classes of asset that are to be excluded from the calculation of capital employed, rather than relying on their useful life. • Item 19.5a)vi): To clarify the meaning of normal operations. • Item 19.5c: To clarify elements that are to be excluded from the calculation of capital employed.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>19.6 Where cash is held in a group pooling arrangement outside the balance sheet of the unit of business used for the calculation, a value of cash required for normal operations of the business unit may be included as an element of Capital Employed.</p>	<p>19.6 Where cash is held in a group pooling arrangement outside the balance sheet of the unit of business used for the calculation, a value of cash required for normal operations of the business unit may be included as an element of Capital Employed.</p>	<ul style="list-style-type: none"> • No change
<p>19.7 Further adjustments may be required as part of the calculation if they can be reliably estimated and have a material impact on the result. Any adjustment required will depend on the information available and the specific circumstances of the contract being delivered. Examples of such situations are:</p> <ol style="list-style-type: none"> where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or where considering the timing of a significant transaction during the period will give a more precise average. 	<p>19.7 Exceptional further adjustments may be agreed with the Secretary of State if they can be reliably estimated and have a material impact on the result. Any adjustment will depend on the information available and the specific circumstances of the contract being delivered. Examples of such situations are:</p> <ol style="list-style-type: none"> where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or where considering the timing of a significant transaction during the period will give a more precise average. 	<ul style="list-style-type: none"> • To clarify that adjustments may be made exceptionally and with the Secretary of State's agreement.
<p>20 Fixed and working capital</p> <p>20.1 To calculate the split of capital employed between fixed and working capital employed a contractor should identify balance sheet items that are fixed in nature; this will generally include items that are held for more than one year. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive or negative.</p>	<p>20 Fixed and working capital</p> <p>20.1 To calculate the split of capital employed between fixed and working capital employed a contractor should identify balance sheet items that are fixed in nature; this will generally include items that are held for more than one year. This 'fixed capital value' figure is subtracted from the capital employed and the balance is the 'working capital value', which may be positive or negative.</p>	<ul style="list-style-type: none"> • No change

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>20.2 Adequate justification should be provided to support the calculation of both fixed and working capital.</p>	<p>20.2 Adequate justification should be provided to support the calculation of both fixed and working capital.</p> <p>In determining what type and standard of information is required, the relevant parties should take a proportionate approach considering:</p> <ol style="list-style-type: none"> the specific requirements and circumstances of the contract; the materiality of particular components of the calculation; and what it is reasonable to expect would be available. 	<ul style="list-style-type: none"> To clarify that the parties should take a proportionate approach in determining what information is required concerning the calculation.
<p>21 Calculation of cost of production</p> <p>21.1 Cost of production is the cost incurred by the functioning of a business before financing charges; the general definition being Operating revenue less Operating profit/loss.</p>	<p>21 Calculation of cost of production</p> <p>21.1 Cost of production is the cost incurred by the functioning of a business before financing charges.</p>	<ul style="list-style-type: none"> No change
<p>21.2 Cost of production should be computed for the same relevant unit of business for which capital employed is computed and should be derived from the same information source to ensure both calculations are made on the same basis.</p> <p>The information should be annualised where appropriate because the Capital Servicing Rates to which the CP:CE ratio is applied are on an annual basis.</p>	<p>(See 18.6)</p> <p>21.2 Where the period to which the cost of production relates is not one year, an equivalent annual value should be computed because the capital servicing rates to which the CP:CE ratio is applied are an annual rate of return.</p>	<ul style="list-style-type: none"> Guidance on information sources moved forward as it relates to the calculation of both capital employed and cost of production. To clarify why data should be 'annualised'.
<p>21.3 The following items should generally be excluded from the general definition of operating revenue less operating profit/loss:</p> <ol style="list-style-type: none"> the cost of raising and servicing capital; costs related to items excluded from capital employed; and costs generally not relevant for single source MOD contracting. 	<p>21.3 The initial definition of cost of production is operating revenue less operating profit/loss. The following items should then generally be excluded:</p> <ol style="list-style-type: none"> borrowing costs; costs related to items excluded from capital employed; and costs whose inclusion would not result in an appropriate Step 6 adjustment. 	<ul style="list-style-type: none"> To clarify elements that are to be excluded from the calculation of cost of production.

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
21.4 Where exceptional adjustments have been made to Capital Employed in accordance with paragraph 19.5, a corresponding adjustment to cost of production may be required.	21.4 Where exceptional adjustments have been made to Capital Employed in accordance with paragraph 19.7, a corresponding adjustment to cost of production may be required.	<ul style="list-style-type: none"> Updated cross reference.
<p>Computation 1</p> <p>Determine Ratio of Capital Employed to Cost of Production</p> <p>Fixed Capital Value</p> <p>Plus</p> <p>Working Capital Value (positive or negative)</p> <p>EQUALS</p> <p>Total Capital Employed</p> <p>Divide into</p> <p>Cost of Production</p> <p>EQUALS</p> <p>Cost of Production as a Proportion of Capital Employed (CP:CE)</p>	<p>Computation 1</p> <p>Determine Ratio of Capital Employed to Cost of Production</p> <p>Fixed Capital Value</p> <p>Plus</p> <p>Working Capital Value (positive or negative)</p> <p>EQUALS</p> <p>Total Capital Employed</p> <p>Divide into</p> <p>Cost of Production</p> <p>EQUALS</p> <p>Cost of Production as a Proportion of Capital Employed (CP:CE)</p>	<ul style="list-style-type: none"> No change
<p>Computation 2</p> <p>Determine the individual proportions of Total Capital Employed</p> <p>Fixed Capital Value</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Working Capital Value (positive or negative)</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Working Capital as a proportion of Capital Employed</p>	<p>Computation 2</p> <p>Determine the individual proportions of Total Capital Employed</p> <p>Fixed Capital Value</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Working Capital Value (positive or negative)</p> <p>Divided by</p> <p>Total Capital Employed</p> <p>EQUALS</p> <p>Working Capital as a proportion of Capital Employed</p>	<ul style="list-style-type: none"> No change

Guidance proposed in consultation	New guidance from 1 April 2019	Changes arising from consultation
<p>Computation 3</p> <p>Apply Capital Servicing Rates</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Fixed Capital Servicing Rate</p> <p>PLUS</p> <p>-----</p> <p>Working Capital (positive) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Positive Working Capital Servicing Rate</p> <p><u>OR (if Working Capital is negative)</u></p> <p>Working Capital (negative) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Negative Working Capital Servicing Rate</p> <p><u>EQUALS</u></p> <p>Capital Servicing Rate⁶</p> <p>⁶ The Capital Servicing Rate can be positive or negative.</p>	<p>Computation 3</p> <p>Apply Capital Servicing Rates</p> <p>Fixed Capital as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Fixed Capital Servicing Rate</p> <p>PLUS</p> <p>-----</p> <p>Working Capital (positive) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Positive Working Capital Servicing Rate</p> <p><u>OR (if Working Capital is negative)</u></p> <p>Working Capital (negative) as a proportion of Capital Employed</p> <p>Multiplied by</p> <p>Negative Working Capital Servicing Rate</p> <p><u>EQUALS</u></p> <p>Capital Servicing Rate⁷</p> <p>⁷ The capital servicing rate can be positive or negative.</p>	<ul style="list-style-type: none"> No change
<p>Computation 4</p> <p>Calculate the Capital Servicing Adjustment for Step 6</p> <p>Capital Servicing Rate</p> <p>Divided by</p> <p>Cost of Production as a proportion of Capital Employed (CP:CE)</p> <p><u>EQUALS</u></p> <p>Capital Servicing Adjustment to be used in Step 6 of CPR</p>	<p>Computation 4</p> <p>Calculate the Capital Servicing Adjustment for Step 6</p> <p>Capital Servicing Rate</p> <p>Divided by</p> <p>Cost of Production as a proportion of Capital Employed (CP:CE)</p> <p><u>EQUALS</u></p> <p>Capital Servicing Adjustment to be used in Step 6 of CPR</p>	<ul style="list-style-type: none"> No change

