



# SSRO

Single Source  
Regulations Office

## SSRO's baseline profit rate, capital servicing rates, and SSRO funding adjustment recommendation: 2021/22 Supporting analysis

January 2021

## Contents

This pack sets out details of the SSRO's rates recommendation to the Secretary of State:

- Baseline profit rate
- Capital servicing rates
- SSRO funding adjustment

And sets out further sensitivity and other analysis, including:

- Analysis of the changes to the baseline profit rate since last year
- Changes in the comparator groups since last year
- Defence sector representation in the benchmark
- Geography

## Baseline profit rate: introduction

The baseline profit rate is step 1 of the 6-step process to calculate the contract profit rate of a contract that falls under the Single Source Contract Regulations.

The baseline profit rate is the average of the underlying rates for the last three years. The underlying rate for a single year is based on the financial performance of a group of companies whose activities are comparable to those that contractors might be expected to perform for single source contracts.

Full details on the approach are set out in the SSRO publication *Single source baseline profit rate, capital servicing rates and funding adjustment methodology*.

## Baseline profit rate approach and methodology



Objective

OECD: Transfer Pricing principles

Replicable



Reliable

Actual profit on actual cost

IFRS / GAAP numbers



Predictable

Stable approach

3 year rolling average



Calibrated

Stakeholder feedback (including QA of accounting data)

Completed contracts

## Company selection process



Databases:  
Orbis, Bloomberg,  
Bank of England



Active  
companies



Limited liability  
companies



Latest year  
of accounts



Consolidated  
accounts



Independence



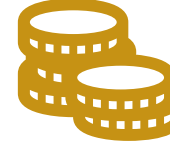
Geographic  
location



Turnover



Operating  
Profit



Assets /  
liabilities



Functions  
NACE code  
Text terms



Activities



MOD  
supplier  
lists



Defence  
keyword



Average



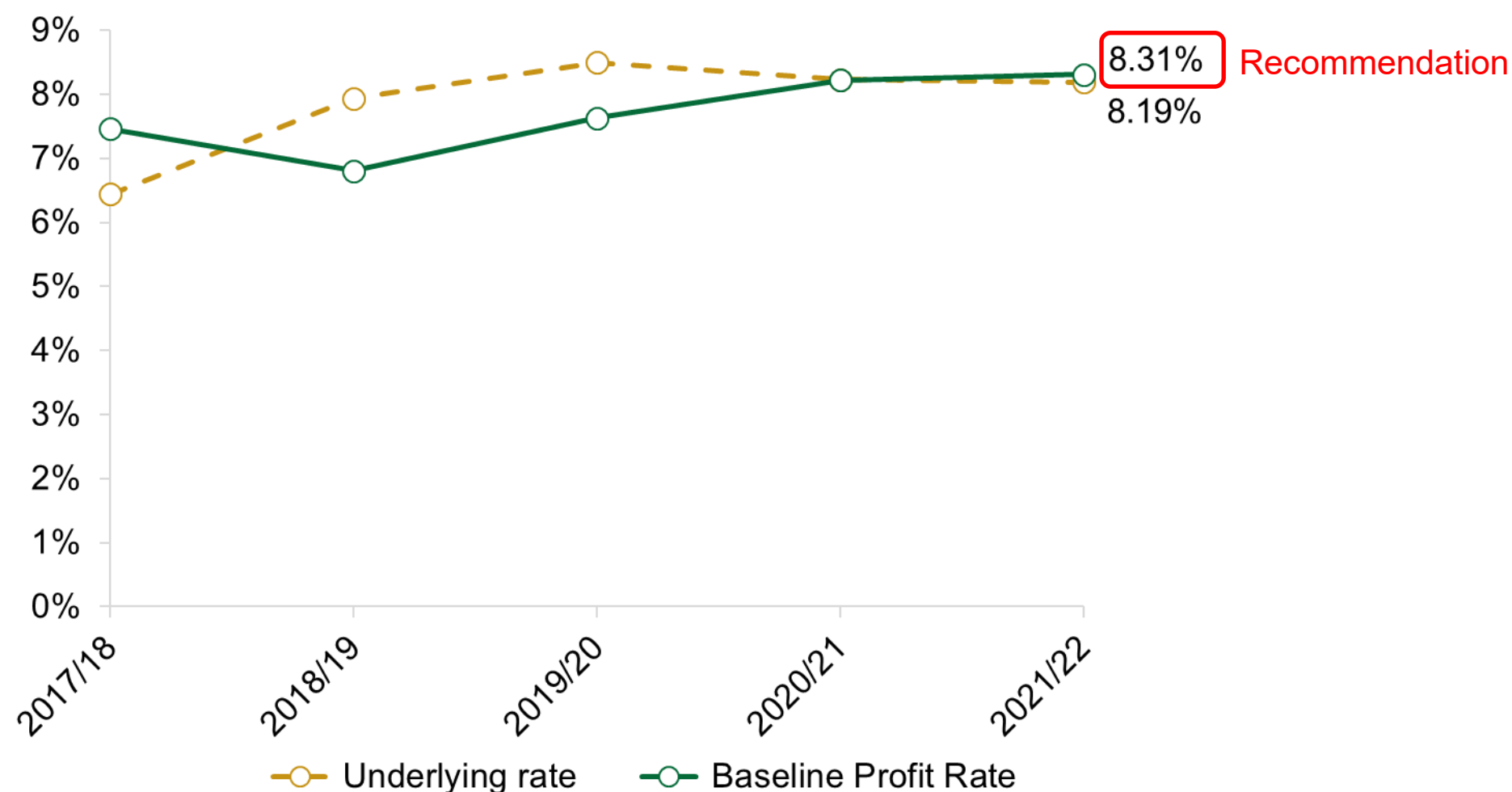
Automated search



Manual review

## Baseline profit rate

The baseline profit rate is the average of the underlying rate for the last three years. The baseline profit rate for 2021/22 is 8.31%.



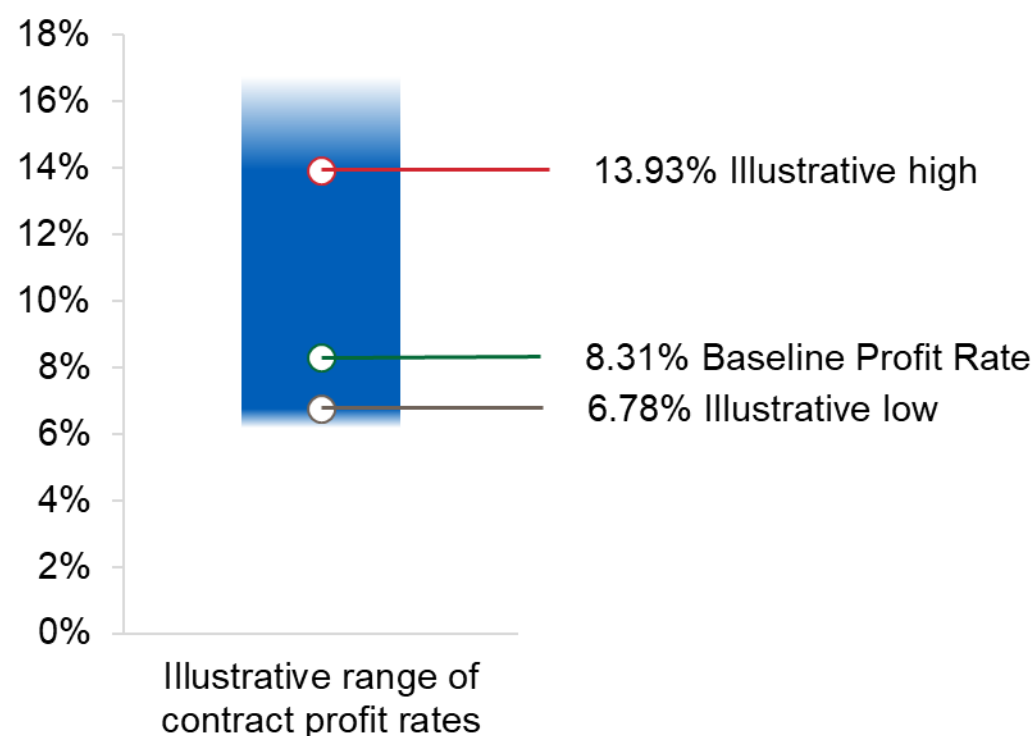
**Notes:** The 2015/16 and 2016/17 underlying rates used for the 2017/18 three-year average were 9.88% and 6.06%. The 2015/16 underlying rate was calculated using the Review Board's methodology.

**Source:** Orbis, Bloomberg and SSRO calculations

## Illustrative high and low contract profit rate

The baseline profit rate is combined with the other profit rate steps to arrive at the contract profit rate (CPR). There is a range available, depending on the application of the steps.

The capital servicing adjustment (step 6) is dependent on the characteristics of the contract in question therefore, for illustrative purposes, we have applied the actual range of capital servicing adjustments agreed for contracts entered into during 2019/20. Details of the calculation are presented on the next slide.



**Notes:** The six-step process is set out in the SSRO's publication *Guidance on the baseline profit rate and its adjustment*.

**Source:** SSRO



## Illustrative high and low Contract Profit Rate: detail

Contract profit rate step		Value/Adjustment			
	Unadjusted rate	9.75%			
	Capital servicing adjustment <sup>†</sup>	-1.44pp			
<b>Step 1</b>	<b>Baseline profit rate</b>	<b>8.31%</b>			
<b>+ Step 2</b>	Cost risk adjustment*	-2.08 pp to +2.08pp			
<b>+ Step 3</b>	POCO adjustment**				
<b>+ Step 4</b>	SSRO funding adjustment	- 0.057pp			
<b>+ Step 5</b>	Incentive adjustment***	up to +2.00pp			
	<b>Range before capital servicing</b>	Low: 6.18%		High: 12.33%	
<b>+ Step 6</b>	Capital servicing adjustment (CSA) <sup>†</sup>	Minimum	Lower quartile	Upper quartile	Maximum
	Illustrative observations from 2019/20 **** :	+0.0%	+0.6%	+1.6%	+4.4%
<b>=</b>	<b>Contract profit rate</b>	Minimum 6.18%	Low 6.78%	High 13.93%	Maximum 16.73%



**Notes:** The six-step process is set out in the SSRO's publication *Guidance on the baseline profit rate and its adjustment*

<sup>†</sup> See Q17 of the Q&A document for an explanation of how the two 'capital servicing adjustments' interact.

\* An adjustment of between -25 and +25 per cent of step 1.

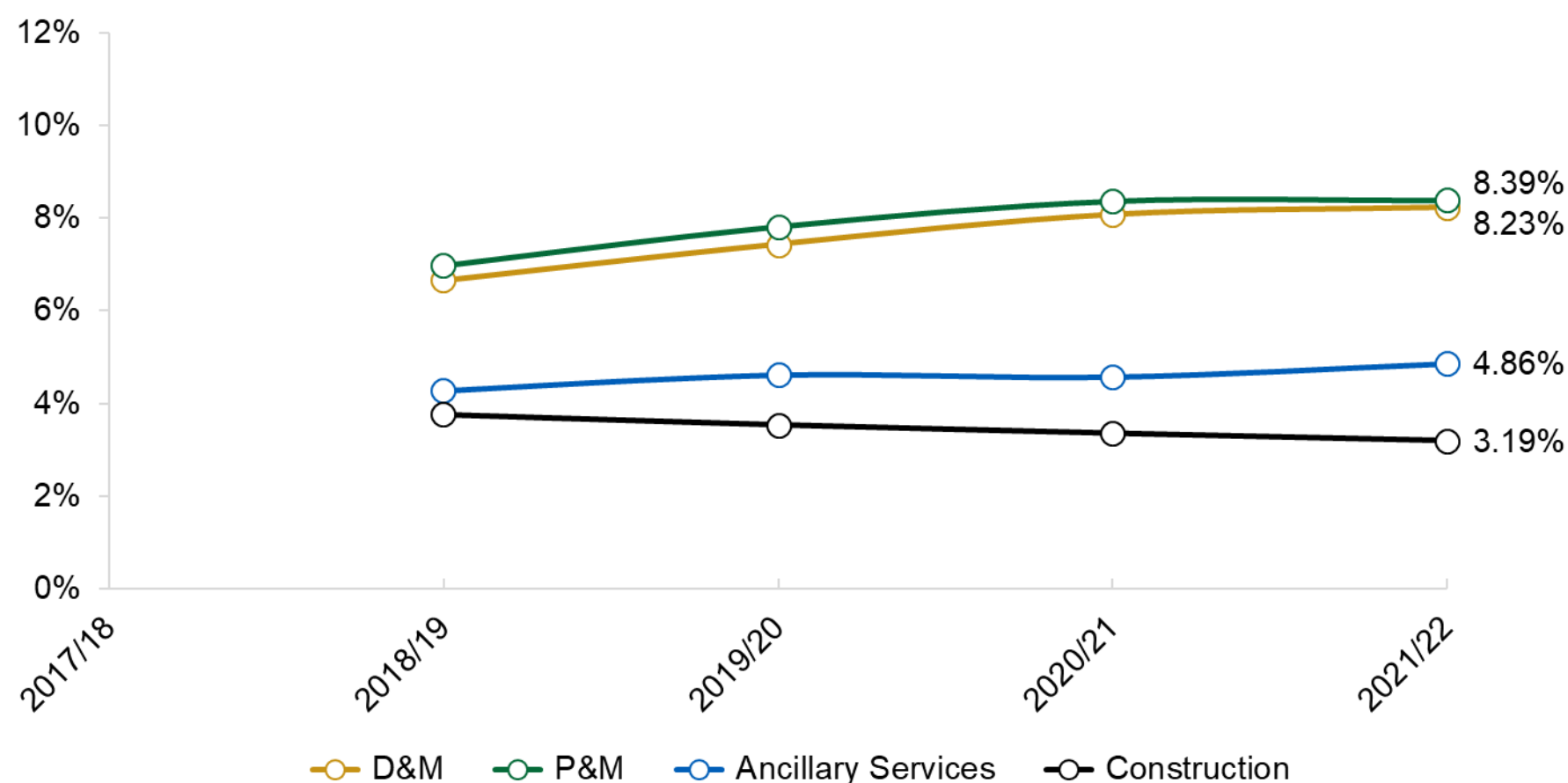
\*\* A POCO adjustment may be applied to ensure that profit arises only once in relation to some intra-group sub-contracts. The adjustment is nil for the majority of contracts, as shown here.

\*\*\* A positive adjustment of up to two percentage points may apply to incentivise the achievement of enhanced performance.

\*\*\*\* These figures are the actual values reported to the SSRO for contracts priced in 2019/20. The actual adjustment may be higher, lower or negative. **Source:** *Annual qualifying defence contract statistics: 2019/20* (SSRO)

## Summary of activity groups

The baseline profit rate is the average of the three-year rolling averages of the underlying rates for the Develop & Make (D&M) and Provide & Maintain (P&M) comparator groups. Rates for two other groups, Ancillary Services and Construction, are presented for information.



**Notes:** The SSRO's methodology was introduced for the 2016/17 recommendation therefore 2018/19 was the first year for which a three-year average can be calculated.

**Source:** SSRO calculations



## Capital servicing rates: introduction

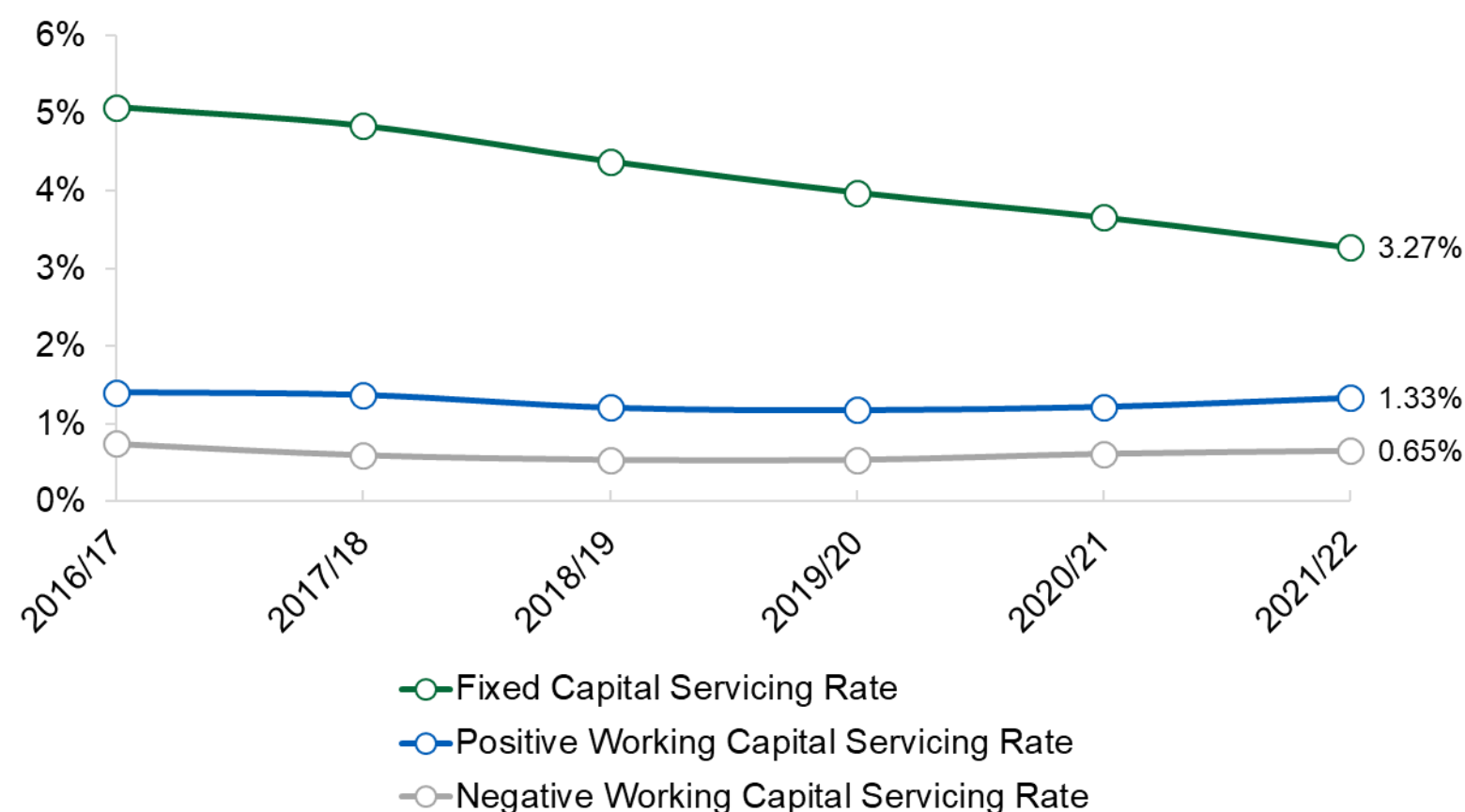
Each year the SSRO calculates the following three capital servicing rates based on averages of bond yields and interest rate data published by Bloomberg and the Bank of England:

- Fixed capital
- Positive working capital
- Negative working capital

Full details on the approach are set out in the SSRO publication *Single source baseline profit rate, capital servicing rates and funding adjustment methodology*.

## Capital servicing rates

Rate	Description	Recommendation
Fixed capital servicing	15 year BBB GBP bond index – 7 year average	3.27%
Working capital (positive)	1 year BBB GBP bond index – 3 year average	1.33%
Working capital (negative)	Monthly interest on short term deposits – 3 year average	0.65%



**Source:** Bloomberg, Bank of England and SSRO calculations

## SSRO funding adjustment: introduction

The SSRO is an executive non-departmental public body sponsored by the Ministry of Defence, who provide a grant-in-aid for the SSRO's running costs. The SSRO's annual report and accounts provide an account of the SSRO and its use of resources.

The SSRO funding adjustment is intended to allow the MOD to recover half of the SSRO's running costs through a reduction in the amounts paid on single source contracts, shared across contractors based upon the value of their contracts.

Full details on the approach are set out in the SSRO publication *Single source baseline profit rate, capital servicing rates and funding adjustment methodology*.

## SSRO funding adjustment calculation

The SSRO funding adjustment is calculated with reference to the average annual total Allowable Costs of contracts entered into, therefore the per cent rate each year may be different whilst still delivering a similar reduction in costs to the MOD.

Recommendation		2017/18	2018/19	2019/20	2020/21	2021/22
SSRO running costs (£ thousand) <i>average of previous 3 years</i>	a	4,920	5,162	5,413	5,822	6,133
Cost of additional tasks requested by Secretary of State (£ thousand) <i>average of previous 3 years</i>	b	-	-	-	-	-
Total Allowable Costs of contracts entered into (£ thousand) <i>average of previous 3 years</i>	c	9,955,272	10,555,829	6,499,333	5,584,333	5,335,000
SSRO funding adjustment = $\frac{a-b}{c} \times 50\%$		0.025%	0.024%	0.042%	0.052%	<b>0.057%</b>

 Previously published figures

**Notes:** For contracts entered into before 31 March 2017 the SSRO funding adjustment is zero.

**Sources:** Quarterly qualifying defence contract statistics: Q2 2020/21 (SSRO), SSRO Annual Report and Accounts 2019/20, 2018/19, 2017/18 and 2016/15 (SSRO)

## Understanding the changes in the baseline profit rate

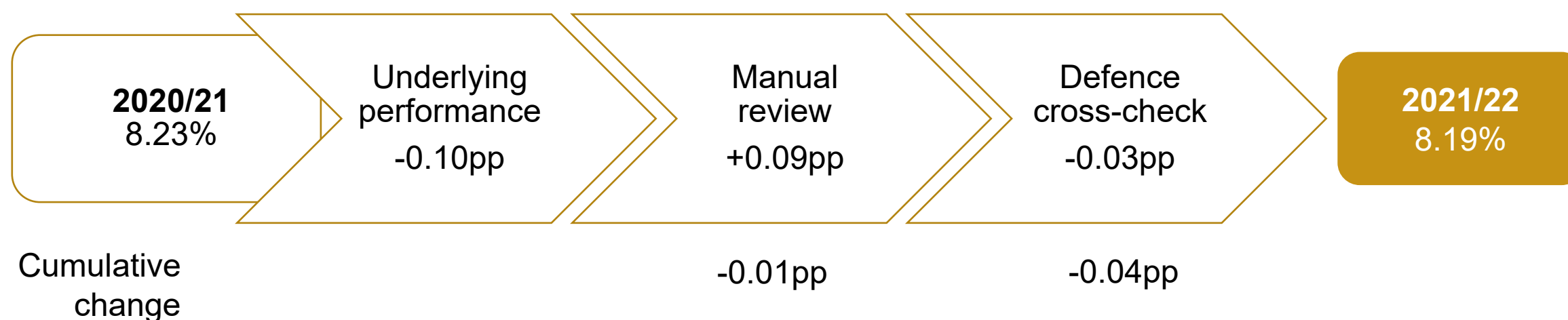
The following slides set out an analysis of the changes in the baseline profit rate since the prior year, including:

- changes to the companies in the comparator groups
- changes to the underlying rate and the baseline profit rate

## 2021/22 Underlying rate: explaining the change from 2020/21

The change in the underlying rate each year is a product of:

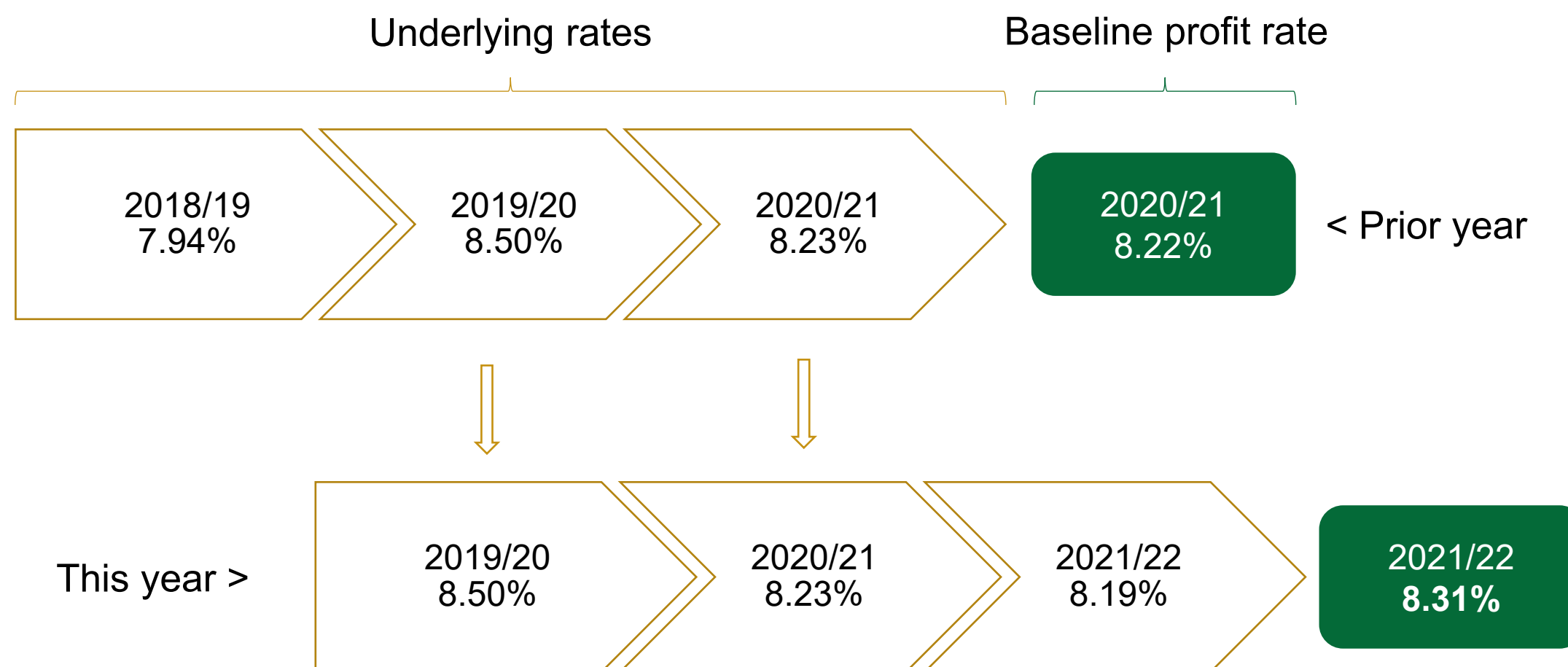
1. **Underlying performance:** changes in the financial performance of the prior year's companies, including the application of the search criteria and the effect of updated capital servicing rates.
2. **Manual review:** companies removed from the comparator groups or moved between groups as a result of the detailed re-validation of company activities and geography.
3. **Defence cross-check:** a small number of companies were added to the comparator groups through a cross-check against MOD suppliers.





## 2021/22 Baseline profit rate: explaining the change from 2020/21

The baseline profit rate is the three-year average of the underlying rate. The 2018/19 underlying rate of 7.94% has been replaced by the 2021/22 underlying rate of 8.19%, causing the baseline profit rate to increase.



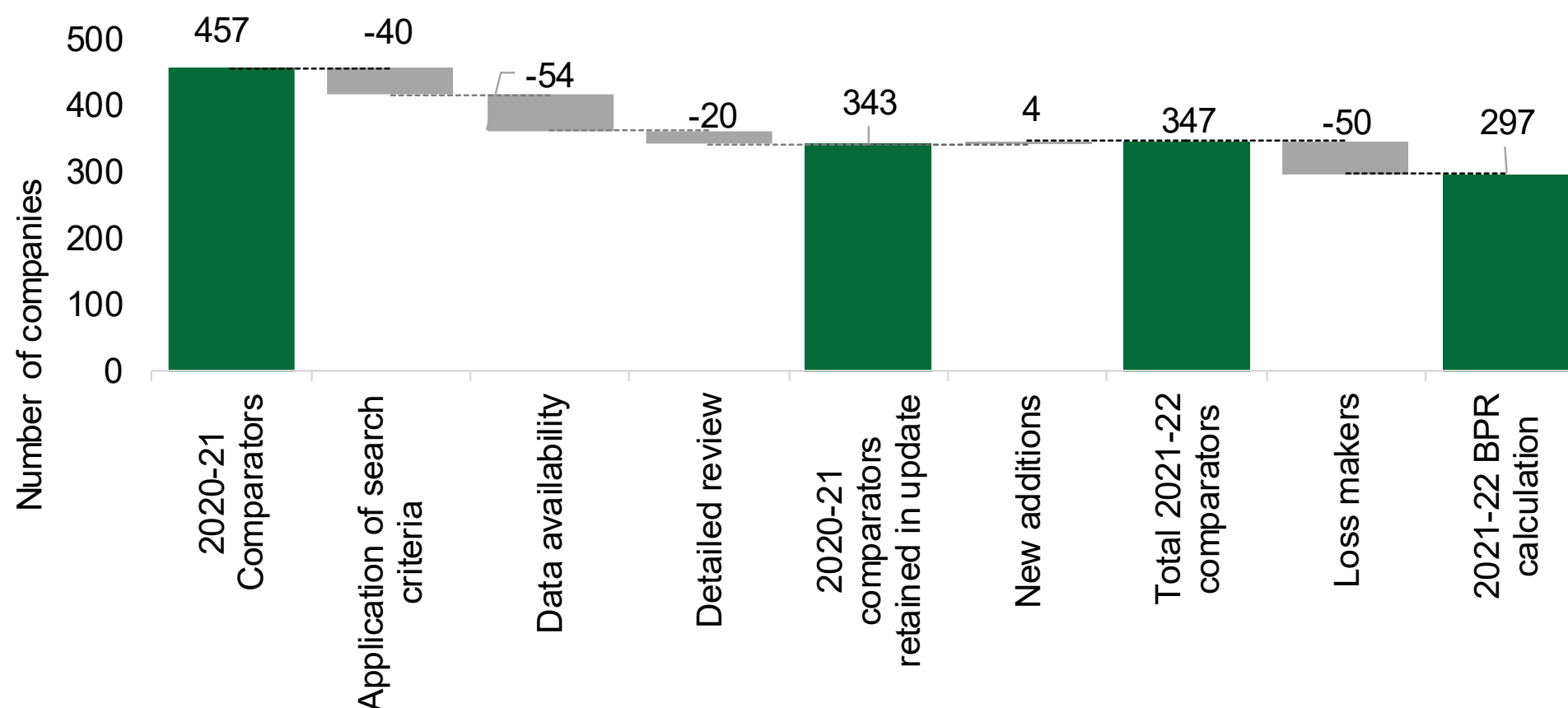


## Joiners and leavers to the comparator groups

Maintaining the number of comparator companies ensures the underlying rate is robust.

We brought forward last year's 457 comparators and applied our methodology.

We used 297 companies to calculate the 2021/22 underlying rate. These companies, the 50 loss-makers in the current year, and the 54 comparators which did not have the latest data at our cut-off date will be taken forward for re-consideration next year.



Source: SSRO calculations

## Comparisons and benchmarking

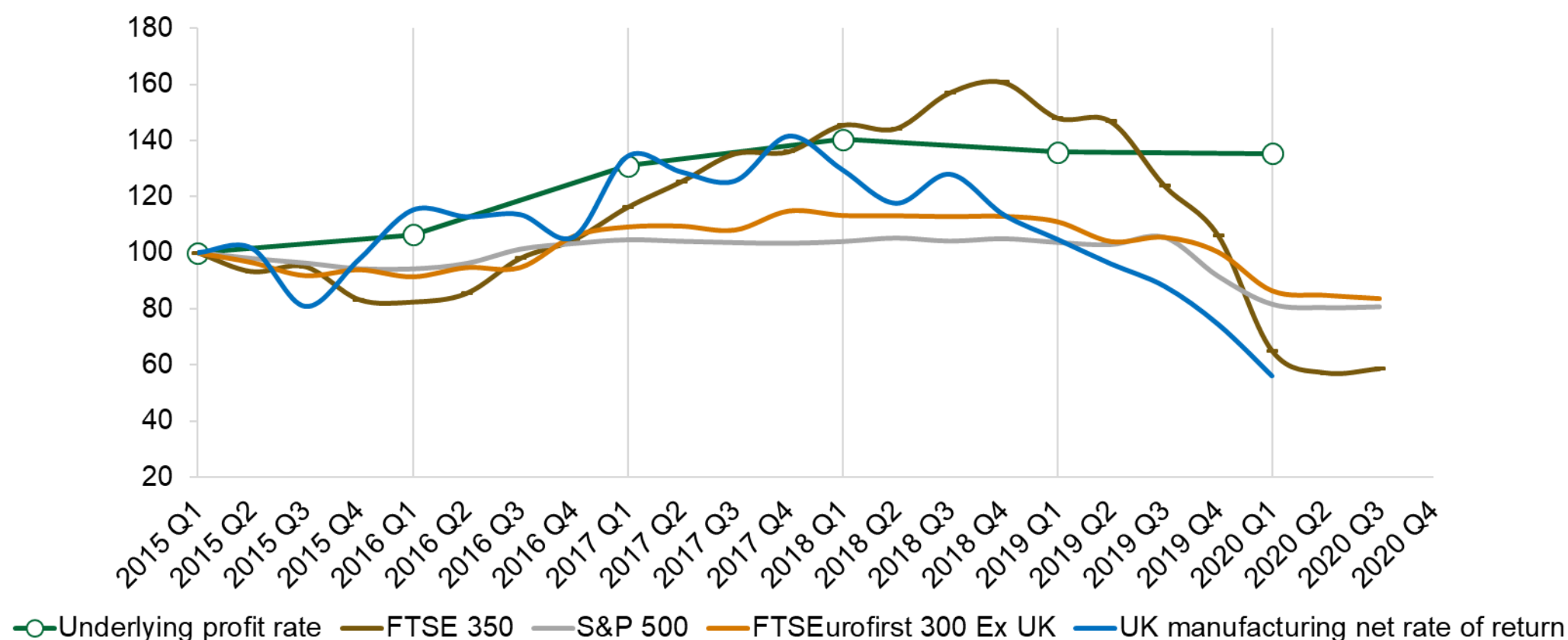
The following compare the trend in the baseline profit rate to the trend in macro-economic indicators and benchmark the range available in the UK regime to those available elsewhere:

- Profitability of major UK, US, and European share indices
- ONS data on UK manufacturing rate of return

## Trends in the performance

This chart compares the trend in the underlying profit rate to the trend in profitability of companies included in major UK, US, and European share indices; and in the UK manufacturing sector.

Note that the ONS' UK manufacturing rate of return is a measure of return on capital, for UK companies. Profit on cost and return on capital are not directly comparable, but we can use this data to compare trends in the underlying profit rate assessment to trends in the wider UK economy.



**Notes:** The underlying profit rate, the operating margin of the companies in the indices, and the ONS measure of profitability (net operating surplus divided by net capital employed) are based to 100 on 31 March 2015. Increases and decreases in those rates are shown over time relative to that starting point.

**Source:** Bloomberg, ONS July 2020 release of *Quarterly net rate of return of manufacturing private non-financial non-UK continental shelf corporations* (series LRYC)



## Defence sector representation

It is not the SSRO's intention that the comparator groups contain only companies from the defence industry, but we expect them to be represented because we are benchmarking activities that those companies typically perform.

The following slides set out analysis of defence sector representation within the comparator groups and their influence on the result, including:

- an explanation for the presence, or otherwise, of the MOD's largest private sector suppliers
- an explanation of the cross-check against MOD supplier lists to ensure that MOD's actual suppliers are represented in the comparator groups; and
- the proportion of defence keyword companies in the analysis and their results compared to non-defence keyword companies



## Presence of MOD suppliers in the comparator groups

Company name	Activity Type
BAE Systems PLC	Develop & Make
Babcock International Group PLC *	Provide & Maintain
Airbus Group SE	Develop & Make
Rolls-Royce Holdings PLC *	Develop & Make
Lockheed Martin Corporation	Develop & Make
Leonardo SpA	Develop & Make
General Dynamics Corporation	Develop & Make
QinetiQ Group PLC	Develop & Make
The Boeing Company	Develop & Make

Company name	Activity Type
Thales Group	Develop & Make
DXC Technology Company *	Not included
Serco Group PLC	Ancillary Services
Jacobs Engineering Group Inc.	Provide & Maintain
Raytheon Technology	Develop & Make
Fujitsu Ltd	Not included
AI Convoy	Not included
NATS Holdings Ltd *	Not included
Marshall of Cambridge (Holdings) Ltd *	Not included

Explanation for companies not included in an activity group:

- **DXC:** Rejected in company review, their activities do not fall within one of the current activity descriptions.
- **Fujitsu:** Incorporated in Japan.
- **AI Convoy:** The company was incorporated in July 2019 and has not yet published financial information.
- **NATS:** Did not have financial data for the most recent year at the cut-off date.
- **Marshall:** Did not have financial data for the most recent year at the cut-off date.

\* Indicates a company is a loss-maker in the current year, as measured by the adjusted underlying profit rate, and so would not be included in the calculation of an underlying rate.

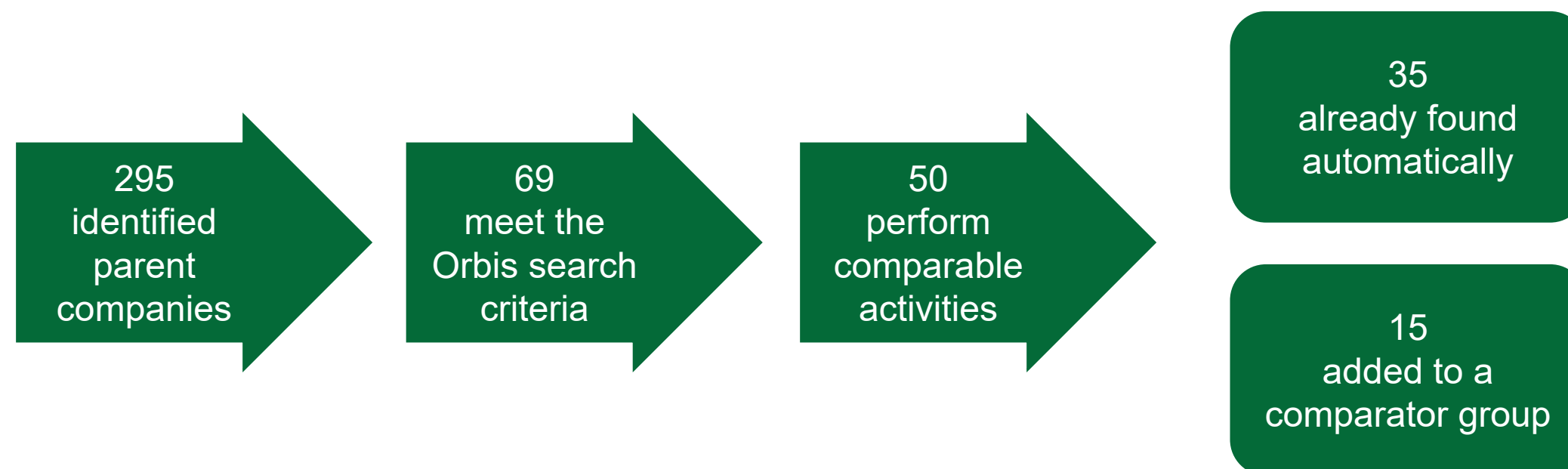
**Notes:** Source of companies are MOD statistics of private sector holding companies paid £250 million or more in 2019/20, *Table 4 Annex MOD trade, industry and contracts: 2020 (MOD)*. The table is ordered by value of spend.



## Defence cross-check

The SSRO inspects MOD statistics on the organisations that the MOD contracts with for more than £5 million, and uses DefCARS data to identify any additional comparators that were not found through the search process.

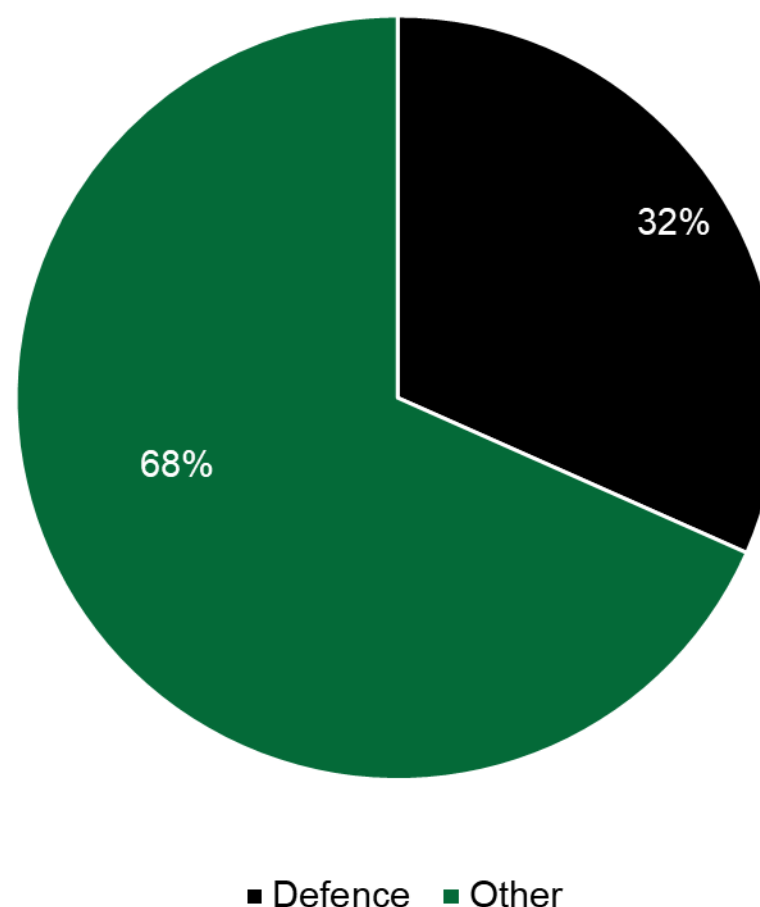
15 additional companies are included in the comparator groups as a result of the defence cross check process, representing 2% of the groups. The majority of MOD suppliers performing comparable activities were already identified by the search process.





## Proportion of 'defence keyword' companies in the BPR calculation

Companies that either have the word 'defence', 'defense' or 'militar\*' included in their Orbis text description account for approximately 32% of the composite comparator group



**Notes:** A company is considered to be a 'defence keyword' company if either the word 'defence', 'defense' or 'militar\*' is included in their Orbis text descriptions. The '\*' indicates that all words starting with those letters, for example 'military' and 'militarised', are included.

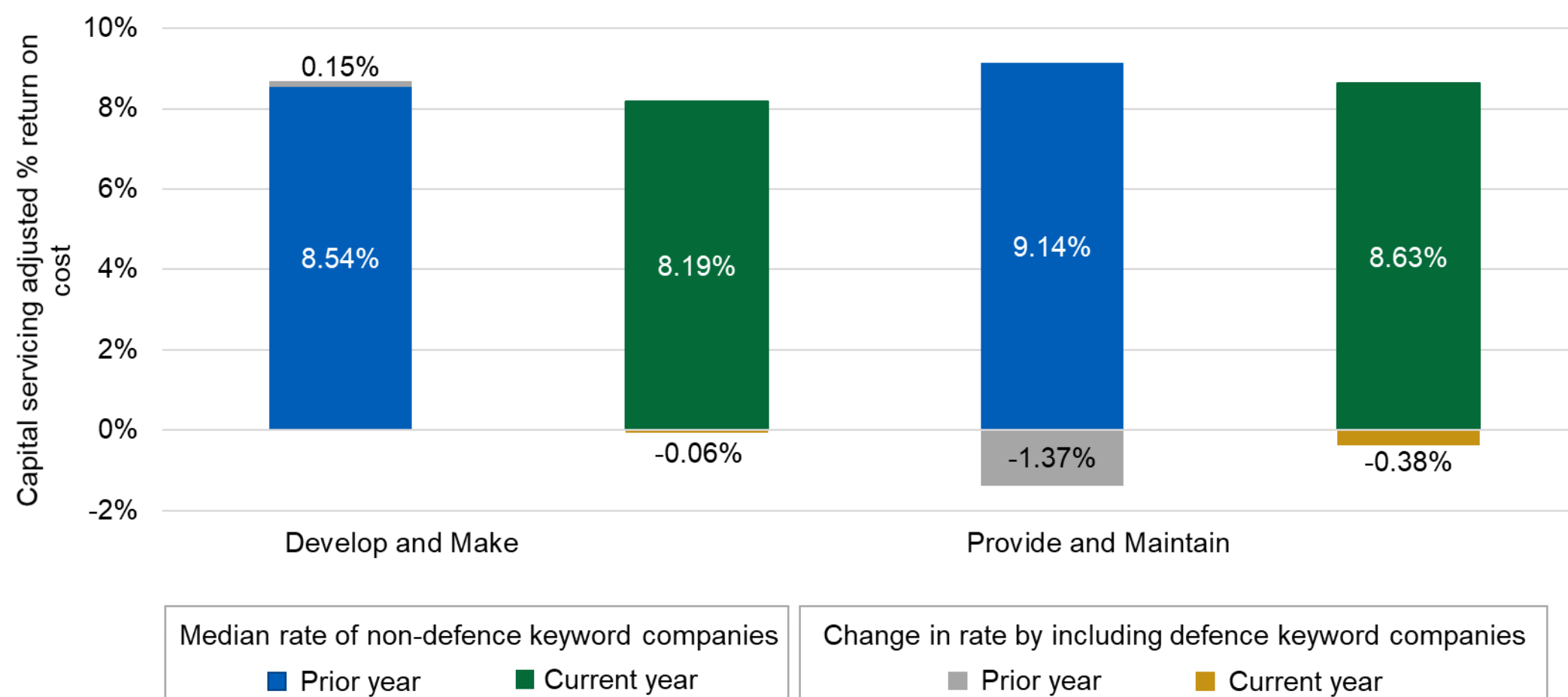
**Source:** Orbis and SSRO calculations





## Impact of 'defence keyword' companies on the result

The chart shows the profit rate of each comparator group excluding defence keyword companies and the corresponding impact of adding those defence keyword companies back to get to the final result.



**Notes:** A company is a 'defence keyword' company if the word 'defence', 'defense' or 'militar\*' is included in their Orbis text description. 'Current year' is the current year comparator group. 'Prior year' is the prior year comparator group and definition, which did not include 'militar\*' as a keyword.

**Source:** Orbis and SSRO calculations



## Geography

Only companies located in Western Europe and North America are included in the comparator groups.

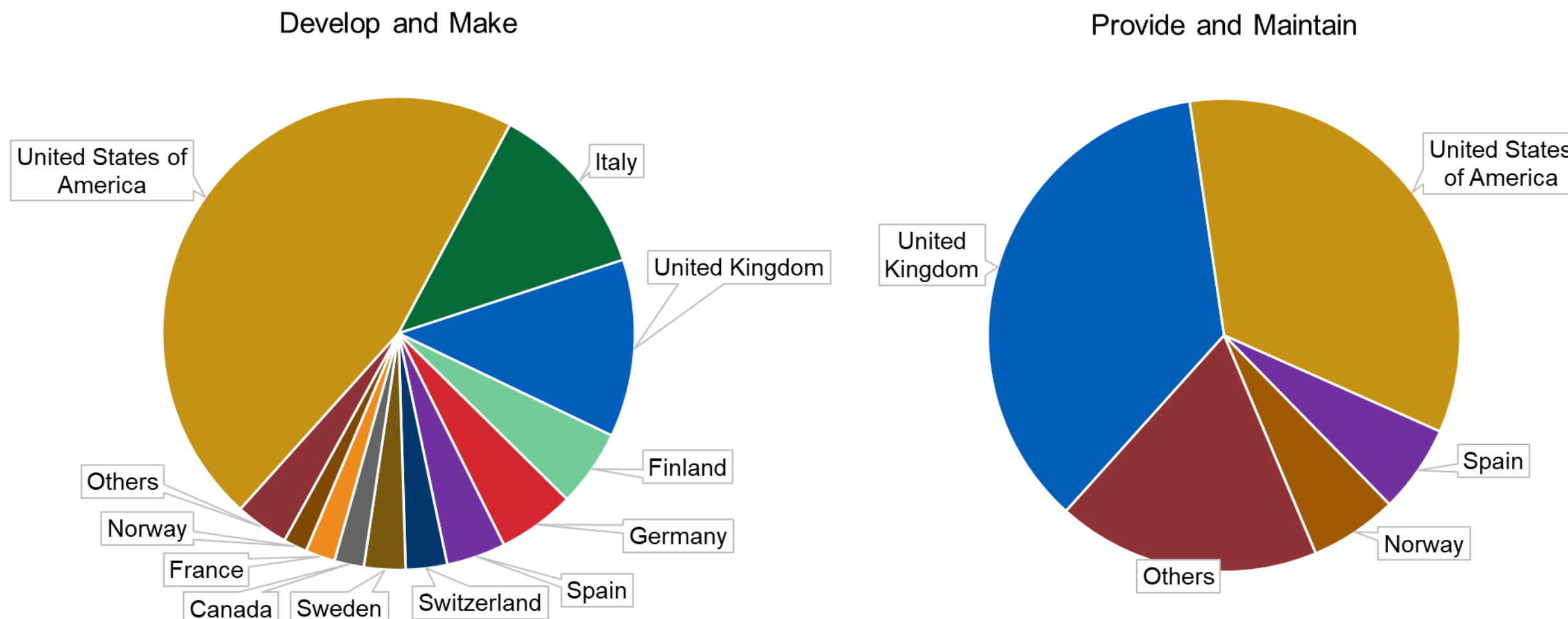
The following slides set out analysis of the geographical characteristics of the comparator groups, including:

- the proportion of companies in the comparator groups from each country.
- the profitability of companies from each a selection of countries; and
- the impact of those countries on the baseline profit rate analysis



## Geographical distribution of the composite comparator group

There is wide representation across Western Europe and North America



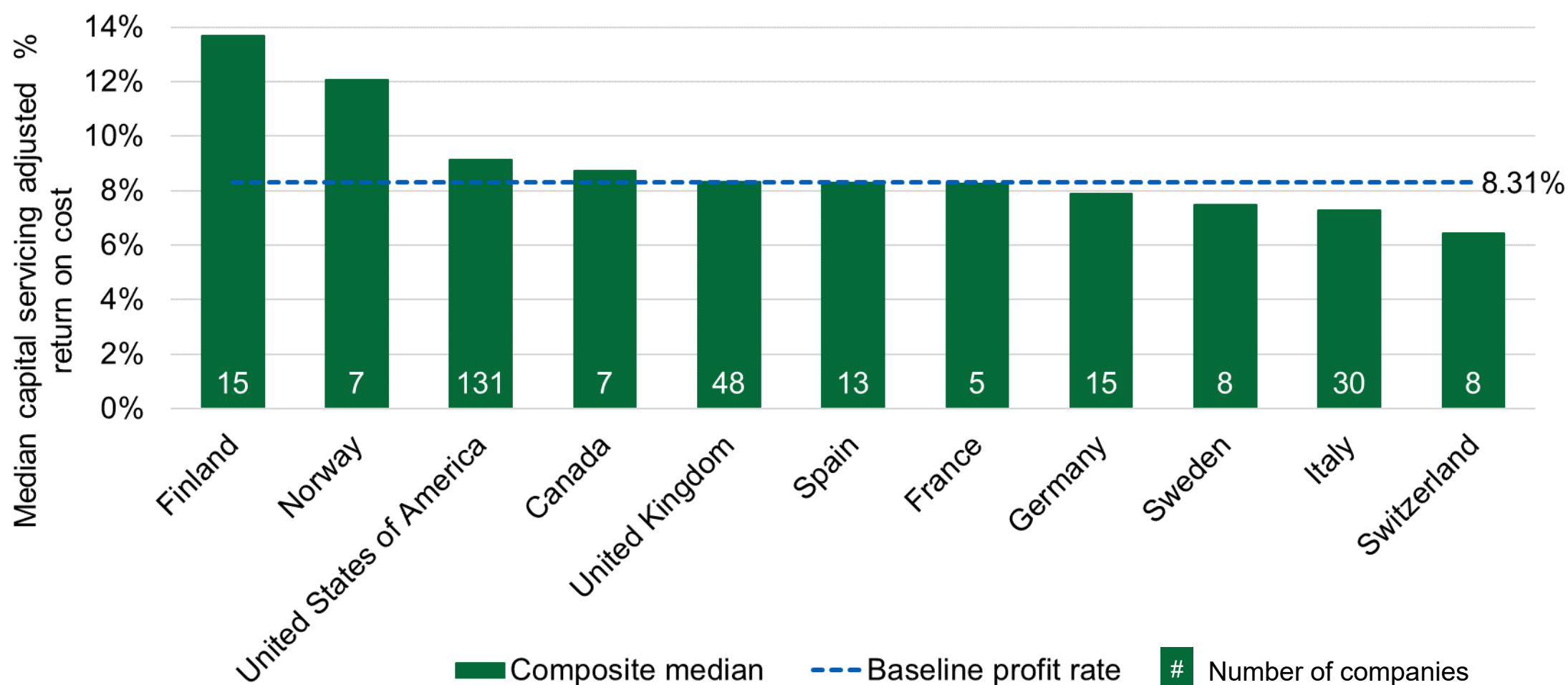
**Notes:** Countries with < 3 number of companies are merged in to 'Others', which includes:  
in the 'Develop and make' chart: Ireland, Belgium, Netherlands, Portugal, Denmark, Iceland.  
in the 'Provide and maintain' chart: Germany, Canada, Switzerland, Ireland, Sweden.

**Source:** Orbis



## Profitability by country

This chart shows the 2021/22 composite underlying rate for each country individually compared to the baseline profit rate. The number of companies is shown at the bottom of each bar.



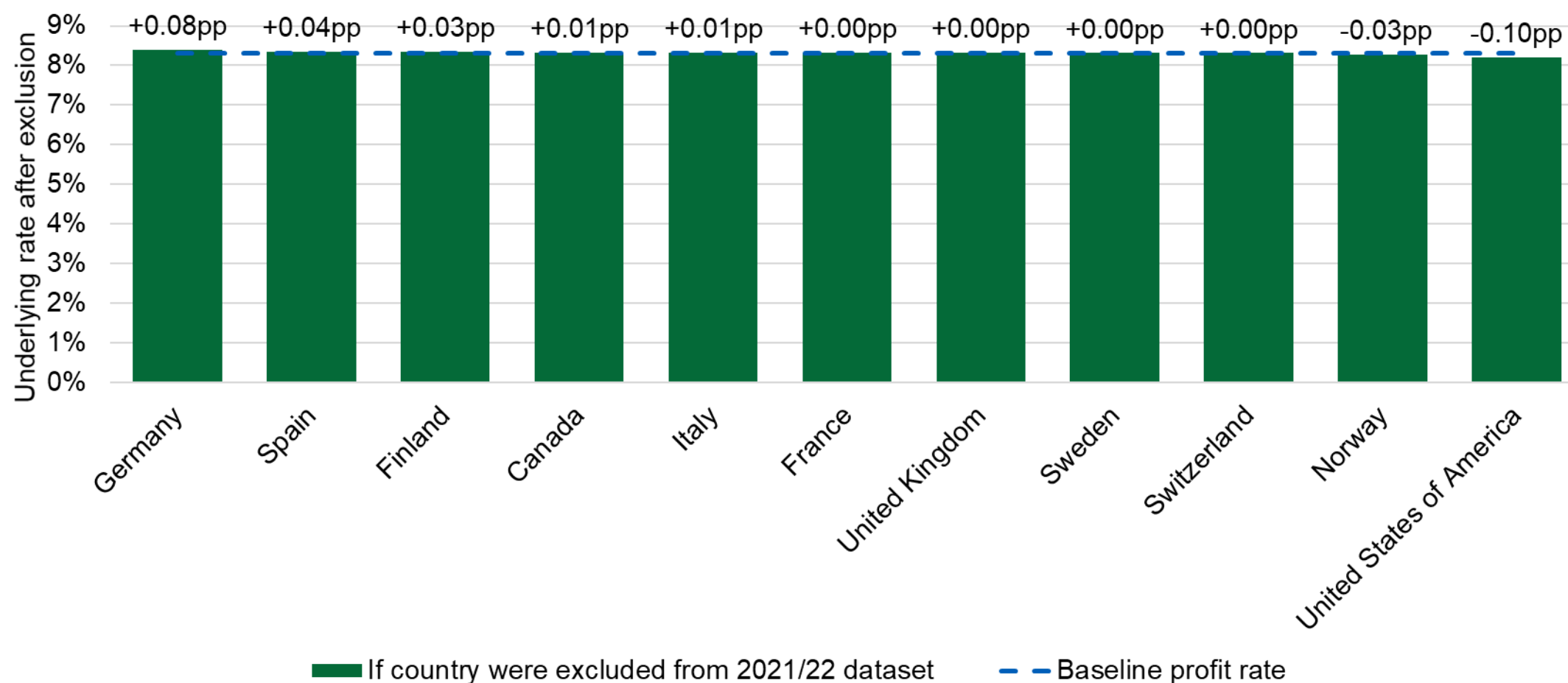
**Notes:** The rates are the composite of the Develop & Make and Provide & Maintain activity groups. Only countries with  $\geq 5$  number of companies are shown.

**Source:** Orbis, SSRO calculations



## Sensitivity to the exclusion of a particular country

This chart shows what the baseline profit rate calculation would have been had a particular country been excluded from the analysis of the 2021/22 composite underlying rate. The figures shown are the differences to the actual baseline profit rate recommendation.



**Notes:** Only countries with  $\geq 5$  number of companies are shown.

**Source:** Orbis, SSRO calculations