SSRO

Single Source
Regulations Office

Key questions and answers regarding the SSRO's Single source baseline profit rate, capital servicing rates and funding adjustment methodology

This document should be read in conjunction with the SSRO publication Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology (March 2021) and Guidance on the Baseline Profit Rate and its Adjustment (March 2021).

1. Terms and definitions

Comparability principle: The aim of the baseline profit rate is to provide the starting point in the determination of the contract profit rate. It is set with reference to the returns of companies whose economic activities are included in whole or in part in the activity types that contribute to the delivery of QDCs and QSCs.

Baseline profit rate: Step 1 of the 6-step process to calculate the contract profit rate of a contract that falls under the Single Source Regulations. The baseline profit rate is the average of the underlying rates for the last three years.

Underlying rate: The median rate of profit (return on cost of production) based on the performance of the companies in a comparator group over a financial year. The SSRO reports this before and after the application of the capital servicing adjustment.

Return on cost of production: The measure of profit used as the basis for the underlying rates and baseline profit rate:

$$\textit{Return on cost of production} = \frac{\textit{Earnings before interest and tax (EBIT)}}{\textit{Cost of Production}}$$

Capital servicing adjustment: An adjustment to the return on cost of production to account for the levels of fixed capital and working capital employed by companies in the comparator groups. A corresponding adjustment is made in the pricing of individual contracts by an adjustment at step 6 of the contract profit rate.

Activity type: A group of economic activities, defined by the SSRO, which correspond to types of activity that contribute to the delivery of QDCs and QSCs.

Comparable companies: A company whose economic activities are included, in whole or in part, within an activity type.

Comparator group: A group of comparable companies undertaking one or more of the economic activities which make up an activity type.

2. The baseline profit rate

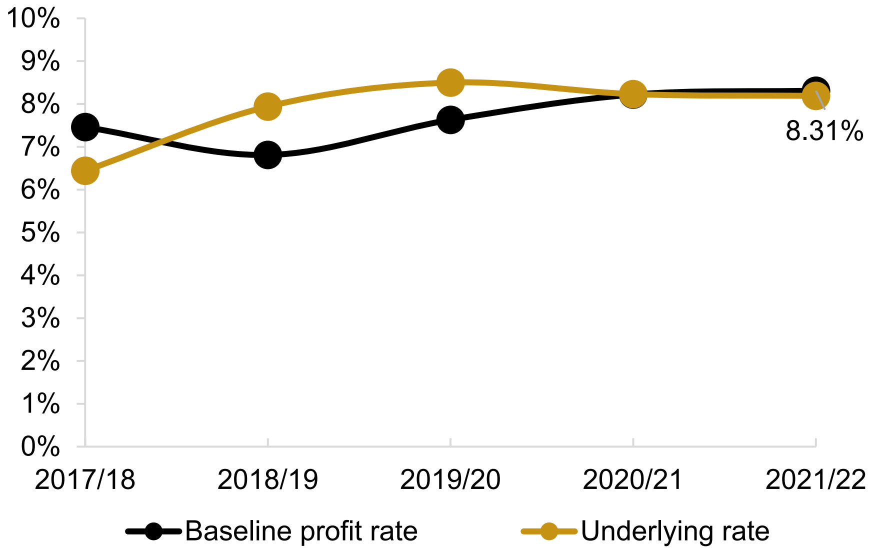
2.1. How is the baseline profit rate calculated?

The baseline profit rate (BPR) is an average of the actual profit rates of companies whose activities are comparable to those that contribute to the delivery of MOD single source contracts. The SSRO categorises those activities under the headings ‘Develop and Make’ and ‘Provide and Maintain’ and companies are selected into those comparator groups based on the nature of their activities. The BPR is the rolling average of the underlying rate for the current year and those of the two previous years.

2.2. Why does the baseline profit rate change every year and why has it increased?

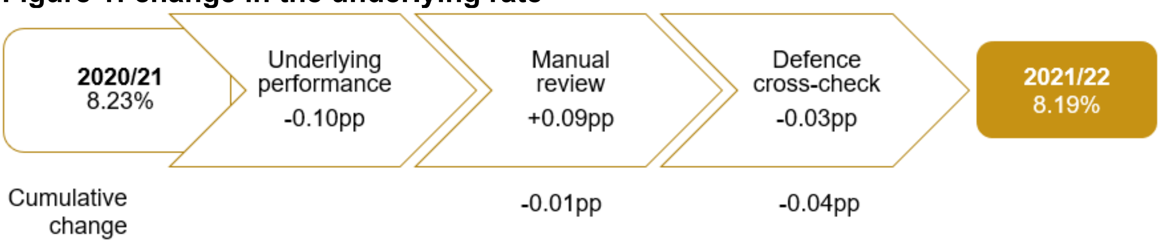
The Defence Reform Act 2014 (the Act) requires the SSRO to provide the Secretary of State with an assessment of the appropriate baseline profit rate for each financial year.

The baseline profit rate for 2021/22 is 8.31 per cent (prior year: 8.22 per cent). This year’s composite underlying rate of 8.19 per cent replaces the 2017/18 underlying rate of 7.94 per cent in the calculation of the three-year average which determines the SSRO’s BPR recommendation. The other two underlying rates in the three-year average are 8.50 and 8.23 percent.



The SSRO’s approach is to use the most recent data available at the time of making its assessment in order to ensure its assessment is appropriate. The underlying rate assessment changes year-on-year in response to changes in the comparator group data, as shown in figure 1.

Figure 1: change in the underlying rate



2.3. What steps has the SSRO taken in response to the COVID-19 pandemic when making its assessment?

The financial information used for the 2021/22 recommendation was taken from annual company financial statements for the year ending on or before 31 March 2020.

The SSRO has analysed the period to which the financial data that informs the recommendation relates and 325 (94%) of companies in the composite comparator groups have financial year ends on or before 31 December 2019. The methodology excludes loss-makers in the current year from the calculation and all companies need to meet all other criteria including having data available in Orbis at the relevant time.

Optional extensions to financial reporting deadlines have been made available in many of the countries from which we take data. There was a risk that not enough data would be available at the cut-off date for the analysis. However, we have continuously monitored the availability of data during the year and are satisfied there are enough companies in the comparator groups. In light of the extended reporting deadlines, the methodology now allows previously accepted companies that had not reported data as at our cut-off date to be retained for consideration next year.

2.4. How will the COVID-19 pandemic impact future SSRO recommendations?

Under the current methodology, the financial information used for the 2022/23 recommendation will be extracted from annual company financial statements for the year ending on or before 31 March 2021.

It is too early to say what the financial effect of COVID-19 will be on the comparator groups or the extent to which the effects can be distinguished from other events that have occurred during the year, which is still ongoing at this time. The impact on the data the SSRO will use will start to become known in 2021 as companies publish their financial statements.

The SSRO's methodology contains a number of stabilising features which mitigate the impact of transient shocks, for example the use of the median and the removal of loss makers. And if there were systematic changes to the underlying rate then the three-year average will phase the impact in a predictable and measured way.

The SSRO will continue to engage with its stakeholders on its approach to delivering its 2022/23 recommendation. As data becomes available the SSRO will be better placed to judge how the methodology will respond to it and what, if any, response is required by the SSRO.

2.5. What is the impact of the new higher baseline profit rate and how much will it cost the taxpayer?

The BPR is the first of six steps that contribute to the Contract Profit Rate (CPR), which supports both value for money in government expenditure and fair and reasonable prices for contractors. The new rate will mean that Step 1 of the CPR will be 0.09 percentage points higher compared to 2020/21, and 0.68 percentage points higher than in 2019/20. The other five steps of the CPR take account of factors such as risk, performance incentives and capital servicing. SSRO data on contract profit rates is shown in the table below.

The implications of an increase in the BPR for MOD will depend on how all six of the steps which determine the contract profit rate are applied. In addition, the performance of the contractor, the pricing method which allocates cost risk between the parties to the contract, specific contract terms and conditions, and any final price adjustment, will come together to determine the final contract price. Prices may therefore decrease or increase alongside a change in the BPR.

Table 1 shows the average contract profit rates of contracts entered into each year and demonstrates that changes in contract profit rates may not always mirror changes in the BPR, as a result of those other factors.

Table 1: Average (mean) estimated contract profit rate by financial year

Financial year in which contract became a QDC/QSC	**Baseline profit rate (%)** Step 1	**Average contract profit rate reported by contractors to the SSRO via statutory reports (%) Steps 1-6**	**Difference – baseline vs. contract (pp)**
2015/16	10.60	11.30	0.70
2016/17	8.95	10.57	1.62
2017/18	7.46	8.32	0.86
2018/19	6.81	8.33	1.52
2019/20	7.63	9.11	1.48
2020/21 Apr to Sep	8.22	9.43	1.22

Source: SSRO (2020) *Quarterly Qualifying Defence Contract Statistics: Q2 2020/21*, *Table 3*.

Note: The differences between the baseline profit rate and the observed contract profit rates are due to the application of steps 2-6 in the calculation. For more details see SSRO (2020) *Guidance on the Baseline Profit Rate and its Adjustment*.

2.6. What are the lowest and highest profit rates achievable under the new BPR?

Table 2 illustrates the range of initial contract profit rates achievable given the adjustments that are possible. The SSRO's Annual qualifying defence contract statistics includes a summary of actual agreed contract profit rates to date.

Depending on the contract pricing method, it is possible for a contractor to achieve a higher percentage profit than was initially agreed at contract signing by outperforming cost estimates, or to achieve a lower profit rate by underperforming. The final contract profit rate will therefore only be known once the contractor has delivered the contract.

Table 2: Illustration of the six steps and the range of CPRs available before the impact of contractor performance

Contract profit rate step		Value/Adjustment
	Unadjusted rate	9.75%
	Capital servicing adjustment†	-1.44pp
Step 1	Baseline profit rate	**8.31%**
Step 2	Cost risk adjustment*	-2.08pp to +2.08pp
Step 3	POCO adjustment**	
Step 4	SSRO funding adjustment	-0.057pp
Step 5	Incentive adjustment***	up to +2.00 pp
Step 6	Capital servicing adjustment (CSA) † ****	Minimum: 0.0% Lower quartile: 0.6% Upper quartile: 1.6% Maximum: 4.4%

Illustrative minimum CPR, based on: -25% step 2, +0pp step 5 and +0.0pp step 6	**6.18%**
Illustrative low CPR, based on: -25% step 2, +0pp step 5 and +0.6pp step 6	**6.78%**
Illustrative high CPR, based on: +25% step 2, +2pp step 5 and +1.6pp step 6	**13.93%**
Illustrative maximum CPR, based on: +25% step 2, +2pp step 5 and +4.4pp step 6	**16.73%**

The six-step process is set out in the SSRO's publication *Guidance on the Baseline Profit Rate and its Adjustment*.

† See Question 3.12 for an explanation of these two capital servicing adjustments

* An adjustment of between +/- 25 per cent of the BPR.

** 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.

**** Estimated using actual values for contracts priced in 2019/20. The actual adjustment may be higher, lower or negative. Source: SSRO (2020) *Annual Qualifying Defence Contract Statistics: 2019/20.*

2.7. How do the profits of the companies who make up the BPR and the range of contract profit rates compare to those of the MOD's main suppliers?

The table below shows the range of profits (5 year median of return on cost of production) exhibited by the top 20 listed companies by value of non-competitive spend in 2019/20, as reported by the MOD.[1] The 5-year median profit rate of the D&M and P&M comparator companies is included for reference. The rates shown for the suppliers are the median over the last five years to illustrate what might be considered typical for each.

Company name	Return on cost of production: median 2015/16 - 2019/20*
Safran	22.61%
CGI	16.17%
Raytheon Technologies	15.57%
Lockheed Martin	14.66%
Northrop Grumman	14.36%
QinetiQ	14.28%
General Dynamics	14.04%
Vinci	12.84%
Ultra Electronics	12.03%
BAE Systems	10.37%
Babcock	10.06%
Thales	8.40%
Boeing	8.06%
Leonardo	5.43%
Airbus	4.50%
Jacobs Engineering	4.01%
Fujitsu	3.52%
DXC Technology	0.94%
Serco	0.88%
Rolls Royce	0.29%

Provide & Maintain median†	**9.72%**
Develop & Make median†	**9.29%**

The suppliers' 5 year median actual profit rates ranged from 0.29 per cent to 22.61 per cent; note the actual profit rate of the company as a whole is also a product of any non-single source work it carries out. The illustrative range of available CPRs at time of agreement (see Q2.4 above) is 6.18 per cent to 16.73 per cent. The actual CPR achieved may be a higher percentage profit by outperforming cost estimates, or a lower profit rate by underperforming.

Source: Orbis and SSRO calculations
**Return on cost of production, unadjusted for capital servicing*
†Median of the underlying rate, unadjusted for capital servicing, of the current year comparator group over the last 5 years

[1] Ministry of Defence (2019) *MOD Trade, Industry and Contracts: 2019*, Table 4 Annex.

3. The methodology and the comparator groups

3.1. What is the basis of the SSRO's methodology and how does this provide a fair and reasonable return to industry?

The SSRO is confident that the baseline profit rate is a fair and reasonable starting point for the contract profit rate calculation because it is set with reference to the actual returns of comparable companies. The methodology takes steps to remove loss-making companies and to only incorporate companies that perform comparable economic activities in comparable countries.

The comparable company search process follows the transfer pricing 'arm's length principle' set out in the OECD transfer pricing guidelines. Transfer pricing is a concept which seeks to ensure that companies operating in a number of territories receive appropriate income and profit in each, as if each territory were operating at arm's length from the other(s), as a third party would do. Transfer pricing is employed extensively by multinational enterprises and tax authorities globally, including the UK,[2] and as such the guidelines, and their related expectations and practices, are widely known and understood and their practical implications have been explored.

For transparency, the SSRO publishes the list of criteria used to select comparable companies in the methodology and publishes the resulting list of comparable companies used in the comparator groups.

3.2. How representative are the activity type comparator groups of the UK defence industry?

It is not the SSRO's intention that the comparator groups contain only companies from the defence industry. To produce a robust, open-market benchmark, the BPR methodology includes companies operating in the defence sector as well as companies operating in non-defence sectors and outside of the single source regime. Companies that either have the words 'defence', 'defense', or 'militar*' included in their activities description in the Orbis database account for 32 per cent of the companies used in the calculation of the composite rate for this year.

The methodology identifies companies whose economic activities are of the type which contribute in whole or in part to the delivery of QDCs and QSCs. The result of the process is a robust comparator group that is relevant to the activities which contribute in whole or in part to the delivery of QDCs and QSCs. The range of contract profit rates achievable given this year's BPR give us confidence an appropriate group of companies has been selected (see questions 2.4 and 2.7).

3.3. Why does the SSRO recommend a composite rate based on the Develop and Make and Provide and Maintain activity types? Why are rates also published for Ancillary Services and Construction?

The composite rate is derived from two activity types: Develop and Make (D&M) and Provide and Maintain (P&M). Together, these types of work represent the vast majority of single-source procurement.

Given Ancillary Services and Construction account for a small minority of single-source contract spend they are not included in the composite rate as doing so would not be consistent with the principle of comparability. The approach taken for the 2021/22 recommendation is the same as for the 2020/21 BPR recommendation.

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[2] Part 4 Taxation (International and Other Provisions) Act 2010.

The data on all four activity types is provided so that the Secretary of State can understand the basis on which the composite rate had been calculated and why it was considered appropriate.

3.4. Why have some companies left the comparator group and some joined?

In accordance with the SSRO's methodology, the set of comparator companies was fully refreshed for the previous (2020/21) recommendation. This means that this year we carried forward the prior year's group and reviewed all those companies against our activity descriptions. This group is anticipated to last for another year before a full search of the Orbis data is carried out to refresh the groups. We have the option to retain companies for next year who have been excluded from this assessment due to delayed financial reporting.

To confirm that the companies selected continue to undertake comparable activities, the SSRO has systematically reviewed each company that met the Orbis selection criteria. Assessments drew on detailed information from Orbis, on company websites, and other reputable information sources such as Bloomberg. This process was carried out independently of any consideration of the companies' profit data. This review contained some subjective elements, but every effort is made to assess these aspects consistently.

Companies may also be added through the annual review of contractors with QDCs or QSCs (or their ultimate parent undertakings) and the latest data on the MOD's spending with suppliers. Inclusion of additional companies is subject to the companies' activities being comparable to the SSRO's activity types and their meeting the relevant selection criteria such as turnover, independence and profitability. The overwhelming majority of the MOD's main suppliers in recent years are included in the comparator groups.

Our process ensures that, as in previous years, companies are included or excluded based on the most up-to-date and robust evidence available to the SSRO.

3.5. What is the source of company data for the SSRO's assessment?

The Orbis database supplied by Bureau van Dijk is used to search for comparable companies and as a source of financial information; the calculation uses publicly-reported financial data that is prepared in accordance with accounting standards and aggregated in to the Orbis database. The SSRO publishes its methodology on its website containing detailed information on the data fields it uses.

For a number of the MOD's major suppliers we have verified the financial data in Orbis against published financial statements. The SSRO is satisfied that the data contained in the Orbis database accurately reflects the financial statements of the comparator companies.

3.6. What are the size criteria for companies to be included in the assessment?

Companies are only included in the search if their financial data is of sufficient quality, determined by if that company is of a size that would normally require an independent financial audit. This requires companies to have data that demonstrates they meet the following criteria for all of the last five years:

- an annual turnover of more than £10.2 million; and either one of the following:
    - total assets worth more than £5.1 million; or

- 50 or more employees on average.

This threshold is set with reference to standardised thresholds used in the UK, and the EU, for determining if a company is small. The threshold in the methodology therefore ensures that there are no small companies in the comparator groups.

3.7. Why is the BPR set at the median average with loss-making companies excluded from the comparator groups?

The methodology is carefully calibrated to ensure that it represents a reasonable starting point for the application of the six steps. The SSRO has published analysis which supports the exclusion of loss makers and using the median as an analytically robust approach.

The choice of average should reflect the specific characteristics of the data set and the median is a superior measure of central tendency compared to the mean or weighted mean given the skewed nature of the data set. The skew is due to the fact that:

- the SSRO excludes loss-makers but does not place an upper limit on the profit measure, resulting in a small number of companies with very high profit rates in the comparator group. The mean is unduly affected by the presence of such outliers; and

- the SSRO excludes small companies but does not place an upper limit on company size, resulting in a small number of very large companies in the comparator group. Using the weighted mean would result in the BPR being heavily influenced by this small group of companies resulting in volatility and uncertainty about the result.

The median is robust to these features of the data set and is the most appropriate choice of average.

Loss-making companies are removed to reflect the expectation of positive profit on estimated Allowable Costs in QDCs. This maintains consistency with the construct of the profit formula as a mark-up on estimated Allowable Costs and removes the possibility of a negative BPR being produced. Incorporating loss-makers this year would have resulted in a decrease in the BPR of less than one per cent.

3.8. What adjustments has the SSRO made to the data?

In line with the OECD guidelines, adjustments are made to the company data where they can be performed accurately and are expected to enhance reliability of the results. The SSRO's calculation of the BPR is based on publicly-reported financial data that is prepared in accordance with accounting standards, is audited by companies' external auditors, and which is subsequently aggregated by Bureau van Dijk.

As contemplated by the OECD transfer pricing guidelines3, the SSRO makes a capital servicing adjustment to take into account the different levels of fixed capital and working capital employed by the companies in the comparator group. (see question 3.11). The SSRO's view is that no further adjustment should be made.

The SSRO does not make any adjustments to the comparable company data to take into account costs that do not meet the requirement of being Allowable Costs. We do not consider it possible to reliably make an assessment of the costs of comparator companies, or to make corresponding adjustments to their other financial results (such as revenue) to reflect the company's position as if the "disallowed" cost had not been incurred. The SSRO assumes the cost of production for each comparator company to be appropriate, attributable and reasonable in the circumstances in relation to the revenue each comparator company receives.

The SSRO does not make any adjustments to the comparable company data to take into account costs that relate to the purchase of one company by another. When a comparator company has subsidiaries the data we use is derived from the consolidated group financial statements. This data reflects that when an acquisition occurs the assets acquired and the revenues and costs associated with it become an integral part of the acquirer's business and activities. Amortisation and impairment of acquired assets are a cost and are recognised in an accounting period in accordance with accounting standards. These costs are therefore treated as costs in both the baseline profit rate methodology and the SSRO's Allowable Costs guidance. An uplift to the baseline profit rate for such costs would circumvent the requirements for contractors to demonstrate such costs were AAR.

We understand that companies might use alternative performance measures in their annual report and accounts. These might, for example, highlight exceptional items in the income statement or include additional subtotals to show profit before amortisation or impairment of some assets. There are a number of reasons why we do not use these measures:

1. In order to do so we would need to apply them consistently across the whole comparator group and:
    a. detailed information may be available for some companies, but we look at a wide range of companies that have different reporting requirements.
    b. where detailed information is available, our observation is that there are no consistent rules or principles we could apply to determine what is or is not 'exceptional'.
2. Despite their separate disclosure, such items remain part of the total operational costs of a company. Individual companies may like to provide additional context to help investors understand their underlying results, but we have a different objective, which is to produce comparable measure of return on total operational expenses of a large group of companies.

[3] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Chapter III para 3.48 (2017), OECD

3.9. Why does the SSRO not adjust for significant one-off events that affect the results of comparator companies?

We understand that companies can be affected by significant one-off events or that companies might be subject to significant one-off adjustments in a current year to reflect past events they were not previously aware of.

As explained in Question 15, we do not think we could reliably adjust for these items. However, the methodology is designed to mitigate the potential impact of these events, in particular:

- whilst some companies might have one-off costs others may have one-off income. The underlying rate is assessed using the financial information of a large pool of companies and so reflects all such one-off events;
- the averaging approaches taken, both the use of the median and the use of a 3-year rolling average, mitigate the impact that a particular one-off event in a particular company can have on the total result; and
- loss-making companies are excluded from the calculation to reflect the expectation of positive profit on estimated Allowable Costs in QDCs. This maintains consistency with the construct of the profit formula as a mark-up on estimated Allowable Costs and removes the possibility of a negative BPR being produced.

3.10. What is the impact on the assessment if a company restates their financial information and will the SSRO reassess a previous year's rate if financial data has changed?

The financial information we draw from Orbis to calculate the underlying rate reflects the latest set of financial statements issued by a company. This means that if a company were to restate their prior financial results due to adopting a new accounting standard the information used to calculate the current year capital servicing adjustment would be those restated figures.

The SSRO calculates each underlying rate once and we do not re-assess previous years' underlying rates. Calculating an underlying rate requires two full years of data and so it would not be possible for us to recalculate previous underlying rates because when companies restate financial information it is usually only presented in detail for the current and prior year.

If a material change in the underlying rate were to occur due to market-wide accounting change, or for any other reason, the three-year averaging helps mitigate short-term volatility in the baseline profit rate assessment and incorporates changes in a phased and predictable way. We consider this to be beneficial to contractors and the MOD. Restating past underlying rates would undermine this process.

3.11. Why does the SSRO make a capital servicing adjustment in calculating the BPR?

Regulation 11(6) of the Single Source Contract Regulations 2011 and section 17(2) of Defence Reform Act 2014 provide for an adjustment to the contract profit rate (step 6) so as to ensure that the contractor receives an appropriate and reasonable return on capital employed to perform the contract.

An adjustment made by the SSRO in the calculation of the baseline profit rate to normalise the data in respect of the capital servicing of each company. This is to ensure the BPR is an appropriate baseline upon which to apply step 6.

A contract profit rate therefore incorporates two adjustments to take into account the different levels of fixed capital and working capital employed by the companies in the comparator group and the performance of a contract; one in the calculation of the BPR and a corresponding adjustment agreed between the contracting parties at step 6 to reflect the circumstances of the particular QDC or QSC. The making of adjustments for capital is contemplated by the OECD transfer pricing guidelines.4

The definitions of "capital employed" used for adjustments at each stage are intended to be similar, to the extent possible. However, "capital employed" for the purposes of these adjustments is not intended to represent all capital employed by the comparator company or all capital employed in the performance of the contract, nor is step 6 representative of the return on capital employed for the contract. The process is one of normalising the comparator company data and then readjusting the BPR at step 6 to ensure that the overall effect of the CPR (taking account of steps 1-6) is that a contractor receives an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purpose of enabling the contractor to perform the contract.

3.12. Is the SSRO consistent in its treatment of intangible assets in its calculation of the baseline profit rate?

Yes. The approach the SSRO takes ensures the aspects of the BPR calculation which relate to intangible assets are treated appropriately in respect of both cost and profit.

There are two circumstances where intangible assets might affect the calculation:

1) amortisation costs of intangible assets; and

2) the inclusion or otherwise of intangible assets in "capital employed" for the purpose of the capital servicing adjustment (see Q3.12).

The capital servicing adjustment in the calculation of the BPR does not remove any element of profit in respect of intangible assets because these are not included in the definition of "capital employed". If an item is not included in the definition of capital employed used for the adjustment in the BPR calculation then the contract will receive an average return that is present within the baseline profit rate for that item, plus any additional amount as a result of the application of the other 6 steps.

Amortisation is the spreading out of the cost of acquiring intangible assets over a specific duration and is therefore rightly treated as a cost-related matter. Such costs may be Allowable Costs. Failing to recognise amortisation as a cost in the BPR calculation (for example by using EBITA as the profit level indicator) would result in contractors being reimbursed for these items at a flat rate, irrespective of whether they are incurred and in what amount. This would not be consistent with the requirements of Allowable Costs and would double-count the return on intangible assets already included in the contract profit rate.

3.13. How does the baseline profit rate compare to the MOD suppliers' weighted average costs of capital (WACC)?

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[4] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Chapter III para 3.48 (2017), OECD

The WACC describes the expected return required by investors on the money they put in to a business. This is a very different measure to the BPR which is based on return on cost of production (also known as a mark-up on cost, or a profit mark-up).

$$Return\ on\ cost\ of\ production = \frac{Profit\ (£)}{Revenue\ (£) - Profit\ (£)}$$

The relationship between investment in a company and cost incurred is complex. For an individual contract, a return on cost of production could be lower, higher or the same as the WACC and meet the requirements of investors. The required contract profit rate will depend on the individual circumstances of each contract and company, and there are few conclusions to be drawn from a direct comparison of the WACC to the BPR.

Measure	Definition	Key similarities and differences
Profit margin or net margin	$\frac{Profit\ (£)}{Revenue\ (£)}$	Uses the same inputs as return on cost but is the return on revenue
Return on capital employed	$\frac{Profit\ (£)}{Capital\ Employed\ (£)}$	The return is measured against the assets that are used as part of operations
Return on invested capital	$\frac{Profit\ (£)}{Invested\ Capital\ (£)}$	The return is measured against the capital that has been invested in operations

4. Capital servicing rates

4.1. How does the SSRO calculate the capital servicing adjustments and how are these used in the calculation of the baseline profit rate?

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

- Fixed capital
- Positive working capital
- Negative working capital

The profit rate of each comparator company is adjusted in proportion to the ratio of fixed and working capital employed to costs of production, a measure of the capital intensity of the company. A corresponding adjustment is made in the pricing of individual contracts by an adjustment at step 6 of the contract profit rate to reflect the capital intensity of the contract (see question 3.11).

This process ensures that the contract profit rate reflects an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purposes of enabling the contractor to perform the contract.

5. SSRO Funding Adjustment

5.1. How does the SSRO funding adjustment fund the SSRO's activities and why does it change year-on-year?

The SSRO is an executive non-departmental public body sponsored by the Ministry of Defence, which provides a grant-in-aid for the SSRO's running costs. The funding adjustment calculation is intended to set the adjustment at a level that allows the MOD to recover half of the SSRO's grant-in-aid through a reduction in the amounts paid on single source contracts, shared across contractors based upon the value of their QDCs.

The funding adjustment is calculated with reference to the average annual total Allowable Costs of contracts entered into, which may change year on year. The adjustment may change accordingly while still delivering a similar reduction in costs to the MOD. The increase in the 2021/22 recommendation compared to 2020/21 is primarily caused by a decrease in the average annual total Allowable Costs of contracts entered into compared to the previous year.