

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](#) and [Guidance on the Baseline Profit Rate and its Adjustment](#) and the [Secretary of State for Defence's announcement on the rates for 2022/2](#)

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:

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

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.

The baseline profit rate

1. How is the baseline profit rate determined?

The Defence Reform Act 2014 requires that the Secretary of State must determine the baseline profit rate for each financial year. The SSRO must provide the Secretary of State each year with its assessment of the appropriate baseline profit rate, to assist in the determination. Where there is a difference between the rate determined by the Secretary of State and the SSRO's assessment, the reasons for the difference must be published along with the rate [\(link\)](#).

2. How is the SSRO's recommended baseline profit rate calculated?

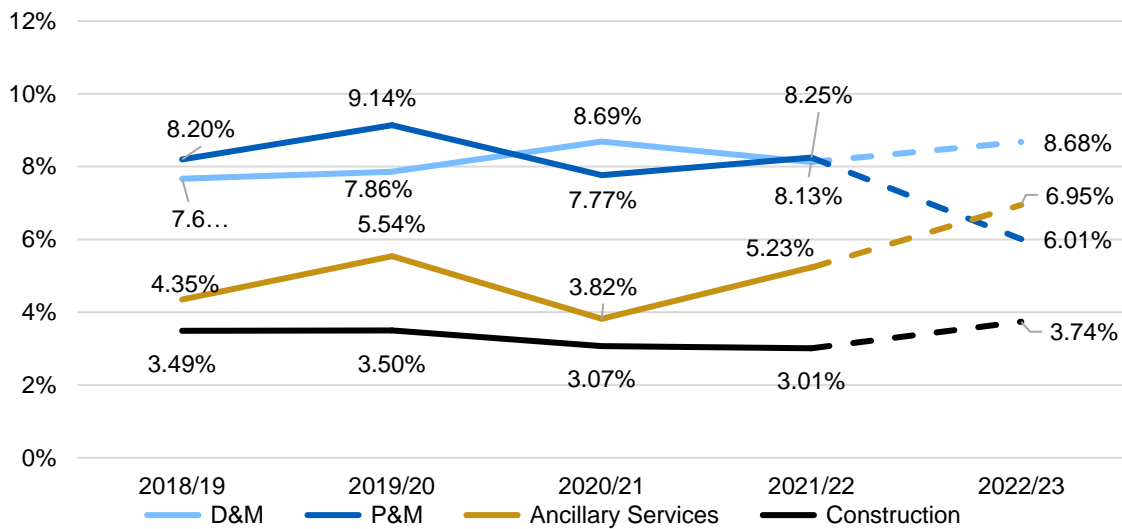
The baseline profit rate (BPR) for 2022/23 is 8.31 per cent (prior year: 8.31 per cent). This year the Secretary of State determined the BPR and capital servicing rates for 2022/23 should remain at the level recommended by the SSRO in the previous year. The BPR is an average of the composite underlying rates for the three years prior to 2022 (8.50%, 8.23%, and 8.19%).

The baseline profit rate (BPR) recommended by the SSRO each year 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.

3. Why does the SSRO's assessment of the baseline profit rate change each year?

The SSRO's approach to making its annual recommendation 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, which is based on the SSRO's 2022/23 BPR analysis. The develop and make (D&M) and provide and maintain (P&M) rates are those that are used in our assessment of the baseline profit rate.

Figure 1: change in the underlying rates (capital servicing deducted)



4. How have comparator companies been affected by COVID-19?

The COVID-19 pandemic impacted the activities of many companies in the most recent year we have analysed.¹ This could mean that data for companies that would ordinarily be suitable may now be the product of non-comparable activities. For example, a company may no longer be suitable for inclusion in a comparator group if it has:

- suffered from significant periods of inactivity; or
- benefitted from engaging in new COVID-related business activities that differ from its normal business.

The SSRO checks that companies are undertaking comparable activities and our approach this year is further explained in question 5.

During the period of the pandemic, companies have displayed both increased and decreased profitability relative to the data we have for the previous reporting year (see Figure 1). These effects are observable across both defence and non-defence sectors. As in any other year, it is not possible to distinguish the effects of one set of circumstances from another in the profit data of comparable companies. This includes the specific impact of the pandemic on a company's profits. Compared to last year the average profitability of the Develop and Make rate is higher and for the Provide and Maintain rate it is lower, with the overall effect on the composite underlying rate being negative. This is the product of a range of external factors and individual business decisions and it is not possible to discern what comparator companies would have earned if the COVID-19 pandemic had not occurred.

¹ This is latest reporting year ending on or before 31 March 2021 that is addressed by the financial statements of each comparator company. For most comparator companies this is the year ended 31 December 2020 but some company financial statements cover different time periods, for example the year ended 31 March 2021, or the year ended 30 June 2020.

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

Every year the SSRO revalidates whether comparator companies in the right geographical areas are carrying out comparable activities. Companies that do not meet these requirements are removed from the comparator groups. This year that process included additional consideration of the impact of the COVID-19 pandemic on each company. It is not the aim of this process to remove the impact of COVID-19, or any other causal factor related to profitability from the comparator group; rather, it is to ensure that the comparator groups constitute only those companies that we know to undertake comparable activities, irrespective of the impact of COVID-19 on the company. We are satisfied that the companies that remain in the 2022/23 comparator groups were carrying out comparable activities in the year we analysed. Question 18 provides additional information on the SSRO's approach to adjusting data.

The SSRO's methodology contains a number of stabilising features which mitigate the impact of transient shocks, or differential impacts on individual companies, and allow for changes in the profitability to be reflected in the BPR over time in a predictable and measured way. Our use of the median, removal of loss makers, and time averaging all help to stabilise the BPR. Given the recent economic instability and heightened future uncertainty we implemented an increase to our averaging over time from three to four years, to increase stability. This change increased the influence of stable historical profit trends relative to transitory perturbations (positive or negative). In taking this action, we sought to preserve the BPR's ability to reflect new trends going forward if this year's assessment is indicative of a longer-term shift from the past.

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

Under the current methodology, the financial information used for the 2023/24 underlying rate will be extracted from annual company financial statements for the year ending on or before 31 March 2022.

It is too early to say what the financial effect of COVID-19 will be on the comparator groups in that period, or the extent to which the effects can be distinguished from other events that have occurred during the year. The impact on the data the SSRO will use will start to become known in 2022 as companies publish their financial statements.

The methodology for the 2023/24 assessment has not yet been decided and is planned to be approved by the SSRO in September 2022. The SSRO will continue to engage with its stakeholders on its approach to delivering its 2023/24 recommendation. As data becomes available the SSRO will be better placed to judge how the methodology will apply.

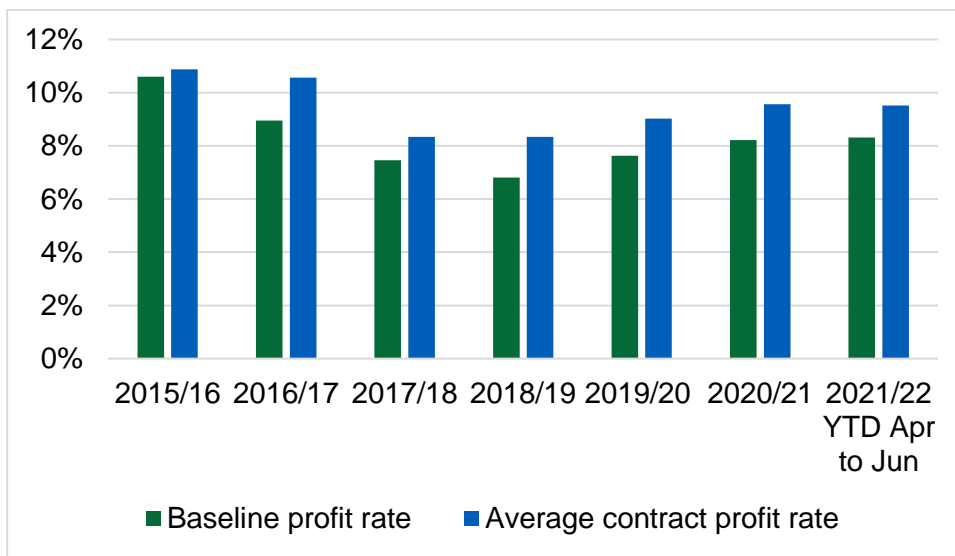
7. What is the impact of the 2022/23 baseline profit rate and how much will it cost the taxpayer?

The BPR is the first of six steps that contribute to the Contract Profit Rate (CPR) and support both value for money in government expenditure and fair and reasonable prices for contractors. This year's rate will mean that Step 1 of the CPR will be the same as that for 2021/22. 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 the BPR for the 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.

Figure 2 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.

Figure 2: Baseline profit rate and average (mean) estimated contract profit rate by financial year



Source: SSRO (2021) *Quarterly Qualifying Defence Contract Statistics: Q2 2021/22, Table 3.* Available at www.ssro.gov.uk

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 the [Guidance on the Baseline Profit Rate and its Adjustment](#).

8. What are the lowest and highest profit rates achievable under the 2022/23 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*² include 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	-0.046pp
Step 5	Incentive adjustment***	up to +2.00 pp
Step 6	Capital servicing adjustment (CSA) ^{† ****}	Minimum: 0.0% Lower quartile: 0.5% Upper quartile: 1.4% Maximum: 4.9%

Illustrative minimum CPR, based on: -25% step 2, +0pp step 5 and +0.0pp step 6	6.19%
Illustrative low CPR, based on: -25% step 2, +0pp step 5 and +0.5pp step 6	6.69%
Illustrative high CPR, based on: +25% step 2, +2pp step 5 and +1.4pp step 6	13.74%
Illustrative maximum CPR, based on: +25% step 2, +2pp step 5 and +4.9pp step 6	17.24%

The six-step process is set out in the SSRO's publication *Guidance on the Baseline Profit Rate and its Adjustment* available on its website.³

[†] See Question 19 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 2020/21. The actual adjustment may be higher, lower or negative. Source: SSRO (2020) *Annual Qualifying Defence Contract Statistics: 2019/20*

² <https://www.gov.uk/government/collections/ssro-qualifying-defence-contract-statistics>

³ <https://www.gov.uk/government/collections/profit-rate>

9. How do the profits of the companies the SSRO uses in its analysis and the range of contract profit rates compare to those of the MOD's main suppliers?

The table below shows the range of profits exhibited by the top 20 listed companies by value of non-competitive spend in 2020/21, as reported by the MOD.⁴ The 5-year median profit rate of the D&M and P&M comparator companies the SSRO used in its assessment this year 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 FY2016 – FY2020*
Safran	22.61%
CGI	16.76%
Lockheed Martin	15.29%
Ultra Electronics	14.53%
QinetiQ Group	14.28%
Northrop Grumman	14.12%
General Dynamics	13.96%
Raytheon Technologies	12.15%
BAE Systems	10.70%
Thales	8.40%
Boeing	8.01%
Babcock International Group	6.40%
Leonardo	5.43%
Jacobs Engineering Group	4.01%
Fujitsu	3.65%
Airbus	3.34%
Serco Group	3.01%
DXC Technology	0.94%
Thyssenkrupp	0.52%
Rolls-Royce Holdings	-4.89%
Provide & Maintain median[†]	9.90%
Develop & Make median[†]	9.28%

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

The suppliers' 5-year median actual profit rates ranged from -4.89 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.

⁴ Ministry of Defence (2020) *MOD Trade, Industry and Contracts: 2020*, Table 4. <https://www.gov.uk/government/statistics/mod-trade-industry-and-contracts-2020>

The methodology and the comparator groups

10. 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 methodology for assessing the baseline profit rate provides a fair and reasonable starting point for the contract profit rate calculation because it is set with reference to the actual returns of companies undertaking activities comparable to those that enable the performance of qualifying contracts. The methodology takes steps to remove loss-making companies and to only incorporate companies in comparable countries that perform comparable economic activities.

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,⁵ 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.

11. 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 31 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 give us confidence an appropriate group of companies has been selected (see questions 8 and 9).

12. 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.

⁵Part 4 Taxation (International and Other Provisions) Act 2010.

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 2022/23 recommendation is the same as for previous BPR recommendations.

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.

13. 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 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. A full search of the Orbis data refresh the groups is expected to be carried out for the next recommendation.

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.⁶ Inclusion of additional companies is subject to the companies' activities being comparable to the SSRO's activity types and meeting 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.

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

The Orbis database⁷ 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.

⁶ <https://www.gov.uk/government/collections/defence-trade-and-industry-index>

⁷ <https://www.bvdinfo.com/en-gb/our-products/data/international/orbis>

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

Companies are included in the search if their financial data is of sufficient quality, determined by whether the 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.

16. Why does the SSRO's BPR methodology use 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 assessment being produced. Incorporating loss-makers this year would have resulted in a decrease in the SSRO's recommended BPR of around 2.5pp. This is an increase on the impact of less than 1pp last year, illustrating the important stabilising effects of this aspect of the methodology.

17. 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 guidelines⁸, 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 20). 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

⁸ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Chapter III para 3.48 (2017), OECD

objective, which is to produce comparable measure of return for carrying out certain activities.

18. 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 17, 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 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 assessment being produced.

Question 5 set out What steps has the SSRO taken in response to the COVID-19 pandemic when making its assessment.

19. 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.

20. Why does the SSRO make a capital servicing adjustment as part of its BPR assessment methodology?

An adjustment made by the SSRO in the calculation of the baseline profit rate to ensure the BPR is an appropriate baseline upon which to apply step 6.

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 for the purposes to of performing the contract.

The return on capital employed is a ratio of the return on the contract to the capital employed for the purpose of performing it (see question 22). This is not the return to capital employed which in this case is the component of profit which relates to the amount of step 6.

A contract profit rate therefore incorporates two adjustments that together 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 second adjustment agreed between the contracting parties at step 6 to reflect the circumstances of the QDC or QSC. The making of adjustments for capital is contemplated by the OECD transfer pricing guidelines.⁹

The definitions of “capital employed” used for both adjustments 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 the return on capital employed for the contract (see above). 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.

21. Is the SSRO consistent in its treatment of intangible assets in its BPR assessment methodology?

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 Q20).

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 assessment calculation then the

⁹ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* Chapter III para 3.48 (2017), OECD

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.

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

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).

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

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

Capital servicing rates

23. How does the SSRO calculate the capital servicing adjustments and how are these used in the calculation of the recommended 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 20).

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.

SSRO Funding Adjustment

24. 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. Therefore the SSRO funding adjustment may change while still delivering a similar reduction in costs to the MOD. The decrease in the 2022/23 recommendation compared to the prior year is primarily caused by the increase in Allowable Costs.