



SSRO

Single Source
Regulations Office

Guidance on the baseline profit rate and its adjustment 2024/25

Version 8.1

Applies from: 10 October 2024

Versions of this guidance

This is version 8.1 of the guidance on the baseline profit rate and its adjustment which applies to contracts agreed on or after 10 October 2024.

The table in Appendix A highlights changes that have been made from the previous version of the guidance.

The publication and application dates of versions of this guidance are shown below.

Version number	Date published	Applies to contracts agreed on or after
8.1	10 October 2024	10 October 2024
8.0	24 January 2024	1 April 2024
7.3	15 March 2023	1 April 2023
7.2	28 March 2022	1 April 2022
7.1	5 August 2021	6 August 2021
7	15 March 2021	1 April 2021
6	16 March 2020	1 April 2020
5	18 March 2019	1 April 2019
4	15 March 2018	15 March 2018
3	15 March 2017	15 March 2017
2	24 March 2016	24 March 2016
1	26 March 2015	27 March 2015

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1. Introduction

Guidance on the baseline profit rate and its adjustment

- 1.1 This document is guidance on the determination of the contract profit rate when using the price formula, following the four-step process. It should be read in conjunction with other SSRO guidance referenced in this document.

Pricing of contracts

- 1.2 The Defence Reform Act 2014 (the Act) and the Single Source Contract Regulations 2014 (the Regulations) require the price payable under a qualifying defence contract (QDC) or qualifying sub-contract (QSC), or component of a QDC or QSC, to be determined in accordance with (1) one of the default pricing methods (by applying the pricing formula) or (2) an alternative pricing method. This guidance aims to help contractors and the Ministry of Defence (MOD) to agree the price of QDCs or QSCs in a way that is consistent with the Act and the Regulations. Where relevant contract pricing matters are referred to the SSRO for an opinion or determination, the SSRO will have regard to its guidance and the extent to which this has been considered and applied by the contracting parties when reaching its conclusion. The SSRO may also take referrals on other matters discussed in this guidance.¹
- 1.3 Section 15 of the Act, and part 3 of the Regulations set out how these pricing methods must be applied to determine the price payable under a QDC or QSC (or a component of such a contract). The methods to price a contract, whether applied individually or in combination, provide for flexibility to accommodate a range of contracting circumstances. It is important that the contracting parties familiarise themselves with the approaches to pricing set out in this and other SSRO pricing guidance and apply these pricing methods in a way that supports a commercial arrangement consistent with value for money and fair and reasonable prices.

The default pricing methods

- 1.4 The price payable under a QDC or QSC, or a component of such a contract, which uses a default pricing method must be determined in accordance with the following formula:
- $$(\text{Contract profit rate} \times \text{Allowable Costs}) + \text{Allowable Costs}$$
- 1.5 The contract profit rate must be determined using the four-step process and the allowable costs must be determined in accordance with one of the six default pricing methods. The contract profit rate applies at the agreed rate for the life of the contract or component and is not affected by future changes in the baseline profit rates or capital servicing rates, unless an amendment is made in respect of which these rates differ. The default pricing methods are:
- Firm pricing;
 - Fixed pricing;
 - Cost-plus pricing;
 - Estimate-based fee pricing;
 - Volume-driven pricing; and
 - Target pricing
- 1.6 The Schedule to the Regulations sets out how the price of a contract or components must be redetermined if the parties propose to make an amendment which affects the original contract price.

¹ <https://www.gov.uk/government/publications/guidance-on-the-ssros-referrals-procedures-under-the-defence-reform-act-2014-and-single-source-contract-regulations-2014>

- 1.7 The SSRO has provided separate guidance to assist the contracting parties determine Allowable Costs and on the use of alternative pricing types.²

About allowable costs

- 1.8 Section 20 of the Act specifies when costs are allowable and sets out related provisions as follows:
- a. Section 20(1) of the Act requires the SSRO to issue guidance about determining whether costs are Allowable Costs under QDCs and QSCs.
 - b. Section 20(2) of the Act states that both parties need to be satisfied that costs are appropriate, attributable to the contract (or component) and reasonable in the circumstances (AAR).
 - c. Section 20(3) of the Act states that the Secretary of State and the contractor must have regard to the SSRO's guidance in determining whether a cost satisfies the AAR test.³
 - d. Section 20(4) of the Act states that a contractor (prime contractor or sub-contractor) may at any time be required to show that a particular cost is allowable.

Alternative pricing methods

- 1.9 There are a range of alternative pricing methods available and these are intended to be used in circumstances where application of the pricing formula may not be possible or because a fair price can be satisfactorily established by other means. This includes, for example, where prices are already regulated or where there is a market price which can act as a reference.
- 1.10 The price payable under a QDC or QSC, or a component of such a contract, which does not apply a default pricing method, must be determined in accordance with one or more of the alternative pricing methods specified in the Regulations. The SSRO has issued separate guidance on the application of these alternative pricing methods. The alternative pricing methods specified in the Regulations are:
- a. Commercial pricing;
 - b. Prices determined in accordance with law;
 - c. Previously agreed price;
 - d. Novated contract price;
 - e. Competed rates applied to uncompleted volumes (CRUV method);
 - f. Agreed changes to the contract profit rate; and
 - g. Aggregation of components.
- 1.11 The Schedule to the Regulations sets out how the price of a contract or component must be redetermined if the parties propose to make an amendment which affects the original contract price.

² <https://www.gov.uk/government/collections/allowable-costs> and <https://www.gov.uk/government/collections/alternative-pricing>

³ For practical purposes, the agreement of allowable costs will generally fall to an MOD officer with delegated authority from the Secretary of State. To reflect this, and where appropriate, this guidance refers to the MOD rather than the Secretary of State directly.

Components

- 1.12 Prior to 1 April 2024, there were limited opportunities for contracts to have more than one contract profit rate. With the introduction of alternative pricing methods, the legislation now provides a definition of a component. A component of a contract, means a part of a contract that is to be treated distinctly from other such parts in determining the price payable under a contract. A part of a contract is to be treated distinctly where either the Regulations contain provision to that effect (i.e. the effect of applying the Regulations is that part of the contract is treated distinctly in determining the price payable), or where the parties agree that it should. Regulation 9A specifies three circumstances in which a component must be formed:
- a. Where a part of the contract uses a different contract pricing method to the contract pricing method used in any other part of the contract. A contract pricing method means an alternative pricing method or a default pricing method.
 - b. Where a part of the contract has a different contract profit rate to the contract profit rate used in any other part of the contract.
 - c. Where it is mandated in the context of certain alternative pricing methods by regulation 19C(6), and paragraphs 14(7)(c) and 16(2)(b) of the Schedule (to the Regulations).⁴
- 1.13 It is ultimately for the parties to decide whether they wish to price a QDC or QSC in a way that results in components being formed. A component is only formed when both parties to the contract elect to price it in a manner which meets the requirements for a component to have been formed. The parties should ensure that they have identified components formed as the result of having made one or more pricing amendments.
- 1.14 There must be a demonstrable commercial purpose for agreeing to price a part of a contract distinctly from other parts i.e. forming components. For example, in order to price an amendment which only affects part of the contract price, or because it makes commercial sense to use different pricing methods for different parts of the contract. This requirement is to prevent the parties from dividing and further subdividing the contract price for no reason other than to avoid application of the final price adjustment. The parties should carefully consider how they structure components as dividing the contract into small components will add complexity to both pricing and reporting. In addition, a disproportionate approach to componentisation may not be consistent with value for money and fair and reasonable prices.
- 1.15 Where a contract has two or more components, the price payable under the contract is the sum of the price payable in respect of each component. Where an aggregated cost risk adjustment or incentive adjustment has been applied (see section 9 of the SSRO's guidance on Alternative Pricing), this also forms part of the price payable under the contract.
- 1.16 There are specific reporting requirements associated with pricing or amending a contract which results in components being formed, such as the need to report profit and cost in a way which make up parts of a component in certain prescribed circumstances. The parties should familiarise themselves with these requirements as part of any agreement to enter into or amend a contract in a way which results in components being formed. This is particularly important when making multiple contract pricing amendments, as whether or not each are treated distinctly for the purposes of pricing will determine the extent of the component level reporting that is required.

⁴ For more detail on this parties should review the schedule to the regulations. We intend to issue specific guidance on contract amendments in due course.

About the SSRO's pricing guidance

- 1.17 The SSRO issues guidance on the pricing of contracts under Sections 18(1), 20(1) and 35A of the Act. The SSRO may issue such guidance as it considers appropriate in relation to the application or interpretation of the Act or Regulations.
- 1.18 The Act also states that, in carrying out its functions, the SSRO must aim to ensure that:
- good value for money is obtained in government expenditure on QDCs and QSCs; and
 - persons (other than the Secretary of State) who are parties to QDCs and QSCs are paid a fair and reasonable price under those contracts.
- 1.19 It is a legal requirement to have regard to guidance the SSRO issues:
- about determining whether costs are Allowable Costs under qualifying defence contracts; and
 - in relation to any of the steps in the calculation of the contract profit rate.
- 1.20 This document provides guidance on the adjustments to make to the baseline profit rate when determining the contract profit rate for all QDCs and QSCs in respect of which the time of agreement (as defined in regulation 2(1)) is on or after the date this guidance takes effect. The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.⁵
- 1.21 This document updates the version published in January 2024⁶ to include amendments arising from feedback on our consultation on updated guidance based on changes to the Act and Regulations which came into force on 1 April 2024.
- 1.22 The SSRO has provided separate guidance that will assist the contracting parties to determine:
- the Allowable Costs of a contract; and
 - a price of a contract or component using an alternative pricing method.
- 1.23 Where terminology used in the guidance is defined in the Act and Regulation, it is explained where that might be helpful. The definitions of specific accountancy terms used can be found in the relevant accounting standards.⁷ Other text in this guidance should be read in accordance with its natural and ordinary meaning. It is important for understanding and interpretation that specific parts of the guidance are not read in isolation from other relevant parts, but instead within the context of the complete text.

Statutory reports

- 1.24 In relation to any QDC (or QSC) the primary contractor (or sub-contractor) must provide statutory reports as described in Part 5 of the Regulations. Suppliers may also be required to provide statutory reports on overheads as described in Part 6 of the Regulations. The SSRO has provided separate guidance that will assist defence contractors with preparing and submitting the reports required.⁸

5 SSRO Guidance on preparation and submission of contract reports, paragraphs 3.27 to 3.52, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

6 A guide to the changes which have occurred from the previous version is provided in Appendix A.

7 For example, those of the International Accounting Standards Board or Financial Reporting Council.

8 SSRO Reporting guidance on preparation and submission of contract reports, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars-and-associated-guidance>

- 1.25 Regulation 23(1) requires a contract pricing statement be provided for the QDC within one month of the initial reporting date. As stated in regulation 23(3)(b) the contract pricing statement must describe the calculation made under regulation 11 to determine the contract profit rate. This includes all adjustments that were made under steps 1 to 4 as detailed in this guidance document.

Contracts entered into prior to 1 April 2024

- 1.26 The price of a contract entered into prior to 1 April 2024 does not need to be redetermined unless the contract is amended in a way that affects the original contract price, in which case the new provisions will apply. As part of the legislative changes which came into force on 1 April 2024, the process for determining a contract profit rate was reduced from six steps to four. The four-step process must be applied to calculate the contract profit rate for a new contract or contract pricing amendments (or a component of these) entered into from 1 April 2024. For contracts or pricing amendments entered into before 1 April 2024 which applied a contract profit rate calculated using the six-step process, those contracts will continue to apply the same contract profit rate and no recalculation is required. Contracts with a POCO adjustment determined under the previous six step process are now subject to the new provisions to make an adjustment through allowable costs. Further guidance on this may be found in section 5 Part I of the Allowable costs guidance.
- 1.27 The SSRO funding adjustment has also been removed from the contract profit rate steps and contracts that are entered into or amended on or after 1 April 2024 will no longer be required to apply this adjustment. This change does not affect contract profit rates agreed prior to 1 April 2024.

Relevant records

- 1.28 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 MOD 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, the determination of Allowable Costs or the calculation of any final price adjustment (where applicable) following contract or component completion.

Opinions and determinations

- 1.29 The Act and Regulations provide for the SSRO to give opinions and make determinations on matters related to the pricing of proposed or agreed qualifying contracts upon referral by specified persons. Further details of the matters that may be referred and how the SSRO responds to referrals can be found in the SSRO's related procedural guidance.⁹

Non-referral advice

- 1.30 The SSRO can provide independent and authoritative advice on a confidential basis on any matter related to the interpretation and application of the regulatory framework for single source defence contracts. Either party to a current or proposed qualifying contract may seek non-referral advice on the application of the regulatory framework to that contract. Further information on the SSRO's non-referral advice service can be found on our website.¹⁰

⁹ <https://www.gov.uk/government/publications/guidance-provided-by-the-ssro>

¹⁰ <https://www.gov.uk/government/publications/the-ssros-non-referral-advice-service>

Key terms and definitions

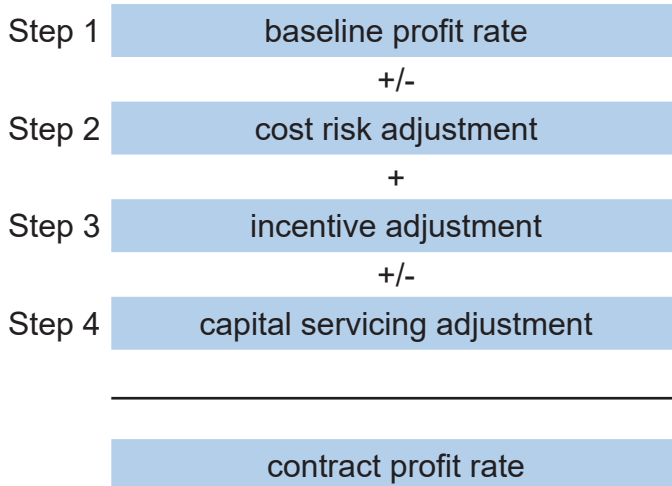
Allowable Costs	A term used for the costs incurred to deliver a QDC or QSC. Costs must be appropriate, attributable to the contract or component and reasonable in the circumstances to be considered allowable.
Alternative pricing method	An alternative pricing method is one of the seven non-default methods specified in the Regulations. These are: Commercial pricing, Prices determined in accordance with law, Previously agreed price, Novated contract price, Competed rates applied to uncompleted volumes, Agreed changes to the contract profit rate, and Aggregation of components.
Baseline profit rate (BPR)	Section 17(2) of the Act and regulation 11 of the Single Source Contract Regulations 2014 (the "Regulations") require that the contract profit rate for any qualifying defence contract that uses the pricing formula must be calculated by applying four steps. The first step requires taking the baseline profit rate which has been determined by the Secretary of State.
Capital employed (CE)	The total amount of capital used for the acquisition of profits or the capital investment necessary for a business to function. The SSRO defines this as the sum of fixed and working capital.
Capital servicing Adjustment	A term used to refer to fixed capital servicing adjustment and positive or negative working capital servicing adjustments collectively.
Cash and cash equivalents	A term used for current assets comprising receivables from other sources, short-term investment of money, and cash at hand and at bank.
Cost of production (CP)	A cost incurred by a business when manufacturing a good or providing a service before financing charges (interest). It is calculated as: cost of production = operating revenue (turnover) – operating profit/loss [EBIT].
Component	A component is a part of the contract that is to be treated distinctly from other such parts in determining the price payable under the contract. A part of a contract must be treated distinctly if Regulations require this, or may be treated distinctly by agreement of the parties.
Contract pricing method	The method that has been used to determine the price of the contract or component. For a qualifying defence contract, or qualifying sub-contract, this must be one of the default pricing methods or one of the alternative pricing methods.
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio can be used at the company level or can be used to attribute a proportion of the contractor's capital employed to individual contracts.
Current assets	A company's balance sheet items that represent the value of all assets that can reasonably expect to be converted into cash within one year.
Current liabilities	A company's balance sheet items that represent debts or obligations that are due within one year.
Default Pricing method(s)	There are six default pricing methods, all of which determine the contract (or component) price by the formula: (Contract profit rate x Allowable Costs) + Allowable Costs These six methods are: Firm Price, Fixed Price, Cost-plus, Estimate based fee, Volume-driven pricing method, and Target pricing method.

Defence Reform Act 2014	The primary legislation applicable to qualifying defence contracts.
Fixed capital	The total capital outlay that is invested in fixed assets, that stay in the business almost permanently – or at the very least, for more than one accounting period. The assets are considered fixed in that they are not used up in the actual production of a good or service but have a reusable value. Fixed capital investments are typically depreciated over a number of years.
Fixed capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in fixed capital.
Fixed capital servicing rate	The cost of servicing medium-term to long-term (i.e. more than one year) debts.
Government owned contractor rate	Where a qualifying defence contract is made between the Secretary of state and a company wholly owned by the UK Government, and both parties agree, the government owned contractor rate will be used instead of the baseline profit rate when calculating the contract price.
Negative working capital	A term used when the working capital number is negative. It results when a company holds less current assets than its current liabilities.
Negative working capital servicing adjustment	An adjustment that accounts for the rate of return (interest earned) which is attributed to investment in negative working capital (i.e. depositing creditors' cash on fixed-deposit accounts).
Negative working capital servicing rate	The rate of return (interest earned) on short-term (i.e. up to one year) bank deposits.
Positive working capital	A term used when the working capital number is positive. It results when a company holds more current assets than its current liabilities.
Positive working capital servicing adjustment	An adjustment that accounts for the cost of debt which is attributed to investment in positive working capital.
Positive working capital servicing rate	The cost of servicing short-term (i.e. up to one year) debts.
Qualifying defence contract (QDC)	Those contracts that fall within the scope of the Defence Reform Act and the Single Source Contract Regulations 2014, and that the Secretary of State has not exempted from being a QDC. In such contracts, where a default pricing method is used, an allowance for profit is calculated by reference to the baseline profit rate applicable at the time of pricing.
Qualifying sub-contract (QSC)	A qualifying sub-contract is a contract between a primary contractor and another contractor or between a sub-contractor and another contractor where it meets the definition laid down in section 28 of the Act and has been assessed and notified as a qualifying sub-contract pursuant to the procedure under section 29 of the Act.
Single Source Contract Regulations (SSCRs)	Secondary legislation in the form of a Statutory Instrument, enabled by the Defence Reform Act.
Single Source Regulations Office (SSRO)	The independent non-departmental public body established under the Defence Reform Act, whose functions are set out in the Act.
Working capital	A measure of both a company's efficiency and current/short-term (up to one year) financial health. It indicates how much capital a company uses in its day-to-day activities.

2. The contract profit rate

About the contract profit rate

- 2.1 The contract profit rate (CPR) is expressed as a percentage mark-up on Allowable Costs. Once applied to the allowable cost to determine the price payable under the contract or component, the contract profit rate does not change unless the parties agree otherwise through a contract amendment. For example, the contract profit rate for a contract entered into in 2024/25 does not change as a result of a new baseline profit rate being determined by the Secretary of State for 2025/26.
- 2.2 Section 17(2) of the Act and regulation 11 of the Regulations require that the CPR for any qualifying defence contract that uses a default pricing method must be calculated by taking the following four steps:



- 2.3 A worked example of the application of the four-step process is provided in section 7 of this document.
- 2.4 In accordance with section 30 of the Act, Part 2 of the Act and the Regulations “apply to qualifying sub-contracts (and to sub-contractors) as they apply to qualifying defence contracts (and to primary contractors).” This means that the four steps also apply to calculating the contract profit rate for qualifying sub-contracts.

3. Baseline profit rate (step 1)

Basis of the Baseline Profit Rate

- 3.1 Section 17(2) of the Act, and regulation 11(2), set out the requirement for the baseline profit rate as the first step in determining the contract profit rate to be applied in the pricing formula:
- “Take the baseline profit rate which is in force at the relevant time”.
- 3.2 The relevant time should be the time of agreement, as defined in regulation 2(1). The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.¹¹

Application of the Baseline Profit Rate

- 3.3 Where the pricing formula is applied, the calculation of a contract profit rate must begin with a baseline profit rate.

Determination of the Baseline Profit Rate

- 3.4 Section 19(1) of the Act requires the Secretary of State to determine the baseline profit rate for each financial year.
- 3.5 The SSRO is required annually to assess the figures used to determine the contract profit rate for pricing single source contracts. Section 19(2) of the Act requires that, for each financial year, the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate for QDCs. The SSRO has published information on its methodology to aid those who may wish to examine or replicate the approach taken.¹²
- 3.6 Section 19(4) of the Act states that the Secretary of State must publish the baseline profit rate for each financial year in the *London Gazette*, no later than 15 March in the preceding financial year. The baseline profit rates in force for the financial year commencing 1 April 2024 are:¹³

Category	2024/25 baseline profit rate
Baseline profit rate (the “standard” baseline profit rate)	8.24%
Baseline profit rate to apply to contracts between the Secretary of State and a company wholly owned by the UK Government and where both parties agree (the “government owned contractor rate (GOCR)”)	0.00%

- 3.7 The baseline profit rate to apply to contracts between the Secretary of State and a company wholly owned by the UK Government and where both parties agree (“government owned contractor rate”) will only apply to qualifying defence contracts where:
- the contract is between Secretary of State and a company incorporated under the Companies Act that is wholly owned by the UK Government; and
 - both parties to the contract agree that it should apply.
- 3.8 The guidance in this document pertaining to steps 2 to 4 applies irrespective of which baseline profit rate is taken.

¹¹ SSRO (2022) Reporting guidance on preparation and submission of contract reports – Version 11.1. paragraphs 3.9 to 3.31, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars- and-associated-guidance>

¹² SSRO (2024) 2024/25 baseline profit rate, capital servicing rates and SSRO funding adjustment methodology, available at <https://www.gov.uk/government/publications/2024-contract-profit-rate-assessment>

¹³ Figures for earlier years are available in the London Gazette.

4. Cost risk adjustment (step 2)

Basis of the cost risk adjustment

- 4.1 Section 17(2) of the Act, and regulation 11(3), set out the requirement for the cost risk adjustment:

“Adjust the baseline profit rate by an agreed amount which is within a range of plus or minus 25% of the baseline profit rate, so as to reflect the financial risks to the primary contractor of entering into the contract or component, taking into account the particular type of activities to be carried out by the primary contractor under that contract or component.”

- 4.2 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)”, but subject to such modifications as set out in the Regulations. The effect of regulation 64(4) is that, in the case of a qualifying sub-contract, the amount of the cost risk adjustment is agreed between the sub-contractor and the contracting authority, rather than the MOD, and this guidance must be modified by reading references to the Secretary of State as the contracting authority and references to the contractor as the sub-contractor.

Application of the cost risk adjustment

- 4.3 The calculation of the contract profit rate must include application of the cost risk adjustment, although the legislation is clear that the permissible range of adjustments includes a zero adjustment. The purpose of this guidance is to provide a consistent approach for contractors and the MOD to follow when agreeing a cost risk adjustment.
- 4.4 This guidance applies to the determination of the cost risk adjustment in pricing a component as it does for pricing a contract. Where a component is formed as the result of single or multiple pricing amendments, the parties should ensure the financial risk of entering into a component as a result of an amendment (or amendments) is reflected in agreeing the adjustment.

Determination of the cost risk adjustment

- 4.5 The cost risk adjustment guidance is principles-based rather than rules-based recognising that judgment needs to be exercised by the contracting parties. Contractors and the MOD must have regard to the following approach and principles when negotiating the cost risk adjustment to the baseline profit rate. The terms and conditions of each individual contract or component should always be considered when determining the adjustment.
- 4.6 The purpose of the cost risk adjustment is to incorporate into the contract profit rate an addition or deduction to reflect the financial risks to the contractor of entering into the contract or component, taking into account the particular type of activities to be carried out by the primary contractor under that contract or component.
- 4.7 Subject to the risk considerations of the relevant default pricing method(s) selected (see paragraphs 4.11-4.14), the starting point for the appropriate cost risk adjustment is that the adjustment should be zero. A positive or negative cost risk adjustment should apply where it can be reasonably justified and evidenced.
- 4.8 Adequate justification should be provided to support the calculation of the cost risk adjustment. In determining what type and standard of information is required, the relevant parties should take a proportionate approach considering:
- a. the specific requirements and circumstances of the contract or component;
 - b. the materiality of particular elements of the calculation; and
 - c. what it is reasonable to expect would be available.

Financial risk

- 4.9 For the purpose of this guidance, financial risk to the primary contractor means the uncertainty associated with the profitability of that contractor relating to the contract or components entered into. Financial risks to the primary contractor may result in consequential losses for the contractor outside of the direct profitability of the contract (for example, reputational risks) however, such consequential losses must be reasonably connected to the risks of entering into the contract or component. The adjustment should be agreed having regard to the principles stated in paragraph 4.23. The SSRO's Allowable Costs guidance states that for a contractor's estimated costs to be allowable costs the estimate should aim to anticipate the allowable costs the contractor will incur in performing the contract or component of such a contract. This may include an element of risk contingency. The inclusion of risk contingency in allowable costs does not mean a contract cannot have positive CRA. One is intended that the contractor covers their estimated allowable costs, and the other is to reward the contractor for taking on risk associated with that estimate through a higher contract profit rate.
- 4.10 Appendix C contains a list of risk factors the parties should consider when determining the cost risk adjustment. The list is not exhaustive and parties should still give specific consideration to the individual circumstances of the contract or component. The extent of risk against each category should guide the overall level of the CRA. For example, if each risk category tends to be low risk, then this would indicate a negative adjustment is required, and vice versa. The parties may also agree that other risk factors not listed are a relevant factor(s), though only if these relate to financial risk as defined above. The parties should only consider additional risk factors if they are satisfied that those risks are not covered by those listed in Appendix C.

Default pricing methods

- 4.11 There are six default pricing methods that the parties to a QDC may decide to use, as set out in regulations 10(4) to 10(11). All default pricing methods use either estimate or actual Allowable Costs in the price formula. The parties to a QDC may agree which of the default pricing methods is to be used for that contract or component of that contract. The parties can also agree a different contract pricing method for components of the contract (regulation 9B). This can be either another default pricing method or, where the circumstances described in an alternative pricing method pertain, an alternative pricing method.
- 4.12 The cost risk adjustment should take account of the overall extent of the risks as well as how those risks are allocated between the contracting parties. Each default pricing method determines how the risk of cost variance is allocated between the parties, alongside any other risk sharing provision of the contract. The cost risk adjustment should generally be in favour of the party that bears the larger burden of risk.
- 4.13 For qualifying defence contracts or components that apply the cost-plus or estimate-based fee default pricing methods (refer to regulation 10), the starting point for the cost risk adjustment should be minus 25 per cent, because the financial risk is held by the MOD. However, the MOD and the contractor should consider the financial risks, including consequential financial risks (explained at paragraph 4.9), having regard to the principles in paragraph 4.23 which may indicate some financial risk remains with the contractor.
- 4.14 For all other default pricing methods, the adjustment may vary from minus 25 per cent to plus 25 per cent, depending on the risk extent and allocation of financial risk between the contracting parties.

Type of activity

- 4.15 When determining a cost risk adjustment, the legislation requires contractors and the MOD to take into account the particular type of activities to be carried out by the primary contractor under that contract or component. The baseline profit rate reflects average rates of profit for activities relating to development, manufacture, support, maintenance and asset provision, which cover the majority of activities that are carried out under QDCs and QSCs.¹⁴ Application of the BPR alone is therefore sufficient in the majority of cases to have taken into account the activities to be carried out and, in those cases, no further adjustment is required.
- 4.16 Where activities under the contract or component differ substantially from those which underpin the baseline profit rate, e.g. contracts or components that are for standard construction, ancillary services or IT services, then consideration should be given to whether this indicates a cost risk adjustment should be made to result in a higher or lower contract profit rate. For example, some construction in a defence context, such as construction on a nuclear site, may have additional complexities or requirements that would make comparison to standard civilian construction inappropriate. The SSRO does not prescribe how an assessment should be undertaken but recommends a proportionate approach. An activity-based adjustment should only be made where there is clear evidence that not making such an adjustment would result in an unfairly high or low rate of profit on the contract or component.
- 4.17 The SSRO publishes activity descriptions which help guide its comparator company selection when making its annual rates/adjustment assessment.¹⁵ The contracting parties may find these can assist in considering how the cost risk associated with the activities under the contract or component may inform the CRA. For example, activities such as common construction or ancillary services tend to offer lower profits on average than the manufacturing and support type activities which make up the baseline profit rate. Other relevant risk factors and the specific circumstances of the contract or component should always be taken into account when agreeing a CRA, together with the principles set out in paragraph 4.23.

Negative adjustment

- 4.18 A negative adjustment should be made where the MOD and the contractor agree that the financial risks to the contractor of entering into the contract or component are negligible or that those risks have been transferred to another party, which may include the MOD.
- 4.19 For example, this may be justified where the MOD has taken on all or most of the financial risks of entering into the contract or component. Adequate justification and explanation which serves as evidence should be provided in respect of the risk categories in appendix C and any other relevant financial risks to support such assessments, taking into account the selected default pricing method for the contract or component.
- 4.20 For some qualifying defence contracts most of the financial risk associated with sub-contracts is held by, or assigned to, the MOD. In these cases, the cost risk adjustment should reflect the reduced financial risk to the primary contractor associated with the sub-contract(s).

Positive adjustment

- 4.21 A positive adjustment should be made where the MOD and the contractor agree there are elevated levels of financial risk to the primary contractor of entering into the contract or component.

¹⁴ For further information on the Baseline profit rate and the comparable activity groups, see the SSRO's Single Source baseline profit rate and capital servicing rates methodology <https://www.gov.uk/government/collections/profit-rate>

¹⁵ The methodology and factsheets containing full activity descriptions may be found on the 2024 contract profit rate recommendation published on the SSRO's website.

4.22 For example, this may be justified where the risk is held by the contractor, and not the MOD, including where financial risks to the primary contractor from entering into the contract or component might have a tangible negative impact on shareholder value, as well as instances where the actual costs cannot be estimated with sufficient accuracy such that they may deviate significantly from the estimated allowable costs and/or are not in the control of the contractor and therefore the risk of variances cannot be mitigated. Adequate justification and explanation which serves as evidence should be provided in respect of the risk categories in appendix C and any other relevant financial risks to support such assessments, taking into account the selected default pricing method for the contract or component.

Principles to consider

- 4.23 The contractor and the MOD must have regard to the following principles (which are not exhaustive) when determining the cost risk adjustment. The adjustment should:
- be based upon an assessment of the financial risks to the primary contractor of entering into the contract or component, taking into account the type of activity carried out under that contract or component (refer to 4.15);
 - only consider the financial risk of entering into the contract or component;
 - give consideration to the contract pricing method (refer to 4.11);
 - not be used to take into account risk that should be estimated and included in the allowable costs (refer to Allowable costs guidance, Section 5 part H);
 - take into account the relative likelihood of financial risks materialising, such that the contractor's financial benefit of entering into the contract may be lower or higher than estimated;
 - take into account the extent to which the probability and expected impact of financial risk has been mitigated, eliminated or transferred to another party, for example, through insurance, or where sub-contract risk is 'passed through' to a party other than the prime contractor (refer to allowable costs guidance Section 5, part H3);
 - be based on assumptions agreed by the parties and/or evidence that reflects the overall approach to risk assessment such as risk allocation, risk management, and risk registers (and be recorded in the contract risk register and in accordance with the relevant statutory reporting requirements¹⁶); and
 - not take into account uncertainty resulting from force majeure, for example, an unforeseeable natural disaster or pandemic.

Agreement of Cost risk adjustment rates on a group basis:

- 4.24 Regulation 13 applies where the MOD proposes to enter into two or more qualifying defence contracts with the same primary contractor ("the prospective contractor") within the period of one year ("the relevant year").
- 4.25 The prospective contractor and the MOD may agree amounts which may be used as the cost risk adjustment (step 2), as the deduction from costs associated with group profits (regulation 13A), or as the capital servicing adjustment (step 4) for any qualifying defence contract entered into between the prospective contractor and the MOD within the relevant year.
- 4.26 The guidance in this document applies to rates agreed on a group basis for multiple contracts as it applies to the contract profit rate for a single contract.

¹⁶ See section 4 paragraphs 4.69-4.77 of the SSRO's Reporting guidance on preparation and submission of contract reports, which deals with reporting of assumptions..

4.27 Note that rates may not be agreed on a group basis for qualifying sub-contracts.

Cost risk adjustment and the aggregation of components

4.28 Regulation 19G provides that when certain conditions are met, the total price of the contract may be further adjusted in order to reflect the financial risk to the primary contractor of entering into the contract, taking account of the requirement to integrate the outputs of different components of the contract. This adjustment is called the total cost risk adjustment and further guidance on its application is set out in section 9 of the guidance on alternative pricing. The total cost risk adjustment is not part of the 4 steps to determine the contract profit rate and is not subject to the Regulations or guidance that govern that process. However, the extent of any cost risk adjustment made under the four steps will determinate the extent of any total cost risk adjustment that is possible.

Cost risk adjustment and costs associated with group profits

4.29 Section 20(2A) of the Act provides for a reduction to the Allowable Costs under a qualifying defence contract or component of such a contract so as to ensure that profit arises only once in the allowable costs that relate to the price payable under any group sub-contract (including any further group sub-contract) (GSC and FGSC). For the purpose of this guidance, this reduction is called the Profit on Costs Once (POCO) adjustment.

4.30 Differences in the rates of profit between the QDC, GSC and FGSC may arise due to differences in the financial risk each contracting entity is exposed to by entering into the contract, and therefore reflected in the CRA of each contract. The POCO adjustment operates in such a way that the price of the prime contract includes an amount of profit which reflects the contract profit rate of each contract in the supply chain **applied once to its own allowable costs** (i.e., not any flowing up the supply chain). Therefore, it is particularly important to ensure when setting the CRA of the QDCs prime contract that it reflects all relevant risks the prime contractor is exposed to as part of the group (and that may be shared with the GSC and FGSC), taking account of the reduction in Allowable Costs for POCO. Section I of the SSRO's Allowable Costs guidance sets out the process of determining the POCO adjustment.

5. Incentive adjustment (step 3)

Basis of the incentive adjustment

- 5.1 Section 17(2) of the Act, and regulation 11(6), set out the requirements for the incentive adjustment:

“Where the Secretary of State determines that the amount resulting from step 2 should be increased so as to give the primary contractor a particular financial incentive as regards the performance of provisions of the contract or component specified by the Secretary of State, increase that amount by an amount (“the incentive adjustment”) specified by the Secretary of State, that amount not to exceed two percentage points.”

- 5.2 This document provides guidance for the MOD to use when determining when to apply the incentive adjustment to a QDC or component of a QDC and what to consider when setting the adjustment between zero and two percentage points.
- 5.3 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)”, but subject to such modifications as set out in the Regulations. The effect of regulation 65(4) is that, in the case of a qualifying sub-contract, the incentive adjustment is determined by the contracting authority.

Application of the incentive adjustment

- 5.4 The incentive adjustment guidance is principles-based rather than rules-based recognising that judgment needs to be exercised by the contracting parties.
- 5.5 It may be desirable for the MOD to include a positive incentive in certain circumstances. The incentive adjustment is not automatic and will be applied exceptionally in the determination of a contract profit rate.
- 5.6 The incentive adjustment can be applied to any qualifying defence contract or component of such a contract, that is priced using the pricing formula.
- 5.7 The incentive adjustment is applied at the MOD’s discretion and must give effect to enhancements in performance of provisions under the contract or component. The incentive adjustment must not be applied for any purpose other than that which is stated in regulation 11(6).
- 5.8 The incentive adjustment must relate to the performance of the contract or component to which it applies and must only be used for delivering performance on a contracted performance metric included within the contract or component to which the incentive adjustment applies. For example, if a contract contains two components A and B, then an incentive adjustment included in the contract profit rate for component A must relate to the performance of that component and not component B. Separate provision is made under the Aggregation of components contract pricing method for an incentive adjustment related to performance under multiple components (see section 9 of the SSRO’s Alternative pricing guidance).

Determination of the incentive adjustment

- 5.9 The incentive adjustment included in the contract profit rate for a contract or component cannot exceed two percentage points, as provided for in regulation 11(6).
- 5.10 The contractor and the MOD must have regard to the following principles (which are not exhaustive) when determining the amount of the incentive adjustment:
- a. The basis on which any costs incurred by the contractor associated with the activities or enhanced performance delivery will be treated, should be agreed by the parties prior to an agreement to include an incentive adjustment in the contract profit rate.
 - b. The performance metric to which the incentive adjustment is linked must be outcome based. Outcome based means being linked to the achievement of a specific result(s) arising from an activity or initiative. The incentive adjustment must not be linked solely to the conduct of an activity or initiative itself.
 - c. The incentive adjustment must relate to performance enhancements which benefit the MOD or wider government policy outcomes. The additional value delivered by the achievement of incentivised elements must be tangible and demonstrable.
 - d. The link between the incentive adjustment and performance must be simple and measurable. The criteria for achievement must be measurable and set objectively.
 - e. The parties should establish the mechanism by which the payment of additional profit will incentivise the contractor to pursue the stated performance objectives.
 - f. The timing of incentive payments related to the incentive adjustment should reflect the accrual of enhanced performance to the MOD.
 - g. The link between the incentive adjustment and performance, and the criteria for achievement and payment, must be agreed prior to the inclusion of any incentive adjustment within the contract (or component) profit rate, be clearly stated in the contract and be clear to all parties at the time of agreement. This includes:
 - i. the required level of performance;
 - ii. how said performance will be demonstrated;
 - iii. when it will be measured; and
 - iv. if incentivised performance is delivered, when any associated incentive payments will be made. The timing of incentive payments should reflect the accrual of enhanced performance to the MOD.
 - h. Where a contractor uses the government owned contractor rate and seeks to achieve a zero rate, the incentive adjustment applied may be set to reflect the baseline profit rate and the cost risk adjustment selected at steps 1 and 2.
- 5.11 The incentive adjustment must not be linked to legislative obligations. An incentive adjustment must not be given for compliance with the Act, Regulations, or other legislative obligations.
- 5.12 The incentive adjustment should not be linked to a reduction in the allowable costs of the contract, or the contract or component price. Reducing allowable costs or the price of a contract or components should be rewarded via the selected default pricing method.
- 5.13 Parties should consider how to treat any costs incurred in unsuccessful pursuit of incentivised performance. In the event of a referral on the allowability of such costs, the SSRO may consider any discussions that were held between the parties.

- 5.14 Where the parties select the Government Owned Contractor Rate (GOCR) as the Baseline Profit Rate, then no incentive adjustment should be applied. This is because the GOCR exists to allow a contract profit rate of zero on the contracts to which it applies.

The incentive adjustment and the aggregation of components

- 5.15 Regulation 19G provides that when certain conditions are met, the total price of the contract may be further adjusted using the Aggregation of components pricing method. This adjustment is called the total incentive adjustment and further guidance on this is set out in section 9 of the SSRO's guidance on Alternative pricing. The total incentive adjustment is not part of the 4 steps to determine the contract profit rate and not subject to the Regulations or guidance that govern that process. However, the extent of any incentive adjustment made under the four steps will determine the extent of any total incentive adjustment that is possible.

6. Capital servicing adjustment (step 4)

Basis of capital servicing adjustment

6.1 Section 17(2) of the Act and regulation 11(7) set out the requirement for the capital servicing adjustment:

“Take the amount resulting from step 3 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 or component.”

6.2 Regulation 11(8) requires that:

“In agreeing the capital servicing adjustment, the primary contractor and the Secretary of State:

- a. must have regard to the capital servicing rates in force at the time of the agreement;
- 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 or component; and
- 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 or component.”

6.3 The SSRO has provided separate guidance that will assist the contracting parties to determine the time of agreement for a particular QDC or QSC.¹⁷

6.4 The three capital servicing rates published by the Secretary of State that are in force for the financial year commencing 1 April 2024 are:¹⁸

Item	Rate
Fixed capital	3.26%
Positive working capital	3.10%
Negative working capital	1.61%

6.5 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)”, but subject to such modifications as set out in the Regulations. The effect of regulation 65 is that, in the case of a qualifying sub-contract, the capital servicing adjustment is agreed between the sub-contractor and the contracting authority, rather than the MOD, and this guidance must be modified by reading references to the Secretary of State as the contracting authority and references to the contractor as the sub-contractor.

Application of the capital servicing adjustment

6.6 The calculation of the contract profit rate must include consideration of the capital servicing adjustment. The purpose of this guidance is to provide a consistent approach for contractors and the MOD to follow when agreeing a capital servicing adjustment.

¹⁷ SSRO (2022) Reporting guidance on preparation and submission of contract reports – Version 11.1, paragraphs 3.9 to 3.31, available at <https://www.gov.uk/guidance/contract-and-supplier-reporting-defcars- and-associated-guidance>

¹⁸ Figures for earlier years are available in the London Gazette

- 6.7 Contracts or components which apply the 2024/25 baseline for profit rate of 8.24% should follow the guidance in paragraphs 6.9 to 6.17 in determining the appropriate adjustment at step 4. 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 4 can be applied for a contract. This process is set out in SSRO (2024) *Single Source Baseline Profit Rate, Capital Servicing Rates and Funding Adjustment Methodology*.
- 6.8 Contracts or components which apply the 2024/25 baseline profit rate of 0.0% for contracts between the MOD and a company wholly owned by the UK Government, and where both parties agree, should follow the guidance in paragraphs 6.18 to 6.21 in determining the appropriate step 4 adjustment.

Determination of the capital servicing adjustment for contracts applying the standard baseline profit rate

- 6.9 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 or component (the "CSA calculation").
- 6.10 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 B to this guidance.
- 6.11 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 or component. On this basis borrowing costs should not form part of allowable costs.
- 6.12 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 or component. 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.
- 6.13 The contractor and the MOD must use the information of the unit of business which they agree is most relevant to the contract or component. 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.
- 6.14 Where the contract is made up of more than one component which applies the default pricing method, a suitable capital servicing adjustment must be determined for the contract profit rate of each component. The parties may agree the capital servicing adjustment is the same for more than one component if the capital intensity of each component is the same or similar. For example, if those components are being delivered by the same business unit. The parties should take a proportionate approach to the agreement of multiple component level capital servicing adjustments.
- 6.15 The calculation has two elements: the capital employed and the cost of production. Both elements 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 elements of capital employed, for example manufactured inventory, may need adjustment to ensure they are valued on the same cost basis.

- 6.16 While a zero rate for adjustment is permissible, applying the calculation correctly will only result in a capital servicing adjustment of zero in exceptional circumstances. Where contractors calculate a zero or negative capital servicing adjustment rate, we recommend that contractors double check their calculations.
- 6.17 Regardless of which financial periods are described in the records from which data is drawn to determine the capital employed and cost of production, the capital servicing rates to which the relevant parties must have regard are those in force at the time of the agreement, not those relating to any other period.

Determination of the capital servicing adjustment for contracts applying the government owned contractor rate

- 6.18 This guidance sets out the approach that should be followed to calculate the capital servicing adjustment when the GOOCR has been applied at step 1. The rate for such contracts entered into in 2024/25 is 0.00%.
- 6.19 The intention is that this rate can be used to set contract profit rates at a rate that does not result in such companies making a profit. A contract or component that makes no profit will make no return on capital. In these circumstances the parties should set the value at step 4 such that when applied to the result of step 3 the resulting amount is zero.
- 6.20 There may be circumstances where the parties agree that the contract price should include a cost of capital employed. In these circumstances the parties must agree the appropriate charge and how it should be captured in the contract price.¹⁹ For example, this may require the following in respect of a cost of capital charge:
- a. an amount estimated by applying the approach to step 4 set out in the 4 computations on page 28, using a set of values for the input parameters specified and agreed between the parties. The parties should apply the guidance in a way that reflects the financing structure of the wholly UK government owned contractor under consideration; or
 - b. an amount established through other reasonable means agreed by the parties to reflect the actual cost of capital employed.
- 6.21 The Allowable Cost guidance makes clear that borrowing costs (a cost of capital employed) are generally not allowable because they are dealt with at step 4. However, in the case where the GOOCR is applied and the parties agree that the contract price should include a cost of capital employed the parties may consider it is preferable for the cost to be included in allowable costs. In the circumstances where the costs of capital employed are allowable costs no further adjustment should be made at step 4.

Capital servicing adjustment rates agreed on a group basis:

- 6.22 Regulation 13 applies where the MOD proposes to enter into two or more qualifying defence contracts with the same primary contractor (“the prospective contractor”) within the period of one year (“the relevant year”).
- 6.23 The prospective contractor and the MOD may agree amounts which may be used as the cost risk adjustment (step 2), as the deduction from costs associated with group profits (regulation 13A), or as the capital servicing adjustment (step 4) for any qualifying defence contract entered into between the prospective contractor and the MOD within the relevant year.
- 6.24 The guidance in this document applies to rates agreed on a group basis for multiple contracts as it applies to the contract profit rate for a single contract.
- 6.25 Note that rates may not be agreed on a group basis for qualifying sub-contracts.

¹⁹ For example, it is a requirement of Managing public money that charges within and among central government organisations should normally also be at full cost, including the standard cost of capital (currently at 4%)

Calculation of capital employed

- 6.26 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. Illustrative worked examples can be found at the end of this section.
- 6.27 Capital employed should be computed as the total assets less total liabilities, excluding interest-bearing liabilities, of the business unit.
- 6.28 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.
- 6.29 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.
- 6.30 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:
- a. items not representing capital employed in normal operations, for example:
 - 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:
 - 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 4 adjustment.
- 6.31 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 not in excess of the amount required for normal operations of the business unit may be included as an element of capital employed. This amount should not include any surplus pooled funds that are utilised by another entity.
- 6.32 Exceptional further adjustments may be agreed with the MOD 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:
- a. where a pervasive change is expected to occur that will affect the capital employed of the unit of business; or

- b. where considering the timing of a significant transaction during the period will give a more precise average.

Fixed and working capital

- 6.33 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.
- 6.34 Adequate justification should be provided to support the calculation of both fixed and working capital. In determining what type and standard of information is required, the relevant parties should take a proportionate approach considering:
 - a. the specific requirements and circumstances of the contract;
 - b. the materiality of particular elements of the calculation; and
 - c. what it is reasonable to expect would be available.

Calculation of cost of production

- 6.35 Cost of production is the cost incurred by the functioning of a business before financing charges.
- 6.36 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.
- 6.37 The initial definition of cost of production is operating revenue less operating profit/loss. The following items should then generally be excluded:
 - a. borrowing costs;
 - b. costs related to items excluded from capital employed; and
 - c. costs whose inclusion would not result in an appropriate step 4 adjustment.
- 6.38 Where exceptional adjustments have been made to capital employed in accordance with paragraph 6.32, a corresponding adjustment to cost of production may be required.

Computation 1
Determine ratio of capital employed to cost of production
Fixed capital value
Plus
Working capital value
<u>EQUALS</u>
Capital employed
Divide into
Cost of production
<u>EQUALS</u>
Cost of production as a proportion of capital employed (CP:CE)

Computation 3
Apply capital servicing rates
Fixed capital as a proportion of capital employed
Multiplied by
Fixed capital servicing rate
PLUS
Working capital (positive) as a proportion of capital employed
Multiplied by
Positive working capital servicing rate
<u>OR (if working capital is negative)</u>
Working capital (negative) as a proportion of capital employed
Multiplied by
Negative working capital servicing rate
<u>EQUALS</u>
Capital servicing rate*

Computation 2
Determine the individual proportions of capital employed
Fixed capital value
Divided by
Capital employed
<u>EQUALS</u>
Fixed capital as a proportion of capital employed
Working capital value
Divided by
Capital employed
<u>EQUALS</u>
Working capital as a proportion of capital employed

Computation 4
Calculate the capital servicing adjustment for step 4
Capital servicing rate
Divided by
Cost of production as a proportion of capital employed (CP:CE)
<u>EQUALS</u>
Capital servicing adjustment to be used in step 4 of CPR

7. Calculation of the Contract profit rate

- 7.1 Having determined the amounts of each adjustment, the final stage is combining the four steps to determine the contract profit rate.
- 7.2 Below are two illustrative examples of how to put together the values determined by steps 1-4 to calculate the contract profit rate, one with a negative CRA and a positive CSA, and one with a positive CRA and a negative CSA.

Example 1

		Example Adjustment 1	Running total CPR	
Step 1	baseline profit rate	8.24%	8.24%	Step 1 requires taking the baseline profit rate determined by the Secretary of State. For 2024/25 this is 8.24%
	+/-			
Step 2	cost risk adjustment	-2.06pp	6.18%	This can range from minus to plus 25% of the BPR. For 2024/25 this range is -2.06pp to +2.06pp (+/-8.24 x 0.25).
	+			
Step 3	incentive adjustment	1.00pp	7.18%	The adjustment may be zero up to a maximum of 2 percentage points (pp)
	+/-			
Step 4	capital servicing adjustment	3.01pp	10.19%	A separate worked example in Appendix B on the calculation of the CSA.
	contract profit rate	10.19%	10.19%	

Example 2

			Example Adjustment 1	Running total CPR	
Step 1	baseline profit rate		8.24%	8.24%	Step 1 requires taking the baseline profit rate determined by the Secretary of State. For 2024/25 this is 8.24%
	+/-				
Step 2	cost risk adjustment		2.06pp	10.30%	This can range from minus to plus 25% of the BPR. For 2024/25 this range is -2.06pp to +2.06pp (+/-8.24 x 0.25).
	+				
Step 3	incentive adjustment		0	10.30%	The adjustment may be zero up to a maximum of 2 percentage points (pp)
	+/-				
Step 4	capital servicing adjustment		2.5pp	12.8%	A separate worked example in Appendix B on the calculation of the CSA.
	contract profit rate		12.8%	12.8%	

Appendix A: Changes from previous version

A.1 The table below highlights changes from version 8 of the guidance to this version.

A.2 References in footnotes have also been updated to the latest applicable versions.

Key to changes:

No change
Deleted
Revised
Added

Section/paragraph 2024 v8	Section/paragraph 2024 v8.1
1. Introduction	
1.1-1.2	1.1-1.2
1.3-1.4	1.3-1.4
1.5	1.5
NA	1.6
1.6	1.7
1.7-1.8	1.8-1.9
1.9	1.10
NA	1.11
1.10-1.12	1.12-1.14
1.13-1.15	1.15-1.17
1.16	1.18
1.19	1.21
1.21-1.22	1.23-1.24
1.23	1.26
1.26	1.28
NA	1.30-1.34
Key terms and definitions	Key terms and Definitions
Baseline profit rate	Baseline profit rate
Component	Component
Government owned contractor rate	Government owned contractor rate
Secretary of State	Secretary of State
2. The contract profit rate	
2.1-2.2	2.1-2.2
2.3	2.3
2.4	2.4
3. Baseline Profit Rate	
3.1-3.5	3.1-3.5

Section/paragraph 2024 v8	Section/paragraph 2024 v8.1
3.6-3.7	3.6-3.7
3.8	3.8
4. Cost risk adjustment (step 2)	
4.1	4.1
4.2-4.3	4.2-4.3
4.4	4.4
4.5	4.5
4.6-4.8	4.6-4.8
4.9-4.11	4.9-4.11
4.12-4.13	4.12-4.13
4.14	4.14
4.15-4.16	4.15-4.16
4.17	4.17
4.18	4.18
4.19-4.26	4.19-4.26
4.27-4.29	4.27-4.29
5. Incentive adjustment (step 3)	
5.1	5.1
5.2	5.2
5.3-5.4	5.3-5.4
5.5-5.8	5.5-5.8
5.9	5.9
5.10	5.10
5.11-5.13	5.11-5.13
6. Capital servicing adjustment (step 4)	
6.1-6.4	6.1-6.4
6.5-6.6	6.5-6.6
6.7	6.7
6.8	6.8
6.9-6.12	6.9-6.12
6.13	6.13
6.14-6.21	6.14-6.21
6.22-6.23	6.22-6.23
6.24-6.25	6.24-6.25
6.26	6.26
6.27-6.29	6.27-6.29
6.30	6.30
6.31	6.31
6.32	6.32
6.33-6.38	6.33-6.38
7 – Final calculation of the CPR	

Section/paragraph 2024 v8	Section/paragraph 2024 v8.1
Appendix A- Changes from previous versions	Appendix A- Changes from previous versions
Appendix B Worked example for capital servicing adjustment	Appendix B Worked example for capital servicing adjustment
Appendix C – Descriptions of financial risks	Appendix C – Descriptions of financial risks

Appendix B: Worked example for capital servicing adjustment

- B.1 The worked example shown below incorporates the four main computations that need to be followed in order to determine the capital servicing adjustment in step 4 of the contract profit rate.
- B.2 To aid the worked example shown below we have provided the following illustrative information:
1. Total capital employed:
 - Example a): £4,000,000;
 - Example b): £4,500,000;
 - Example c): £2,500,000; and
 - Example d): (£1,000,000).
 2. Fixed capital:
 - Examples a), b), and c): £3,000,000; and
 - Example d): £1,500,000.
 3. Working capital (by way of calculation i.e. total capital employed less fixed working capital):
 - Example a): £1,000,000;
 - Example b): £1,500,000;
 - Example c): (£500,000); and
 - Example d): (£2,500,000).
 4. Cost of production: £6,000,000 (in all four examples).
 5. This worked example uses the following published capital servicing rates for 2024/25:
 - Fixed capital servicing rate: 3.26%;
 - Working capital servicing rate for positive working capital: 3.10%; and
 - Working capital servicing rate for negative working capital: 1.61%.

	Example (a)	Example (b)	Example (c)	Example (d)
Computation 1				
CP: CE ratio calculation:				
(a) Fixed capital	£3,000,000	£3,000,000	£3,000,000	£1,500,000
(b) Working capital	£1,000,000	£1,500,000	-£500,000	-£2,500,000
(c) Total capital employed	£4,000,000	£4,500,000	£2,500,000	-£1,000,000
(d) Total cost of production	£6,000,000	£6,000,000	£6,000,000	£6,000,000
(e) CP:CE ratio (D/C)	1.5	1.3	2.4	-6.0
Computation 2				
(f) Fixed capital as a proportion of capital employed (a/c)	0.75	0.67	1.20	-1.50
(g) Positive Working Capital as a proportion of capital employed (b/c)	0.25	0.33	-	-
(h) Negative working capital as a proportion of capital employed (b/c)	-	-	-0.20	2.50
Capital servicing rates (published annually. 2024/25 rates are used for this worked example)				
(i) Fixed capital servicing rate	3.26%	3.26%	3.26%	3.26%
(ii) Positive working capital servicing rate	3.10%	3.10%	3.10%	3.10%
(iii) Negative working capital servicing rate	1.61%	1.61%	1.61%	1.61%
Computation 3				
Fixed capital servicing allowance (f x i)	2.45%	2.17%	3.91%	-4.89%
Positive working capital servicing allowance (g x ii)	0.78%	1.03%	-	-
Negative working capital servicing allowance (h x iii)	-	-	-0.32%	4.03%
Capital servicing allowance "x"	3.22%	3.21%	3.59%	-0.87%
Computation 4				
Capital servicing adjustment for step 4 ("x" / e)	2.15%	2.41%	1.50%	0.14%
Computation 5				
Fixed Capital element of Capital Servicing Adjustment (i/(d/a))	1.63%	1.63%	1.63%	0.82%
Working Capital element of Capital Servicing Adjustment (positive)(ii/(d/b))	0.52%	0.78%		
Working Capital element of Capital Servicing Adjustment (negative) (iii/(d/b))			-0.13%	-0.67%
Capital servicing Adjustment Combined Fixed & Working Capital (Total)	2.15%	2.41%	1.50%	0.14%

Appendix C: Descriptions of financial risks

C.1 This section sets out illustrative descriptions of the categories of risk that might be considered as financial risks for the purposes of the Cost Risk Adjustment. Table A provides the description of each risk, as described by the MOD, and our proposed description for the purpose of guidance. This list is not exhaustive, and parties are encouraged to use their judgement when considering what constitutes the Financial risks of entering into a contract or component, taking into account the activities to be carried out under the contract or component.

Table A: Categories of risk

Category	Risk Description
Technical risk	<p>Risk category one: Technical risk</p> <p>Technical risk is the risk associated with the availability, complexity, maturity and maintenance of technical capabilities which may give rise to cost risk. The contracting parties may take account of the following considerations in relation to the delivery of the contract or component to determine risk adjustment to the extent that they are associated with the delivery of the contract:</p> <ul style="list-style-type: none"> • The contractors' knowledge of or familiarity with the technology associated with the contract and maturity of that technology. • The age, condition and tailoring of any systems or platform(s). • The availability and access to specialised skills the contractor requires. • The contractual requirements in respect of technical performance, engineering tolerances and the contractor's familiarity with their execution. • The complexity, familiarity and ease of integration of the capabilities with current systems or platforms.

Category	Risk Description
Delivery and integration	<p>Risk category two: Delivery and integration</p> <p>This risk category centres on complexity in the supply chain and flexibility in delivery schedule. The contracting parties may take account of the following considerations to determine the cost risk adjustment to the extent that they are associated with the delivery of the contract or component:</p> <ul style="list-style-type: none"> • The availability of materials, bought-in labour, infrastructure and other resources including dependencies on third parties and particular infrastructure. • The length of the supply chain in terms of numbers of suppliers. • The number and fragility of suppliers of key inputs to the contract. • The complexity and extent of interdependencies within the supply chain.
Efficiency and performance	<p>Risk category three: Efficiency and performance</p> <p>This risk category centres on efficiency and performance of the contractor and how this has been reflected in the contract price and delivery schedule. The contracting parties may take account of the following considerations to determine the cost risk adjustment to the extent that they are associated with the delivery of the contract or component:</p> <ul style="list-style-type: none"> • The extent of efficiency gains to be made that have been assumed and reflected in the allowable costs of the contract or component. • The availability of benchmarks or knowledge of similar contracts upon which to base efficiencies assumed in the contract price and schedule. • The extent of flexibility, contingency or challenge within contracted delivery schedule. • Degree to which the mechanisms which are intended to deliver efficiencies are newly developed or well understood.

Category	Risk Description
Contract Conditions, Quality, and Reputational risk	<p>Risk category four: Contract Conditions, Quality, and Business Level risk</p> <p>This risk category centres on the conditions of the contract, the quality of the outputs and external risks the contractor may expose themselves to by entering into the contract. The contracting parties may take account of the following considerations to determine the cost risk adjustment:</p> <ul style="list-style-type: none"> • Whether the contract contains warranties and/ or guarantees for work and/or liquidated damages clauses that create high risk of the contractor being exposed to claims or other financial liability. • The extent of regulation which relates to the contractor’s operations in delivering the contract or component which seems susceptible to change with consequential financial impacts. • Exposure to the effects of currency exchange rate variations that relate to the costs of the contract or component. • Extent to which the contractor is exposed to unusual risk and the extent to which this risk is shared with the MOD. • Reputational risks arising as a result of entering into the contract (or component) or fulfilling the obligations of the contract (or component).