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.*

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 Qualifying Defence Contracts (QDCs) and Qualifying Sub-Contracts (QSCs).

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

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

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

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

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

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

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

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

The baseline profit rate

1. How is the baseline profit rate calculated?

The baseline profit rate (BPR) is an average of the actual profit rates of companies whose activities are comparable to those that contribute to the delivery of MOD single source contracts. The SSRO categorises those activities under the headings ‘Develop and Make’ and ‘Provide and Maintain’ and companies are selected into those comparator groups based on the nature of their activities. The 2023/24 BPR is the rolling average of the underlying rate for the current year and two previous years, excluding data from the period of the COVID-19 pandemic (see question 3).

2. Why has baseline profit rate changed this year?

The Defence Reform Act 2014 (the Act) requires the SSRO to provide the Secretary of State with an assessment of the appropriate baseline profit rate for each financial year. The BPR can change annually to reflect what markets’ have recently determined rates of profit on comparable activities, which we consider to be a fair basis for the assessment. Year on year changes may be small but accumulate over time to ensure the profit of single source contracts do not drift away from competitive market outcomes. The change this year is due to historically high profit rates of five years ago dropping out of the calculation as it is updated to include more recent data. The latest rates remain amongst the highest that the methodology has observed, explaining the limited change.

The baseline profit rate for 2023/24 is 8.29 per cent. This is higher than the 8.07 per cent recommended by the SSRO for 2022/23. However it should be noted that, for 2022/23 the Secretary of State went further than the SSRO to remove the effects of COVID-19 for the BPR by using the average of the three years prior to 2021 in the calculation. This resulted in the BPR remaining at the same level as the SSRO assessed for the prior year of 8.31 percent (see figure 1).

The baseline profit has reduced by 0.02 percentage points, because the 2019/20 underlying rate of 8.50 per cent has been replaced in the three-year average with this year’s underlying rate of 8.44 per cent. This year’s underlying rate of 8.44 per cent is up on last year’s 7.35 per cent, primarily due to improved profit rates of the comparator companies that have been carried over from last year. 8.44 per cent is averaged with underlying rates for 2021/22 and 2020/21 (8.19 per cent and 8.23 per cent respectively) to calculate the BPR. The averaging excludes the underlying rate from last year (FY2020) which coincides with the peak of the COVID-19 pandemic, which the Secretary of State also excluded last year (see question 3).

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

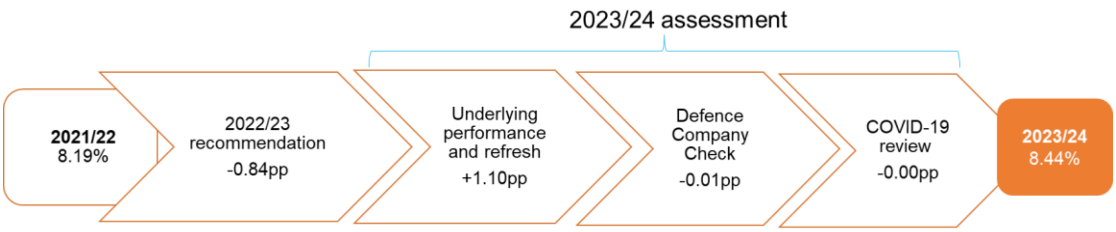


Figure 1: change in the underlying rate

3. How has the SSRO responded to the Secretary of State's request to return to a market based benchmark based on our established methodology that reflects their intention to remove the impact of COVID-19.

The SSRO launched a consultation in June 2022 on the approach to the 2023/24 baseline profit rate assessment. The outcome of the consultation was that the SSRO would proceed with this year's assessment in line with the Secretary of State's announcement.

The SSRO's assessment has therefore returned to our established methodology which is a market benchmark of actual company profit rates, which excluded data from the financial year 2020 (FY2020).[1]

The available macroeconomic data shows an adverse COVID-19 impact in FY2020 and subsequent recovery in FY2021. This improvement in FY2021 is consistent with the profit data for comparator companies used in the 2022/23 rates assessment. The SSRO's assessment excludes FY2020 company financial data and includes FY2021 company financial data. The assessment of the baseline profit rate is therefore calculated as a three-year average of FY2021, FY2019 and FY2018.

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

Every year the SSRO revalidates whether comparator companies are in the correct geographical areas and 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. This is in addition to the removal of FY2020 data (see question 3) or the removal of companies making losses which may have been the result of the pandemic. These checks are to ensure that the comparator groups constitute only those companies that we know to undertake comparable activities, which they may have been prevented from doing due to the impact of COVID-19 on the company. We are satisfied that the companies that remain in the 2023/24 comparator groups were carrying out comparable activities in the year we analysed. Question 17 provides additional information on the SSRO's approach to adjusting data.

[1] FY2020 means the latest 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

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 produce a stable and predictable BPR. The period of the pandemic validated the effectiveness of this approach over others, such as use of alternative averaging approaches, that are less resilient to variations in the data. A predictable and stable BPR will be important going forwards given the uncertain economic environment (see question 5).

5. How do the current increases in inflation and interest rates impact the baseline profit rate?

The BPR remains at a similar level to earlier periods with lower rates of inflation and interest rates. We have seen no evidence of direct impact of the war in Ukraine or other specific drivers of inflation, such as food and energy prices on the BPR. The stabilising features of the SSRO's methodology mitigate the impact of temporary economic shocks and allow for any longer lasting change to be reflected in the BPR in a predictable and measured way.

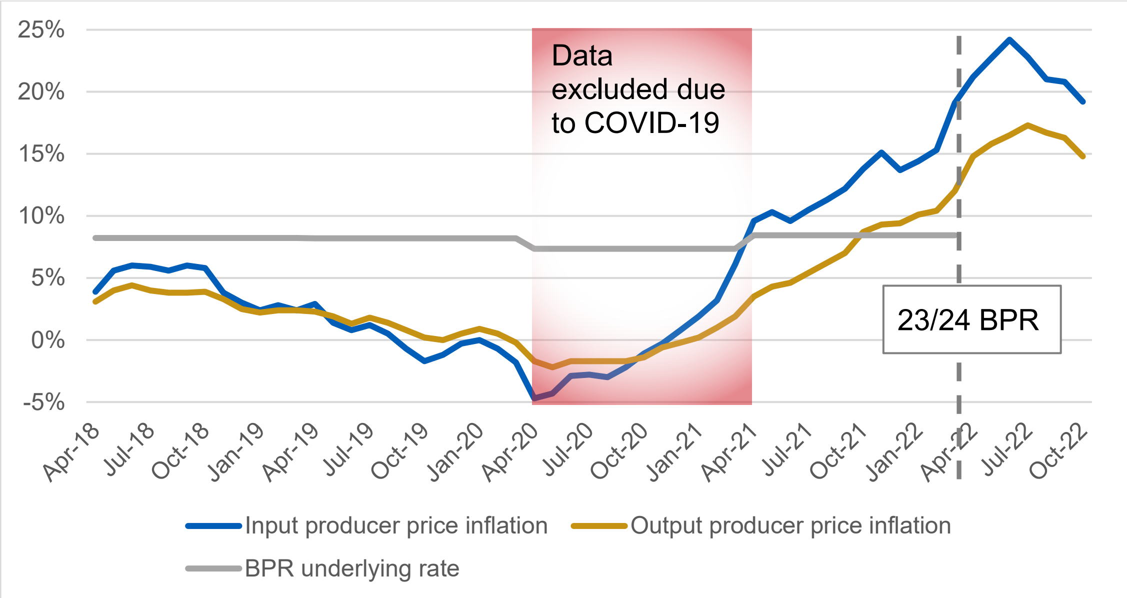
Inflation is primarily intended to be reflected in the price of QDCs and QSCs through the allowable costs, rather than changes in the baseline profit rate. The capital servicing adjustment ensures that changes in the cost of borrowing (interest rates) are reflecting in profit and prices in the transparent and economically rational manner.

Inflation can increase both a company's costs and the prices of its goods or services it sells. This means higher inflation may result in the return on costs of production used in the calculation of the BPR rising, falling or staying the same (see question 22). Figure 2 shows the underlying rates included in this year's baseline profit rate and producer price inflation over the same period. It shows the average profitability remaining stable against rising and falling inflation.

Under the current methodology, the financial information used for the next year's 2024/25 underlying rate will be extracted from annual company financial statements for the year ending on or before 31 March 2023. The impact on the data the SSRO will use in the baseline profit rates assessment will start to become known in 2023 as companies publish their financial statements.

The effect of inflation on a contractor's costs may also be reflected in the price of a QDC or QSC through the allowable costs. This will depend on 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.

Figure 2 – Baseline profit underlying rate and inflation data



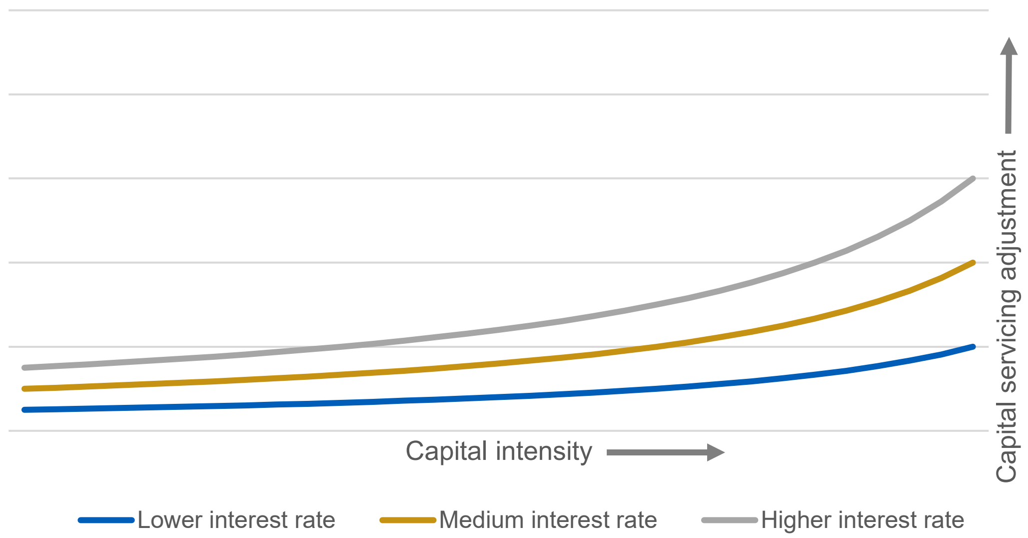
Source: Office for National Statistics and SSRO calculations

Interest rate changes are factored into the baseline profit rate through the capital servicing adjustment. Capital servicing rates change to reflect changes in the current cost of borrowing and that which has been accumulated over time, so will move by less than recent market movements. The impact will depend on the particular circumstances in which the adjustment is applied. All else unchanged, higher interest rates increase capital servicing rates which in turn produce higher capital servicing adjustments. The relationship between interest rates and return on cost mean increases in contract profit rates need only be a fraction of the rise in interest rates to cover any interest rate changes.

The capital servicing adjustment is applied in the baseline profit rate and in the calculation of the contract profit rates applied to a contract (see question 20 for a further explanation of this process). These two adjustments act in opposing directions. The overall effect on contract profit will depend on the capital intensity of companies in the baseline profit rate calculation and of companies or business units of contract being priced [2]. Higher interest rates will have a greater effect on contract profit rates for relatively more capital intensive companies or business units, with a lesser effect where capital intensity is lower. This is illustrated in figure 3.

[2] The measure of the capital intensity of the company or business unit is used as a ratio of fixed and working capital employed to costs of production known as the CP:CE ratio. A higher CP:CE ratio would indicate relatively lower capital intensity.

Figure 3: Relationship between capital intensity, interest rates and the capital servicing adjustment.



Source: Hypothetical scenarios based on SSRO calculations.

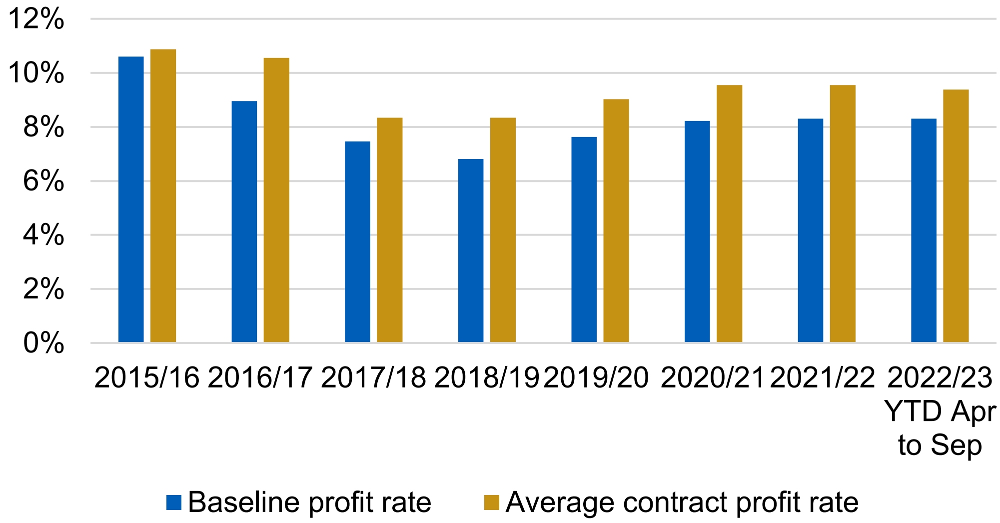
6. What is the impact of the new baseline profit rate and how much will it cost the taxpayer?

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. The new rate will mean that Step 1 of the CPR will be 0.02 percentage points lower compared to 2022/23. 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 a decrease in 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 4 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 4: Baseline profit rate and average (mean) estimated contract profit rate by financial year



Source: SSRO (2022) 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.

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

Table 1 illustrates the range of initial contract profit rates achievable given the adjustments that are possible. The SSRO's *Annual qualifying defence contract statistics*[3] 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, or make a loss by underperforming. The final contract profit rate will therefore only be known once the contractor has delivered the contract.

Table 1: 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	9.63%
	Capital servicing adjustment†	-1.34pp
Step 1	Baseline profit rate	**8.29%**
Step 2	Cost risk adjustment*	-2.07pp to +2.07pp
Step 3	POCO adjustment**	
Step 4	SSRO funding adjustment	-0.038pp
Step 5	Incentive adjustment***	up to +2.00 pp
Step 6	Capital servicing adjustment (CSA) † ****	Minimum: 0.0% Lower quartile: 0.7% Upper quartile: 1.2% Maximum: 3.2%

Illustrative minimum CPR, based on: -25% step 2, +0pp step 5 and +0.0pp step 6	**6.18%**
Illustrative low CPR, based on: -25% step 2, +0pp step 5 and +0.7pp step 6	**6.88%**
Illustrative high CPR, based on: +25% step 2, +2pp step 5 and +1.2pp step 6	**13.52%**
Illustrative maximum CPR, based on: +25% step 2, +2pp step 5 and +3.2pp step 6	**15.52%**

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.[4]

† See Question 20 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 2022/23. The actual adjustment may be higher, lower or negative. Source: SSRO (2022) *Annual Qualifying Defence Contract Statistics: 2021/22*

[3] https://www.gov.uk/government/collections/ssro-qualifying-defence-contract-statistics
[4] https://www.gov.uk/government/collections/profit-rate

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

The table below shows the range of profits (5-year median of return on cost of production) exhibited by the top 20 listed companies by value of non-competitive spend in 2020/21, as reported by the MOD.[5] The 5-year median profit rate of the D&M and P&M comparator companies is included for reference. The rates shown for the suppliers are the median over the last five years to illustrate what might be considered typical for each.

Company name	Return on cost of production: median FY2017 – FY2021*
CGI Inc.	16.89%
Safran	15.88%
Lockheed Martin Corp	15.82%
General Dynamics Corp	13.39%
Northrop Grumman Corporation	13.29%
BAE Systems PLC	10.83%
Qinetiq Group PLC	10.74%
DXC Technology Company	10.74%
Raytheon Technologies Corporation	9.04%
Thales	8.40%
Boeing Company (The)	8.01%
Fujitsu Limited	6.53%
Kbr, Inc.	5.99%
Leonardo S.P.A.	5.66%
Airbus SE	4.50%
Jacobs Engineering Group INC	4.11%
Serco Group PLC	3.26%
Babcock International Group PLC	1.91%
Thyssenkrupp AG	0.52%
Rolls-Royce Holdings PLC	-4.89%
Provide & Maintain median†	**9.90%**
Develop & Make median†	**9.45%**

*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 16.89 per cent. Note the actual profit rate of the company as a whole is also a product of any non-single source work it carries out. The illustrative range of available CPRs at time of agreement (see Q7 above) is 6.18 per cent to 15.52 per cent. The actual profit rate achieved on a contract may be higher than shown here by outperforming cost estimates, or a lower profit rate by underperforming. We would expect those who agreed the highest contract profit rates by taking on risk to achieve higher actual rates of profit

[5] Ministry of Defence (2021) *MOD trade, industry and contracts: 2021*, [MOD trade, industry and contracts: 2021 - GOV.UK (www.gov.uk)]

where risk is managed successfully, and companies who agree the lower rates due to low risking to achieve similarly lower rates of actual profit.

The methodology and the comparator groups

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

The SSRO is confident that the baseline profit rate is a fair and reasonable starting point for the contract profit rate calculation because it is set with reference to the actual returns of 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,[6] 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.

10. 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 'military', or close variants of these words 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 given this year's BPR, give us confidence an appropriate group of companies has been selected (see questions 7 and 8).

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

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

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

Given Ancillary Services, Construction and Information Technology Services 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 2023/24 recommendation is the same as for previous BPR recommendations.

The data on all five 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.

12. Why has the SSRO introduced an information technology services benchmark

The SSRO considered an IT services activity group during the initial development of the profit rate methodology in 2016. We did not take IT services forward as a distinct group at that time because we did not perceive there to be sufficient requirement. We have since reviewed that position because stakeholders have represented that the IT sector is insufficiently represented in the existing four activity groups and the recent Defence and Security Industry Strategy set out proposals that may alter the make-up of what MOD chooses to procure without competition.

The IT services rate is achievable within the range of available contract profit rates under the regime (see question 7). The IT services rate is provided for information only and does not form part of the baseline profit rate (see question 11).

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 this year's assessment. This means we conducted a full search of the Orbis database against the criteria set out in the methodology and individually reviewed. Following this process approximately 80% of the companies in last year's BPR comparator group were retained. Of the total number of companies this year, around one third are new additions to the group.

To confirm that the companies resulting from the search 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.[7] 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 database[8] 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.

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

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

[7] https://www.gov.uk/government/collections/defence-trade-and-industry-index
[8] https://www.bvdinfo.com/en-gb/our-products/data/international/orbis

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.

The SSRO's methodology seeks to measure a central markup on cost to be used in determining the price of a contract. Since it would not be normal to determine a price at a loss, measures of loss-making are not used in the baseline profit rate assessment. The exposure to loss-making on a qualifying contract is dealt with through the application of the price formula rather than the BPR (see question 7). Incorporating loss-making into the BPR would result in double counting and have resulted in a decrease in this year's underlying rate of around 1.4pp.

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 guidelines[9], 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 19). 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

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

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 appropriate, attributable to the contract and reasonable in the circumstances.

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

1. In order to do so we would need to apply them consistently across the whole comparator group and:
    a. detailed information may be available for some companies, but we look at a wide range of companies that have different reporting requirements.
    b. where detailed information is available, our observation is that there are no consistent rules or principles we could apply to determine what is or is not 'exceptional'.
2. Despite their separate disclosure, such items remain part of the total operational costs of a company. Individual companies may like to provide additional context to help investors understand their underlying results, but we have a different objective, which is to produce comparable measure of return 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 15, we do not think we could reliably adjust for these items. However, the methodology is designed to mitigate the potential impact of these events, in particular:

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

Question 4 sets out what steps the SSRO has 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 in calculating the BPR?

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 of performing the contract.

The return **on** capital employed is a ratio of the return on the contract (i.e. the total amount of contract profit) to the capital employed for the purpose of performing it (see question 21). This should not be confused with 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.[10]

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

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

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 calculation of the baseline profit rate?

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

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

1) amortisation costs of intangible assets; and

2) the inclusion or otherwise of intangible assets in “capital employed” for the purpose of the capital servicing adjustment (see 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 calculation then the contract will receive an average return that is present within the baseline profit rate for that item, plus any additional amount as a result of the application of the other 6 steps.

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

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).

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

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

Measure	Definition	Key similarities and differences
Profit margin or net margin	$\frac{Profit\ (£)}{Revenue\ (£)}$	Uses the same inputs as return on cost but is the return on revenue

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

Capital servicing rates

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

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

- Fixed capital
- Positive working capital
- Negative working capital

The profit rate of each comparator company is adjusted in proportion to the ratio of fixed and working capital employed to costs of production, a measure of the capital intensity of the company. A corresponding adjustment is made in the pricing of individual contracts by an adjustment at step 6 of the contract profit rate to reflect the capital intensity of the contract (see question 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 does not involve any payments between the contractor, the MOD or the SSRO.

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 2023/24 recommendation compared to the prior year is primarily caused by the cost contribution that industry makes being spread out over a larger value of contracts.

25. The MOD are removing the SSRO funding adjustment from the six steps, how will the SSRO respond to this?

As at 31 January 2023 the Defence Reform Act requires that the SSRO provides its assessment to the Secretary of State of the appropriate SSRO funding adjustment, and that it is applied step 4 of the six steps. We understand the MOD propose to change the Defence Reform Act to remove these requirements. The SSRO will update its guidance and methodologies to remove references to the funding adjustment.

At the point the legislation changes it will no longer be a requirement to make the deduction for the funding in adjustment where determining the contract profit rate for a contract or an amendment. Contract profit rates prior to the change will be unaffected as once determined they apply for the life of the contract or the amendment contract.