



SSRO

Single Source
Regulations Office

SSRO's baseline profit rate, capital servicing rates, and SSRO funding adjustment recommendation: 2023/24 Supporting analysis

March 2023

Contents

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

- Baseline profit rate
- Capital servicing rates
- SSRO funding adjustment
- Government-owned contractor rate

It includes sensitivity and other analysis, including:

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

Baseline profit rate: introduction

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

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

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

Baseline profit rate approach and methodology



Objective

OECD: Transfer Pricing principles

Replicable



Reliable

Actual profit on actual cost

IFRS / GAAP numbers



Predictable

Stable approach

3 year rolling average



Calibrated

Stakeholder feedback (including QA of accounting data)

Completed contracts

Company selection process



Databases:
Orbis, Bloomberg,
Bank of England



Active
companies



Limited liability
companies



Latest year
of accounts



Consolidated
accounts



Independence



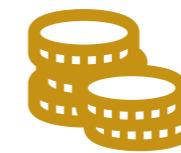
Geographic
location



Turnover



Operating
Profit



Assets /
liabilities



Functions
NACE code
Text terms



Activities



MOD
supplier
lists



Defence
keyword



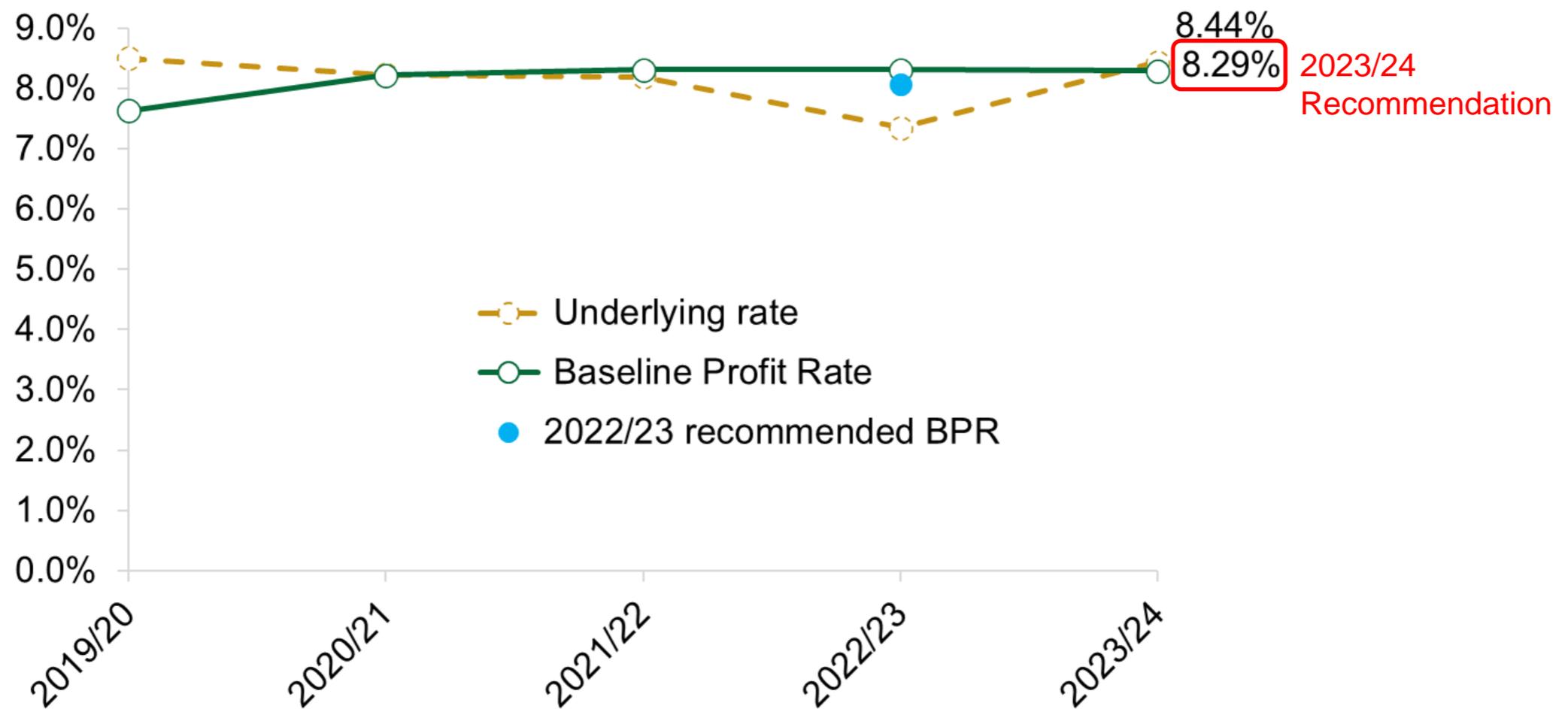
Average

Automated search

Manual review

Baseline profit rate

The baseline profit rate is a three-rolling average of the underlying rate. The 2023/24 recommended baseline profit rate is 8.29 per cent.

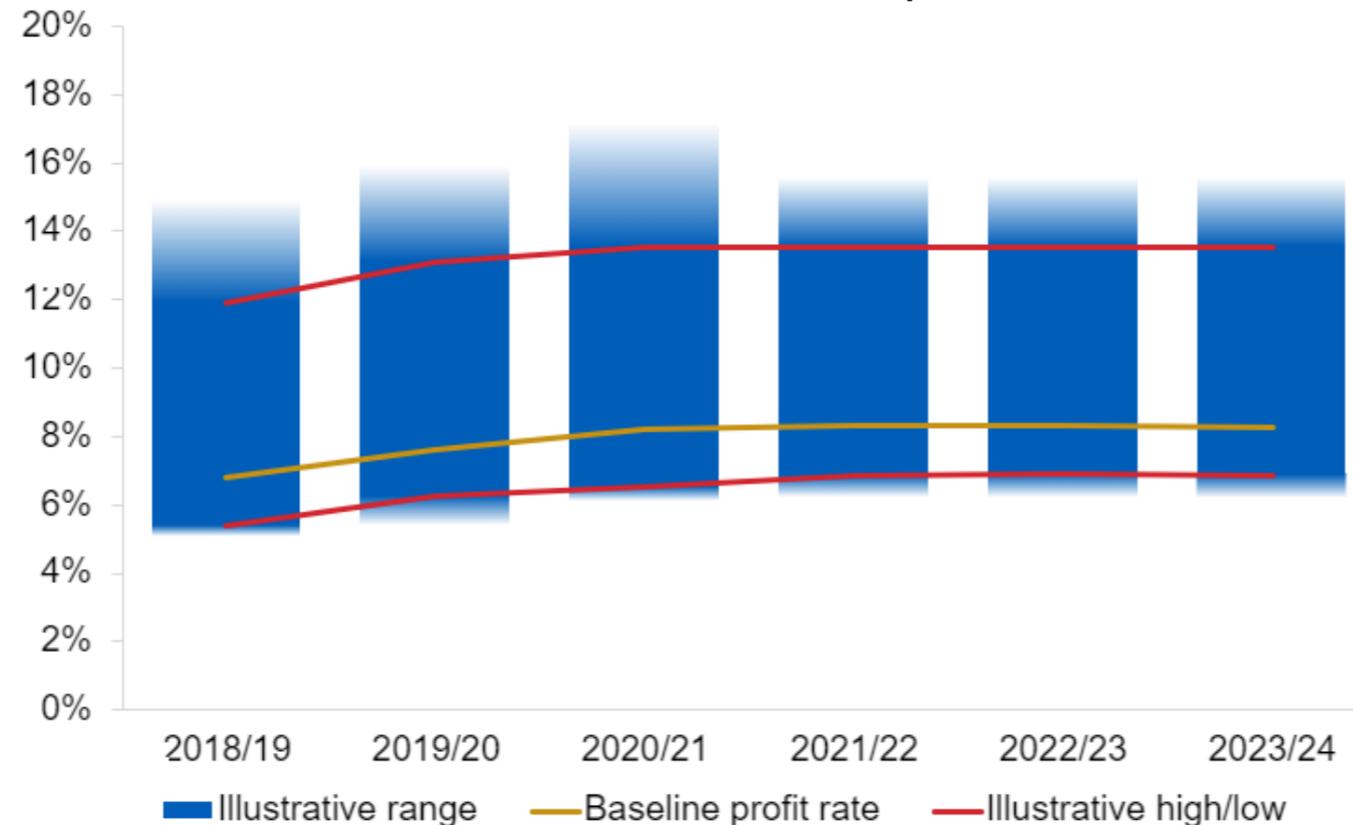


Note: Historical baseline profit rates are shown as they were determined by the Secretary of state. The SSRO's recommended rate for 2022/23 is shown as a floating dot. The underlying rates for each year are shown as calculated by the SSRO.

Source: Orbis, Bloomberg and SSRO calculations

Illustrative high and low contract profit rate

The baseline profit rate is combined with the other profit rate steps to arrive at the contract profit rate (CPR). There is a range available, depending on the application of the steps. Full details on the calculation are set out in the SSRO publication [Guidance on the baseline profit rate and its adjustment](#). Details of the calculation for 2023/24 are presented on the next slide.



Notes: The solid area is an illustrative low/high for a standard contract, applying assumptions about the typical values of certain components of profit. The gradient areas end at a theoretical minimum and maximum, applying reasonable limits where a profit component is unbounded.

The capital servicing adjustment (step 6) is dependent on the characteristics of the contract in question therefore, for illustrative purposes, we have applied the actual range of capital servicing adjustments agreed for contracts entered into during the year in question, or the most recent year data is available.

Illustrative high and low Contract Profit Rate: detail

| 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** | 0.00pp | | | |
| + Step 4 | SSRO funding adjustment | -0.038pp | | | |
| + Step 5 | Incentive adjustment*** | up to +2.00pp | | | |
| | Range before capital servicing | Low: 6.18% | | High: 12.32% | |
| + Step 6 | Capital servicing adjustment (CSA) [†] | Minimum | Lower quartile | Upper quartile | Maximum |
| | Illustrative observations from 2021/22 **** : | +0.0% | +0.7% | 1.2% | +3.2% |
| = | Contract profit rate | Minimum 6.18% | Low 6.88% | High 13.52% | Maximum 15.52% |



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

[†] See Q20 of the Q&A document for an explanation of how the two 'capital servicing adjustments' interact.

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

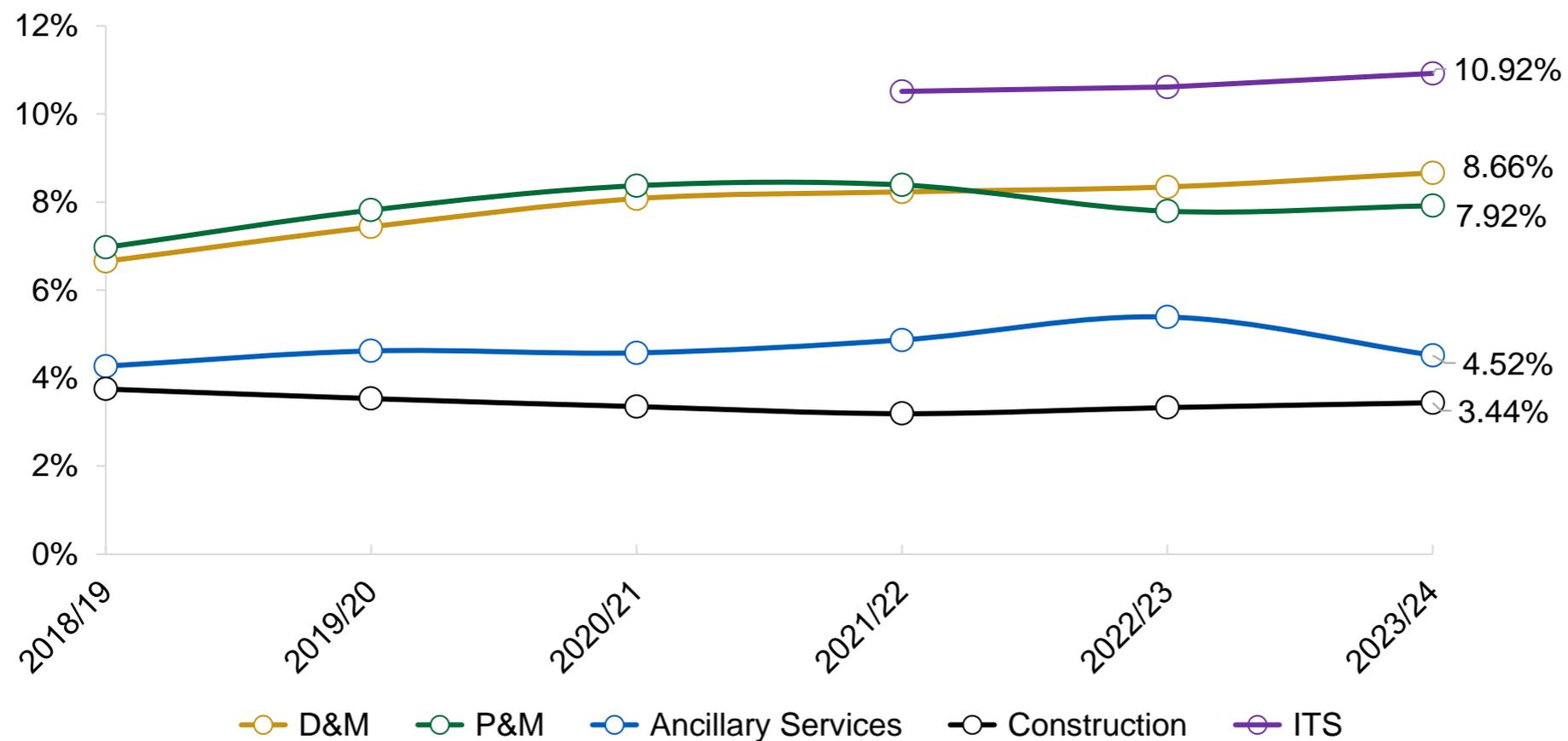
** A POCO adjustment may be applied to ensure that profit arises only once in relation to some intra-group sub-contracts. The adjustment is nil for the majority of contracts, as shown here.

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

**** These figures are the actual values reported to the SSRO for contracts priced in 2022/23. The actual adjustment may be higher, lower or negative. **Source:** *Annual qualifying defence contract statistics: 2021/22* (SSRO)

Summary of activity groups

The baseline profit rate is the average of the Develop & Make (D&M) and Provide & Maintain (P&M) comparator groups. Rates for three other groups, Ancillary Services, Construction and Information Technology Services (ITS) are presented for information.



Notes: The chart shows results for three year (four year for 2022/23) rolling average of underlying rates. The 2022/23 rates were determined at the 2021/22 levels, but the above chart shows the rates that the SSRO recommended. ITS is a new activity group. Its historical numbers are based on the historical data for this year's set of comparators.

Source: SSRO calculations

Capital servicing rates: introduction

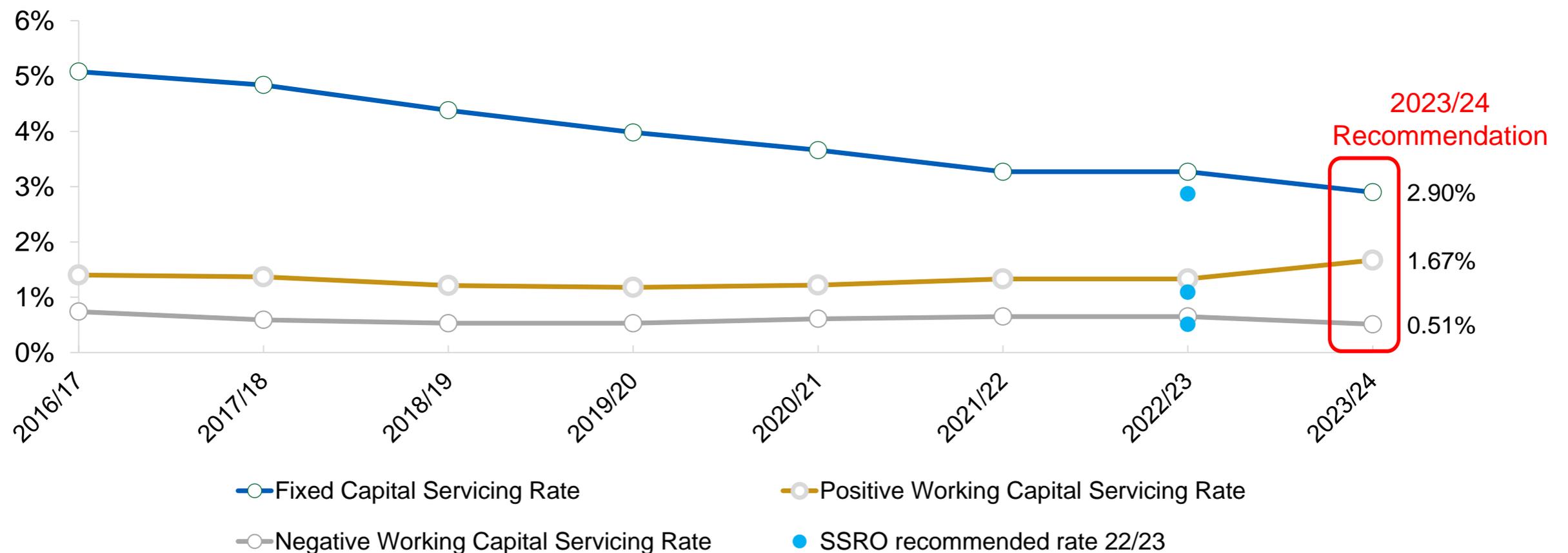
Each year the SSRO calculates the following three capital servicing rates based on averages of bond yields and interest rate data published by Bloomberg and the Bank of England:

- Fixed capital
- Positive working capital
- Negative working capital

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

Capital servicing rates

| Rate | Description | Recommendation |
|----------------------------|--|----------------|
| Fixed capital servicing | 15 year BBB GBP bond index – 7 year average | 2.90% |
| Working capital (positive) | 1 year BBB GBP bond index – 3 year average | 1.67% |
| Working capital (negative) | Monthly interest on short term deposits – 3 year average | 0.51% |



Note: The Secretary of State determined that the 2022/23 rates would use the rates prior to 2021. The floating data points for 2022/23 are the SSRO recommended rates.

Source: Bloomberg, Bank of England and SSRO calculations

SSRO funding adjustment: introduction

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

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

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

SSRO funding adjustment calculation

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

| Recommendation | | 2019/20 | 2020/21 | 2021/22 | 2022/23 | 2023/24 |
|---|---|-----------|-----------|-----------|-----------|---------------|
| SSRO running costs (£ thousand) <i>average of previous 3 years</i> | a | 5,413 | 5,822 | 6,133 | 6,299 | 6,363 |
| Cost of additional tasks requested by Secretary of State (£ thousand) <i>average of previous 3 years</i> | b | - | - | - | - | - |
| Total Allowable Costs of contracts entered into (£ thousand) <i>average of previous 3 years</i> | c | 6,499,333 | 5,584,333 | 5,335,000 | 6,896,000 | 8,273,667 |
| SSRO funding adjustment = $\frac{a-b}{c} \times 50\%$ | | 0.042% | 0.052% | 0.057% | 0.046% | 0.038% |

Previously published figures

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

Sources: *Quarterly qualifying defence contract statistics: Q2 2022/23 (SSRO), SSRO Annual Report and Accounts 2021/22, 2020/21, and 2019/20 (SSRO)*

Government owned contractor rate: introduction

The government owned contractor rate is a baseline profit rate that can be used to deliver a contract profit rate (CPR) of zero on QDCs between the Secretary of State and companies wholly owned by the Secretary of State.

The government owned contractor rate must only apply to qualifying defence contracts where:

- a) the contract is between Secretary of State and a company incorporated under the Companies Act that is wholly owned by the UK Government; and
- b) both parties to the contract agree that it should apply.

Full details on the approach are set out in the SSRO publication *Government owned contractor rate methodology*.

Government owned contractor rate

The government owned contractor rate is set at a level that is opposite to the application of the SSRO funding adjustment. This approach delivers a contract profit rate of zero if steps 2, 5 and 6 are determined to be zero.

| Recommendation | 2021/22 | 2022/23 | 2023/24 |
|----------------------------------|---------|---------|---------------|
| Government-owned contractor rate | 0.057%* | 0.046% | 0.038% |

Previously published figures

Notes: The Government-owned contractor rate was first introduced for 2021/22.

* The SSRO did not recommend a government owned contractor rate for 2021/22 and the rate was assessed by the Secretary of State. The reason for doing so is set out in the London Gazette: <https://www.thegazette.co.uk/notice/3760612>

Source: SSRO funding adjustment recommendation

Understanding the changes in the baseline profit rate

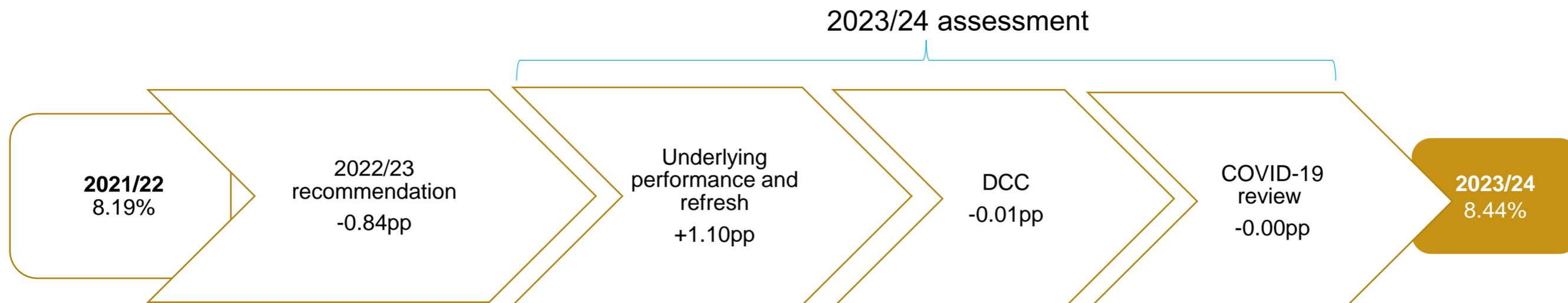
The following slides set out an analysis of the changes in the baseline profit rate since the prior year, including:

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

Draft 2023/24 Underlying rate: explaining the change to 2023/24

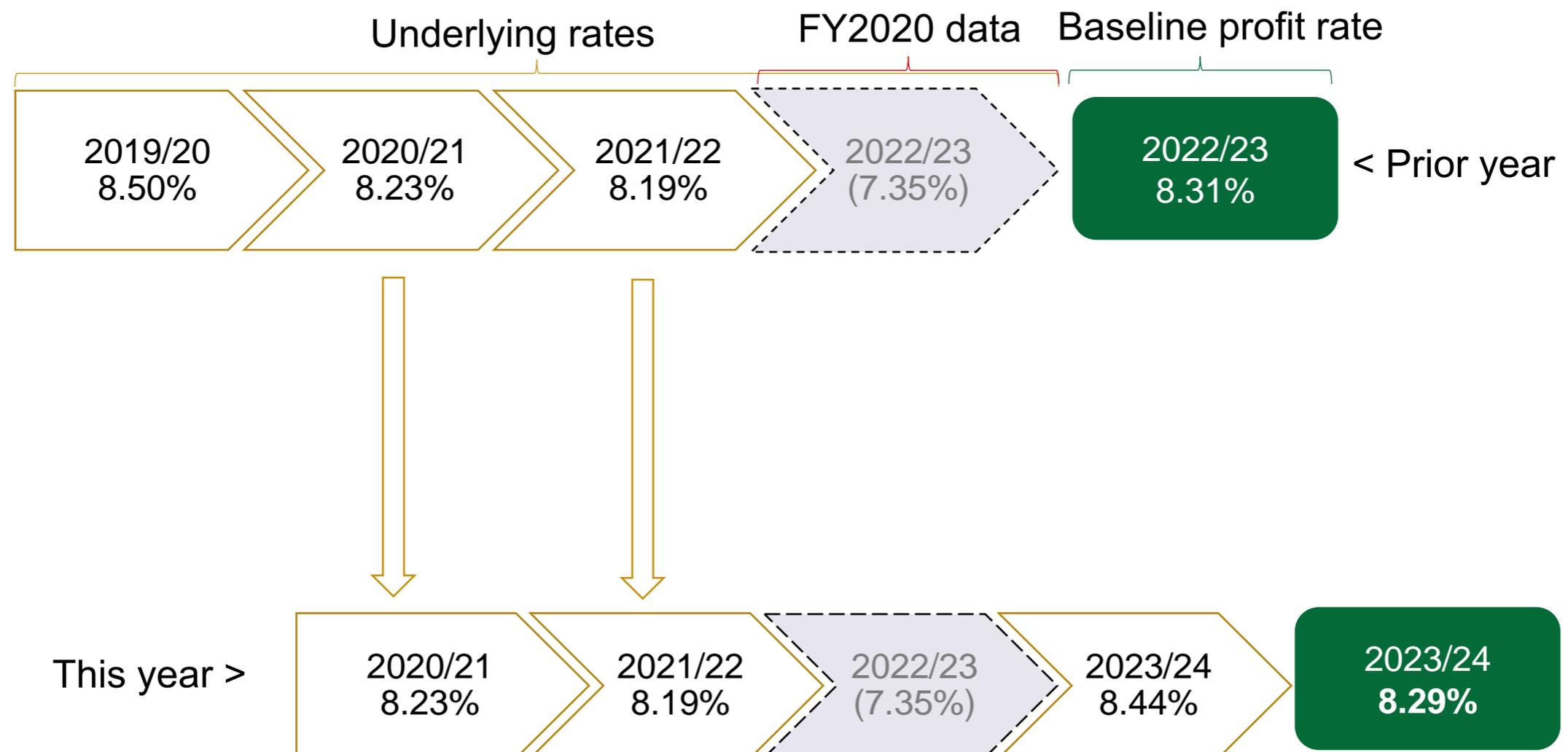
The change in the underlying rate each year is a product of:

1. **2023/24 recommendation:** change to the underlying rate not reflected in the 2022/23 BPR fixed at the 2021/22 BPR rate
2. **Underlying performance and full refresh:** predominantly driven by changes in the financial performance of the prior year's comparator companies. Additionally, this also includes new & removed companies as part of the standard full refresh cycle and updated capital servicing rates.
3. **Defence cross-check:** companies from the MOD supplier lists added to the comparators identified through the Orbis search.
4. **Additional COVID-19 review:** companies removed from the comparator groups as part of the manual review process. Companies removed where COVID-19 was deemed to have adversely impacted their ability to operate in the period. Note that the underlying rate is not affected due to identified companies already removed as loss-making.



2023/24 Baseline profit rate: explaining the change from 2022/23

The baseline profit rate is the three-year average of the underlying rate of the most recent years excluding data for FY2020. The 2019/20 underlying rate of 8.50% has been replaced by the 2023/24 underlying rate of 8.44%, resulting in a baseline profit rate of 8.29%. The 2022/23 underlying rate is not used in the calculation.

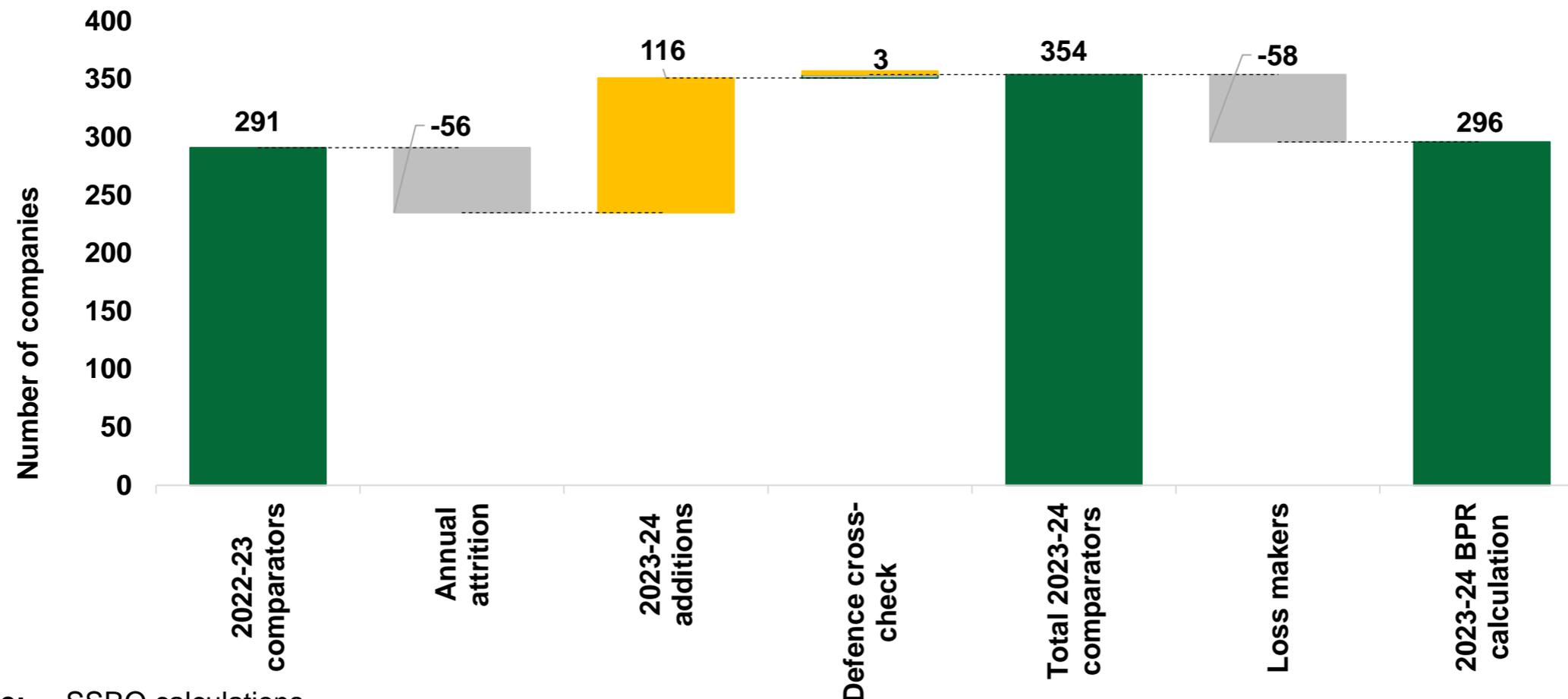


Joiners and leavers to the comparator groups

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

This year we undertook a full company search refresh and started a new three-year company selection cycle. We downloaded 3063 companies, and identified 354 of them as suitable comparators. 235 were retained from last year, 116 were new comparators and 3 were identified through the defence cross-check process. 58 of the suitable comparators were loss makers.

We used 296 companies to calculate the 2023/24 underlying rate.



Source: SSRO calculations

Comparisons and benchmarking

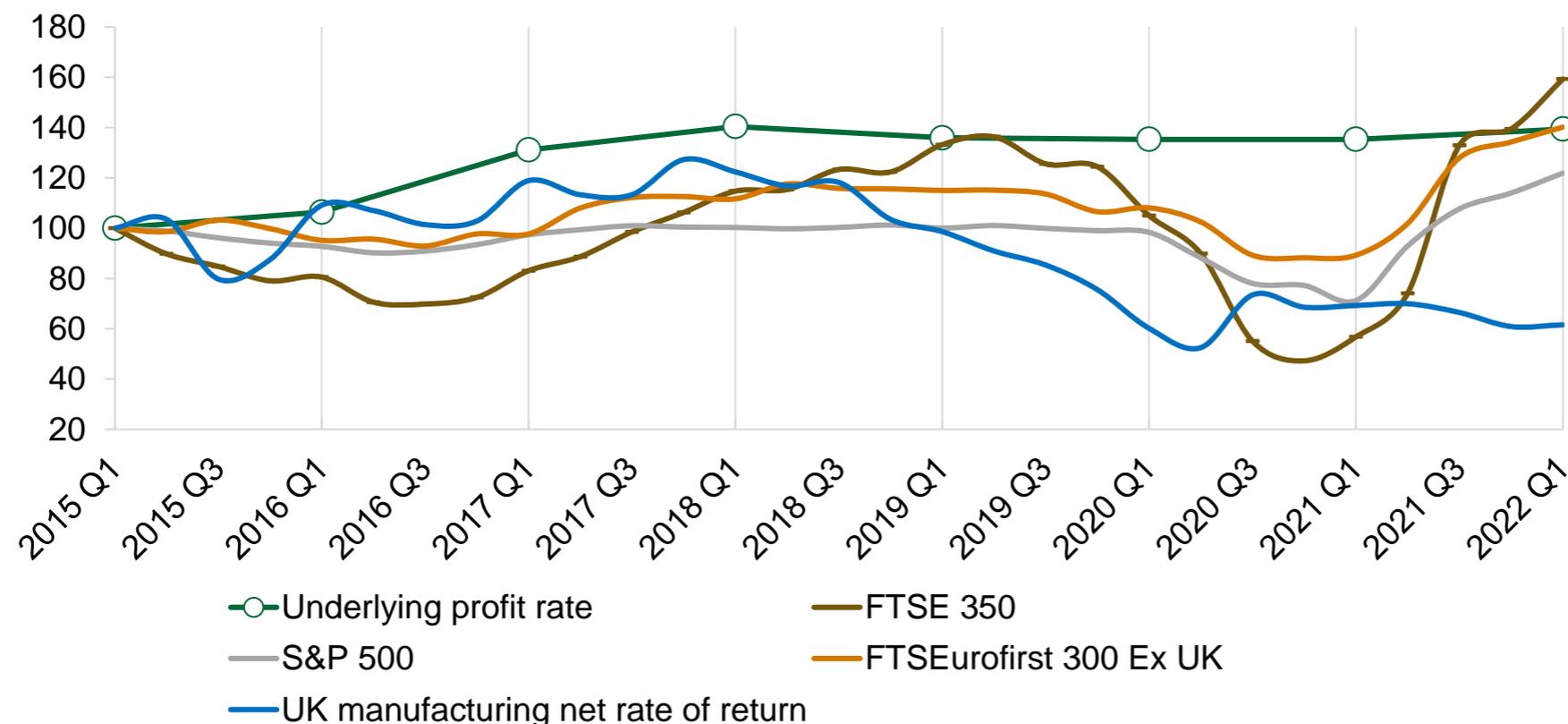
The following compare the trend in the baseline profit rate to the trend in macro-economic indicators and benchmark the range available in the UK regime to those available elsewhere:

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

Trends in the performance

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

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



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

Source: Bloomberg, ONS Dec 2022 release of *Quarterly net rate of return of manufacturing private non-financial non-UK continental shelf corporations* (series LRYC)



Defence sector representation

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

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

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



Presence of MOD suppliers in the comparator groups

| Company name | Activity Type | Company name | Activity Type |
|--|--------------------|---------------------------------------|----------------|
| BAE Systems PLC | Develop & Make | Marshall of Cambridge (Holdings) Ltd* | Not Included |
| Babcock International Group PLC | Provide & Maintain | Raytheon Technologies Corporation | Develop & Make |
| Rolls-Royce Holdings PLC | Develop & Make | Glebe Holdings Ltd* | Not Included |
| Leonardo SpA | Develop & Make | Safran S.A. | Develop & Make |
| The Boeing Company** | Develop & Make | Daisybright Ltd* | Not Included |
| Airbus Group SE | Develop & Make | Draken International, LLC* | Not Included |
| QinetiQ Group PLC | Develop & Make | General Dynamics Corporation | Develop & Make |
| Thales | Develop & Make | NATS Holdings Ltd* | Not Included |
| Lockheed Martin Corporation | Develop & Make | Rheinmetall Aktiengesellschaft* | Develop & Make |
| General Atomic Technologies Corporation* | Not Included | CGI Inc | IT Services |

Explanation for companies not included in an activity group:

* Companies that failed the Orbis search criteria; primarily the main activity of the company was not a comparable activity, or the company lacked financial data for the most recent year at the cut-off date.

** Comparable company that was a loss-maker for the current year, as measured by the adjusted underlying profit rate, failing the criteria for inclusion in the BPR calculation.

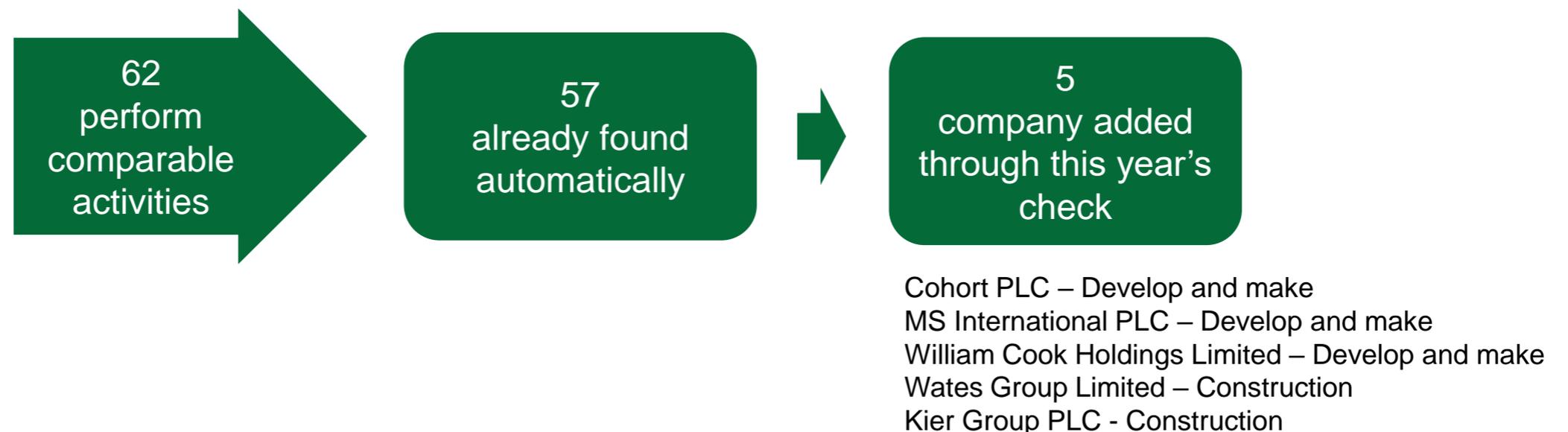
Notes: Source of companies are MOD statistics of private sector holding companies paid £50 million or more in 2021/22, *Table 4 MOD trade, industry and contracts: 2022 (MOD)*. The table is ordered by value of spend.



Defence cross-check

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

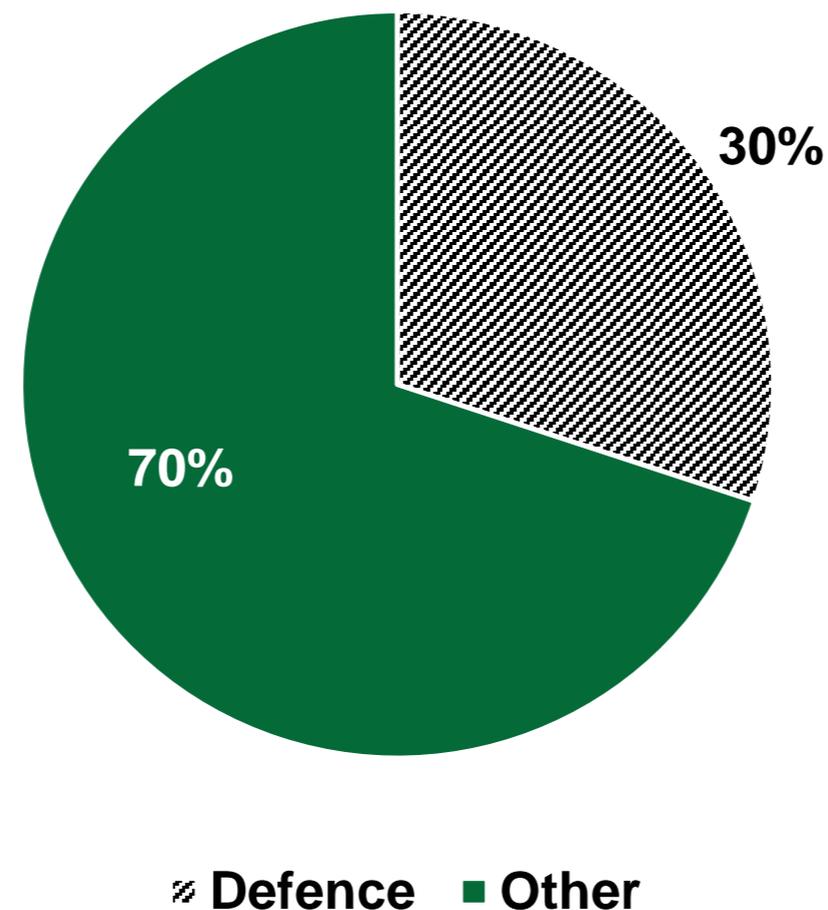
5 additional companies are included in the comparator groups as a result of the defence cross check process, representing 1% of the groups. The majority of MOD suppliers performing comparable activities were already identified by the search process.





Proportion of 'defence keyword' companies in the BPR calculation

Companies that either have the word 'defence', 'defense' or 'militar*' included in their Orbis text description account for 30% of the composite comparator group



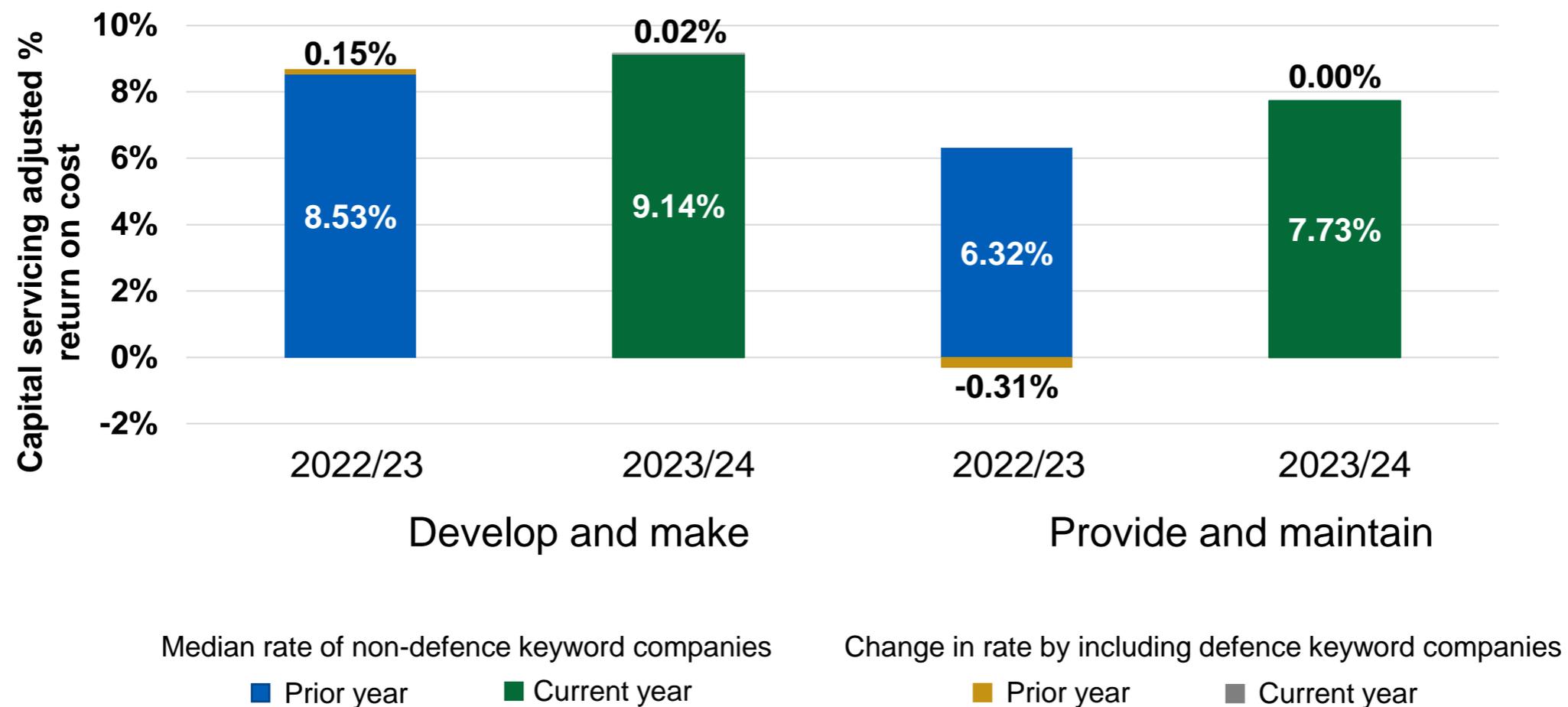
Notes: A company is considered to be a 'defence keyword' company if either the word 'defence', 'defense' or 'militar*' is included in their Orbis text descriptions. The '*' indicates that all words starting with those letters, for example 'military' and 'militarised', are included.

Source: Orbis and SSRO calculations



Impact of ‘defence keyword’ companies on the result

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



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

Source: Orbis and SSRO calculations



Geography

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

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

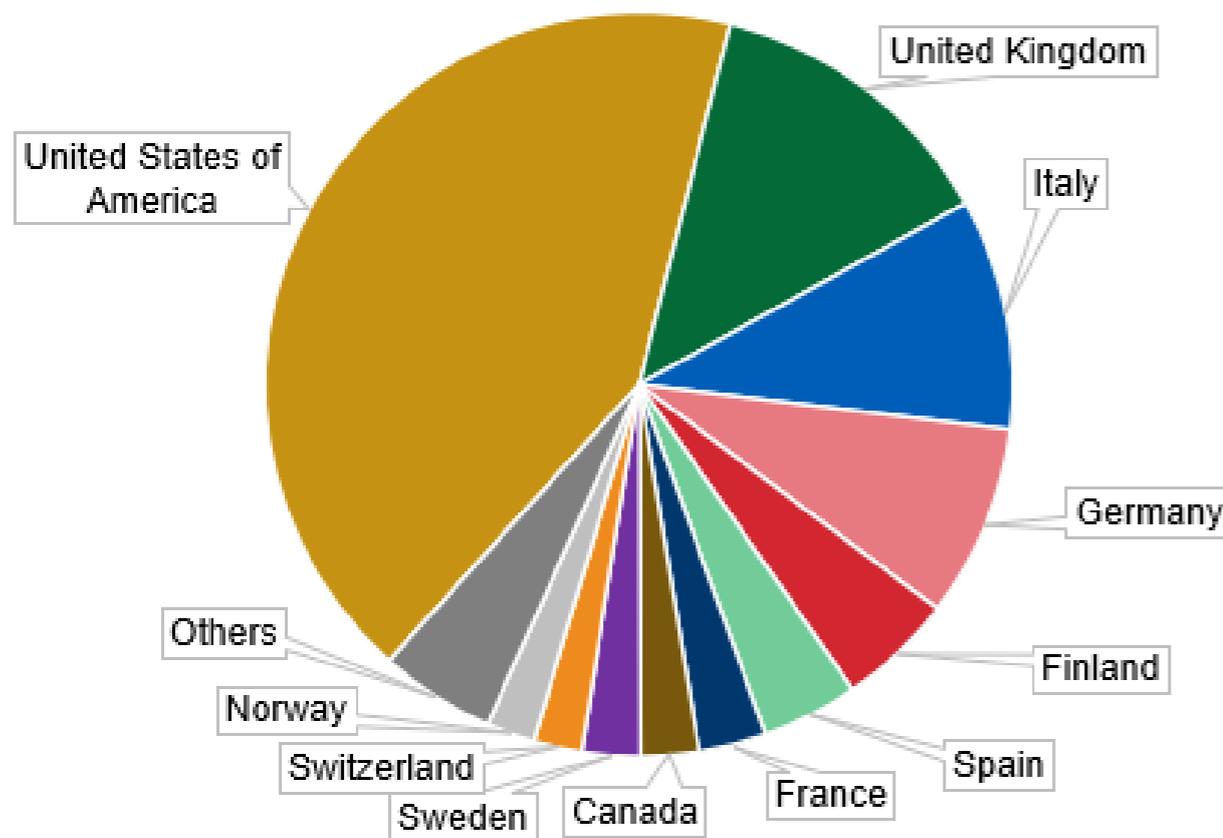
- the proportion of companies in the comparator groups from each country
- the profitability of companies from each a selection of countries; and
- the impact of those countries on the baseline profit rate analysis.



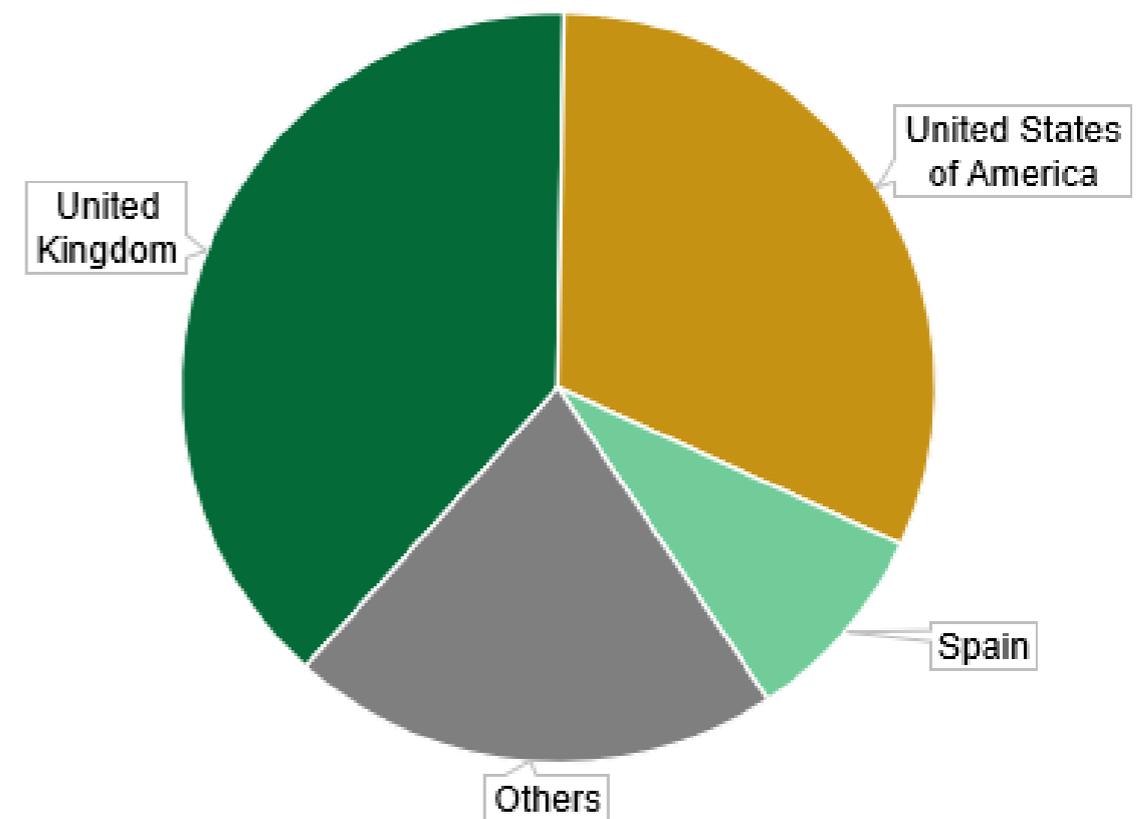
Geographical distribution of the composite comparator group

There is wide representation across Western Europe and North America

Develop and make



Provide and maintain



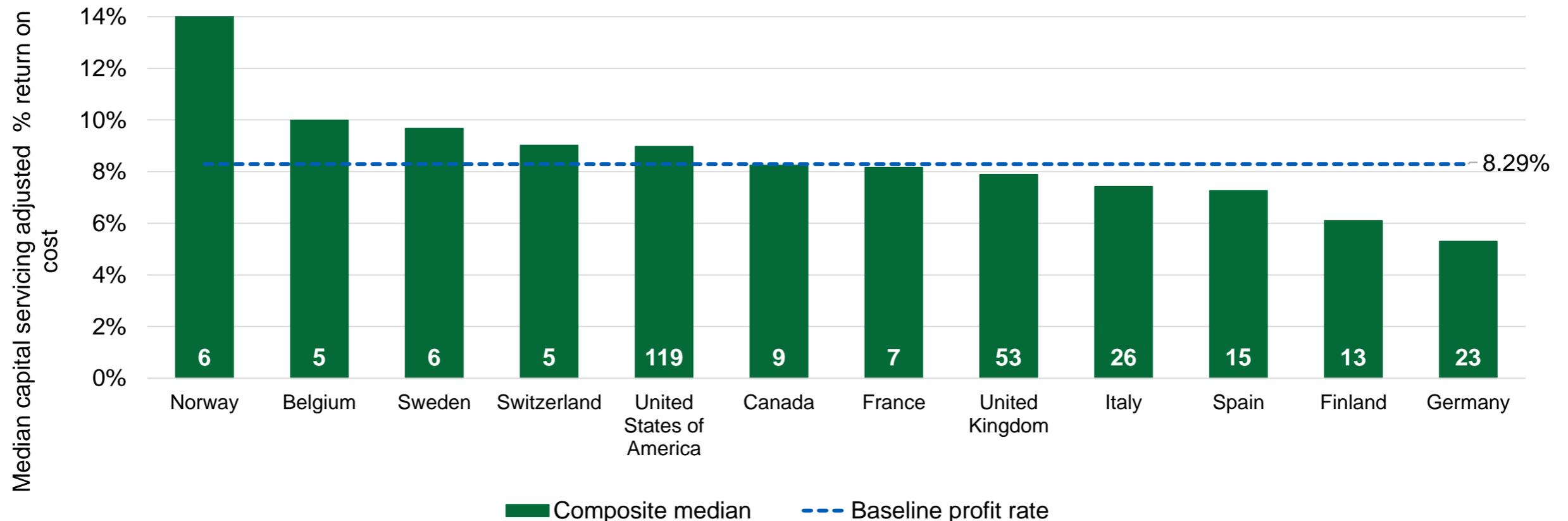
Notes: Countries with < 5 number of companies are merged in to 'Others', which includes:
 in the 'Develop and make' chart: Austria, Belgium, Denmark, Iceland, Ireland, Netherlands, Portugal.
 in the 'Provide and maintain' chart: Canada, Germany, Italy, Denmark, Belgium, Norway, Finland.

Source: Orbis



Profitability by country

This chart shows the 2023/24 composite underlying rate for each country individually compared to the baseline profit rate. The number of companies is shown at the bottom of each bar.



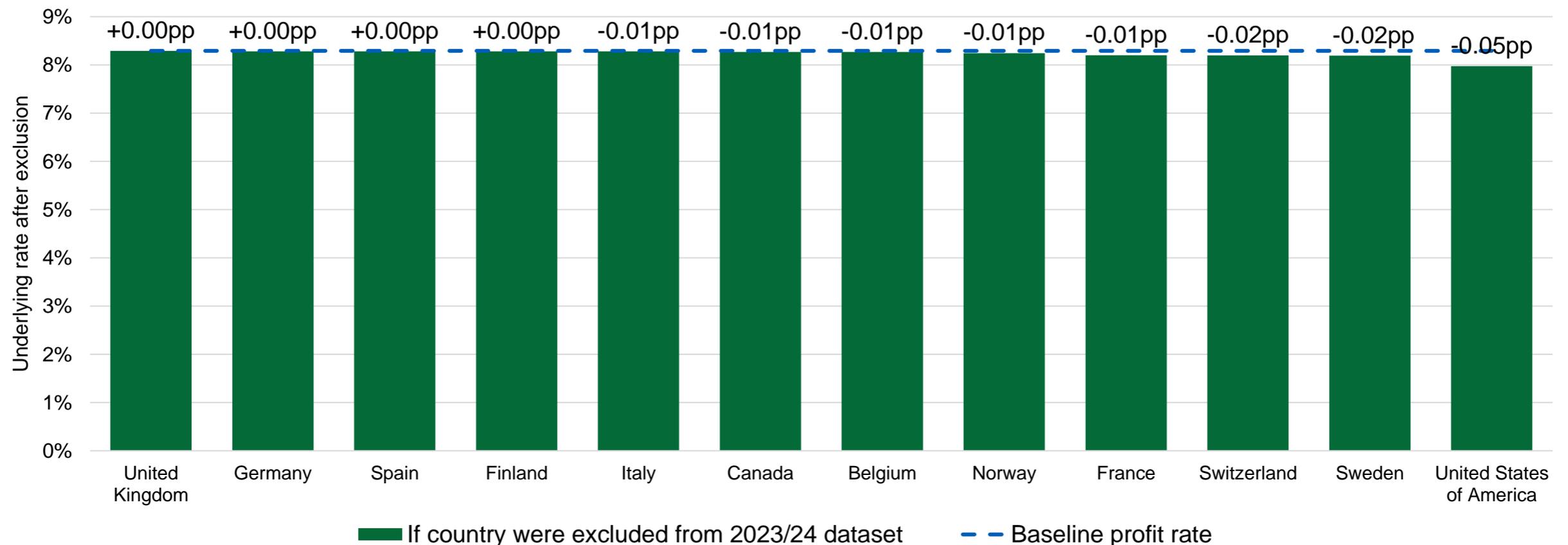
Notes: The rates are the composite of the Develop & Make and Provide & Maintain activity groups. Only countries with ≥ 5 number of companies are shown.

Source: Orbis, SSRO calculations



Sensitivity to the exclusion of a particular country

This chart shows what the baseline profit rate calculation would have been had a particular country been excluded from the analysis of the 2023/24 composite underlying rate. The figures shown are the differences to the actual baseline profit rate recommendation.



Notes: Only countries with ≥ 5 number of companies are shown.

Source: Orbis, SSRO calculations