

Key questions and answers regarding the SSRO's single source baseline profit rate and capital servicing rates methodology

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

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Terms and definitions

Comparability principle: The aim of the baseline profit rate is to provide the starting point in the determination of a 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 4-step process to calculate the contract profit rate of a contract that falls under the Single Source Contract Regulations. The baseline profit rate (BPR) is the average of the underlying rates for the last three years.

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

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

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

Capital servicing adjustment: An adjustment to the return on cost of production to account for the levels of fixed capital and working capital employed by companies in the comparator groups. A corresponding adjustment is made in the pricing of individual contracts by an adjustment at step 4 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. Why does the SSRO calculate a baseline profit rate and how is it done?

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 (BPR) for each financial year. The BPR can change annually to reflect what markets' have recently determined as 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 qualifying contracts do not drift away from competitive market outcomes.

The BPR is an average of the actual profit rates of companies whose activities are comparable to those that contribute to the delivery of MOD's qualifying contracts. The SSRO categorises those activities under the heading 'Develop, Make and Support' (DM&S) and companies are selected into that comparator group based on the nature of their activities. The median profit rate of a comparator group in each year is called the underlying rate. The BPR is calculated as the average of the underlying rates for the most recent three years.

2. What is the role of the baseline profit rate in determining the profit earned on a QDC?

The baseline profit rate (BPR) provides an important starting point for determining a reasonable level of contract profit. However, it is only the initial anchor; the final profit on a QDC or QSC is also determined by several additional factors, including:

- **Adjustments to the BPR** for risk, incentive payments and capital servicing, allowing flexibility around determining a wider range of contract profit rates as appropriate to the circumstances (see Q7); and
- **Contractor performance and pricing method**, which affect cost control and allocation of financial risk between the parties. This can lead to profit rates significantly above the BPR of 9.10% or, in cases of poor performance, even losses.

The BPR influences overall profitability across QDCs and QSCs, but its effect on individual contracts depends on the contracting parties' actions, which can cause significant variance from the baseline. The legislation provides several methods by which the price of a QDC or QSC may be set without the need to apply the BPR and four-step profit calculation in setting the contract price. For example, in some cases, the price of a QDC or QSC may be set with reference to the competitive market price of any goods and services being supplied under the contract.

3. What is the baseline profit rate change this year and why has it changed?

The BPR for 2026/27 is 9.10 per cent. The 2026/27 BPR is the rolling average of the annual underlying profit rate for the current year and two previous years. This year's rate is 0.54 percentage points higher than last year's rate. This is because the underlying rate from 2022/23 of 8.19% has dropped out of this year's rolling average and has been replaced with a higher 2026/27 underlying rate of 10.07%. This is shown in figure 1 below.

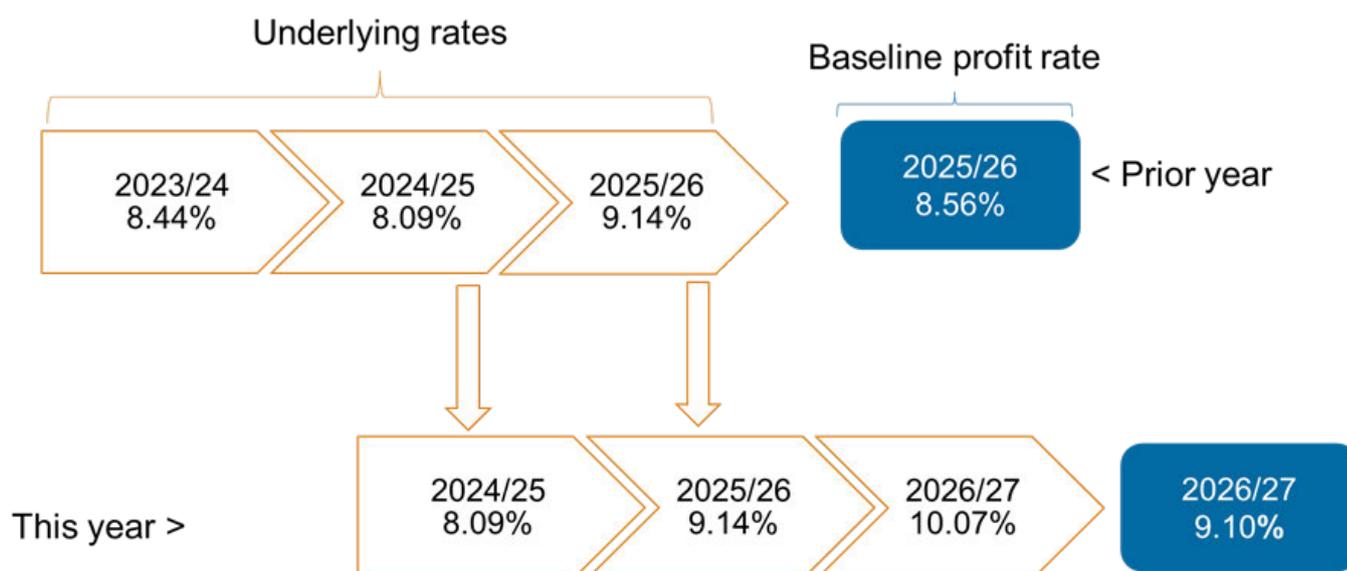
The underlying rate for this year, which measures the average rate of profit of the comparator companies before the capital servicing adjustment, is 11.68 per cent, up on last year's rate of 10.60 per cent. A capital servicing adjustment related to interest rates of -1.6 percentage points has then been applied (-1.46 per cent last year), resulting in the figure used in the rolling average of 10.07 per cent. See figure 1. This deduction to the underlying rate is higher than last year, reflecting higher historic interest rates during the period from which the comparator company data is drawn. There is a compensating upward increase when contract profit rates are agreed for individual contracts known as the capital servicing adjustment to ensure that contractors receive an appropriate and reasonable return on the capital. Question 19 sets out this process and the reasons for it in more detail.

4. What are the reasons for the baseline profit rate increasing this year?

The SSRO's BPR assessment is made with reference to the actual profit rates of companies undertaking economically comparable activities to those that enable the performance of qualifying contracts. This approach produces a robust, open-market profit benchmark which tracks developments in the wider economy. Therefore, rates can fall as well as rise over time.

This year the benchmark rates have risen, reflecting higher profit rates in our underlying company data and the ongoing effect of elevated costs of corporate borrowing. These increases are reflected in this year's higher BPR and CSRs, in line with our open-market comparability principle. These increases ensure that MOD contractors continue to be fairly rewarded when they undertake single source defence work, whilst protecting the MOD against risks to value for money in the absence of profits set through competition.

Figure 1 – Rolling average changes to the baseline profit rate



5. How does the SSRO's assessment reflect the outcomes of the Strategic Defence Review and Defence Industrial Strategy?

The SSRO's assessment provides a stable, transparent and replicable framework for setting profit rates on qualifying contracts. These features give defence suppliers confidence that they can contract with the MOD on a single-source basis, knowing what they are likely to earn if they perform. This certainty contributes to encouraging innovation and investment, while supporting broader objectives such as supply chain resilience and economic growth.

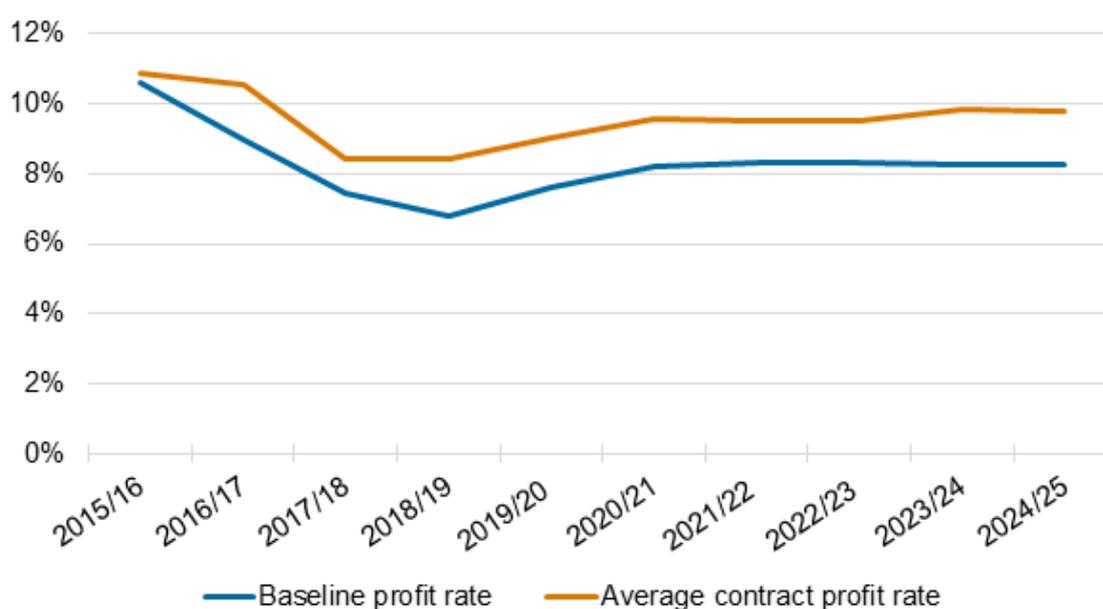
These outcomes align with the SSRO's statutory aims of delivering value for money and fair prices, which underpins all our functions.

6. What is the impact of the higher baseline profit rate on the defence industry and how much will it cost UK taxpayers?

The implications of an increase in the BPR for the taxpayers will depend on how all four of the steps which determine a contract profit rate are applied by the MOD and contractor. In addition, the performance of the contractor, the pricing method which allocates cost risk between the contracting parties, the specific contract terms and conditions, and any final price adjustment, will collectively determine the final contract price. In the short term, prices may therefore decrease or increase alongside a change in the BPR.

Figure 2 shows the average contract profit rates of contracts entered into each year and demonstrates that changes in contract profit rates may not always mirror changes in the BPR, as a result of those other factors.

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



Source: [SSRO \(2025\) Annual qualifying defence contract statistics: 2024/25](#), Table 6.

Note: The differences between the baseline profit rate and the observed contract profit rates are due to the application of adjustments to the BPR used in the contract profit rate 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 baseline profit rate?

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](#) include a summary of actual agreed contract profit rates to date.

Table 1: Illustration of the four steps and the range of contract profit rates available before the impact of contractor performance

Contract profit rate step		Value/Adjustment
	Unadjusted rate	10.53%
	Capital servicing adjustment ¹	-1.43pp
Step 1	Baseline profit rate	9.10%
Step 2	Cost risk adjustment ²	-2.27pp to +2.27pp
Step 3	Incentive adjustment ³	up to +2.00 pp
Step 4	Capital servicing adjustment (CSA) ^{1,4}	Minimum: -0.07% Lower quartile: +0.49% Upper quartile: +1.59% Maximum: +5.23%

Illustrative minimum CPR, based on: -25% step 2, +0pp step 3 and -0.07pp step 4	6.76%
Illustrative low CPR, based on: -25% step 2, +0pp step 3 and +0.49pp step 4	7.32%
Illustrative high CPR, based on: +25% step 2, +2pp step 3 and +1.59pp step 4	14.96%
Illustrative maximum CPR, based on: +25% step 2, +2pp step 3 and +5.23pp step 4	18.60%

The four-step process is set out in the SSRO's publication [Guidance on the Baseline Profit Rate and its Adjustment](#).

¹ See Question 24 for an explanation of these two capital servicing adjustments

² An adjustment of between +/- 25 per cent of the BPR.

³ A positive adjustment of up to two percentage points may apply to incentivise the achievement of enhanced performance.

⁴ These figures are the average of actual values reported to the SSRO for contracts priced between 2018/19 to 2024/25. The actual adjustment may be higher, lower or negative. Source: [SSRO \(2025\) Annual Qualifying Defence Contract Statistics: 2024/25](#).

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 fully delivered the contract.

It should be noted that the capital servicing adjustment in the table reflect actual rates agreed between the MOD and contractors. These may be less than adjustments that apply in the future due to this year's increase in the capital servicing rates.

8. 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 into a business, and can be thought of as the cost of financing a company. This is a 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) for a contract and is not directly comparable to the WACC as a means of assessing profitability. The definition used by the SSRO is:

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

The relationship between investment in a company as a whole and cost incurred for individual contracts 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.

Table 2: Definitions of measures used

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

9. How do the profits of the companies who make up the baseline profit rate 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 2024/25, as reported by the MOD.¹ The 5-year median profit rate of the DM&S 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.

Table 3: Return on cost of production of the top 20 listed companies by value of non-competitive spend

Company name	Return on cost of production: median FY2020 – FY2024*
Safran	18.99%
BT Group PLC	16.52%
Lockheed Martin Corporation	14.50%
BAE Systems PLC	12.46%
Rheinmetall AG	11.97%
General Dynamics Corporation	11.96%
Kongsberg Gruppen ASA	11.64%
Northrop Grumman Corporation	11.47%
Qinetiq Group PLC	10.13%
Saab AB	8.20%
Airbus SE	8.18%
RTX Corporation	8.08%
Thales	7.80%
Rolls-Royce Holdings PLC	7.10%
Leonardo S.P.A.	5.66%
Skanska AB	5.38%
Serco Group PLC	5.03%
Babcock International Group PLC	2.85%
Balfour Beatty PLC	1.31%
The Boeing Company	-5.00%
Develop, Make and Support median†	11.68%

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.

¹ Ministry of Defence (2025) MOD trade, industry and contracts: 2025, [MOD trade, industry and contracts: 2025 - GOV.UK \(www.gov.uk\)](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/118111/mod_trade_industry_and_contracts_2025.pdf)

The top 20 listed companies' 5-year median actual profit rates ranged from -5.00 per cent to 18.99 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 6.76 per cent to 18.60 per cent. The actual profit rate achieved on a contract may be higher than shown here by outperforming cost estimates, or lower than shown here by underperforming. We would expect those who agreed the highest contract profit rates by taking on risk to achieve higher actual rates of profit where that risk is managed successfully, and companies who agree the lower rates due to lower risk to achieve similarly lower rates of actual profit.

10. How does the baseline profit rate affect small and medium sized enterprises?

The baseline profit rate and the four-step contract profit rate process ensures that contractors can earn a fair and reasonable price and profit irrespective of company or contract size. The regime is designed to offer protections to both contractor and the MOD from market power that might otherwise represent a challenge to smaller companies.

The SSRO is able to support smaller contractors who may be less familiar with the regime in a number of ways, including:

- Guidance published on our website
- A helpdesk service
- Contractor onboarding and training

Further information can be found on [our website](#).

The methodology and the comparator groups

11. 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 profit rates 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 SSRO has been providing its rates assessment on this basis for ten years. The MOD continues to successfully contract with suppliers within the range of rates our assessment provides for, demonstrating the suitability of our approach.

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, 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.

12. 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 28 per cent of the companies used in the calculation of the 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, gives us confidence an appropriate group of companies has been selected (see questions 7 and 9).

13. Why are rates also published for Ancillary Services, Construction and Information Technology Services?

Given Ancillary Services, Construction and Information Technology Services account for a small minority of single-source contract spend they are not included in the BPR as doing so would not be consistent with the principle of comparability.

The data on all of the SSRO's activity types is provided so that the Secretary of State can understand the basis on which the rate has been calculated and why it was considered appropriate. This information may also be informative to the agreement of the step 2 cost risk adjustment, as the parties can take into account the particular type of activities to be carried out under the contract.

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

The [Orbis database](#) supplied by Bureau van Dijk, a Moody's Analytics company, 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 into the Orbis database. Data for the capital servicing adjustment is supplied by Bloomberg and the Bank of England. The SSRO publishes its methodology on its website which contains detailed information on the data fields it uses.

15. 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. Each company arising from reviewed to assess if it was a valid comparator and could form part of the assessment. Following this process approximately 85% of the companies in last year's BPR comparator group were retained (223 of 261). Of the total number of companies this year, around 39% are new additions to the group (142 of 365).

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

Companies may also be added through the annual review of contractors with QDCs or QSCs (or their ultimate parent undertakings) and the [latest data on the MOD's spending with suppliers](#). Inclusion of additional companies is subject to the companies' activities being comparable to the SSRO's activity types and 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.

16. 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 for determining if a company is small. The threshold in the methodology therefore ensures that there are no small companies in the comparator groups. These criteria were recently updated and the SSRO plans to reflect this change in the methodology for 2027/28.

17. Why is the baseline profit rate 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.

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 9). 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 1.82pp.

18. 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](#), 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 17). 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's approach assumes the cost of production for each comparator company to be appropriate, attributable and reasonable in the circumstances in relation to the revenue each comparator company receives.

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

19. Why does the SSRO make a capital servicing adjustment in calculating the baseline profit rate?

An adjustment is 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 4.

Regulation 11(7) of the Single Source Contract Regulations 2014 and section 17(2) of Defence Reform Act 2014 provide for an adjustment to the contract profit rate (step 4) 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 4.

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 as agreed between the contracting parties at step 4 to reflect the circumstances of the QDC or QSC. The making of adjustments for capital is contemplated by the [OECD transfer pricing guidelines](#).

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 4 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 4 to ensure that the overall effect of the CPR (taking account of steps 1-4) is that a contractor receives an appropriate and reasonable return on the fixed and working capital employed by the contractor for the purpose of enabling that contractor to perform the contract.

20. 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:

- amortisation costs of intangible assets; and
- the inclusion or otherwise of intangible assets in “capital employed” for the purpose of the capital servicing adjustment (see Q19).

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 three 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.

21. Why does the SSRO not remove the effects of amortisation from the baseline profit rate?

The SSRO does not make any adjustments to the comparable company data to remove the cost of revenue generating assets that are amortised over time, for example costs that relate to the purchase of one company by another.

When a comparator company has subsidiaries the data we use is derived from the consolidated group financial statements. This data reflects that when an acquisition occurs, the assets acquired and the revenues and costs associated with it become an integral part of the acquirer’s business and activities. Amortisation and impairment of acquired assets are a cost and are recognised in an accounting period in accordance with accounting standards. These costs are therefore treated as costs in both the baseline profit rate methodology and the SSRO’s Allowable Costs guidance. An uplift to the baseline profit rate for such costs would circumvent the requirements for contractors to demonstrate such costs were appropriate, attributable to the contract and reasonable in the circumstances.

22. 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 of which they were not previously aware.

As explained in Question 18, 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.

23. 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 e.g. due to accounting standard changes, 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 for the relevant period. Therefore, 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 year (not required for the calculation) and the prior restated year and not restated for any earlier years which the calculation would require.

If a material change in the underlying rate was 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. 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 4 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 4 to ensure that the overall effect on the CPR (taking account of steps 1-4) is that a contractor receives an appropriate and reasonable return on the fixed and working capital employed by that contractor for the purpose of enabling the contractor to perform the contract.

Capital servicing rates

24. 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 4 of the contract profit rate to reflect the capital intensity of the contract (see question 19).

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.

25. Why are the capital servicing rates not set as high as headline interest rates such as those set by the Bank of England?

The capital servicing rates for this year are:

- Fixed capital 4.05%
- Positive working capital 5.25%
- Negative working capital 4.18%

These rates, calculated based on time period averages of market interest rates, provide an allowance for servicing debt used to finance the operations of a company to deliver a QDC and QSC and generate profits. Most commonly, the cost of borrowing (e.g. an interest rate on a loan) tends to reflect the economic conditions when that borrowing takes place, rather than when the debt is repaid. In the case of long-term borrowing this means current capital servicing cost relates to debt accumulated from many years back. This results in capital servicing rates reflecting the period of low interest rates which precedes the more recent increase and are therefore lower than current headline rates set by the Bank of England and other central banks.

This process also means that the capital servicing rates move more slowly than changes in headline interest rates, as old borrowing gradually expires and new borrowing is entered into at current market rates. Conversely changes in short term borrowing is more quickly reflected in the working capital servicing rates, which can be seen in this year's relatively larger increases compared to the fixed capital servicing rate.