

**SSRO**

Single Source  
Regulations Office

*Assuring value, building confidence*

# Baseline profit and capital servicing rates methodology 2017/18

Illustrative example

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# Methodology

## 1. Introduction

- 1.1. Under the Defence Reform Act 2014 (the Act), the Single Source Regulations Office (SSRO) is required annually to review the figures used to determine the contract profit rate for pricing qualifying defence contracts (QDCs) and qualifying sub-contracts (QSCs). Section 19(2) of the Defence Reform Act 2014 requires that, for each financial year, the SSRO must provide the Secretary of State with its assessment of the appropriate baseline profit rate, capital servicing rates and funding adjustment.
- 1.2. This paper sets out the methodology the SSRO uses to calculate the baseline profit rates, capital servicing rates and funding adjustment for recommendation to the Secretary of State in January of each year.
- 1.3. The SSRO's Guidance on adjustments to the baseline profit rate provides details on the steps required to determine the contract profit rate.

## 2. Approach

2.1. This section summarises the approach taken in the SSRO's methodology for calculating the baseline profit rates and capital servicing rates.

2.2. The methodology is used to calculate six baseline profit rates. The rates relate to four separate activity types, a composite activity category and a zero rate:

- develop and make;
- provide and maintain;
- ancillary services;
- construction;
- a composite rate for 'develop and make' and 'provide and maintain'; and
- a zero rate category for contracts with organisations which are not permitted or do not wish to make a profit and/or when the MOD and contractor agree that a zero rate is appropriate.

2.3. In overview, the methodology identifies comparable companies tailored to the activities, including assets and contract risks, involved in QDCs and QSCs. These companies form the comparator reference groups for each activity type. The profit range for each set of comparable companies is then used to determine a baseline profit rate for each activity type. This is achieved by:

- identifying characteristics of activities typically covered by QDCs and QSCs;
- determining appropriate and robust comparable company financial data using a third party company database;
- reviewing this comparable data in the context of contract types seen by the SSRO and the activities of the comparable companies;
- using this data to set the baseline profit rate for each contract activity; and
- ensuring that this data is maintained year-on-year.

2.4. The SSRO will calculate and publish capital servicing rates for fixed capital, positive working capital and negative working capital.

### 3. Determining appropriate comparable data

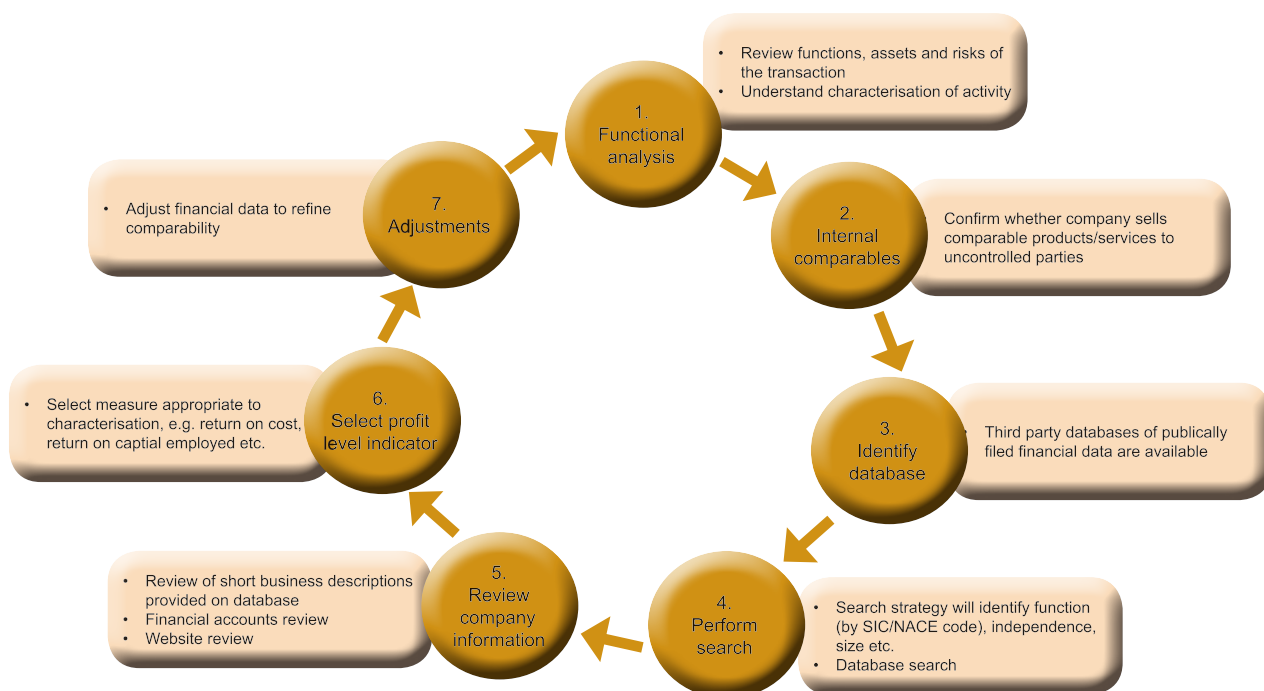
#### Data sources

- 3.1. An analysis of comparable companies is performed to identify and gather the data required to determine the profit rate for the activity characterisations to provide six baseline profit rates.
- 3.2. Publicly filed company financial results compiled in a database are used for this analysis. For example the ORBIS database provided by Bureau van Dijk is a comprehensive global database containing financial information on over 100 million public and private companies. The data is scrutinised for quality assurance purposes and financial data is supplemented where necessary by other publicly available information.

#### Figure 1: Best practice approach to transfer pricing

- 3.3. Additional publicly available data is also reviewed, including information from company accounts, websites and trade descriptions.

#### Comparable company search process



- 3.4. The comparable search process follows transfer pricing principles and the best practice approach set out by the OECD and supported by HMRC. This is summarised above in Figure 1.
- 3.5. In order to conduct an analysis of comparable company data, the SSRO considered the nature of the functions, assets and risks involved in QDCs and QSCs to determine the appropriate activity characterisations (stage 1 of Figure 1). Descriptions of the activities a company is typically expected to undertake to be considered as a comparable company were developed (see Appendix A).
- 3.6. The comparable company review process is divided into two phases, shown in stages 4 and 5 of Figure 1.

- 3.7. The first phase (stage 4 of Figure 1) is the initial data review. This applies tailored search criteria to a database of company information.
- 3.8. The second phase (stage 5 of Figure 1) is a detailed data review of the potential comparable companies identified in the first phase. This includes a review of business descriptions provided in the financial database, together with a review of company accounts and company website information.

#### Initial data review – search criteria

- 3.9. The search criteria used to perform comparable company searches are set out below.

#### Financial data

- 3.10. Comparable companies are identified by applying the following search criteria over a period of five years of data. The use of multiple year data is permitted for comparable searches, as per the OECD guidelines.
- 3.11. When calculating the profit rates, the SSRO uses the most recent year's data from the comparable companies identified in the search.
- 3.12. The most recent year of available data is for the previous calendar year or full financial year. For example when calculating the rates during 2016, data from the 2015 calendar year or for the 2015/2016 financial year is used, due to a time lag between company year ends and accounts filing dates. This is consistent with the approach adopted in previous years.

#### Active companies

- 3.13. Only active trading companies are included in the search.

#### Legal form

- 3.14. The search includes private limited companies (for example Ltd, Gmbh, SARL, SRL, BV and AS) and public companies (for example PLC, SA and NV).
- 3.15. Limited Liability Partnerships and partnerships are not included due to the potentially incomparable nature of their base costs (for example payments to partners are recorded and reported as drawings not salaries).

#### Independence

- 3.16. The SSRO includes only those companies that are independent and transact solely with third parties rather than related entities.
- 3.17. Companies are only included in the search if they are classified as "A independent" (where no person could have a shareholding of >25 per cent) or "B independent" (where no person could have a shareholding of >50 per cent).

## Region

- 3.18. Western European<sup>1</sup> and North American<sup>2</sup> companies are included in the search. A company's region is determined by its place of incorporation (where the company is established and formally registered). A company's place of incorporation is typically, but not always, the location of its headquarters and management function.

## Turnover

- 3.19. A minimum turnover of £5,000,000 (approximately €6,000,000 or \$7,500,000) for at least one of the selected years under consideration is specified to eliminate companies of a non-comparable size. The SSRO excludes companies with a turnover of less than £5,000,000 in a given calculation year.

## Profit

- 3.20. Companies are selected where they report a profit in at least one of the selected years in order to avoid going concern issues. The SSRO excludes companies which make a loss in a given calculation year.

## Function

- 3.21. Searches use NACE Rev 2 industry codes and relevant search terms in the short business description contained in the database to target comparable functions. NACE Rev 2 codes are used as they classify economic activities in the European Community and financial databases can also map these to North American industry codes. A company may have more than one NACE code and the database draws on all codes attributed to a company.

- 3.22. Tables B1, B2, B3 and B4 in Appendix B present the industry codes and text search terms used in the search strategy for the activity types of 'develop and make', 'provide and maintain', 'construction' and 'ancillary services'.

## Geographical considerations

- 3.23. Separate search strategies are prepared for North America and Western Europe although the same criteria are applied to both. Given that financial information is only available publicly for significantly large companies in North America, the database holds less company data for North America compared to the company data held for Western Europe. As such, North American company samples are typically smaller than Western European samples.

## Detailed data review – search criteria

- 3.24. Once an initial sample of potentially comparable companies is identified, they are reviewed in detail to confirm that they are appropriate comparable companies.
- The short business description for each company provided by the financial database is reviewed.
  - The company accounts are reviewed, where these are available, to provide greater detail about factors such as the primary sources of income and geographic footprint.

<sup>1</sup> Western Europe is defined as the UK, Austria, Belgium, France, Germany, Luxembourg, Netherlands, Switzerland, Denmark, Finland, Greece, Iceland, Ireland, Italy, Malta, Norway, Portugal, Spain and Sweden.

<sup>2</sup> North America is defined as the USA and Canada.

- Company websites are reviewed to provide more detail regarding the nature and location of each business' activities.

3.25. Key considerations in this stage of the review include:

- Whether the business model is comparable to the tested activity characterisation.
- Whether the tested activity characterisations are the principal activities of the identified companies. Companies may not exclusively perform a particular function, but to be accepted as a comparable company the selected characterisation needs to be a principal activity.
- Whether the activities of a business take place in comparable locations. For example, a UK business which earns the majority of its income and profit from work in the Far East, where pricing and cost are at different levels to those seen in Western Europe is not considered to be comparable.

3.26. This review contains some subjective elements – for example what is a 'principal level' of activity. Every effort is made to assess these consistently, using financial indicators where possible.

3.27. The outcome of the comparables search is a set of comparable companies from which financial indicators are identified.

#### 4. Calculating the baseline profit rate

4.1 To determine the profit rate for 'develop and make' and 'provide and maintain', an appropriate profit level indicator (PLI) must be used. A profit level indicator refers to the margin or measure used relative to an appropriate base (for example costs, sales or assets) that is realised from a transaction.

4.2. The net cost plus margin (also known as return on total cost) is the PLI used by the SSRO and is calculated as:

$$\text{Net cost plus} = \frac{\text{Operating profit}}{\text{Total expenses}}$$

4.3. 'Net cost plus', is the ratio of operating profit to total cost. The net cost plus margin is a measure of return on costs using the total operational expenses of the company. The ratio can allow for differences in functions by assuming that they are reflected in the level of total operating expenses, with many items able to be included in either cost of goods sold or other operating expenses.

4.4. The profit range for each set of comparable companies is used to determine the unadjusted underlying profit rate for the **four** activity characterisations.

4.5. The median value of the range of profit data is identified and used as an unadjusted underlying profit rate for each of the **four** activity characterisations.

4.6. The unadjusted underlying profit rate for each of the **four** activity types is then adjusted to remove capital servicing. Each comparable company's result is adjusted using the method set out in the guidance for the capital servicing adjustment calculation, and a revised median rate is calculated. **Appendix E sets out the principles that determine this adjustment.** This adjustment determines the underlying profit rates for 'develop and make' and 'provide and maintain'.



- 4.7. A three year rolling average is calculated to determine the profit rate for each of the **four** activity characterisations, using the underlying profit rate for each characterisation in the current year and the underlying baseline profit rates of the two immediately preceding years.
- 4.8. The composite profit rate is calculated by taking a simple average of the two profit rates for the 'develop and make' activity type and the 'provide and maintain' activity type.

## 5. Ensuring that data is maintained year-on-year

- 5.1. To remain current, the profit data will be updated annually to reflect the latest available financial data.
- 5.2. The comparable companies in the existing set will be reviewed to ensure that they remain appropriate to the activities in question.
- 5.3. A full revision of the search is anticipated every three years, which will involve rerunning the full comparables search process to determine if any additional companies should be incorporated within the reference group.

## 6. Calculating capital servicing rates

- 6.1 The SSRO calculates the following capital servicing rates for:
  - fixed capital;
  - positive working capital; and
  - negative working capital.
- 6.2 These are calculated using a similar methodology utilised in the previous 'Yellow Book' regime, but this has been amended to use more appropriate corporate bonds in the calculations.

### Fixed and positive working capital rates

- 6.3 The calculation of fixed and positive working capital servicing rates is based on corporate bond rates. A number of factors are assessed to determine the rates:
  - a. Firstly, the credit ratings of the top defence suppliers to the MOD for 2014/15 were analysed to identify an appropriate credit rating. This was assessed as a BBB rating using December 2015 data and is believed to be the right proxy for credit ratings of contractors with QDCs.
  - b. The interest rates achieved by sterling denominated debt at a BBB credit rating issued during the calendar year **(2016 for rates calculated for 2017/18)** are then analysed over two different time periods:
    - for fixed capital a 15 year bond rate is used with a seven year moving average; and
    - for positive working capital a one year bond rate is used, with a three year moving average.
- 6.4. The previous 'Yellow Book' methodology used data based on a BBB- credit rating. When calculating the rolling averages, data relating to a BBB- bond rate is used for previous years and data based on BBB bond rates is used for 2016/17 onwards.

## Negative working capital rate

- 6.5 The negative working capital rate is determined by using a three year rolling average of the Bank of England statistics on interest for short term deposits. Data to the year ending November 2015 is used in the calculation for the 2016/17 rate.

## 7. The SSRO funding adjustment

- 7.1 The method to calculate the funding adjustment calculation is intended to set it at a level that allows the MOD to recover half of the SSRO's costs through a reduction in the amounts paid on single source contracts shared across contractors based upon the value of their QDCs.

- 7.2 The SSRO funding adjustment is calculated as:

$$\text{SSRO funding adjustment} = \frac{\text{SSRO costs - costs of additional tasks requested by the Secretary of State}}{\text{Total value of QDCs}}$$

- 7.3 The SSRO costs and those of additional tasks requested by the Secretary of State are the arithmetic averages of the three full financial years preceding the year of the recommendation. All SSRO costs including referrals and one-off items will be included unless specifically incurred as a result of a request for additional work by the Secretary of State. The part year costs incurred during the set-up year (2014/15) and costs incurred by the MOD in establishing the SSRO will not be included.

- 7.4 SSRO costs and those of additional tasks requested by the Secretary of State will be drawn from the audited financial statements in the preceding three financial years. Where audited financial information is not yet available for three years it will be based on those years where it is available. For the 2017/18 funding adjustment the SSRO will use audited financial information for the year 2015/16 only.

- 7.5 The total value of QDCs will be an arithmetic average of the annual sum of the Total Allowable Costs (including any Risk Contingency Allowance) values reported in the Contract Pricing Statement Report for all QDCs signed in each of the three preceding financial years. Where contract amendments are made the most recently reported values will be used but each contract will be included only once in the calculation.

- 7.6 QDC data will be drawn from the period which aligns to that used for SSRO running costs. Where information is not available for three years it will be based on those years that are available. For the 2017/18 funding adjustment the SSRO will use reported Allowable Cost values from 1 April 2015 until 31 March 2016.

- 7.7 The SSRO expects the MOD to reconcile the intended and actual level of recovery at contract closure. A review will take place every five years of the level of SSRO cost recovery by the MOD and an assessment made of any under- or over-recovery from contracts concluded in the previous five years. This may result in a further adjustment being made if it is practical and proportionate to do so.

# Appendix A – Comparable companies analysed

**Table A1 – Characteristics of comparable companies analysed**

Rate	Types of companies analysed
1. Develop and Make	<p>Companies typically undertaking both manufacturing activities and design and development activities.</p> <p>Manufacturing activities (i.e. not distribution or marketing activities) and the products manufactured would include vehicles or equipment typically used for military or defence purposes. This could cover a broad range of products (e.g. including structural metal products, tanks, containers, general machinery, ships, aircraft, military fighting vehicles, trucks).</p> <p>Scientific or technical research, design, development or testing activities typically include those relating to military equipment, vehicles, software or systems.</p>
2. Provide and Maintain	<p>Companies typically undertaking both upkeep and maintenance support services and capacity provision services. Companies undertake activities such as:</p> <ul style="list-style-type: none"> <li>• repair and maintenance for vehicles, machinery or equipment;</li> <li>• servicing for vehicles, machinery or equipment;</li> <li>• provision of training services for vehicles, machinery or equipment;</li> <li>• installation of equipment;</li> <li>• providing availability contracts for vehicles, machinery or equipment where these assets are not owned by the contractor; or</li> <li>• renting and leasing out assets such as vehicles, trucks, tanks, containers, and other items of heavy machinery or means of transportation.</li> </ul>
Construction	<p>Companies that undertake construction of an industrial nature (for example factories, warehouses, plants or metal structures).</p> <p>Companies that undertake construction activities on a contract basis (with constructions based on designs and specifications received).</p> <p>The companies undertake pure construction or engineering activities and do not own or hold land for long term appreciation purposes.</p> <p>The companies do not bear any significant market risk in respect of the buildings or sites they are constructing.</p> <p>Companies undertaking construction activities that bear contract risk, procurement risk, staff risk and some quality control risk in respect of these activities, and are responsible for the management of the construction project.</p> <p>Companies undertaking comparable construction activities are not expected to own land banks and, as such, developers of residential properties are not considered comparable.</p> <p>Companies involved in comparable construction activities including architectural, engineering and/or building activities.</p>
Ancillary Services	<p>Companies undertaking:</p> <ul style="list-style-type: none"> <li>• IT support services (for example data processing, network hosting, IT repairs and maintenance and IT security services);</li> <li>• Facilities support services (for example property cleaning, property repairs and maintenance, gardening and security services);</li> <li>• Administrative support services (for example business outsourcing such as data management, bookkeeping and clerical work); and</li> <li>• Companies undertaking these support services which do not bear any significant risks other than the risk of failing to provide the contracted support services.</li> </ul>

# Appendix B – Industry codes and text search terms used in activity type search strategies

**Table B1 – Industry codes (NACE Rev 2) and Text Search terms used in Develop and Make search strategy**

Develop and Make	
NACE Rev 2 codes	2511 – Manufacture of metal structures
	2512 – Manufacture of doors and windows of metal
	2521 – Manufacture of central heating, radiators and boilers
	2529 – Manufacture of other tanks, reservoirs and containers
	2530 – Manufacture of steam generators
	2540 – Manufacture of weapons and ammunition
	2591 – Manufacture of steel drums and similar containers
	2592 – Manufacture of light metal packaging
	2593 – Manufacture of wire products, chains and springs
	2594 – Manufacture of fasteners and screw machine products
	2599 – Manufacture of other fabricated metal products
	2811 – Manufacture of engines and turbines, except aircraft, vehicle and cycle engines
	2812 – Manufacture of fluid power equipment
	2813 – Manufacture of other pumps and compressors
	2814 – Manufacture of other taps and valves
	2815 – Manufacture of bearings, gears, gearing and driving elements
	2821 – Manufacture of ovens, furnaces, furnace burners
	2822 – Manufacture of lifting and handling equipment
	2823 – Manufacture of office machinery and equipment
	2824 – Manufacture of power-driven hand tools
	2825 – Manufacture of non-domestic cooling and ventilation equipment
	2829 – Manufacture of other general purpose machinery
	2830 – Manufacture of agricultural and forestry machinery
	2841 – Manufacture of metal forming machinery
	2849 – Manufacture of other machine tools

Develop and Make	
NACE Rev 2 codes	2891 – Manufacture of machinery for mining, quarrying and construction
	2893 – Manufacture of machinery for food, beverages and tobacco processing
	2894 – Manufacture of machinery for textile apparel and leather production
	2896 – Manufacture of plastic and rubber machinery
	2899 – Manufacture of other special purpose machinery
	2910 – Manufacture of motor vehicles
	3011 – Building of ships and floating structures
	3012 – Building of pleasure and sporting boats
	3020 – Manufacture of railway locomotives and rolling stock
	3030 – Manufacture of air and spacecraft
	3040 – Manufacture of military fighting vehicles
	7211 - Research and experimental development on biotechnology
	7219 – Other research and experimental development on natural sciences and engineering
	7120 – Technical, testing and analysis
	7490 – Other professional, scientific and technical activities
	7410 – Specialised design activities
Text search:	(manuf* or produc* or fabric* or build*)
	(research* or develop* or design*) AND (test* or equip* or machin* or militar* or vehic*)

**Table B2 – Industry codes (NACE Rev 2) and Text Search terms used in Provide and Maintain search strategy**

Provide and Maintain	
NACE Rev 2 codes	3311 – Repair of fabricated metal products,
	3312 – Repair of machinery
	3313 – Repair of electronic and optical equipment
	3314 – Repair of electrical equipment
	3315 – Repair and maintenance of ships and boats
	3316 – Repair and maintenance of aircraft and spacecraft
	3317 – Repair and maintenance of other transport equipment
	3319 – Repair of other equipment
	3320 – Installation of industrial machinery and equipment
	4520 – Maintenance and repair of motor vehicles
	7712 – Renting and leasing of trucks
	7734 – Renting and leasing of water transport equipment
	7735 – Renting and leasing of air transport equipment
	7739 – Renting and leasing of other machinery, equipment and tangible goods
Text search:	(repair* or maint* or upkeep* or updat* or train*) AND (equip*)
	(rent* or leas* or hir*) AND (truck* or tank* or trailer* or container* or machin* or equip* or industr* or aircraft*)

**Table B3 – Industry codes (NACE Rev 2) and Text Search terms used in Construction search strategy**

Construction	
NACE Rev 2 codes	2511 – Manufacture of metal structures
	2599 – Manufacture of other fabricated metal products
	2891 – Manufacture of machinery for metallurgy
	2892 – Manufacture of machinery for mining, quarrying and construction
	2899 – Manufacture of other special purpose machinery
	4110 – Development of building projects
	4120 – Construction of residential and non-residential buildings
	4211 – Construction of roads and motorways
	4213 – Construction of bridges and tunnels
	4291 – Construction of water projects
	4299 – Construction of other civil engineering projects
	4311 – Demolition
	4312 – Site preparation
	4329 – Other construction installation
	4390 – Other specialised construction activities
Text search:	(construct* or build* or engineer* or architect*)

**Table B4 – Industry codes (NACE Rev 2) and Text Search terms used in Ancillary Services search strategy**

Ancillary Services	
NACE Rev 2 codes	6311 - Data processing, hosting and related activities
	6312 – Web portals
	8110 - Combined facilities support activities
	8121 - General cleaning of buildings
	8122 - Other building and industrial cleaning activities
	8129 - Other cleaning activities
	8211 – Combined office administrative service activities
	8219 – Photocopying, document preparation and other specialised office support activities
	8291 – Activities of collection agencies and credit bureaus
	8292 – Packaging activities
	8299 – Other business support service activities
Text search:	(outsourc* or support* or maint*) OR ((clean* or maint* or facil* or industr* or upkeep*) OR (office* or data* or cleric* or admin* or IT!))



## Comparable companies

- 1.1 Table 1 presents the [TBD] companies that were used to determine the 2017/18 underlying profit rate for the 'develop and make' activity characterisation.
- 1.2 The following criteria were applied to extract potentially comparable companies from the financial database, in the initial data review. These criteria are company legal form, independence, whether companies were active, region (place of incorporation), turnover and profit. Specific NACE codes and text search terms were also applied to the data at this stage to extract companies with potentially comparable functions (see paragraphs 3.9 to 3.23). A detailed data review of this initial group was then undertaken and companies were excluded if examination of data and information about them showed they were not an appropriate comparator (see paragraphs 3.24 to 3.27). This review process resulted in [TBD] accepted comparator companies.
- 1.3. Companies were excluded if they did not meet the turnover and profit criteria in the most recent year (see section 5). Of the [TBD] companies that were identified, [TBD] met the turnover criteria and had positive capital servicing adjusted net cost plus rates in the most recent year (2015) for which financial data was available. These were therefore used to calculate the 'develop and make' activity type's 2017/18 underlying profit rate.

[To be populated after company search review]

[illegible]

2. Companies used to determine the 2017/18 profit rate for the 'provide and maintain' activity type

- 2.1. Table 2 presents the [TBD] companies that were used to determine the 2017/18 underlying profit rate for the 'provide and maintain' activity characterisation.
- 2.2. The following criteria were applied to extract potentially comparable companies from the financial database, in the initial data review. These criteria are company legal form, independence, whether companies were active, region (place of incorporation), turnover and profit. Specific NACE codes and text search terms were also applied to the data at this stage to extract companies with potentially comparable functions (see paragraphs 3.9 to 3.23). A detailed data review of this initial group was then undertaken and companies were excluded if examination of data and information about them showed they were not an appropriate comparator (see paragraphs 3.24 to 3.27). This review process resulted in [TBD] accepted comparator companies.
- 2.3. Further companies were excluded if they did not meet the turnover and profit criteria in the most recent year (see section 5). Of the [TBD] companies that were identified, [TBD] met the turnover criteria and had positive capital servicing adjusted net cost plus rates in the most recent year (2015) for which financial data was available. These were therefore used to calculate the 'provide and maintain' activity type's 2017/18 underlying profit rate.

## Table 2

[To be populated after company search review]

3. Companies used to determine the 2017/18 profit rate for the 'construction' activity type

3.1. Table 3 presents the [TBD] companies that were used to determine the 2017/18 underlying profit rate for the 'construction' activity characterisation.

3.2. The following criteria were applied to extract potentially comparable companies from the financial database, in the initial data review. These criteria are company legal form, independence, whether companies were active, region (place of incorporation), turnover and profit. Specific NACE codes and text search terms were also applied to the data at this stage to extract companies with potentially comparable functions (see paragraphs 3.9 to 3.23). A detailed data review of this initial group was then undertaken and companies were excluded if examination of data and information about them showed they were not an appropriate comparator (see paragraphs 3.24 to 3.27). This review process resulted in [TBD] accepted comparator companies.

3.3. Further companies were excluded if they did not meet the turnover and profit criteria in the most recent year (see section 5). Of the [TBD] companies that were identified, [TBD] met the turnover criteria and had positive capital servicing adjusted net cost plus rates in the most recent year (2015) for which financial data was available. These were therefore used to calculate the 'construction' activity type's 2017/18 underlying profit rate.

Table 3

[To be populated after company search review]



## Appendix D - The SSRO's assessment of the appropriate baseline profit and capital servicing rates, 2017/18

**Table 1: Profit rates underlying the baseline profit rate, 2017/18**

	Unadjusted for capital servicing, annual	Adjusted for capital servicing, annual	Three year rolling average, adjusted for capital servicing
Develop and Make	[TBD]	[TBD]	[TBD]
Provide and Maintain	[TBD]	[TBD]	[TBD]
Construction	[TBD]	[TBD]	[TBD]
Ancillary Services	[TBD]	[TBD]	[TBD]
Composite of 'develop and make' and 'provide and maintain'	[TBD]	[TBD]	[TBD]

**Table 2: Recommended capital servicing rates, 2017/18**

	Recommended rate for 2016/17
Fixed capital servicing rate	[TBD]
Positive working capital servicing rate (applied to positive working capital balances)	[TBD]
Negative working capital servicing rate (applied to negative working capital balances)	[TBD]

**Table 3: Baseline profit rate, 2014/15 to 2016/17**

	2014/15 (actual)	2015/16 (actual)	2016/17 (actual)
Underlying (annual)	10.92%	9.88%	6.06%
Three year rolling average	10.70%	10.60%	8.95%

# Appendix E – The principles of the capital servicing adjustment

## Computation 1

Determine Ratio of Capital Employed  
versus Cost of Production

Fixed Capital Cost

Plus

Working Capital Cost (Positive or Negative)

EQUALS

Total Capital Employed

Divided into

Cost of Production

EQUALS

Cost of Production as a Proportion  
of Capital Employed (CP:CE)

## Computation 2

Determine the individual proportions  
of Total Capital Employed

Fixed Capital Cost

Divided by

Total Capital Employed

EQUALS

Fixed Capital as a proportion of  
Capital Employed

Working Capital Cost  
(positive or negative)

Divided by

Total Capital Employed

EQUALS

Working Capital as a proportion  
of Capital Employed

## Computation 3

Apply Capital Servicing Rates

Fixed Capital as a proportion  
of Capital Employed

Multiplied by

Fixed Capital Servicing Rate

Plus

Positive Working Capital as a proportion  
of Capital Employed

Multiplied by

Positive Working Capital Servicing Rate

OR (if negative)

Negative Working Capital as a proportion  
of Capital Employed

Multiplied by

Negative Working Capital Servicing Rate

EQUALS

Capital Servicing Rate

## Computation 4

Calculate the Capital Servicing Adjustment  
for Step 6

Capital Servicing Rate

Divided by

Cost of Production as a proportion of  
Capital Employed (CP:CE)

EQUALS

Capital Servicing Adjustment to be subtracted from  
each company result

