REVIEW BOARD

FOR

GOVERNMENT CONTRACTS

REPORT ON

THE 2012 ANNUAL REVIEW OF

THE PROFIT FORMULA FOR

NON-COMPETITIVE

GOVERNMENT CONTRACTS

January 2012

The Rt Hon Philip Hammond MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
SW1A 2HB

January 2012

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2012 Annual Review of the profit formula for non-competitive Government contracts.

Copies have been sent to the President of the CBI and to the Director Corporate Commercial & Exports.

Yours sincerely

John Price
Chairman

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NOTE:

[Published reports usually contain a note at this point, stating whether recommendations have been accepted by the Ministry of Defence and the Joint Review Board Advisory Committee and cross-referring to an agreed statement by the parties which is presented as an addendum to this report.]

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APPENDICES

ADDENDUM

EXPLANATION OF TERMS AND ABBREVIATIONS USED IN THIS AND IN PREVIOUS REPORTS

Acquisition Operating Framework ('AOF')	A web based tool that sets out MOD's acquisition policy and practice and which can be located in the 'Defence for... Business' section of the MOD website.
Adjusted Standard Baseline Profit Allowance ('ASBPA')	The profit allowance on cost applicable to firm, fixed price and target cost contracts and contract amendments with an estimated or target cost of £50 million or more subject to any further adjustment in accordance with the risk/reward matrix.
AIM companies	Companies listed on the Alternative Investment Market in the United Kingdom.
Annual return	The return to the Review Board prepared by a contractor showing the profit achieved each year on its non-competitive Government contracts. The 2010 annual returns have been completed for company year ends falling in the period 1 April 2010 to 31 March 2011.
Annual Review	The review by the Review Board of the principal components of the profit formula, undertaken annually between General Reviews. The most recent General Review was dated 2010. The most recent Annual Review was the 2011 Annual Review which was published by The Stationery Office (ISBN 978-0-11-773103-5) in 2011.
Baseline Profit Rate ('BPR')	The profit of the Reference Group after deducting allowances for the servicing of capital employed, expressed as a percentage of the Reference Group's cost of production.
BBB3 Corporate Bond	The credit quality of debt obligations issued by corporations is evaluated by organisations such as Thomson Financial BankWatch, Moody's, S&P and Fitch Investors Service. Bloomberg uses these evaluations to produce a composite rating. BBB3 is the lowest investment grade rating ie immediately above non investment grade.
CBI	Confederation of British Industry.
CE	Capital employed.
Comparability principle	The aim of the Government Profit Formula, which is to give contractors engaged in non-competitive Government contract work a return equal on average to the overall return earned by British industry having regard to both capital employed and the cost of production.

Contract Baseline Profit Allowance ('CBPA')	The profit allowance on cost applicable to a specific contract after making all appropriate adjustments in accordance with the risk/reward matrix.
Contractor Group	A generic term for the group of contractors who are engaged in non-competitive Government work using the Government Profit Formula. The composition of the group may vary from year to year.
CP	Cost of production.
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio is used to attribute to individual contracts a proportion of the contractor's capital employed.
CP:CE ratio unit	The business unit or other sub-division of a contractor's business for which a CP:CE ratio is calculated for the purposes of pricing non-competitive Government contracts.
CSAs	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
DEFCONs	The series of defence contract conditions applicable to MOD contracts. These are contained in the Commercial Managers' Toolkit which can be accessed on the MOD's Acquisition Operating Framework website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
EBIT	Earnings Before Interest and Tax.
FCSA	Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible assets.
Financial Reporting Standard ('FRS') 17	The accounting standard on retirement benefits issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.
Firm Price	A price, agreed for articles or services, or both, which is not subject to variation.
Fixed Price	A price, agreed for articles or services, or both, that is subject to variation in accordance with the variation of price provision of the contract.

General Review	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The report on the 2010 General Review was published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.
Government Accounting Conventions ('GACs')	The accounting conventions used for the determination of costs and capital employed attributable to non-competitive Government contracts.
Government Profit Formula and its Associated Arrangements ('GPFAA')	The Government Profit Formula ('GPF') incorporating the 1968 Memorandum of Agreement between the Government and the CBI and subsequent revisions and changes since that time, as agreed between the representatives of Government and the CBI. The extant GPFAA is published as an Appendix in each General Review report; and an updated version is placed on the MOD website after each Annual or General Review, to incorporate the outcome of that latest Review.
Government Profit Formula ('GPF')	The formula for the pricing of non-competitive Government contracts.
International Accounting Standards ('IASs')	International Accounting Standards issued by the International Accounting Standards Committee, the body that preceded (1973-2001) the International Accounting Standards Board.
International Financial Reporting Standards ('IFRSs')	International Financial Reporting Standards issued by the International Accounting Standards Board.
Intra-group inter-unit trading ('IGIU')	Trading between different CP:CE ratio units within the same group of companies.
Joint Review Board Advisory Committee ('JRBAC')	A body comprising representatives of the CBI and those trade associations and companies that have particular interest in non-competitive Government contracts.
LIBOR	London Inter Bank Offered Rate.

Ministry of Defence ('MOD')	The Ministry of Defence is the predominant user of the Government Profit Formula for non-competitive Government contracts and since the 1987 General Review has had the responsibility, formerly vested in HM Treasury, for communicating with the Board on behalf of Government on all matters concerning the profit formula. However, if both contracting parties agree, the GPFAA are available for application to non-competitive contracts placed by other Government departments or public sector bodies, by incorporation of the appropriate contract conditions. References in this report to MOD include, where appropriate, reference to other bodies making use of the GPFAA.
Modified historic cost ('MHC')	MHC is not defined in accounting standards or company law. For the purposes of the GACs it is taken to refer to the depreciated fixed asset value shown in a company's statutory accounts. These assets might be shown at cost or might be revalued in accordance with recognised accounting standards.
MPTC	Maximum Price Target Cost contracts. See Target Cost Incentive Fee.
No Acceptable Price No Contract ('NAPNOC') contracts	Contracts placed according to arrangements introduced by MOD in July 1992 where MOD's aim is that such contracts should be priced before they are placed.
Non-competitive Government contracts	Those Government contracts, or sub-contracts in aid of Government contracts, let other than by means of competitive tendering and priced either prior to or following contract award with reference to the Government Profit Formula.
Non-risk Baseline Profit Allowance ('NBPA')	The profit allowance on cost applicable to cost-plus (ie non-risk) contracts, being the SBPA less 25 per cent.
Non-risk contract	A contract placed on a cost reimbursement basis (whether with a fixed fee or a percentage profit) which insulates a contractor against loss.
Post-costing	A review by MOD of the actual costs incurred on a contract, for comparison with the costs as estimated at the time when the price for the contract was agreed.
Profit formula	The formula for the pricing of non-competitive Government contracts.
Private Venture Research and Development ('PV R & D')	Research and development expenditure which is not directly chargeable to the Government or any other customer under the terms of a specific contract.
Questionnaire on the Method of Allocation of	A document that the MOD requires its contractors to complete when engaged in non-competitive contracting

Costs ('QMAC')	which discloses to the MOD the contractor's cost accounting practices.
Reference Group	The group of UK companies representative of British industry whose average rate of return is used by the Review Board to determine the target rate of return in the Government Profit Formula.
Risk contract	A contract with a pricing arrangement which does not insulate the contractor against loss.
Risk/Reward matrix	A table with notes that sets out the adjustments to be made to the SBPA (or ASBPA for risk contracts and contract amendments with an estimated or target cost of £50 million or more) to reflect the differing levels of risk for different types of work.
SAYE	Save As You Earn.
SMEs	Small and Medium-sized Enterprises.
Standard Baseline Profit Allowance ('SPBA')	The profit allowance on cost applicable to all GPF contracts after adjustments to the BPR for differences between the Reference Group CP, the Contractor Group CP and the individual contractor CP as appropriate.
Standard Conditions of Government Contracts for Stores Purchases (SCs)	The series of conditions applicable to Government contracts published as Form GC/STORES/1 and now replaced by similar DEFCONs in contracting with MOD.
Statement of Standard Accounting Practice ('SSAP') 24	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the financial statements of enterprises. For UK listed companies this has now been superseded by IAS 19, and FRS 17 for other UK companies that have not elected to adopt IFRS.
Target Cost Incentive Fee ('TCIF') Contracting	A pricing basis whereby a target cost and target fee are agreed at the outset, along with a formula which sets out how the Government and the contractor will share cost over-runs and cost savings. Where such an arrangement is subject to an overall maximum price, it is usually referred to as a Maximum Price Target Cost ('MPTC') contract.
The 1968 Memorandum of Agreement	The agreement between the Government and the CBI establishing the Review Board.
The Profit Formula Agreement	The agreement between the Government and the CBI reached in 1968 which sets out the basis of pricing non-competitive Government contracts.

Total Contract Profit Allowance ('TCPA')	The total profit allowance applicable to a specific contract or contract amendment, expressed as a percentage of cost, comprising the sum of the CBPA, the FCSA and the WCSA.
Trigger points	A contract or sub-contract, incorporating the appropriate conditions, is eligible for reference to the Board where outturn costs vary from estimated costs by more than a specified percentage. The limits thus defined are referred to as the trigger points and are currently set by reference to a 10 per cent variation from estimated costs (see also paragraph 17 of the 1968 Memorandum of Agreement).
UITF 17	Urgent Issues Task Force Abstract 17 Employee Share Schemes. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment for various issues.
UK GAAP	UK Generally Accepted Accounting Practice.
WCSA	Working Capital Servicing Allowance provided to contractors for their investment in working capital.

SECTION I

INTRODUCTION

101. The basis for pricing non-competitive Government contracts is set out in The Government Profit Formula and its Associated Arrangements ('GPFAA') as agreed between the Ministry of Defence ('MOD'), on behalf of Government, and the Joint Review Board Advisory Committee ('JRBAC') representing the CBI, on behalf of industry. This agreement encapsulates a 1968 Agreement between Government and industry and numerous revisions since that date. A hard copy version of the GPFAA is published in the Review Board's General Reviews, the latest of which is the 2010 General Review[1]. However, after each Annual Review the GPFAA is updated and made available in soft-copy version on the MOD's external website at http://www.mod.uk/DefenceInternet/AboutDefence/CorporatePublications/FinanceandProcurementPublications/ReviewBoardGovContracts/.

102. The aim of the Government Profit Formula ('GPF') is to give contractors engaged on non-competitive Government contracts a fair return; that is to say, a return equal on average to the overall return earned by British industry in recent years, by reference to both capital employed and cost of production – this is known as the comparability principle.

103. The Review Board was established as an independent body in 1969 following the 1968 Agreement between Government and industry. The role of the Review Board includes carrying out General and Annual Reviews to consider aspects of the GPFAA.

104. Wide ranging General Reviews of the profit formula arrangements have been undertaken, normally triennially, since that date. These Reviews involve considerable participation by Government and by industry, and any relevant stakeholder is also able to contribute. In particular, the 2003 General Review resulted in a significant modernisation in the way in which the GPF operates following various studies initiated by HM Treasury.

105. Annual Reviews of the profit formula, like this 2012 Annual Review, are normally limited to examination of changes to the Reference Group rate of return and to other statistical data and their application to the GPF. The methodology used at an Annual Review is determined from the previous General Review.

106. At the conclusion of each General Review or Annual Review the Board makes a report to MOD giving its recommendations. This report is simultaneously made available to the JRBAC and forms the basis for discussions between MOD and the JRBAC.

107. This report, on the 2012 Annual Review of the Profit Formula for non-competitive Government Contracts, contains the Board's recommended profit formula for the year from 1 April 2012.

Review by Lord Currie of Marylebone

108. On 26 January 2011 the Minister for Defence Equipment, Support and Technology announced that Lord Currie of Marylebone was to chair an independent review of

[1] The report on the 2010 General Review of the Profit Formula for non-competitive Government Contracts was published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.

regulations used by MOD when pricing work to be procured under single source conditions without reference to competition (the 'Review').

109. The Minister's announcement stated that the Review implied no criticism of the Review Board for Government Contracts, which was considered a valued part of the existing framework and whose remit has been to maintain the profit formula and examine only those issues set before it by Government and industry.

110. On 10 October 2011 Lord Currie released the report on his Review and it went through a process of public consultation until 6 January 2012. The Board provided information to Lord Currie during the Review and submitted a response to his report.

111. The Board understands it is MoD's intention that there will be continued consultation on Lord Currie's proposals through 2012. Pending the outcome of the consultation, the Review Board has been asked to maintain the Government Profit Formula through the conduct of a 2013 review of the GPF, to apply from 1 April 2013. The content of the 2013 review will be agreed between MoD and the JRBAC.

Contract Reference

112. The Board concluded a contract reference in June 2011. A copy of the Board's decision is attached to its Annual Return dated August 2011 and has been lodged in the House of Commons Library. The decision can be viewed on the House of Commons Library website at http://deposits.parliament.uk under document reference DEP2011-1762.

SECTION II

SUMMARY

Profit Formula Recommendations

201. To achieve comparability with the return earned by British industry, the profit formula from 1 April 2012 should be structured as follows:

		2011 Annual Review %	*2012 Annual Review* %
FCSA	Fixed Capital Servicing Allowance (paragraph 311)	6.65	6.54
WCSA	Working Capital Servicing Allowance (paragraph 313)	4.25	2.86
BPR	Baseline Profit Rate (paragraph 317)	9.04	9.25

202. As part of the 2011 Annual Review MOD and the JRBAC agreed to a revised methodology for adjusting the BPR so it can be applied to individual contracts and this is described in more detail in section III of the report. The main adjustments to the BPR are:

- Standard Baseline Profit Allowance ('SBPA') (paragraph 321): for a contractor that does not conduct any Intra-Group Inter-Unit ('IGIU') trading, the 2012 Annual Review SBPA should be the same as the BPR, which is 9.25 per cent. Contractors that are part of a group of companies that undertake IGIU trading will compute and agree with MOD a reduced SBPA to be applied to contract costs so as to eliminate the impact of their IGIU trading.
- Adjusted Standard Baseline Profit Allowance ('ASBPA') (paragraph 325): a contractor's ASBPA, in respect of firm or fixed price contracts or amendments with costs in excess of £50m, should be 0.30 of a percentage point lower than its SBPA. Therefore, for the 2012 Annual Review, a contractor that does not undertake IGIU trading should have an ASPBA of 8.95 per cent.
- Contracts placed on a cost reimbursement basis should attract the SPBA less 25 per cent (paragraph 326). Therefore, for the 2012 Annual Review, a contractor that does not undertake IGIU trading should have a Non-risk Baseline Profit Allowance ('NBPA') of 6.94 per cent.

203. A flowchart showing the various stages of Baseline Profit is included at Appendix B.

Implementation of the Board's Recommendations

204. As agreed between MOD and the JRBAC the implementation date should be 1 April 2012.

Recent Profits on Non-Competitive Contracts

205. The comparison of target and outturn results on profit formula contracts is made from two sources: annual returns received directly from contractors and the results of the post-costing exercise undertaken by MOD.

206. The Board has analysed the 2010 annual returns received from contractors and notes that contractors, as a body, appear to have exceeded their expected return on cost of production ('ROCP') by 0.71 per cent for that year. However, this is an average figure and it masks a wide variety of results from individual contractors (paragraphs 402-407).

207. In 2010, as in 2009, the post-costing process was completed in respect of only 8 contracts. The Board considers that this is unlikely to be a large enough sample for the MOD to make a broad assessment of performance on non-competitive contracts. The Board has previously been provided with assurances that additional resources were being allocated to the post-costing programme, but the number of contracts completing the process remains disappointingly low (paragraphs 408-414).

Other Aspects of Non-Competitive Pricing

208. A number of issues relating to non-competitive contracting were mentioned in the Board's report on its 2011 Annual Review where it was anticipated that there would be discussions and agreement between MOD, the JRBAC and the Board during the course of the year. These issues being:

- The treatment of risk and reward on non-competitive contracts.
- Aligning DEFCONs and the GPFAA.
- Update of the QMAC.

209. The first two of these issues are directly affected by Lord Currie's Review and are not being addressed separately. Further progress on these issues will depend on the final outcome of the Review. The third issue, update of the QMAC, is being progressed through ongoing dialogue between MOD and the JRBAC.

SECTION III

THE TARGET RATE OF RETURN

Introduction

301. In order to apply the comparability principle which is the aim of the profit formula, the Board needs to consider, first, the return earned by British industry and, secondly, how that return should be expressed for pricing non-competitive Government contracts. In this section the Board considers the determination of the target rate of return based on the latest available evidence of the return earned by British industry.

The Reference Group

302. In general the Board has considered it appropriate to include in the Reference Group all sectors of British industry that operate in a fully competitive environment and represent the alternative uses that a contractor would have for its capital if that capital were not deployed on non-competitive contracts. This leads to a broadly based Reference Group which has the benefit of reducing volatility, making it less susceptible to any special circumstances that may affect an individual sector from time to time.

303. The constituents of the Reference Group have been considered in detail at each General Review. The general principle adopted by the Board has been that all British listed companies are eligible to be included in the Reference Group except where:

- the Board considers that a sector comprises companies that are so fundamentally different, in their capital structure and areas of operation, from the companies undertaking non-competitive Government contracts that it would be inappropriate to include that sector in the Reference Group. Significant sectors currently falling into this category are: banking, insurance, investment trusts, property investment, mining, oil and gas; or
- the Board considers that a particular sector is dominated by companies that do not operate on a sufficiently competitive basis. Sectors currently falling into this category are the water sector and certain subsectors of the power sector.

304. The Reference Group for this Review comprises 674 companies with a total capital employed of £222 billion and sales of £808 billion as compared with 718 companies with capital employed of £233 billion and sales of £787 billion at the 2011 Annual Review.

305. The Reference Group is derived from data obtained from the ‘Worldscope’ database which is compiled by Thomson Reuters.

306. The Board considers that the Reference Group is sufficiently large and broadly based to provide a sound basis for application of the principle of comparability.

Determination of the Baseline Profit

307. The target rate of return in the profit formula is determined on a three-year rolling average basis to reduce the volatility of the target rate caused by year-to-year fluctuations in the level of the Reference Group’s profitability. The simple average of the Reference Group Baseline Profit Rates for 2009, 2010 and 2011 is 9.25 per cent and the Board recommends that this should be adopted in the Profit Formula.

The Profit Formula Methodology

308. At the 2003 General Review it was agreed that the return on non-competitive contracts should be made up of three elements:

a. An allowance for the servicing of Fixed Assets used for non-competitive contracts (referred to as a 'Fixed Capital Servicing Allowance' or 'FCSA');

b. An allowance for the servicing of Working Capital used for non-competitive contracts (referred to as a 'Working Capital Servicing Allowance' or 'WCSA'); and

c. After making allowances for servicing recognised capital through the FCSA and WCSA (together the 'Capital Servicing Allowances' or 'CSAs'), the Reference Group has a residual profit figure (referred to as 'Baseline Profit'). The Baseline Profit figure is expressed as a percentage of cost of production (to arrive at the Baseline Profit Rate ('BPR')) which, after adjusting for any differences in the reporting of cost of production as between the Reference Group, the Contractor Group and the individual CP:CE ratio unit, determines the Standard Baseline Profit Allowance ('SBPA') on the cost of production of individual non-competitive Government contracts.

309. The underlying methodology is therefore that the Reference Group return should be reduced by the FCSA and the WCSA in order to derive a Baseline Profit figure from the Reference Group.

The FCSA

310. The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in fixed assets. The FCSA is:

- Linked to the 7 year moving average of the 15 year BBB corporate bond rate; plus
- 0.5 of a percentage point to incorporate a premium for a BBB3 rating and a liquidity discount.

311. Based on the rates prevailing up to 30 November 2011, this gives a FCSA of 6.54 per cent.

The WCSA

312. The purpose of the WCSA is to provide contractors with an appropriate allowance for their investment in working capital and it is therefore appropriate to link the WCSA to the cost of short-term funds. It is the Board's view that an appropriate short-term funding rate for the Reference Group is 1.25 percentage points above the one year LIBOR.

313. To reduce volatility the WCSA is based on a moving average of the one-year LIBOR rate. The 36 month moving average of the one year LIBOR based on rates prevailing up to 30 November 2011 was 1.61 per cent, so the appropriate WCSA should be 2.86 per cent.

314. From time to time a few contractors do have negative capital employed. In such cases, a negative WCSA should be computed on all of the negative capital employed and this

amount should be deducted from that contractor's Baseline Profit entitlement, except where the contractor can demonstrate that the negative capital employed does not relate to non-competitive Government work.

The Baseline Profit

315. By taking the total profit earned by the Reference Group and deducting the capital servicing allowances for financing fixed assets and working capital, the balance of the profit can be expected to represent, inter alia, the average return companies will receive for the risks they have assumed and as a return on their uncapitalised intangible assets. This can be expressed as a percentage of the Reference Group cost of production. This percentage, referred to as the Baseline Profit Rate, can then be used to determine the Standard Baseline Profit Allowance paid on the cost of production of non-competitive Government contracts. The calculation of the last five years' Baseline Profit Rates is set out below:

	2006/7 Reference Group £m	2007/8 Reference Group £m	2008/9 Reference Group £m	2009/10 Reference Group £m	2010/11 Reference Group £m
(A) Cost of Production	425,872	477,563	687,083	705,897	718,833
(B) Capital Employed	169,899	185,913	224,567	232,951	221,846
(C) CP:CE ratio (A÷B)	2.51	2.57	3.06	3.03	3.24
(D) FC:WC ratio	89:11	89:11	101:-1	109:-9	112:-12
(E) Actual Profit (EBIT)	54,067	58,073	71,812	81,523	88,709
(F) FCSA % (see note 1 below)	6.71%	6.70%	6.68%	6.71%	6.63%
(G) WCSA % (see note 1 below)	6.23%	6.55%	6.66%	5.30%	3.80%
(H) FCSA (B×(D['FC']÷100)×F)	10,146	11,086	15,162	17,035	16,473
(I) WCSA (B×(D['WC']÷100)×G)	1,164	1,340	-149	-1,112	-1,012
(J) Total CSA (H+I)	11,311	12,425	15,014	15,923	15,462
(K) Baseline Profit (E-J)	42,757	45,647	56,798	65,600	73,247
(L) BP as % of CP (K÷A)	10.04%	9.56%	8.27%	9.29%	10.19%
3 year rolling average			**9.29%**	**9.04%**	**9.25%**

Note. 1. The FCSA and WCSA percentage figures are derived using the methodology set out earlier in this section. However, for the purposes of calculating the Baseline Profit, the figures used are those prevailing up to 31 March of each year concerned.

Note 2. Figures in the table are subject to rounding differences

316. The Baseline Profit Rate is calculated from the average Baseline Profit of the Reference Group for the latest three years. It can be seen from the table that the three year simple average calculation has increased by 0.21 of a percentage point since the 2011 Annual Review. The Board has concluded that for the 2012 Annual Review the Baseline Profit Rate derived on the basis of strict comparability with the returns of British industry should be 9.25 per cent.

317. Accordingly the Board recommends that the Reference Group Baseline Profit Rate of 9.25 per cent should be used in the profit formula arrangements. This figure needs to be adjusted before it can be applied to individual contracts, and this process is considered in the following section.

The Standard Baseline Profit Allowance

318. The Reference Group Baseline Profit Rate on cost of production of 9.25 per cent, on the modified historic cost basis, needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractor Group.

319. The Board's assessment is that the calculation of cost of production in the Contractor Group will be different from that of the Reference Group, because the Contractor Group's figures for cost of production include IGIU trading whereas similar trading within the Reference Group will be eliminated as consolidation adjustments in group accounts. Therefore intra-group trading within the Contractor Group needs to be assessed and eliminated in order to maintain comparability.

320. In a submission to the 2011 Annual Review MOD and the JRBAC agreed that there should be a refinement to the process and methodology for eliminating IGIU trading which reflects experience gained since the IGIU adjustment was first introduced, following the 2003 General Review. It was agreed at the 2011 Annual Review that the IGIU adjustment should be calculated for each corporate group of companies rather than applying a 'blanket' IGIU adjustment to the Contractor Group. This adjustment, together with any other adjustment that might be required in a particular year, results in the SBPA.

321. As a consequence of the change described above, and because the Board does not consider that any other adjustment is required, for contractors that are part of a group that does not undertake IGIU trading the recommended SBPA is the same as the recommended BPR for the 2012 Annual Review. However, individual CP:CE ratio units will agree lower SBPA rates with MOD if they are part of a group that undertakes IGIU trading. The Board requests that the JRBAC continues to support the MOD in providing the Board with data on IGIU trading and on agreed profit rates so the Board can continue to monitor any differences between expected and outturn profits on GPF contracts.

The Risk/Reward Matrix

322. The MOD and the JRBAC recognise that the risk profiles of different types of work will vary and the principle that contracts should be priced at a target rate of return that relates to their risk profile is a sound principle. The parties took steps in the 2003 General Review to further embed this principle into the GPF through the agreement of interim arrangements. These arrangements consisted of a variable Risk/Reward matrix and a reduction of 30 basis points on the SBPA for firm or fixed price contracts over £50 million.

323. At reviews since 2003 the Board has urged the parties to review the interim arrangements dealing with the subject of risk and reward in GPF contracts. In paragraph 411 of its report on the 2010 General Review the Board noted that the parties were in discussion on this topic, although little progress was made.

324. The assessment of the appropriate balance of risk and reward falls within the scope of Lord Currie's ongoing Review of Single Source Pricing Regulations so it is appropriate to wait for the Review to be completed before giving the matter any further consideration.

325. The Board recommends that the existing arrangements should continue until the Review of Single Source Pricing Regulations has been completed. The recommended Adjusted Standard Baseline Profit Allowance ('ASBPA') for the 2012 Annual Review is therefore 30 basis points below its SBPA. For CP:CE ratio units that are part of a group that does not undertake IGIU trading the ASBPA will be 8.95 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced ASBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading.

326. The Risk/Reward matrix also addresses the issue of non-risk contracts and notes that non-risk contracts should attract the Standard Baseline Profit Allowance less 25 per cent. Therefore the Board recommends that if CP:CE ratio units that are part of a group that does not undertake IGIU trading its non-risk contracts should attract a Contract Baseline Profit Allowance of 6.94 per cent. For CP:CE ratio units that are part of a group with IGIU trading a reduced NBPA will be computed and agreed with MOD so as to eliminate the impact of IGIU trading. The Risk/Reward matrix, as it currently stands, is reproduced at Appendix C.

The Comparability Principle

327. In Section 1.36 of the GPFAA the Board is asked 'to bring to notice in its reports anything that it regards as relevant to the operation of the GPF. This would include, should the occasion arise, respects in which the Board might wish to draw attention to any perceived ill-effect for either party, or for both, deriving from strict observance of the comparability principle and to make further recommendations which should be separately identified'. The Board has concluded that there is no such matter that it wishes to bring to notice in the Report on the 2012 Annual Review.

SECTION IV

RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

Introduction

401. The Board receives information on profits recently achieved on non-competitive Government contracts from two sources. Historically the primary source has been annual returns prepared for the Board by contractors, on a confidential basis, showing the overall results achieved on their non-competitive work in each financial year. The Board also receives reports summarising the results of MOD's post-costing investigations into the profits achieved on individual contracts.

Annual Returns

402. Thirty-eight contractors have submitted their 2010 annual returns for consideration at this Review. The returns analyse GPF contract work performed in the year with total sales of £6.6bn. The comparable figures for 2009 are 37 returns with total GPF sales also of £6.6bn.

403. In previous years the Board has been able to compare the level of non-competitive sales recorded in annual returns with the total level of non-competitive contracts placed, as recorded in the annual UK Defence Statistics publication prepared by DASA[2]. However, in the 2011 version of the publication DASA has changed the source of its data on contracts placed and it no longer includes information on contract amendments. DASA has undertaken that at future Reviews it will provide the Board with additional data on non-competitive contracts and amendments.

404. The Board's analysis of the 2010 annual returns shows that the contractors' overall expected rate of return on cost of production ('ROCP') on GPF contracts was 8.16 per cent on their cost of production (7.94 per cent in 2009), and that they achieved an actual ROCP of 8.87 per cent (8.75 per cent in 2009). Therefore contractors, as a body, appear to have exceeded their expected ROCP by 0.71 of a percentage point (0.81 percentage points in 2009). This is a weighted average calculation of contracts with a variety of profit rates and which started in a number of different years.

405. The Board notes that the overall outturn profit of the Contractor Group appears to be very close to the overall target profit. However, analysis of the 2010 data shows that there is a very wide variety in the results achieved by individual contracting units, with exactly half of the contracting units falling above and below the target rate. Analysing historic data has shown that the performance of some contractors has deviated from the target for a period of several years. The Board would expect that MOD's post costing exercises would enable it to understand such variances and would inform its estimating procedures. The Board does note that some 90 per cent (by sales value) of the contracts included in the returns relate to Risk contracts where the price is fixed at the outset.

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[2] 2011 UK Defence Statistics released 28 September 2011 produced by Defence Analytical Services and Advice (DASA), Ministry of Defence.

406. The following table shows the figures for variance of actual returns from the target return for the past 15 years:

Year	Variance	Year	Variance	Year	Variance
2010	+0.71%	2005	-1.1%	2000	-7.8%
2009	+0.81%	2004	-3.37%	1999	No returns
2008	+3.81%	2003	No returns	1998	No returns
2007	+1.05%	2002	No returns	1997	No returns
2006	+2.29%	2001	-26.3%	1996	+15.4%

407. The Board will continue to monitor the performance of contractors in order to determine any developing trend and, if so, will seek to understand the causes for it.

Post-Costing

408. Post-costing is a review by MOD of the actual costs incurred on a contract, for comparison with the costs estimated at the time when the price of the contract was agreed. Post-costing is designed to assist MOD in contract pricing by providing a check on the accuracy of estimating procedures and to provide a guide to follow-on pricing.

409. Past post-costing results received from MOD are shown below:

All contracts post-costed by MOD				
	2006	**2008**	**2009**	**2010**
Total of contracts post-costed				
(a) Number (b) Value	13 £694m	15 £807m	8 £1,057m	8 £1,404m

Analysis of costs of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2006	**2008**	**2009**	**2010**
A – Contracts where +/- 5 per cent accuracy was achieved:				
(a) Percentage by Number (b) Percentage by Value	67% 78%	27% 30%	63% 17%	43% 72%
B – Contracts where +/- 10 per cent accuracy was achieved:				
(a) Percentage by Number (b) Percentage by Value	92% 84%	47% 51%	75% 84%	57% 77%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):				
(a) Number (b) Value	10 £503m	4 £73m	5 £827m	3 £909m
D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):				
(a) Number (b) Value	Nil Nil	3 £121m	2 £144m	2 £193m
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:				
(a) Number (b) Amount of refund	Nil Nil	1 £0.5m	2 £3m	1 £9m
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):				
(a) Number (b) Value	1 £11m	4 £526m	1 £13m	1 £148m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):				

(a) Number	1	4	Nil	1
(b) Value	£100m	£38m	Nil	£21m

Note: MOD did not report any post-costing results for 2007.

410. The number of contracts included in the post-costing exercise remains small. As can be seen, outturn costs were below target costs by more than 10 per cent on two contracts with total estimated costs of £193m. One of these contracts was referred to the Review Board and resulted in the contractor being required to repay £9m to MOD.

411. Whilst the total value of contracts post-costed has risen, the number post-costed remains at a very low level. The Board notes that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment under DEFCON 648a, which was introduced following the 2003 General Review.

412. The Board's direct use for post-costing results is to gain an understanding, in addition to that achieved through annual returns, of how closely contract performance matches profit formula target performance.

413. At the time of writing this document Lord Currie's report on his Review of Single Source Pricing Regulations has been released and is in the consultation phase. It is not clear how, or indeed whether, Lord Currie's recommendations will be adopted and whether post-costing will continue in its current form.

414. The Board can only reiterate the view it has stated several times in recent years, that post-costing is a vital exercise for MOD and must provide it with valuable information to understand costs, thus informing subsequent pricing. The Board has consistently encouraged MOD to increase the coverage of its post-costing exercise and has received a number of previous assurances that this was in train, but continues to be disappointed with the results. The Board will continue to monitor post-costing activity and will provide further commentary in its next Review.

SECTION V

OTHER ASPECTS OF NON-COMPETITIVE PRICING

Other Matters

501. A number of issues relating to non-competitive contracting were mentioned in the Board's report on its 2011 Annual Review where it was anticipated that there would be discussions and agreement between MOD, the JRBAC and the Board during the course of the year. These issues being:

- The treatment of risk and reward on non-competitive contracts.
- Aligning DEFCONs and the GPFAA.
- Update of the QMAC.

502. The first two of these issues are directly affected by Lord Currie's Review and are not being addressed separately. Further progress on these issues will depend on the final outcome of the Review. The third issue, update of the QMAC, is being progressed through ongoing dialogue between MOD and the JRBAC.

APPENDIX A

THE RECOMMENDED PROFIT FORMULA - ILLUSTRATIONS

This appendix provides some illustrations on the use of the recommended profit formula to determine the Total Contract Profit Allowance for individual contracts.

Set out in Annex I to this appendix are a range of illustrations on the application of the recommended profit formula assuming:

1. a CP:CE ratio of 3:1 and a contract attracting the Standard Baseline Profit Allowance

2. a CP:CE ratio of 6:1 and a contract attracting the Standard Baseline Profit Allowance

3. a CP:CE ratio of 1.5:1 and a contract attracting the Standard Baseline Profit Allowance

4. a CP:CE ratio of 3:1 and a contract for a repeat production order attracting the Standard Baseline Profit Allowance less 10 per cent

5. a CP:CE ratio of 3:1 and a contract requiring specialist skills and attracting the Standard Baseline Profit Allowance plus 10 per cent

6. a CP:CE ratio of 3:1 and a non-risk contract attracting the Standard Baseline Profit Allowance less 25 per cent

Annex II to this appendix provides an illustration of the application of the recommended profit formula on contracts with an estimated or target cost of £50 million or more.

APPENDIX A: ANNEX I

ILLUSTRATIONS OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
CP:CE ratio calculation:						
(A) Fixed capital (80%)	2,400,000	1,200,000	4,800,000	2,400,000	2,400,000	2,400,000
(B) Working capital (20%)	600,000	300,000	1,200,000	600,000	600,000	600,000
(C) Total capital (A + B)	3,000,000	1,500,000	6,000,000	3,000,000	3,000,000	3,000,000
(D) Total cost of production of CP:CE unit	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000
(E) CP:CE ratio is therefore (D/C)	3	6	1.5	3	3	3
CSA calculation:						
(F) FCSA	6.54%	6.54%	6.54%	6.54%	6.54%	6.54%
(G) FC proportion (A)	80.00%	80.00%	80.00%	80.00%	80.00%	80.00%
(H) (F x G)	5.23%	5.23%	5.23%	5.23%	5.23%	5.23%
(I) WCSA	2.86%	2.86%	2.86%	2.86%	2.86%	2.86%
(J) WC proportion (B)	20.00%	20.00%	20.00%	20.00%	20.00%	20.00%
(K) (I x J)	0.57%	0.57%	0.57%	0.57%	0.57%	0.57%
(L) CSA (H + K)	5.80%	5.80%	5.80%	5.80%	5.80%	5.80%
(M) CSA as percentage of CP (L/E)	1.93%	0.97%	3.87%	1.93%	1.93%	1.93%
Individual contract price:						
(N) Contract CP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
(O) Standard Baseline Profit Allowance	9.25%	9.25%	9.25%	9.25%	9.25%	9.25%
(P) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(Q) Contract Baseline Profit Allowance	9.25%	9.25%	9.25%	8.33%	10.18%	6.94%
(R) CSA (M)	1.93%	0.97%	3.87%	1.93%	1.93%	1.93%
(S) Total Contract Profit Allowance (Q + R)	11.18%	10.22%	13.12%	10.26%	12.11%	8.87%
(T) Total formula payments (N x S)	111,800	102,200	131,200	102,600	121,100	88,700
(U) Total contract price (N + T)	1,111,800	1,102,200	1,131,200	1,102,600	1,121,100	1,088,700

Explanation: the above illustrations assume contracts with a CP of £1 million in a variety of circumstances. Example 1 assumes that the Standard Baseline Profit Allowance of 9.25% is applicable (ie that there is no IGIU trading) and the contractor's CP:CE ratio is 3:1. Examples 2 and 3 illustrate how payments will change for contractors with varying CP:CE ratios. Examples 4, 5 and 6 illustrate how payments change for contracts where the Standard Baseline Profit Allowance requires an adjustment in accordance with the risk/reward matrix.

APPENDIX A: ANNEX II

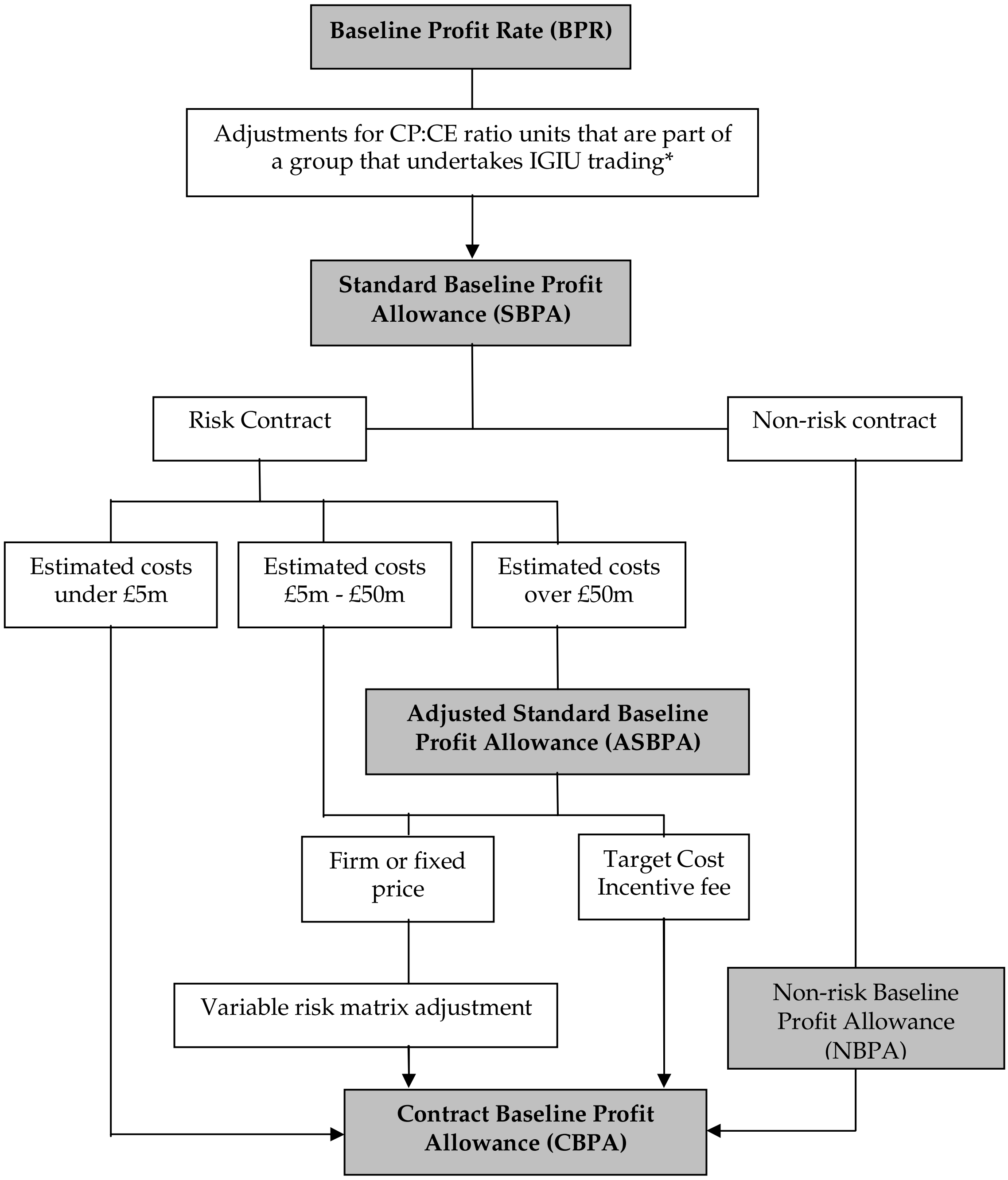
ILLUSTRATION OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA UNDER THE SPECIAL ARRANGEMENTS FOR CONTRACTS IN EXCESS OF £50 MILLION

		CSAs	Total
Contractor's CP:CE ratio:			
(A) Fixed capital (80%)		24,000,000	
(B) Working capital (20%)		6,000,000	
(C) Total capital (A + B)		30,000,000	
(D) Total cost of production		90,000,000	
(E) CP:CE ratio is therefore (D/C)		3	
CSA calculation:			
(F) FCSA		6.54%	
(G) FC proportion (A)		80.00%	
(H) (F x G)		5.23%	
(I) WCSA		2.86%	
(J) WC proportion (B)		20.00%	
(K) (I x J)		0.57%	
(L) CSA (H + K)		5.80%	
(M) CSA as percentage of CP (L/E)		1.93%	
Individual contract price:			
(N) Contract CP		75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	9.25%		
(P) Reduction for contracts over £50m	0.30%		
(Q) Adjusted Standard Baseline Profit Allowance (O – P)		8.95%	
(R) Adjustment in accordance with the Risk/Reward matrix		nil	
(S) Contract Baseline Profit Allowance		8.95%	
(T) CSA (M)		1.93%	
(U) Total Contract Profit Allowance (S + T)		10.88%	
(V) Total formula payments (N x U)		8,160,000	8,160,000
(W) Total contract price (N + V)			£83,160,000

Explanation:
The illustration assumes a contract with a CP of £75 million being undertaken by a contractor with a CP:CE ratio of 3:1. It also assumes the SBPA is 9.25% (ie that there is no IGIU trading) and that the Adjusted Standard Baseline Profit Allowance does not require any adjustment in accordance with the risk/reward matrix for this contract.

APPENDIX B

FLOWCHART SHOWING THE VARIOUS LEVELS OF BASELINE PROFIT AND THE RECOMMENDED TERMINOLOGY AND ABREVIATIONS TO BE USED



* Exceptionally, there could also be an adjustment at this point for any divergence between strict comparability between reference group profitability and GPF profitability.

CBPA + FCSA + WCSA = **Total Contract Profit Allowance (TCPA)**

APPENDIX C

The Risk/Reward Matrix

FLEXIBLE PROFIT ADJUSTMENT (TO STANDARD BASELINE PROFIT ALLOWANCE)			
TYPE OF WORK	**SBPA – 10%**	**SBPA**	**SBPA + 10%**
SUPPLY	• Follow on and repeat orders for production/ supply involving existing specification • Repeatable quality	• Interrupted production • Typical/normal production orders	• First production batch for a new requirement with significant development/production overlap • One-off high technology procurement
SUPPORT/SERVICE PROVISION	• Clearly defined specification • Repeatable quality • Reactive support/repairs, maintenance or ongoing contracts	• Initial repair and support order • Customer specified repair and maintainability standards • Support requirements not fully defined	• Long term commitment to Service and Capability provision to a defined output standard
DEVELOPMENT	• After design certification, support activities involving routine document maintenance and simple analysis of existing designs • Post development work, minor development work and programmes involving minor modification of established technologies	• Development work • Contractor accepts full responsibility for performance and integration • Modification Programmes including proposals for, and analysis of, extensive changes to existing design in respect of established technologies • Fault management	• High Technology or Specialist skills or new concepts

NOTES

1. Deciding on the appropriate rate on individual contracts should depend on a balance of factors. The underlying principle should be that the majority of activity should attract the standard rate of profit unless there are strong characteristics to indicate otherwise. Where there are strong characteristics indicating otherwise the profit rate applicable to that contract shall be the rate that is applicable to the majority of activity.
2. The risk matrix set out above should apply to contracts with an estimated cost in excess of £5 million. Contracts below this amount should receive the standard rate of risk (or non-risk) profit.
3. Cost-plus (ie non-risk) contracts should attract the Standard Baseline Profit Allowance less 25 per cent in all instances. The risk matrix set out above does not apply to cost-plus contracts.
4. In the case of firm or fixed price contracts and contract amendments with an estimated or target cost of £50 million or more, the Baseline Profit allowance should be 30 basis points less than the Standard Baseline Profit Allowance (known as the Adjusted Standard Baseline Profit Allowance or ASPBA) subject to any further adjustment in accordance with the risk/reward matrix.
5. The Target Baseline Profit on TCIF contracts and contract amendments:
   - should be based on the Standard Baseline Profit Allowance for contracts or contract amendments with a target cost below £50 million; and
   - should be based on the Adjusted Standard Baseline Profit Allowance (ie the SBPA less 30 basis points) for contracts or contract amendments with a target cost of £50 million or more.
6. The aim of the variable profit rate arrangements should be to achieve a broadly neutral cost impact for MOD, assessed not on an annual basis but over a time period covering a number of years. The assessment should not include contracts that are dealt with in accordance with notes 4 and 5 above.
7. The variable profit arrangements and their application on individual contracts are subject to review and monitoring in order that the arrangements can be refined and developed.

ADDENDUM

Agreed Statement by MOD and the JRBAC

[Published reports usually contain an agreed statement at this point, stating whether recommendations have been accepted by Ministry of Defence and the Joint Review Board Advisory Committee.]