REVIEW BOARD

FOR

GOVERNMENT CONTRACTS

REPORT ON THE 2007 GENERAL REVIEW OF THE PROFIT FORMULA FOR NON-COMPETITIVE GOVERNMENT CONTRACTS

November 2007

The Rt Hon Des Browne, MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
SW1A 2HB

9 November 2007

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2007 General Review of the profit formula for non-competitive Government contracts.

Copies have been sent to the President of the CBI and to the Defence Commercial Director.

Yours sincerely

George Staple
Chairman

REVIEW BOARD FOR GOVERNMENT CONTRACTS

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IMPORTANT NOTICE

The recommendations in this report are accepted by the Ministry of Defence and the Joint Review Board Advisory Committee, subject to certain implementation arrangements contained in an agreed statement, presented as an Addendum to this report on page 87. The Addendum shows that the parties have agreed:

To implement a **Standard Baseline Profit Allowance of 9.2%** (in place of the 9.39% detailed in this report). This agreement to modify the SBPA has a consequential impact on:

- **The Adjusted Standard Baseline Profit Allowance, which becomes 8.9%** (from the 9.09% detailed in this report); and
- **The Non-risk Baseline Profit Allowance, which becomes 6.9%** (in place of the 7.04% detailed in this report).

To recognise an implementation date of **1 February 2008**.

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APPENDICES

ADDENDUM

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

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.
Annual Review	The review by the Review Board of the principal components of the profit formula, undertaken annually between General Reviews. The report on the 2006 Annual Review was published by The Stationery Office (ISBN 0-11-773056-4) in May 2006.
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.
CE	Capital employed
Comparability principle	The aim of the profit formula is to give contractors 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.
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 website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
DIS	Defence Industrial Strategy, a Defence White Paper presented to Parliament in December 2005.
FCSA	Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible fixed assets.
Financial Reporting Standard ('FRS') 17	The accounting standard issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.
FPIF	Fixed Price Incentive Fee contracts - also referred to as Maximum Price Target Cost ('MPTC') contracts.
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 2003 General Review was published by The Stationery Office (ISBN 0-11-773023-8) in March 2004.
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 Confederation of British Industry ('CBI') and subsequent revisions and changes agreed between the representatives of Government and CBI in 2007.
Historic cost	The accounting basis incorporating all assets at their original cost less depreciation and excluding revaluations.
Historic cost rate of return	Operating profit (before interest and taxation) as a percentage of the average of the opening and closing historic cost capital employed.

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	Trading between different CP:CE 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 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 profit formula and its associated arrangements 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 profit formula and its associated arrangements.
Modified historic cost ('MHC')	MHC is not defined in accounting standards or company law. For the purposes of the GACs we take it 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 UK GAAP.
MPTC	Maximum Price Target Cost contracts - also referred to as Fixed Price Incentive Fee ('FPIF') contracts
NAPNOC contracts	'No Acceptable Price No Contract'. 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 from other contractors 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 profit formula.

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.
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 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-size Enterprises
Semi-CCA	A basis of inflation accounting incorporating fixed assets at their depreciated current cost, but making no allowance for the effect of inflation on the value of stocks and net working capital.
SORP	Statements of Recommended (Accounting) Practice relating to specialised sectors.
Standard Baseline Profit Allowance ('SPBA')	The profit allowance on cost applicable to firm, fixed price and target cost contracts and contract amendments with an estimated or target cost of less than £50 million, subject to any further adjustment in accordance with the risk/reward matrix.
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	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the

('SSAP') 24	financial statements of enterprises. For UK listed companies this is now been superseded by IAS 19, and FRS 17 for other UK companies that have not elected to adopt IAS 19.
Target Cost Incentive Fee ('TCIF') Contracting	A pricing basis whereby the target fee is calculated by reference to the average total cost outturn estimate and a formula is agreed between Government and the contractor on how to share cost over-runs and cost savings. Where such an arrangement is subject to an overall maximum price, it is referred to as a Maximum Price Target Cost ('MPTC') or Fixed Price Incentive Fee ('FPIF') 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 set 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. There is no formal definition of UK GAAP, but in simple terms it means compliance with UK company law and accounting standards (including UITF abstracts and SORPs and, where relevant, IASs and IFRSs).
WCSA	Working Capital Servicing Allowance provided to contractors for their investment in working capital.
WIP	Work in progress.

SECTION I

INTRODUCTION

The Board

101. The Review Board for Government Contracts was established under the terms of a Memorandum of Agreement ('the 1968 Memorandum of Agreement') applicable from February 1968 following agreement between the Government and the Confederation of British Industry ('CBI'), the latter representing the interests of contractors engaged in non-competitive Government contract work.

The Government Profit Formula and its Associated Arrangements

102. The basis for pricing non-competitive Government contracts was set-out in The Profit Formula Agreement, which was agreed between Government and the CBI in 1968 and has since been subject to numerous changes. In view of these changes, a consolidated document, referred to as the Government Profit Formula and its Associated Arrangements ('GPFAA'), has been accepted by the MOD and the JRBAC as representing the status of the profit formula arrangements immediately prior to the issue of this report and is reproduced at Appendix D of this report.

103. The GPFAA, as reproduced at Appendix D, reflects the agreement between the parties as it stands immediately prior to the issue of this General Review. To the extent that recommendations contained in the Review are accepted by the parties the GPFAA will need to be updated.

The 2003 General Review

104. The 2003 General Review[1] was completed by the Review Board and submitted to Government and the CBI in March 2004. The Review contained recommendations for major revisions to the methodology underlying the profit formula, which were accepted by Government and the CBI. The previous formula was based on a return on capital employed and the revised formula is based partly on a return on cost of production, and partly on a return on capital employed. The full details of the changes are contained in the 2003 General Review and summarised in the GPFAA.

The 2007 General Review

105. We have conducted this review on the basis of agreement between MOD and the JRBAC regarding the terms of reference and scope of the review. As in previous reviews, the Board invited MOD and the JRBAC to make submissions concerning any issues that they wished the Board to address during the review in addition to issues the Board is required to address at each review.

106. The additional issues raised by both parties concerned:

- The impact of the introduction of IFRS on the Reference Group;

[1] The report on the 2003 General Review of the Profit Formula for non-competitive Government Contracts was published by The Stationery Office (ISBN 0-11-773023-8).

- Accounting for pension plans;
- The risk/reward matrix;
- Materiality – simplified arrangements for contractors undertaking relatively little non-competitive work;
- The sharing of unconscionable losses on TCIF contracts with a maximum price; and
- The Defence Industrial Strategy – the parties considered that the Board's report should comment on the relationship between the profit formula arrangements and the Defence White Paper entitled Defence Industrial Strategy presented to Parliament in December 2005.

107. The parties also agreed that they would seek to address the issues concerning the risk/reward matrix and simplified arrangements between themselves in the first instance and inform the Board of the outcome of their discussions.

108. The recommendations are summarised in Section II. The organisation of the remainder of this report is as follows:

III: The Reference Group and the target rate of return
IV: The recommended profit formula
V: Recent profits on non-competitive Government contracts

SECTION II

SUMMARY OF RECOMMENDATIONS

The Profit Formula

201. To achieve comparability with the return earned by British industry, the profit formula from 1 October 2007 should be structured as follows:

		2007 General Review %	*2006 Annual Review %*
FCSA	Fixed Capital Servicing Allowance (page 11)	6.71	6.79
WCSA	Working Capital Servicing Allowance (page 11)	6.23	5.74
BPR	Baseline Profit Rate (page 12)	9.74	7.27
SBPA	Standard Baseline Profit Allowance (page 13)	9.39	7.05
ASBPA	Adjusted Standard Baseline Profit Allowance (page 16)	9.09	6.75
NBPA	Non-risk Baseline Profit Allowance (page 16)	7.04	5.29

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

203. The Board notes that the 3-year rolling average Baseline Profit Rate for 2005-06 based on IFRS is 2.47% higher than the UK GAAP 3-year rolling average Baseline Profit Rate for 2004-05. Whilst the profitability of British industry has been increasing in recent years, another significant reason is the change in accounting rules as a consequence of IFRS which is particularly marked in the case of accounting for defined benefit pension plans. Under UK GAAP, the reported profits were arrived at after charging any top-up contributions made to reduce pension plan deficits whereas, the IFRS based profits shown in the above table exclude any such top-up payments and, as noted later, the Board is recommending that such top-up payments or any actuarial gains or losses arising on defined benefit pension plans should no longer be allowed in pricing non–competitive contracts under the profit formula.

The Impact of International Financial Reporting Standards (IFRS)

204. All UK companies listed on the Main Market of the London Stock Exchange have been required to apply IFRS in their consolidated accounts for periods commencing 1 January 2005. Accordingly, the Board considers that the determination of the target rate of return should now be based entirely on a Reference Group of companies that have reported under IFRS. Companies listed on the Alternative Investment Market have been given dispensation to delay application of IFRS until periods commencing 1 January 2007 and therefore they have not been included in the Reference Group in the current year.

205. The total capital employed and total sales of the Reference Group for the current year represent 65% and 70% respectively when compared to the Reference Group for the previous Review and the Board is satisfied that this Reference Group is still representative of British industry as a whole (page 10).

Accounting for Pension Plans

206. The current Review Board guidance dealing with pension costs and other retirement benefits is based on the application of SSAP 24 under UK GAAP. With the introduction of IFRS, IAS 19 now supersedes SSAP 24. A key difference between SSAP 24 and IAS 19 relates to the accounting treatment of actuarial gains and losses arising on defined benefit pension schemes.

207. Following the introduction of IAS 19, the Board's recommendations on accounting for pensions are as follows:

- The guidance issued by the Board in its 1990GR which was based on SSAP 24, the prevailing accounting practice at that time in terms of pensions, is no longer appropriate now that SSAP 24 has been superseded by the introduction of IAS 19;
- Defined contribution plan costs should continue to be allowed in full for pricing purposes;
- The normal annual cost for defined benefit pension plans charged to the income statement (including the net financing charge relating to pensions) should be allowed in pricing contracts under the Government Profit Formula arrangements; and
- Actuarial gains and losses arising on defined benefit pension plans should not be allowed as a cost of production in pricing contracts under the Government Profit Formula arrangements.

208. In order to conform with the principle of comparability, any material charges or credits relating to actuarial gains or losses on defined benefits pension plans taken through the Income Statement by Reference Group companies will need to be excluded in determining the Baseline Profit Rate of the Reference Group. Accordingly, it is the Board's intention to review and analyse the accounting treatment for pensions adopted by some of the largest Reference Group companies each year and exclude any identified material charges or credits relating to actuarial gains or losses on defined benefit pension plans taken through the Income Statement by those companies in determining the Baseline Profit Rate.

The Risk/Reward Matrix

209. At this General Review, the MOD and the JRBAC set up a joint technical committee to establish whether any changes to the structure or operation of the matrix should be proposed to the Review Board in the light of surveys by both MOD and industry into the use of the matrix.

210. Following the deliberations of the joint technical committee, the MOD and the JRBAC made a joint submission to the Board stating that there is currently no great benefit to be gained in making changes to the structure or operation of the risk/reward matrix. The parties are agreed that the risk matrix is in its early days and should be given a further period to become established. The risk/reward matrix, as it currently stands, is reproduced at Appendix C.

211. Both parties are also agreed that there would be merit in further publicising the existence of the matrix and its purpose, in order to increase the incidence of its use. The Board has been advised that a joint MOD/JRBAC leaflet specifically addressing the risk/reward matrix will be prepared for distribution to MOD and industry pricing teams and the parties will review the existing guidance to both MOD and industry officers and strengthen this if necessary.

212. The Board wishes to thank the parties for undertaking this review of the risk/reward matrix and, in the light of the joint submission, it is not proposing any changes at this review. The Board does note however that one possible reason for there being a high level of awareness of the risk/reward matrix but little use being made of it could be that the commercial officers see little merit in spending time negotiating a risk premium or discount when the resulting adjustment would be just 10% of the standard profit allowance. The Board requests that any future survey should specifically seek to establish whether this is the case. It is the Board's view that the current risk/reward matrix is far too simplistic to adequately deal with the very diverse range of non-competitive contracts that are now negotiated between MOD and defence contractors.

213. One further matter addressed in the notes to the current risk/reward matrix is an interim arrangement to recognise the fact that as sub-contract costs pass up through a prime contractor's books they attract a second layer of profit. The Board reiterates its view that there are differences in risk as between a prime's own costs and those of subcontractors that pass through its books. This interim arrangement agreed by the parties at the 2003 General Review was also due to be reviewed to see if there was a more appropriate mechanism for dealing with these variations in risk. The Board is disappointed to note that the recent joint review of the risk/reward matrix did not extend to cover this issue and urges the parties to give this matter further consideration (Page 16).

Materiality – Simplified Arrangements

214. One other matter considered by the joint technical committee was the possible introduction of simplified arrangements for contractors undertaking relatively little non-competitive work. In a joint submission to the Board the MOD and the JRBAC have now stated that at this point in time the disadvantages of introducing a flat rate of profit on cost would outweigh any advantages for MOD or the contractors concerned.

215. The Board is however pleased to learn that, in an effort to remove disincentives on SMEs undertaking relatively little non-competitive Government work, newly developed software (referred to as RateMaster-Lite), is currently being tested. It is expected that when this software is introduced it will enable SMEs to submit simplified pricing information in electronic form (Page 16).

The Sharing of Unconscionable Profits and Losses

216. At the time of recommending the sharing of unconscionable profits and losses on firm/fixed price non-competitive contracts, the Board drew a distinction between the sharing arrangements for firm/fixed price contracts and TCIF and other similar arrangements such as Maximum Price Target Cost ("MPTC") or Fixed Price Incentive Fee ("FPIF") contracts. It noted that such arrangements are (and should continue to be) used

where there is considerable uncertainty as to the likely final outcome and where the cost estimate is more a target than a reliable estimate of cost.

217. The JRBAC has submitted that the sharing arrangements should be extended to also cover MPTC/FPIF contracts. The JRBAC's contention is that, while TCIF contracts without a maximum price provide for the sharing of all cost-increases and while firm/fixed price contracts address the sharing of unconscionable losses, MPTC/FPIF contracts provide the contractor with an unbounded liability for unconscionable losses above the maximum (fixed) price. It argues that MPTC/FPIF contracts are generally entered into where there is greater uncertainty about the likely outcome and therefore greater risk of unconscionable losses.

218. The Board has some sympathy for JRBAC's view that there is little difference in nature between a fixed price contract and an MPTC/FPIF contract in that unconscionable losses can arise in both cases. It does not however accept that an MPTC/FPIF contract carries more risk than a firm/fixed price contract because the setting of the target cost, the shareline and the maximum price are all intended to reduce the risk of undertaking the work to an acceptable level. If this cannot be achieved, the parties should seek to agree other courses of action such as TCIF contracts with no maximum price, cost plus contracts or risk reduction studies.

219. The Board notes that the parties have the choice of entering into MPTC/FPIF contracts or TCIF contracts with no maximum price. So long as the parties mutually agree that a particular type of contractual arrangement is more appropriate under a given set of circumstances, then it is not for the Board to set aside arrangements freely entered into by the parties, except in very exceptional cases.

220. The JRBAC's submission also states that, in general, the contractor is in the weaker position in negotiating a contract price and it is the contractor who is expected to overcome "affordability" pressures in price negotiation. The Board is prepared to accept that there may be instances when a contractor is in the weaker negotiating position particularly where it is reliant on MOD for work (Page 19).

The Defence Industrial Strategy

221. At the request of the parties, the Board has considered the White Paper entitled The Defence Industrial Strategy and its potential impact on the profit formula arrangements. The principal issues identified by the Board were presented at a joint meeting with MOD and the JRBAC on 13 November 2006. These issues relate to:

- The Reference Group in the context of globalisation: If it is considered that overseas suppliers are disadvantaged as a consequence of the comparability principle being based on a solely UK Reference Group then the parties need to consider whether the Profit Formula Agreement should be modified to encompass overseas companies. However, it might be argued that, in addition to the practical difficulties of doing so, so long as there is evidence that overseas organisations and individuals continue to invest in British industry, the returns earned in the UK must be sufficiently attractive.

- New procurement models: The DIS makes a number of references to flexibility of procurement models. As the Board is not party to discussions on individual contracts it is not currently in a position to assess whether the existing profit formula arrangements adequately deal with partnering or alliancing arrangements or whether this is an issue that has more to do with transparency and better cost estimating techniques.
- Through-life acquisition models and systems integration: The paper notes that the Government's priority is to promote a more integrated approach to the delivery of military capability by focussing on through-life delivery of integrated solutions. It also recognises the growing importance of systems integrators. In this context, the Board notes that there may be issues that need to be considered, for example whether the existing risk/reward matrix needs to be expanded to deal more effectively with differential levels of risk and reward as between designers, systems integrators, manufacturers and service providers.
- Driving long-term best value for money: This is an issue that probably needs to be addressed through improved cost estimating techniques and greater transparency. However, in the context of the profit formula arrangements, the parties are invited to consider whether there should be further guidance to underpin the principle of "equality of information" and whether the arrangements for post costing and contract references could be improved so as to be of greater assistance in ensuring better value for money.
- Encouraging SMEs: The Board notes that this issue has been addressed during the course of this review but there may be more that could be done to encourage SME entry into a broader range of defence opportunities.

222. The Board is prepared to give these and other issues further consideration if invited to do so by the parties (Page 24).

223. In a late submission by the MOD on 21 June 2007, it asked the Board to consider two further issues:

- Whether the GACs need to explicitly embed the principle that the MOD as customer should only pay a share of any cost where, in doing so, there is a demonstrable value for money benefit; and
- Whether the Board believes that the inclusion of Capital Servicing Allowances is the best way to incentive the behaviours of both MOD and industry in the direction set out in DIS.

224. The Board considers that it is unreasonable to incorporate a statement such as "MOD will only pay a share of any cost where, in doing so, there is a demonstrable value for money benefit" in the GACs without also incorporating additional safeguards to ensure that contractors are always able to recover legitimate costs incurred in carrying out their obligations. If the MOD believes that, in the context of ongoing rationalisation and globalisation of the defence industry, the list of overhead costs to be excluded needs to be extended, it is for MOD to identify the general or specific nature of such items and the Board will be pleased to consider them at a future Review.

225. In the 2003 General Review, the Board recommended that it was no longer appropriate to link the profit formula solely to a return on capital employed and recommended a formula that was predominantly based on a return on cost of production

but acknowledged that a contractor should also be reimbursed the "time value of money" on capital employed. Without doing so would disadvantage contractors with high capital investment requirements such as large scale manufacturing businesses. However, in the context of on-going rationalisation and globalisation of the defence industry, there may be instances where a contractor is not making efficient use of capital by not disposing of surplus or redundant assets in a timely manner. Accordingly, the Board recommends that the GAC clause 5(A)1(f), set out in the GPFAA, be re-worded to read as follows:

> 'Capital not employed efficiently such as capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use where held for speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposing of surplus assets.'

Annual Returns and Post-Costing Data

226. Annual returns have been received from 30 contractors with total profit formula sales in 2005 of £4 billion. This indicates a high level of coverage and the Board would like to acknowledge the assistance it has received from the JRBAC in co-ordinating the collection of annual returns from contractors.

227. The Board's analysis of the annual returns shows that the contractors' overall target rate of return on profit formula contracts was 6.64 per cent on their cost of production, and that they achieved an actual return of 5.53 per cent. However, there is considerable variation in outturn performance by individual contractors (Page 28).

228. The Board has also reviewed the results of post-costing undertaken by the MOD. 36 contracts were post-costed in 2005 and the Board is encouraged by the results which suggest that eventual outturn costs were reasonably close to the target costs used for pricing.

Implementation of the Board's Recommendations

229. There has been considerable delay in finalising this General Review principally because MOD required additional time to make its submissions. The Board urges the parties to try to adhere to the agreed timetable for each review as delays are not only disruptive but can disadvantage one or other of the parties.

230. As agreed between MOD and the JRBAC the implementation date for the recommendations set out in this report should be 1 October 2007.

SECTION III

THE REFERENCE GROUP AND 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 impact of International Financial Reporting Standards (IFRS)

302. All UK companies listed on the Main Market of the London Stock Exchange have been required to apply IFRS in their consolidated accounts for periods commencing 1 January 2005. IFRS differs from UK GAAP in certain material respects particularly with regard to accounting for defined benefit pension plans and research and development and the presentation of items such as the results of associated companies. Accordingly, the Board considers that the determination of the target rate of return should now be based entirely on a Reference Group of companies that have reported under IFRS. The Board is satisfied that, with the exception of pensions, the accounting changes introduced by IFRS lead principally to timing differences in the recognition of income and costs. Accounting for pensions is considered further in Section IV.

303. A review of data sources providing detailed financial information on UK companies has confirmed that Worldscope is still the database that provides the most comprehensive financial information. Companies listed on the Alternative Investment Market ("AIM") have been given dispensation to delay application of IFRS until periods commencing 1 January 2007 and the Worldscope analysis of AIM IFRS results has not been as comprehensive as for the Main Market companies. Accordingly, AIM companies have not been included in the Reference Group in the current year.

The Reference Group

304. 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 was not deployed on non-competitive contracts. This leads to a broadly based Reference Group which has the benefit of reducing volatility, making the return less influenced by the special circumstances that may affect an individual sector from time to time.

305. The constituents of the Reference Group have been considered at each review. The general principle adopted by the Board has been that all British listed companies 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 contracts that it would be inappropriate to include that sector in the Reference Group. Sectors currently falling into this category

are: banking, insurance, investment trusts, property investment, mining, oil and gas; or

- where 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 water and power.

In addition one company, Eurotunnel plc, is excluded as an exceptional case.

306. For the purposes of this Review, the Reference Group has been further restricted to only British companies listed on the Main Market of the London Stock Exchange in view of the findings discussed in paragraph 303 above. Accordingly, the Reference Group for the 2007 Review comprises 256 companies with a total capital employed of £160 billion and sales of £490 billion as compared with 938 companies with capital employed of £247 billion and sales of £696 billion at the last Review.

307. The total capital employed and total sales of this Reference Group represent 65% and 70% respectively when compared to the Reference Group for the previous Review and the Board is satisfied that the Reference Group is still representative of British industry as a whole.

Determination of the Baseline Profit

308. Following the 1993 General Review it was agreed between MOD and the JRBAC that the target rate of return in the profit formula should be determined on a 3-year rolling average basis. At the present time, IFRS data is only available for 2 years, namely 2004-05 and 2005-06, but the Board believes that it is important to preserve the principle of a 3-year rolling average. It therefore recommends that the actual IFRS baseline profit rate for 2004-05 be used to construct an assumed IFRS baseline profit rate for 2003-04 such that the mathematical relationship between those two years is the same as it was when previously calculated under UK GAAP (i.e. the baseline profit rate in 2003-04 is 93% of the baseline profit rate in 2004-05). This issue will not arise in future as we will then have at least 3 years of actual IFRS data.

The Profit Formula Methodology

309. 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 above elements (a and b) (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 and the

Contractors, determines the Standard Baseline Profit Allowance ('SBPA') on the cost of production of individual contracts.

310. 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

311. Taking account of the fact that the fixed assets the FCSA is intended to finance will have been acquired over a number of years and may have been financed at different rates, the FCSA is:

- Linked to the 7 year moving average of the 15 year Gilt rate; plus
- A 1.5 percentage point premium to take it up to the average cost of a BBB rated corporate bond; plus
- 0.5 of a percentage point to incorporate a premium for a BBB3 rating and the liquidity discount.

312. Based on the rates prevailing up to 31 March 2007, this gives an FCSA of 6.71%.

The WCSA

313. 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.

314. 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 31 March 2007 was 4.98%, so the appropriate WCSA should be 6.23%.

315. 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

316. 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 the return the average company gets on its uncapitalised intangible assets and for the risks it assumes. 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 contracts. The calculation of the last three years' Baseline Profit Rates is set out below:

	2002/3 Reference Group UK GAAP £m	2003/4 Reference Group UK GAAP £m	2004/5 Reference Group UK GAAP £m	2004/5 Reference Group IFRS £m	2005/6 Reference Group IFRS £m
(A) Cost of Production	580,164	615,558	629,467	395,754	432,434
(B) Capital Employed	253,589	253,826	246,884	146,274	160,393
(C) CP:CE ratio (A÷B)	2.29	2.43	2.55	2.71	2.70
(D) FC:WC ratio	92:8	92:8	94:6	101:-1	94:6
(E) Actual Profit (EBIT)	57,533	62,885	66,351	47,815	57,622
(F) FCSA % (see note 1 below)	7.62%	7.17%	6.90%	6.90%	6.78%
(G) WCSA % (see note 1 below)	6.23%	5.57%	5.66%	5.66%	5.82%
(H) FCSA (B×(D['FC']÷100)×F)	17,778	16,743	16,013	10,194	10,222
(I) WCSA (B×(D['WC']÷100)×G)	1,264	1,131	838	(83)	560
(J) Total CSA (H+I)	19,041	17,874	16,851	10,111	10,782
(K) Baseline Profit (E-J)	38,491	45,011	49,500	37,704	46,840
(L) BP as % of CP (K÷A)	6.63%	7.31%	7.86%	9.53%	10.83%
3 year rolling average	**6.13%**	**6.25%**	**7.27%**	**N/A**	**9.74%** (see note 2)

Note. 1. The FCSA and WCSA percentage figures are derived using the methodology set out earlier in this Section, using the data applicable as at 31 March of the year concerned.

2. This 3-year rolling average has been calculated as set out in paragraph 308., assuming a 2003/04 'IFRS' baseline profit rate of 8.86% i.e. (8.86% + 9.53% + 10.83%)/3 = 9.74%.

317. The Board notes that the 3-year rolling average Baseline Profit Rate for 2005-06 based on IFRS is 2.47% higher that the UK GAAP 3-year rolling average Baseline Profit Rate for 2004-05. Whilst there is general acceptance that the profitability of British industry has been increasing in recent years, another significant reason is the change in accounting rules as a consequence of IFRS which is particularly marked in the case of accounting for defined benefit pension plans. Under UK GAAP, the reported profits were arrived at after charging any top-up contributions made to reduce pension plan deficits whereas the IFRS based profits shown in the above table exclude any such top-up payments. For instance, a sample of just 16 of the larger companies made aggregate top-up lump sum pension contributions amounting to over £800 million in 2005-06. The Board's recommendations in relation to the future GAC on pension contributions are discussed in Section IV.

318. The Board has concluded that the Baseline Profit Rate derived on the basis of strict comparability with the returns of British industry should be 9.74 per cent expressed on the modified historic cost basis.

319. Accordingly the Board recommends that the reference group Baseline Profit Rate of 9.74 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.

SECTION IV

THE RECOMMENDED PROFIT FORMULA

Introduction

401. The Reference Group Baseline Profit Rate of 9.74 per cent on the modified historic cost basis as computed in the previous section needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts.

402. This section considers the principal steps in the development of a profit formula which are:

- The Standard Baseline Profit Allowance ('SBPA');
- The Risk/Reward Matrix; and
- The Contract Baseline Profit Allowance and the Total Contract Profit Allowance.

403. The section then considers some further matters that are relevant to the pricing of non-competitive contracts:

- Materiality – Simplified Arrangements;
- Sharing of Unconscionable Profits and Losses;
- Accounting for Pension Plans;
- The Defence Industrial Strategy; and
- The Comparability Principle.

The Standard Baseline Profit Allowance

404. In order to use the BPR in the pricing of non-competitive contracts, it needs to be adjusted for any known systematic differences between Reference Group companies and contractor group companies.

405. The Board is aware that the level of cost of production in the contractor group will be higher than that of the Reference Group, because the contractor group includes intra-group trading whereas similar trading within the Reference Group will be eliminated as consolidation adjustments in company accounts. Therefore the amount of intra-group trading by the contractor group needs to be assessed and eliminated in order to maintain comparability.

406. The MOD and the JRBAC have undertaken a joint assessment of the level of intra-group trading and have agreed that, for the purposes of adjusting recommended BPR in the 2007 General Review, it comprises 3.66 per cent of the Cost of Production on all non-competitive work. This compares with a calculation of 3.1 per cent at the 2006 Annual Review.

407. Part of the 3.66 per cent intra-group trading estimate will relate to contracts priced in excess of £50 million, and will therefore attract a reduced profit rate in accordance with the arrangements outlined in paragraphs 414-416 below. The Board estimates that the 3.66 per cent intra group trading figure needs to be reduced to 3.60 per cent to allow for this effect.

408. The Baseline Profit Rate of 9.74 per cent therefore needs to be reduced by the abated intra-group trading figure of 3.60 per cent of the Baseline Profit Rate, giving a rate of 9.39 per cent. The Board therefore recommends that the Standard Baseline Profit Allowance to be used for pricing non-competitive contracts should be 9.39 per cent.

The Risk/Reward Matrix

409. The MOD and the JRBAC recognise that the risk profiles of different types of work will vary and that the higher risk contracts should receive a higher target return than lower risk contracts. At the 2003 General Review the parties agreed that, to start with, the variable risk/reward matrix should be kept relatively simple to facilitate implementation and deal only with different types of work. The intention was that as Government and Industry gained experience of applying the risk/reward matrix to individual contracts, it could be further developed and could perhaps also address varying degrees of risk in the context of different types of contract.

410. At this General Review, the MOD and the JRBAC set up a joint technical committee to establish whether any changes to the structure or operation of the matrix should be proposed to the Review Board in the light of surveys by both MOD and industry into the use of the matrix. The principal findings of the surveys were as follows:

- The MOD surveyed contracts valued at £2.6 billion. Responses to qualitative questions suggested a reasonably good awareness of the new profit formula arrangements, including the matrix and the requirement to negotiate on the risk aspect of the Baseline Profit. Despite the high awareness level, the survey found that over 90% of contracts by value were still priced using the Standard Baseline Profit Allowance.
- The industry survey reported similar findings to the MOD. There was less quantitative data from the industry survey but the qualitative outcome was generally positive. It found a high level of awareness of the new arrangements, with 95% awareness of the risk/reward matrix amongst the surveyed industry senior commercial officers.

411. The joint technical committee then considered a number of possible changes in the structure or operation of the matrix. The issues considered and the conclusions reached by the committee are summarised in the table below.

Issues considered	Conclusions
1. The risk/reward matrix currently applies to contracts with an estimated cost above £5m. Should this £5m threshold be amended to take in more/fewer contracts, to widen participation or concentrate negotiating effort?	There was no real appetite for increasing the negotiating workload on pricing teams by lowering the threshold below £5m. Equally, it was not considered appropriate to raise the threshold at this point, given the relatively low incidence of contracts being agreed at other then the Standard Baseline Profit Allowance.
2. Should the percentage variation of ±10% of profits be treated as a range, rather than fixed points, thereby making the matrix more flexible?	Both parties considered this to be an unnecessary complication and preferred to retain fixed point variations to the SBPA.
3. Should the matrix be developed to also take account of different types of contract, as intimated by the Board in the 2003 General Review?	Both parties felt it was too early to consider this, and wished to first see a greater take-up of the existing matrix arrangements.
4. Should the percentage variation of ±10% of profits be increased to better reflect the differences in levels of risk that arise on different types of work?	Again, it was agreed that it was too early to consider this, and the parties wished to first see a greater take-up of the existing arrangements.

412. In view of the above, the MOD and the JRBAC made a joint submission to the Board stating that there is currently no great benefit to be gained in making changes to the structure or operation of the risk/reward matrix. The parties are agreed that the risk matrix is in its early days and should be given a further period to become established. However, both parties are also agreed that there would be merit in further publicising the existence of the matrix and its purpose, in order to increase the incidence of its use. The Board has been advised that a joint MOD/JRBAC leaflet specifically addressing the risk/reward matrix will be prepared for distribution to MOD and industry pricing teams and the parties will review the existing guidance to both MOD and industry officers and strengthen this if necessary.

413. The Board wishes to thank the parties for undertaking this review of the risk/reward matrix and, in the light of the joint submission, it is not proposing any changes at this review. The Board does note however that one possible reason for there being a high level of awareness of the risk/reward matrix but little use being made of it could be that the commercial officers see little merit in spending time negotiating a risk premium or discount when the resulting adjustment would be just 10% of the standard profit allowance. The Board requests that any future survey should specifically seek to establish whether this is the case. It is the Board's view that the current risk/reward matrix is far too simplistic to adequately deal with the very diverse range of non-competitive contracts that are now negotiated between MOD and defence contractors.

414. One further matter addressed in the notes to the current risk/reward matrix is an interim arrangement to recognise the fact that as sub-contract costs pass up through a prime contractor's books they attract a second layer of profit. The Board reiterates its view that there are differences in risk as between a prime's own costs and those of subcontractors that pass through its books. This is because, in the Board's view, a competent prime contractor should be able to lay off a significant element of the risk relating to work that it sub-contracts to others and, conversely, a competent prime contractor brings specialist contract management and risk management skills to bear which enable it to take the risks of integrating and managing all the sub-contracts – risks that justify a higher profit allowance on the prime's own costs.

415. The interim arrangement agreed by the parties at the 2003 General Review was also due to be reviewed to see if there was a more appropriate mechanism for dealing with these

variations in risk. The Board is disappointed to note that the recent joint review of the risk/reward matrix did not extend to cover this issue and urges the parties to give this matter further consideration.

416. In the meantime the interim arrangement should continue. Accordingly, the Standard Baseline Profit Allowance applicable to all risk contracts or contract amendments with a value of £50 million or more will be reduced by a net 30 basis points. The Board therefore recommends that the Adjusted Standard Baseline Profit Allowance ('ASBPA') should now be 9.09 per cent.

417. 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, ie they should attract a Contract Baseline Profit Allowance of 7.04 per cent. The risk/reward matrix, as it currently stands, is reproduced at Appendix C.

The Contract Baseline Profit Allowance and the Total Contract Profit Allowance

418. The SPBA (for contracts over £5 million but under £50 million) or ASBPA (for contracts over £50 million) relating to firm, fixed price or target cost contracts is subject to possible further adjustment in accordance with the risk/reward matrix set out in Appendix C. Following this consideration the resultant allowance for a particular contract is known as the Contract Baseline Profit Allowance ('CBPA').

419. As described in paragraph 309, the profit formula methodology is made up of three elements. The profit allowance applicable to specific contracts and contract amendments therefore comprises the sum of the CBPA, the FCSA and the WCSA. This total allowance applicable to a non-competitive contract using the profit formula methodology is known as the Total Contract Profit Allowance ('TCPA').

Materiality – Simplified Arrangements

420. One other matter that the MOD/JRBAC joint technical committee agreed to discuss with a view to a possible joint submission to the Board concerned the introduction of simplified arrangements for contractors undertaking relatively little non-competitive work.

421. In their joint submission to the Board the parties now state that at this point in time the disadvantages of introducing a flat rate of profit on cost would outweigh any advantages for MOD or the contractors concerned. However in an effort to remove disincentives on SMEs undertaking relatively little non-competitive Government work, the parties committed themselves to introducing process improvements and simplified arrangements in pricing procedures and practices.

422. The Board is pleased to learn that, as a first step, newly developed software (referred to as RateMaster-Lite), which should enable SMEs to submit simplified pricing information in electronic form, is currently being tested with a view to it being introduced shortly.

The Sharing of Unconscionable Profits and Losses

423. In its report on the 2003 General Review, the Board recommended the sharing of unconscionable profits and losses on firm/fixed price non-competitive contracts. It defined unconscionable profits and losses, for the purposes of the sharing arrangements, to be as follows:

- Unconscionable profit: that proportion of any unintended profit that exceeds five per cent of the contract value.
- Unconscionable loss: that proportion of any unintended loss that exceeds five per cent of the contract value.

424. It further recommended that:

- unconscionable profits and losses should be shared in the proportions 75:25 as between MOD and the contractor;
- the arrangements should apply to all firm/fixed price contracts with a contract price in excess of £5 million. Alternative arrangements, such as TCIF, may be adopted with the agreement of both parties; and
- the amount of any payment under these sharing arrangements should exceed £250,000 before it becomes payable.

425. The Board recognised that there could be circumstances where there might be serious inequity that is not remedied by application of the standard sharing arrangements. It therefore agreed to accept references of individual contracts that fell within the standard sharing arrangements but where one or other party believed there were wholly exceptional circumstances that justified a departure from the arrangements.

426. At the time of making the above recommendations, the Board drew a distinction between the proposed sharing arrangements for firm/fixed price contracts and TCIF and other similar arrangements. It noted that TCIF arrangements are (and should continue to be) used where there is considerable uncertainty as to the likely final outcome and where the cost estimate is more a target than a reliable estimate of cost.

427. The JRBAC has now submitted that the sharing arrangements should be extended to cover certain TCIF contracts. It notes that TCIF arrangements are divided into two categories:

- TCIF without a maximum price; and
- Maximum Price Target Cost ("MPTC") or Fixed Price Incentive Fee ("FPIF").

428. TCIF without a Maximum Price is a pricing arrangement under which a target price is agreed between the parties together with a mechanism for sharing all cost-savings or cost-increases arising under the contract.

429. MPTC/FPIF are pricing arrangements that provide for the agreement of both a target cost and a maximum (fixed) price with a mechanism for sharing cost-savings below the target cost but cost-increases only up to the maximum (fixed) price.

430. The JRBAC's contention is that, while TCIF contracts provide for the sharing of all cost-increases and while firm/fixed price contracts address the sharing of unconscionable losses, MPTC/FPIF contracts provide the contractor with an unbounded liability for unconscionable losses above the maximum (fixed) price. It believes this is an anomaly that should be rectified particularly as MOD has issued internal guidance that it will seek to cap its liability on TCIF contracts through a maximum price.

431. The JRBAC acknowledges that it has been the view of the Board that specific contractual arrangements freely entered into by the parties should not be set aside by the

Board other than in exceptional circumstances. The JRBAC does not however consider that this should apply in this case because, in its view:

- the Review Board has already set a precedent by taking a position on the sharing of unconscionable losses where a fixed price applies. MPTC/FPIF contracts are generally entered into where there is greater uncertainty about the likely outcome and therefore greater risk of unconscionable losses;
- whilst it might be argued that a contractor that incurs unconscionable losses on an MPTC/FPIF contract could refer the contract to the Review Board on the grounds that there is a serious inequity, the Board has already stated (in a 1973 decision on a contract reference): "It cannot be emphasised too strongly that the Board ought not to be regarded as providing an automatic safety-net against the consequences of commercial imprudence"; and
- although it may appear that it is up to the contractor to refuse to negotiate a maximum price that is unrealistically low, in general, the contractor is in the weaker position in negotiating a contract price and it is the contractor who is expected to overcome "affordability" pressures in price negotiation.

432. The MOD does not accept the JRBAC's proposal and in its response, it argues that:

- MPTC/FPIF contracts already have a built in mechanism which automatically adjusts profit in relation to a variation in outturn costs from target costs up to the agreed maximum price. The maximum price is subject to negotiation between the parties in the process of agreeing a fair and reasonable price;
- usual practice provides for the setting of maximum prices which are a sufficient distance from the target cost as to encompass all but the most exceptional of cost overruns;
- in such exceptional circumstances, where the maximum price is in danger of being breached, the contractor ultimately has the right to make a reference to the Board if discussions with the MOD are unsatisfactory to the contractor; and
- the remote possibility that a contractor may incur an unbounded liability under an MPTC/FPIF contract is not dissimilar to the MOD's own unbounded liability under a firm/fixed price contract where a contractor incurs unconscionable losses (except that MOD's liability in such cases is 75% of the loss rather than 100%). MOD is satisfied that such an outcome is extremely unlikely and, if it does arise, it is afforded sufficient protection by its right to make a reference to the Board.

433. The Board has some sympathy for JRBAC's view that there is little difference in nature between a fixed price contract and an MPTC/FPIF contract in that unconscionable losses can arise in both cases. It does not however accept that an MPTC/FPIF contract carries more risk than a firm/fixed price contract because the setting of the target cost, the shareline and the maximum price are all intended to reduce the risk of undertaking the work to an acceptable level. If this cannot be achieved, the parties should seek to agree other courses of action such as TCIF contracts with no maximum price, cost plus contracts or risk reduction studies.

434. The MOD has pointed out that the unbounded liability of a contractor under an MPTC/FPIF contract is not dissimilar to MOD's unbounded liability under the sharing arrangements for unconscionable profits and losses on firm/fixed price contracts and in both cases the liability should arise only in exceptional cases and the parties would have the

right to make a reference to the Board in such circumstances. However, the Board reaffirms its decision in the 1970 contract reference that it must not be regarded as providing an automatic safety-net against the consequences of commercial imprudence. It is therefore important for both parties to ensure that the arrangements they are seeking to negotiate are appropriate to the circumstances and there are, of course, alternative arrangements available to the parties as noted above.

435. The Board notes that MPTC/FPIF type arrangements, as set out in Commercial Policy Group Guideline No 7 which deals with the issue of maximum prices, resulted from an agreement between industry and MOD on 27 January 2004, only two months before the Board formally signed off its report on the 2003 General Review which introduced the sharing arrangements for unconscionable profits and losses on firm/fixed price contracts. The arrangements agreed by the parties were not based on any recommendation by the Board and it is not the Board's normal practice to overturn bilateral agreements between the MOD and industry.

436. The Board notes that the parties have the choice of entering into MPTC/FPIF contracts or TCIF contracts with no maximum price. So long as the parties mutually agree that a particular type of contractual arrangement is more appropriate under a given set of circumstances, then it is not for the Board to set aside arrangements freely entered into by the parties, except in very exceptional cases.

437. The Board has difficulty in accepting the JRBAC's contention that, in general, the contractor is in the weaker position in negotiating a contract price. So far as the Board is aware, the vast majority of TCIF type contracts entered into to date are for very large and complex projects between the MOD and some of the largest defence companies acting as prime contractors. Presumably, the only reason for such a contract to be let under the Government Profit Formula is that MOD has no alternative source of supply. In the circumstances, it is the contractor who should, in general, be in the stronger negotiating position. If a contractor in a strong negotiating position nevertheless decides to assist the MOD to overcome "affordability" pressures in order to secure a contract then it would seem reasonable that the contractor has to bear the consequences of any commercial imprudence on its part.

438. Having considered the JRBAC's submissions and the counter arguments put forward by the MOD, the Board does not consider it appropriate to extend the sharing arrangements for unconscionable profits or losses beyond firm/fixed price contracts as a similar arrangement already exists under TCIF contracts with no maximum price. If it were to extend the sharing arrangements to include MPTC/TCIF contracts, then such contracts would merely serve to duplicate the TCIF arrangement.

439. The Board also considers that, in general, a contractor agreeing to undertake a complex transaction under some type of target fee type arrangement in a non-competitive environment should not be in a weak negotiating position. It is, however, prepared to accept that there may be instances when a contractor is in the weaker negotiating position particularly where it is reliant on MOD for work.

Accounting for Pension Plans

440. The current Review Board guidance dealing with pension costs and other retirement benefits is based on the application of SSAP24 under UK GAAP. With the introduction of IFRS, IAS 19 now supersedes SSAP 24. Accordingly, the parties asked the Board to review the existing guidance on accounting for pensions and agreed to make formal submissions.

441. The JRBAC made its submission on 22 September 2006, specifically reserving the usual right to make a further submission if it felt it necessary following MOD's definitive statement on the issue. The JRBAC's submission of September 2006 proposed that:

a. In the case of defined contribution pension plans the amounts charged in the Income Statement represent the actual employers' contribution made in the period and these costs should continue to be allowed in full; and

b. As costs in respect of defined benefit pension plans required to be charged in the Income Statement or the Statement of Recognised Income and Expense ('SORIE') in accordance with IAS 19 are likely to be significant, highly volatile and not comparable, the existing accounting convention should be retained. This allows the actual cash contributions made to be included as admissible costs when pricing non-competitive government contracts.

442. In putting forward its proposal in respect of defined benefit pension plans, the JRBAC argued that:

a. The cash contributions are in general less volatile than the amounts required to be charged under IAS 19;

b. Its proposal accords with the existing accounting convention which has been acceptable to both parties;

c. It also conforms with HM Revenue and Customs' practice to allow defined benefit costs on the cash contribution basis; and

d. Such costs represent the actual cash outlays incurred by contractors.

443. The JRBAC also pointed out that in the event that a contribution made by a contractor is exceptional in size or incidence, the MOD has the protection under GAC 6(B)1 which states that where the allowable portion of some costs (as negotiated on a case by case basis) is exceptional or abnormal in size and incidence, it may be spread over a period exceeding one year (but not normally exceeding three years).

444. The MOD made an interim submission to the Review Board in September 2006, indicating a final position would be communicated following cross-Government consideration of this significant pricing issue. In the event the MOD did not make its formal submission until 21 June 2007 which is the principal reason for the delay in finalising this General Review. This formal submission, which deals only with defined benefit pension plans, confirmed the views expressed by MOD in September 2006, in which it argued that, with the introduction of NAPNOC, contracts are priced at risk rates of profit and in return MOD's liability is capped at an agreed amount. Therefore, pension costs arising on contracts that have been formally closed are not relevant to future pricing. In its formal submission of June 2007 MOD states that the Government does not accept any liability for its suppliers' pension deficits arising from past, priced contracts and will not make contributions aimed at reducing them, either through non-competitive pricing rates or lump sum payments. MOD is prepared to discuss whether fair and reasonable pension costs relevant to the appropriate agreed future benefits earned by staff in respect of work on unpriced, current contracts maybe allowed into overheads and a relevant share included in non-competitive contract prices.

445. The MOD's formal submission noted that where a deficit exists or has been addressed, a copy of the pension fund's latest scheme funding Schedule of Contributions, produced under Part 3, Section 227 of the Pensions Act 2004, may prove helpful in differentiating between what should be considered an admissible cost and that which must be viewed as an inadmissible pension deficit contribution.

446. The Board has reviewed the changes introduced by IAS 19 and is satisfied that in the case of defined contribution pension plans the amounts charged in the Income Statement continue to represent the actual employers' contributions made in the period. The Board therefore concurs with the JRBAC's proposal that the actual employers' contribution made in respect of defined contribution plans should continue to be allowed in full when pricing non-competitive contracts.

447. In the case of defined benefit pension plans, the net effect under SSAP 24 was that actuarial gains were recognised through the Income Statement, but spread over a number of years:

- Actuarial gains were typically recognised by taking pension holidays; and
- Actuarial losses were typically recognised by increased pension contributions over a number of years, and those contributions were charged to the Income Statement.

448. This meant that any pension holidays or top-up contributions had a direct impact on the profitability of the reference group and consequently also had a direct impact on the Government Profit Formula.

449. IAS 19 on the other hand, states that, on an ongoing basis, actuarial gains and losses arise that comprise both 'experience adjustments' (the effects of differences between the previous actuarial assumptions and what has actually occurred) and the effects of changes in actuarial assumptions. These actuarial gains and losses are now required to be accounted for by using one of the following methods:

- Recognise the gains or losses directly in equity by taking to reserves through SORIE; or
- Adopt what is referred to as the "corridor" method whereby any accumulated gain or loss that is 10% or less of the defined benefit obligation or the fair value of plan assets is deferred and any excess is either:
    a) recognised immediately in the Income Statement by spreading the adjustment over a maximum period of the average remaining service life of the participating employees; or
    b) recognised immediately through the Income Statement as an adjustment to operating profits.

450. In view of the fact that IAS 19 permits companies to adopt alternative accounting treatments, the Board has sought to analyse the effect of IAS 19 on the reported profitability of Reference Group companies. Some 200 companies were selected and reviewed to determine how they accounted for actuarial gains and losses. These included all fully listed defence contractors and the companies with the highest turnover in the Reference Group. Where a company employed the "corridor" method, further analysis was undertaken to determine the extent of the impact upon reported profitability.

451. The results of this analysis were as follows:

- 170 companies recognised the actuarial gains or losses directly in equity by taking to reserves through SORIE;
- 23 companies either did not have any defined benefit pension plans or appeared to have year ends that preceded the date when IFRS became mandatory;
- Just 6 companies had adopted the "corridor" method to recognise actuarial gains and losses and the aggregate amount charged to their Income Statements was just around £3 million.

452. In view of the above, it is reasonable to conclude that the overwhelming majority of companies use the SORIE to account for actuarial gains and losses. As a consequence their profits, as shown in the Income Statements do not include any actuarial gains or losses arising in their defined benefit pension plans. Furthermore, for those companies that do use the "corridor" method, the effect on reported profitability has been minimal in the current period.

453. The Board's recommendations on accounting for pensions are therefore as follows:

a. The guidance issued by the Board in its 1990GR which was based on SSAP24, the prevailing accounting practice at that time in terms of pensions, is no longer appropriate now that SSAP24 has, for UK listed companies, been superseded by the introduction of IAS 19, and FRS 17 for other UK companies that have not elected to adopt IAS 19;

b. Defined contribution plan costs should continue to be allowed in full for pricing purposes;

c. The normal annual cost for defined benefit pension plans charged to the Income Statement (including the net financing charge relating to pensions) should be allowed in pricing contracts under the Government Profit Formula arrangements; and

d. Actuarial gains and losses arising on defined benefit pension plans should not be allowed as a cost of production in pricing contracts under the Government Profit Formula arrangements.

454. The Board has noted the MOD's proposal that the pension fund's latest funding Schedule of Contributions, produced under the Pensions Act 2004 may prove helpful in differentiating between admissible and inadmissible pension contributions. The Board's recommendation as set out paragraph 453 (c) above refers to the amounts actually charged in a contractor's Income Statement whereas the Schedule of Contributions provides an analysis of the cash contributions to be made by the contractor which can be different. However, in implementing the Board's recommendations, the parties may agree, if they so wish, that the Schedule of Contributions provides a quick and reliable estimate of the admissible costs.

455. Finally, in order to conform with the principle of comparability, any identified material charges or credits relating to actuarial gains or losses on defined benefits pension schemes taken through the Income Statement by Reference Group companies will need to be excluded in determining the Baseline Profit Rate of the Reference Group. Accordingly, it is the Board's intention to review and analyse the accounting treatment for pensions adopted

by some of the largest Reference Group companies each year and exclude any material charges or credits relating to actuarial gains or losses on defined benefit pension schemes taken through the Income Statement by those companies in determining the Baseline Profit Rate.

The Defence Industrial Strategy

456. The Government presented a Defence White Paper entitled Defence Industrial Strategy ('DIS') to Parliament in December 2005 and the parties invited the Board to comment on the relationship between DIS and the profit formula arrangements.

457. The Board has considered the White Paper and its potential impact on the profit formula arrangements. The principal issues identified by the Board were presented at a joint meeting with MOD and the JRBAC on 13 November 2006 and are summarised below:

a. *The Reference Group in the context of globalisation:* DIS recognises that there has been considerable consolidation of the defence supply base across national boundaries over recent years and this is likely to have an effect on strategic investment decisions. It points out the need to ensure the UK is an attractive place to invest in.

The constituents of the Reference Group are considered at each General Review. The 2003 General Review, states:

"*The Board has concluded that overseas companies should continue to be excluded from the Reference Group. The principal reasons are that:*

- *the stated aim of the profit formula is to give contractors a return 'equal on average to the overall return earned by British industry'; and*
- *it is not possible to analyse a sufficiently representative group of overseas companies on a basis consistent with UK GAAP."*

If it is considered that overseas suppliers are disadvantaged as a consequence of the comparability principle being based on a solely UK Reference Group then the parties need to consider whether the Profit Formula Agreement should be modified to encompass overseas companies. However, it might be argued that, in addition to the practical difficulties of doing so, so long as there is evidence that overseas organisations and individuals continue to invest in British industry, the returns earned in the UK must be sufficiently attractive.

b. *New procurement models:* The DIS makes a number of references to flexibility of procurement models and the need to innovate, particularly with new "Partnering" arrangements in order to suit the requirements of individual acquisition programmes.

As the Board is not party to discussions on individual contracts it is not currently in a position to assess whether the existing profit formula arrangements adequately deal with partnering or alliancing arrangements or whether this is an issue that has more to do with transparency and better cost estimating techniques.

c. *Through-life acquisition models and systems integration:* The paper notes that the Government's priority is to promote a more integrated approach to the delivery of military capability by focussing on through-life delivery of integrated solutions. It also recognises the growing importance of systems integrators in

consolidating a disparate supply chain and ensuring effective through-life deployment of cutting edge technology.

The Board considers that there may be issues that need to be considered, for example whether the existing risk/reward matrix needs to be expanded to deal more effectively with differential levels of risk and reward as between designers, systems integrators, manufacturers and service providers. This matter has already been discussed at some length earlier in this section.

d. *Driving long-term best value for money:* This is a theme that runs through the document and lies at the heart of the Government's Defence Acquisition Policy.

This is an issue that probably needs to be addressed through improved cost estimating techniques and greater transparency. However, in the context of the profit formula arrangements, the parties wish to consider whether:

- there would be merit in underpinning the principle of "equality of information" with further guidance; and
- the arrangements for post costing and contract references could be improved so as to be of greater assistance in ensuring better value for money.

e. *Encouraging SMEs:* The DIS notes the Government's desire to encourage SME entry into a broader range of defence opportunities.

In the context of the profit formula arrangements, the key issue is whether these arrangements place an unduly heavy burden on SMEs which serves to discourage them from greater participation. This issue now appears to have now been addressed by the parties as set out in paragraphs 420 to 422 above.

458. The Board considers that some, if not all, of these issues may be highly relevant to the Government Profit Formula and the Board is prepared to give them further consideration if required to do so by the parties.

459. Following the joint meeting with MOD and the JRBAC on 13 November 2006, the MOD advised the JRBAC and the Board that it was commissioning an internal study into the Government Profit Formula arrangements in the context of DIS. In a submission dated 21 June 2007, the MOD has set out two further matters it would like to be addressed as part of this General Review:

a. Government Accounting Conventions ('GACs'): The MOD considers that the GACs appear fundamentally to be designed for a 'steady state' defence industry where costs that are abnormal in size and incidence are the exception. It believes that, despite the existence of provisions such as GAC 1(A)10 (now clause 7(A)9 in Annex D to Section 2 of the GPFAA) and GAC 2 (now clause 7 in Annex D to Section 2 of the GPFAA), there appears to be a default assumption that the only point of discussion is how to spread such costs, not whether they are an appropriate cost for Government to pay. The MOD argues that the GACs need to explicitly embed the principle that the Government as customer should only pay a share of any cost where, in doing so, there is a demonstrable value for money benefit; and

b. Principle of Comparability: The MOD asks the Board to restate what it sees as the relative advantages and disadvantages of a profit formula which rewards both capital employed and cost of production. It seeks assurance that, on balance, the Board believes that the inclusion of CSAs is the best way to incentive the behaviours of both MOD and industry in the direction set out in the DIS.

460. On receipt of a copy of the MOD's submission, the JRBAC wrote to the Board to state that it believes it is now too late to change the agreed scope of this General Review and that the package of measures implemented from 1 July 2004, following the last General Review, represents a significant modernisation of the profit formula arrangements and remains consistent with DIS.

461. The Board shares these views and notes that this late submission by the MOD has caused a considerable delay in finalising this Review. However, the Board has considered the issues raised by MOD.

Government Accounting Conventions

462. If the MOD believes that, in the context of on-going rationalisation and globalisation of the defence industry, the list of overhead costs to be excluded needs to be extended, it is for MOD to identify the general or specific nature of such items and the Board will be pleased to consider them at the next review. The Board considers that it is unreasonable to incorporate a statement such as "MOD will only pay a share of any cost where, in doing so, there is a demonstrable value for money benefit" in the GACs without incorporating additional safeguards to ensure that contractors are always able to recover all legitimate costs incurred in carrying out their obligations.

Principle of Comparability

463. The 1968 Memorandum of Agreement stated that the aim of the profit formula was "to give contractors a fair return on capital employed". In the 2003 General Review, the Board recommended that it was no longer appropriate to link the profit formula solely to a return on capital employed and recommended a formula that was predominantly based on a return on cost of production but acknowledged that a contractor should also be reimbursed the "time value of money" on capital employed. Without doing so would disadvantage contractors with high capital investment requirements such as large scale manufacturing businesses.

464. In the context of on-going rationalisation and globalisation of the defence industry, there may be instances where a contractor is not making efficient use of capital by not disposing of surplus or redundant assets in a timely manner. GAC 4(A)1(f) (now clause 5(A)1(f) in Annex D to Section 2 of the GPFAA) specifically disallows capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use where held for speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposing of surplus assets. However, this GAC does not make specific reference to the need for contractors to make efficient use of capital. Accordingly, the Board recommends that the GAC set out in clause 5(A)1(f) of GPFAA be re-worded to read as follows:

> 'Capital not employed efficiently such as capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use where held for

speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposing of surplus assets.'

The Comparability Principle

465. In accordance with the provisions of an agreement between MOD and the JRBAC during the 1990 General Review the Board is asked to consider whether there is 'any perceived ill-effect for either party, or for both, deriving from the strict observance of the comparability principle' to which the Board wishes to draw attention. The Board has concluded that it has seen no evidence of any such ill effect.

SECTION V

RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

Introduction

501. Under its terms of reference the Board has an obligation to assess whether the use of the profit formula has achieved the general intention of giving overall returns on Government profit formula work equivalent to the overall average earnings of British industry provided the information necessary for it to do so has been made available by the parties.

502. 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 received reports summarising the results of MOD's post-costing investigations into the profits achieved on individual contracts.

Annual Returns

503. In the past, annual returns have been received from contracting units each year, showing the non-competitive work undertaken by the unit. Returns have been the principal source of data to enable the Board to compare contractors' target rate of profit with their outturn profit rates.

504. The Board's collection of annual returns has been disrupted in recent years. First it was asked to cease collecting annual returns during the period following the 1999 General Review, when Government was considering alternative methodologies for pricing non-competitive contracts, so that no returns were received for the period 1997-1999. Secondly, part way through the 2005 annual review process MOD and the JRBAC asked the Board to withdraw the requirement for annual returns as they believed they would be of limited value owing to the new profit formula arrangements introduced in the 2003 General Review. This meant that the Board had limited information available to assess how well contractors were performing in comparison with their target formula rates.

505. It was agreed that completion of returns should be resumed for the 2006 Annual Review, although the format of returns needed to be altered, and to some extent abridged, owing to the availability of data relating to contracts placed using the new profit formula arrangements introduced in the 2003 General Review.

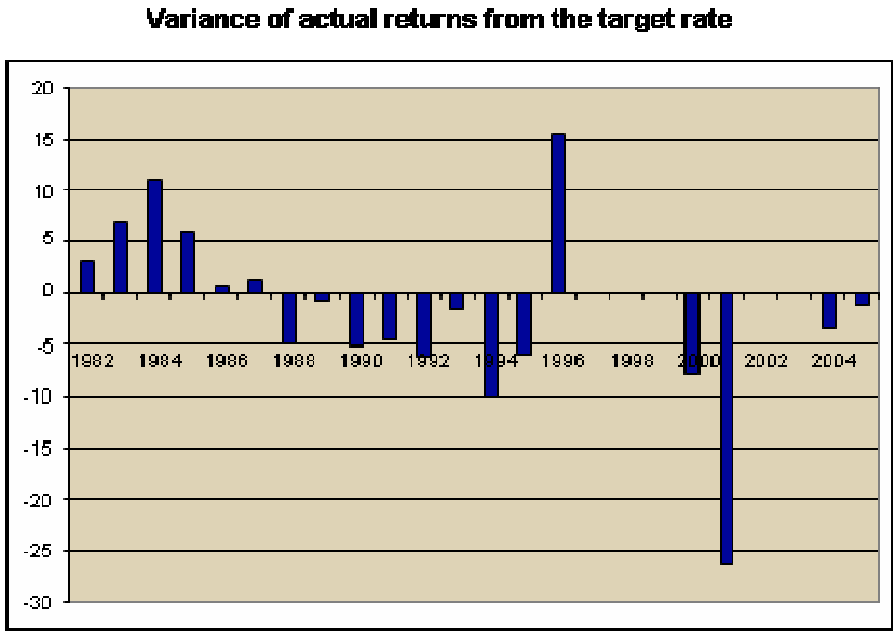
506. For the purposes of this review, annual returns have been received from 30 contractors with total profit formula sales in 2005 (being company year ends ending in the year to 31 March 2005) of £4 billion. This suggests a high level of coverage given the level of contracts and amendments placed by MOD in recent years and the Board would like to acknowledge the assistance it has received from the JRBAC in co-ordinating the collection of annual returns from contractors.

507. The Board's analysis of the annual returns shows that the contractors' overall target rate of return on profit formula contracts was 6.64 per cent on their cost of production, and that they achieved an actual return of 5.53 per cent. The shortfall therefore appears to be 1.11 per cent. The Board notes that:

- 13 of the 30 contracting units exceeded their target profit;
- 5 of the 30 units incurred losses on their non-competitive work; and
- Results reported in annual returns tended to be volatile.

508. These results show that there is considerable variation in outturn performance by individual contractors. Volatility can also be seen in the pattern of returns earned by contractors in recent years:

Variance of actual returns from the target rate	
Year	%
1982	3.2
1983	6.8
1984	11
1985	6
1986	0.6
1987	1.2
1988	-5
1989	-0.7
1990	-5.2
1991	-4.6
1992	-6.1
1993	-1.4
1994	-10
1995	-6
1996	15.4
1997	No returns
1998	No returns
1999	No returns
2000	-7.8
2001	-26.3
2002	No returns
2003	No returns
2004	-3.37
2005	-1.11



509. Analysis in previous years has shown that where there have been large variations from the target these have tended to be heavily influenced by a few large contracts. Given the volatility, and the lack of data for some of the recent years, the Board is unable to draw definitive conclusions from the data but notes that the data that is available for the past two years shows actual returns that are close to the target rate. The Board intends to continue to monitor the situation at future reviews.

Post-costing

510. 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. It is intended that the post-costing data should be agreed between MOD and the contractor, but the JRBAC has previously expressed concerns that post-costing results do not always reflect an agreed final position, as the parties see little benefit in negotiating the position if it will not result in a refund or affect follow-on contracts.

511. The Board has received post-costing data from MOD for all contracts that were post-costed in 2005. This data, together with comparative data for contracts post-costed in 2001-2004, is set out below.

512. The detailed analysis excludes TCIF contracts. TCIF contracts are designed to cope with a range of outturn costs, and any variation from the target outturn cost will be shared between the parties in accordance with the agreed shareline. Therefore, it is not appropriate to include these contracts in an analysis of other contracts, where cost under and overruns all fall to the contractor.

513. Post-costing results received from MOD over the past 5 years are shown below:

All contracts post-costed by MOD					
	2001	2002	2003	2004	2005
Total of contracts post-costed					
(a) Number	84	28	17	15	36
(b) Value	£1,896m	£738m	£450m	£1,048m	£989m
Of which the following were not fully analysed:					
(a) Number	3	4	Nil	Nil	Nil
(b) Value	£22m	£66m	Nil	Nil	Nil

Analysis of all contracts fully analysed by MOD (excluding TCIF contracts)					
	2001	2002	2003	2004	2005
A – Contracts where +/- 5 per cent accuracy was achieved:					
(a) Percentage by Number	41%	46%	36%	57%	76%
(b) Percentage by Value	72%	71%	51%	89%	72%
B – Contracts where +/- 10 per cent accuracy was achieved:					
(a) Percentage by Number	78%	88%	83%	79%	88%
(b) Percentage by Value	93%	98%	98%	96%	97%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):					
(a) Number	42	11	9	9	17
(b) Value	£599m	£218m	£372m	£139m	£361m
D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):					
(a) Number	11	2	3	3	Nil
(b) Value	£70m	£13m	£6m	£13m	Nil
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:					
(a) Number	10	Nil	1	Nil	Nil
(b) Value	£112m	Nil	£1m	Nil	Nil
(c) Amount of refund	£3.9m	Nil	£0.04m	Nil	Nil
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):					
(a) Number	16	10	5	2	12
(b) Value	£537m	£437m	£72m	£178m	£387m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):					
(a) Number	5	1	Nil	Nil	4
(b) Value	£22m	£3m	Nil	Nil	£27m

514. The Board is encouraged by the figures in boxes A and B above, which indicate that target costs used for pricing remain close to eventual outturn costs.

515. The following tables show the average returns on capital earned on risk contracts for which post-costing was completed in the five year period to 2005.

Post-costing: Average Return on Capital for Contracts Priced on Historic Cost							
Year Post Costing Completed	Value	Contract target ROCE	Actual return on intended capital	Variance	Actual return on actual capital	Overall variance	Variance Adjusted For Refunds
	£m	%	%	Percentage Points	%	Percentage points	Percentage Points
A	B	C	D	E	F	G	H
2001	952	28.8	31.6	+2.7	33.1	+4.3	+2.6
2002	404	17.3	17.2	-0.1	23.0	+5.7	+5.7
2003	415	26.2	42.1	+15.9	46.2	+20	+20
2004	307	19.1	19.4	+0.3	28.9	+9.8	+9.8
2005	162	23.9	27.1	+3.2	30.4	+6.5	+6.5

Post-costing: Average Return on Capital for Contracts Priced on Semi-CCA							
Year Post Costing Completed	Value	Contract target ROCE	Actual return on intended capital	Variance	Actual return on actual capital	Overall variance	Variance Adjusted For Refunds
	£m	%	%	Percentage Points	%	Percentage Points	Percentage Points
A	B	C	D	E	F	G	H
2001	276	14.9	21.3	+6.4	24.8	+10.0	+9.9
2002	267	19.2	21.8	+2.6	22.7	+3.45	+3.45
2003	36	13.5	11.0	-2.5	14.9	+1.4	+1.4
2004	7	27.4	80.4	+53.0	74.9	+47.5	+47.5
2005	610	13.1	5.8	-7.3	6.1	-7.0	-7.0

516. All post-costed contracts were priced under the pricing methodology which existed prior to the 2003 General Review so the contract target return is calculated by applying the profit formula to the contractor's CP:CE ratio. A variance on a fixed price contract can arise if:

- actual costs are different from those used in the pricing estimate. This difference results in the return shown in column 'D' above, and the variance shown in column 'E'; and/or
- the outturn capital employed required on the contract is different from that indicated by the CP:CE ratio used for pricing. This difference causes the figures in column 'D' above to be varied to those shown in column 'F'.

517. The overall variance between the target return on the intended capital at the time of price fixing ('C') and the actual outturn return on the actual outturn capital employed on the contract ('F') is shown in column 'G'. Column 'H' shows the overall variance ('G') after adjusting for refunds negotiated by MOD.

APPENDIX A

THE RECOMMENDED PROFIT FORMULA - ILLUSTRATIONS

Prepared by the Review Board for Government Contracts – September 2007

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 is 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 (67%)	2,000,000	1,000,000	4,000,000	2,000,000	2,000,000	2,000,000
(B) Working capital (33%)	1,000,000	500,000	2,000,000	1,000,000	1,000,000	1,000,000
(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	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	6.71%	6.71%	6.71%	6.71%	6.71%	6.71%
(G) FC proportion (A)	67.00%	67.00%	67.00%	67.00%	67.00%	67.00%
(H) (F x G)	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
(I) WCSA	6.23%	6.23	6.23%	6.23%	6.23%	6.23%
(J) WC proportion (B)	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%
(K) (I x J)	2.06%	2.06%	2.06%	2.06%	2.06%	2.06%
(L) CSA (H + K)	6.55%	6.55%	6.55%	6.55%	6.55%	6.55%
(M) CSA as percentage of CP (L/E)	2.18%	1.09%	4.37%	2.18%	2.18%	2.18%
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	9.39%	9.39%	9.39%	9.39%	9.39%	9.39%
(P) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(Q) Contract Baseline Profit Allowance	9.39%	9.39%	9.39%	8.45%	10.33%	7.04%
(R) CSA (M)	2.18%	1.09%	4.37%	2.18%	2.18%	2.18%
(S) Total Contract Profit Allowance (Q + R)	11.57%	10.48%	13.76%	10.63%	12.51%	9.23%
(T) Total formula payments (N x S)	115,700	104,800	137,600	106,300	125,100	92,300
(U) Total contract price (N + T)	1,115,700	1,104,800	1,137,600	1,106,300	1,125,100	1,092,300

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 9.39% is applicable 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

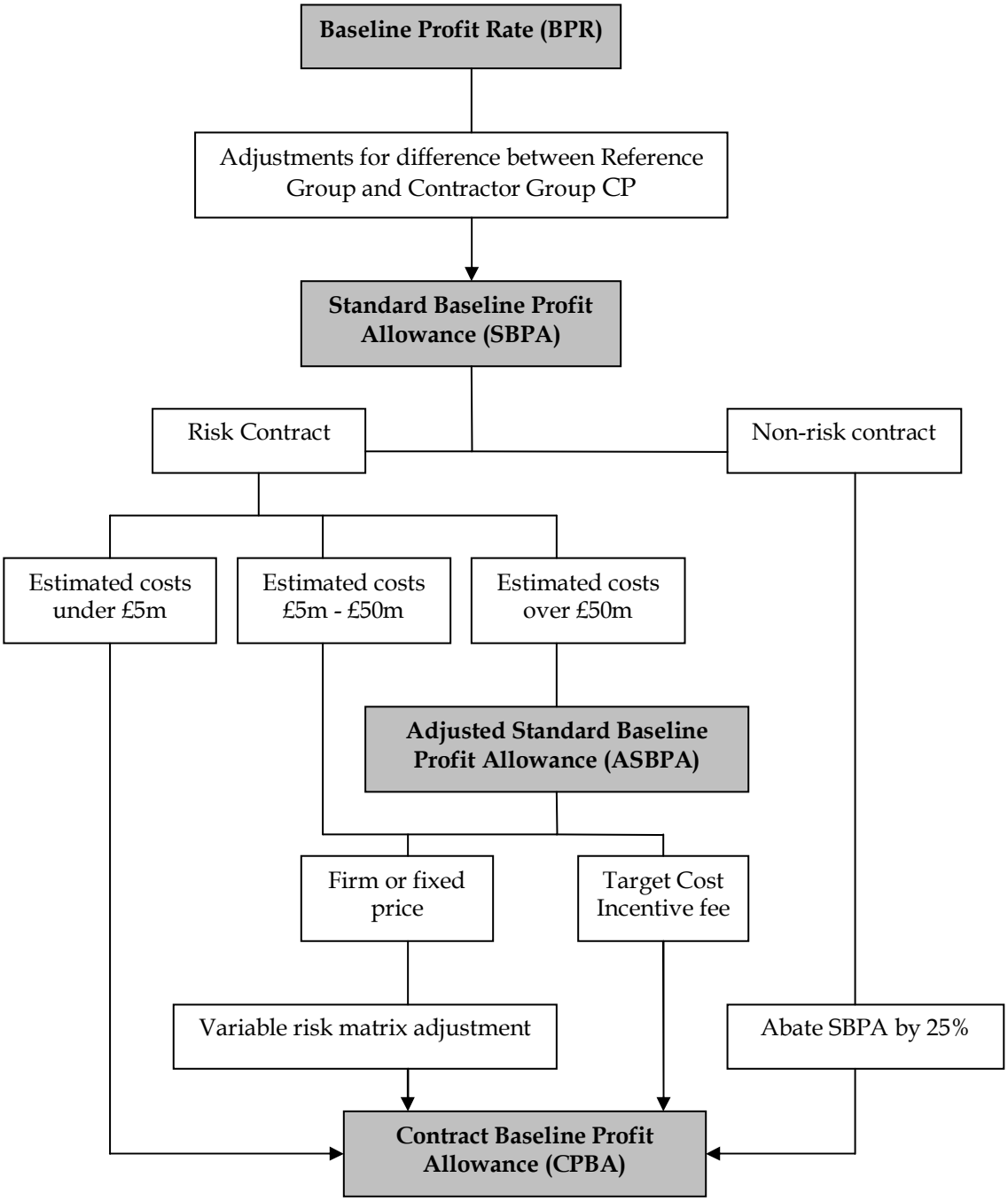
		CSAs	Total
Contractor's CP:CE ratio:			
(A) Fixed capital (80%)		24,000,000	
(B) Working capital (20%)		6,000,000	
(C) Total capital (A + B)		30,000,000	
(D) Total cost of production		90,000,000	
(E) CP:CE ratio is therefore (D/C)		3	
CSA calculation:			
(F) FCSA		6.71%	
(G) FC proportion (A)		80.00%	
(H) (F x G)		5.37%	
(I) WCSA		6.23%	
(J) WC proportion (B)		20.00%	
(K) (I x J)		1.25%	
(L) CSA (H + K)		6.61%	
(M) CSA as percentage of CP (L/E)		2.20%	
Individual contract price:			
(N) Contract CP		75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	9.39%		
(P) Reduction for contracts over £50m	0.30%		
(Q) Adjusted Standard Baseline Profit Allowance (O – P)		9.09%	
(R) Adjustment in accordance with the Risk/Reward matrix		nil	
(S) Contract Baseline Profit Allowance		9.09%	
(T) CSA (M)		2.20%	
(U) Total Contract Profit Allowance (S + T)		11.29%	
(V) Total formula payments (N x U)		8,467,500	8,467,500
(W) Total contract price (N + V)			83,467,500

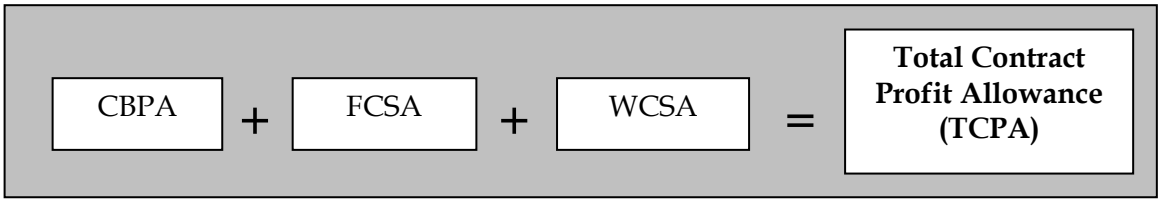
Explanation:

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 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





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.

APPENDIX D

THE GOVERNMENT PROFIT FORMULA AND ITS ASSOCIATED ARRANGEMENTS

The GPFAA as reproduced below represents the status of the agreement between the parties as it stands immediately prior to the issue of this General Review. To the extent that recommendations contained in the Review are accepted by the parties and implemented, the Agreement will be updated and placed on the main MOD website.

THE GOVERNMENT PROFIT FORMULA and its ASSOCIATED ARRANGEMENTS

THE GOVERNMENT PROFIT FORMULA and its ASSOCIATED ARRANGEMENTS

Text agreed between Government and industry in July 2007

Introduction

1.1. On 26th February 1968, the Chief Secretary, HM Treasury, announced to Parliament that the Government had reached agreement with industry on new arrangements for placing and pricing non-competitive Government contracts.

1.2. The underlying objective of these arrangements is that fair and reasonable prices shall be agreed. The detailed arrangements have been modified from time to time, most recently by this agreement between the Ministry of Defence ('MOD') acting on behalf of the Government and the CBI acting on behalf of industry. This Profit Formula Agreement, which supersedes the 1968 Memorandum of Agreement, the 1968 Profit Formula Agreement and all previous amendments thereto, contains three sections: Section 1 (Principles), Section 2 (Arrangements agreed following the 2006 Annual Review) and Section 3 (Review Board guidance).

SECTION 1: Principles

1.3. Section 1 of this agreement covers the following matters of principle:

(a) **Part A** - a profit formula based strictly on the principle of comparability (the Government profit formula or GPF);

(b) **Part B** - the adoption of contractual conditions governing equality of information and post-costing; and

(c) **Part C** - the establishment of the Review Board for Government Contracts, a body independent of both the Government and industry, to conduct periodic reviews of the GPF for pricing non-competitive Government contracts and its associated arrangements and make recommendations on the basis of those reviews; and to review and determine the price of individual contracts referred to it for that purpose.

PART A: THE GOVERNMENT PROFIT FORMULA

Use of the formula

1.4. The GPF and its associated arrangements are to be used to determine an allowance for profit to be included in the price (or the target price) of all non-competitive Government contracts and non-competitive amendments to competitive contracts.

1.5. For the purpose of this Agreement, non-competitive Government contracts are contracts let by a Government department where the price has not been determined as a result of competitive tendering or by reference to the price of proprietary articles for which a competitive general market price exists.

1.6. As the predominant user of the GPF the Ministry of Defence has the responsibility, formerly vested in HM Treasury, for communicating with the Board on behalf of Government on all matters concerning the GPF. However, if both contracting parties agree, the GPF and its associated arrangements are available for application to non-competitive

contracts placed by other Government departments or public sector bodies, by the incorporation of the appropriate contract conditions.

Aim of the formula

1.7. The aim of the formula shall be to give contractors 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. The overall return for British industry is derived from a Reference Group of major listed UK companies.

Elements of the formula

1.8. The GPF shall comprise three elements:

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

(b) an allowance for the servicing of Working Capital used for non-competitive contracts referred to as the **Working Capital Servicing Allowance, or WCSA**; and

(c) an allowance on the cost of production of individual non-competitive contracts representing a Standard Baseline Profit Allowance derived from the baseline profit of the Reference Group, adjusted if necessary in accordance with paragraph 1.9 below, to arrive at the **Contract Baseline Profit Allowance, or CBPA**.

Any adjustments to take account of the risk characteristics of individual non-competitive Government contracts shall be incorporated in the CBPA (see paragraph 1.10 below) and not in the FCSA and WCSA.

Recognition of relative risk of non-competitive Government contracts compared with the Reference Group

1.9. The Standard Baseline Profit Allowance (SBPA) shall reflect the difference, if any, in the risk involved in non-competitive Government contracts as compared with the risks to which companies in the Reference Group are generally exposed.

Recognition of relative risk of individual non-competitive Government contracts

1.10. The Contract Baseline Profit Allowance (CBPA) on individual non-competitive Government contracts shall, through adjustments to the SBPA where necessary, also reflect the level of risk inherent in different types of work and the risk or non-risk pricing methodology.

The application of Government Accounting Conventions

1.11. The Government and industry shall agree the accounting conventions for pricing non-competitive Government contracts (the GACs). Costs and capital employed shall be computed in accordance with the GACs for determining the level of capital employed, overhead costs and the cost of production applicable at the time of pricing, on the basis of which the GPF is to apply in determining a non-competitive price. The attribution of costs between overhead costs and direct contract costs shall be a matter for agreement between Government and individual contractors based on the contractor's normal accounting system.

PART B: EQUALITY OF INFORMATION AND POST-COSTING

Equality of information

1.12. Contracts with a price agreed, or to be determined, by inclusion of the GPF allowances applicable at the time of pricing ('GPF contracts') and with a pricing arrangement which does not insulate the contractor against loss (referred to as 'GPF risk contracts') shall incorporate contractual conditions giving the Government the right to equality of information for the purposes of pricing the contract, or changes to it, or both. Equality of information is provided for in Standard Condition No. 43 'Price Fixing' of Form GC/Stores/1 from which MOD has derived DEFCON 643.

1.13. It is intended that as a result of equality of information the Government and the contractor will be in the same position at the time the price is fixed. The Government will not normally expect more information from a contractor than is available to him up to the time of fixing the price. The Government must have access to information adequate for price fixing purposes. In general, this will be information from the contractor's normal accounting system. The Government will therefore limit any demand for further information to what can reasonably be shown to be necessary for price fixing purposes. The principle of equality of information shall apply equally to information held by the Government that is relevant to pricing.

Post-costing

1.14. Post-costing is a review by the Government of the costs incurred on a contract, for comparison with the estimated (or target) costs agreed at the time of fixing the price.

1.15. GPF risk contracts will incorporate contractual conditions giving the Government the right to post-cost individual contracts. Post-costing is provided for in Standard Condition No. 48 'Availability of Information' in Form GC/Stores/1 from which MOD has derived DEFCON 648.

1.16. Post-costing rights are to be exercised for the following purposes only:

(a) in pricing follow-on contracts, as an essential element in equality of information;

(b) to enable departments to check the accuracy of their estimating procedures;

(c) to provide the information for a selective scrutiny of the outcome of particular contracts so that a reference may be made by either side to the Review Board; and

(d) to provide verification of outturn costs for fixed or firm prices where contract terms require a sharing of the outcome of a cost over-run or under-run by means of an adjustment to the Contract Price. A reference may be made by either side to the Review Board where a party considers that the sharing outcome is inequitable.

1.17. It does not necessarily follow that the right to post-cost must always be exercised whenever this condition is included in the terms of a contract; there should be selectivity so that no undue burden is placed either on departments or on contractors.

Application of equality of information and post-costing to low value contracts

1.18. For small value contracts below a threshold of £250,000 a simplified requirement for equality of information should suffice and Standard Condition 43 'Price Fixing' of Form GC/Stores/1 (from which MOD has derived DEFCON 643) is not used. MOD has established a condition that reflects this simplified requirement in DEFCON 127. In addition, where the contract is below the small value threshold of £250,000 the post costing

condition Standard Condition 48 'Availability of Information' of Form GC/Stores/1 (from which MOD has derived DEFCON 648) is not used. The threshold of £250,000 is to be taken an indication of the parties' intentions but it is accepted that it is not possible to define 'small value' for all contracts and, in any case, the inclusion of the conditions in any particular contract is a matter for negotiation between the parties.

Contingencies

1.19. Contingency provisions are adjustments that are made to estimated costs to cater for events the occurrence of which is uncertain. They are to be distinguished from estimating allowances in respect of events (e.g. scrap and rectification) that are certain to occur.

1.20. The Government and industry have agreed that under the GPF arrangements and the contract conditions providing for equality of information and post-costing it will still be necessary to include reasonable and justifiable contingency provisions in estimated costs for the purpose of fixing prices based on forward estimates. In order, as far as possible, to avoid both over-estimating and under-estimating contingency provisions, the following principles should be taken into account by both sides:

(a) Equality of information and post-costing do not lessen the need for contractors to include reasonable contingency provisions in their price estimates, but increase the need for these provisions to be separately identified and justified by reference to previous experience, the length of the contract, its complexity, or the degree of technical innovation involved.

(b) It is intended that the prices negotiated should on average result in profits being earned in line with the GPF allowances in force at the time of contract pricing, and that higher profits should be achieved in contracts carried out with above average efficiency and/or effective risk management, but consistent over-provision for contingencies cannot be regarded as a legitimate means of attaining above average profits.

(c) There may be occasions when a contingency provision openly declared and agreed at price fixing and accepted by reference either to the need for a similar provision in a comparable previous contract or to any of the reasons listed in (a) above turns out after post-costing to have been unnecessary in whole or in part. In such cases, the basic consideration is whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

(d) If there is too much uncertainty to enable fair and reasonable prices to be fixed with appropriate contingency margins incorporated, the use of incentive contracts with profit sharing provisions should be considered.

PART C: ARRANGEMENTS FOR AN INDEPENDENT REVIEW BOARD FOR THE PRICING OF GOVERNMENT CONTRACTS

1.21. The Government and industry agree to the continuation of the 1968 Memorandum of Agreement arrangements for the establishment of an impartial Review Board for Government Contracts ('the Review Board'). The agreed functions of the Review Board and administrative arrangements for its operation are set out below.

ESTABLISHMENT AND ADMINISTRATIVE ARRANGEMENTS

1.22. The Review Board for Government Contracts ('the Review Board') shall be independent of both the Government and industry.

1.23. The Review Board shall consist of a Chairman and four other Members as follows:

(a) The MOD (on behalf of Government) and the CBI (on behalf of industry) shall each nominate two independent candidates for appointment as Members, and shall consult each other to ensure that both these nominations and also the nomination for the Chairmanship are acceptable to both parties.

(b) The MOD shall appoint the Chairman and other Members. Subject to (c) and (d) below these appointments are for a period of not less than three and not more than five years. These appointments may be renewed.

(c) Appointments may be terminated by the MOD after consultation with the CBI.

(d) Members may resign at any time by giving notice in writing to the MOD.

(e) Casual vacancies, caused for example by resignation, shall be filled after consultation between the two parties as provided in (a) above.

1.24. All appointments to the Board, and any renewal of an appointment, and determination of its emoluments, are to be undertaken in accordance with the Code of Practice for Ministerial Appointments to Public Bodies, published from time to time by the Office of the Commissioner for Public Appointments ('OCPA') or any successor body. For the purpose of that Code the CBI shall be regarded as a 'Nominating Body'.

1.25. The Review Board is a public authority listed in Part VI of Schedule 1 to the Freedom of Information Act 2000 and it shall use the processes and procedures established by MOD for the handling and discharge of applications for access to information under that Act.

1.26. The Secretariat necessary to service the Review Board shall, unless and until the Review Board shall recommend otherwise, be provided by the engagement of a firm of professional accountants, whose terms of appointment and terms of reference shall be determined by agreement between the Review Board, the Government and the CBI. If the Review Board recommends that it should employ other professional advice or staff of its own, the number, pay and conditions of these staff shall also be determined by agreement between those three parties.

1.27. The arrangements for accommodating the Review Board and supporting staff shall be agreed between the Review Board, the Government and industry.

1.28. The Government shall determine, after consultation with industry, the remuneration of the Chairman and other Members of the Review Board.

Costs

1.29. The arrangements for meeting the running costs of the Review Board will be determined by agreement between the MOD and the CBI in consultation when appropriate with the Review Board.

1.30. Costs incurred by Government departments, by contractors or by sub-contractors arising from reference of individual contracts or sub-contracts to the Review Board, shall lie

where they fall. Those incurred by contractors or sub-contractors will be regarded as allowable costs in arriving at overhead rates.

Procedures

1.31. Subject to the arrangements set out below for the review of individual contracts and sub-contracts and for General and Annual Reviews, the Board shall determine its own procedures and all other matters not otherwise provided for in this Part C to the Agreement.

FUNCTIONS

General Reviews

1.32. The Government and the CBI have agreed that the Review Board shall at three-yearly intervals carry out a comprehensive General Review of the GPF (as revised in the light of any subsequent modifications) and to make recommendations accordingly. The Review Board, taking account of the effect of the Government accounting conventions, shall advise whether:

(a) the GPF has achieved its aim for the three years under review in the light of the evidence of actual earnings on GPF work, both risk and non-risk;

(b) the aim of the GPF requires any modification;

(c) the allowances for each element of the GPF require modification in the light of its advice on (a) and (b) above.

1.33. In conducting these General Reviews the Board will invite submissions from Government and industry, which may be made jointly or individually, and may take account not only of the submissions made to it by the Government and those organisations representing industry generally or any particular industry but also of any representations made to it by any person or body it wishes to consult. In their submissions to General Reviews the parties should be free to raise any issue connected with the GPF and its associated arrangements.

1.34. The Review Board will from time to time identify the information it reasonably requires to carry out its functions, either from industry (for example by way of annual returns of aggregate annual profitability of GPF work) or from MOD (for example by way of reports on the result of its post-costing of selected individual contracts). Government and industry will agree the information to be provided to the Review Board to enable it to carry out its Reviews.

1.35. The Board shall recommend allowances for each element of the GPF, strictly in accordance with the principle of comparability, and the date of their implementation. The Board may also indicate the level at which (or if more appropriate the range within which) allowances fair to both parties should be established, taking into account and separately identifying any other relevant considerations in accordance with paragraph 1.36 below.

1.36. The Review Board will be expected 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. But any such

recommendations should not be allowed to override the formal application of the comparability principle itself without prior consultation with the parties.

1.37. Each Review will result in a written report from the Review Board to the MOD (on behalf of Government). The report will be made simultaneously available to the CBI for consideration by industry. The report will be provided to both parties on a strictly confidential basis. Representatives of both parties will convene to discuss the report and will seek to agree allowances for each element of the GPF and related matters, consulting the Review Board as necessary on matters of fact or interpretation or as otherwise agreed by both parties and:

(a) If agreement is reached, notify the Board accordingly;

(b) Should agreement not be reached the Government will decide the allowances for each element of the GPF, having regard to the recommendations of the Board, its negotiation with industry and any other factors. Before announcing its decision the Government will advise industry of the proposed allowances and the reasons for arriving at such allowances and will allow industry the opportunity to present its case at a more senior level in the Government should it elect to do so;

(c) Once the allowances for each element of the GPF and related matters have been established under these arrangements, the Government will announce the result, notify the Board and arrange publication of the Board's report to include an annex detailing the final GPF whether agreed under 1.37(a) or determined under 1.37(b).

Annual Reviews

1.38. The operation of the GPF shall also be subject to intermediate review at the end of the first and second year of each succeeding three-year period. Unless otherwise agreed between the parties, these intermediate reviews will be limited to examination of the data underlying the allowances for each element of the GPF and consequent recommendations for modification of those allowances. The publication of the Board's reports on its Annual Reviews shall be in accordance with the procedures set out in paragraph 1.37 above in relation to its General Reviews.

Review of individual contracts and sub-contracts

1.39. The Government and the CBI have agreed that the Review Board shall review and give rulings on the pricing of individual contracts and sub-contracts that are referred to it by either of the parties. By the terms of contract both parties shall agree to accept the rulings of the Review Board. The Board will consider only Government GPF risk contracts or sub-contracts, and only those referred in accordance with paragraphs 1.41 to 1.43 below. The task of the Review Board in these circumstances is to assess whether the price negotiated was fair and reasonable, and in the light of this assessment determine whether any payment, and, if so, how much, should be made by one of the two parties to the other.

1.40. For the purpose of interpreting paragraph 1.39 above and subject to the provisions of paragraphs 1.41 to 1.43 below:

(a) GPF risk contracts comprise those contracts or contract amendments (including amendments to contracts other than GPF risk contracts) placed with contractors by Government departments which:

(i) incorporate a condition covering availability of information (normally Standard Condition No. 48 'Availability of Information' of Form GC/Stores/1, from which MOD has derived DEFCON 648) and requiring the contractor to

provide on request information to the department in connection with a post-costing investigation of the contract; and

(ii) include in the price (or the target price) an allowance for profit calculated at the GPF rate applicable at the time of pricing.

(b) GPF risk sub-contracts comprise sub-contracts placed by contractors for the purpose of and in connection with their own fulfilment of GPF risk contracts, and such other sub-contracts as may be specified by the department under the terms of any contract. Sub-contracts placed by competitive tender, or which incorporate a pricing arrangement which insulates the sub-contractor against loss, are not GPF risk sub-contracts.

1.41. GPF risk contracts will incorporate a condition covering reference of the contract to the Review Board in certain specified circumstances (normally Standard Condition No. 50 of Form GC/Stores/1, from which MOD has derived DEFCON 650). Such a reference may be made either by the Government department or by the contractor or jointly by both these parties to the contract. GPF risk sub-contracts of a value exceeding a threshold specified in the main contract may incorporate a similar condition. In such circumstances the sub-contract may be referred to the Review Board either by the Government department concerned in the related main contract or by the sub-contractor or jointly by both.

1.42. A contract or sub-contract incorporating a condition such as is mentioned at paragraph 1.41 above may, subject to the terms of that condition, be referred to the Review Board by any party entitled to make such a reference where outturn costs vary from estimated costs by 10% or more. These figures do not of themselves involve any presumption of whether any payment should be made by one of the two parties to the other.

1.43. In exceptional cases, although the profit or loss made by the contractor or sub-contractor was not such as to justify a reference under the terms of paragraph 1.43 above, any party entitled to make a reference may do so if it considers that the achievement of fair and reasonable price was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

1.44. For the purposes of paragraphs 1.39 and 1.41 to 1.43 above, and for acting upon the provisions in the conditions in contracts and sub-contracts which relate to making references to the Review Board, notice of a reference to the Review Board shall have effect only on and from the date on which it is received by the Review Board's Secretariat and also only if:

(a) the notice is in writing, identifying the parties to the reference, the contract or sub-contract being referred, and the specific circumstances which have occasioned the reference; and

(b) except when the reference is made jointly by both the Government department on the one hand and the contractor or sub-contractor as the case may be on the other hand, the party making the reference has simultaneously sent a copy of the notice to the other party to the reference.

1.45. In considering any reference to it of any individual contract or sub-contract, the Review Board shall have especial regard to:-

(a) the information available to the Government department, and to the contractor or the sub-contractor as the case may be, when the price was fixed; and

(b) the standard of efficiency with which the contract or sub-contract was performed.

1.46. Either party to a reference or both parties jointly may bring further considerations to the attention of the Review Board if these could in their view have a bearing on its deliberations. Relevant considerations might include for example:

(a) the degree of risk involved in performing the contract or sub-contract;

(b) the record of profits achieved or losses sustained by the contractor or sub-contractor on Government GPF work over recent years;

(c) in references of sub-contracts by the department or the sub-contractor, respective responsibilities of the department, the contractor and the sub-contractor for the situation leading to the reference.

1.47. In connection with a reference to it of an individual contract or sub-contract, the Review Board may have occasion to consider a contingency provision which had turned out after post-costing to have been unnecessary in whole or in part. The Review Board shall examine such a provision only from the aspect of the situation at the time of price fixing and in doing so shall have especial regard to:

(a) whether the contingency provision was openly declared and agreed at price fixing and accepted then by reference either to the need for a similar provision in a comparable previous contract or to previous experience or the length or complexity of the contract or the degree of technical innovation involved in the performance of the contract; and

(b) whether the nature of the contingency and the amount of the provision were fair and reasonable in the light of the information available to the two sides at price fixing.

1.48. The Government and the CBI have agreed the following framework, within which the Review Board would determine its own procedures, for the reference to the Review Board of individual contracts and sub-contracts:-

(a) The two parties to a reference shall present their evidence in writing to the Review Board and make it available to the other party. The Review Board shall decide whether it wishes the two parties to present further evidence whether written or oral, and whether it wishes to call for evidence from the main contractor on a sub-contract under reference, or from a sub-contractor when a main contract is under reference.

(b) References of individual contracts or sub-contracts may be examined and determined by the Chairman and two other members only one being a Member nominated by the Government and the other a Member nominated by the CBI.

(c) The Review Board shall give its decision on a reference in a written report signed by the Chairman to the parties to the reference. A copy shall be made available to HM Treasury. In the event of disagreement between the other Members as to the quantum of an award, the Chairman's decision shall prevail. If any decision is not unanimous this shall not be revealed.

(d) The Review Board shall, in addition to its Annual and General Reviews, publish an annual report on its work which shall include details of its decisions on all individual cases referred to it in the year, together with an assessment of the general considerations (in particular those listed in paragraph 1.45 above) which led to these decisions. The Review Board will not be obliged to publish the names of the contractors or sub-contractors concerned in these decisions. If the Review Board decides in any particular case to identify the parties to the reference it shall inform them of this decision in advance of publication of the annual report.

(e) Except as provided in paragraph (d) above, or to the extent necessary to comply with a statutory or judicial obligation, the reference process and anything said, done or produced in or in relation to the reference process (including any awards) shall be held in confidence as between the parties. Except as provided in paragraph (d) above, no report relating to anything said, done or produced in or in relation to the reference process may be made beyond the Review Board, the parties, their legal representatives and any person necessary to the conduct of the proceedings, without the concurrence of all the parties to the reference.

1.49. It will at all times remain open to Government departments and contractors or sub-contractors to agree to settle between them in any way any matter arising out of a contract or sub-contract which could be, or has been, referred as provided above to the Review Board. Whenever such a settlement is agreed upon, whether or not a reference has already been made to the Review Board and whether or not the terms of the settlement involve payment, any party to the settlement may report its terms to the Review Board for information. Any such report will, unless the parties to the settlement agree otherwise, be confined to statements of fact and will whenever possible be in a form agreed between the parties as part of the terms of the settlement.

SECTION 2: Arrangements agreed following the 2006 Annual Review

PROFIT FORMULA ALLOWANCES

2.1. As outlined in paragraph 1.8 above, the Government profit formula (GPF) comprises three elements: the Fixed Capital Servicing Allowance, the Working Capital Servicing Allowance and a Contract Baseline Profit Allowance.

Fixed Capital Servicing Allowance (FCSA)

2.2. The FCSA[b] shall be:

(a) linked to the 7 year moving average of the 15 year Gilt rate; plus

(b) a 1.5 percentage point premium to take it up to the average cost of a BBB rated corporate bond; plus

(c) 0.5 of a percentage point to incorporate a premium for a BBB3 rating and the liquidity discount.

Based on rates prevailing up to 30 December 2005, this gives an FCSA of 6.79%.

Working Capital Servicing Allowance (WCSA)

2.3. The WCSA[c] shall be:

(a) linked to the 36 month moving average of the one year LIBOR; plus

(b) 1.25 percentage points.

Based on rates prevailing up to 30 December 2005, this gives a WCSA of 5.74%.

2.4. A negative WCSA shall be calculated for any contractor having negative capital employed and this amount shall 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.

Contract Baseline Profit Allowance (CBPA)

2.5. The purpose of the CBPA is to provide contractors with a return on their uncapitalised intangible assets and for the risks they assume. The CBPA upholds the principle of comparability: it is derived from the overall rate of return of the Reference Group after deducting the allowances for servicing recognised capital through FCSA and WCSA (paragraphs 2.2 to 2.4 above) to arrive at the Baseline Profit Rate of the Reference Group (paragraphs 2.6 to 2.7 below) and then making the further adjustments described in paragraphs 2.8 to 2.13 below.

Baseline Profit Rate (BPR)

2.6. The Reference Group baseline profit expressed as a percentage of the Reference Group cost of production (the Baseline Profit Rate (BPR)) shall be taken to represent the return that an average company in the Reference Group earns on its uncapitalised intangible assets and for the risks it assumes.

[b] See GPFAA 3.15 to 3.18 for further background explanation of FCSA.
[c] See GPFAA 3.19 and 3.20 for further background explanation of WCSA.

2.7. The Baseline Profit Rate shall be determined on a three year rolling average basis. Based on the rates for 2002, 2003 and 2004, this gives a BPR of 7.27%, as follows:

	2002/3 Reference Group £m	2003/4 Reference Group £m	2004/5 Reference Group £m
(A) Cost of Production	580,164	615,558	629,467
(B) Capital Employed	253,589	253,826	246,884
(C) CP:CE ratio (A÷B)	2.29	2.43	2.55
(D) FC:WC ratio	92:8	92:8	94:6
(E) Actual Profit (EBIT)	57,533	62,885	66,351
(F) FCSA % (see note below)	7.62%	7.17%	6.90%
(G) WCSA % (see note below)	6.23%	5.57%	5.66%
(H) FCSA (B×(D['FC']÷100)×F)	17,778	16,743	16,103
(I) WCSA (B×(D['WC']÷100)×G)	1,264	1,131	838
(J) Total CSA (H+I)	19,041	17,874	16,851
(K) Baseline Profit (E-J)	38,491	45,011	49,500
(L) BP as % of CP (K÷A)	6.63%	7.31%	7.86%
3 year simple average			**7.27%**

Note. The FCSA and WCSA percentage figures are derived using the methodology set out earlier in this Section, using the data applicable as at 31 March of the year concerned.

Standard Baseline Profit Allowance (SBPA)

2.8. The Reference Group Baseline Profit on cost of production of 7.27% as calculated above is embodied in the GPF after making adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractors.

2.9. The Reference Group cost of production, and consequently the BPR, reflects the position after costs of intra-group inter-unit trading have been eliminated on consolidation in accordance with UK GAAP. In non-competitive pricing however the CBPA will be applied to costs before any of those types of deduction are made. To maintain the principle of comparability, the level of relevant intra-group inter-unit ('IGIU') trading[d] by the contractor group needs to be assessed and its effect eliminated.

2.10. The current level of IGIU trading in the contractor group is 3.1%, of which part relates to contracts priced in excess of £50 million which attract a reduced profit rate in accordance with the arrangements outlined in paragraph 2.13(a) below. In order to allow for this effect, the 3.1% IGIU percentage has been reduced to 3.04%. The SBPA shall be 7.05%, representing the BPR of 7.27% less the 3.04% abated reduction in recognition of the impact of intra-group inter-unit trading.

2.11. The MOD and the JRBAC have agreed to review the process for collecting relevant IGIU trading data in future to ensure that it is as robust as possible.

[d] Sales to other CP:CE units within the group in respect of GPF contracts…but excluding (a) Sales to related units not fully consolidated within the group eg Minority interests or Joint Ventures, and (b) Sales to related units fully consolidated within the group where there is no question of duplication of GPF profit allowances.

Recognition of relative risk of non-competitive government contracts compared with the Reference Group

2.12. No adjustment is currently made, in either direction, in respect of the relative risk, if any, involved in non-competitive Government contracts as compared with the risks to which companies in the Reference Group are generally exposed.

Recognition of risk variability in type of work

2.13. The profit to be paid on individual non-competitive Government contracts should reflect the level of risk inherent in different types of work through adjustments to the SBPA if appropriate. The agreed variable risk/reward matrix for different types of work is reproduced at Annex B to this Section 2. The matrix, and its footnotes, provide for:

(a) a reduction of 30 basis points[e] from 7.05% (the SBPA) to 6.75% (the Adjusted Baseline Profit Allowance (ASBPA)) in the baseline profit allowance applicable to contracts and contract amendments with estimated or target cost in excess of £50 million;

(b) depending on the type of work, possible 10% increases or decreases in the SBPA or ASBPA on firm or fixed price contracts and contract amendments whose cost is £5M or over ; and

(c) a reduction of 25% from 7.05% to 5.29% (the Non-risk Baseline Profit Allowance (NBPA)) in the baseline profit allowance applicable to contracts priced on a non-risk basis.

Summary

2.14. The profit allowance applicable to specific contracts and contract amendments therefore comprises the sum of the CBPA, the FCSA and the WCSA. This total allowance applicable to a non-competitive contract using the GPF methodology is known as the Total Contract Profit Allowance ('TCPA'). A flowchart showing how the various levels of Baseline profit allowance are applied is included at Annex A to this section 2. The GPF allowances applicable from 1 June 2006 shall be:

		%
FCSA	Fixed Capital Servicing Allowance (para 2.2)	6.79 on FC
WCSA	Working Capital Servicing Allowance (para 2.3)	5.74 on WC
SBPA	Standard Baseline Profit Allowance (para 2.10)	7.05 on CP
ASBPA	Adjusted Standard Baseline Profit Allowance (para 2.13(a))	6.75 on CP
NBPA	Non-risk Baseline Profit Allowance (para 2.13(c))	5.29 on CP

ARRANGEMENTS ASSOCIATED with the PROFIT FORMULA

Unconscionable profits and losses

2.15. Where a contractor makes either an unconscionable profit or an unconscionable loss under a firm or fixed price contract and the contract price exceeds £5 million, such profit or loss is to be shared 75:25 as between Government and the contractor.

[e] Based on the view expressed by the Review Board in 2003 General Review, paragraphs 518-519.

2.16. For the purposes of the sharing arrangements, unconscionable profit is defined as that proportion of any additional profit made by the contractor that exceeds five per cent of the contract value and unconscionable loss as that proportion of any loss that exceeds five per cent of the contract value. Payments by either party only become due where these exceed £250,000.

2.17. Where one or other party considers there is serious inequity that has not been remedied by application of these sharing arrangements, the matter may be referred to the Review Board to assess whether there are wholly exceptional circumstances that justify a departure from these arrangements. Such exceptional circumstances might include:

(a) evidence to suggest that there was inequality of information at the time of pricing; or

(b) evidence that the excess profits arose through the contractor's innovation or use of new technology that could not have been foreseen at the time of pricing; or

(c) evidence to suggest that the losses arose as a consequence of the contractor willingly and recklessly pricing the contract in the knowledge that it could rely on the sharing arrangements, or evidence to support the view that the contractor was seriously negligent or incompetent in carrying out the contract.

2.18. A reference under these circumstances would follow the same procedures as a normal contract reference as described at paragraphs 1.39 to 1.49. The Board shall assess whether the price negotiated was fair and reasonable and, in the light of this assessment determine whether any payment should be made by one of the two parties to the reference to the other and, if so, how much.

Timely submission of post-costing data

2.19. The Government and industry have agreed that, given the purpose of post costing detailed at paragraph 1.16, it is desirable that processes are put in place to encourage the timely submission of post costing data by industry and audit of that data by Government. To this end, Government is entitled to a deposit of up to 2% of the contract price pending the submission of post-costing data. The percentage is to be stated in the contract.

2.20. The due date for submission of a post-costing summary cost statement is six months from submission of a formal post-costing request by Government, or six months after delivery of the articles, whichever occurs later. The use of estimated cost statements is encouraged in order to facilitate timely submission of post-costing data where the element of cost still subject to estimates is less than 2 per cent of the total contract value or as agreed between the parties. Interim cost statements, and estimated cost statements for the final year, may be used in the case of large, and particularly long-run contracts, where collating the data on termination can be a difficult task.

2.21. The deposit is to be released on the earlier of Government completing or ceasing its audit of the statement, or six months after receipt of the statement, unless the statement, or elements of it, has been formally returned within two months on the grounds that it is inadequate as to form or content.

2.22. Contractors are entitled to claim a working capital servicing allowance at the prevailing rate on the amount of the deposit from the date of payment of the deposit until the deposit is released, provided that:

(a) there is to be no entitlement in respect of the period from the due date for submission and the actual date of submission if later;

(b) a contractor who makes a late submission forfeits the right to make this claim; and

(c) the allowance under a contract amounts to at least £10,000.

2.23. If either the contractor or the Government is required to make a payment to the other as determined by the Board (see paragraph 2.18) or otherwise (see paragraphs 2.16 and 2.22) the payee is entitled to make a claim equivalent to the working capital servicing allowance, at the prevailing rate, on the amount of any refund, from the due date for submission of a summary cost statement up to the date when the refund is made, provided that:

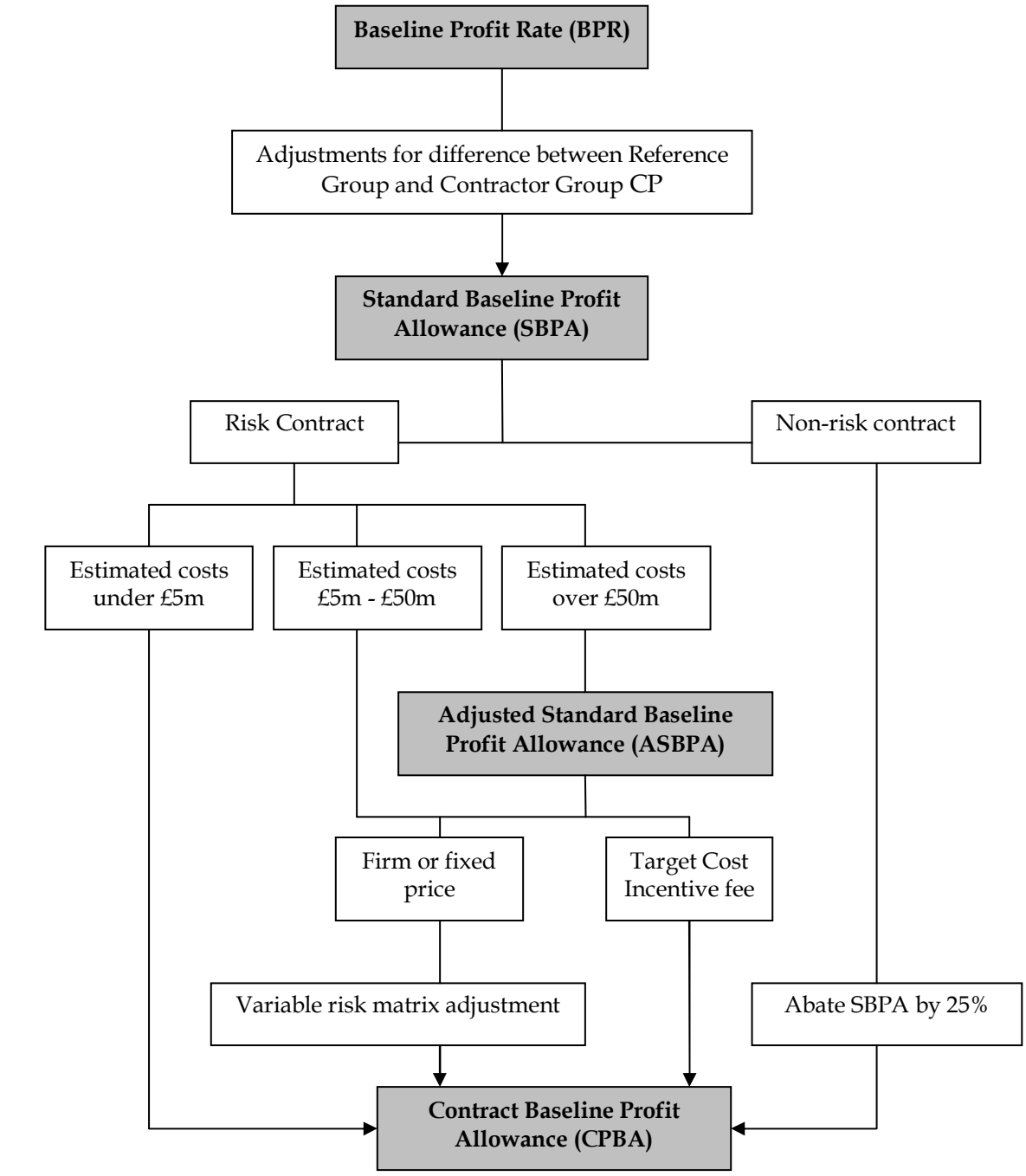
(a) the claim for the period when Government undertakes its audit is restricted to a maximum of six months allowance unless the statement or elements of it had been formally returned on the grounds of inadequacy;

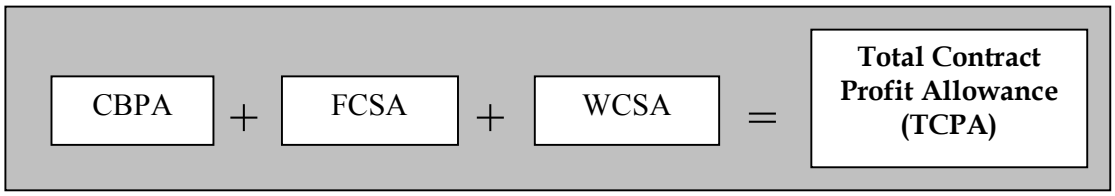
(b) once the audit has been completed the allowance should start to accrue again during any period where the parties negotiate the quantum of the refund; and

(c) the allowance under a contract amounts to at least £10,000.

2.24. For the purposes of the foregoing provisions, a late submission is defined as one that is not received within 12 months of the due date.

ANNEX A to SECTION 2: Flowchart showing the various levels of baseline profit and the recommended terminology and abbreviations to be used





ANNEX B to SECTION 2: 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 or amendments to the existing specification should depend on a balance of factors. The underlying principle should be that the contract should attract the Standard Baseline Profit Allowance 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. If the contract is amended for a new requirement then the amendment will be treated on a stand-alone basis for assessing the flexible profit adjustment.
2. The risk matrix set out above should apply to contracts with an estimated cost in excess of £5 million. Contracts with an estimated cost of £5 million or less 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 risk matrix set out above does not apply to TCIF contracts. 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.

ANNEX C to SECTION 2: Pricing of intra-group inter-unit trading

Statement agreed between Government and industry – May 2006

2.C1. The parties note that profits on intra-group inter-unit trading do not, except for possible small time-lag effects, result in any overall increase in prices paid by HMG or in the total income earned by contractors under the profit formula. This outcome is the result of the adjustment to the Standard Baseline Profit Allowance referred to in paragraphs 2.9 and 2.10 above.

2.C2. Accordingly, the parties continue to accept that, in general, it is neither necessary nor desirable to prohibit the payment of profit at two or more stages of the production process whether to separate contractors or to different units of the same contractor.

2.C3. However the parties recognise that in some circumstances the sub-division of an existing CP/CE unit into a number of units, resulting in an increase in IGIU transfers of work priced under the profit formula, could lead to an inequitable redistribution of formula profit as between contractors if it resulted in a contractor's prices being increased to an extent not making commercial or business sense.

2.C4. In this connection the parties note two important safeguards available to HMG by its withholding consent to:

a) sub-contracts being placed with other units of a contractor's business when it would be cheaper and more practicable to deal with an outside supplier; and

b) the introduction of additional CP/CE units.

2.C5. However, the parties agree that, where in individual cases the effects of inter-unit trading on MOD pricing would otherwise be significant and the safeguards mentioned above were impractical or undesirable, it would be necessary for HMG and the Contractor to consider whether the arrangements for inter-unit work made commercial or business sense and, if they do not, to reach agreement on appropriate treatment of IGIU trading costs. Such case-by-case agreements would remain in force until there were material changes in the relevant circumstances (eg in the definition of CP/CE units or value of IGIU transfers of formula work).

2.C6. The parties note that where purchases from another unit of the same contractor are not priced exactly as if they were purchases from an external supplier, then to the extent that the inter-unit costs do not effectively qualify for the full rate of formula profit, they should be excluded from the recipient's cost of production for CP:FA and CP:WC ratio computation purposes and the IGIU trading data referred to at paragraphs 2.9 to 2.11 above. Such exclusion is necessary in order for the aggregate of contractors' capital- and cost-related profit allowances to represent the returns on capital employed and cost of production intended by the Board.

ANNEX D to SECTION 2: Accounting Conventions for Non-competitive Government Contracts

Aim of the Government Accounting Conventions

1. The GACs set out the basis for computing a contractor's capital employed, cost of production and overheads for the purpose of pricing non-competitive Government contracts.

2. Wherever possible a contractor's normal accounting systems will be utilised. The Contractor is to disclose his cost accounting practices to the Government department concerned and to apply them consistently.

3. Where costs arise which are exceptional or abnormal in size or incidence then the parties will negotiate on a case-by-case basis the extent to which such costs may be allowable, and the method of recovery (see 7(B)1 below).

CAPITAL EMPLOYED

4. The aim is to establish the average capital employed in the most relevant unit of a contractor's business relative to the contract (e.g. subsidiary company, sub-group, division, geographical location etc.). If, exceptionally, separate figures cannot reasonably be made available, the capital employed is calculated for a contractor's business as a whole. In order to determine the contractor's capital employed it is necessary to allocate employment of capital shown in the balance sheet ('net assets') between those items which qualify for capital-related profit and those which do not, thereby enabling the apportionment of qualifying net assets between individual contracts pro-rata to cost of production.

5. Provided no further adjustment has taken place in Group Accounts, a contractor's total capital employed is taken as the average of his total net assets as shown in the relevant balance sheets for the entity as described in convention 3 above for the period under review (based on the company's accounts subject to any adjustment required in order to comply with UK GAAP), adjusted for the following where relevant:

5(A) Assets:

5(A)1 Exclude:

5(A)1(a) Goodwill and preliminary expenses.

5(A)1(b) Adverse (debit) balance on profit and loss account.

5(A)1(c) Investments in shares and securities.

5(A)1(d) Shares held in and permanent loans to subsidiary companies (trading balances are included in capital employed) being capital not employed in the business of the parent Company.

5(A)1(e) Cash demonstrably surplus to requirements (i.e. short term investments; deposits; and cash demonstrably in excess of the amount required for working cash resources for day to day operations).

5(A)1(f) Land and buildings not in occupation and plant and machinery demonstrably not in use where held for speculative purposes or for long term expansion not yet planned, or where there has been unreasonable delay in disposal of surplus assets.

5(A)1(g) Certificates of tax deposit.

5(A)2 Other adjustments (these may result in either an addition to or a deduction from balance sheet figures, according to the circumstances):

5(A)2(a)(i) Investment grants, building grants, other capital grants and depreciation are to be deducted from gross asset values for capital employed purposes.

5(A)2(a)(ii) Where fixed assets have been acquired under finance leases, which are capitalised in accordance with the requirements of Statement of Standard Accounting Practice 21 or any successor, the assets will be treated for all purposes as if they had been purchased by the contractor. The total amount included in the balance sheet as being due to the lessor in relation to the costs of the asset will be treated as capital employed i.e. not deducted from assets.

5(A)2(b) The net balance sheet figure for stocks and work in progress is included in capital employed based on costs derived from values recorded in the statutory accounts subject to any adjustment necessary to reinstate overheads attributable for pricing purposes but excluded from the valuation of work-in-progress in the balance sheet, provided it is accompanied by auditor attestation. If a company has not already done so in its balance sheet, interim payments on account of work in progress are deducted therefrom in accordance with 5(A)2(e).

5(A)2(c) Patents and trade marks may be included in capital employed on a consistent and reasonable basis to the extent that a company can demonstrate that they are 'live' and contribute to its earnings, although not shown in the company's balance sheet.

5(A)2(d) Development expenditure may be included in capital employed up to the value shown in the balance sheet 'net' of provisions provided orders have been received, or are likely to be received, for the product under development, and there is a reasonable prospect, therefore, of recovery of development costs in the prices of those orders.

5(A)2(e)(i) Advance payments received from customers prior to the company's performance of the sales contract are treated as capital employed, i.e. not deducted from assets, subject to an appropriate transfer being made from advance payments to progress payments, in accordance with the billing arrangements of the contract wherever possible, or failing that, pro-rata to the value of work-in-progress in the same proportion as the total advance payments bear to the contract price.

5(A)2(e)(ii) Progress payments in respect of the partial completion of a contract are deducted from the value of the related work-in-progress and any excess is treated as capital employed.

5(A)2(e)(iii) Prepayments by the Government on non-competitive contracts, calculated after adjusting the contractor's work in progress for any difference between the balance sheet's valuation of labour and overhead costs and the valuation for pricing purposes, are deducted except where otherwise agreed.

5(A)2(f) Where costs are spread over several years under 7(B)1, any amount not written off at a balance sheet date will be included as an asset in capital employed.

5(A)2(g) The net balance sheet figure for debtors is included in capital employed, although balance sheet figures of debtors will be adjusted for increases or decreases becoming known after the balance sheet date, due to any revision of prices. Such adjustments may relate to non-Government contracts as well as to Government contracts of all kinds.

5(B) Creditors and other general adjustments:

5(B)1 All loans (including bank overdrafts) are allowable as capital employed – i.e. not deducted from assets.

5(B)2 Share capital and any fixed interest loans such as debentures and specific bank (or other) loans, are usually averaged on the balance sheet figures unless any new items have been introduced during the year, when the date of such introduction is used to give a more precise average figure for that year. Short-term and fluctuating borrowed moneys such as bank overdrafts may be averaged by deducting the balance sheet figures as ordinary liabilities and substituting as an addition to capital employed the value of the capitalised interest paid during the year under review.

5(B)3 Mainstream corporation tax and deferred taxation are treated as capital employed. Liabilities to make payments in respect of group relief should be treated in the same way.

5(B)4 Launching aid is usually treated as a creditor in computing capital employed, and as such is deducted from launching costs as the equivalent of cash on account of work done.

5(B)5 Declared and proposed dividends are treated as capital employed.

5(B)6 Provisions for future cost liabilities where excluded from allowable costs should be allowed in capital employed.

COST OF PRODUCTION

6. Cost of production, annualised where appropriate, should be computed for the same operating unit for which capital employed is computed. Inter alia, it should:

6(A) Include:

6(A)1 Direct costs – direct wages, materials, bought out equipment, subcontractors' and other direct charges.

6(A)2 Indirect costs –with the exceptions set out in 6(B) below.

6(B) Exclude:

6(B)1 Capital expenditure.

6(B)2 The cost of raising and servicing loan capital.

6(B)3 Appropriation of profits, e.g. dividends, corporation tax.

6(B)4 Notional transactions.

6(B)5 Costs related to assets excluded from capital employed in accordance with 5(A)1 above.

6(B)6 Discounts allowed on sales, which are treated as abatements of selling prices.

6(B)7 Unnecessary, extravagant or wasteful outlays excluded from overheads under 7(A)9 below.

6(B)8 Loss of profit insurance premiums (profit element only).

6(B)9 Compensation payments of an abnormal nature to the extent that they are excluded under 7(B)1(a) below.

6(B)10 Lump sum additions to pension schemes to the extent that they are excluded from overheads under 6(B)1(b) below.

6(B)11 Subscriptions and donations of a political nature.

6(C) Credits, grants or refunds dealt with under 7(C)1 below should be deducted from cost of production.

OVERHEAD COSTS ATTRIBUTABLE TO GOVERNMENT WORK

7. It is not possible to produce an exhaustive list covering all the adjustments which may from time to time be required in computing overheads on non-competitive Government contracts. Nor is it possible to lay down absolutely fixed rules, given the varying circumstances prevailing within the different organisations. Whenever partial disallowance of any specific items of expense is proposed the contractor is entitled to ask for and receive a full written explanation of the reason for the proposed disallowance. In assessing contractors' claims for overhead costs on non-competitive Government work current practice is to adopt the costs charged in the contractors' accounts subject to any adjustment required in order to comply with UK GAAP and subject to the following further adjustments:

7(A) Items which are normally totally excluded:

7(A)1 Any expenditure of a capital nature and any distributions of profit.

7(A)2 The cost of raising and servicing capital, including short-term financing and finance leases.

7(A)3 Bad debts and any provision therefore, unless they arise on Government sub-contracts.

7(A)4 Discounts allowed on sales.

7(A)5 Insurance of credit and goods in transit and any other related to civil work risks unless required for Government work.

7(A)6 Agents' commissions.

7(A)7 Outward carriage of finished products.

7(A)8 Notional transactions.

7(A)9 Unnecessary, extravagant or wasteful outlays. The contractor is entitled to a full written explanation on the exclusion of this type of expenditure.

7(A)10 Loss of profits insurance (profit element only).

7(A)11 Royalties and licence fees where these can be identified as direct costs.

7(A)12 Costs and income related to assets excluded from capital employed in accordance with 5(A)1 above.

7(A)13 Subscriptions and donations of a political nature.

7(B) Items which may be partially excluded or deferred:

7(B)1 Where the allowable portion of some costs (as negotiated on a case by case basis) is exceptional or abnormal in size and incidence, it may be spread over a number of years. Costs spread forward in this way will be eligible for inclusion in capital employed under 5(A)2(f).

Examples of these costs are:

7(B)1(a) Compensation payments of an abnormal nature.

7(B)1(b) Lump sum additions to pension schemes.

7(B)1(c) Bid and Proposal costs.

7(B)2 Research and Development (see 7(D)5 below).

7(B)3 Marketing and selling expenses (including salaried salesmen's commissions). Marketing & Selling is a broad heading which refers to a range of costs and overheads that relate to the function. Expenses should be analysed by type of cost and by product group so as to ensure that the share of the total expenses borne by each product group fairly reflects the correct incidence of costs falling on the product groups which the expenditure was designed to benefit.

7(C) Items treated as reducing overhead costs:

7(C)1 Credits, grants or refunds generally, in relation both to overhead items and also to direct cost items where the credit cannot be identified to a particular contract.

7(C)2 Shipbuilders' relief which will however continue to be treated as a direct credit to the contract price.

7(D) Other items:

7(D)1 The amount to be included for depreciation/amortisation should be calculated at the contractor's own rates, provided they are consistent, reasonable, and relate to the fixed asset values, subject to exclusions in 5(A). The depreciation charge should be calculated on the fixed asset values net of any grants received. Amortisation of development expenditure carried forward should be treated as costs to be recovered under 7(D)5(b)(i)(b) below.

7(D)2 General stock losses and obsolescence, including provisions which cannot be charged directly either to Government or civil work, should be included in attributable overhead costs. This convention requires that the contractor's costing system must provide for the isolation of those stock losses which are directly attributable to civil contracts as well as those that are attributable to Government contracts.

7(D)3 Redundancy payments in accordance with the rates laid down by statute will be included in attributable costs; reasonable redundancy payments in excess of such rates should also be included, provided they are made under the terms of a bona fide scheme.

7(D)4 Rationalisation and/or Plant Closures

Reasonable net costs incurred on rationalisation and/or plant closures should be included in attributable costs. Such costs may include:

7(D)4(a) Redundancy payments;

7(D)4(b) Employee relocation expenses;

7(D)4(c) Job creation scheme costs;

7(D)4(d) Transfer costs for equipment;

7(D)4(e) Education/learner costs on transferred work;

7(D)4(f) Disruption costs – waiting and idle time;

7(D)4(g) In the case of total or near total closure of a unit, excess or unabsorbed overheads.

Rationalisation and/or plant closure costs should be offset/supplemented by profits/losses from the disposal or alternative use of related assets, calculated on the following basis:

7(D)4(g)(i) Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits should exceed such costs the Government department should not be entitled to share in the excess.

7(D)4(g)(ii) The net profit from asset disposals set against rationalisation and/or closure costs should be calculated by reference to the gains realised by the company on disposal of that asset. The amount of profit taken into account should not be restricted to the amount of depreciation previously allowed. the amount of any loss realised on asset disposal is to be added to the rationalisation or closure costs.

7(D)4(g)(iii) Estimated Profits/losses should be calculated at the time that rationalisation or plant closure takes place. Either party should be permitted to re-open this calculation within a limited period, if the assumptions upon which the original calculation was based prove to be materially inaccurate; such period should not, except in the exceptional case, extend more than five years after the date from which the asset concerned is excluded from capital employed for CP:CE ratio purposes. Substantial net costs may be spread in accordance with clause 7(B)1. Where a site is closed, the attributable net rationalisation and/or plant closure costs should be recovered in the overheads of the other sites in the same group gaining work as a result of the site closure. For this purpose "site" and "group" should be taken to include Joint Venture arrangements. The amount of the costs would be subject to agreement on a case by case basis between the government department and the contractor.

7(D)5 Private venture research and development expenditure

7(D)5(a) Recording, classification and attribution of expenditure

7(D)5(a)(i) Contractors will classify in their accounting records all expenditure on private venture research and development (R&D) in accordance with the definitions in UK GAAP.

7(D)5(a)(ii) Private venture research and development expenditure will be attributed as closely as possible to the product groups or, where this is realistic and appropriate, to the specific products which the expenditure is designed to benefit. Product groupings already established for his own purposes by a contractor will normally be adopted and will be disturbed only when this is clearly necessary to achieve a fair attribution of the expenditure.

7(D)5(a)(iii) The principles described in paragraphs 7(D)5(a)(i) and (ii) above will also apply to expenditure incurred by a contracting group at a research and development establishment including those cases where this is operated by a separate company.

7(D)5(b) Recovery of expenditure

7(D)5(b)(i) When private venture research and development expenditure has been identified, classified and attributed in accordance with the foregoing principles, the following rules for its recovery will, subject to the qualifications contained in paragraphs 7(D)5(b)(ii) to 7(D)5(c)(ii) below, normally apply:

(a) In the case of a product or service under development, the nature of which is such that it should be possible to ascertain the utilisation of the product or service developed, the recovery will be by direct charge to the product or service concerned. The direct charge should be a fair apportionment of the contractor's unfunded private venture product development costs (whether or not these have been carried forward in the contractor's accounts) calculated on the basis of the forecast total sales of the product or service.

(b) In the case of private venture research and development, the nature of which is such that it is not possible to ascertain the utilisation of the product or service developed, the costs will be recovered by a charge to the current total output of

the product group. Abortive private venture research and development expenditure admitted for recovery under paragraphs 7(D)5(c)(i) and (ii) below will be recovered on this basis.

7(D)5(b)(ii) It will be a condition of admitting private venture research and development expenditure for recovery on Government contracts (whether in overheads or otherwise) that the Department concerned be satisfied:

(a) having regard to all the circumstances, that the classification, allocation and apportionment of expenses adopted by the contractor is fair and reasonable; and.

(b) that any unreasonable, unnecessary, extravagant or wasteful expenditure is excluded.

Expenditure attributable to an agreement between the contracting Department and a contractor which specifically limits the amount of the Department's contribution (including those cases where the limit is expressed as a share to total expenditure) will not, unless specifically provided for in the agreement, normally be recoverable through overheads on Government contracts.

7(D)5(b)(iii) The fact that a contractor may have adopted a particular accounting treatment for research and development expenditure in his financial accounts will not, in itself, prejudice the appropriate recovery of such expenditure on Government contracts.

7(D)5(c) Abortive expenditure

7(D)5(c)(i) Abortive research and technology expenditure should be treated in the same way as any other research and be admitted for recovery on the principle described in paragraph 7(D)5(b)(i)(b) above.

7(D)5(c)(ii) Expenditure on product development which proves abortive or is otherwise irrecoverable (for example, because of inadequate sales of the product concerned) will be admitted for recovery in accordance with paragraph 7(D)5(b)(i)(b) above only to the extent that the development had potential benefit to the Department concerned and subject to the provisions of paragraphs 7(D)5(a)(ii), 7(D)5(a)(iii) above and 7(D)5(d)(i) below.

7(D)5(d) Timing of recovery

7(D)5(d)(i) As a result of the long time span or fluctuating level of some research and development programmes, it may be impossible to reach final decisions on the treatment for pricing purposes of certain expenditure at a time when, for example, it is necessary to settle an annual overhead rate negotiation or to fix production prices which will be subject to post-costing. In these circumstances it should be possible for an agreed amount of such 'undecided' expenditure to be carried forward for decision as to recovery to be made in a future period.

7(D)5(d)(ii) If also carried forward in the financial accounts of the contractor, such expenditure will rank as capital employed for Government Profit Formula purposes. If, however, the expenditure is written-off, it will cease to rank as capital employed and the relevant costs should also be excluded from costs of production until the period in which the treatment of the expenditure is agreed.

SECTION 3: Guidance provided by the Review Board

INTRODUCTION

3.1 Section 1 of this agreement sets out the principles underlying the profit formula and Section 2 describes the current arrangements that give effect to those principles. This Section 3 provides further guidance on matters relating to the profit formula and its associated arrangements and has been extracted from past reports from the Review Board and statements by the parties to the agreement. The Section is divided into two parts: Part A deals with matters related to the scope and construction of the profit formula, Part B deals with the application of the profit formula in a number of specific areas.

PART A: MATTERS RELATING TO THE SCOPE AND CONSTRUCTION OF THE FORMULA

SCOPE OF THE GOVERNMENT PROFIT FORMULA AND ITS ASSOCIATED ARRANGEMENTS

2003 General Review, paragraph 109

3.2 The total annual value of non-competitive MOD contracts placed fluctuates depending on the timing of major defence projects, but tends to be around £3-4 billion. This equates to about 30% of all MOD procurement. Around a further 60% is let through competition, with the remainder (some 10%) being let by reference to market forces, for example using price lists.

NON-COMPETITIVE CONTRACTS PRICED OUTSIDE THE PROFIT FORMULA

Seventh General Review (1993), paragraph 710

3.3 The Government's main criterion in deciding whether to rely upon a supplier's list price for proprietary items is whether there are comparable products marketed in the UK by at least one other supplier whose market share is large enough to provide genuine competition. The JRBAC have…contended that the UK defence market for many products is not large enough for such a criterion to be met. The JRBAC propose that the international nature of the market should be recognised by the deletion of the words "in the UK" from the criterion. This change has been agreed by MOD. The criterion would therefore in future be as follows: "There are comparable products marketed in direct competition with the supplier by at least one other supplier whose market share is large enough to ensure that competition is genuine".

Fourth General Review (1984), paragraphs 195-196

3.4 …Where [the Government's] criterion is inapplicable, the purchasing department normally endeavours so far as possible to secure information analogous to that obtainable under the equality of information principle. They told us that, although most contractors co-operate fully, some object to the 1968 [profit formula] arrangements being used to regulate the prices of proprietary items which they claim should be based on what the market will bear. The Government do not accept this view and assert that 'an element of transparency' is essential whenever goods are purchased on a non-competitive basis. In such cases, the only distinction to be made between proprietary and non-proprietary purchases is that in the former case a fair share of the contractor's product development expenditure is allowed for in the price.

3.5 The Board considers that the Government's approach to this matter is correct; those contractors who are at present reluctant to co-operate should fall in line with the majority.

NON-COMPETITIVE CONTRACTS PRICED UNDER THE GOVERNMENT PROFIT FORMULA

The comparability principle

Returns earned by British industry

2003 General Review, paragraph 415

3.6 Following the 1993 General Review it was agreed between MOD and the JRBAC that the target rate of return in the profit formula should in future be determined on a rolling average basis. Appendix I of the 1993 General Review records that MOD and the JRBAC "would invite the Review Board to base its recommendations concerning the target rate of return in future Annual and General Reviews on a simple three year average of the returns earned by British industry for the latest year and for the two previous years". The purpose of this was to introduce a greater degree of stability into the profit formula by reducing the volatility of the target rate caused by year-to-year fluctuations in the level of the Reference Group's profitability. Whilst this practice was introduced under the previous profit formula methodology we see no reason why it should not be, and recommend that it is, adopted for the revised methodology.

The composition of the Reference Group

2003 General Review, paragraphs 402-405

3.7 Since 1968 the profit formula has been derived from a Reference Group of UK companies. The reason for having a Reference Group is to provide a measure of the return earned by British industry so that a profit formula can be framed to produce a similar return for contractors.

3.8 In general the Review 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 was not deployed on non-competitive contracts. This leads to a broadly based Reference Group which has the benefit of reducing volatility, making the return less influenced by the special circumstances that may affect an individual sector from time to time.

3.9 The constituents of the Reference Group have been considered at each review. The general principle adopted by the Board has been that all British listed companies be included in the Reference Group except where:

a) 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 contracts that it would be inappropriate to include that sector in the Reference Group. Sectors currently falling into this category are: banking, insurance, investment trusts, property investment, mining, oil and gas; or

b) where 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 water and power. In addition one company, Eurotunnel plc, is excluded as an exceptional case.

3.10 The Board has considered…the suggestion that the Reference Group should be radically cut back, to a few sectors of industry which would be "directly comparable" to non-competitive contracting. This would have a number of disadvantages - the selection would be arbitrary, with profit variable and highly dependent on a few companies; any attempt to match risks would again be arbitrary and variable through

time; and, if confined to sectors closely related to defence contracting, there would be a problem of circularity. But in any case a move in this direction would be to misunderstand the comparability principle embodied in our terms of reference – namely to aim at a fair return "equal on average to the overall return earned by British industry". The logic of this is to match the average return which contractors could expect to achieve if they were to invest in other businesses (where returns can be measured on a comparable basis). If there were evidence that non-competitive defence contracts were more or less risky than the average for the Reference Group, this would need to be addressed as a separate issue.

The relative risks faced by contractors and members of the Reference Group

2003 General Review, paragraphs 416-418

3.11 In previous reviews the Board has taken into account the risk involved in non-competitive Government contracts as compared with the risks to which companies in the Reference Group are generally exposed. There are factors which point in both directions. On the one hand, many defence contractors operate in areas of high technology and are subject to the greater risk inherent in innovation and change. On the other hand, the relative security of the work and the method of pricing have been considered to be factors which tend to diminish the risks. In the 1984 and 1987 General Reviews the Board concluded that, on balance, the risks entailed in non-competitive Government work were in general slightly less than those to which most UK companies were exposed and that this should be reflected in a small reduction in the target rate. In its 1990 report the Board concluded that recent developments, in particular an increase in the percentage of contracts placed on a risk as opposed to a non-risk basis, had increased the relative risk involved in non-competitive Government work to the extent that no reduction in the target rate should be made on this account. In its 1993 report the Board again reviewed developments in the placing and pricing of non-competitive Government contracts and confirmed its 1990 conclusion that no allowance should be made for relative risk.

3.12 At the 1996 General Review the JRBAC expressed a view that non-competitive Government work had become more risky owing, principally, to changing contract terms. The Board reviewed these changes and considered that they were not sufficiently weighty to require that the straightforward application of the comparability principle be distorted by introducing a relative risk allowance.

3.13 At the unpublished 1999 General Review the Board considered that the evidence presented to it did not support an allowance in either direction. The Board has considered the matter again at the current Review and has reached the same conclusion.

Measurement of the overall return earned by members of the Reference Group

3.14 For the purpose of applying the principle of comparability the overall return earned by members of the Reference Group has been analysed by the Review Board between three elements:

a) a return for investment in book fixed assets as adjusted for GACs;

b) a return for investment in working capital as adjusted for GACs; and

c) a residual profit figure after deducting the allowances for servicing recognised capital through elements (a) and (b) above, referred to as the 'Baseline Profit'.

The Government profit formula (GPF)

Fixed Capital Servicing Allowance or FCSA

2003 General Review, paragraphs 307-311 f

3.15 The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in book fixed assets as adjusted for GACs. The finance for these assets might be expected to be provided from two sources: equity and debt, and normally such an allowance would be based on:

a) long term corporate borrowing rates; and

b) a premium to reflect the return required by equity providers.

3.16 The estimation of an appropriate equity return is a complex matter and the Board does not consider it appropriate to base this on the book value of equity as recorded in individual contracting units, for the following reasons:

a) The financing structure put in place between a parent and its individual contracting units is an internal matter, not governed by normal commercial considerations, and may not reflect the equity required in the business.

b) The equity recorded in an entity's accounts may not adequately reflect the investment that may have been made in the intangible assets of that business, but investors expect a return on both the tangible and the intangible assets of a business.

c) When pricing individual contracts a business will have regard to the risks of that particular contract and will seek a return that is commensurate with the risks involved.

3.17 Accordingly, the Board believes that the FCSA should be based entirely on the long term borrowing rate and the issue of risk should be addressed through the Baseline Profit allowance as discussed in paragraphs 3.23 to 3.28 below.

3.18 On the basis that the average asset might be expected to have a life of around 15 years it seems appropriate to base the FCSA on the 7 year moving average cost of 15 year finance, as that is reasonably representative of the average cost that might be incurred by the Reference Group. A BBB3 rated corporate bond is the lowest investment grade security and would be a reasonable benchmark. However, there are relatively few in issue in the UK and their yield may not therefore be representative. Accordingly, the Board proposes that the FCSA be based on the average cost of BBB rated corporate bonds which is currently about 1.5 per cent above the 15 year Gilt rate. This needs to be further adjusted by 0.5 per cent:

a) to take account of the premium that a BBB3 rated bond might need to pay; and

b) to take account of the fact that bond rates command a discount for liquidity as compared to bank borrowings.

Working Capital Servicing Allowance or WCSA

2003 General Review, paragraphs 313-314

3.19 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.

[f] With minor drafting changes to improve clarity

3.20 To reduce volatility the WCSA should be based on a 36 month moving average of the one year LIBOR.

Standard Baseline Profit Allowance or SBPA

2003 General Review, paragraphs 316; 2005 Annual Review, paragraph 317

3.21 By taking the total profit earned by the Reference Group and deducting the Capital Servicing Allowances ('CSA') for financing fixed assets and working capital, the balance of the profit can be expected to represent the return the average company gets on its uncapitalised intangible assets and for the risks it assumes. This can be expressed as a percentage of the Reference Group cost of production. The Board recommends that this Reference Group Baseline Profit Rate percentage should, after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the contractors, be used to determine the average Baseline Profit paid on the cost of production of non-competitive contracts...

3.22 The Board's assessment is that the level of cost of production in the contractor group will be higher than that of the Reference Group, because the contractors' figures for cost of production include intra-group inter-unit trading whereas similar trading within the Reference Group will be eliminated as consolidation adjustments in company accounts. Therefore the level of intra-group trading by the contractor group needs to be assessed and eliminated in order to maintain comparability.

Assessment of risk on individual contracts

2003 General Review, paragraph 317 with terminology as amended by 2005AR

3.23 The Board further recommends that, for larger contracts, the Standard Baseline Profit allowance ['SBPA'] should be adjusted to reflect the varying risk exposure of different contracts sometimes referred to as the concept of 'Value at Risk' which is an attempt to recognise that some projects will have more predictable outcomes whereas others may be highly volatile. This will help to achieve the MOD's aim of having a profit formula that provides a more measured return reflecting varying degrees of risk.

The risk-reward matrix

2003 General Review, paragraph 318

3.24 A risk/reward matrix which reflects the risk characteristics of different types of contracts would provide a mechanism for tailoring the Baseline Profit to the quantum of costs and risks associated with individual contracts...

2003 General Review, paragraph 510

3.25 …The parties have asked for the Board's views as to whether the variable risk/reward matrix should include any direct link to estimating contingencies in contract prices. The Board's view is that, whilst it is possible that contracts that have a higher level of contingencies may also be eligible for a higher rate of profit, the level of contingencies should remain a matter for negotiation according to the circumstances of the particular contract...

2005 Annual Review, paragraph 321

3.26 The MOD and the JRBAC recognise that the risk profiles of different types of work will vary and that the higher risk contracts should receive a higher target return than the lower risk contracts. At the 2003 General Review the parties agreed that, to start with, the variable risk/reward matrix should be kept relatively simple to facilitate implementation and deal only with different types of work. The intention was that as Government and industry gain experience of applying the risk/reward matrix to

individual contracts, it can be further developed and perhaps also address varying degrees of risk in the context of different types of contract.

Adjusted Standard Baseline Profit Allowance or ASBPA
2005 Annual Review, paragraphs 322-323

3.27 One particular matter addressed in the notes to the risk/reward matrix is an interim arrangement to recognise the fact that as sub-contracts pass up through a prime contractor's books they attract a second layer of profit and the Board considers that there are differences in risk as between a prime's own costs and those of subcontractors that pass through its books. This is because, in the Board's view, a competent prime contractor should be able to lay off a significant element of the risk related to work that it sub-contracts to others and, conversely, a competent prime contractor brings specialist contract management and risk management skills to bear which enable it to take the risk of integrating and managing all the sub-contracts – risks that justify a higher profit allowance on the prime's own costs.

3.28 The interim arrangement agreed by the parties at the 2003 General Review was to reduce the Standard Baseline profit allowance applicable to all risk contracts or contract amendments with a value of £50 million or more by a net 30 basis points...

The differential between risk and non-risk rates

2005 Annual Review, paragraph 324; Sixth General Review (1987), paragraph 509-510

3.29 The risk/reward matrix also addresses the issue of non-risk[g] contracts and notes that non-risk contracts should attract the Standard Baseline Profit Allowance less 25 per cent [This is equivalent to a differential of 33% between the profit rates for risk and non-risk work…. It reflects past guidance from the Review Board which recommended that the differential between the profit rates for risk and non-risk work should remain at approximately 30%.]

Target cost incentive fee (TCIF) contracts

Extracted from Fourth General Review(1984) paragraphs 188 and 189

3.30 There are bound to be situations in which it is impracticable to determine at the outset whether a particular contract can properly be regarded as suitable for pricing on a full risk basis. A number of contract variants have been evolved to deal with situations of that kind. Both sides are agreed that the [TCIF] contract has proved a useful instrument and the Board would welcome an extension of its use in appropriate cases.

(a) Target cost contracts

In these contracts the MOD and the contractor agree a target cost for the work and a target profit, together with a formula according to which either cost savings beneath the target or costs in excess of the target will be shared. The precise form of the cost-sharing varies according to circumstances of the contract, particularly the degree of confidence which the parties have in the estimate of target cost. In some cases the formula includes the provision of a ceiling or maximum price, above which all costs fall to be borne entirely by the contractor. This type of target cost contract is used when the parties consider that they are able to predict the cost of performing the work with a fair degree of confidence, but not with sufficient confidence to agree a fixed price. Target cost contracts without a maximum price are used when there is greater uncertainty, but not so great as to necessitate use of cost-plus. These contracts usually contain a

[g] Non-risk contract: a contract placed on a cost reimbursement basis (whether with a fixed fee or percentage profit) which insulates a contractor against loss [2005 Annual Review, page x].

provision that the contractor's profit shall not fall below a specified level; after this point is reached, all further costs fall to be borne entirely by the MOD.
Target cost contracts which do not include a minimum profit provision are classed as risk contracts. For target contracts which do include a minimum profit provision, the profit rate is a matter for negotiation within the range of the risk and non-risk rates.

Second General Review (1977), paragraph 79

3.31 …the characteristic which should determine into which category a target cost contract should fall is not, as the Government have suggested, whether or not a maximum price is provided but whether or not there is a minimum profit provision; a contract without a maximum price may still entail the risk of loss for the contractor if there is no provision of a minimum profit. We recommend therefore that, for target cost contracts which include a minimum profit provision, the profit rate should be negotiated between the parties within the range of the risk and non-risk rates.

Reporting the profitability of non-competitive Government contracts

Comparison of annual returns and post costing statistics

1998 Annual Review, paragraphs 502-505

3.32 In aggregate terms, post-costing data and annual returns might be expected to reveal comparable results as they both seek to record the profitability of profit formula contracts. Owing to apparent inconsistencies between the two sets of data we stated in the report on the 1996 General Review that we intended to undertake a study of the two sets of data to see how far they can be reconciled. The results of this study are included at Appendix D to [the report on the 1998 Annual Review] and our principal conclusions are summarised here.

3.33 Our survey demonstrates that the two sets of data are not reconcilable owing to fundamental differences in their coverage. They are prepared on different timescales, they are recorded differently and different samples are used. Reporting of results in post-costing follows several years behind their reporting in annual returns. Nevertheless our examination of individual contracts has not revealed any significant, systematic, differences in the measurement of profit in the two sets of data.

3.34 Post-costing and annual returns were introduced to address different problems and the differences between the two surveys reflect their differing purposes:

a) Post-costing – is designed to assist MOD in contract pricing by providing a check on the accuracy of pricing procedures, a guide to follow-on pricing and, in appropriate cases, a basis for renegotiation. The information is detailed, specific and on a completed contract basis, and is intended to be agreed between MOD and the contractor – all of which contributes to the delay in reporting results. Post-costing was never intended to be a comprehensive or statistical survey. There is a substantial degree of selection by MOD in determining the coverage, and MOD very properly seeks to target its post-costing resources towards achieving its specific objectives.

b) Annual returns – are designed to provide an overall measurement of profit on non-competitive Government contracts and to enable the Review Board to monitor the application of the comparability principle. The information is comprehensive and reasonably up-to-date, but it is highly aggregated and would be of little assistance to MOD in contract pricing.

3.35 Post-costing and annual returns each provides useful information and we agree with the view expressed to us by both MOD and the JRBAC that they should both continue to be produced. We consider that annual returns are more relevant for our purposes and

will continue to rely on annual returns as the primary source of information on the profitability achieved by contractors on non-competitive Government contracts.

Review Board assistance to resolve disagreements

Contractual terms

1996 General Review, paragraph 310

3.36 …We consider that disagreements over contractual terms should be capable of being resolved between the parties and that a process of discussion between those involved in contract negotiations is the best way of achieving a mutually acceptable outcome. The Board would, at the request of both parties, be prepared at any time to take evidence on such an issue and give an advisory recommendation if agreement cannot be reached otherwise. The Board suggests to both parties that their negotiations over issues concerning contractual terms should take into account the general principle of comparability upon which the profit formula is based. So far as appropriate, the contractual terms of Government contracts, as well as the profit formula, should reflect general commercial arrangements accepted by parties to comparable competitive contracts.

Relevant CP/CE units

Fourth General Review (1984), paragraph 37

3.37 Disagreements may well arise between contractors and the MOD as to precisely what constitutes the relevant unit for the purpose of arriving at the CP/CE[h] ratio. The Board would be ready to rule on a test case or cases which it considered suitable for the purpose of establishing general principles. The establishment of guidelines ought to facilitate the resolution of other similar disputes.

Value for money

Sixth General Review (1990), paragraphs 429, 431 and 432

3.38 The MOD contended that the relative efficiency of defence contractors compared to that of companies in the Reference Group should be taken into account in the target rate. They suggested that defence contractors engaged on non-competitive work were in general under less pressure as regards efficiency than the average company in the Reference Group. To support their assertion they claimed that price reductions had been secured through competitive tendering. They invited us to examine, and quantify as far as practicable, non-competitive defence contractors' efficiency compared with that of the Reference Group. They offered no suggestion as to how this might be done.

3.39 …Our conclusion is that such quantification is not feasible: there is no methodology for measuring the relative efficiency of diverse activities, and hence of different sectors of industry. Existing techniques for measuring efficiency involve assessing how far a company's efficiency in one activity diverges from best practice for that activity. This best practice cannot be compared between diverse activities because there is no basis for assessing whether achievement of best practice in one activity involves more or less skill and effort than its achievement in another.

3.40 In the 1984 report, following a similar contention from MOD, the Board commented that relative efficiency was not a matter for which regard could properly be had when determining the target rate of return. Any adjustment to the profit formula on this account

[h] Under the profit formula introduced after the 2003 General Review, the CP:CE ratio is no longer used for pricing purposes, having been replaced by the two separate ratios (of Cost of Production:Fixed Assets and Cost of Production:Working Capital) which are needed to compute the FCSA and WCSA respectively (see GPFAA, 1.8(a) and 1.8(b)).

would tend to penalise the efficient contractor without necessarily acting as a spur to the inefficient contractor. If a particular contractor's performance was perceived to be unsatisfactory, it should be MOD's responsibility to take whatever action they considered appropriate in relation to that contractor. That remains our view. We refer however, in paragraphs [3.41 to 3.45] to certain measures being taken to ensure that incentives to improve efficiency are provided within the profit formula.

Sixth General Review (1990), paragraphs 814-818

3.41 The encouragement of an efficient defence industry continues to be one of the Board's primary concerns, insofar as the profit formula and pricing arrangements for non-competitive contracts can play a part in achieving this objective. Efficiency is a vital component of securing value for money for MOD and of assuring the competitiveness of contractors who have to obtain a large part of their business in competitive export markets. In competitive industries the threat from competitors is an important mechanism for stimulating improvements in efficiency, but this is necessarily much reduced, or absent, in non-competitive work. Alternative mechanisms therefore have to be found for ensuring adequate incentives to efficiency.

3.42 For risk work, the main incentive is the agreement of fixed contract prices based on estimated costs at an assumed level of efficiency at as early a stage as is practicable. The contractor is then rewarded for improving his efficiency beyond the level assumed in cost estimating. However, it can be argued that a contractor's incentives to efficiency are reduced where, as is generally the case, efficiency improvements achieved on a contract set the benchmark for subsequent contracts, with the result that the profit on those contracts is reduced.

3.43 During the 1984 review the Board requested the MOD and the JRBAC to consider methods for rewarding improved levels of efficiency in relation to follow-on contracts. Following a joint review a new pricing arrangement was devised in the form of Cost Reduction Schemes (CRS) which were introduced for a trial period of three years from 1984. The operation of CRS has now been reviewed by a joint working party, which agreed that they had failed to have a significant impact, as a result of an inherent inflexibility and the lack of adequate mechanisms for measuring the benefits foreseen by the proposed schemes. The working party has agreed that revised schemes, to be known as Cost Reduction Bonus Schemes (CRBS), will now be introduced for a further three year period. The working party believes that these will address the failings in the CRS. The report of the working party, and the arrangements for CRBS, are set out in Appendix L [of the report on the Sixth General Review].

3.44 CRS and its successor CRBS apply only to risk contracts. In its 1984 report the Board urged MOD and the JRBAC to consider how incentive procedures could be introduced in the non-risk field, particularly since the parties had requested the abolition of the efficiency allowance which prior to 1984 provided some incentive to efficiency on non-risk work. Since 1984 considerable progress has been made in reducing the proportion of contracts placed on a non-risk basis. Furthermore the issue has been addressed by a joint MOD/JRBAC working party which concluded that there were a number of mechanisms for introducing incentives into non-risk contracts on a non-risk basis and that few non-risk contracts were now placed without an incentive mechanism of some form.

3.45 We support the continuing efforts by MOD and the JRBAC to develop, within the profit formula and the pricing arrangements for non-competitive contracts, means of fostering efficiency in the defence industry and we will continue to monitor initiatives in this important area.

First General Review (1974), paragraph 19

3.46 Before embarking on detailed consideration of the profit formula, it may be appropriate to offer some observations of a more general character as a background to our recommendations on specific topics:

a) In our view the primary objective of all involved with policy-making in the area with which we are concerned in this report should be the encouragement of an efficient industry, capable of giving value for money. This is in the interests of the contractors who have to obtain a large part of their business in competitive export markets. It is also undoubtedly in the interests of the Government since, as the customer, their aim must be to obtain a high quality product at the right time and at a reasonable price. The division of that price between cost and profit on any particular contract does not necessarily provide the criterion of reasonableness; a low profit does not mean that a price is reasonable any more than a high profit means that it is unreasonable. This is not to say that the Government should be indifferent as to the level of contractor's profits, but excessive concentration on limitation of profits, as against value for money, may well be against the Government's real interests.

b) an important element in an efficient industry is an adequate level of profitability – both to attract new capital and to enable companies to risk the investment of funds in research and in development of new products…

c) We are firmly convinced of the advantages of using a fixed price contract as a means of encouraging efficiency. The essence of this type of contract is that the contractor, who is the only person who can exercise any practical control over production costs, assumes responsibility for them. The contractor then has a clear incentive to efficiency so as to reduce the costs of production and increase his profit; conversely he also accepts the risk that production will turn out to be more costly and his profit lower than expected. The alternative of a 'cost plus' form of contract is generally acknowledged to be inferior as a means of controlling production costs, and it can lead to extravagant production habits which are damaging in an industry which must compete in international markets. We accept that there are some contracts, such as research contracts, where the unknown element is so great that they do not lend themselves, at least at the outset, to negotiation of a fixed price or other form of risk contract. In our view, however, it is highly desirable that the extent of the work carried out without the discipline imposed by a risk contract should be kept to a minimum.

d) Every fixed price contract involves an element of hazard, possibly substantial, on both sides. Cost estimation will always be subject to a margin of error and it is unrealistic to expect that the outcome of a contract will in all cases approximate closely to what was expected when the price was fixed. Prices should be agreed on the basis of a reasonable expectation of the contractor's level of efficiency, taking a realistic view of the various contingencies which may arise, and no stigma should attach to the Ministry in cases where the contractor earns a high profit because he has achieved a higher level of efficiency than was reasonably anticipated. For our part, we would not regard it as our function to revise the terms of a risk contract referred to us where the financial outcome – although less than satisfactory to one side or the other – could properly be regarded as no more than an ordinary consequence of the work in question having been undertaken on the risk basis.

PART B: MATTERS RELATING TO THE APPLICATION OF THE FORMULA

Quantification of fixed and working capital on non-competitive Government contracts

Accounting basis for the profit formula

2003 General Review, paragraph 408

3.47 …[T]he historic cost[i] and semi-CCA[j] bases…should be replaced [with effect from 1 July 2004] with the modified historic cost[k] ('MHC') basis.

Relevant CP:CE units

Fourth General Review (1984), paragraphs 34-35[l] [updated in italics]

3.48 ...It is…generally not possible to identify to a particular Government contract all the elements of capital employed. There are also very great practical difficulties in separating the capital employed in a contractor's Government business generally from that employed in the rest of his operations. The approach in practice has been to derive the capital employed [*since 1 July 2004 fixed assets (FA) and working capital (WC)*] for each individual Government contract from the cost of production of that contract using the CP/CE ratio [*since 1 July 2004 CP/FA and CP/WC ratios*] for the contractor's business as a whole (comprising both Government and non-Government work) or the CP/CE ratio [*since 1 July 2004 CP/FA and CP/WC ratios*] for such a smaller business unit as may be agreed between the contractor and the MOD to be the relevant unit for this purpose.

3.49 Whether this practical approach produces a rate of return on Government work in line with the target rate of return depends on whether the capital employed on Government contracts bears the same relation to the cost of production as it does on non-Government work. In its 1969/70 report the Public Accounts Committee questioned in particular whether the working capital requirements of Government contracts might be lower than those of comparable non-Government contracts. If this was so, and if there were no offsetting factors elsewhere in the capital employed computation, then the return on capital earned on Government contracts could well be greater than planned. Following these comments, the Board undertook a detailed study and concluded in its 1974 report that there was no evidence that the capital requirements of Government contracts were consistently lower than for non-Government work. The Board did, however, in the 1974 report, express concern as to whether the practice of calculating a CP/CE ratio for the totality of a contractor's business was the most satisfactory way of applying the profit formula to an individual contract. Whilst recognising that only rarely will it be practicable to calculate the ratio for individual contracts, the Board recommended that CP/CE ratios should be calculated for smaller and more relevant units within a contractor's overall operation. These recommendations were in principle accepted by the Government and the CBI.

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[i] Historic cost: The accounting basis incorporating all assets at their original cost less depreciation and excluding revaluations [2005 Annual Review, page viii].

[j] Semi-CCA: A basis of inflation accounting incorporating fixed assets at their depreciated current cost, but making no allowance for the effect of inflation on the value of stocks and working capital [2005 Annual Review, page x].

[k] Modified historic cost (MHC): MHC is not defined in accounting standards or company law. For the purposes of the GACs we take it 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 UK GAAP [2005 Annual Review, page ix].

[l] Updated to reflect 2003GR profit formula structure.

Fifth General Review (1987), paragraphs 86-87

3.50 The Board has consistently advocated the introduction of more relevant units of contractors' businesses for the purpose of determining CP:CE ratios, viewing this as a means of improving the practical application of the profit formula. This was the main recommendation of the special study of capital employed which was undertaken at the first Annual Review, a recommendation accepted by both the Government and the JRBAC. In that study the Board took the view that what constitutes the appropriate unit would depend on the circumstances. In most cases it would be a business division, but in others it might be an individual Government project or a contractor's Government work as a whole. The Board continues to hold these views.

3.51 The principal reason for adopting more relevant units is to improve the measurement of the capital employed on Government work. In doing this, the commercial realities of contractors' businesses should be reflected in the definition of the more relevant units. For example, if two parts of a contractor's business are doing Government work independently of each other and with separate contracts, it will be appropriate to agree that they operate as separate CP:CE units. If one part of a contractor's business is effectively acting as sub-contractor to another, it may be appropriate to agree a separate CP:CE ratio for each part. But if the business comprises an integrated manufacturing operation spread over a number of locations, it will probably be inappropriate to agree separate CP:CE ratios. The MOD have the power to ensure that proposals for more relevant units properly reflect commercial realities.

Use of forecast CP/CE ratios

Third General Review (1980), paragraph 76

3.52 In our 1977 Report we recommended that the Ministry should seek to agree with contractors estimated CP/CE ratios[m] which would have greater relevance to the period when the work would be undertaken, using for that purpose budgeted or forecast information which could be obtained from contractors. The Government have reported that there has been a lack of progress because the requisite information has not been forthcoming from contractors. The JRBAC's response was that contractors were ready and willing to co-operate but found that in practice Ministry negotiators were reluctant to accept the risk inherent in using financial projections. Wherever the fault may have lain, we hope that there will now be a determined effort, on both sides, to enable progress to be made.

Assets in course of construction

1996 General Review, paragraphs 607-608

3.53 The JRBAC contended that some contractors have encountered an unwillingness by the MOD to admit assets in course of construction as part of a contractor's capital employed. They sought an amendment to the GACs to make clear that assets in the course of construction are admissible as part of capital employed, subject to the specific exemptions provided by paragraph 4(A)(f)[n] in respect of assets "demonstrably not in use where held for speculative purposes or for long term expansion not yet planned".

3.54 In the Board's view no amendment to the GACs is necessary. Assets in course of construction are a normal element in capital employed and are treated as such in the accounts of the Reference Group companies which form the basis for the target rate of return in the profit formula. The specific exclusions in paragraph 4(A)(f) are unlikely to be of widespread application and do not contradict the general proposition that assets in course of construction are admissible as capital employed.

[m] See footnote on page 72 above.

[n] Now GAC 5(A)1(f).

Cash

2003 General Review, paragraphs 713-715

3.55 Under the existing GAC 4(A)l(e)[o] cash "demonstrably surplus to requirements" may be excluded from assets for the purpose of calculating a contractor's capital employed. The JRBAC has contended that many contractors are part of large conglomerates and do not have an independent cash balance representative of the CP/CE unit's requirements. It has argued that contractors should have an assumed level of cash, calculated as a proportion of the unit's cost of production.

3.56 MOD's current practice is to exclude all cash deposits, on the basis that contractors will earn interest on cash deposits and it would therefore be unfair to include such cash in capital. Contractors would, in effect, earn profit on the same asset twice.

3.57 Under the proposed revised profit formula methodology any working capital balance would attract the WCSA, which is based on recent interest rates. The Board considers that MOD's current interpretation of GAC 4(A)l(e) is appropriate for use under the proposed revised profit formula methodology.

Third General Review (1980), paragraph 77(i)

3.58 The JRBAC propose that a distinction be drawn between cash placed on deposit for long and short periods of time, and that only cash on long-term deposit should be excluded from capital employed. We do not recommend such a distinction. The current practice of excluding all deposits is fair because it ensures that a contractor's cash balances are not remunerated both in interest and under the profit formula.

Quantification of cost of production on non-competitive Government contracts

Disallowance of overheads

Fifth General Review (1987), paragraphs 104-106

3.59 The JRBAC complained to us that the MOD was endeavouring to restrict overhead rates in what they described as an arbitrary manner, contrary to the Government Accounting Conventions. The JRBAC's complaint was that the restriction took the form of an arbitrary limitation of increases in overhead rates, for example by reference to inflation, or of an arbitrary disallowance of specific categories of overheads. The JRBAC provided a report of a recent survey of 23 major contractors, according to which almost two-thirds had experienced MOD attempts to limit year-on-year increases in overheads and almost half experienced the disallowance of specific overheads. The reported reductions in overheads sought by the MOD varied between 1 per cent and 6 per cent; and the reductions agreed varied between 0.5 per cent and 5 per cent. The JRBAC acknowledged that the impact of such restrictions was small but they believed that the practice was growing.

3.60 The MOD's view was that the contractors affected were few in number and that the amount of the reductions achieved was relatively minor. The MOD, in aiming for value for money, would continue to examine closely any increase in overheads which was disproportionately high in relation to the previous year, particularly where the MOD were the contractor's major customer. Any restriction of overheads would be discussed with the contractor concerned.

3.61 The Government Accounting Conventions give the MOD the power to exclude expenditure which is unnecessary, extravagant or wasteful; we believe it right that this power should be exercised in appropriate cases but when it is, the contractor is entitled to a full written explanation. The Board recommends that such exclusions ought to be

[o] Now GAC 5(A)1(e).

justified by reference to the circumstances of the individual case, rather than solely by reference to some rigid criterion, such as the change in the retail price index. The Board intends to keep this subject under review and will be prepared to receive evidence at the next Annual Review.

Seventh General Review (1993), paragraphs 625-627

3.62 The JRBAC complained to us that there was an increasing tendency for MOD to disregard the overhead rates computed by application of the Government Accounting Conventions and to apply its own maximum limit to the overhead rate that it is prepared to agree. This situation has arisen through the increase in calculated overhead rates that has in some instances resulted from reductions in throughput caused by the changed pattern of defence procurement. Such increases in overhead rates may well, the JRBAC contend, be unavoidable because some overhead costs are incapable of being reduced in line with a fall in activity; the resulting increase in unit costs should be accepted for pricing purposes.

3.63 In the Board's view this issue should be dealt with in accordance with the Government Accounting Conventions. The conventions provide (in Clause 1(A)10)[P] for the disallowance of "unnecessary extravagant or wasteful outlays". If in the reasonable judgement of MOD a contractor were to be at fault in not reducing overhead expenses to match foreseeable reductions in the level of activity, such expenditure would fall to be disallowed in whole or in part under Clause 1(A)10. The conventions provide that in these circumstances the contractor is entitled to a full written explanation of the exclusion. They also provide that in cases where only a small proportion of a contractor's turnover is made up of non-competitive Government contracts; there is a presumption that all expenses are reasonably incurred. In our opinion any disallowances of costs of the kind referred to by the JRBAC should be considered and dealt with under Clause 1(A)10 of the conventions and any disallowance should be justified by reference to the particular circumstances of the individual case, rather than by reference to some overall criterion such as the change in the retail price index.

3.64 Turning to a different aspect of overhead costs, the JRBAC has again proposed that the role of the Review Board should be extended to include that of arbitrator in disputes between MOD and individual contractors concerning the allowability of overhead costs. This issue was raised in the Sixth General Review, when our conclusion was that it would not be sensible to extend the Board's role in this way. We have seen no evidence which causes us to alter the view which we expressed in 1990.

Employees' profit sharing schemes

Interim Review (1971), paragraphs 31-32

3.65 According to the current [Government Accounting] Convention, payments under employees' profit sharing schemes are normally totally excluded from attributable costs. Several contractors have submitted that this is unrealistic, because it is common in industry for certain employees to be remunerated partly by a basic salary and partly by a percentage of profits. Such schemes are, it is contended, merely a method of arriving at employees' total remuneration, the whole of which should be included in attributable costs.

3.66 We agree with the contractors that where payments under employees' profit sharing schemes are simply an element of an employees' normal remuneration the payments should be included in attributable costs. In some cases, however, such schemes are more of the nature of a distribution of profits and the payments should be excluded. The Government representatives suggested that a suitable test to determine the true nature

[P] Now GAC 7(A)9.

of a scheme might be whether the payments were accepted by the Inland Revenue as charges against the company's profits for tax purposes, and we consider that this would be a fair basis on which to treat these costs.

Bonuses paid in cash or in kind

1999 General Review, paragraphs 605-608

3.67 The JRBAC and MOD provided submissions on the subject of bonuses paid in cash or in kind. The JRBAC contended that in the absence of any specific relevant GAC, there has been some doubt as to the correct treatment for pricing purposes of costs and assets associated with incentivised pay structures. There has been an increase in the use of bonuses paid to employees involving various means of payment, for example profit related pay schemes, bonus payments or employee share schemes.

3.68 MOD expressed three principal concerns, which we paraphrase:

a) that bonuses might increase salary bills above a level that is 'fair and reasonable';

b) that such bonuses might constitute a distribution of profits, which would be disallowable under GAC1(A)1[q]; and

c) that the issue of new shares to employees constitutes a notional cost to the company, and as such is disallowable under GAC1(A)9[r].

3.69 We note the JRBAC's request for clarification, but do not consider that this matter requires any amendment to the GACs. In paragraphs 31 and 32 of the Board's Interim Review in 1971, the principle was set out that "where payments under employees' profit sharing schemes are simply an element of employees' normal remuneration the payments should be included in attributable costs". Paragraphs 31 and 32 of the Interim Review are reproduced in [paragraphs 3.65 and 3.66 above]. For clarification, we confirm that the cost of providing benefits such as shares or benefits in kind should be treated in the same way as "payments under employees' profit sharing schemes". The principal reason for our decision is that charges made in accordance with UITF Abstract 17 'Employee Share Schemes' will be treated as costs in the accounts of the Reference Group and should be treated as allowable costs for pricing purposes on the grounds of comparability. Therefore, the cost of shares issued to employees at favourable prices should be arrived at in the manner prescribed by UITF 17.

3.70 We note MOD's concerns. Regarding the first point, MOD has the remedy under GAC1(A)10[s] which enables it to exclude "unnecessary, extravagant or wasteful outlays". If a bonus is of such magnitude that it falls into this category, rather than being an element of normal remuneration, then MOD will be able to exclude it. Regarding the second point, we envisage that in an exceptional case MOD will be able to exclude a bonus as being a distribution of profits. This could be the case where it can be demonstrated that the owners of an owner-managed business have taken an element of 'profit distribution' through a share or bonus scheme, rather than through a dividend. We do not accept MOD's third point - that the issue of new shares to employees constitutes a notional cost. Any issue of shares at less than full value constitutes a real cost to a company's shareholders.

Levies

Fifth General Review (1987), paragraph 135

3.71 The JRBAC proposed that levies paid to the MOD should not form part of cost of

[q] Now GAC 7(A)1.
[r] Now GAC 7(A)8.
[s] Now GAC 7(A)9.

production. Such levies are paid on the overseas sales of products which have been developed with financial assistance from the Government and which are based either on a percentage of sales or a profit sharing arrangement. The JRBAC's view was that levies are a sharing of income, not a cost falling on the contractor. We consider that levies are more akin to royalty costs and should be treated as a cost of production. We recommend that the present convention should not be changed.

Marketing and Selling Expenses

Seventh General Review (1993), paragraphs 605-613

3.72 The treatment of marketing and selling expenses was raised as an issue in the Sixth General Review in 1990. For the past twenty years the convention has been that such expenses should be allocated or apportioned to products or product groups on an appropriate basis, and that provided MOD are satisfied that the method of classification, allocation and apportionment adopted by the contractor is fair and reasonable and that the expenses were reasonably incurred, marketing and selling expenses should be included in the overhead rate applicable to each product or product group as the case may be. Two principal issues were raised in the Sixth General Review. The first concerned the methods of establishment of product groups for the purpose of allocating and apportioning expenditure. MOD submitted that contractors did not attach sufficient importance to the establishment of realistic and reasonable product groups; guidance was needed on criteria to be considered by contractors for the establishment of such groups. The second point, also raised by MOD, was more fundamental in character. They questioned whether, having regard to the changed pattern of MOD business since the basis of the current convention was established, the present arrangements could any longer be regarded as appropriate. They suggested a move to a revised convention under which all expenditure on marketing and selling activities was excluded from overheads on non-competitive work.

3.73 These issues were not resolved in the Sixth General Review but it was agreed that a joint working party should be established, following that review, to consider these matters further and to report their conclusions to MOD, the JRBAC and the Review Board.

3.74 In the Board's view, the subject of effective marketing and selling by defence contractors has assumed even greater importance with the changes in the pattern and volume of defence procurement foreshadowed in the Government White Paper "Options for Change". As existing domestic markets shrink, contractors must, if they are to remain viable, be successful in developing new markets for their products; this will help to keep production costs, and hence the prices of the products purchased by MOD, at acceptable levels.

3.75 The working party established following the Sixth General Review concentrated its attention upon the principles and methodology for the establishment of appropriate product groups for the allocation and apportionment of expenditure. The working party concluded that there were essentially two approaches to defining a product group. These were:

(a) *Market-driven:* a product group consists of products designed for one market; the market may be defined by reference to products which use the same technology or products designed for a similar purpose, or by reference to the identity or geographical location of the potential customers;

(b) *Production-driven:* a product group consists of products which share common overhead costs derived from shared production activities.

3.76 It appeared to the working party that the basis of the issue between MOD and contractors is that MOD wish to follow the market-driven approach to identification of product groups whilst contractors contend that the production-driven approach is generally the more appropriate. In the working party's view each of the two approaches could be appropriate in particular cases; the decision must depend upon the circumstances. The working party identified the information which would be relevant to this decision and proposed a standard framework of analysis which could be used for this purpose. The working party recommended that the next step should be for the Review Board to apply the suggested approach to a sample of three case references which would be jointly referred to the Board by MOD and the contractors concerned, with the aim of developing more detailed guidance on the criteria for selection of product groups in particular cases.

3.77 The working party's approach has been endorsed by MOD and the JRBAC and we recommend that this subject should be pursued, in the way proposed by the working party, following the completion of this review. The Board will play its part in considering and adjudicating upon the three case references, on the basis that the contract parties in each case agree in advance to accept the Board's conclusions. This, in the Board's view, is a necessary condition if the process of considering case references is to have its intended effect of providing authoritative guidance which will enable further cases to be settled without the Board's involvement. [It should be noted that MOD and the contractors were unable to identify appropriate cases which could be referred to the Board so the case references did not take place.]

3.78 The MOD have more recently informed the Board that a review of its policy towards the admission of marketing and selling expenses has resulted in two decisions:

a) that the general level of marketing and selling expenses admitted into overheads for non-competitive contracts must, taking one year with another, be restricted to the current average level as a proportion of total admissible costs of production; and

b) that it is not appropriate for the Ministry to accept the costs of entertainment in the costs of its non-competitive work and that entertainment costs will therefore be specifically excluded.

MOD have also proposed some detailed amendments to the recommended classification of marketing and selling expenses set out in clause l(B)3(b) of the Government Accounting Conventions; these amendments are currently the subject of discussion with the JRBAC.

3.79 It is far from certain at this stage what the practical impact of the first of the two foregoing decisions will be. It will clearly be difficult for MOD to exercise effective control over the general level of marketing and selling expenses admitted in overhead costs, given that contractors' overhead rates are agreed piecemeal throughout the year. It is not clear what significance should be attached to the words "taking one year with another". It is possible that MOD's enforcement of an aggregate limit for such expenses could result in the arbitrary disallowance of a contractor's costs which had been reasonably incurred and would be allowable under the Government Accounting Conventions. Such a result would clearly not be equitable. Moreover we find it hard to reconcile the additional measures for control of marketing and selling expenses with MOD's policy of simplification of the procedures for placing and pricing non-competitive contracts, following the staff reductions that have been announced.

3.80 Both elements of MOD's proposals set out in paragraph 611 represent unilateral initiatives to change the Government Accounting Conventions, outside the normal

framework for determining the Conventions which has been established since 1968. Neither the JRBAC nor the Board were consulted in advance. The JRBAC have expressed their objections to both of MOD's proposed changes. In these circumstances the Board cannot endorse the proposals in paragraph 611. In particular, the Board considers that an overall financial limitation such as that set out in paragraph 611(a) has no place in the Government Accounting Conventions which define the accounting rules applicable to individual contractors.

PV product development costs

2003 General Review, paragraphs 706-708

3.81 The JRBAC contended that there should be a change in the way in which contractors recover Private Venture Product Development ('PVPD') costs from MOD. Currently a contractor is allowed to recover a proportion of its development costs as a cost to be included in the product price, providing such costs are separately identified to discrete projects. The JRBAC claimed that the guidance document on the recovery of these costs was written in 1970 and the nature of products has since changed, making it increasingly difficult to separately identify and recover such costs as a discrete charge. It has suggested that in future all PVPD costs relating to a product group should be recovered by a charge to current total output of that product group.

3.82 MOD recognised that the existing system can cause difficulties but was unwilling to switch to the JRBAC's proposed system without receiving enhanced rights over the products involved. There was no substantive progress in these discussions.

3.83 The Board recognises that the JRBAC's proposal would reduce contractors' administrative burden but is not convinced by the overall argument. The revised system would result in MOD incurring development charges on programmes in which it does not wish to participate, and there appears to be a gulf between the rights required and offered in return for MOD's additional funding. The Board recommends that the GACs and the Guidance Document on this subject should remain unchanged. However, the Board suggests that in individual instances where MOD agrees that it will benefit from a particular PVPD programme, the parties should agree that the programme should be treated in the same way as applied research for cost recovery purposes.

Rationalisation and closure costs

1996 General Review, paragraphs 605-606

3.84 The JRBAC raised again in the current review a point which had been dealt with by the Board in the Seventh General Review. It concerned the extent to which, in the event of a major rationalisation, the profit made by a contractor on disposal of surplus properties should be offset against the rationalisation costs borne by MOD. The JRBAC contended that this profit should be calculated on an inflation adjusted basis instead of the historic cost basis prescribed by the current GACs. An inflation adjusted calculation would generally produce a smaller calculation of the profit on disposal leading to a larger reimbursement of rationalisation costs by MOD.

3.85 This was one of a number of aspects of the calculation of allowable rationalisation costs which the Board dealt with in its 1993 report on the Seventh General Review. The Board then decided that profits on disposal of surplus properties should be taken into account by reference to the historic costs of the properties concerned. To use an inflation adjusted calculation would, in the Board's view, lead to MOD bearing an unreasonably large share of rationalisation costs. Having considered the further argument advanced by the JRBAC the Board sees no reason to alter its earlier view on this matter.

2003 General Review, paragraphs 703-704

3.86 The allowability of rationalisation and/or site closure costs is considered under GAC 1(D)4[t], and the JRBAC has sought some further clarification concerning the extent to which these costs may be recovered from MOD through allowable overhead costs.

3.87 Under GAC 1(D)4, reasonable net costs on rationalisation and/or plant closures may be included in attributable costs. However, when no work is transferred to other production facilities within the same group it will not always be possible to recover such costs through overhead recovery rates. As part of the discussions relating to this Review, MOD agreed that it would be prepared to consider such costs when agreeing the contract price for the final batch(es) – for example, by including in the contract costs an estimate of the rationalisation costs. The JRBAC agreed that if subsequent batches do occur, then the price of those subsequent batches should reflect the fact that rationalisation costs have been claimed under a previous contract. The Board believes it is preferable that the parties should address the issue of rationalisation costs at the time of pricing so that retrospective adjustments to the contract price can be avoided.

Cost of production

Fourth General Review (1984), paragraphs 170-171

3.88 The Government and the JRBAC agreed that there was a need for a new [Government accounting] convention defining cost of production for the purposes of calculating CP/CE ratios, and each side submitted a suggested definition. The Government's definition would include in cost of production all direct and indirect costs with the exception of capital expenditure, the cost of servicing loan capital, profit appropriations and notional transactions. The JRBAC contended that there should be consistency in the treatment of cost of production and overheads: all costs excluded from overheads should likewise be excluded from cost of production.

3.89 In the Board's view the costs excluded from overheads should for this purpose be divided into two categories: (a) those which are excluded because they are associated with non-Government work (eg certain bad debts), and (b) those which are excluded because they are inappropriate per se to act as a base for the calculation of profit (eg wasteful costs, interest, etc). In our view costs of type (a) should, for the present, continue to be included in cost of production for the purposes of calculating CP/CE ratios. It would not be appropriate to seek to identify either the non-Government or the Government elements of the cost of production of a business unit, when no similar analysis is made in respect of capital employed. This conclusion will, however, fall to be reviewed during the further examination of capital employed which, it is proposed, should form part of the 1984 intermediate review (see paragraph 3.50). Costs of type (b), on the other hand, should be excluded from cost of production so that there is a consistency with the way in which admissible contract costs are defined. The foregoing distinction is reflected in our recommended new Convention [GAC] 5[u].

[t] Now GAC 7(D)4.

[u] Now GAC 6.

ANNEX A to SECTION 3 PART B:
Principles embodied in published Review Board Decisions

The Government Profit Formula arrangements specify the conditions under which non-competitive Government contracts or sub-contracts may be referred to the Review Board in order for it to decide whether the price negotiated was fair and reasonable and, in the light of that assessment, to determine whether any payment and, if so, how much should be made by one of the two parties to the other (GPFAA 1.39 to 1.49).

The Board has published six Decisions arising from such references. One reason for the relatively small number is that the Board has taken considerable pains to set out the bases on which it has reached its Decisions. In this way there is now a substantial body of 'case law' to provide guidance as to how the Board would approach any reference which has facilitated the resolution of disputes by direct negotiation by the parties.

An indication of the principles embodied in the published Review Board Decisions is set out below. For a better understanding of the Board's reasoning in each case it is necessary to refer to the text of the Decisions.

1: Decision of the Board on contract reference 73/1

(a) The Board ought not to be regarded as providing an automatic safety net against the consequences of commercial imprudence. Both parties should negotiate procurement contracts with the same degree of care and circumspection as one would expect to be exercised if the Board did not exist.

(b) To justify revision of the terms by the Board at the instance of either party, a case should have some special characteristic which causes the financial outcome to go beyond what could properly be regarded as a normal consequence of a risk contract.

(c) Disputes which are susceptible of resolution under the normal machinery of the contract should be determined, so far as possible, before the broader issue which gives rise to a Reference to the Board.

(d) The Board will not make an award of interest, as such, in any case. If the circumstances warrant some allowance for interest, this will be taken into account in arriving at the comprehensive amount awarded, but no such interest will ordinarily be included unless there has been some unusual degree of delay in dealing with the case.

2: Decision of the Board on contract references 73/2 and 73/3

(a) When a case is referred for the purpose of determining whether the price agreed was fair and reasonable, the Board must, in general, have regard to the situation obtaining at the date when the price was finally agreed and for the purpose of determining whether there was at that time an acceptable degree of 'equality of information', it would not necessarily be enough for it to be shown that the contractor had duly complied with his obligations under Clause 3 of SC43 [*or DEFCON 643*].

(b) Non-disclosure of relevant information that is attributable to some inadequacy or breakdown of internal communications within the organisation concerned may, of itself, give rise to 'inequality of information'.

(c) In principle cost estimates should be based upon the use of whatever manufacturing processes are most likely to be employed. In this context, a distinction should be drawn between practices which have become established at the time of pricing, even though of quite recent introduction, and those which have been introduced experimentally or as a temporary expedient and which cannot therefore be treated as 'established' in the sense that they are likely to constitute a regular feature of future production.

(d) Account should ordinarily be taken of sub-contracting only if, at the estimating stage, it is the intention that certain identifiable aspects of the work will be placed to sub-contract.

Subject to giving effect to such an intention, estimates should ordinarily assume 'in-house' production, and they should not be regarded as subject to revision to reflect savings or increases in cost (there could be either or both) resulting from what could be treated as a normal level of subcontracting under the contract in question.

(e) The general rule ought to be that the contractor's stock position should be ignored for estimating purposes, and that the estimate should be based upon current prices.

(f) It would be inappropriate to enunciate general principles concerning 'equality of information' within the context of this decision but:

(i) "It could hardly be suggested that a price agreed was fair and reasonable if it were based on an estimate which was manifestly too low in the light of some special information which was known to the Ministry but unknown to the contractor", and

(ii) "Even within the confines of SC 43, 'inequality of information' could result, not from lack of readiness of a contractor to disclose the relevant information but from failure of the Ministry to avail itself fully of the facilities afforded to it under SC43, eg by requiring the contractor to maintain records of a specified kind but then not calling for production of the relevant records. It would have to be considered, in that kind of situation, whether the contractor was under an obligation to make voluntary disclosure of information of which the Ministry remained in ignorance simply through failure to make full use of SC43, or whether the availability of information under SC43 relieves the contractor *pro tanto* from any positive duty of disclosure."

3: Decision of the Board on contract reference 77/2

(a) Where a contractor has failed to fulfil his obligation to keep proper record in accordance with SC 48, he cannot be permitted to pray that circumstance in aid, whether it be by way of defence to a claim by the Ministry for a refund or by way of founding a claim against the Ministry for additional remuneration.

(b) A contractor who has failed to keep adequate records can have little reason to complain if, faced with particular areas of uncertainty, the Board resolves them in favour of the Ministry.

(c) The Board cannot properly take into account the argument that a contractor's present parent should not be penalised for the shortcoming's of the contractor's previous management.

4: Decision of the Board on contract reference 79/1

It is imperative that neither party should enter into a contract on what was at the time considered an unwarranted pricing basis simply in the expectation that matters could always be put right by a reference to the Board.

5: Decision of the Board on contract reference 81/1

(a) It would not be appropriate for the Board to consider a contractor's claim for relief in respect of delays in performance which it maintained were caused by 'force majeure' circumstances, or a claim by the Ministry for liquidated damages, as these would necessitate enquiry into matters with which the Board is not equipped to deal, involving not only detailed factual evidence but also consideration of the legal effect of the relevant contract provisions. Such matters should be left to be determined in accordance with the contract terms.

(b) Contract provisions such as escalation clauses and clauses protecting the contractor against delays due to industrial disputes or other circumstances beyond his control must be treated as accepted by both parties as providing the appropriate measure of protection and relief from those particular hazards with which the performance of any relatively long-term contract may be beset. To the extent that protection is absent or limited by the terms of the particular contract the risk of the resulting loss, however grievous, must normally rest on the contractor.

6: Decision of the Board on contract references 86/1 and 86/2

(a) Where a contractor's estimator is unaware of facts known elsewhere in his organisation, the contractor cannot shelter behind this ignorance of the facts and claim that there was equality of information at the time of price fixing.

(b) There may well be information available to a contractor regarding probable or possible events which would, if they occur, materially affect the contract costs. In the Board's view, the contingent nature of such events is not sufficient ground for their non-disclosure.

(c) As a corollary to the requirement for equality of information at the time of price fixing, it is clear that no advantage should be gained by one party by failure to disclose material information. In the event that such advantage is gained, the Board has grounds for making a price adjustment. As a general indication of the level of disclosure required, where an event would give rise to material uncertainty as to the reasonableness of the price agreed, then it should be disclosed.

(d) The Board considers that the requirement of Annex B to the [Working Guidelines for the Pricing of non-competitive Risk Contracts] for each party to bring additional information of a material nature to the notice of the other party does not relieve the Ministry from a duty to make enquiries regarding those matters of which it reasonably ought to be aware. Such an approach will not relieve from the party having the information the primary responsibility for disclosure but the Board will have regard to the enquiries made by the other party when determining the amount of any price adjustment.

(e) In the Board's view, the duty of disclosure does not cease with price fixing and the Board will, in determining the amount of any price adjustment, have regard to the conduct of both parties at all times but especially during the negotiation of prices and during post-costing.

(f) The CP/CE ratio is one of the factors which has to be estimated when compiling the total contract price. As such, this estimate is open to consideration by the Board together with the other estimates underlying the agreed contract price.

ADDENDUM

AGREED STATEMENT BY MOD AND THE JRBAC

2007 GENERAL REVIEW

1. We accept the Review the Review Board's recommendations as set out in Section II of its report on the 2007 General Review, subject to paras 2 and 3 below.

2. The MoD and JRBAC have discussed the recommendation concerning the level of Standard Baseline Profit Allowance (SBPA) and have agreed, without prejudice to the principle of comparability, to implement a minor adjustment when pricing contracts under the 2007GR. This adjustment takes the SBPA from 9.39% to 9.2%. Further guidance on implementation of the 2007GR will be published in the Government Profit Formula section of the Commercial Toolkit, publicly available through www.mod.uk

3. The MoD and JRBAC have recognised that the 2007GR should be implemented with effect from the 1st February 2008.

4. In respect of the Review Board recommendations concerning the costs of defined benefit pension plans, the MOD and JRBAC have subsequently agreed a definition of 'normal annual cost' which is attached as Appendix 1 to this Addendum.

5. We accept that Appendix D of this report 'The Government Profit Formula and its Associated Arrangements' represents the status of the Agreement between HM Government and the CBI immediately prior to the issue of this 2007 General Review. Upon implementation of the 2007 General Review the Agreement will be updated and placed on the main MoD website.

Signed
W R J Hockin OBE
Chairman,
JRBAC

Signed
A C E Morse
Defence Commercial Director
MoD

APPENDIX 1
(to the 2007GR Addendum – Agreed Statement by MoD and the JRBAC)

MoD/JRBAC agreed definition concerning defined benefit pension schemes (Review Board 2007GR report, para 454c refers)

Post-retirement benefits: defined benefit schemes

The amount to be allowed in attributable costs under the Government Profit Formula arrangements should be limited to the **current service cost (deemed 'normal')** as recorded in the Income Statement. Other elements in the income statement that may be considered to be 'normal' may include, but are not necessarily limited to, the following items:

(i) Changes to commutation arrangements;

(ii) Discretionary increases where it is normal scheme practice.

Amounts that may form part of a charge or credit to the Income Statement that are not to be considered 'normal' should be disallowed. These may include, but are not necessarily limited to, the following items:-

(i) Financing Charge or Credit;

(ii) Experience (or Actuarial) Gains and Losses;

(iii) Amortizations.

(iv) Pension curtailment and /or settlement gains

(v) Any element of current service cost related to deficit funding.

Any amounts that appear in the SORIE should also be excluded.