REVIEW BOARD

FOR

GOVERNMENT CONTRACTS

REPORT ON

THE 2009 ANNUAL REVIEW OF

THE PROFIT FORMULA FOR

NON-COMPETITIVE

GOVERNMENT CONTRACTS

January 2009

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

January 2009

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2009 Annual 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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NOTE:

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

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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 most recent such 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.
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 2007 General Review was published by The Stationery Office (ISBN 978-0-11-773079-3) in 2008.
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. The GPFAA is contained in the 2007 General Review and is expected to be placed on the MoD website when it is updated.
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
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 ('SSAP') 24	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the financial statements of enterprises. For UK listed companies this 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

101. The basis for pricing non-competitive Government contracts is set-out in The Government Profit Formula and its Associated Arrangements ('GPFAA') as agreed between the Ministry of Defence ('MOD')[1], on behalf of Government, and the Joint Review Board Advisory Committee[2] ('JRBAC'), on behalf of industry. This agreement encapsulates a 1968 Agreement between Government and industry and numerous revisions since that date. The GPFAA was first published in the 2007 General Review[3] and an updated version is expected to be available on the MOD website shortly.

102. The Review Board was established in 1969 and wide ranging General Reviews of the profit formula arrangements have been undertaken, normally triennially, since that date. Annual Reviews of the profit formula, like this 2009 Annual Review, are normally limited to examination of the target rate of return and of other statistical data underlying the profit formula.

103. The report on the most recent General Review was released by the Board in November 2007, following protracted discussions. The recommendations in the report were subject to an adjustment agreed between MOD and the JRBAC and were implemented as from 1 February 2008. Owing to the delays to the 2007 General Review it was agreed that the Review Board should collect the data for a 2008 Annual Review but not publish a report on the Review, instead incorporating the 2008 data into this 2009 Annual Review.

104. Following the delay in publishing the 2007 General Review the Board requested, and is pleased to have received, a joint statement from MOD and the JRBAC reaffirming their commitment to the role of the Review Board. A copy of the statement is included at Appendix D to this report.

105. This report, on the 2009 Annual Review of the Profit Formula for non-competitive Government Contracts, contains the Board's recommended profit formula for the year from 1 April 2009.

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

[1] See Explanation of Terms.

[2] See Explanation of Terms.

[3] The report on the 2007 General Review of the Profit Formula for non-competitive Government Contracts was published by The Stationery Office (ISBN 978-0-11-773079-3).

SECTION II

SUMMARY

Profit Formula Recommendations

201. To achieve comparability with the return earned by British industry, the profit formula from 1 April 2009 should be structured as follows:

		2007 General Review %	*2009 Annual Review* %
FCSA	Fixed Capital Servicing Allowance (paragraph 313)	6.71	6.69
WCSA	Working Capital Servicing Allowance (paragraph 315)	6.23	6.85
BPR	Baseline Profit Rate (paragraph 319)	9.74	10.14
SBPA	Standard Baseline Profit Allowance (paragraph 322)	9.39[4]	9.74
ASBPA	Adjusted Standard Baseline Profit Allowance (paragraph 329)	9.09	9.44
NBPA	Non-risk Baseline Profit Allowance (paragraph 331)	7.09	7.31

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

Implementation of the Board's Recommendations

203. As agreed between MOD and the JRBAC the implementation date should be 1 April 2009.

Recent Profits on Non-Competitive Contracts

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

205. Having analysed the data from the annual returns, the Board is satisfied that there does not appear to be any systemic underperformance or overperformance by contractors. However, the Board will continue to monitor the performance so it can identify any developing trends. (paragraphs 402-408)

206. The Board has also reviewed the results of post-costing undertaken by the MOD. Whilst it is concerned that only one contract was post-costed in 2007, it has received assurances from MOD that it is currently in the process of further increasing the resources it dedicates to monitoring contract costs including post-costing. The Board will report on any further developments in this area at the next review but remains concerned about the current low volume of post-costing being undertaken. (paragraphs 402-408)

[4] At the 2007 General Review the Board recommended that the SBPA should be 9.39 per cent. MoD and the JRBAC agreed between them, without prejudice to the principle of comparability, to implement a minor adjustment to the SBPA reducing it from 9.39 per cent to 9.20 per cent. As a consequence the ASBPA and NBPA were also reduced, to 8.90 per cent and 6.90 per cent respectively.

Topics for the 2010 General Review

207. The Board, together with Government and industry, has recently begun its consideration of matters to be included in the 2010 General Review of the profit formula. The Board considers that the following topics should be reviewed as part of the 2010 General Review, together with any further topics raised by the parties:

- The 0.3 percentage point reduction to the SBPA for contracts with a value in excess of £50m.
- The methodology used to determine the Fixed Capital Servicing Allowance and Working Capital Servicing Allowance.
- The methodology used to determine the IGIU adjustment.
- The constituents of the Reference Group.
- The risk/reward matrix.
- Post-costing and other contract monitoring procedures adopted by MOD to determine whether there is more information the Board could use when determining how closely contract performance matches profit formula target performance.

SECTION III

THE TARGET RATE OF RETURN

Introduction

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

The 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. The introduction and implementation of IFRS was considered at the 2007 General Review.

303. Companies listed on the Alternative Investment Market ("AIM") were given dispensation to delay application of IFRS until periods commencing 1 January 2007 so it has only been possible to include these companies in the latest Reference Group.

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 it less susceptible to any special circumstances that may affect an individual sector from time to time.

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

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

306. Accordingly, the Reference Group for the 2009 Review comprises 751 companies with a total capital employed of £186 billion and sales of £536 billion as compared with 256 companies with capital employed of £160 billion and sales of £490 billion at the last Review.

307. The Reference Group contains considerably more companies than at the 2007 General Review because, as mentioned in paragraph 303, it now contains AIM companies which had to be excluded in 2007 because at that time they had not adopted IFRS. The inclusion of 509

AIM companies makes the Reference Group more representative of British industry, but it has made little difference to the overall results of the Reference Group. The inclusion of AIM listed companies in the 2007/08 Reference Group results in a reduction to overall return on cost of production by 0.39% to 12.16%.

308. The Reference Group is derived from data obtained from the 'Worldscope' database which is compiled by Thomson Reuters.

309. The Board considers that the constituents of the Reference Group should be considered at the 2010 General Review.

Determination of the Baseline Profit

310. 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 to reduce the volatility of the target rate caused by year-to-year fluctuations in the level of the Reference Group's profitability. The simple average of the Reference Group Baseline Profit Rates for 2006, 2007 and 2008 is 10.14 per cent and we recommend that this should be adopted in the Profit Formula.

The Profit Formula Methodology

311. 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 non-competitive Government contracts.

312. 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

313. 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.

314. Based on the rates prevailing up to 30 November 2008, this gives a FCSA of 6.69 per cent.

The WCSA

315. 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.

316. To reduce volatility the WCSA is based on a moving average of the one year LIBOR rate. The 36 month moving average of the one year LIBOR based on rates prevailing up to 30 November 2008 was 5.6 per cent, so the appropriate WCSA should be 6.85 per cent.

317. 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.

318. The Board considers that the methodology used to determine the Fixed Capital Servicing Allowance and Working Capital Servicing Allowance should be reviewed at the next General Review to establish whether it needs to be adapted in the light of changes in the UK economy.

The Baseline Profit

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

	2004/5 Reference Group IFRS £m	2005/6 Reference Group IFRS £m	2006/7 Reference Group IFRS £m	2007/8 Reference Group IFRS £m
(A) Cost of Production	395,754	432,434	425,872	477,563
(B) Capital Employed	146,274	160,393	169,899	185,913
(C) CP:CE ratio (A÷B)	2.71	2.70	2.51	2.57
(D) FC:WC ratio	101:-1	94:6	89:11	89:11
(E) Actual Profit (EBIT)	47,815	57,622	54,067	58,073
(F) FCSA % (see note 1 below)	6.90%	6.78%	6.71%	6.70%
(G) WCSA % (see note 1 below)	5.66%	5.82%	6.23%	6.55%
(H) FCSA (B×(D['FC']÷100)×F)	10,194	10,222	10,146	11,086
(I) WCSA (B×(D['WC']÷100)×G)	(83)	560	1,164	1,340
(J) Total CSA (H+I)	10,111	10,782	11,311	12,425
(K) Baseline Profit (E-J)	37,704	46,840	42,757	45,647
(L) BP as % of CP (K÷A)	9.53%	10.83%	10.04%	9.56%
3 year rolling average		**9.74%**	**10.13%**	**10.14%**

Note. 1. The FCSA and WCSA percentage figures are derived using the methodology set out earlier in this Section. However, for the purposes of calculating the Baseline Profit, rather than using the rates prevailing up to 30 November 2008, the figures used are those prevailing up to 31 March of each year concerned.

320. The Baseline Profit Rate is calculated from the average Baseline Profit of the Reference Group for the latest three years. It can be seen from the table that the three year simple average calculation has increased by 0.4 of a percentage point since the 2005/6 Reference Group, which was used in the 2007 General Review. The Board has concluded that the Baseline Profit Rate derived on the basis of strict comparability with the returns of British industry should be 10.14 per cent expressed on the modified historic cost basis.

321. Accordingly the Board recommends that the Reference Group Baseline Profit Rate of 10.14 per cent should be used in the profit formula arrangements. This figure needs to be adjusted before it can be applied to individual contracts, and this process is considered in the following section.

The Standard Baseline Profit Allowance

322. The Reference Group Baseline Profit Rate on cost of production of 10.14 per cent, on the modified historic cost basis, needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractors.

323. 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.

324. For the purposes of the 2009 Annual Review MOD and the JRBAC have undertaken a joint assessment of the level of intra-group trading and have agreed that it is 4.01 per cent. Part of the 4.01 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 328 and 329 below. The Board estimates that the 4.01 per cent intra-group trading figure needs to be reduced to 3.93 per cent to allow for this effect.

325. The Baseline Profit Rate of 10.14 per cent therefore needs to be reduced by the abated intra-group trading figure of 3.93 per cent, giving a rate of 9.74 per cent. The Board therefore recommends that the Standard Baseline Profit Allowance to be used for pricing non-competitive contracts should be 9.74 per cent.

326. The Board considers that the 2010 General Review should include a review of the methodology used to calculate the IGIU adjustment.

The Risk/Reward Matrix

327. 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 perhaps also address varying degrees of risk in the context of different types of contract. The MOD and the JRBAC made a joint submission to the Review Board at the 2007 General Review stating that they had undertaken a review of the risk/reward matrix and considered that there is 'currently no great benefit to be gained in making changes to the structure or operation of the risk/reward matrix. In the light of this submission the Board did not propose any changes to the matrix at the 2007 General Review. The risk/reward matrix is reproduced at Appendix C.

328. 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 contractor'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 an enhancement to the profit allowance added to the prime contractor's own costs.

329. 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. This interim arrangement was also due to be reviewed to see if there is a more appropriate mechanism for dealing with variations in risk. At the 2007 General Review the Board recorded its

disappointment that the joint review of the matrix (see paragraph 327 above) did not extend to cover this issue and urged the parties to give the matter further consideration. Accordingly, the quantum of the adjustment has not changed and the Board recommends that Adjusted Standard Baseline Profit Allowance ('ASBPA') should now be 9.44 per cent, being 30 basis points below the SBPA.

330. The Board considers that the 2010 General Review should include a review of, what was only intended as, an interim arrangement to deal with the differences in risk as between a contractor's own costs and those of subcontractors that pass through its books.

331. 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 7.31 per cent.

332. The SBPA (for contracts with a value over £5 million but under £50 million) or ASBPA (for contracts over £50 million) for firm, fixed price or target cost contracts is subject to possible further adjustment in accordance with the risk/reward matrix referred to in paragraph 327. Following this consideration the resultant allowance for a particular contract is known as the Contract Baseline Profit Allowance ('CBPA').

333. As described in paragraph 311, 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').

334. The Board considers that the 2010 General Review should include a review of the risk/reward matrix to determine whether it should now be further developed and to perhaps also address varying degrees of risk in the context of different types of contract.

The Comparability Principle

335. In Section 1.36 of the GPFAA the Board is asked 'to bring to notice in its reports anything that it regards as relevant to the operation of the GPF. This would include, should the occasion arise, respects in which the Board might wish to draw attention to any perceived ill-effect for either party, or for both, deriving from strict observance of the comparability principle and to make further recommendations which should be separately identified'. The Board has concluded that there is no such matter that it wishes to bring to notice in the Report on the 2009 Annual Review.

SECTION IV

RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

Introduction

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

Annual Returns

402. Annual returns have been received from 34 contractors in 2007 (being company year ends ended in the year to 31 March 2008) with total profit formula sales of £5.5 billion. Returns have also been received from 33 contractors with profit formula sales of £4.4 billion in 2006. This suggests a very high level of coverage given the level of contracts and amendments placed by MOD in recent years.

403. The Board's analysis of the annual returns shows that the contractors' overall target rate of return on profit formula contracts in 2007 was 6.86 per cent on their cost of production (6.98 per cent in 2006), and that they achieved an actual return of 7.90 per cent (9.27 per cent in 2006). Therefore contractors appear to have exceeded their target profit by 1.05 per cent (2.29 per cent in 2006). However, the Board is satisfied that this does not indicate a systemic overperformance by contractors because analysis of the 2007 results shows that:

- there is a wide variety in the results achieved by individual contractors;
- almost half of the excess is accounted for by just two large contracting units; and
- eleven of the units performed below the target.

Further, the historic run of results suggests that performance against target does tend to be volatile. This can be seen from the figures for variance of actual returns from the target return for the past 15 years:

Year	Variance	Year	Variance	Year	Variance
2007	+1.05%	2002	No returns	1997	No returns
2006	+2.29%	2001	-26.3%	1996	+15.4%
2005	-1.1%	2000	-7.8%	1995	-6.0%
2004	-3.37%	1999	No returns	1994	-10.0%
2003	No returns	1998	No returns	1993	-1.4%

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

Post-Costing

405. 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 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 an adjustment or affect follow-on contracts.

406. In the past the Board has expressed concern that the number of contracts being post-costed is low. The tables below show that just 13 contracts were post-costed in 2006. The 2007 analysis has been omitted from the table as the Board has been informed by MOD that there was only one low value contract where post-costing work was completed in that year.

407. The Board's direct use for post-costing results is to gain understanding, in addition to that achieved through annual returns, of how closely contract performance matches profit formula target performance. Whilst the Board is concerned that only one contract was post-costed in 2007, it has been given to understand that post-costing activity is not the sole measure of MOD's overall contract monitoring work. In particular any contract with stage payments, and particularly Target Cost Incentive Fee contracts, needs to be examined closely before any payment can be made. The Board also understands that MOD is currently in the process of further increasing the resources it dedicates to monitoring contract costs including post-costing. The Board will report on any further developments in this area but remains concerned about the current low volume of post-costing being undertaken. As part of the 2010 General Review, the Board is keen to gain a better understanding of MOD's contract monitoring process in order to better inform the Board's work on monitoring industry's profitability on non-competitive contracts.

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

All contracts post-costed by MOD				
	2003	**2004**	**2005**	**2006**
Total of contracts post-costed				
(a) Number (b) Value	17 £450m	15 £1,048m	36 £989m	13 £694m
Of which the following were not fully analysed:				
(a) Number (b) Value	Nil Nil	Nil Nil	Nil Nil	Nil Nil

Analysis of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2003	**2004**	**2005**	**2006**
A – Contracts where +/- 5 per cent accuracy was achieved:				
(a) Percentage by Number (b) Percentage by Value	36% 51%	57% 89%	76% 72%	67% 78%
B – Contracts where +/- 10 per cent accuracy was achieved:				
(a) Percentage by Number (b) Percentage by Value	83% 98%	79% 96%	88% 97%	92% 84%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):				
(a) Number (b) Value	9 £372m	9 £139m	17 £361m	10 £503m

D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):				
(a) Number (b) Value	3 £6m	3 £13m	Nil Nil	Nil Nil
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:				
(a) Number (b) Value (c) Amount of refund	1 £1m £0.04m	Nil Nil Nil	Nil Nil Nil	Nil Nil Nil
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):				
(a) Number (b) Value	5 £72m	2 £178m	12 £387m	1 £11m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):				
(a) Number (b) Value	Nil Nil	Nil Nil	4 £27m	1 £100m

APPENDIX A

THE RECOMMENDED PROFIT FORMULA - ILLUSTRATIONS

Prepared by the Review Board for Government Contracts - January 2009

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

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

1. a CP:CE ratio of 3:1 and a contract attracting the Standard Baseline Profit Allowance
2. a CP:CE ratio of 6:1 and a contract attracting the Standard Baseline Profit Allowance
3. a CP:CE ratio of 1.5:1 and a contract attracting the Standard Baseline Profit Allowance
4. a CP:CE ratio of 3:1 and a contract for a repeat production order attracting the Standard Baseline Profit Allowance less 10 per cent
5. a CP:CE ratio of 3:1 and a contract requiring specialist skills and attracting the Standard Baseline Profit Allowance plus 10 per cent
6. a CP:CE ratio of 3:1 and a non-risk contract attracting the Standard Baseline Profit Allowance less 25 per cent

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

APPENDIX A: ANNEX I

ILLUSTRATIONS OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
CP:CE ratio calculation:						
(A) Fixed capital (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 of CP:CE unit	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000	9,000,000
(E) CP:CE ratio is therefore (D/C)	3	6	1.5	3	3	3
CSA calculation:						
(F) FCSA	6.69%	6.69%	6.69%	6.69%	6.69%	6.69%
(G) FC proportion (A)	67.00%	67.00%	67.00%	67.00%	67.00%	67.00%
(H) (F x G)	4.48%	4.48%	4.48%	4.48%	4.48%	4.48%
(I) WCSA	6.85%	6.85%	6.85%	6.85%	6.85%	6.85%
(J) WC proportion (B)	33.00%	33.00%	33.00%	33.00%	33.00%	33.00%
(K) (I x J)	2.26%	2.26%	2.26%	2.26%	2.26%	2.26%
(L) CSA (H + K)	6.74%	6.74%	6.74%	6.74%	6.74%	6.74%
(M) CSA as percentage of CP (L/E)	2.25%	1.12%	4.50%	2.25%	2.25%	2.25%
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	9.74%	9.74%	9.74%	9.74%	9.74%	9.74%
(P) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(Q) Contract Baseline Profit Allowance	9.74%	9.74%	9.74%	8.77%	10.71%	7.31%
(R) CSA (M)	2.25%	1.12%	4.50%	2.25%	2.25%	2.25%
(S) Total Contract Profit Allowance (Q + R)	11.99%	10.86%	14.24%	11.02%	12.96%	9.56%
(T) Total formula payments (N x S)	119,876	108,638	142,352	110,136	129,616	95,526
(U) Total contract price (N + T)	1,119,876	1,108,638	1,142,352	1,110,136	1,129,616	1,095,526

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 9.74% 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

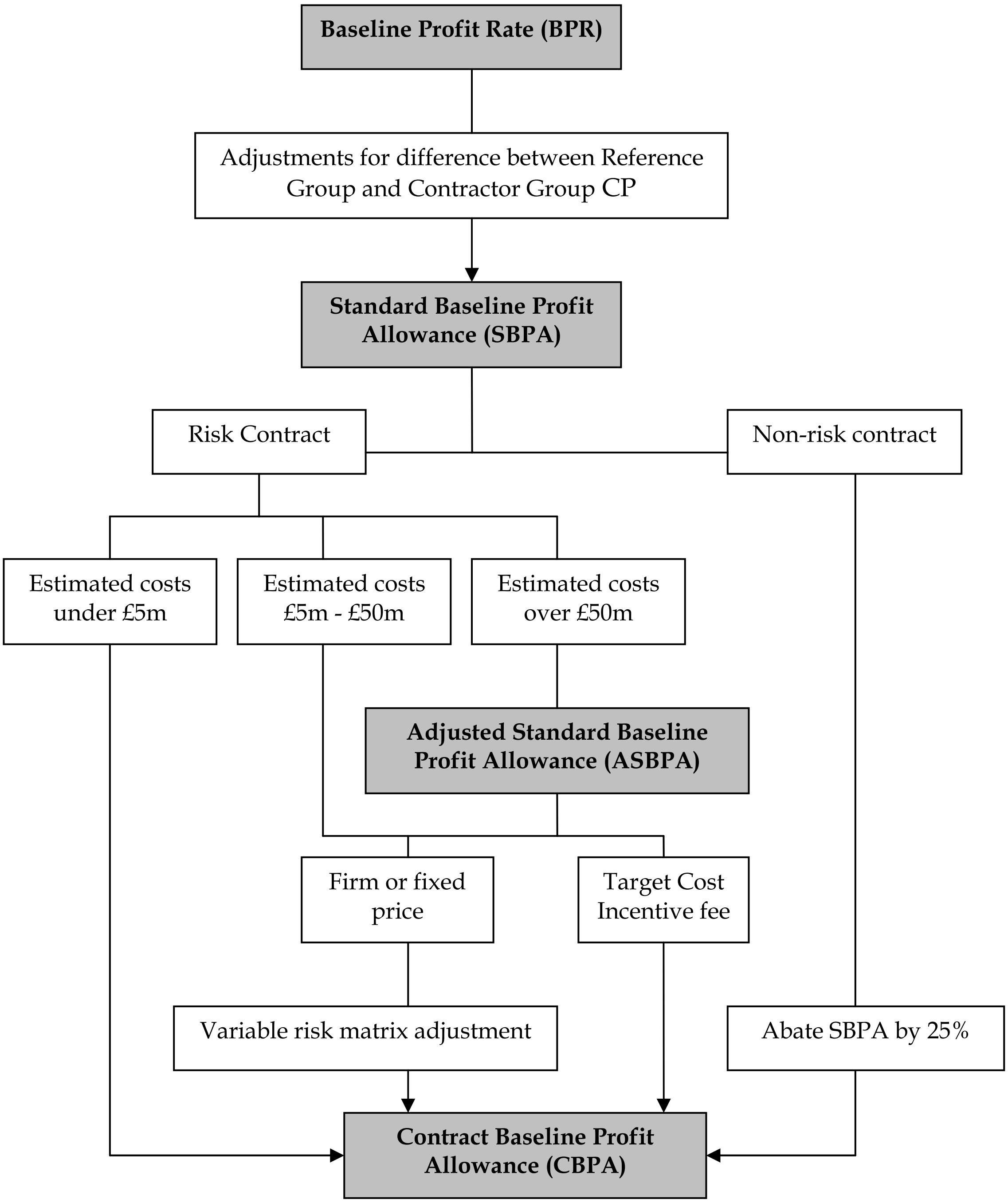
ILLUSTRATION OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA UNDER THE SPECIAL ARRANGEMENTS FOR CONTRACTS IN EXCESS OF £50 MILLION

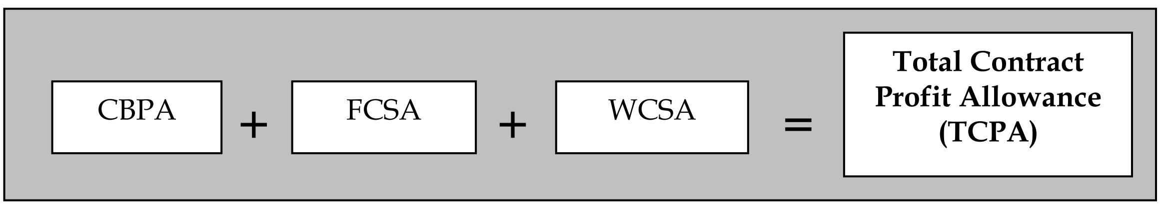
		CSAs	Total
Contractor's CP:CE ratio:			
(A) Fixed capital (80%)		24,000,000	
(B) Working capital (20%)		6,000,000	
(C) Total capital (A + B)		30,000,000	
(D) Total cost of production		90,000,000	
(E) CP:CE ratio is therefore (D/C)		3	
CSA calculation:			
(F) FCSA		6.69%	
(G) FC proportion (A)		80.00%	
(H) (F x G)		5.35%	
(I) WCSA		6.85%	
(J) WC proportion (B)		20.00%	
(K) (I x J)		1.37%	
(L) CSA (H + K)		6.72%	
(M) CSA as percentage of CP (L/E)		2.24%	
Individual contract price:			
(N) Contract CP		75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	9.74%		
(P) Reduction for contracts over £50m	0.30%		
(Q) Adjusted Standard Baseline Profit Allowance (O – P)		9.44%	
(R) Adjustment in accordance with the Risk/Reward matrix		nil	
(S) Contract Baseline Profit Allowance		9.44%	
(T) CSA (M)		2.24%	
(U) Total Contract Profit Allowance (S + T)		11.68%	
(V) Total formula payments (N x U)		8,760,000	8,760,000
(W) Total contract price (N + V)			£83,760,000

Explanation:
The illustration assumes a contract with a CP of £75 million being undertaken by a contractor with a CP:CE ratio of 3:1. It also assumes 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/produ ction 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

Reaffirmation by the JRBAC and the MOD of their commitment to the role of the Review Board

The JRBAC and the MOD reaffirm their commitment to the role of the Review Board for Government Contracts as set out in Appendix D of the 2007 General Review of the Profit Formula for Non-Competitive Government Contracts

- **AN INDEPENDENT REVIEW BOARD** - The continuance of the Review Board for Government Contracts as an impartial Non-Departmental Public Body independent of both Government and Industry.

- **THE INVOLVEMENT OF THE BOARD** – Taking care to involve the Review Board and its Secretariat in discussions and developments which impact upon the operation of the Government Profit Formula and the associated arrangements for non-competitive contract pricing.

- **THE BOARD'S ROLE TO ENCOURAGE AN EFFICIENT DEFENCE INDUSTRY** – The encouragement of an efficient defence industry should continue 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.

- **THE BOARD'S ROLE AS AN ARBITER** – A Review Board which shall review and give rulings on the pricing of individual contracts and sub-contracts that are referred to it by either of the parties, individually or together, under the terms of the relevant contract conditions.

- **TIMELINESS OF REVIEWS** - The Review Board's role in carrying out periodic reviews of the Profit Formula for Non-Competitive Government Contracts and the need for the JRBAC and MOD to act in good faith to adhere to the agreed timetables for conducting such reviews.

AMYAS MORSE　　　　　　　　　　WILLY HOCKIN

[A signed copy of this statement was received with a letter dated 30 September 2008.]