REVIEW BOARD

FOR

GOVERNMENT CONTRACTS

REPORT ON THE 2013 GENERAL REVIEW OF THE PROFIT FORMULA FOR NON-COMPETITIVE GOVERNMENT CONTRACTS

February 2013

The Rt Hon Philip Hammond, MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
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February 2013

Dear Secretary of State

I have pleasure in submitting the Review Board's report on the 2013 General Review of the profit formula for the pricing of non-competitive Government contracts.

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

Yours sincerely

John Price
Chairman

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NOTE:

The recommendations in this report are accepted by the Ministry of Defence and the Joint Review Board Advisory Committee in an agreed statement which is presented as an addendum to this report on page 113.

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APPENDICES

ADDENDUM

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

Acquisition Operating Framework ('AOF')	A web based tool that sets out MOD's acquisition policy and practice and which can be located at www.gov.uk/acquisition-operating-framework.
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 Government Profit Formula, undertaken annually between General Reviews. The most recent such review, the 2012 Annual Review, was published by The Stationery Office (ISBN 978-0-11-773107-3) in 2012.
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 i.e. immediately above non investment grade.
CBI	Confederation of British Industry.
CE	Capital employed.
Comparability principle	The aim of the Government Profit Formula, which is to give contractors engaged in non-competitive Government contract work a return equal on average to the overall return earned by British industry having regard to both capital employed and the cost of production.
Contract Baseline Profit Allowance ('CBPA')	The profit allowance on cost applicable to a specific contract after making all appropriate adjustments in accordance with the risk/reward matrix.

Contractor Group	A generic term for the group of contractors who are engaged in non-competitive Government work using the Government Profit Formula. The composition of the group may vary from year to year.
CP	Cost of production.
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio is used to attribute to individual contracts a proportion of the contractor's capital employed.
CP:CE ratio unit	The business unit or other sub-division of a contractor's business for which a CP:CE ratio is calculated for the purposes of pricing non-competitive Government contracts.
CSAs	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
Currie Review	An independent report by Lord Currie of Marylebone into the Single Source Pricing Regulations used by MOD, dated October 2011, together with ongoing consultations between MOD and industry where the context requires.
DEFCONs	The series of defence contract conditions applicable to MOD contracts. These are contained in the Commercial Managers' Toolkit which can be accessed on the MOD's Acquisition Operating Framework website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
EBIT	Earnings before Interest and Tax.
FCSA	The Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible assets.
Financial Reporting Standard ('FRS') 17	The accounting standard on retirement benefits issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.
Firm Price	A price, agreed for the articles or services, or both, which is not subject to variation.
Fixed Price	A price, agreed for the articles or services, or both, that is subject to variation in accordance with the variation of price provision of the contract.

General Review	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The most recent such review, prior to the 2013 General Review, was the 2010 General Review, published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.
Government Accounting Conventions ('GACs')	The accounting conventions used for the determination of costs and capital employed attributable to non-competitive Government contracts.
Government Profit Formula and its Associated Arrangements ('GPFAA')	The Government Profit Formula ('GPF') incorporating the 1968 Memorandum of Agreement between the Government and the CBI and subsequent revisions and changes since that time, as agreed between the representatives of Government and the CBI. The GPFAA sets out the arrangements for placing and pricing non-competitive Government contracts.
Government Profit Formula ('GPF')	The formula for determining 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.
International Accounting Standards ('IASs')	International Accounting Standards issued by the International Accounting Standards Committee, the body that preceded (1973-2001) the International Accounting Standards Board.
International Financial Reporting Standards ('IFRSs')	International Financial Reporting Standards issued by the International Accounting Standards Board.
Intra-group inter-unit trading ('IGIU')	Trading between different CP:CE 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.
LIBID	London Interbank Bid Rate.
LIBOR	London Interbank Offered Rate.
Maximum Price Target Cost ('MPTC')	A pricing basis whereby a target cost and a target fee are agreed at the outset, along with a formula that sets out how the Government and the contractor will share cost over-runs and cost savings. Where such an arrangement is subject to an overall maximum price, it is usually referred to as a MPTC contract.

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

Reference Group	The group of UK companies representative of British industry whose average rate of return is used by the Review Board to determine the target rate of return in the Government Profit Formula.
Risk contract	A contract with a pricing arrangement which does not insulate the contractor against loss.
Risk/Reward matrix	The 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. The current Risk/Reward matrix is set out in the GPFAA – Section 2 Annex B.
Single Source Pricing Regulations ('SSPRs')	Regulations intended to be introduced by the MOD in 2013 and 2014 and then governed by the SSRO. These Regulations will replace the GPFAA.
Single Source Regulations Office ('SSRO')	The body recommended in the Currie Review, with wider powers and remit, intended to replace the Review Board when formally established and resourced.
Standard Baseline Profit Allowance ('SPBA')	The profit allowance on cost applicable to all GPF contracts and amendments after adjustments to the BPR as appropriate.
Standard Conditions of Government Contracts for Stores Purchases (SCs)	The series of conditions applicable to Government contracts published as Form GC/STORES/1 and now replaced by similar DEFCONs in contracting with MOD.
Statement of Standard Accounting Practice ('SSAP') 24	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the financial statements of enterprises. For UK listed companies this has now been superseded by IAS 19, and by FRS 17 for other UK companies that have not elected to adopt IAS 19.
Target Cost Incentive Fee ('TCIF') Contracting	A pricing basis whereby a target cost and a target fee are agreed at the outset, along with a formula which sets out how the Government and the contractor will share cost over-runs and cost savings.
The 1968 Memorandum of Agreement	The agreement between the Government and the CBI establishing the Review Board.
The Profit Formula Agreement	The Profit Formula Agreement, which supersedes the 1968 Memorandum of Agreement, the 1968 Profit Formula Agreement and all subsequent amendments thereto, is now made up of three sections: Section 1 Principles, Section 2 Arrangements agreed following the 2012 Review, and Section 3 Review Board Guidance.

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 Review 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.
UITF 17	Urgent Issues Task Force Abstract 17 Employee Share Schemes. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment for various issues.
UK GAAP	UK Generally Accepted Accounting Practice.
WCSA	The Working Capital Servicing Allowance provided to contractors for their investment in working capital.

SECTION I

INTRODUCTION

The Board

101. The basis for pricing non-competitive Government ('Government Profit Formula' or 'GPF') contracts is set out in The Government Profit Formula and its Associated Arrangements ('GPFAA') as agreed between the Ministry of Defence ('MOD'), on behalf of Government, and the Joint Review Board Advisory Committee ('JRBAC') representing the CBI, on behalf of industry. The GPFAA encapsulates a 1968 Agreement between Government and industry and numerous revisions since that date.

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

103. The Review Board for Government Contracts ('the Review Board') was established as an independent non-statutory body in 1969 following the 1968 Agreement between Government and industry. The role of the Review Board includes carrying out General and Annual Reviews to recommend allowances for the GPF and to consider other aspects of the GPF and associated arrangements.

104. Wide ranging General Reviews of the profit formula arrangements have been undertaken, normally triennially, since that date. These Reviews, the scope of which may include matters raised independently or agreed jointly by MOD and JRBAC, involve considerable participation by Government and by industry, whilst any other interested party may contribute if it wishes. In particular, the 2003 General Review resulted in a significant modernisation in the way in which the GPF operates following various studies initiated by HM Treasury.

105. Specifically, at General Reviews, the Review Board is required, taking into account the effect of the Government Accounting Conventions, to 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.

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

107. At the conclusion of each General Review or Annual Review the Review Board makes a report to MOD giving its recommendations for the GPF and any other matters included in the scope of its work. This report is simultaneously made available to the JRBAC and forms the basis for discussions between MOD and the JRBAC on the recommendations included in the report.

108. This report, on the 2013 General Review of the Profit Formula for Non-Competitive Government Contracts, contains the Review Board's recommended rate for the Government Profit Formula for the year from 1 April 2013.

The Government Profit Formula and its Associated Arrangements

109. The basis for pricing non-competitive Government contracts was set out in the 1968 Profit Formula Agreement, which was agreed between Government and the CBI 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'), was introduced at the 2007 General Review and was accepted by MOD and the JRBAC as representing the status of the GPF arrangements at that time. An updated version is placed on the MOD website after each Annual and General Review, to incorporate the agreed changes arising from that latest Review.

110. The GPFAA is divided into three sections. Section 1 covers the following matters:

- Part A: a profit formula based strictly on the principle of comparability;
- Part B: the adoption of contractual conditions governing equality of information and post-costing; and
- Part C: the establishment of the Review Board to conduct periodic reviews of the GPF and its associated arrangements and make recommendations on the basis of those reviews; and to review and determine the price of individual contracts that are referred to it for that purpose.

111. Section 2 covers arrangements agreed following the previous review in respect of profit formula allowances and associated arrangements. Section 3 gives guidance provided by the Review Board in the course of its reviews and references.

112. It should be noted that the scope of the Review Board's work in respect of pricing non-competitive Government contracts is limited to recommending an appropriate profit rate comparable to that earned by British industry and does not extend to making recommendations in respect of cost estimation unless specifically requested by both parties.

The 2013 General Review

113. The Review Board has conducted this Review on the basis of the terms of reference and scope for a General Review as contained in the GPFAA. In addition, MOD and the JRBAC agreed that the Review should consider the following principal matters:

- Eligibility of companies for inclusion in the Reference Group (paragraphs 302-307);
- The methodology used to determine Capital Servicing Allowances (paragraphs 309-321);
- Resolution process for disputes relating to overhead recovery (paragraphs 504-510); and
- The GPFAA in relation to contract references (paragraphs 501-503).

114. In conducting this Review, the Review Board has been cognisant of the ongoing Currie Review and has not sought to include those matters being discussed by MOD and its major contractors in that context. For instance, in recent years the Review Board has

encouraged the two parties to consider the treatment of risk and reward on non-competitive contracts; the Review Board now understands this topic is being addressed by MOD and its major contractors as part of the Currie Review, with the aim of incorporating a new risk/reward mechanism into new Single Source Pricing Regulations ('SSPRs').

Review by Lord Currie of Marylebone

115. On 26 January 2011 the Minister for Defence Equipment, Support and Technology announced that Lord Currie of Marylebone was to chair an independent review of regulations used by MOD when pricing work to be procured under single source conditions without reference to competition (the 'Currie Review').

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

117. On 10 October 2011 Lord Currie released his report[1], which included nine key recommendations and fourteen ancillary recommendations. During the course of the Currie Review the Board provided information to Lord Currie to assist him with his considerations.

118. The most significant recommendations made by Lord Currie were that there should be greater transparency between MOD and contractors, supported by enhanced reporting, and that the Review Board should be replaced by a new statutory body (referred to as the Single Source Regulation Office or SSRO) with wider responsibilities aimed at encouraging efficiency and value for money in MOD single source procurement.

119. It should also be noted that the Currie Review saw little merit in changing the approach to calculating the baseline profit allowance based on the principle of comparability. Lord Currie considered the approach developed by the Review Board was sound and when considering efficiency he was mindful that profit is generally less than ten per cent of the total costs of a contract.

120. There followed a public consultation period, during which the Review Board provided a response, which concluded on 6 January 2012 following which MOD prepared a Summary of Public Consultation Responses document[2], released in March 2012.

121. The MOD has continued to consult with its major contractors on single source procurement, primarily around the implementation of and transition to new SSPRs and the new SSRO regime.

122. The Review Board has been asked by MOD to continue to provide its existing services for an interim period pending the proposed introduction of the SSRO as well as to be prepared to receive references connected with certain cost-based disputes and with the introduction of the SSPRs.

[1] Lord Currie's report is available at the following web address:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35913/review_single_source_pricing_regs.pdf

[2] The Summary of Public Consultation Responses following the Currie Review is available at the following web address:
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/35914/Currie_Response2012.pdf

Contents of this report

123. The Board's recommendations for this General Review are summarised in Section II. The organisation of the remainder of this report is as follows:

II: Summary;

III: The Reference Group and the target rate of return;

IV: Recent profits on non-competitive Government contracts;

V: Other aspects of non-competitive Government contracting.

SECTION II

SUMMARY

Profit Formula Recommendations

201. The Review Board recommends that the Government Profit Formula from 1 April 2013 should be structured as follows:

		2012 Annual Review %	*2013 General Review %*
BPR	Baseline Profit Rate (para 328)	9.25	10.16
FCSA	Fixed Capital Servicing Allowance (para 312)	6.54	6.39
WCSA	Working Capital Servicing Allowance (positive) (para 320)	2.86	2.43
WCSA	Working Capital Servicing Allowance (negative) (para 321)	2.86	1.42

202. 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 average of the returns that companies in the Reference Group earn on their uncapitalised intangible assets and for the risks they assume. The BPR is adjusted to generate:

- The Standard Baseline Profit Allowance ('SBPA') (paragraph 328): for a contractor that does not conduct any IGIU trading, the 2013 General Review SBPA should be the same as the BPR, which is 10.16 per cent. Contractors that are part of a group of companies that undertake IGIU trading will compute and agree with MOD a reduced SBPA to be applied to contract costs so as to eliminate the impact of their IGIU trading.
- The Adjusted Standard Baseline Profit Allowance ('ASBPA') (paragraph 329): a contractor's ASBPA, in respect of firm or fixed price contracts or amendments with costs in excess of £50m, should be 0.30 of a percentage point lower than its SBPA. Therefore, for the 2013 General Review, a contractor that does not undertake IGIU trading should have an ASBPA of 9.86 per cent.
- Contracts placed on a cost reimbursement basis should attract the SPBA less 25 per cent (paragraph 329). Therefore, for the 2013 General Review, a contractor that does not undertake IGIU trading should have a Non-risk Baseline Profit Allowance ('NBPA') of 7.62 per cent.

203. A flowchart showing how the Reference Group Baseline Profit Rate is the basis of deriving the Standard Baseline Profit Allowance and the Contract Baseline Profit Allowance for a non-competitive contract is included at Appendix A. Illustrations of the application of the recommended formula are shown at Appendix B.

Implementation date of the Review Board's Recommendations

204. The Review Board recommends that the implementation date should be 1 April 2013.

Recommendations for defining eligibility for inclusion in the Reference Group

205. The constituents of the Reference Group have been considered in detail at each General Review to ensure that the overall return reflects that of British Industry. The Review Board has concluded that no changes should be made to the constituent members of the Reference Group (paragraphs 304-306).

206. As part of this Review, the Review Board has recommended that the definition of the Reference Group should be refined. The revised definition may be found in paragraph 304. This revised definition has had no impact on the constituent members of the Reference Group in the current year, but the Review Board believes the refined definition better explains its existing criteria to determine the constituents of the Reference Group.

Recommendations for refining the methodology used to determine Capital Servicing Allowances

207. As part of the scope of this Review, the Review Board has considered whether its methodology for calculating the FCSA and WCSA remains appropriate in the current economic climate, taking account of available sources of information. The Review Board has concluded that it would be appropriate to refine the methodology used to calculate the FCSA and WCSA to reduce elements of subjectivity and introduce a more dynamic method of capturing changing market conditions. In addition, the Review Board has concluded that it would be appropriate to recognise a separate rate for a contractor with net negative working capital and accordingly has used LIBID to calculate the WCSA in these circumstances. The Review Board is satisfied that these changes do not make a material difference to the CSAs in the current year compared to the use of the previous methodology (paragraphs 309-321).

Recent Profits on Non-Competitive Contracts

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

209. For the 2013 General Review annual returns have been received from 40 contractors with total GPF sales in 2011/12 of £5.7 billion. The Review Board would like to acknowledge the assistance it has received from the JRBAC in co-ordinating the collection of annual returns from contractors.

210. The Review Board's analysis of the annual returns shows that contractors, as a body, appear to have exceeded their expected return on cost of production by 1.75 per cent with an overall target rate of return on GPF contracts of 9.08 per cent on their cost of production, and an actual return of 10.83 per cent achieved. However, this is a weighted average figure and it masks a wide variety of results from individual contractors (paragraphs 402-408).

Post-Costing

211. The Review Board has reviewed the results of post-costing undertaken by MOD to gain an understanding, in addition to that achieved through annual returns, of how closely contract performance matches GPF target performance.

212. The Review Board notes that the number of contracts being post-costed is still low and is concerned that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment under DEFCON 648A. The Review Board continues to believe strongly that post-costing provides an essential tool for assessing the effectiveness of cost estimating procedures.

213. A significant part of Lord Currie's recommendations was for enhanced reporting by contractors to give greater transparency of costs throughout the contracting process. Despite this, the Review Board recommends that MOD continues to exercise its rights in connection with post-costing (paragraphs 409-415).

Recommendations for re-drafting the GPFAA and alignment with DEFCONs

214. As part of the scope of this Review, and in the light of the Review Board's experience on Contract Reference Decision 2009/2, the Review Board considered whether paragraphs 1.39 to 1.49 of the GPFAA were adequate. It concluded that they were not and has made a number of recommendations for change that better reflect current practices and which the Review Board now proposes should be incorporated into the GPFAA. These changes have been discussed with MOD and the JRBAC and are set out in Appendix D.

215. As has been mentioned in recent Reviews, it has been recognised by all parties, including the Review Board, that the DEFCONs and the GPFAA are no longer properly aligned, which could lead to confusion over the Review Board's jurisdiction and terms of reference if a contract dispute were to be referred to it. It has also been recognised by all parties that DEFCONs need to be amended to reflect current best practice but MOD has determined that there should be no amendment to DEFCONs whilst plans for implementing new contract conditions through the new SSPRs are being considered.

216. The Review Board's recommendations for redrafting paragraphs 1.39 to 1.49 include changes required, as far as possible, to align the GPFAA with the existing DEFCONs (paragraphs 501-503).

Terms of reference and jurisdiction of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs[3]

217. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[3], the Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.

218. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[3], the Government and the CBI have also agreed that disputes relating to certain terms, such as the failure to supply an adequate summary of costs incurred, and disproportionate actions may be referred to the Review Board.

219. The bases for referral are considered in paragraphs 506 to 510.

[3] In this context the term 'pricing DEFCONs' refers to SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

220. The Review Board considers that further work should be carried out by the parties to establish in more detail the terms of reference and processes which are acceptable to the Review Board, as otherwise there might be uncertainty and delays in the take-on of a reference.

221. The terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD and the JRBAC in consultation with the Review Board. It is expected that these processes will be developed by 1 April 2013.

222. The matters described above are considered in more detail in paragraphs 504 to 510 of this Report. For the purposes of this General Review and subject to the Review Board's comments in paragraph 508 below, the Review Board recommends that paragraphs 504-506 and 508 are incorporated into the GPFAA.

Recommendations relating to high level principles for referring disputes to the Review Board

223. In the light of the various issues relating to dispute references, mentioned above, the Review Board prepared a set of high level principles for a reference which it believed should apply to all references it was asked to undertake. The Review Board recommends that these high level principles should be incorporated into the GPFAA so that parties to a contract are cognisant of these principles (paragraph 511).

Amendments to Government Accounting Conventions

224. In the course of the 2013 General Review, MOD and the JRBAC reviewed the GACs to consider whether any further adjustments might be needed. The resulting recommended changes are considered at paragraphs 512 to 514.

Principles embodied in Review Board Decision 2009/2

225. The Review Board recommends that certain principles embodied in its recent Contract Reference, 2009/2, should be included in the GPFAA as guidance (paragraphs 515-517). It should be noted that for a better understanding of the Review Board's reasoning behind the principles embodied, it is necessary to refer to the full text of the decision, which has been placed in the House of Commons library.

Updated GPFAA

226. The GPFAA set out in Appendix E of this Report has been updated to incorporate the changes recommended in this Report. To the extent these recommended changes are not accepted, this will be recorded in the Addendum to this Report.

Questionnaire on the Method of Allocation of Costs (QMAC)

227. The Review Board's Report on its 2012 Annual Review noted that the QMAC was being updated through ongoing dialogue between MOD and the JRBAC. The Review Board understands that this process has been completed and the revised QMAC will be implemented as soon as practical from 1 April 2013 (paragraph 519).

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 GPF, the Review 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 Review Board considers the determination of the target rate of return based on the latest available evidence of the return earned by British industry.

The Constituents and Comparability of the Reference Group

302. The constituents of the Reference Group have been considered in detail at each General Review. At this Review the underlying criteria for inclusion in the Reference Group have remained unchanged, but the Review Board has sought to provide a clearer explanation of those criteria, as follows.

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

304. For the purposes of the Reference Group the Review Board defines British industry as being represented by all companies involved in any type of economic activity producing goods or services that are listed on the London Stock Exchange main market or on AIM, and with headquarters in the United Kingdom. The Reference Group includes all sectors of British industry except where inclusion of a sector compromises the comparability principle. For example, the comparability principle would be compromised where a fair return, which is based on return on cost of production and return on capital employed, is distorted by sectors where the majority of companies' revenues and profits are not directly linked to their cost of production or capital employed. The Review Board considers that the following should be excluded:

- Primary industry sectors – Revenues and profits in these industries are largely dependent on the natural resources being exploited and on the valuation of those resources rather than the cost of bringing the goods or services to sale. Significant sectors currently falling into this category are: agriculture, mining and oil & gas.
- Sectors dominated by companies where a significant proportion of their activity is based on investment and lending, i.e. either the purchase of speculative assets, including financial instruments, or lending, with the expectation of favourable future returns. Significant sectors currently falling into this category are: banking, insurance and investment.
- Sectors dominated by companies that are subject to price regulation on their operations which could have a significant influence on their profitability. In certain companies pricing may be regulated, for instance, by capping prices by reference to RPI or CPI or by reference to return on capital. This pricing structure is not comparable to companies undertaking non-competitive Government contracts. Significant sectors currently falling into this category are: water and multi-utilities.

305. As part of the General Review the Review Board additionally considered the impact of the exclusion of overseas revenues of UK domiciled companies and the inclusion of large private companies in the Reference Group and whether the movement of companies' headquarters overseas had a material impact on Reference Group profitability. The Review Board concluded that there were no grounds to recommend a change to the criteria for components of the Reference Group to take these into account.

306. The Reference Group for this Review comprises 639 companies with a total capital employed of £215 billion and sales of £805 billion as compared with 674 companies with capital employed of £222 billion and sales of £808 billion at the 2012 Annual Review.

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

The GPF Methodology

308. The return on non-competitive Government contracts is made up of three elements:

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

The FCSA

309. The purpose of the FCSA is to provide contractors with an appropriate allowance for their investment in book fixed assets, as adjusted for the GACs. On the basis that the average asset is assumed to have a life of around 15 years it seems appropriate to base the FCSA on the cost of 15 year finance, as that is reasonably representative of the average cost that might be incurred by the Reference Group.

310. At the 2003 General Review it was accepted that it would be reasonable to use the yield on BBB3 (or BBB-) rated corporate bonds as a reasonable benchmark rate as BBB- is the lowest investment grade security. Because of the lack of liquidity in the Sterling BBB- corporate debt market resulting in limited reference data, the Review Board has in the past based its FCSA calculation on the 7 year moving average of the 15 year Sterling BBB corporate bond rate plus an adjustment of 0.5 of a percentage point to incorporate a premium for a BBB- rating and the liquidity discount.

311. The Euro debt market is considerably more liquid than the Sterling debt market and in this General Review the Review Board has undertaken analysis suggesting that it would be less subjective and more dynamic to replace the static 0.5 percentage point adjustment

between Sterling BBB and Sterling BBB- with the actual spread between Euro BBB and Euro BBB-. The Review Board is satisfied that these changes do not make a material difference to the FCSA in the current year compared to the use of the previous methodology. The Review Board has shared its analysis with MOD and the JRBAC and they have accepted that the new methodology should be adopted. Therefore, as of the 2013 General Review, the FCSA calculation is based on:

- The 7 year moving average of the 15 year Sterling BBB corporate bond rate; adjusted for
- The spread between 10 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling denominated BBB and BBB- corporate bond rates.

312. Based on the methodology described above and using the rates prevailing up to 30 November 2012, this gives a FCSA of 6.39%.

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.

314. Since the 2003 General Review it has been accepted that it is reasonable to base the WCSA on one year LIBOR plus a premium of 1.25 percentage points. To reduce volatility the WCSA has been based on a 36-month moving average of the one-year LIBOR rate.

315. This methodology has been reviewed and the Review Board now considers that the WCSA should continue to be based on a 36 month moving average but that it should use:

- The 1 year Sterling BBB corporate bond rate; adjusted for
- The spread between 1 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling denominated BBB and BBB- corporate bond rates.

316. This revised methodology is less subjective and more dynamic than the previous methodology and is also more consistent with the FCSA methodology. The Review Board is satisfied that these changes do not make a material difference to the WCSA in the current year compared to the use of the previous methodology. Again, the Review Board's analysis has been shared with MOD and the JRBAC and they have accepted that the new methodology should be adopted subject to an annual review as a safeguard against any unintended consequences.

317. From time to time some contractors have net negative working capital employed. In such cases, a negative WCSA should be computed on net negative working capital employed and this amount should be deducted from that contractor's Baseline Profit entitlement, except where the contractor can demonstrate that the negative working capital employed does not relate to non-competitive Government work.

318. The Review Board has considered whether it is appropriate to use the same WCSA on both net positive and net negative working capital balances as it seems likely that a company will be charged more to borrow money than it will earn if it deposits money.

319. The Review Board has been advised that the 1 month LIBID (London Interbank Bid Rate) is likely to represent the highest level of interest that a company might expect to earn

on short term cash deposits. The MOD and the JRBAC have accepted that where a contractor has net negative working capital its WCSA should be based on a 36 month moving average of 1 month LIBID. Whilst there is no official published LIBID rate, for the purposes of the WCSA, we have calculated 1 month LIBID as 1 year LIBOR less 1/8 of a percentage point (0.125%).

320. Based on the methodology described above and using the rates prevailing up to 30 November 2012, the WCSA for positive working capital balances is 2.43%.

321. Based on the methodology described above and using the rates prevailing up to 30 November 2012, the WCSA for negative working capital balances is 1.42%.

The Baseline Profit

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

	2007/8 Reference Group £m	2008/9 Reference Group £m	2009/10 Reference Group £m	2010/11 Reference Group £m	2011/12 Reference Group £m
(A) Cost of Production	477,563	687,083	705,897	718,833	711,002
(B) Capital Employed	185,913	224,567	232,951	221,846	215,478
(C) CP:CE ratio (A÷B)	2.57	3.06	3.03	3.24	3.30
(D) FC ratio (see Note 1)	89%	101%	109%	112%	111%
(E) WC (positive) (see Notes 1, 2)	11%	n/a	n/a	n/a	14%
(F) WC (negative) (see Notes 1, 2)	n/a	-1%	-9%	-12%	-25%
(G) Actual Profit (EBIT)	58,073	71,812	81,523	88,709	93,739
(H) FCSA % (see Note 1)	6.70%	6.68%	6.71%	6.63%	6.48%
(I) WCSA % (positive) (see Notes 1, 2)	6.55%	6.66%	5.30%	3.80%	2.77%
(J) WCSA % (negative) (see Notes 1, 2)	6.55%	6.66%	5.30%	3.80%	1.41%
(K) FCSA (B×(D÷100)×H)	11,086	15,162	17,035	16,473	15,499
(L) WCSA(pos+) (B×(E÷100)×I)	1,340	n/a	n/a	n/a	836
(M) WCSA(neg-) (Bx(F÷100)×J)	n/a	(149)	(1,112)	(1,012)	(760)
(N) Total CSA (K+L+M)	12,425	15,014	15,923	15,462	15,575
(O) Baseline Profit (G-N)	45,647	56,798	65,600	73,247	78,164
(P) BP as % of CP (O÷A)	9.56%	8.27%	9.29%	10.19%	10.99%
3 year rolling average	**10.14%**	**9.29%**	**9.04%**	**9.25%**	**10.16%**

Note 1. The FCSA and WCSA percentage figures are derived using the data applicable as at 31 March of the year concerned.
Note 2. As part of the 2013 GR, it was agreed that separate rates should be applied to the Reference Group's positive and negative working capital balances in order to determine the value of the Capital Servicing Allowances. This has been calculated as from the 2011/12 Reference Group. Previously, a single WCSA% was applied to both positive and negative working capital balances, effectively applying a single rate to the net working capital. Therefore the working capital balances up to 2010/11 in the above table reflect the net position.
Note 3. Figures in the table are subject to rounding differences.

323. The Baseline Profit Rate is calculated from the average Baseline Profit of the Reference Group for the latest three years to reduce the volatility of the target rate caused by year-to-year fluctuations in the Reference Group's profitability. It can be seen from the table that the three year simple average calculation has increased by 0.91 of a percentage point from the 2012 Annual Review.

324. The Review Board has concluded that the Baseline Profit Rate derived on the basis of strict comparability with the overall return of British industry should be 10.16 per cent.

325. Accordingly the Review Board recommends that the Reference Group Baseline Profit Rate of 10.16 per cent should be used in the Government 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

326. The Reference Group Baseline Profit Rate on cost of production of 10.16 per cent, on the modified historic cost basis, needs to be embodied in a profit formula suitable for the pricing of non-competitive Government contracts after making any adjustments for differences in the reporting of cost of production as between the Reference Group and the Contractor Group.

327. The Review Board's assessment is that the calculation of cost of production in the Contractor Group will be different from that of the Reference Group, because the Contractor Group's figures for cost of production include intra-group trading whereas similar trading within the Reference Group will be eliminated through consolidation adjustments in group accounts. Therefore, intra-group trading within the Contractor Group needs to be assessed and eliminated in order to maintain comparability. This is undertaken through negotiations between MOD and the Contractor Groups undertaking intra-group inter-unit ('IGIU') trading in order to calculate appropriately lower SBPA rates. This adjustment, together with any other adjustment that might be required in a particular year, results in the SBPA.

328. This year the Review Board does not consider that any such other adjustment is required. Therefore, for Contractor Groups with no IGIU trading, the recommended SBPA is the same as the recommended BPR for the 2013 General Review.

Risk/Reward

329. The MOD and the JRBAC recognise that the risk profiles of different types of work will vary and the Review Board considers that the principle of pricing to reflect contract risk profile is sound. The parties took steps in the 2003 General Review to embed this principle into the GPF through the agreement of interim arrangements consisting of:

- A reduction of 30 basis points on the SBPA resulting in the Adjusted Standard Baseline Profit Allowance ('ASBPA') for firm or fixed price risk contracts over £50 million. Therefore, for CP:CE ratio units that are part of a group that does not undertake IGIU trading the recommended SBPA of 10.16 per cent reduces to an ASBPA of 9.86 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced ASBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading;
- A variable Risk/Reward matrix for contracts with estimated costs over £5 million. Depending on the type of work, possible 10 per cent increases or

decreases in the SBPA or ASBPA on firm or fixed price contracts and contract amendments whose cost is £5 million or over; and

- A reduction of 25 per cent on the SBPA for non-risk contracts. For CP:CE ratio units that are part of a group that does not undertake IGIU trading the recommended SBPA of 10.16 per cent reduces to a Non-risk Baseline Profit Allowance (NBPA) of 7.62 per cent. For CP:CE ratio units which are part of a group with IGIU trading a reduced NBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading.

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

331. The assessment of the appropriate balance of risk and reward is now being addressed by MOD and its major contractors as part of the Currie Review.

332. The Review Board recommends that the existing arrangements, as set out in Annex B to Section 2 of the GPFAA (reproduced also in Appendix C to this Report), should continue until such time as MOD and suppliers contract under new SSPRs that, amongst other things, implement an alternative approach to risk and reward.

The Contract Baseline Profit Allowance and the Total Contract Profit Allowance

333. The SBPA (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 after adjustment in accordance with the risk/reward matrix for a particular contract becomes the Contract Baseline Profit Allowance ('CBPA').

334. As described in paragraph 308, the GPF 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 GPF methodology is known as the Total Contract Profit Allowance ('TCPA'). A flowchart setting out this methodology is at Appendix A of this Report and illustrations of the application of the recommended profit formula are at Appendix B.

The Comparability Principle

335. In Section 1.36 of the GPFAA the Review 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 Review 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 Review Board has concluded that there is no such matter that it wishes to bring to notice in its Report on the 2013 General Review.

SECTION IV

RECENT PROFITS ON NON-COMPETITIVE GOVERNMENT CONTRACTS

Introduction

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

Annual Returns

402. Forty contractors have submitted their 2011 annual returns[4] for consideration at this Review. The returns analyse GPF contract work performed in the year with total sales of £5.7bn. The comparable figures for 2010 are 38 returns with total GPF sales of £6.6bn.

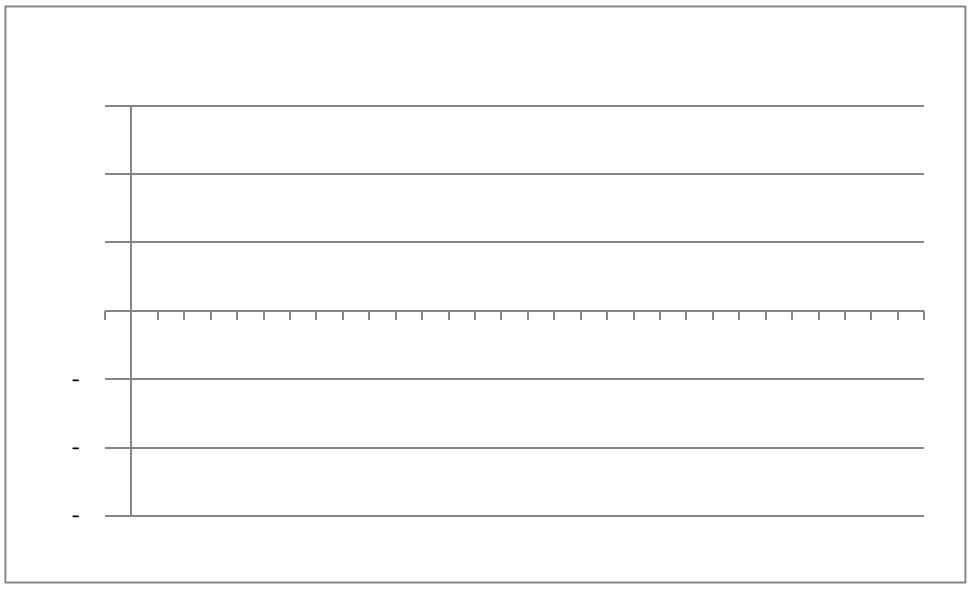
403. Defence Analytical Services and Advice (DASA) provides analytical, economic and statistical services and advice to MOD. DASA analysis shows that non-competitive Government contracts placed by MOD in 2011/12 totalled £3.69bn. A considerable volume of non-competitive amendments to contracts will also have been placed in the year. DASA's statistics show that £3.14bn of contract amendments were placed, but it notes that there are data quality issues with this figure. This suggests total non-competitive Government contracts and amendments placed by MOD of some £6.8bn. Notwithstanding the data quality issues, and that there will be timing differences between the annual returns and the contracts placed data, it would appear that annual returns provide a high level of coverage of the population of GPF contracts.

404. The Review Board's analysis of the 2011 annual returns shows that the contractors' overall expected rate of return on cost of production ('ROCP') on GPF contracts was 9.08 per cent (8.16 per cent in 2010), and that they achieved an actual ROCP of 10.83 per cent (8.87 per cent in 2010). Therefore contractors, as a body, appear to have exceeded their expected ROCP by 1.75 percentage points (0.71 percentage points in 2010). This is a weighted average calculation of contracts with a variety of profit rates and which started in a number of different years.

405. Analysis of the 2011 data shows that there is a very wide variety in the results achieved by individual contracting units. Analysing historic data has shown that the performance of some contractors has deviated from the target for a period of several years. The Review Board would expect that MOD's post costing exercises would enable it to understand such variances and would inform its estimating procedures. The Review Board notes that some 86 per cent (by sales value) of the contracts included in the returns relate to Risk contracts where the price is fixed at the outset.

[4] 2011 annual returns cover company year ends falling in the year to 31 March 2012.

406. The following table shows the variance of actual returns from the target return in recent years:



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

408. The Review Board requests that the JRBAC continues to support MOD in providing the Review Board with data on IGIU trading and on agreed profit rates so the Review Board can continue to monitor any differences between expected and outturn profits on GPF contracts.

Post-Costing

409. 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 pricing.

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

- in pricing follow-on contracts, as an essential element in equality of information;
- to enable departments to check the accuracy of their estimating procedures;
- 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
- 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.

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

412. Post-costing results received from MOD are shown below:

All contracts post-costed by MOD				
	2008	**2009**	**2010**	**2011**
Total of contracts post-costed				
(a) Number	15	8	8	13
(b) Value	£807m	£1,057m	£1,404m	£748m

Analysis of costs of all contracts fully analysed by MOD (excluding TCIF contracts)				
	2008	**2009**	**2010**	**2011**
A – Contracts where +/- 5 per cent accuracy was achieved:				
(a) Percentage by Number	27%	63%	43%	38%
(b) Percentage by Value	30%	17%	72%	19%
B – Contracts where +/- 10 per cent accuracy was achieved:				
(a) Percentage by Number	47%	75%	57%	69%
(b) Percentage by Value	51%	84%	77%	42%
C – Contracts where target cost exceeded cost outturn by 0 per cent to 10 per cent (i.e. cost underrun):				
(a) Number	4	5	3	7
(b) Value	£73m	£827m	£909m	£215m
D – Contracts where target cost exceeded cost outturn by more than 10 per cent (i.e. cost underrun):				
(a) Number	3	2	2	4
(b) Value	£121m	£144m	£193m	£404m
E – Contracts on which refunds were negotiated by MOD in light of post-costing results:				
(a) Number	1	2	1	2
(b) Amount of refund	£0.5m	£3m	£9m	£15.4m
F – Contracts where cost outturn exceeded target cost by 0 per cent to 10 per cent (i.e. cost overrun):				
(a) Number	4	1	1	2
(b) Value	£526m	£13m	£148m	£75m
G – Contracts where cost outturn exceeded target cost by more than 10 per cent (i.e. cost overrun):				
(a) Number	4	Nil	1	Nil
(b) Value	£38m	Nil	£21m	Nil

413. The number of contracts included in the post-costing exercise remains small. As can be seen, outturn costs were below target costs by more than 10 per cent on four contracts with total estimated costs of £404m. Repayments totalling £15.4m were negotiated in relation to two of these contracts following the post-costing exercise. This emphasises the importance to MOD of continuing to post-cost contracts.

414. The Review Board notes that the number of contracts being post-costed is still low and is concerned that the low level of post-costing activity might result in MOD or contractors failing to identify contracts where one party is entitled to a price adjustment under DEFCON 648A. The Review Board continues to believe strongly that post-costing provides an essential tool for assessing the effectiveness of cost estimating procedures.

415. A significant part of Lord Currie's recommendations was for enhanced reporting by contractors to give greater transparency of costs throughout the contracting process. Despite this, the Review Board recommends that MOD continues to exercise its rights in connection with post-costing

SECTION V

OTHER ASPECTS OF NON-COMPETITIVE GOVERNMENT CONTRACTING

Re-drafting the GPFAA and alignment with the DEFCONs

501. As part of the scope of this Review, and in the light of the Review Board's experience on Contract Reference Decision 2009/2, the Review Board has considered whether paragraphs 1.39 to 1.49 of the GPFAA were adequate. It concluded that they were not and has made a number of recommendations for change that better reflect current practices and which the Review Board now proposes should be incorporated into the GPFAA. These changes have been discussed with MOD and the JRBAC and are set out in Appendix D.

502. As has been mentioned in recent Reviews, it has been recognised by all parties, including the Review Board, that the GPFAA and the DEFCONs are no longer properly aligned, which could lead to confusion over the Review Board's jurisdiction and terms of reference if a contract dispute were to be referred to it. For example, DEFCON 643 on Price Fixing does not refer directly to Equality of Information which is a fundamental feature of the GPF arrangements. DEFCON 650 on References to the Review Board does not refer to the GPF rate which is referred to in the GPFAA in the section entitled 'Review of individual contracts and sub-contracts'. MOD has determined that there should be no amendment to DEFCONs at this point in time whilst plans for implementing new contract conditions through the new SSPRs are being considered.

503. The Review Board's recommendations for redrafting paragraphs 1.39 to 1.49 include changes required, as far as possible, to align the GPFAA to the existing DEFCONs.

Terms of reference and jurisdiction of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs[5]

504. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[5], the Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.

505. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[5], the Government and the CBI have also agreed that disputes relating to certain terms, such as the failure to supply an adequate summary of costs incurred, and disproportionate actions may be referred to the Review Board.

506. The bases for a referral to the Review Board, whether for a pre-contractual cost-based dispute or for an individual contract referral made other than through the provisions of the pricing DEFCONs[5], are any of the following:

- where there is a statutory provision that provides for a reference to be made by the Government, a supplier, or both;
- where there is an agreement between the Government and a supplier that provides for a reference to be made by the Government, a supplier, or both; and

[5] In this context the term 'pricing DEFCONs' refers to SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

- where there is a procurement contract between the Government and a supplier that includes a term, other than SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A, that provides for a reference to be made by the Government, a supplier, or both.

507. The Review Board considers that further work should be carried out by the parties to establish in more detail the terms of reference and processes which are acceptable to the Review Board, as otherwise there might be uncertainty and delays in the acceptance of a reference.

508. To the extent that they are not provided for in the arrangements described in paragraph 506 above, the terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD and the JRBAC in consultation with the Review Board.

509. It is expected that these processes will be developed by 1 April 2013.

510. For the purposes of this General Review, and subject to the Review Board's comments in paragraph 508 above, the Review Board recommends that paragraphs 504-506 and 508 are incorporated into the GPFAA. These changes to the GPFAA are incorporated in Appendix D.

High level principles for referring disputes to the Review Board

511. In the light of the various issues relating to dispute references, mentioned above, the Review Board has prepared a set of high level principles for a reference to fall under the existing framework arrangements set out in the GPFAA and that it believes should apply to all references it may be asked to undertake. These principles have been discussed and agreed with MOD and the JRBAC. It is recommended that the following should be included as Annex A to Section 1 of the GPFAA under the heading 'Principles for a reference to the Review Board':

a. The general jurisdiction of the Review Board to accept a reference should be framed in clear and concise terms to ensure that time is not wasted in establishing whether or not the Review Board has the power to review and give rulings on any particular reference.

b. The general terms of reference of the Review Board should be defined clearly so all parties understand what the Review Board is required to do and how it will reach its decision.

c. The following principles should apply to a contract reference to the Review Board for Government Contracts:

(i) The Review Board will be making a determination acting as an expert, not acting as an arbitrator, and the provisions of the Arbitration Act 1996 will not apply. The Review Board's expert determination will be final and conclusive and will be enforceable between the parties as a contract term.

(ii) Once a reference has been established following due process (in accordance with paragraph 1.44 of the GPFAA Section 1), the party seeking the reference should submit to the Review Board, in writing, a clear summary of its case identifying any relevant information, setting out the remedy sought and explaining how the matter is within the jurisdiction of the Review Board.

(iii) The Review Board is free to establish procedures and a timetable for each reference, within the framework for references included at paragraph 1.51 of the GPFAA Section 1, according to the individual circumstances. The procedures adopted should enable the Review Board to give its determination on a timely basis, whilst ensuring all parties to the reference have the opportunity to present their case.

(iv) The approach of the Review Board will be inquisitorial. It may make its own enquiries on matters relating to or arising out of the reference and is not restricted to arguments put forward, in whatever form, by the parties.

(v) The parties should not seek to rely on external legal representation to present their case except in very exceptional circumstances. Ultimately it is for the Board to determine whether legal representation will be allowed in presenting either of the parties' case.

(vi) The parties should provide the Review Board with an agreed set of facts. If the parties are unable to agree a joint set of facts, or if it appears to the Review Board that the agreed set of facts is not complete, the Review Board may ask its secretariat to carry out an exercise to establish the facts necessary, in the opinion of the Review Board, to enable the Review Board to reach its determination. In asking the secretariat to undertake such an exercise the Board will take into account the views of the parties and the expected costs and benefits of the exercise.

(vii) Once a party has formally notified the other in writing of its intention to put forward a reference, the parties to the reference should preserve all the information relevant to the reference, whether supporting or adverse to their case, which is in their possession, custody or control.

(viii) The parties to the reference should disclose all relevant information to enable the Review Board to reach its determination, at the outset of the reference, or as requested from time to time by the Review Board.

(ix) The Review Board should be free to call on those witnesses it considers appropriate to explain the facts of the reference. The parties should be obliged to use all reasonable endeavours to make those witnesses available.

(x) The parties should be encouraged to reach a settlement during a reference and the Review Board's expert determination should be a remedy of last resort.

(xi) 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.

(xii) The Review Board shall publish, in its Annual Report, details of its decisions on all individual cases referred to it, together with an assessment of the general considerations which led to these decisions. This publication need not contain the names of the contractors or sub-contractors concerned but if they are to be named the Review Board shall inform them prior to publication. Other than the published decision, the Review Board will not release information on anything said, done or produced in or in relation to the reference process, unless all parties to the reference concur or if the Review Board is required to do so to comply with a statutory or judicial obligation. Where a case has been settled between the parties the Review Board's Annual

Report will include the fact that a reference has been settled but will not include details of the case.

d. The same principles in paragraph 511c above will apply to pre-contract references except that the Review Board decision will be on an advisory basis only, unless the parties agree otherwise.

Amendments to Government Accounting Conventions

512. The MOD has advised the Review Board that it has proposed a number of small changes to the GACs which have been agreed with the JRBAC.

513. The Review Board has reviewed the proposed changes and does not believe that the changes proposed will impact on the Review Board's work in relation to the determination of the GPF rate. Where changes have been proposed, these represent either:

- Confirmation or clarification of existing practice; or
- Changes relating to such low level detail (applicable to CP:CE unit level) that they could not be applied to consolidated accounts and would not, as a result, be applied by the Review Board when determining the GPF rate.

514. The changes agreed by MOD and the JRBAC are the addition of the following:

To be added to Annex D to Section 2, as a new paragraph 4.6.5:
Emission Permit Costs:
Costs incurred to purchase permits under the EU Emissions Trading System ('EU ETS') will be included in attributable costs provided that the contractor can demonstrate that it is taking reasonable measures to minimise its emissions. Attributable costs will be reduced by the value of any credits gained through the sale of permits. The cost of fines or penalties imposed on a contractor for breaches of emissions regulations will be excluded from attributable costs.

To be added to Annex D to Section 2, as a footnote to Part 7, Pensions:
Pension Protection Levy:
Pension Protection Levy reimbursed to pension schemes in whole or in part by companies employing scheme members will be allowed in attributable costs.

Principles embodied in the Review Board's Decision on Contract Reference 2009/2

515. Annex A to Section 3 Part B of the GPFAA sets out the principles embodied in published Review Board decisions arising from references. The Review Board has taken considerable pains to set out the basis on which it has reached its decisions. Consequently, there is a substantial body of 'case law' to provide guidance as to how the Review Board would approach any references. This may have facilitated the resolution of disputes by direct negotiation between the parties and may be one reason for the relatively small number of references made to the Review Board in recent years.

516. The Review Board has reviewed its Decision on Contract Reference 2009/2, reported in the Review Board's 2011 Annual Report, and recommends that the following be added to Annex A to Section 3 Part B of the GPFAA, 'Principles embodied in published Review Board decisions':

7: Decision of the Board on contract reference 2009/2

(a) It is the Board's opinion that, once a reference has been accepted, it is the Board's role to establish whether the pricing of the contract at the time of pricing was fair and reasonable, in the light of all the information available. In order to fulfil the Board's task in accordance with paragraph 1.39 of the GPFAA, and to meet the requirements of paragraphs 1.45 – 1.47 of the GPFAA, the Board considers that it is acting as an expert and has the power:

- to make wide-ranging enquiries;
- to take responses to those enquiries into consideration in any determination that it might make; and
- to consider the surrounding circumstances, including the conduct of the parties.

(b) The Board's role is limited to assessing whether the price negotiated was fair and reasonable *at the time of pricing*, whatever the outcome on the contract.

(c) The Board considers the following are fundamental in relation to fair and reasonable pricing:

- That the requirement for the negotiation of a "fair and reasonable" price is largely fulfilled through compliance with EoI obligations.
- That EoI suggests a mutuality of frankness and confidence between the parties.
- That information likely to affect pricing negotiations should be volunteered to the other party and should not be withheld.
- That, whilst not relieving the party having the information of the primary responsibility for disclosure, there is an obligation to make normal commercial enquiries. A party cannot simply rely on the other party's obligation to volunteer information.
- That there is an EoI obligation at the time of fixing the price of a contract and that this obligation continues, where appropriate, to be effective at other specific points in the contracting process, such as at post-costing.

(d) The Board believes that an individual contract in a programme should be looked at on its merits but that in considering the individual contract it is necessary to consider the circumstances and evolution of all the contracts related to the full programme, given their close relationship, in order to understand properly the circumstances of the individual contract. It follows, therefore, that in looking at the threshold above which a reference may be heard in accordance with paragraph 1.42 of the GPFAA, the Board is satisfied that it only needs to look at the threshold in connection with the individual contract referred to it.

(e) The Board is clear that the relevant point for price fixing in the context of determining a fair and reasonable price is at the acceptance of a contract or contract amendment which should be contemporaneous with the EoI Pricing Statement. This price may well be based on previous discussions and agreements, but unless those discussions and agreements are formally bound into a contract and the contract is specific as to a price fixing point at some time other than the date of the signing of the contract, this must be the date which is relevant for determining a fair and reasonable price.

(f) EoI is the bedrock of non-competitive contracting and is underpinned by the demonstration of good faith. It applies across all non-competitive contracts and is applied in a very specific way for NAPNOC contracts, through the provision of an EoI Pricing Statement, signed by both parties to the contract and annexed to the contract. It is the Board's opinion that for each contract entered into there should be equality of information at the time of entering into the contract.

(g) The Board does not consider that in order to provide EoI between the point of price agreement and the signing of the EoI Pricing Statement it would be expected that a full re-pricing exercise would have to be undertaken. Rather, there is a requirement to identify whether there are reasons that would cause a material change in the agreed price. This may be by reason of price changing events, further information becoming available or assumptions subsequently proving to be inaccurate, which would cause the basis of the price to change. Clearly, the longer the period of time between the initial price agreement and the signing of the EoI Pricing Statement, the greater the likelihood that changes will have taken place.

(h) The Board notes that there will be instances where there are contract costs which are disallowed under the GACs but which, from a contractor's point of view, are genuine contract costs. The Board's view is that the cost certificate presented by the contractor for post-costing should compare costs directly with those incorporated into the EoI Pricing Statement. The Board can envisage situations where it would be helpful for a contractor to inform MoD of costs that it has incurred that were not envisaged or were disallowed at price fixing, which might be relevant when considering the price of subsequent contracts[6].

(i) Whilst it might not be a requirement of the contractor to furnish MoD with forecasts of outcomes during the course of a contract, it would be appropriate to make MoD aware if any forecast, before or at the time of pricing, was different from costs agreed at pricing[6].

(j) Even if an article exceeds the specified performance levels required under a contract, this is not a contractual requirement so it is not appropriate to make any allowance for it in calculating the amount to be awarded.

517. It should be noted that for a better understanding of the Review Board's reasoning behind the principles embodied, it is necessary to refer to the full text of the decision, which has been placed in the House of Commons library.

Updated GPFAA

518. The GPFAA set out in Appendix E of this Report has been updated to incorporate the changes recommended in this Report. To the extent these recommended changes are not accepted, this will be recorded in the Addendum to this Report.

Questionnaire on the Method of Allocation of Costs (QMAC)

519. The Review Board's Report on its 2012 Annual Review noted that the QMAC was being updated through ongoing dialogue between MOD and the JRBAC. The Review Board understands that this process has been completed and the revised QMAC will be implemented as soon as practical from 1 April 2013.

Aims of the GPF

520. Section 1.7 of the GPFAA defines the aim of the GPF as '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

[6] The MOD and the JRBAC note the Review Board's statements at (h) and (i). However, in relation to paragraph (h), MOD and the JRBAC observe that cost certificates are currently prepared in accordance with existing contract conditions that do not require the contractor to compare costs. In relation to (i), MOD and the JRBAC note that this is an example of the existing principle of Equality of Information, rather than a new principle.

as the comparability principle.' As a consequence of this defined aim the Review Board is required to focus its efforts on the setting of an appropriate profit rate for non-competitive Government contracting.

521. Under Section 1.32 of the GPFAA the Review Board is required, taking account of the GACs, to 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; and

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

522. The Review Board has considered each of the items in the previous paragraph and advises as follows:

a. Having analysed the annual returns and post-costing data provided to the Review Board, the Review Board is satisfied that there is no evidence to suggest that the aim of the GPF has not been achieved during the three years under review (considered in Section IV of this Report);

b. In the course of the Review the Review Board has not been presented with any evidence' which suggests that the aim of the GPF requires modification. However, following the Currie Review, discussed elsewhere in this report, the Review Board recognises MOD's intent to broaden the wider aims and objectives of the GPFAA; and

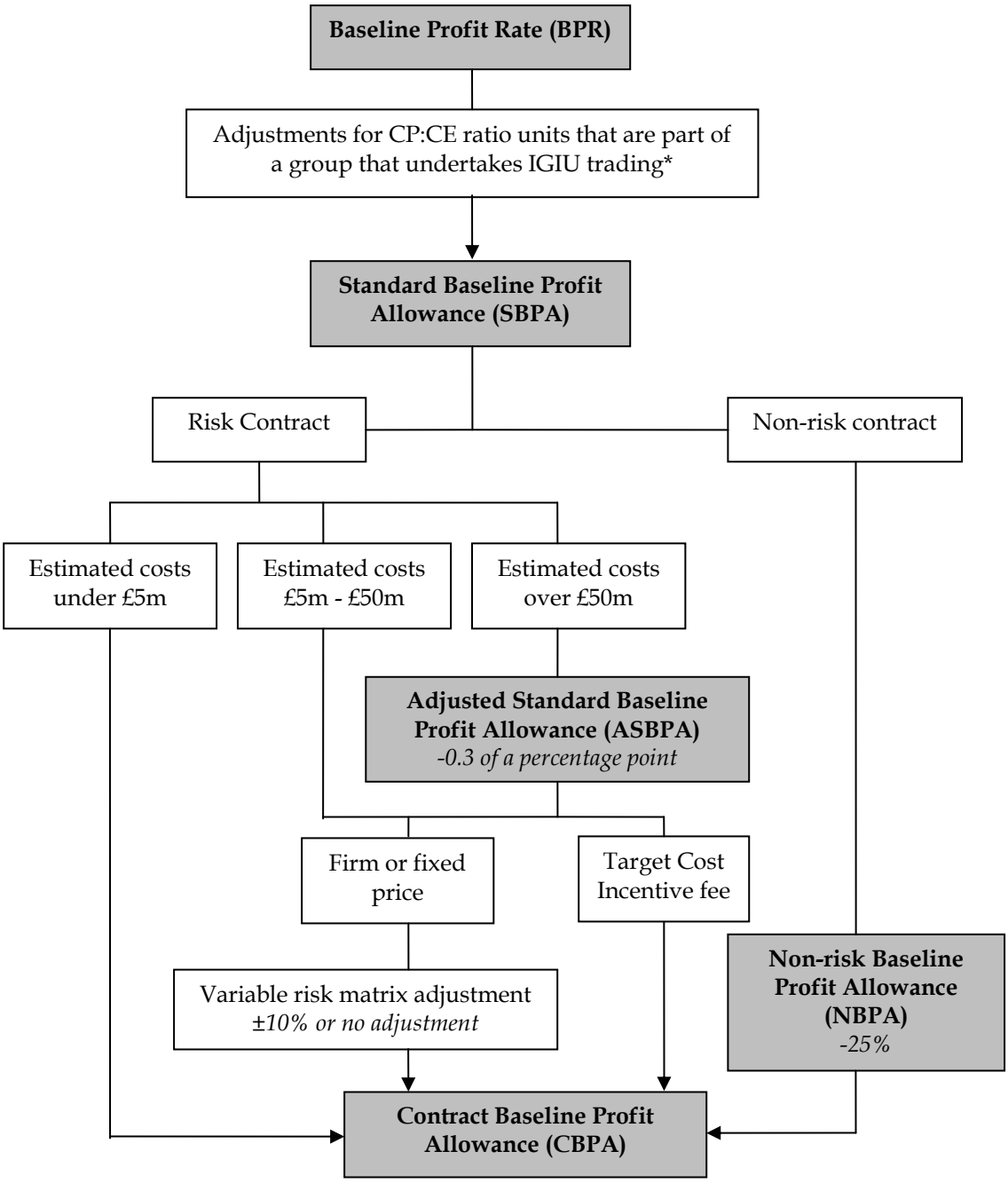
c. The Review Board does not consider that any element of the GPF requires any modification in the light of (a) and (b) above, although the Review Board has recommended changes to elements of the GPF for other reasons explained elsewhere in this Report.

523. The Review Board is satisfied that the GPF itself has met its aim for the three years under review and notes that Lord Currie's report endorsed the approach to calculating the baseline profit allowance based on the principle of comparability. However, the Review Board recognises the need for other aspects of single source pricing to be addressed but these are beyond the scope of the work required of the Review Board as currently set out in the GPFAA.

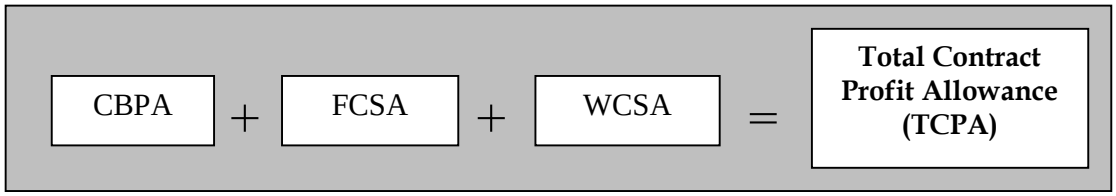
APPENDIX A

BASELINE PROFIT FLOWCHART

Flowchart showing how the Reference Group Baseline Profit Rate is the basis of deriving the Total Contract Profit Allowance for a non-competitive Government contract



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



APPENDIX B

THE RECOMMENDED PROFIT FORMULA - ILLUSTRATIONS

Prepared by the Review Board for Government Contracts – January 2013

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 3.6:1 and a contract attracting the Standard Baseline Profit Allowance;

3. A CP:CE ratio of 6:1, net negative working capital 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; and

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 B: 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	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
(B) Working capital	1,000,000	500,000	-500,000	1,000,000	1,000,000	1,000,000
(C) Total capital (A + B)	3,000,000	2,500,000	1,500,000	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 (D/C)	3	3.6	6	3	3	3
CSA calculation:						
(F) FCSA	6.39%	6.39%	6.39%	6.39%	6.39%	6.39%
(G) FC proportion (A/C)	67.00%	80.00%	133.00%	67.00%	67.00%	67.00%
(H) (F x G)	4.28%	5.11%	8.50%	4.28%	4.28%	4.28%
(I) WCSA (positive)	2.43%	2.43%	2.43%	2.43%	2.43%	2.43%
(J) WC proportion (B/D)	33.00%	20.00%	0.00%	33.00%	33.00%	33.00%
(K) (I x J)	0.80%	0.49%	0.00%	0.80%	0.80%	0.80%
(L) WCSA (negative)	1.42%	1.42%	1.42%	1.42%	1.42%	1.42%
(M) WC proportion (B/D)	0.00%	0.00%	-33.00%	0.00%	0.00%	0.00%
(N) (L x M)	0.00%	0.00%	-0.47%	0.00%	0.00%	0.00%
(O) CSA (H + K + N)	5.08%	5.60%	8.03%	5.08%	5.08%	5.08%
(P) CSA as percentage of CP (O/E)	1.69%	1.56%	1.34%	1.69%	1.69%	1.69%
Individual contract price:						
(Q) Contract CP	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
(R) Standard Baseline Profit Allowance	10.16%	10.16%	10.16%	10.16%	10.16%	10.16%
(S) Adjustment in accordance with the Risk/Reward matrix	nil	nil	nil	-10%	+10%	-25%
(T) Contract Baseline Profit Allowance	10.16%	10.16%	10.16%	9.14%	11.18%	7.62%
(U) CSA (P)	1.69%	1.56%	1.34%	1.69%	1.69%	1.69%
(V) Total Contract Profit Allowance (T + U)	11.85%	11.72%	11.50%	10.83%	12.87%	9.31%
(W) Total formula payments (Q x V)	118,500	117,200	115,000	108,300	128,700	93,100
(X) Total contract price (Q + W)	1,118,500	1,117,200	1,115,000	1,108,300	1,128,700	1,093,100

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 10.16% 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 and with negative working capital. 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 B: ANNEX II

ILLUSTRATION OF THE APPLICATION OF THE RECOMMENDED PROFIT FORMULA UNDER THE INTERIM 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 (D/C)		3	
CSA calculation:			
(F) FCSA		6.39%	
(G) FC proportion (A)		80.00%	
(H) (F x G)		5.11%	
(I) WCSA		2.43%	
(J) WC proportion (B)		20.00%	
(K) (I x J)		0.49%	
(L) CSA (H + K)		5.60%	
(M) CSA as percentage of CP (L/E)		1.87%	
Individual contract price:			
(N) Contract CP		75,000,000	75,000,000
(O) Standard Baseline Profit Allowance	10.16%		
(P) Reduction for contracts over £50m	0.30%		
(Q) Adjusted Standard Baseline Profit Allowance (O – P)		9.86%	
(R) Adjustment in accordance with the Risk/Reward matrix		Nil	
(S) Contract Baseline Profit Allowance		9.86%	
(T) CSA (M)		1.87%	
(U) Total Contract Profit Allowance (S + T)		11.73%	
(V) Total formula payments (N x U)		8,797,500	8,797,500
(W) Total contract price (N + V)			83,797,500

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 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 (i.e. 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 (i.e. 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

Existing GPFAA paragraphs 1.39 to 1.49 marked-up with recommended additions and deletions arising from the 2013 General Review

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, including contract amendments, 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~~ decision of the Review Board will be final and conclusive and the parties to the reference shall take all reasonable steps to give prompt effect to the decision. The Board will act as an expert and not as an arbitrator.

1.40 The Board will consider only ~~Government~~ GPF risk contracts or sub-contracts (as defined in paragraph 1.12), and only those referred in accordance with paragraphs ~~1.41 to 1.43~~ 1.42 to 1.45 below. The task of the Review Board in these circumstances is to assess whether the price ~~negotiated~~ agreed at the time of signing the contract or contract amendment 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.

1.41 The following principles are considered to be fundamental to the concept of 'fair and reasonable' pricing:

(a) The requirement for negotiation of a 'fair and reasonable' price is largely fulfilled through compliance with equality of information obligations.

(b) Equality of information suggests a mutuality of frankness and confidence between the parties.

(c) Information likely to have a material impact on pricing negotiations and price fixing should be volunteered to the other party and should not be withheld.

(d) Whilst not relieving the party having the information of the primary responsibility for disclosure, there is an obligation on the other party to make normal commercial enquiries and follow them up accordingly. One party cannot rely solely on the other party's obligation to volunteer information.

(e) There is an equality of information obligation at the time of fixing the price of a contract, i.e. when the contract is signed. This obligation continues, where appropriate, to be effective at other specific points in the contracting process, such as at post-costing (where information is required under the contract terms to be disclosed to the other party) or where there are significant contract amendments.

(f) The price should reflect reasonable costs (whether estimated or actual) in performing the contract requirement and a fair return calculated by reference to the GPF rate applicable at the time of pricing.

1.42 ~~For the purpose of interpreting paragraph 1.39 above and subject to the provisions of paragraphs 1.41 to 1.43 below: GPF risk contracts comprise~~ In considering whether to accept a reference, the Review Board may review only those contracts or contract amendments (including amendments to contracts other than GPF risk contracts) placed with contractors by Government departments which:

(a) incorporate a condition covering ~~availability of information~~ circumstances where contracts can be referred to the Review Board (normally DEFCON 650, which has been derived from Standard Condition No. ~~48 'Availability of Information'~~ 50 'References To The Review Board Of Questions Arising Under The Contract' of Form

GC/Stores/1, ~~from which MOD has derived DEFCON 648~~ or DEFCON 650A); and ~~requiring the contractor to provide on request information to the department in connection with a post-costing investigation of the contract; and~~

(b) include in the price (or the target price) an allowance for profit calculated ~~at~~ by reference to the GPF rate applicable at the time of pricing. ~~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.~~

1.43 ~~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~~ A reference may be made either by the Government department or by the contractor (or sub-contractor, where appropriate) 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.~~

1.44 A contract or sub-contract incorporating a condition such as ~~is mentioned at paragraph 1.41 above~~ DEFCON 650 or DEFCON 651 (or equivalent condition covering reference of the contract to the Review Board) may, subject to the terms of that condition, be referred to the Review Board by any party entitled to make such a reference where it appears to either party that:

(a) a variance of or exceeding 10% between the estimated and outturn cost has occurred; or

(b) the achievement of a fair and reasonable price for the Contract was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

1.45 A contract or subcontract incorporating a condition such as DEFCON 650A or 651A (or equivalent condition covering reference of the contract to the Review Board) 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.~~ it appears to either party:

(a) that:

(i) ~~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 1.42 above, any party entitled to make a reference may do so if it considers~~ the outturn profit exceeds the profit allowance applicable to the Contract Price in accordance with the relevant Government Profit Formula by a sum greater than five percent of the Contract Price;

(ii) the outturn costs exceed the Contract Price by a sum greater than five per cent of the Contract Price; or

(iii) the Contractor fails to submit an adequate summary of costs under DEFCON 696

and there is a serious inequity that is not remedied by the provisions of DEFCON 648A Clause 4; or

(b) that the achievement of a fair and reasonable price for the Contract was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

1.46 ~~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~~ 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.

1.47 In considering any reference to it of any individual contract or sub-contract, the Review Board ~~shall have especial regard to~~ may consider:

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

(b) the ~~standard of efficiency with which the contract or sub-contract was performed~~ the circumstances surrounding the pricing and performance of the contract;

(c) principles embodied in previously published Review Board decisions (a summary of which is set out in Annex A of section 3 of the GPFAA); and

(d) any other consideration that either party considers relevant and brings to the attention of the Review Board.

~~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) 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.~~

1.48 In considering the amount of any award the Review Board:

(a) will seek to put the parties into the position that they would have been had equality of information been observed; and

(b) may adjust its award resulting from (a) above to take account of the surrounding circumstances, including the conduct of the parties.

1.49 If, in the course of a contract reference, it appears to the Review Board that there may have been a criminal offence or regulatory breach justifying further action it may refer the matter to MOD or to an alternative authority and will do so if required by law.

1.50 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 the time the price ~~fixing~~ was fixed 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 the time the price ~~fixing~~ was fixed.

1.51 The Government and the CBI have agreed the following framework, within which the Review Board ~~would~~ will 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~~ the reference to the parties 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~~ such as those listed in paragraph ~~1.45~~ 1.47 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.

1.52 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. The Review Board should positively encourage and facilitate settlement between the parties. 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. The Review Board's Annual Report will include the fact that a reference has been settled but will not include details of the case.

Terms of reference and jurisdiction of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs[7]

1.53 In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[7], the Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.

1.54 In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[7], the Government and the CBI have also agreed that disputes relating to certain terms, such as the failure to supply an adequate summary of costs incurred and disproportionate actions may be referred to the Review Board.

1.55 The bases for a referral to the Review Board, whether for a pre-contractual cost-based dispute or for an individual contract referral made other than through the provisions of the pricing DEFCONs[7], are any of the following:

(a) where there is a statutory provision that provides for a reference to be made by the Government, a supplier, or both;

(b) where there is an agreement between the Government and a supplier that provides for a reference to be made by the Government, a supplier, or both; and

(c) where there is a procurement contract between the Government and a supplier that includes a term, other than SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A, that provides for a reference to be made by the Government, a supplier, or both.

1.56 To the extent that they are not provided for in the arrangements described in paragraph 1.55 above, the terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD and the JRBAC in consultation with the Review Board.

1.57 Principles which the Review Board will adopt in support of paragraphs 1.39 to 1.56 are attached at Annex A to this Section 1.

[7] In this context the term 'pricing DEFCONs' refers to SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

APPENDIX D: ANNEX I

Wording to be included as Annex A to Section 1 of the GPFAA (see paragraph 1.57 of Appendix D of the Report on the 2013 General Review)

ANNEX A to SECTION 1: Principles for a reference to the Review Board

1. The general jurisdiction of the Review Board to accept a reference should be framed in clear and concise terms to ensure that time is not wasted in establishing whether or not the Review Board has the power to review and give rulings on any particular reference.

2. The general terms of reference of the Review Board should be defined clearly so all parties understand what the Review Board is required to do and how it will reach its decision.

3. The following principles should apply to a contract reference to the Review Board for Government Contracts:

(a) The Review Board will be making a determination acting as an expert, not acting as an arbitrator, and the provisions of the Arbitration Act 1996 will not apply. The Review Board's expert determination will be final and conclusive and will be enforceable between the parties as a contract term.

(b) Once a contract reference has been established following due process (in accordance with paragraph 1.44 of the GPFAA Section 1), the party seeking the reference should submit to the Review Board, in writing, a clear summary of its case identifying any relevant information, setting out the remedy sought and explaining how the matter is within the jurisdiction of the Review Board.

(c) The Review Board is free to establish procedures and a timetable for each reference, within the framework for references included at paragraph 1.51 of the GPFAA Section 1, according to the individual circumstances. The procedures adopted should enable the Review Board to give its determination on a timely basis, whilst ensuring all parties to the reference have the opportunity to present their case.

(d) The approach of the Review Board will be inquisitorial. It may make its own enquiries on matters relating to or arising out of the reference and is not restricted to arguments put forward, in whatever form, by the parties.

(e) The parties should not seek to rely on external legal representation to present their case except in very exceptional circumstances. Ultimately it is for the Review Board to determine whether legal representation will be allowed.

(f) The parties should provide the Review Board with an agreed set of facts. If the parties are unable to agree a joint set of facts, or if it appears to the Review Board that the agreed set of facts is not complete, the Review Board may ask its secretariat to carry out an exercise to establish the facts necessary, in the opinion of the Review Board, to enable the Review Board to reach its determination. In asking the secretariat to undertake such an exercise the Review Board will take into account the views of the parties and the expected costs and benefits of the exercise.

(g) Once a party has formally notified the other in writing of its intention to put forward a contract reference, the parties to the reference should preserve all the information relevant to the reference, whether supporting or adverse to their case, which is in their possession, custody or control.

(h) The parties to the reference should disclose all relevant information to enable the Review Board to reach its determination, at the outset of the reference, or as requested from time to time by the Review Board.

(i) The Review Board should be free to call on those witnesses it considers appropriate to explain the facts of the reference. The parties should be obliged to use all reasonable endeavours to make those witnesses available.

(j) The parties should be encouraged to reach a settlement during a reference and the Review Board's expert determination should be a remedy of last resort.

(k) 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.

(l) The Review Board shall publish, in its Annual Report, details of its decisions on all individual cases referred to it, together with an assessment of the general considerations which led to these decisions. This publication need not contain the names of the contractors or sub-contractors concerned but if they are named the Review Board shall inform them prior to publication. Other than the published decision, the Review Board will not release information on anything said, done or produced in or in relation to the reference process, unless all parties to the reference concur or if the Review Board is required to do so to comply with a statutory or judicial obligation. Where a case has been settled between the parties the Review Board's Annual Report will include the fact that a reference has been settled but will not include details of the case.

4. The same principles in paragraph 3 above will apply to pre-contract references except that the Review Board decision will be on an advisory basis only, unless the parties agree otherwise.

APPENDIX E

THE GOVERNMENT PROFIT FORMULA AND ITS ASSOCIATED ARRANGEMENTS UPDATED FOR THE RECOMMENDATIONS CONTAINED IN THE REPORT ON THE 2013 GENERAL REVIEW OF THE PROFIT FORMULA FOR NON-COMPETITIVE GOVERNMENT CONTRACTS

The GPFAA as reproduced below reflects the accepted position following the 2012 Annual Review as amended for the Review Board's recommendations in its Report on the 2013 General Review of the Government Profit Formula.

Summary of the Review Board's recommended changes to the GPFAA contained in the Report on the 2013 General Review

The following are the main areas of change recommended by the Review Board:

(a) Section 1, paragraphs 1.39 to 1.49 have been replaced by paragraphs 1.39 to 1.57 and Annex A to Section 1 of the GPFAA.

(b) Section 2 has been updated to reflect recommendations for the 2013 General Review profit rate and Capital Servicing Allowances and updates to the Government Accounting Conventions to clarify the allowability of Emission Permit Costs and the Pension Protection Levy.

(c) Section 3 has been updated to reflect changes in Capital Servicing Allowances, IGIU methodology, Review Board assistance to resolve disagreements and for principles arising as a result of Decision 2009/2.

THE GOVERNMENT PROFIT FORMULA and its ASSOCIATED ARRANGEMENTS

EXPLANATION OF TERMS AND ABBREVIATIONS

Acquisition Operating Framework ('AOF')	A web based tool that sets out MOD's acquisition policy and practice and which can be located at www.gov.uk/acquisition-operating-framework.
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 Government Profit Formula, undertaken annually between General Reviews. The most recent such review, the 2012 Annual Review, was published by The Stationery Office (ISBN 978-0-11-773107-3) in 2012.
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 i.e. immediately above non investment grade.
CBI	Confederation of British Industry.
CE	Capital employed.
Comparability principle	The aim of the Government Profit Formula, which is to give contractors engaged in non-competitive Government contract work a return equal on average to the overall return earned by British industry having regard to both capital employed and the cost of production.
Contract Baseline Profit Allowance ('CBPA')	The profit allowance on cost applicable to a specific contract after making all appropriate adjustments in accordance with the risk/reward matrix.

Contractor Group	A generic term for the group of contractors who are engaged in non-competitive Government work using the Government Profit Formula. The composition of the group may vary from year to year.
CP	Cost of production.
CP:CE ratio	The ratio formed by dividing a contractor's cost of production by its capital employed. This ratio is used to attribute to individual contracts a proportion of the contractor's capital employed.
CP:CE ratio unit	The business unit or other sub-division of a contractor's business for which a CP:CE ratio is calculated for the purposes of pricing non-competitive Government contracts.
CSAs	Capital Servicing Allowances, a term used to refer to Fixed Capital Servicing Allowances and Working Capital Servicing Allowances collectively.
Currie Review	An independent report by Lord Currie of Marylebone into the Single Source Pricing Regulations used by MOD, dated October 2011, together with ongoing consultations between MOD and industry where the context requires.
DEFCONs	The series of defence contract conditions applicable to MOD contracts. These are contained in the Commercial Managers' Toolkit which can be accessed on the MOD's Acquisition Operating Framework website. DEFCONs replaced the Standard Conditions of Government Contracts for Stores Purchases.
EBIT	Earnings before Interest and Tax.
FCSA	The Fixed Capital Servicing Allowance provided to contractors for their investment in tangible and, subject to the GACs, capitalised intangible assets.
Financial Reporting Standard ('FRS') 17	The accounting standard on retirement benefits issued by the Accounting Standards Board which replaced SSAP 24 with effect from 1 January 2005.
Firm Price	A price, agreed for the articles or services, or both, which is not subject to variation.
Fixed Price	A price, agreed for the articles or services, or both, that is subject to variation in accordance with the variation of price provision of the contract.

General Review	The review conducted by the Review Board, usually triennially, at which all aspects of non-competitive Government contracts are open to examination. The most recent such review, prior to the 2013 General Review, was the 2010 General Review, published by The Stationery Office (ISBN 978-0-11-773095-3) in 2010.
Government Accounting Conventions ('GACs')	The accounting conventions used for the determination of costs and capital employed attributable to non-competitive Government contracts.
Government Profit Formula and its Associated Arrangements ('GPFAA')	The Government Profit Formula ('GPF') incorporating the 1968 Memorandum of Agreement between the Government and the CBI and subsequent revisions and changes since that time, as agreed between the representatives of Government and the CBI. The GPFAA sets out the arrangements for placing and pricing non-competitive Government contracts.
Government Profit Formula ('GPF')	The formula for determining 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.
International Accounting Standards ('IASs')	International Accounting Standards issued by the International Accounting Standards Committee, the body that preceded (1973-2001) the International Accounting Standards Board.
International Financial Reporting Standards ('IFRSs')	International Financial Reporting Standards issued by the International Accounting Standards Board.
Intra-group inter-unit trading ('IGIU')	Trading between different CP:CE 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.
LIBID	London Interbank Bid Rate.
LIBOR	London Interbank Offered Rate.
Maximum Price Target Cost ('MPTC')	A pricing basis whereby a target cost and a target fee are agreed at the outset, along with a formula that sets out how the Government and the contractor will share cost over-runs and cost savings. Where such an arrangement is subject to an overall maximum price, it is usually referred to as a MPTC contract.

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

Reference Group	The group of UK companies representative of British industry whose average rate of return is used by the Review Board to determine the target rate of return in the Government Profit Formula.
Risk contract	A contract with a pricing arrangement which does not insulate the contractor against loss.
Risk/Reward matrix	The 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. The current Risk/Reward matrix is set out in the GPFAA – Section 2 Annex B.
Single Source Pricing Regulations ('SSPRs')	Regulations intended to be introduced by the MOD in 2013 and 2014 and then governed by the SSRO. These Regulations will replace the GPFAA.
Single Source Regulations Office ('SSRO')	The body recommended in the Currie Review, with wider powers and remit, intended to replace the Review Board when formally established and resourced.
Standard Baseline Profit Allowance ('SPBA')	The profit allowance on cost applicable to all GPF contracts and amendments after adjustments to the BPR as appropriate.
Standard Conditions of Government Contracts for Stores Purchases (SCs)	The series of conditions applicable to Government contracts published as Form GC/STORES/1 and now replaced by similar DEFCONs in contracting with MOD.
Statement of Standard Accounting Practice ('SSAP') 24	The accounting standard issued by the Accounting Standards Board concerning the accounting for, and the disclosure of, pension costs and commitments in the financial statements of enterprises. For UK listed companies this has now been superseded by IAS 19, and by FRS 17 for other UK companies that have not elected to adopt IAS 19.
Target Cost Incentive Fee ('TCIF') Contracting	A pricing basis whereby a target cost and a target fee are agreed at the outset, along with a formula which sets out how the Government and the contractor will share cost over-runs and cost savings.
The 1968 Memorandum of Agreement	The agreement between the Government and the CBI establishing the Review Board.
The Profit Formula Agreement	The Profit Formula Agreement, which supersedes the 1968 Memorandum of Agreement, the 1968 Profit Formula Agreement and all subsequent amendments thereto, is now made up of three sections: Section 1 Principles, Section 2 Arrangements agreed following the 2012 Review, and Section 3 Review Board Guidance.

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 Review 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.
UITF 17	Urgent Issues Task Force Abstract 17 Employee Share Schemes. UITF abstracts are issued by the Accounting Standards Board to assist in the identification of acceptable accounting treatment for various issues.
UK GAAP	UK Generally Accepted Accounting Practice.
WCSA	The Working Capital Servicing Allowance provided to contractors for their investment in working capital.

THE GOVERNMENT PROFIT FORMULA and its ASSOCIATED ARRANGEMENTS

GPFAA updated for recommendations contained in the report on the 2013 General Review of the profit formula for non-competitive Government contracts

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 2009 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 Baseline Profit Rate derived from the baseline profit of the Reference Group, adjusted if necessary in accordance with paragraphs 1.9 to arrive at the Standard Baseline Profit Allowance (SBPA) and 1.10, 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) and not in the FCSA and WCSA.

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

1.9. The 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 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 DEFCON 643 (which has been derived from Standard Condition No. 43 'Price Fixing' of Form GC/Stores/1).

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 DEFCON 648 (which has been derived from Standard Condition No. 48 'Availability of Information' in Form GC/Stores/1).

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 DEFCON 643 (which has been derived from Standard Condition 43 'Price Fixing' of Form GC/Stores/1) 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 DEFCON 648 (which has been derived from Standard Condition 48 'Availability of Information' of Form GC/Stores/1) 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. No Annual Return provided by any individual contractor will be made available in any way to any Government department.

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, including contract amendments, and sub-contracts that are referred to it by either of the parties. By the terms of contract the decision of the Review Board will be final and conclusive and the parties to the reference shall take all reasonable steps to give prompt effect to the decision. The Board will act as an expert and not as an arbitrator.

1.40. The Board will consider only GPF risk contracts or sub-contracts (as defined in paragraph 1.12), and only those referred in accordance with paragraphs 1.42 to 1.45 below. The task of the Review Board in these circumstances is to assess whether the price agreed at the time of signing the contract or contract amendment 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.

1.41. The following principles are considered to be fundamental to the concept of 'fair and reasonable' pricing:

(a) The requirement for negotiation of a 'fair and reasonable' price is largely fulfilled through compliance with equality of information obligations.

(b) Equality of information suggests a mutuality of frankness and confidence between the parties.

(c) Information likely to have a material impact on pricing negotiations and price fixing should be volunteered to the other party and should not be withheld.

(d) Whilst not relieving the party having the information of the primary responsibility for disclosure, there is an obligation on the other party to make normal commercial enquiries and follow them up accordingly. One party cannot rely solely on the other party's obligation to volunteer information.

(e) There is an equality of information obligation at the time of fixing the price of a contract, i.e. when the contract is signed. This obligation continues, where appropriate, to be effective at other specific points in the contracting process, such as at post-costing (where information is required under the contract terms to be disclosed to the other party) or where there are significant contract amendments.

(f) The price should reflect reasonable costs (whether estimated or actual) in performing the contract requirement and a fair return calculated by reference to the GPF rate applicable at the time of pricing.

1.42. In considering whether to accept a reference, the Review Board may review only those contracts or contract amendments (including amendments to contracts other than GPF risk contracts) placed with contractors by Government departments which:

(a) incorporate a condition covering circumstances where contracts can be referred to the Review Board (normally DEFCON 650, which has been derived from Standard Condition No. 50 'References To The Review Board Of Questions Arising Under The Contract' of Form GC/Stores/1, or DEFCON 650A); and

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

1.43. A reference may be made either by the Government department or by the contractor (or sub-contractor, where appropriate) or jointly by both these parties to the contract.

1.44. A contract or sub-contract incorporating a condition such as DEFCON 650 or DEFCON 651 (or equivalent condition covering reference of the contract to the Review Board) may, subject to the terms of that condition, be referred to the Review Board by any party entitled to make such a reference where it appears to either party that:

(a) a variance of or exceeding 10% between the estimated and outturn cost has occurred; or

(b) the achievement of a fair and reasonable price for the Contract was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

1.45. A contract or subcontract incorporating a condition such as DEFCON 650A or 651A (or equivalent condition covering reference of the contract to the Review Board) may, subject to the terms of that condition, be referred to the Review Board by any party entitled to make such a reference where it appears to either party:

(a) that:

(i) the outturn profit exceeds profit allowance applicable to the Contract Price in accordance with the relevant Government Profit Formula by a sum greater than five percent of the Contract Price; or

(ii) the outturn costs exceed the Contract Price by a sum greater than five per cent of the Contract Price; or

(iii) the Contractor fails to submit an adequate summary of costs under DEFCON 696

and there is a serious inequity that is not remedied by the provisions of DEFCON 648A Clause 4; or

(b) that the achievement of a fair and reasonable price for the Contract was frustrated because the information on which it was based has proved to be materially inaccurate or incomplete.

1.46. 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 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.

1.47. In considering any reference to it of any individual contract or sub-contract, the Review Board may consider:

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

(b) the circumstances surrounding the pricing and performance of the contract;

(c) principles embodied in previously published Review Board decisions (a summary of which is set out in Annex A of section 3 of the GPFAA); and

(d) any other considerations that either party considers relevant and brings to the attention of the Review Board.

1.48. In considering the amount of any award the Review Board:

(a) will seek to put the parties into the position that they would have been had equality of information been observed; and

(b) may adjust its award resulting from (a) above to take account of the surrounding circumstances, including the conduct of the parties.

1.49. If, in the course of a contract reference, it appears to the Review Board that there may have been a criminal offence or regulatory breach justifying further action it may refer the matter to MOD or to an alternative authority and will do so if required by law.

1.50. 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 the time the price was fixed 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 the time the price was fixed.

1.51. The Government and the CBI have agreed the following framework, within which the Review Board will 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 the reference to the parties in a written report signed by the Chairman. 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 (such as those listed in paragraph 1.47 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.

1.52. 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. The Review Board should positively encourage and facilitate settlement between the parties. 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. The Review Board's Annual Report will include the fact that a reference has been settled but will not include details of the case.

Terms of reference and jurisdiction of the Review Board in relation to disputes other than those referred through the provisions of the pricing DEFCONs[8]

1.53. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[8], the Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.

1.54. In addition to the review of individual contracts and subcontracts through the provisions of the pricing DEFCONs[8], the Government and the CBI have also agreed that disputes relating to certain terms, such as the failure to supply an adequate summary of costs incurred and disproportionate actions may be referred to the Review Board.

1.55. The bases for a referral to the Review Board, whether for a pre-contractual cost-based dispute or for an individual contract referral made other than through the provisions of the pricing DEFCONs[8], the circumstances for contract referral under paragraphs 1.53 and 1.54 are any of the following:

(a) where there is a statutory provision that provides for a reference to be made by the Government, a supplier, or both;

(b) where there is an agreement between the Government and a supplier that provides for a reference to be made by the Government, a supplier, or both; and

(c) where there is a procurement contract between the Government and a supplier that includes a term, other than SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A, that provides for a reference to be made by the Government, a supplier, or both.

1.56. To the extent that they are not provided for in the arrangements described in paragraph 1.55 above, the terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD

[8] In this context the term 'pricing DEFCONs' refers to SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A.

and the JRBAC in consultation with the Review Board to the extent that they are not provided for in the arrangements described in paragraph 1.55 above.

1.57. Principles which the Review Board will adopt in support of paragraphs 1.39 to 1.56 are attached at Annex A to this Section 1.

ANNEX A to SECTION 1: Principles for a reference to the Review Board

1. The general jurisdiction of the Review Board to accept a reference should be framed in clear and concise terms to ensure that time is not wasted in establishing whether or not the Review Board has the power to review and give rulings on any particular reference.

2. The general terms of reference of the Review Board should be defined clearly so all parties understand what the Review Board is required to do and how it will reach its decision.

3. The following principles should apply to a contract reference to the Review Board for Government Contracts:

(a) The Review Board will be making a determination acting as an expert, not acting as an arbitrator, and the provisions of the Arbitration Act 1996 will not apply. The Review Board's expert determination will be final and conclusive and will be enforceable between the parties as a contract term.

(b) Once a contract reference has been established following due process (in accordance with paragraph 1.44 of the GPFAA Section 1), the party seeking the reference should submit to the Review Board, in writing, a clear summary of its case identifying any relevant information, setting out the remedy sought and explaining how the matter is within the jurisdiction of the Review Board.

(c) The Review Board is free to establish procedures and a timetable for each reference, within the framework for references included at paragraph 1.51 of the GPFAA Section 1, according to the individual circumstances. The procedures adopted should enable the Review Board to give its determination on a timely basis, whilst ensuring all parties to the reference have the opportunity to present their case.

(d) The approach of the Review Board will be inquisitorial. It may make its own enquiries on matters relating to or arising out of the reference and is not restricted to arguments put forward, in whatever form, by the parties.

(e) The parties should not seek to rely on external legal representation to present their case except in very exceptional circumstances. Ultimately it is for the Review Board to determine whether legal representation will be allowed.

(f) The parties should provide the Review Board with an agreed set of facts. If the parties are unable to agree a joint set of facts, or if it appears to the Review Board that the agreed set of facts is not complete, the Review Board may ask its secretariat to carry out an exercise to establish the facts necessary, in the opinion of the Review Board, to enable the Review Board to reach its determination. In asking the secretariat to undertake such an exercise the Review Board will take into account the views of the parties and the expected costs and benefits of the exercise.

(g) Once a party has formally notified the other in writing of its intention to put forward a contract reference, the parties to the reference should preserve all the information relevant to the reference, whether supporting or adverse to their case, which is in their possession, custody or control.

(h) The parties to the reference should disclose all relevant information to enable the Review Board to reach its determination, at the outset of the reference, or as requested from time to time by the Review Board.

(i) The Review Board should be free to call on those witnesses it considers appropriate to explain the facts of the reference. The parties should be obliged to use all reasonable endeavours to make those witnesses available.

(j) The parties should be encouraged to reach a settlement during a reference and the Review Board's expert determination should be a remedy of last resort.

(k) 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.

(l) The Review Board shall publish, in its Annual Report, details of its decisions on all individual cases referred to it, together with an assessment of the general considerations which led to these decisions. This publication need not contain the names of the contractors or sub-contractors concerned but if they are named the Review Board shall inform them prior to publication. Other than the published decision, the Review Board will not release information on anything said, done or produced in or in relation to the reference process, unless all parties to the reference concur or if the Review Board is required to do so to comply with a statutory or judicial obligation. Where a case has been settled between the parties the Review Board's Annual Report will include the fact that a reference has been settled but will not include details of the case.

4. The same principles in paragraph 3 above will apply to pre-contract references except that the Review Board decision will be on an advisory basis only, unless the parties agree otherwise.

SECTION 2: Arrangements agreed following the 2013 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[9] shall be:

(a) linked to the 7 year moving average of the 15 year Sterling BBB corporate bond rate; adjusted for

(b) the spread between 10 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling-denominated BBB and BBB- corporate bond rates.

Based on rates prevailing up to 30 November 2012, this gives an FCSA of 6.39%.

Working Capital Servicing Allowance (WCSA)

2.3. For positive working capital balances the WCSA[10] shall be:

(a) linked to the 36 month moving average of one year Sterling BBB corporate bond rates; adjusted for

(b) the spread between 1 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling-denominated BBB and BBB- corporate bond rates.

Based on rates prevailing up to 30 November 2012, this gives a WCSA for positive working capital balances of 2.43%.

2.4. A negative WCSA shall be calculated for any contractor having net 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. For negative working capital balances the WCSA shall be one month LIBID where one month LIBID is defined as one year LIBOR less 1/8 of a percentage point (0.125%). Based on rates prevailing up to 30 November 2012, this gives a WCSA for negative working capital balances of 1.42%.

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.

[9] See GPFAA 3.20 to 3.25 for further background explanation of FCSA.
[10] See GPFAA 3.26 and 3.32 for further background explanation of WCSA.

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 average of the returns that companies in the Reference Group earn on their uncapitalised intangible assets and for the risks they assume.

2.7. The Baseline Profit Rate shall be determined on a three year rolling average basis. Based on the rates for 2009, 2010 and 2011, this gives a BPR of 10.16%, as follows:

	2007/8 Reference Group £m	2008/9 Reference Group £m	2009/10 Reference Group £m	2010/11 Reference Group £m	2011/12 Reference Group £m
(A) Cost of Production	477,563	687,083	705,897	718,833	711,002
(B) Capital Employed	185,913	224,567	232,951	221,846	215,478
(C) CP:CE ratio (A÷B)	2.57	3.06	3.03	3.24	3.30
(D) FC ratio (see Note 1)	89%	101%	109%	112%	111%
(E) WC (positive) (see Notes 1, 2)	11%	n/a	n/a	n/a	14%
(F) WC (negative) (see Notes 1, 2)	n/a	-1%	-9%	-12%	-25%
(G) Actual Profit (EBIT)	58,073	71,812	81,523	88,709	93,739
(H) FCSA % (see Note 1)	6.70%	6.68%	6.71%	6.63%	6.48%
(I) WCSA % (positive) (see Notes 1, 2)	6.55%	6.66%	5.30%	3.80%	2.77%
(J) WCSA % (negative) (see Notes 1, 2)	6.55%	6.66%	5.30%	3.80%	1.41%
(K) FCSA (B×(D÷100)×H)	11,086	15,162	17,035	16,473	15,499
(L) WCSA(pos+) (B×(E÷100)×I)	1,340	n/a	n/a	n/a	836
(M) WCSA(neg-) (Bx(F÷100)×J)	n/a	(149)	(1,112)	(1,012)	(760)
(N) Total CSA (K+L+M)	12,425	15,014	15,923	15,462	15,575
(O) Baseline Profit (G-N)	45,647	56,798	65,600	73,247	78,164
(P) BP as % of CP (O÷A)	9.56%	8.27%	9.29%	10.19%	10.99%
3 year rolling average	**10.14%**	**9.29%**	**9.04%**	**9.25%**	**10.16%**

Note 1. The FCSA and WCSA percentage figures are derived using the data applicable as at 31 March of the year concerned.
Note 2. As part of the 2013 GR, it was agreed that separate rates should be applied to the Reference Group's positive and negative working capital balances in order to determine the value of the Capital Servicing Allowances. This has been calculated as from the 2011/12 Reference Group. Previously, a single WCSA% was applied to both positive and negative working capital balances, effectively applying a single rate to the net working capital. Therefore the working capital balances up to 2010/11 in the above table reflect the net position.
Note 3. Figures in the table are subject to rounding differences.

Standard Baseline Profit Allowance (SBPA)

2.8. The Reference Group Baseline Profit on cost of production of 10.16% 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 Contractor Group. Such adjustments, for any divergence between strict comparability between Reference Group profitability and GPF profitability, are exceptional and there was no such adjustment made for the 2013 General Review.

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 IFRS. 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[11] for each corporate group of companies needs to be assessed and its effect eliminated.

2.10. For contractors that are part of a group that do not undertake IGIU trading the recommended SBPA is the same as the recommended BPR. However, individual CP:CE units will agree lower SBPA rates with MOD if they are part of a group that undertakes IGIU trading.

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

2.11. 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

2.12. 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) CP:CE ratio units that are part of a group that does not undertake IGIU trading with a reduction of 30 basis points[12] from 10.16% (the SBPA) to 9.86% (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. For CP:CE ratio units which are part of a group with IGIU trading a reduced ASBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading;

(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) CP:CE ratio units that are part of a group that does not undertake IGIU trading with a reduction of 25% from 10.16% to 7.62% (the Non-risk Baseline Profit Allowance (NBPA)) in the baseline profit allowance applicable to contracts priced on a non-risk basis. For CP:CE ratio units where part of a group with IGIU trading a reduced NBPA will be computed and agreed with MOD so as to eliminate the impact of their IGIU trading.

Summary

2.13. 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 April 2013 shall be:

[11] 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 e.g. 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.

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

		%
FCSA	Fixed Capital Servicing Allowance (para 2.2)	6.39 on FC
WCSA (pos)	Working Capital Servicing Allowance (para 2.3)	2.43 on WC
WCSA (neg)	Working Capital Servicing Allowance (para 2.4)	1.42 on WC
BPA	Baseline Profit Allowance (para 2.8)	10.16 on CP
SBPA and NBPA	For CP:CE ratio units that are part of a group that Does not undertake IGIU trading be 9.86% and 7.62% respectively. For CP:CE ratio units which are part of a group with IGIU trading these rates will be computed and agreed with MOD so as to further eliminate the impact of their IGIU trading.	

ARRANGEMENTS ASSOCIATED with the PROFIT FORMULA

Unconscionable profits and losses

2.14. 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.

2.15. 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.

2.16. 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.

2.17. A reference under these circumstances would follow the same procedures as a normal contract reference as described at paragraphs 1.39 to 1.52. 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

2.18. 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.

2.19. 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.

2.20. 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.

2.21. 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.

2.22. If either the contractor or the Government is required to make a payment to the other as determined by the Board (see paragraph 2.17) or otherwise (see paragraphs 2.15 and 2.21) 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;

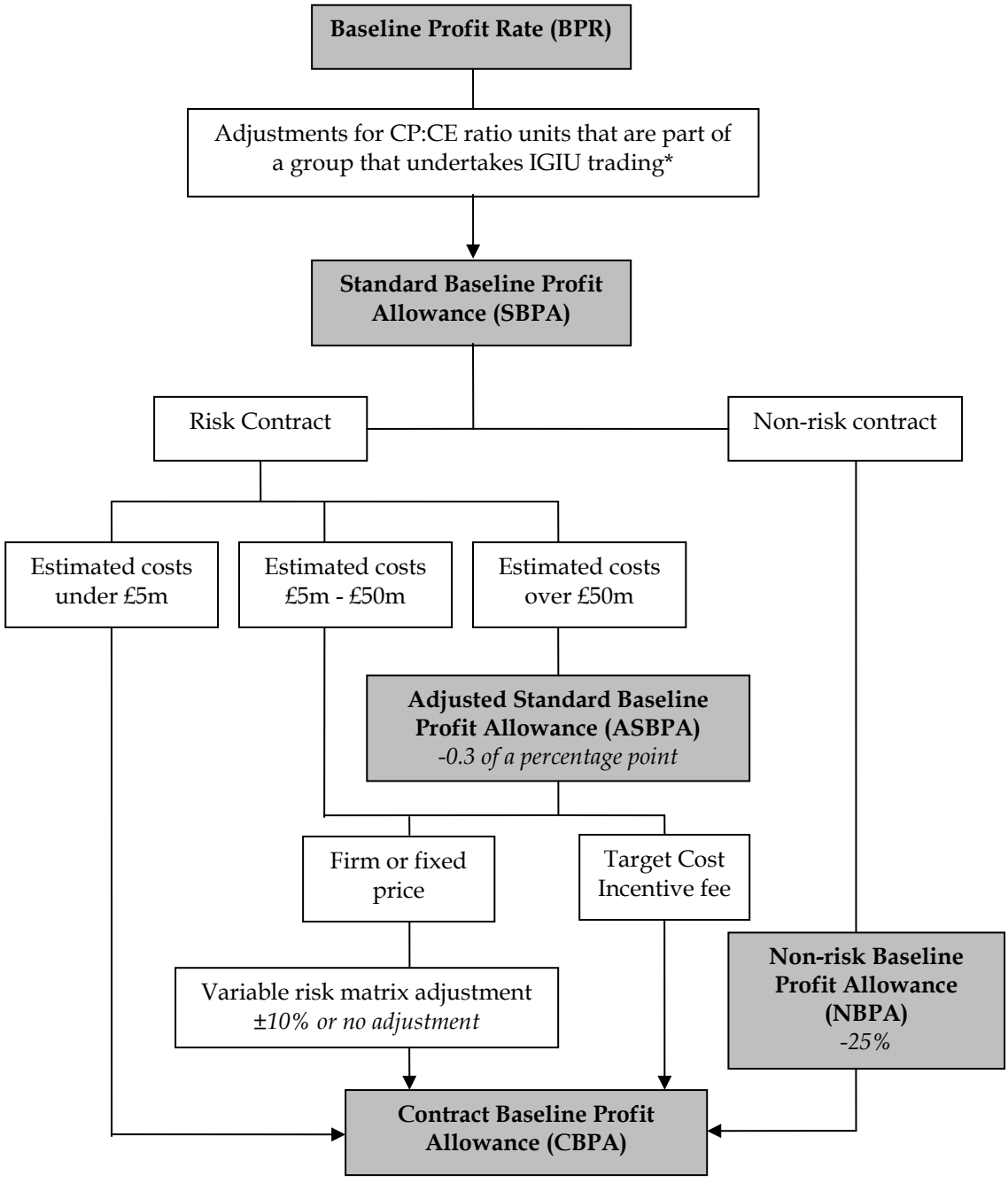
(b) once the audit has been completed the allowance should start to accrue again during any period where the parties negotiate the quantum of the refund; and

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

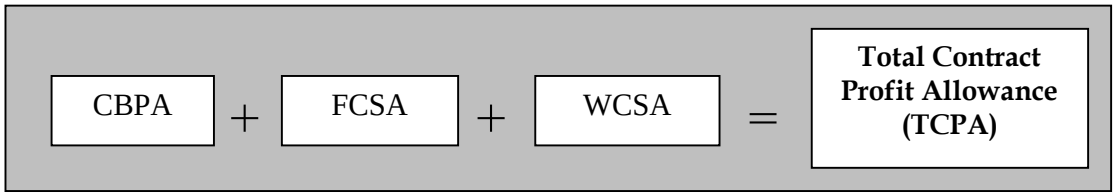
2.23. For the purposes of the foregoing provisions, a late submission is defined as one that is not received within 12 months of the due date.

ANNEX A to SECTION 2: Baseline Profit Flowchart

Flowchart showing the various levels of baseline profit and the recommended terminology and abbreviations to be used



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



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[13]

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 [now 2.10] 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.

[13] In the 2011 Annual Review a refinement for the methodology for eliminating Intra-Group Inter-Unit ('IGIU') trading was introduced whereby Contractors that are part of a group of companies that undertake IGIU trading will compute and agree with MOD a reduced SBPA to be applied to contract costs so as to eliminate the impact of their IGIU trading.

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

1. Aim of the Government Accounting Conventions

1.1 The Government Accounting Conventions (GACs) are those accounting conventions agreed from time to time, between the Ministry of Defence ('MOD') acting on behalf of the Government and the CBI acting on behalf of industry, for pricing non-competitive Government contracts. These Conventions are applicable to both direct contract costs and indirect costs. These Government Accounting Conventions are available for use by all other Government departments.

1.2 The aim of the GACs is to set out the basis upon which a Contractor includes direct costs in a contract price proposal and computes its capital employed, cost of production and overheads for a rate claim submission to the Government department concerned, for the purpose of pricing non-competitive Government contracts. Wherever possible a contractor's normal accounting systems will be used. The Contractor is to disclose his cost accounting practices and apply them consistently.

1.3 At the request of the Government department considering the direct labour and overhead costs submitted in accordance with 1.2 above the contractor will give access to the department to information that it holds adequate to justify the direct labour rates and specific elements of the burden rates claimed.

1.4 The Government department concerned will examine the information described in paragraphs 1.2 to 1.3 above, with the aim of reaching agreement with the Contractor concerning those rates. Where costs are disallowed a written explanation will be provided to the Contractor by the Government department. In cases where the Government department concerned is not persuaded by the justification of costs provided and consequent disallowances mean that an agreement cannot be reached, then the dispute over claimed costs may be referred to a third party[14] for an expert opinion.

1.5 Costs and capital employed shall be computed in accordance with the GACs for determining the level of fixed capital employed, working capital employed, overhead costs and the cost of production applicable at the time of pricing.

1.6 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 (wholly or in part) can be agreed to be settled outside of the overheads. In all cases where costs arise or are expected to arise which are exceptional or abnormal in size or incidence, then the parties should inform each other and commence confidential discussions at the earliest opportunity.

[14] Which may be the Review Board for Government Contracts.

1.7 The attribution of costs between overhead costs and direct contract costs is a matter for agreement between Government and individual contractors based on the contractor's normal accounting system.

2. Disclosure of Cost Accounting Practices

2.1 The contractor is to disclose his cost accounting practices to the Government department concerned and is to apply them consistently. In the MOD, this information is obtained through the use of a contractor disclosure statement known as a Questionnaire on the Method of Allocation of Costs (QMAC).

2.2 The contractor's costing system should be the same for his Government work as it is for his non-Government work. If it is proposed that the allocations on his Government work should differ from that on his non-Government work this should be clearly stated and full explanations provided.

3. Computation of Capital Servicing Allowances

3.1 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.

3.2 Capital Employed. 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 servicing allowances and those which do not, thereby enabling the apportionment of qualifying net assets between individual contracts pro-rata to cost of production. 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 3.1 above for the period under review (based on the company's accounts subject to any adjustment required in order to comply with International Accounting Standards[15]), adjusted for the following where relevant:

3.2.1 Exclude from assets

3.2.1.1 Goodwill.

3.2.1.2 Adverse (debit) balance in retained earnings.

3.2.1.3 Investments in shares and securities.

3.2.1.4 Shares held in and permanent loans to subsidiary companies being capital not employed in the business of the parent Company.

3.2.1.5 Cash demonstrably surplus to requirements (i.e. short term investments; deposits; and cash demonstrably in excess of the amount required for working cash resources

[15] However UK GAAP may be appropriate in circumstances where the parties agree.

for day to day operations).

3.2.1.6 Capital not employed efficiently such as capital employed in land and buildings not in occupation and plant and machinery demonstrably not in use[16] 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.

3.2.1.7 Certificates of tax deposit.

3.2.2 Include within assets

3.2.2.1 Trading balances with subsidiary, affiliate and other group companies.

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

3.2.3.1 The balance sheet figure for inventories 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 3.2.3.4. through 3.2.3.6.

3.2.3.2 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.

3.2.3.3 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.

3.2.3.4 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

[16] Assets in course of construction are admissible as capital employed.

to the contract price.

3.2.3.5 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.

3.2.3.6 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.

3.2.3.7 Where costs are spread over several years under 4.4.1, any amount not written off at a balance sheet date will be included as an asset in capital employed.

3.2.3.8 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.

3.2.4 Creditors and other general adjustments:

3.2.4.1 Where non current assets have been acquired under finance leases, the amount included in the balance sheet as a creditor will be treated as a source of capital i.e. not deducted.

3.2.4.2 All loans (including bank overdrafts) are treated as a source of capital – i.e. not deducted.

3.2.4.3 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.

3.2.4.4 Mainstream corporation tax and deferred taxation are treated as a source of capital – i.e. not deducted. Liabilities to make payments in respect of group relief should be treated in the same way.

3.2.4.5 Launch 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.

3.2.4.6 Declared and proposed dividends are treated as a source of capital – i.e. not deducted.

3.2.4.7 Provisions for future cost liabilities where excluded from allowable costs should be treated as a source of capital - i.e. not deducted.

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

3.3.1 Include:

3.3.1.1 Direct costs – direct wages, materials, bought out equipment, subcontractors' and other direct charges.

3.3.1.2 Indirect costs –with the exceptions set out in 3.3.2 below.

3.3.2 Exclude:

3.3.2.1 Capital expenditure.

3.3.2.2 The cost of raising and servicing loan capital.

3.3.2.3 Appropriation of profits, e.g. dividends, corporation tax.

3.3.2.4 Notional transactions.

3.3.2.5 Costs related to assets excluded from capital employed in accordance with 3.2.1 above.

3.3.2.6 Discounts allowed on sales, which are treated as abatements of selling prices.

3.3.2.7 Unnecessary, extravagant or wasteful outlays excluded from overheads under 4.2.8 below.

3.3.2.8 Loss of profit insurance premiums (profit element only).

3.3.2.9 Compensation payments of an abnormal nature to the extent that they are excluded under 4.4.1.1 below.

3.3.2.10 Lump sum additions to pension schemes to the extent that they are excluded from overheads under 4.4.1.2 below.

3.3.2.11 Subscriptions and donations of a political nature.

3.3.2.12 Credits, grants or refunds dealt with under 4.5.1 below should be deducted from cost of production.

4. Overhead costs attributable to government work

4.1 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 written justification 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 International Accounting Standards[17] and subject to the following adjustments:

4.2 Items which are normally totally excluded:

4.2.1 Any expenditure of a capital nature (depreciation is allowable).

4.2.2 Any distributions of profit.

4.2.3 The cost of raising and servicing capital, including short-term financing and finance leases.

4.2.4 Bad debts and any provision therefore, unless they arise on Government sub-contracts.

4.2.5 Discounts allowed on sales.

4.2.6 Insurance of goods in transit and any other related to civil work risks unless required for Government work.

4.2.7 Notional transactions.

4.2.8 Unnecessary, extravagant or wasteful outlays. The contractor is entitled to a written justification on the exclusion of this type of expenditure.

4.2.9 Loss of profits insurance (profit element only).

4.2.10 Costs and income related to assets excluded from capital employed in accordance with 3.2.1 above.

4.2.11 Subscriptions and donations of a political nature.

4.3 Items which are normally treated as direct:

4.3.1 Agents' commissions.

4.3.2 Outward carriage of finished products.

4.3.3 Insurance of credit risk, royalties and licence fees where these can be identified as direct costs.

[17] However UK GAAP may be appropriate in circumstances where the parties agree.

4.4 Items which may be partially excluded or deferred:

4.4.1 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 3.2.3.7. Examples of these costs are:

4.4.1.1 Compensation payments of an abnormal nature.

4.4.1.2 Lump sum additions to pension schemes.

4.4.1.3 Bid and Proposal costs.

4.4.2 Research and Development (see 6 below).

4.4.3 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.

4.5 Items treated as reducing overhead costs:

4.5.1 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.

4.6 Other items:

4.6.1 Depreciation/amortisation. 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 3.2. Amortisation of development expenditure carried forward should be treated as costs to be recovered under 6.2.1 below.

4.6.2 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.

4.6.3 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.

4.6.4 Bonuses paid in cash or in kind. Where payments under

employees' profit sharing schemes are simply an element of employees' normal remuneration the payments should be included in attributable costs. 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 cost of shares issued to employees at favourable prices should be arrived at in the manner prescribed by IFRS.

4.6.5 Costs incurred to purchase permits under the EU Emissions Trading System ('EU ETS') will be included in attributable costs provided that the contractor can demonstrate that it is taking reasonable measures to minimise its emissions. Attributable costs will be reduced by the value of any credits gained through the sale of permits. The cost of fines or penalties imposed on a contractor for breaches of emissions regulations will be excluded from attributable costs.

5. Rationalisation and/or Plant Closures.

5.1 Rationalisation and/or plant closure costs may arise which are exceptional in size or incidence and by agreement between the parties may be negotiated as a separate, stand-alone arrangement, as described at GAC 1.6 above. The parties will agree on a case-by-case basis when such situations arise, noting the following are likely to be indicators that a separate agreement should be considered:

- Site closures
- Substantial redundancy programmes
- Substantial site reorganisation and remodelling
- Where there is no future business at a site

5.2 In such cases where it is agreed that negotiations are to be on a stand-alone basis, any negotiation should consider as its starting point the GACs. Whilst the negotiation of any sum to be paid by the Government department concerned may initially have to be made on the basis of projected estimated costs, the Government department will look to negotiate final settlement on the basis of the actual costs incurred.

5.3 Where reasonable net costs incurred on rationalisation and/or plant closures are to be included in attributable costs to be recovered through overheads, then such costs may include:

- Redundancy payments;
- Employee relocation expenses;
- Job creation scheme costs;
- Transfer costs for equipment;
- Education/learner costs on transferred work;
- Disruption costs – waiting and idle time;
- In the case of total or near total closure of a unit, excess or unabsorbed overheads.

5.4 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.

5.5 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:

5.5.1 Such profits should only be taken into account up to the amount of allowable rationalisation and closure costs; if profits exceed such costs the Government department should not be entitled to share in the excess unless the profits arise on disposal of assets to which the department has contributed significant investment.

5.5.2 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.

5.5.3 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.

6. Private venture research and development expenditure

6.1 Recording, classification and attribution of expenditure

6.1.1 Contractors will classify in their accounting records all expenditure on private venture research and development (R&D) in accordance with the definitions in UK SSAP 13.

6.1.2 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.

6.1.3 The principles described in paragraphs 6.1.1 and 6.1.2 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.

6.2 Recovery of expenditure

6.2.1 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 6.2.2 to 6.3.2 below, normally apply:

6.2.1.1 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.

6.2.1.2 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 6.3.1 and 6.3.2 below will be recovered on this basis.

6.2.2 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:

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

6.2.2.2 that any unreasonable, unnecessary, extravagant or wasteful expenditure is excluded.

6.2.3 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.

6.2.4 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.

6.3 Abortive expenditure

6.3.1 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 6.2.1.2 above.

6.3.2 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 6.2.1.2 above only to the extent that the development had potential benefit to the Department concerned and subject to the provisions of paragraphs 6.1.2, 6.1.3 above and 6.4.1 below.

6.4 Timing of recovery

6.4.1 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.

6.4.2 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.

7. Pensions[18]

7.1 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;

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

7.3 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

7.4 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.

[18] FOOTNOTE:

Following the Review Board's 2007GR recommendation on pension costs, captured in GAC 7 above, the MOD and the JRBAC did further work to assist with its implementation, and published their agreement in an Addendum to the 2007GR. Appendix 1 to the Addendum recorded the agreement of a definition concerning defined benefit pension schemes, as follows:

MOD/JRBAC agreed definition concerning defined benefit pension schemes (Review Board 2007GR report, paragraph 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; and
(v) Any element of current service cost related to deficit funding.

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

During the 2013GR, the MOD and the JRBAC agreed the following concerning the Pension Protection Levy:

Pension Protection Levy reimbursed to pension schemes in whole or in part by companies employing scheme members will be allowed in attributable costs.

ANNEX E to SECTION 2: The impact of International Financial Reporting Standards on the GPF

As indicated in paragraph 217 of the 2010 General Review MoD and JRBAC continued to review the consequences of the adoption of IFRS by some CP:CE ratio units. The MoD and JRBAC have agreed that:-

Financial Instruments; Recognition and Measurement. IAS39.
IAS 39 hedge accounting fair value (mark to market) adjustments represent timing adjustments and should be excluded from contractor returns and submissions for both Cost of Production and Capital Employed.

Borrowing costs. IAS 23
Where a contractor capitalises borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, such costs should be included within Cost of Production, Capital Employed and depreciation in the same way as the qualifying asset to which it forms an integral element of cost.

The Effects of Changes in Foreign Exchange Rates. IAS21 and IAS39
As required by IAS 21 (except where exchange difference occur on monetary items that qualify as hedging instruments in a cash flow hedge) differences arising on the settlement of monetary items at rates changed from those at which they were translated on initial recognition should be recognised in profit or loss in the period in which they arise.

As required by IAS 39 exchange differences on monetary items that qualify as hedging instruments in a cash flow hedge should be recognised initially in other comprehensive income to the extent that the hedge is effective. IAS 39 sets out the test to determine if a hedging instrument is to be classified as a cash flow hedge or a fair value hedge. Hedging instruments that are not 'highly effective' should be classified as fair value and the hedging instrument should not be linked to related contracts of purchase or sale.

Profits or losses on exchange arising from transactions and balances in foreign currencies that, in the contractor's normal accounting system, are not matched to the contracts of purchase or sale should be treated as financing costs and excluded from cost of production.

IFRS for SMEs
Additionally MoD and JRBAC considered the exposure draft of IFRS for SMEs (issued by the IASB on 9 July 2009). MoD and JRBAC noted that the European Union is still considering adoption within the member states. The topics within IFRS for SMEs are very similar to that of IFRS but some of the detailed proposals within the exposure draft are different in key areas. MoD and JRBAC will give further and fuller consideration to the impact of IFRS for SMEs on government accounting when the implementation date and standards to be applied are more certain.

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 deals with matters related to the scope and construction of the profit formula and 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

2013 General Review, paragraphs 302 and 304

3.7 The constituents of the Reference Group have been considered in detail at each General Review. At this Review the underlying criteria for inclusion in the Reference Group have remained unchanged, but the Review Board has sought to provide a clearer explanation of those criteria, as follows.

3.8 For the purposes of the Reference Group the Review Board defines British industry as being represented by all companies involved in any type of economic activity producing goods or services that are listed on the London Stock Exchange main market or on AIM, and with headquarters in the United Kingdom. The Reference Group includes all sectors of British industry except where inclusion of a sector compromises the comparability principle. For example, the comparability principle would be compromised where a fair return, which is based on return on cost of production and return on capital employed, is distorted by sectors where the majority of companies' revenues and profits are not directly linked to their cost of production or capital employed. The Review Board considers that the following should be excluded:

a) Primary industry sectors – Revenues and profits in these industries are largely dependent on the natural resources being exploited and on the valuation of those resources rather than the cost of bringing the goods or services to sale. Significant sectors currently falling into this category are: agriculture, mining and oil & gas.

b) Sectors dominated by companies where a significant proportion of their activity is based on investment and lending, i.e. either the purchase of speculative assets, including financial instruments, or lending, with the expectation of favourable future returns. Significant sectors currently falling into this category are: banking, insurance and investment.

c) Sectors dominated by companies that are subject to price regulation on their operations which could have a significant influence on their profitability. In certain companies pricing may be regulated, for instance, by capping prices by reference to RPI or CPI or by reference to return on capital. This pricing structure is not comparable to companies undertaking non-competitive Government contracts. Significant sectors currently falling into this category are: water and multi-utilities.

2010 General Review, paragraphs 304 and 308

3.9 The constituents of the Reference Group have been considered in detail at each General Review. At this Review the Board has also given thorough consideration to the principles for including sectors in the Reference Group. Both parties have concluded that they are willing to retain the existing principles as defined in the Report on the 2009 Annual Review of the Profit Formula at this time. The Board has accepted the views of the parties and agreed to retain the existing principles for this Review.

3.10 The Board has concluded that under these principles the power generation sector can now be included within the Reference Group.

2007GR paragraph 204

3.11 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.

2003 General Review, paragraphs 402-405

3.12 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.

3.13 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.

3.14 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.

3.15 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

3.16 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.

3.17 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.

3.18 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

3.19 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

2013 General Review, paragraph 312

3.20 The Euro debt market is considerably more liquid than the Sterling debt market and in this General Review the Review Board has undertaken analysis suggesting that it would be less subjective and more dynamic to replace the static 0.5 percentage point adjustment between Sterling BBB and Sterling BBB- with the actual spread between Euro BBB and Euro BBB-. The Review Board has shared its analysis with MOD and the JRBAC and they have accepted that the new methodology should be adopted. Therefore, as of the 2013 General Review, the FCSA calculation is based on:

a) The 7 year moving average of the 15 year Sterling BBB corporate bond rate; adjusted for

b) The spread between 10 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling denominated BBB and BBB- corporate bond rates.

2010 General review, paragraph 317

3.21 The Board considers that the overall methodology remains appropriate. However, the Board does now have access to 15 year BBB bond data and has decided to use in place of the adjusted 15 year Gilt rate. The FCSA calculation is now linked to the 7 year moving average of the 15 year Gilt rate; plus 0.5 of a percentage point to incorporate a premium for a BBB3 rating and the liquidity discount.

2003 General Review, paragraphs 307-311 [19]

3.22 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:

c) long term corporate borrowing rates; and

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

3.23 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.

3.24 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.

[19] With minor drafting changes to improve clarity

3.25 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

2013 General Review, paragraphs 315-319

3.26 … the Review Board now considers that the WCSA should continue to be based on a 36 month moving average but that it should use:

a) The 1 year Sterling BBB corporate bond rate; adjusted for

b) The spread between 1 year Euro BBB and Euro BBB- corporate bond rates, as a suitable proxy for the difference in Sterling denominated BBB and BBB- corporate bond rates.

3.27 This revised methodology is less subjective and more dynamic than the previous methodology and is also more consistent with the FCSA methodology…

3.28 From time to time some contractors have net negative working capital employed. In such cases, a negative WCSA should be computed on net negative working capital employed and this amount should be deducted from that contractor's Baseline Profit entitlement, except where the contractor can demonstrate that the negative working capital employed does not relate to non-competitive Government work.

3.29 The Review Board has considered whether it is appropriate to use the same WCSA on both net positive and net negative working capital balances as it seems likely that a company will be charged more to borrow money than it will earn if it deposits money.

3.30 The Review Board has been advised that the 1 month LIBID (London Interbank Bid Rate) is likely to represent the highest level of interest that a company might expect to earn on short term cash deposits. The MOD and the JRBAC have accepted that where a contractor has net negative working capital its WCSA should be based on a 36 month moving average of 1 month LIBID. Whilst there is no official published LIBID rate, for the purposes of the WCSA, we have calculated 1 month LIBID as 1 year LIBOR less 1/8 of a percentage point (0.125%).

2003 General Review, paragraphs 313-314

3.31 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.

3.32 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

2011 Annual Review paragraphs 320 through 322

3.33 The methodology for deriving the GPF has remained unchanged since it was first introduced, following the Board's 2003 General Review. Within the significant changes to the GPF in the 2003 General Review it was agreed that the Contractor Group's IGIU trading should be eliminated through an adjustment to the BPR, applied to all contractors constituting the Contractor Group. The adjustment was calculated from the results of an annual exercise between MOD and the contractors to determine the level of IGIU trading across the whole Contractor Group. Although this 'blanket' adjustment had the merit of simplicity, it had the disadvantage that contractors with no IGIU trading received a lower SBPA than they would otherwise have received.

3.34 In a submission to this 2011 Annual Review MOD and the JRBAC have agreed that there should be a refinement to the process and methodology for eliminating IGIU trading which reflects experience gained since the IGIU adjustment was first introduced. It has been agreed that for this and for subsequent reviews the IGIU adjustment should be calculated for each corporate group of companies rather than applying a 'blanket' IGIU adjustment to the Contractor Group. The Board agrees that this methodology is a sensible refinement of the previous methodology and recommends that it should be applied from 1 April 2011. This adjustment, together with any other adjustment that might be required in a particular year, results in the SBPA.

3.35 As a consequence of the change described above, and because the Board does not consider that any other adjustment is required, for contractors that are part of a group that do not undertake IGIU trading the recommended SBPA is the same as the recommended BPR for the 2011 Annual Review. However, individual CP:CE ratio units will agree lower SBPA rates with MOD if they are part of a group that undertakes IGIU trading….

2010 General Review paragraphs 314 and 315

3.36 As part of the scope of this Review, and in the light of the current economic climate, the Board has considered the potential for the Capital Servicing Allowances to have a disproportionate impact upon the GPF Baseline Profit Rate. The Board has concluded that at this time there is no such disproportionate impact. However, the Board recognises that there might be instances in the future when the relationship between the Reference Group EBIT and the Capital Servicing Allowances has such a disproportionate effect on the GPF Baseline Profit Rate that it would be appropriate to make an adjustment based on the facts and circumstances at that time.

3.37 For this Review, the Board is satisfied that volatility in the CSAs and in the Baseline Profit is already mitigated sufficiently through the use of:

- A broadly based Reference Group;
- 3 year averaging of the Baseline Profit figure; and
- Medium and long-term averaging of the CSA data.

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

3.38 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...

3.39 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

3.40 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

2005 Annual Review, paragraph 321

3.41 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.

2003 General Review, paragraph 318

3.42 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

3.43 …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...

Adjusted Standard Baseline Profit Allowance or ASBPA

2007GR paragraphs 209 and 210

3.44 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.

3.45 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.

2005 Annual Review, paragraphs 322-323

3.46 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.

3.47 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

3.48 The risk/reward matrix also addresses the issue of non-risk[20] 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

2007GR paragraphs 216-220

3.49 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.

3.50 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.

[20] 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].

3.51 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.

3.52 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.

3.53 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.

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

3.54 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 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

3.55 …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

2011 Annual Review, paragraphs 412 and 413

3.56 During the course of this review there has been debate between the Review Board, MOD and the JRBAC concerning the derivation of the post-costing statistics, which are provided to the Public Accounts Committee as well as to the Board. The process adopted for post-costing is that MOD identifies a contract for post-costing and the contractor then produces a certificate containing its record of the actual outturn cost of that contract. MOD then refers to the estimates of cost used at the time of pricing (including pricing of amendments) and compares the actual costs with the estimates included in the price. The process does not require the two parties to agree the extent of any variance between estimated and outturn costs so the cost variance reported to the Board by MOD will be MOD's view on the outturn.

3.57 The Board believes that it would be advantageous if both MOD and the contractor were to state their respective positions on each post-costed contract; MOD and the JRBAC have an aspiration of amending the post-costing process accordingly.

1998 Annual Review, paragraphs 502-505

3.58 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.

3.59 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.

3.60 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.

3.61 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

2013 General Review, paragraphs 504-508

3.62 The Government and the CBI have agreed that cost-based disputes may be referred to the Review Board in certain circumstances, such as the agreement of overhead recovery costs and rates and the attribution of allowable costs to contracts.

3.63 The Government and the CBI have also agreed that disputes relating to certain terms, such as the failure to supply an adequate summary of costs incurred, and disproportionate actions may be referred to the Review Board.

3.64 The circumstances for referral under paragraphs 504 and 505 are any of the following:

a) where there is a statutory provision that provides for a reference to be made by the Government, a supplier, or both;

b) where there is an agreement between the Government and a supplier that provides for a reference to be made by the Government, a supplier, or both; and

c) where there is a procurement contract between the Government and a supplier that includes a term, other than SC50 or DEFCON 650 or DEFCON 650A or SC51 or DEFCON 651 or DEFCON 651A, that provides for a reference to be made by the Government, a supplier, or both.

3.65 The Review Board considers that further work should be carried out by the parties to establish in more detail the terms of reference and processes which are acceptable to the Review Board, as otherwise there might be uncertainty and delays in the acceptance of a reference.

3.66 To the extent that they are not provided for in the arrangements described in paragraph 506 above, the terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD and the JRBAC in consultation with the Review Board.

1996 General Review, paragraph 310

3.67 …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.

Seventh General Review (1993), paragraph 627

3.68 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.

Relevant CP/CE units

Fourth General Review (1984), paragraph 37

3.69 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[21] 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.

Justification of labour and overhead costs

2011 Annual Review paragraphs 505- 508

3.70 The MOD expressed concern that contractors needed to do more to justify and support the levels of claimed costs and sought to clarify a contractor's responsibility by inserting an explicit requirement to make information available to justify the reasonableness of rates claimed.

3.71 The JRBAC accepted the principle proposed by MOD but was concerned that an increased scrutiny of costs appears likely to result in an increase in the number of disputes between MOD and its contractors. The JRBAC sought to introduce a mechanism whereby MOD or the contractor might refer to a third party for the resolution of disputes that could not be resolved in a reasonable manner between them.

3.72 MOD and the JRBAC have agreed the consequent revisions to sections 1 and 4 of the GACs which are shown in Appendix D.

3.73 At the time this report was finalised it was agreed that the parties should be able to refer matters to a third party and it was considered that the Review Board might be that third party. However, the process and the terms of reference for a referral have not been finalised and it is agreed that disputes of this nature should not be accepted by the Review Board, or any other body, until the process and terms of reference are agreed. The Review Board has offered to assist in developing the process and terms of reference.

Value for money

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

3.74 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

[21] 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)).

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.

3.75 …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.

3.76 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 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

3.77 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.

3.78 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.

3.79 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].

3.80 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.

3.81 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

3.82 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

3.83 …[T]he historic cost[22] and semi-CCA[23] bases…should be replaced [with effect from 1 July 2004] with the modified historic cost[24] ('MHC') basis.

Relevant CP:CE units

Fourth General Review (1984), paragraphs 34-35[25] [updated in italics]

3.84 ...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.

3.85 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.

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

[23] 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].

[24] 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 accounting standards [2005 Annual Review, page ix].

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

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.

Fifth General Review (1987), paragraphs 86-87

3.86 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.

3.87 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

3.88 In our 1977 Report we recommended that the Ministry should seek to agree with contractors estimated CP/CE ratios[26] 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

3.89 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

[26] See footnote p on page 42 above.

course of construction are admissible as part of capital employed, subject to the specific exemptions provided by paragraph 4(A)(f)[27] in respect of assets "demonstrably not in use where held for speculative purposes or for long term expansion not yet planned".

3.90 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.

Cash

2003 General Review, paragraphs 713-715

3.91 Under the existing GAC 4(A)l(e)[28] 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.

3.92 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.

3.93 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)

3.94 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

2007 General Review, paragraphs 459 and 462

3.95 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 4.2.8 in Annex D to Section 2 of the GPFAA) and GAC 2 (now clause 4.1 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.

[27] Now GAC 3.2.1.6
[28] Now GAC 3.2.1.5

3.96 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.

Seventh General Review (1993), paragraphs 625-626

3.97 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.

3.98 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)[29] 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.

Fifth General Review (1987), paragraphs 104-106

3.99 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.

3.100 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

[29] Now GAC 4.2.8

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.

3.101 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 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.

Employees' profit sharing schemes

Interim Review (1971), paragraphs 31-32

3.102 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.

3.103 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 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

3.104 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.

3.105 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[30]; 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[31].

[30] Now GAC 4.2.2
[31] Now GAC 4.2.7

3.106 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 3.73 and 3.74 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.

3.107 We note MOD's concerns. Regarding the first point, MOD has the remedy under GAC1(A)10[32] 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

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

3.109 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

[32] Now GAC 4.2.8

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.

3.110 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.

3.111 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.

3.112 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.

3.113 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.

3.114 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.]

3.115 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.

3.116 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.

3.117 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.

Rationalisation and closure costs

2011 annual Review paragraphs 502 and 503

3.118 The MOD wished to establish the principle that there should not be an automatic application of a profit allowance on rationalisation costs and it agreed modified wording to the GACs with the JRBAC so such costs can be dealt with on a stand-alone basis. The MOD was also concerned that the existing wording of the GACs is unreasonably restrictive on MOD's rights to participate in a contractor's profit on the sale of assets. MOD agreed with the JRBAC that GAC 5.5.1 should be amended so that account should be taken of any significant investment contributed by the Government.

3.119 The consequent revisions to section 5 of the GACs, as proposed by MOD and the JRBAC, are included in Appendix D. The Board accepts these revisions and recommends that they are adopted.

1996 General Review, paragraphs 605-606

3.120 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.

3.121 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

3.122 The allowability of rationalisation and/or site closure costs is considered under GAC 1(D)4[33], and the JRBAC has sought some further clarification concerning the extent to which these costs may be recovered from MOD through allowable overhead costs.

3.123 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

3.124 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.

3.125 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

[33] Now GAC 5

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[34].

Simplification of arrangements for contractors undertaking relatively little non-competitive work

2010 General review paragraphs 416 - 418

3.126 One of the topics for consideration at this Review was whether contractors might be discouraged from entering into the market for non-competitive work by the perceived complexity of the Government's accounting reporting requirements to undertake such work, and, if so, whether it might be appropriate to provide a simplified approach for smaller contractors or for contractors engaged in low levels of non-competitive activity.

3.127 MOD and the JRBAC have undertaken separate stakeholder consultations and reviews of this issue and neither has found any evidence to suggest that Government accounting reporting requirements are a barrier to entry into non-competitive work. However, the parties do consider that small and larger contractors alike would benefit from improved guidance on the accounting requirements and processes of non-competitive Government work and the parties have confirmed that they are working towards this. In particular, MOD has confirmed that it is already undertaking an exercise to update and improve the operation of the QMAC, the arrangements for setting overhead rates and other similar areas provided for in the AOF.

3.128 As a consequence of the foregoing the Board does not recommend the introduction of simplified approaches for smaller contractors or for contractors engaged in low levels of non-competitive Government work. The Board welcomes the additional activity to update and improve guidance on non-competitive pricing.

[34] Now GAC 3.3.

ANNEX A to SECTION 3: 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 1.52).

The Board has published seven 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, which have been placed in the House of Commons library.

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.

7: Decision of the Board on contract reference 2009/2

(a) It is the Board's opinion that, once a reference has been accepted, it is the Board's role to establish whether the pricing of the contract at the time of pricing was fair and reasonable, in the light of all the information available. In order to fulfil the Board's task in accordance with paragraph 1.39 of the GPFAA, and to meet the requirements of paragraphs 1.45 – 1.47 of the GPFAA, the Board considers that it is acting as an expert and has the power:

- to make wide-ranging enquiries;
- to take responses to those enquiries into consideration in any determination that it might make; and
- to consider the surrounding circumstances, including the conduct of the parties.

(b) The Board's role is limited to assessing whether the price negotiated was fair and reasonable at the time of pricing, whatever the outcome on the contract.

(c) The Board considers the following are fundamental in relation to fair and reasonable pricing:

- That the requirement for the negotiation of a "fair and reasonable" price is largely fulfilled through compliance with EoI obligations.
- That EoI suggests a mutuality of frankness and confidence between the parties.
- That information likely to affect pricing negotiations should be volunteered to the other party and should not be withheld.
- That, whilst not relieving the party having the information of the primary responsibility for disclosure, there is an obligation to make normal commercial enquiries. A party cannot simply rely on the other party's obligation to volunteer information.

- That there is an EoI obligation at the time of fixing the price of a contract and that this obligation continues, where appropriate, to be effective at other specific points in the contracting process, such as at post-costing.

(d) The Board believes that an individual contract in a programme should be looked at on its merits but that in considering the individual contract it is necessary to consider the circumstances and evolution of all the contracts related to the full programme, given their close relationship, in order to understand properly the circumstances of the individual contract. It follows, therefore, that in looking at the threshold above which a reference may be heard in accordance with paragraph 1.42 of the GPFAA, the Board is satisfied that it only needs to look at the threshold in connection with the individual contract referred to it.

(e) The Board is clear that the relevant point for price fixing in the context of determining a fair and reasonable price is at the acceptance of a contract or contract amendment which should be contemporaneous with the EoI Pricing Statement. This price may well be based on previous discussions and agreements, but unless those discussions and agreements are formally bound into a contract and the contract is specific as to a price fixing point at some time other than the date of the signing of the contract, this must be the date which is relevant for determining a fair and reasonable price.

(f) EoI is the bedrock of non-competitive contracting and is underpinned by the demonstration of good faith. It applies across all non-competitive contracts and is applied in a very specific way for NAPNOC contracts, through the provision of an EoI Pricing Statement, signed by both parties to the contract and annexed to the contract. It is the Board's opinion that for each contract entered into there should be equality of information at the time of entering into the contract.

(g) The Board does not consider that in order to provide EoI between the point of price agreement and the signing of the EoI Pricing Statement it would be expected that a full re-pricing exercise would have to be undertaken. Rather, there is a requirement to identify whether there are reasons that would cause a material change in the agreed price. This may be by reason of price changing events, further information becoming available or assumptions subsequently proving to be inaccurate, which would cause the basis of the price to change. Clearly, the longer the period of time between the initial price agreement and the signing of the EoI Pricing Statement, the greater the likelihood that changes will have taken place.

(h) The Board notes that there will be instances where there are contract costs which are disallowed under the GACs but which, from a contractor's point of view, are genuine contract costs. The Board's view is that the cost certificate presented by the contractor for post-costing should compare costs directly with those incorporated into the EoI Pricing Statement. The Board can envisage situations where it would be helpful for a contractor to inform MoD of costs that it has incurred that were not envisaged or were disallowed at price fixing, which might be relevant when considering the price of subsequent contracts.[35]

(i) Whilst it might not be a requirement of the contractor to furnish MoD with forecasts of outcomes during the course of a contract, it would be appropriate to make MoD aware if any forecast, before or at the time of pricing, was different from costs agreed at pricing.[35]

(j) Even if an article exceeds the specified performance levels required under a contract, this is not a contractual requirement so it is not appropriate to make any allowance for it in calculating the amount to be awarded.

[35] The MOD and the JRBAC note the Review Board's statements at (h) and (i). However, in relation to paragraph (h), MOD and the JRBAC observe that cost certificates are currently prepared in accordance with existing contract conditions that do not require the contractor to compare costs. In relation to (i), MOD and the JRBAC note that this is an example of the existing principle of Equality of Information, rather than a new principle.

ADDENDUM

AGREED STATEMENT BY THE MOD AND THE JRBAC

2013 General Review

1. We accept the Review Board's recommendations to revise the profit formula allowances for Government non-competitive contracts, as set out in paragraph 201 of its report on the 2013 General Review.

2. We accept that the revised allowances summarised at paragraph 201 should be implemented with effect from 1 April 2013 for contracts where no pricing arrangement has been agreed.

3. We have agreed that the terms of reference and jurisdiction of the Review Board should be extended in relation to cost-based disputes and disputes relating to proposed Single Source Procurement Regulations. The terms of reference for the Review Board and the processes applicable to the making of references in each circumstance will be developed between MOD and the JRBAC in consultation with the Review Board.

4. The amendments to the GPFAA agreed between MOD and the JRBAC are reflected in an updated document reproduced in the 2013 General Review report at Appendix E. The updated GPFAA will be placed on the main MOD website.

W R J Hockin OBE
Chairman
JRBAC

S Mason
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