



# Commercial Contracts

## De-mystifying contracting with the Ministry of Defence

Contracting with the MoD can often be seen as a confusing process. This briefing explores how MoD contracts, which have not been competitively tendered, limit contractors' profits and losses.

### INTRODUCTION

The MoD has established a contractual framework of standard provisions to be used in defence contracts, which are named DEFCONs. One of the more interesting and complicated provisions in the DEFCONs restricts the profits contractors may make and limits the losses they might suffer from a defence contract in a similar way to the US Defense Federal Acquisition Rules (DFARs). This bulletin explores how the MoD rules operate.

### BACKGROUND

As a matter of general government policy, contractors should receive a 'fair and reasonable price', which is considered to be one established either by:

- effective competitive tendering;
- reference to established market prices; or
- in the absence of competition, by negotiation.

Often, given the nature of MoD contracts, such competition is not possible, with prices instead being negotiated between the supplier and the MoD.

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Contract (NAPNOC) initiative for non-competitive contracts, which requires all aspects of the contract, including price, to be agreed in advance of the start of any work. In circumstances in which it is not possible to agree or fix a firm price at the outset, the MoD adopts a method of incentivised pricing.

In non-competitive contract situations, the MOD and the contractor will negotiate estimated costs acceptable to each of them and the contractor will be expected to earn a reasonable profit in line with a specific formula. The profit percentages for the majority of non-competitive contracts priced by negotiation are established in

accordance with the 'Government Profit Formula' ("GPF"). The GPF was initiated in 1968 by the Government and the Confederation of British Industry (CBI). The GPF aims to provide contractors with a fair return equal, on average, to the overall return earned by industry in the United Kingdom, this is known as the comparability principle. The 1968 GPF arrangements included the establishment of an independent Review Board for Government Contracts (the "Review Board") to conduct a general review of the GPF every three years, an annual review of the GPF, and the review of individual contracts in certain circumstances. In 2003 the Review Board ("the 2003 Review") recommended changes to

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modernise the profit formula methodology whilst retaining the comparability principle, with the revised methodology applying to all new contracts entered into on or after 1 July 2004. The annual review by the Review Board ensures that the profit rate continues to reflect the average overall return earned by industry in the United Kingdom.

## REVISED GPF METHODOLOGY

Since the 2003 Review, the modernised GPF gives contractors a return equal to the average overall return earned by industry in the UK, having regard to both capital employed and (more heavily weighted) the cost of production. The formula used to price contracts takes into account three elements:

- (a) an allowance for the servicing of fixed assets (the fixed capital servicing allowance, or "FCSA");
- (b) an allowance for the servicing of working capital (the working capital servicing allowance, or "WCSA"); and
- (c) the standard baseline profit allowance, which is a percentage of the contract's cost of production ("SBPA").

Whilst the FCSA and WCSA in any one year remain the same for all contracts, the SBPA is adjusted for the risk undertaken by the contractor, with three possible levels of profit.

However, the MoD expects the majority of contracts to have a profit calculated on the basis of SBPA without adjustment.

## WHAT HAPPENS TO PROFITS OR LOSSES?

The 2003 Review introduced an arrangement for sharing between the MoD and the contractor what are termed 'unconscionable' profits or losses, without reference to the Review Board. This arrangement can be incorporated in MoD contracts by reference to relevant DEFCONs. DEFCON 648A provides that any contract where:

- (a) the outturn profit exceeds the profit allowance applicable to the contract price in accordance with the relevant GPF by a sum greater than five percent of the contract price or the outturn costs exceed the contract price by a sum greater than five percent of the contract price; and
- (b) the estimated costs exceed £5 million,

the profits or losses associated with that contract will be shared 75% (MoD): 25% (contractor). This sharing is only triggered where the liability of either party to the other exceeds £250,000.

## AUDITING AND THE CALCULATION OF PROFITS OR LOSSES

DEFCON 648A also sets out the manner in which a contractor is required to maintain and produce accounts of costs. Final Cost Certificates and Summary Cost Statements might be required under the contract and under the new GPF arrangements, the MoD encourages the timely submission of these documents by the retention of 2% of the contract price under the terms of DEFCON 696.

DEFCON 648A requires contractors to maintain a record of the costs incurred by it in performing the contract (including, for example, time taken and wage costs) and such other particulars as may be required by the MoD for the purpose of determining such costs with reasonable accuracy. Contractors must maintain such records for a period of either two years following final payment of all sums due under the contract or three years following final delivery (or completion) under the contract, whichever is sooner.

## The Government Profit Formula aims to provide contractors with a fair return equal to the overall return earned by industry in the UK.

The MoD will use the records obtained under DEFCON 648A to calculate the outturn profit or outturn cost and will issue a statement (a DEFFORM 648A) if either the profit (or cost) test (as set out above) is triggered. The MoD will then reduce or increase (as appropriate) the contract price (subject to the £250,000 de minimis provision and the ratio) and the contractor or the MoD shall then be liable to pay the other (as applicable) the difference.

Either party may refer the matter to the Review Board within two years of the final payment of all sums due under the contract by notifying the other party of its intention to do so and by making the reference within 30 days of that notice. References to the Review Board are governed by DEFCON 650A and its decisions are final.

### CONCLUSION

Contracting with the MoD can be daunting, and whilst contractors' profits might be limited, so too are their losses. The contracting process developed by the MoD shields contractors from significant losses and ensures that its public procurement obligations are met. The downside for contractors is that any savings they make which generate profits in excess of an agreed level will go, in the most part, back into MoD coffers.

If you have any questions on contracting with the MoD, please do not hesitate to contact Andrew Inkester (details shown overleaf) or your usual Nabarro contact.



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CLARITY MATTERS

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