Australian Government

Department of Defence
Capability Acquisition and Sustainment Group

CASG Profit Principles

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Profit Principles

Aim

1. The aim of the CASG Profit Principles is to provide guidance in the determination of Defence contract pricing where market competition does not occur. This is achieved by setting a standard approach for the determination of a fair and reasonable profit for sole source procurement and to provide transparency and clarity to all stakeholders. The Principles provide guidance rather than regulation in regards to profit determination.

Objectives

2. The objectives of the Profit Principles are to:
    - reward contractors fairly and reasonably commensurate with risk;
    - treat all contractors equitably and in a consistent manner;
    - in conjunction with the Cost Principles, pay reasonable prices (allowable cost + profit) for procurement;
    - incentivise and sustain a viable and profitable Defence Industry; and
    - achieve value for money for sole source procurements.

Overview

3. There are three steps for determining the contract profit rate:

Return for Contractual Risk

+

Return for Activity Risk

+

Return for General Business Risk

=

Contract Profit Rate

4. Once the rates of return have been determined they are added together to derive the contract profit level guidance. The contract profit rate is expressed as a return on cost (contract profit divided by allowable contract expenses).
5. The Profit Principles will provide guidance for all new CASG sole source procurements greater than two million Australian dollars (AUD $2m) and if appropriate can be used as guidance for contracts below this value. Additionally, where a prime contract is sole source and any associated sub-contract is not competitively sourced and is over $2m, the Profit Principles may be used by CASG to determine the reasonableness of the profit included in the sub-contract.

Considerations

6. Both contract costs and profit must be analysed. CASG views the contract price in totality considering both the profit element in conjunction with costs. Contract profit usually represents 7–15% of the total contract price and accordingly there should not be an excessive focus on profit relative to what is contained in contract costs.

7. All cost based risk reserves such as contingency and management reserves are not included in the profit margin. Within the Australian Defence Industry allowance for risk is typically included in contract costs or tendered price and is separate to profit. However, as the risk reserve is provided to alleviate the overall risk of the contract, both risk and profit are related and this will need to be considered when assessing a reasonable contract profit level.

Types of Contracts Affected by the Profit Principles

8. The Profit Principles are to be used when setting and negotiating profit levels for sole source procurements, including associated survey and quotes and applicable contract change proposals. If the contract change is for the same type and mix of work, similar cost elements and risk profile, then the existing contract profit level can be maintained, otherwise the level of contract profit may need to be reassessed as per the Profit Principles.
9. Pricing in competitive tenders is market driven, hence the Profit Principles are not intended to apply in these types of procurements.

Risk Reward

10. Risk Reward is the profit return that industry should expect for the additional risk they accept. The assessed level of risk for the contract will be a major influence on the application of the Profit Principles as there is a direct correlation between the level of risk and the level of profit required to compensate for the risk.
11. When determining the level of profit there needs to be a clear understanding of the types of risks evident in the various types of contracts. The greater the risk accepted by the contractor the greater the profit reward. CASG will have regard to representations made by the contractor when making the risk assessment for determining profit.
12. The risks in sole source defence procurements are those broadly represented by contractual risk, activity risk, and general business risk. These are the risk factors specific to the contract and specific to the company and its ability to deliver the capability or service and they are an integral part of the methodology.
13. An important consideration is to what degree the risk is shared between the company and the Commonwealth in the contractual arrangements. This level of risk sharing will determine the residual risk that the contractor bears and therefore the return, in the form of profit that should be awarded.

Proposed Payment Regime and Capital Servicing

14. The ideal payment regime for Defence contracts is one that provides a neutral cash flow to the contractor so that revenue derived from the contract offsets the contract cost outlays. Normal operating working capital requirements will be satisfied from contract profit.
15. However, in some contracts, there is a requirement for significant capital to be employed by the contractor and therefore in these circumstances a fair return on their capital outlay should be provided as part of the contract price. Any specific or special requirements regarding servicing capital, is to be included in the contractor's costs and is allowed for in the CASG Cost Principles. Accordingly, there is no allowance for capital servicing in the Profit Principles.

STEP ONE: Contractual Risk

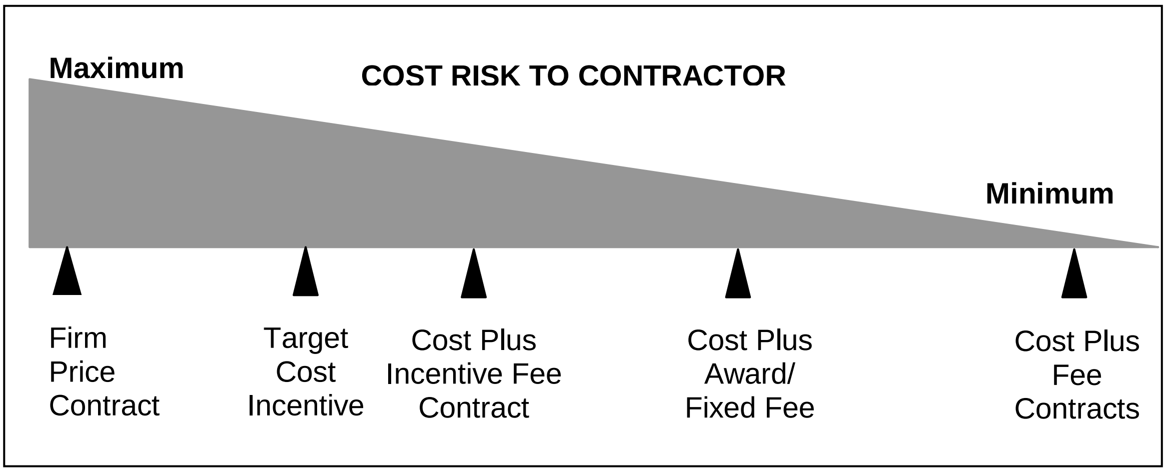
16. Fundamental to the determination of a fair profit is the type of contract and the cost risk it represents to the contracting parties. Firm price contracts can potentially result in contractors incurring significant losses and inherently carry a high level of risk. Performance Based Contracts are more innovative and incentivise contractor performance with rewards / remedies (which could include the forgoing of profit or fee if targets are not met). Target Cost Incentive Contracts include a "pain share /gain share" formula that operates to adjust the contractor's

profit or fee according to its performance against an agreed target cost. Cost Plus Margin Contracts where all incurred allowable costs are paid plus an agreed profit, are considered low risk.

17. It is important to ensure the appropriate type of contract is used for each procurement. Specifying the type of contract to be used before tender release should alleviate the level of perceived risk. If an inappropriate contract type is proposed then the tenderer could build additional contingencies into the price to protect against potential loss.

18. A standard risk spectrum illustrating contract types and associated risk levels is depicted at Figure 1 below:

Figure 1: Contract Risk Spectrum



19. Different types of contracts will be assigned a percentage range of profit to compensate for the contractual risk pertaining to that specific contract type. The appropriate profit level to be applied depends on the features of the proposed contract as shown in Table 1.

Table 1: Contract Risk

Contract Type	Contract Rate (%)
Variable and Firm Price	8 – 10
Target Cost Incentive (TCIM)	7 – 8
Cost Plus Incentive Fee (CPIF)	6 – 7
Cost Plus Award/Fixed Fee (CPAF/CPFF)	5 – 6
Cost Plus Margin (CPM) / Time & Materials	4

20. Determining the appropriate contract risk premium for individual contracts depends on a number of factors, including discrete contract terms.

21. For each contract type, assign values towards the higher end of the range when:

- incentive provisions (e.g. cost and performance incentives) place a high degree of risk on the contractor;
- the contract uses an aggressive performance-based payment schedule that increases risk;
- the contractor is responsible for warranty and latent defects.

22. Assign values towards the lower end of the range when:

- contractual provisions substantially reduce the contractor’s risk;

- risks are mitigated by the inclusion of contingency and management reserves;
- incentive provisions place a low degree of risk on the contractor;
- there is a performance-based payment schedule that is routine with minimal risk.

STEP TWO: Activity Risk

23. Different kinds of activities have different risks associated with them and the complexity of the activities undertaken will influence the rate of return that applies for the contract. Clear guidance on the type of activity should be included in the Statement of Work (SOW) that is included with the Request for Tender (RFT).

24. Acquisition and Sustainment contracts tend to have different characteristics. The type of activities to be undertaken will determine the level of risk with development and manufacturing activity being inherently riskier than the supply of developed Commercial off the Shelf (COTS) and Military off the Shelf (MOTS) items or spares procurement.

25. Higher profit levels are assigned for acquisition contracts for more complex activities such as: leading edge technology, high degree of development and design, research and development, development of intellectual property, software integration, and coding and proto-typing activities. In addition, high profit levels should be expected if the contractor accepts an aggressive delivery schedule to meet Defence requirements or where there is minimal cost history.

26. Lower profit levels are assigned for a sustainment contract for a very mature product line with extensive cost history or where there is a well-defined specification and a comprehensive SOW. The lower the technical risk and complexity the lower the return. Conversely, risks and returns may be higher for first of type/class and in the initial stages of the life cycle where there is little information on the performance of the program or potentially when the platform nears the end of its life cycle.

27. Routine activities such as facility support and preventative maintenance have a much lower risk profile and associated risk reward.

28. There are four activity categories and they are shown in descending order of risk in Table 2. Where there are various activities performed in a contract, the profit range for the main activity will be used.

Table 2: Activity Risk

Contract Type	Description	Activity Rate (%)
Acquisition	Includes develop and make activities such as: research and development, design and development, intellectual property development, manufacture, assembly to specification and order.	2.0 – 3.0
Acquisition and Sustainment	Where a single contract includes significant elements of acquisition (develop & make) and sustainment (provide & maintain activities).	2.0
Sustainment	Includes: capacity provision, maintenance and support, spare parts procurement, IT services, training.	0.5 – 1.5
Ancillary Services	This includes off the shelf items or standard services such as COTS, routine support services and facilities support.	0

STEP THREE: General Business Risk

29. Profit is calculated by applying profit percentages to allowable direct project costs and overhead costs (including general & administrative). The award of profit for General Business Risk recognises the level of effort or value-add that a contractor makes in the management of resources required to perform the contract. The value added is considered to vary with cost elements, hence the rate of profit applied to the various cost elements within the contract will also vary. Where a range has been provided, the maximum would be payable if the contractor demonstrates high levels of value add.

30. The return for General Business Risk should be commensurate with the level of effort, responsibility and risk that the contractor has to bear in managing all the various cost elements in the contract.

31. For sub-contracted work the risk and responsibility of managing subcontractors will vary depending on the nature and extent of the sub-contracted activity and the capability, experience and past performance of the subcontractor. The assessment should take into account the extent to which risk has been passed to the sub-contractor, noting that the subcontractor has already included profit and possibly contingency in their price. The level of profit ascribed to the prime contractor should reflect the value-add provided and the risk retained and managed by the prime.

32. Where a prime contractor sub-contracts to a related company there is to be no duplication of profit. The profit level awarded will take into account the combined level of profit to the Group (taking into consideration any ATO transfer pricing requirements). Where the subcontract was awarded competitively, the level of profit will be determined by market forces.

33. For material procurement, consideration should be given to the complexity of the items required and the requirement for source development. For Other Direct Costs (ODCs) such as depreciation of equipment, an assessment of the tangible benefits to the contract resulting from the investment should be made.

34. If a small or medium enterprise (SME is defined as a firm with fewer than 200 FTEs) can demonstrate that it has a lower profit return due to nil or minimal overhead and G&A costs included in their contract price, then CASG may consider recompensing the SME with an additional profit award which is not to exceed one percentage point.

35. Table 3 illustrates the applicable profit or profit ranges for the various cost categories:

Table 3: General Business Risk

Cost Element	Profit on Cost Element (%)
Direct Labour	3.5
Overhead	3.5
Material	0 – 2
Subcontract	0 – 2
Spares	0 – 2
ODCs	0 – 2
Travel	0
G&A	Overall profit rate

36. To correctly apply the percentages, the tendered cost must be built up by cost element or category. Ideally cost details are available for each category, however the degree of granularity must be balanced against the requirement for a practical easy to use model. Once each cost element has been established, the assigned profit percentage will then be applied to each cost to determine the profit amount for general business risk.
37. In some circumstances it may be appropriate for the contract to specify different rates of profit to be applied to different cost elements within the contract.

Pass Through Costs

38. Where the contractor carries minimal or no risk with a cost element or the contractor is acting purely as an agent of the Commonwealth in a transaction, the cost element or category will be identified as a pass through cost. Pass through costs should attract little or no profit. Where the contractor assumes risk or otherwise adds value or a benefit then an appropriate level of profit will be negotiated.

Contingency and Management Reserves

39. To meet possible shortfalls in the cost estimation methodology and to manage risks, contractors will identify and model risks and provide for them in contingency reserve (CR) and management reserve (MR). Typically in the Australian Defence Industry, these reserves are included in the overall costs and are in addition to profit. Given that the reserves are made to alleviate the overall risk of the contract, they must be taken into account when determining the appropriate level of profit.
40. CR or MR is the cost or time reserve that is used to manage identified risks or “known-unknowns” and is fully costed using management techniques such as Predict, Monte Carlo or Decision Tree Methodology. This is normally controlled by the contractor and used to meet additional expenditure incurred to rectify risks over the contract term. Where the CR or MR is detailed in a document such as a Risk Register and costed according to a valid risk management technique it will attract a level of profit in line with the level of general business risk applicable to the cost element.

Warranty

41. Where the warranty is specifically or statistically costed with a valid explanation for the warranty amount it may attract profit (similar to contingency and management reserves).

Total Contract Profit Rate

42. Once the rates of return have been determined for the Contract Risk, Activity Risk and General Business Risk, they are added together to derive the contract profit level guidance. The profit is expressed as a percentage return on total contract cost. Appendix 1 provides a worked example of contract profit rate determination.
43. It is anticipated that the application of the profit ranges contained in the Profit Principles will provide returns comparable to the recent historical average. However historically profit levels have varied over a large range, even for similar types of sole source contracts. Having a standard approach to profit determination will provide more consistent outcomes and reward all contractors in a fair and equitable manner.
44. If either the contractor or the CASG representative consider the Profit Principles are not being followed when setting or negotiating profit levels in sole source procurements, the matter should be referred to the CASG Financial Investigation Service to give an opinion or undertake a contract profit rate determination.

Appendix 1 – Worked Example of Profit Determination

FINANCIAL INVESTIGATION SERVICE (FIS) RECORD OF PROFIT DETERMINATION

Name of Contractor:	
FIS Job Number:	
Job Description:	
Contract Type:	
Date:	

Cost Element	Value $	Weighting
Direct Labour	$400,000	40%
Overhead (excl. G&A)	$130,000	13%
Material	$50,000	5%
Subcontract	$200,000	20%
Spares	$80,000	8%
Other Direct Costs (ODCs)	$20,000	2%
Travel	$20,000	2%
G&A	$100,000	10%
Total Costs	**$1,000,000**	**100%**

Example 1 - Profit Factors - Firm Price Contract										
	Contract Risk (8-10%)		**Activity**		**General Business Risk**		**TOTAL %**		**Profit ($)**	
	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX
Direct Labour	8.0%	10.0%	0.0%	3.0%	3.5%	3.5%	11.5%	16.5%	$ 46,000	$ 66,000
Overhead (excl. G&A)	8.0%	10.0%	0.0%	3.0%	3.5%	3.5%	11.5%	16.5%	$ 14,950	$ 21,450
Material	8.0%	10.0%	0.0%	3.0%	0.0%	2.0%	8.0%	15.0%	$ 4,000	$ 7,500
Subcontract	8.0%	10.0%	0.0%	3.0%	0.0%	2.0%	8.0%	15.0%	$ 16,000	$ 30,000
Spares	8.0%	10.0%	0.0%	3.0%	0.0%	2.0%	8.0%	15.0%	$ 6,400	$ 12,000
ODCs	8.0%	10.0%	0.0%	3.0%	0.0%	2.0%	8.0%	15.0%	$ 1,600	$ 3,000
Travel	8.0%	10.0%	0.0%	3.0%	0.0%	0.0%	8.0%	13.0%	$ 1,600	$ 2,600
Sub Total (Excl G&A)									**$ 90,550**	**$142,550**
G&A							10.1%	15.8%	$ 10,061	$ 15,839
Total Profit									**$100,611**	**$158,389**
Profit Mark-up (on Estimated Cost)									**10.1%**	**15.8%**

Example 2 - Profit Factors - Target Cost Incentive										
	Contract Risk (7-8%)		**Activity**		**General Business Risk**		**TOTAL %**		**Profit ($)**	
	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX
Direct Labour	7.0%	8.0%	0.0%	3.0%	3.5%	3.5%	10.5%	14.5%	$ 42,000	$ 58,000
Overhead (excl. G&A)	7.0%	8.0%	0.0%	3.0%	3.5%	3.5%	10.5%	14.5%	$ 13,650	$ 18,850
Material	7.0%	8.0%	0.0%	3.0%	0.0%	2.0%	7.0%	13.0%	$ 3,500	$ 6,500
Subcontract	7.0%	8.0%	0.0%	3.0%	0.0%	2.0%	7.0%	13.0%	$ 14,000	$ 26,000
Spares	7.0%	8.0%	0.0%	3.0%	0.0%	2.0%	7.0%	13.0%	$ 5,600	$ 10,400
ODCs	7.0%	8.0%	0.0%	3.0%	0.0%	2.0%	7.0%	13.0%	$ 1,400	$ 2,600
Travel	7.0%	8.0%	0.0%	3.0%	0.0%	0.0%	7.0%	11.0%	$ 1,400	$ 2,200
Sub Total (Excl G&A)									**$ 81,550**	**$124,550**
G&A							9.1%	13.8%	$ 9,061	$ 13,839
Total Profit									**$ 90,611**	**$138,389**
Profit Mark-up (on Target Cost)									**9.1%**	**13.8%**

Example 3 - Profit Factors - Cost Plus Margin Contract										
	Contract Risk (4%)		**Activity**		**General Business Risk**		**TOTAL %**		**Profit ($)**	
	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX	MIN	MAX
Direct Labour	4.0%	4.0%	0.0%	3.0%	3.5%	3.5%	7.5%	10.5%	$ 30,000	$ 42,000
Overhead (excl. G&A)	4.0%	4.0%	0.0%	3.0%	3.5%	3.5%	7.5%	10.5%	$ 9,750	$ 13,650
Material	4.0%	4.0%	0.0%	3.0%	0.0%	2.0%	4.0%	9.0%	$ 2,000	$ 4,500
Subcontract	4.0%	4.0%	0.0%	3.0%	0.0%	2.0%	4.0%	9.0%	$ 8,000	$ 18,000
Spares	4.0%	4.0%	0.0%	3.0%	0.0%	2.0%	4.0%	9.0%	$ 3,200	$ 7,200
ODCs	4.0%	4.0%	0.0%	3.0%	0.0%	2.0%	4.0%	9.0%	$ 800	$ 1,800
Travel	4.0%	4.0%	0.0%	3.0%	0.0%	0.0%	4.0%	7.0%	$ 800	$ 1,400
Sub Total (Excl G&A)									**$ 54,550**	**$ 88,550**
G&A							6.1%	9.8%	$ 6,061	$ 9,839
Total Profit									**$ 60,611**	**$ 98,389**
Profit Mark-up (on Cost)									**6.1%**	**9.8%**