

# COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS

2111 Wilson Boulevard, Suite 400  
Arlington, VA 22201  
www.codsia.org  
(703) 247-9490

January 8, 2002  
CODSIA Case No. 11-00

Ms. Sandra G. Haberlin  
Defense Acquisition Regulations Council  
OUSD (AT&L) DP (DAR)  
IMD 3C132  
3062 Defense Pentagon  
Washington, DC 20301-3062

Subject: Changes to Profit Policy (DFARS Case 2000-D018)

Dear Ms. Haberlin:

The undersigned members of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to comment on the proposed rule published in the *Federal Register* on September 21, 2001 (66 Fed. Reg. 48649) and commend the DAR Council on its progress in developing changes to the weighted guidelines that will enhance the health of the defense industry. Formed in 1964 by industry associations with common interests in the defense and space fields, CODSIA is currently composed of seven associations representing over 4,000 member firms across the nation. Participation in CODSIA projects is strictly voluntary. A decision by any member association to abstain from participating in a particular activity is not necessarily an indication of dissent.

The Department of Defense (DoD) proposes to amend the Defense Federal Acquisition Regulation Supplement (DFARS) in order to revise DoD's contract profit policy in a manner that would reallocate the emphasis on performance risk and facilities capital investment.<sup>1</sup> Specifically, DoD proposes the following changes to the Weighted Guidelines Method (WGM) for establishing pre-negotiation profit objectives:

- Add general and administrative (G&A) expenses and contractor independent research and development and bid and proposal (IR&D/B&P) expenses to the cost base used to establish profit objectives for performance risk and contract type risk;

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<sup>1</sup> The proposed rule replaces the proposed rule issued on July 24, 2000 (*Federal Register*, Vol. 65, No. 121, pages 45574 - 45579). See also CODSIA letter, September 29, 2000.

- Increase the normal values and designated ranges for performance risk by one percentage point;
- Remove buildings from the facilities capital employed factor;
- Reduce the normal value and designated range for the equipment portion of the facilities capital employed factor by 50%; and
- Install a new cost efficiency factor that allows up to four percentage points for contractor cost reduction efforts.

The undersigned members of CODSIA are encouraged by the action taken by the new administration on issues identified in last year's Defense Science Board Task Force Report.<sup>2</sup> The Board had concluded that a competitive defense marketplace with financially sound companies that are able to attract excellent technical and management talent was essential. We strongly agree with that conclusion. While the Board offered recommendations in many areas, those directed specifically at DoD's profit policy were as follows:

- Use incentives to drive positive performance, allowing excellent performance to yield significantly higher profit margins;
- Revise profit guidelines so that IR&D is fee bearing;
- Revise profit guidelines to remove incentive to make rather than buy;
- Revise profit guidelines to reduce the reward for fixed assets and add a factor to reward contractor cost efficiencies; and
- Allow higher profit margins on successful defense contracts (e.g., excellent cost/schedule/performance, technical performance exceeding specification, etc.).

The actions proposed by DoD are generally consistent with the Defense Science Board recommendations, however, the term "revenue neutral" used by DoD in the public meeting to describe the desired result, stops short of the DSB recommendation for a change that would allow higher profit margins on successful defense contracts. In addition, industry analysis of the proposed change indicates that the WGM calculation would not produce a revenue neutral result, rather a result that would be reduced profit.

While a change to the weighted guidelines methods is appropriate, it must produce both a change in motivation aligned with the current business environment, and at the same time,

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<sup>2</sup> Defense Science Board Task Force Report, "Preserving a Healthy and Competitive U.S. Defense Industry to Ensure our Future National Security," November, 2000.

provide a calculation for profit and fee rates that reward an industry with the opportunity for solid returns. Consistent with these objectives, the following recommendations must be considered and addressed in the proposed rule change:

### **Facilities Capital**

Some of our member's companies are concerned with the proposed reduction in emphasis on facilities. If implemented as proposed, we believe the industry will be penalized in comparison with the existing policy. While we recognize that some companies may have excess facilities and would benefit from the reduction of emphasis on facilities, other companies have made, and will continue to make, significant investments in facilities that are needed for efficient performance of defense contracts. We recommend DoD not reduce the normal range and designated range for the equipment portion of the facilities capital employed factor by 50%. To do so undermines the incentive for contractor investment in equipment modernization. In addition, remaining with the current equipment weighting would address the industry's concern that there is a "less than revenue neutral" result with the rule as proposed.

### **Cost Efficiency**

We support the addition of the cost efficiency factor. The objective of the factor is stated as a "special factor to encourage cost reduction efforts." Cost reduction is beneficial to the Government whether it is at the enterprise level or at the level of a specific contract. As noted above, industry also believes strongly that this factor and its use in the calculation must be revised to insure the WGM produces the intended result. These revisions include:

- This factor should not be restricted to the "pending contract." Instead, it should be expanded to consider long term cost reduction and productivity criteria with wider application. It could be revised as follows: "...evaluate the benefit the contractor's cost reduction efforts will have on pending *and/or subsequent contract(s) or overall cost to the Government...*". Consistent with this revision, it is recommended that the factor be renamed "Productivity & Cost Efficiency" to reflect this broadened view. A time frame should also be specified over which contractors' macro cost reduction efforts would be considered.
- The cost efficiency factor must be considered a mandatory element in the contracting officer's evaluation – not simply "to determine if using this factor is appropriate" [Proposed 215.404-71-5(b)]. A requirement to employ cost efficiency as a profit factor will help assure industry that its cost efficiency efforts are important and recognized and will be given due consideration in each profit/fee assessment.
- It is important that it be clearly communicated in the guidelines how various actions and accomplishments will be translated into actual profit recognition. The current guidelines provide examples of areas of consideration but do not provide guidance as to what level

of action or accomplishment equates to a specific percentage of the scoring. Other factors in the guidelines provide indicators for receiving above or below normal ratings.

Consistent with this format, the guideline should provide clear indicators for normal, above normal and below normal ratings.

- Consistent with our remarks on facilities capital, we recommend that there be an element within this cost efficiency factor that would recognize new facilities where appropriate to provide credit for investment in buildings, but only when such investments contribute to better asset utilization or improved productivity, or are demonstrated to be vital to the contract or program under consideration.

With these changes, we support this new cost efficiency factor. We, however, remain concerned that the factor could suffer the same fate as the previous "special productivity factor." That factor was found by DoD not to be credible and rarely to have been used by contracting officers, which is why it was eliminated. A more recent example is the technology incentive factor for performance risk that was implemented on December 13, 2000. We have seen infrequent use of this incentive as confirmed by the recent GAO report (GAO-010-801, Use of Profit Policy to Promote Innovation, dated July 26, 2001). These types of incentives, whether for technology or cost efficiency, must be utilized consistently to achieve the DoD desired result and the Defense Science Board recommendations.

### **Training for Implementation**

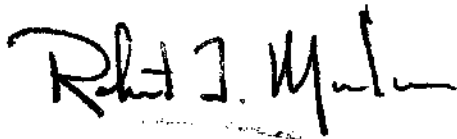
The training of the acquisition work force and industry counterparts is essential for success and achievement of the desired result. A key objective of the training activity must be developing an understanding among the acquisition workforce of the "macro economics" of the defense marketplace and its industry. Members of our associations stand ready to partner with DoD in developing and deploying an effective training and education effort to implement this change.

We appreciate the opportunity to comment on the proposed rule and look forward to working with the DAR Council. We encourage you to press forward with the proposed rule and incorporate our recommendations. Additionally, industry pledges its support in working with DoD on the training and implementation action plans.

If you have any questions or need additional information, please contact Patrick Sullivan, the CODSIA Project Officer for this case, at (202) 371-8522.

Sincerely,

(SEE ATTACHED CODSIA SIGNATORIES)



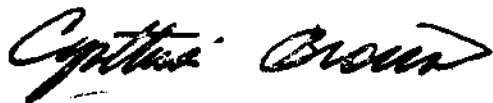
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Robert T. Marlow  
Vice President, Government Division  
Aerospace Industries Association



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Lorraine M. Lavet  
Chief Operating Officer  
American Electronics Association



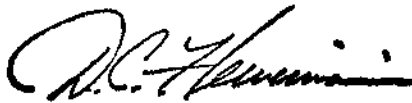
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Cynthia Brown  
President  
American Shipbuilding Association



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Gary D. Engebretson  
President  
Contract Services Association



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Dan C. Heinemeier  
President, GEIA  
Electronic Industries Alliance



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Lt. Gen. Lawrence P. Farrell, Jr., USAF (Ret.)  
President and CEO  
National Defense Industrial Association