

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS

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July 21, 2000
CODSIA Case No. 23-99

Ms. Amy Williams
Defense Acquisition Regulations Council
PDUSD(AT&L) DP(DAR)
IMD 3D139
3062 Defense Pentagon
Washington, DC 20301-3062

Re: DFARS Case 2000-D300; Profit Incentives to Produce Innovative New Technologies

Dear Ms. Williams:

The undersigned members of the Council of Defense and Space Industry Associations (CODSIA) appreciate the opportunity to offer comments on the proposed rule regarding Public Law 106-65 Section 813 as published in 65 Federal Register 32066 on May 22, 2000. Formed in 1964 by industry associations with common interests in the defense and space fields, CODSIA is currently composed of eight 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 DAR Council proposed to implement Section 813 of the National Defense Authorization Act for Fiscal Year 2000, which requires the Department of Defense to review its profit guidelines and provide an increased profit incentive for contractors to develop and produce complex and innovative new technologies.

The proposed rule amends the weighted profit guidelines at DFARS 215.404-71 as follows:

- combines the management and cost control elements of the performance risk factor,
- establishes a new "technology incentive" range for technical risk and,
- slightly modifies some of the cost control standards based on comments received at the public meeting.

In addition, the rule amends DFARS 215.404-4(b) to clarify that DoD departments and agencies must use structured approaches for developing a pre-negotiation profit or fee objective on any negotiated contract action when cost or pricing data is obtained.

The undersigned CODSIA members commend this effort by the DoD to advance acquisition reform by proposing this revision to the weighted profit guidelines. CODSIA members strongly support DoD's effort to revise its profit policy. We consider this proposed rule to be a partial improvement that addresses some of the current deficiencies of the weighted profit guidelines.

The following comments and suggested changes to the proposed rule are provided for your consideration in developing the final rule:

- 1) DFARS 215.404-4 (b) (1) states that "Departments and agencies must use a structured approach for developing a pre-negotiation profit or fee objective on any negotiated contract action when cost or pricing data is obtained except for cost-plus-award-fee contracts. . . ." One of the key tenets of the acquisition reform movement has been to increase empowerment of the contracting officer. Requiring that the contracting officer must use a structured approach for determining profit seems to be contrary to the emphasis on empowering the contracting officer. We suggest that the word "must" be changed to "is encouraged to." This would allow the contracting officer to consider all the circumstances of the procurement in determining whether to use a structured approach for determining profit, or how structured/formal that approach should be. Note that this change would also necessitate revision to FAR 15.404-4 Profit.

The undersigned CODSIA members do not believe that the proposed changes are significant enough to motivate the type of innovation that is contemplated by the statute. The Government has been shifting to a performance-based business environment, however performance incentives are rarely included in firm fixed price contracts. The DoD has reviewed many different alternatives for contractual incentives that can be employed to ensure timely delivery of the highest quality goods and services at the best value to the customer. Many of these incentives have been successfully used in the commercial marketplace to obtain the benefits from both the pace of technology advancement and the innovation that high technology companies offer. Accordingly, it is recommended that 215.404-4 be revised to include the following paragraph:

In addition to the objective established in accordance with this structured approach, when using a performance based statement of work, performance incentives may be agreed upon between the contracting officer and the contractor. To the maximum extent practicable, the contracting officer shall consider establishing incentives where performance is critical to the Government's mission and incentives are likely to motivate the contractor.

- 2) DFARS 215.404-71-2—The footnote under the example of how to calculate the weighting states: "Block 18 is total contract costs, excluding general and administrative expenses, contractor independent research and development and bid and proposal expenses, and facilities capital cost of money." It is suggested that an additional sentence be added immediately after that sentence as follows: "General and administrative expenses are

excluded from the calculations of the weighted guidelines formula, but General and Administrative expenses are included in the base to which the profit percentage is applied.”

- 3) DFARS 215.404-71-2 (c) “Values,” includes only a two percent additional value for the technology incentive. This is a minor increase in profit for assuming the additional risk associated with innovative new technologies. It is doubtful that this will spur the innovation intended by the statute. Since many of these new technologies may have the potential to reduce costs, the contractor should be allowed to share in those savings. A minimum of five percent is necessary to encourage the contractor to assume these additional risks.
- 4) DFARS 215.404-71-2 “Performance Risk” Subsection (c)(3)—The language of the proposed subsection, as presently drafted, is overly restrictive and should be broadened to expand the application of the incentive. The current terminology implies that for the contracting officer to consider the use of the incentive, the acquisition must include the “development or production” of innovative new technology. The focus appears to be on the creation of new technology. For the technology incentive provisions to have the maximum benefit for the Government, the rule should also allow for innovative applications of technology. This incentive should not only address newly developed or produced technology, but also the application of existing advanced or new technology to the acquisition in a manner that creates benefits for the Government. Accordingly the following revisions are recommended:

(3) *Technology incentive.* For the technical factor only, contracting officers may use the technology incentive range for acquisitions that include development, **production, or application of innovative new or existing advanced technologies to the governments programs.**

- 5) In Subsection (4) “Technology Incentive Range,” the first sentence of subparagraph (i) should be clarified to confirm that use of the Technology Incentive Range is not reserved exclusively for contractor performance over and above the contract requirements regardless of the contract type. Most high technology contracts would typically be cost reimbursable contracts. It is not in the Government’s best interest for contractors to expend Government funds for effort outside of the scope of a cost reimbursable contract. Addition of the introductory phrase “Keeping in mind that the Government’s expectation of the contractor is that the contractor performs the contracted scope of effort,” is suggested. Then the first sentence reads: “The second sentence of subparagraph (i) as presently drafted would result in a very narrow application of the proposed rule.” The term “only,” as well as the phrase “the most innovative,” will be a very constraining factor for contracting officers who are trying to determine whether to use the technology incentive. It is recommended that this paragraph be revised to read:

(i) Keeping in mind that the Government’s expectation of the contractor is that the contractor performs the contracted scope of effort, the contracting officer may assign values within the technology incentive range when contracting performance includes the introduction of new, significant technological innovation. The contracting officer may use the technology incentive range for

innovative contract efforts that produce benefits for the Government by the development, production, or application of new or existing advanced technologies.

Additionally, subparagraph (A) under subsection (4)(i) requires that innovation be in the form of development or application of new technology that fundamentally changes the characteristics of an existing product or subsystem, *and* that results in increased technical performance, improved reliability, or reduces costs. Both these criteria are of value and significant enough to be stand alone requirements. Therefore the word “and” should be changed to “or” so either requirement could be met separately. This will allow greater application of the technology incentive and provide maximum benefit to the Government and motivation to the contractor.

- 6) DFAR 215.404-71-2 (e) (vi)—In the phrase “square parts pricing reform” correct the spelling from “square” to “spare.”
- 7) DFAR 215.404-71-2(e) (3) (F). This states that the contracting officer may assign a lower than normal value when the management effort is minimal. The language further cites an indicator of such to be “(F) The contractor does not cooperate in the evaluation and negotiation of the proposal.” This is a subjective statement, which is inappropriate in today’s acquisition environment.
- 8) DFAR 215.404-71-2(e) (3). This section addresses assessment of evaluation criteria for management/cost control for below normal conditions. Included among the enumerated indicators of below normal conditions are: “(D) The contractor provides poor quality, untimely proposals” and “(I) The contractor’s cost proposal is inadequate.” These two indicators are so similar that it is recommended that they be combined. Not combining (D) and (I) may inadvertently result in the contractor being penalized twice for the same deficiency.

In addition to these specific changes, the undersigned CODSIA members believe that the weighted profit guideline provisions should be reviewed and updated to align them with the new business realities of the 21st Century. These realities do not promote such activities as the acquisition of plant and equipment, or other assets such as inventory and receivables. Instead, they manage by returns generated on their assets through good capacity management and outsourcing of non-competencies. Today’s companies employ cycle-time reduction and process reengineering to increase the responsiveness of their enterprise (e.g., inventory turns). They also promote new methods to deliver goods and services directly to the consumer around the clock and around the globe, without relying on traditional models of distribution and warehousing.

The current version of the DoD weighted profit guidelines falls short in addressing these new factors to incentivize contractor performance. In several areas of the current guidelines there are contradictions in the incentives. For example, companies that outsource to a lower cost provider will be penalized in the application of weighted profit guidelines. Also, total G&A costs are excluded, thereby excluding the companies’ investment in independent R&D from any

profit consideration at a time when DoD hopes to gain greater access to industrial R&D to offset its own diminishing investments in R&D.

When addressing the subject of profit/fee, the Government should consider that in recent years industry contractors have been encouraged by DoD to achieve cost economies by entering into business combinations. Industry is now incurring large consolidation costs without an adequate way to recover those costs. From a financial accounting standpoint, consolidation costs cannot be amortized over the long term, but must be dealt with in the near term, which further exacerbates the negative impact on profitability for industry.

There are several areas of misalignment with the "New Economy" practices, as noted below:

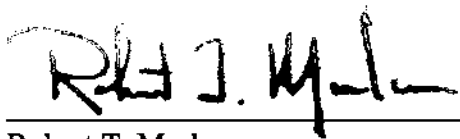
Weighted Profit Guidelines	"New Economy" Best Practices
<ul style="list-style-type: none">• Encourage investment in plant and equipment assets	<ul style="list-style-type: none">• Minimize assets – Increase "turns"
<ul style="list-style-type: none">• Provide no incentive for company-funded R&D	<ul style="list-style-type: none">• Encourage heavy investment in R&D
<ul style="list-style-type: none">• Penalize out-sourcing	<ul style="list-style-type: none">• Retain strategic capability – out-source the rest
<ul style="list-style-type: none">• Focus highly on payments and cash flow	<ul style="list-style-type: none">• Stress the importance of cash flow but not at the expense of growth
<ul style="list-style-type: none">• Provide no explicit incentive for cost reduction or reducing cycle time	<ul style="list-style-type: none">• Reduce costs while increasing velocity and value
<ul style="list-style-type: none">• Reduce profits if commercial off-the-shelf items are used on contracts	<ul style="list-style-type: none">• Encourage evolutionary product development to minimize risk and incrementally improve profitability
<ul style="list-style-type: none">• Create an effective cap on earnings	<ul style="list-style-type: none">• Reward innovation and first to market achievements
<ul style="list-style-type: none">• Establishes limits on profitability	<ul style="list-style-type: none">• Emphasize profitability to attract investment and talented young professionals

In parallel to this DoD proposed rule change, the DSB task force is close to completing its study of "The Impact of DoD Acquisition Policies and Practices on the Health and Competitiveness of the United States Defense Industry." We are hopeful that the DSB study will recommend a major reexamination of the weighted profit guidelines.

In closing, the undersigned CODSIA members appreciate the opportunity to comment on the proposed rule and look forward to working with the DAR Council to finalize these changes. If you have any questions or need additional information, please contact Tim Nunnally-Olsen, Administrative Officer, at (703) 247-9490.

Sincerely,

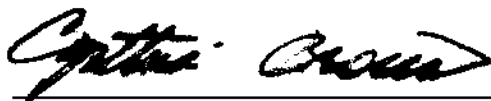
SEE ATTACHED CODSIA SIGNATORIES



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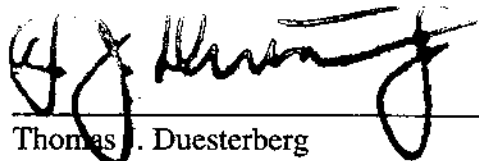
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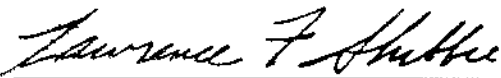
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