



ISSUE PAPER

Acquisition Policy Changes: Impacts on Contract Profitability

Federal acquisition policy expressly recognizes the importance of the contractor's ability to earn reasonable returns on business with the Government. FAR 15.404-4(a)(2) provides that "[i]t is in the Government's interest to offer contractors opportunities for financial rewards sufficient to stimulate efficient contract performance, attract the best capabilities of qualified large and small business concerns to Government contracts, and maintain a viable industrial base." Recent acquisition trends and policies, however, have attacked the profit and fee portions of contractor's prices, either through the elimination of fee on certain cost elements or by negotiation strategies impacting overall returns on government contracts. In addition, proposed policy changes aimed at forcing business system improvements and delaying fee until contract completion would significantly impede government contract cash flow, a critical part of the value proposition when doing business with the Government. Finally, for research and development, acquisition policy trends now favor cost-share, no-fee, or firm-fixed-price contracts, making full compensation for the development of government-unique technologies virtually impossible. Industry believes acquisition trends focused on elements of profitability, including changes to contract cash flow and policies for R&D funding, will have negative consequences for the Government and the nation as a whole as contractors and investors move resources away from unprofitable government business.

Perspectives on Profitability

Businesses view contracts from the perspective of profitability because contractors must make money in order to stay in business. Businesses measure the profitability of a

particular business deal on several factors, among which the FAR definition of profit or fee is only one metric. As FAR 15.404-4(a)(1) recognizes, "[p]rofit or fee prenegotiation objectives do not necessarily represent net income to contractors." Contractors must cover legitimate business costs that are not recognized as allowable by the Government, such as debt collection costs, losses on contracts, or interest on borrowings. A contractor's actual costs incurred may be higher than negotiated profit rates due to performance challenges and unforeseen increases in material and labor costs. In addition, cash flow and working capital are significant factors that businesses use to measure the overall returns of a particular contract. Whether a contract may lead to more business is also an important consideration of the value of the business deal.

In February 2009, the Institute for Defense Analysis released a report entitled "Defense Department Profit and Contract Finance Policies and Their Effects on Contract and Contractor Performance", prepared under a contract with the Department of Defense. The report addressed the question of whether DoD's profit policies provide adequate profit to defense contractors. In answering the question, IDA looked not only at the weighted guidelines but also contract types and contract financing to determine the profitability of government business. The report concludes that the defense industry is healthy because government contracts produce good cash flow and include direct funding of R&D and some capital expenses. The study admits, however, that the margins for the defense industry are lower than companies in other sectors. The health of the industry resides in the trade-off of good working capital financing, which offsets low profit margins. In fact, the report states that "[c]ontract financing is critical to offsetting low margins." IDA's analysis also points out the importance of government funding of

R&D to offset low margins, such that “[t]he financial structure of the defense prime contractors is leaner than other industrial firms due to the unique relationship between defense firms and the Defense Department.” The report concludes that any changes to policy “should be stress-tested with rigorous cash flow and risk analysis” due to the significance of cash flow and R&D funding in such a low-margin business.

Recent acquisition policy changes and government buying trends seem to be focus on the three facets of profitability discussed in the IDA report: profit/fee percentages, cash flow, and R&D funding. The acquisition community has sent a clear message to contractors that use of weighted guidelines by contracting officers will be scrutinized and that profits will be going down – not due to poor performance or reduced complexity of products and services supplied, but just reduction for the sake of reduction. There has also been a trend of eliminating fee on certain elements of cost, including work performed by subcontractors, without regard to integration and subcontract management risk, and contractor-acquired government property that, although required to perform the contract, is not a deliverable under a contract. The proposed business systems rule would use large-scale withholding of payments to address perceived deficiencies in business systems, thereby reducing the benefit of contract financing normally available when doing business with the Government. A proposed rule would mandate backloading of fee under cost-reimbursement contracts, again with the consequence of reduced cash flow. Policy changes have limited the circumstances under which a cost reimbursement contract is appropriate, making fixed-price development possible and reducing the likelihood that R&D expenses will be funded.

Profit Promotes Government Interests

Contractors use earnings for a variety of purposes that promote the mutual interests of industry and the Government. Of particular interest to the Government are investments in the following areas: cost reduction, new technology, and a highly educated workforce.

Cost Reduction

Earnings are used to invest in cost reduction and efficiency initiatives for existing products and services. Cutting recurring costs often requires investments in new equipment, infrastructure, and process improvements. Reducing contract profit rates jeopardizes contractors’ ability to reinvest in businesses and improve upon cost structures to meet the Government’s efficiency goals.

New Technologies

Contract profit allows companies to invest in the development of new technologies for future applications. Tight budgets mean that the Government will be increasingly dependent on the private sector to fund R&D to meet public and defense needs and reduce lead-times for the introduction of technology. Current policies either limit the Government’s ability to compensate contractors for past R&D spending, or if a mechanism is available, it is rarely used by acquisition professionals. In addition, trends in the government’s use of aerospace products have been difficult to predict, making private investment in the business riskier. Programs may be terminated or changed, contractors may be shut out of portions of the market in a single source selection, regulations may introduce additional costs of doing business with the government, policies may change following an election, evolving national security threats may cause a rapid change in priorities, and spending cuts can impact the viability of an entire market segment. If acquisition policies make government business an unattractive investment option for private funding because it is not profitable, the Government will suffer through the lack of available technologies needed to support the mission.

Workforce

Profitable businesses can support competitive salaries that will attract a highly educated workforce, and a healthy industry has the means to invest in programs to support math, science and engineering education to develop tomorrow’s workforce, both for private business and for the Government. Many of the major aerospace contractors contribute money and other resources to promote science, technology, engineering and math (STEM) education at all levels of schooling. Contributions include the contractors’ employees donating time to teaching and mentoring programs, as well as funding for employees’ pursuit of their own higher education.

In 2009, Aviation Week published a workforce study to provide a comprehensive overview of the aerospace and defense industry workforce. The study reveals significant contributions to STEM programs from private industry. Of the 43 companies responding to the survey, each company supported an average of 23.8 STEM programs with an average investment of \$1.8 million in 2008. In the same year, each company’s employees recorded an average of 19,009 hours volunteering and mentoring under STEM programs. A financially healthy industrial base can continue to provide support to STEM programs that would be difficult and costly to replicate using direct public funding alone.

Specific Concerns about Profit Policies

A general concern for Department of Defense contracts is the under-utilization of the incentives provided in the weighted guidelines (WG) system. Industry's continued experience with WG outcomes often appear to result in the same profit percentage determinations as in the past with no apparent behavior modification associated with the 2000 and 2002 revised Weighted Guidelines.

There is an imbalance in DoD profit practice because the most difficult and complex development contracts to develop the best weapon systems in the world earn profits in the low single digits. Recent OSD profit promulgations have exacerbated the problem by making it even more difficult to earn reasonable award fees. R & D and Low Rate Initial Production contracts, where margins are traditionally the lowest and often experience the application of the zero base fee policy, require the greatest investment and the most highly skilled human resources of industry. The follow-on production programs, which typically yield higher margins, can no longer be depended upon due to budget constraints, changing Government requirements and the priorities of the Global War On Terrorism. The combination of lower margins in development, a higher percentage of development programs compared to full rate production, and the uncertainty of capturing higher margins in the production phases jeopardizes the financial stability of the DoD industrial base.

There is also a general perception among Contracting Officers that one of their roles is to drive down contractor profit, believing that lower profit equates to a better deal for the taxpayer. The data from past surveys of Contracting Officers have supported this perception. This is also seen in the response to DOD initiatives such as the Technology Incentive and Cost Efficiency Incentives. In each case, we observe that contracting officers seem to believe that in spite of any adjustments in policy, the profit that is calculated can be no higher than has been historically agreed to. This is very shortsighted, and contrary to the stated DOD policy. No amount of adjusting of profit policy will have the desired effect until this perception is corrected.

Technology Incentive

Section 813 of Public Law 106-65, the FY 2000 NDAA, directed the Secretary of Defense to review DFARS profit guidelines to consider whether appropriate modifications would provide an increased profit incentive for contractors to develop and produce complex and innovative new technologies. In December 2000, DoD issued a final rule implementing Section 813, establishing a new technology

incentive with a higher range of profit objectives applicable to the technical factor in Weighted Guidelines, to be used for acquisitions that include development, production, or application of innovative new technologies. However, the rule provided that the technology incentive range does not apply to studies, analyses, or demonstrations that have a technical report as their primary deliverable. The policy fails to recognize the necessity to utilize the most highly trained and experienced personnel for state-of-the-art technological advances that may be first recognized as part of a study, demonstration, or analysis.

In July 2001, GAO issued a report concluding that DoD's policy needed clarification, and that it may have limited effect on encouraging additional innovation because the policy has limited reach during research and development when technology innovation is a high priority. DoD's response was that it would review use of the factor after its first year of effectivity and consider whether additional clarifications were warranted. In October 2002, at the urging of industry, OSD issued a memorandum to the Military Departments and Defense Agencies surveying the use of the technology incentive in Weighted Guidelines. We have not seen the results of the survey nor any indications that GAO's conclusions are being addressed. Our experience is that this incentive is rarely being used.

Industry recommends DoD remove the restriction on use of the technology incentive range for acquisitions that have a technical report as the primary deliverable. Early research, studies and analyses are key initial steps in implementing innovative new technologies. We also encourage more frequent use of the incentive in the later stages of complex programs.

Cost Efficiency

The cost efficiency factor at DFARS 215.404-71-5 was created as part of the 2002 Weighted Guidelines revision that was intended to shift the incentive away from contractor investment in capital facilities and equipment (hence the simultaneous reduced range for facilities capital employed) and to incentivize contractor investment in cost reductions and efficiency. It has long been observed that in DOD business, there is little incentive for contractors to drive down production costs given that lower labor and material costs will only result in lower profit dollars. This outcome is contrary to the best long term interests of DOD.

Industry suggests that if DoD is serious about encouraging investment, the DFARS should be strengthened to read:

"To the extent that the contractor can demonstrate cost reduction efforts that benefit the ~~pending~~

~~contract~~ Department of Defense, the contracting officer ~~may~~ shall increase the prenegotiation profit objective by an amount not to exceed 4 percent of total objective cost..."

DFARS should make *consideration* of the factor obligatory, since the range of zero to 4% does not obligate the contracting officer to provide any recognition for work the contractor may have done in these two areas. Additionally, the requirement to demonstrate benefit to the pending contract can be difficult, particularly for initiatives that reduce indirect cost. If DoD wants to encourage cost reduction and efficiency, contracting officers should be required to consider cost efficiency as an element of profit objective, while being given greater flexibility to recognize contractor investment in cost efficiency initiatives. Examples of initiatives include Earned Value Management System (EVMS), lean, Six Sigma, CMMI, and ISO qualifications, or consolidating accounting systems such as implementation of SAP. Similar comments were offered when DFARS Case 2000–D018 proposed rule was initially issued for public comment, but were rejected at the time.

Also, Contractors are being required to assume more performance and financial risk to capture new work and to fund contracts in anticipation of Government funding. The Government's profit policy should recognize this contractor behavior that ultimately benefits the Government. It is common for the Government to rely on contractor provided "bridge" funding to prevent costly work stoppages in the period of transition between fiscal years. Consideration for providing these interest free loans to the Government is virtually never provided.

Undefinitized Contractual Actions

Undefinitized Contractual Actions (UCAs) have recently been discussed as targets for reducing contractor profit as a means of incentivizing earlier definitization. UCAs are only utilized by the government customer when the requirement is of such urgent need that there is not time for the usual proposal and evaluation/negotiation process. Most often the delays in definitization are attributable to the government customer rather than the contractor. Further, true cost risk is not reasonably understood or realized until the end of the process when inspection and testing reveal other issues. Therefore, there is normally very limited justification for reducing profit based on reduced cost risk.

Nevertheless, DFARS 215.404-71-3 mandates that the contracting officer assess the extent to which costs have been incurred prior to definitization for purposes of evaluating contract type risk and the working capital adjustment.

Contractors have even seen this portion of the DFARS used to eliminate profit on work performed in advance of contract award to protect the Government schedule, under the rationale that there is no risk because costs have already been incurred. The UCA policy on profit, combined with the practice of extending its application beyond UCAs, merely serves to discourage contractors from performing in advance of price agreement to protect schedules and dampens contractors' willingness to enter into UCAs, thereby reducing the availability of a type of contract that is important for mission fulfillment.

Change to Government Property Regulations

Recent proposed and final rules amending FAR Part 45 included language excluding from profit calculations any contractor-acquired property that meets the definition of equipment directly charged to the contract. The stated rationale for the change is that this type of government property is a pass through merely because it is not a contract deliverable. This change is evidence of a trend toward eliminating profit on specific elements of cost, despite the fact that the purpose of calculating pre-negotiation profit objectives is to arrive at an overall fair and reasonable contract price and should not be focused on single elements. The language is likely to have the unintended consequence of steering contractors away from specialized equipment purchases that could improve the quality of deliverables under the contract and could even reduce manufacturing costs. The change also unnecessarily complicates price analysis and the calculation of pre-negotiation profit objectives at a time when the acquisition community is stretched thin by increased workload and reduced staffing.

Relationship to DoD Efficiency Initiatives

Ashton Carter's recent series of memoranda on Better Buying Power tie together the concepts of reducing DoD cost by incentivizing performance, including cost control and subcontract management, through higher profit. The September 14, 2010 memorandum points out the value of cash flow in defense acquisition with a discussion of progress payments. The memorandum also discusses the R&D funding, specifically in the areas of proper contract type and the value of IR&D reimbursement. The next step in the analysis of improving DoD buying power should be to examine the interplay of these three aspects of profitability (profit/fee, cash flow, and R&D funding), along with contract type, to provide updated guidance to the acquisition community to promote the goal of fiscal health, both for the Government and for industry.

