A SPECIAL REPORT

Defense Acquisition Reform:

Moving Toward an Efficient Acquisition System

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AEROSPACE INDUSTRIES ASSOCIATION

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Over the years, the Aerospace Industries Association has worked with numerous presidential commissions and task forces charged with examining the policy maze that is the defense acquisition process. We have offered concrete recommendations to remedy some of its systemic inconsistencies, redundancies and inefficiencies. We have also successfully advocated for statutory changes such as lowering of procurement barriers through simplified procurement procedures, reliance on commercial off-the-shelf technology and best value acquisitions.

The Federal Acquisition Streamlining Act of 1994 and the Federal Acquisition Reform Act of 1996 removed traditional oversight mechanisms that had been in place for decades, paving the way for a new method of awarding federal government contracts. Unfortunately, the benefits have been hindered by decades-long layering of byzantine statutes, regulations and policies, compounding the complexities of a system that is today fundamentally broken.

We were cautiously optimistic when former Secretary of Defense Gates announced the creation of the *Efficiencies Initiative* in 2010 and asked AIA to provide industry perspective on changes that would create the greatest cost efficiencies. DOD stated that its efforts would focus primarily on the elimination of "duplicative, unnecessary overhead costs."

This report identifies the key elements of the *Efficiencies Initiative* that are both doable and necessary. This report also identifies reforms to the system not included in the *Efficiencies Initiative* that we believe are necessary to ensure the ultimate beneficiary — the warfighter — has the tools needed at a cost that is acceptable to the taxpayer.

Most of our recommendations can be accomplished by DOD in the short term and without legislative remedies. They are not a panacea, but if adopted would eliminate some of the more unpredictable and burdensome aspects of the current acquisition process. Government and industry agree that retaining the status quo is no longer an option. As the Defense Science Board found in 2009: "U.S. Government policies, practices, and processes do not facilitate the development, deployment, and support of the innovative, affordable, and rapidly acquired weapons, systems, and services needed for the 21st century forces."

In order to maintain a robust and stable 21st century national defense industrial base, we must work together to sustain the momentum for appropriate government actions (*i.e.*, acquisitions, policies, practices, and laws) that advance the national security interests of the United States.

Marion C. Blakey
President and Chief Executive Officer

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EXECUTIVE SUMMARY

Acquisition reform strategies have evolved in response to changing national security threats, technology-driven product life cycles, workforce adjustments and budgetary constraints. Under increasing financial pressure, in May 2010 the Defense Department undertook a comprehensive effort to increase efficiencies, reduce overhead costs and eliminate redundant functions. This effort — known as the *DOD Efficiencies Initiative* — focused on reprioritizing DOD's use of resources to more effectively support and sustain the warfighter.

At the request of the department, the Aerospace Industries Association reviewed the *Efficiencies Initiative* to determine whether it would result in quantifiable and empirically verifiable improvements in acquisitions cost performance while sustaining the national defense industrial base.

While we found that a number of the *Efficiencies* initiatives represented positive steps toward achieving the government's "better buying power" goal, we also identified key elements of an efficient and simplified acquisition system, and recommended specific policies to encourage and reward good performance, promote fairness and stability, incentivize cost savings and establish balanced and equitable risk/reward financial relationships. To that end, we proposed five actions to serve as the foundation of meaningful and actionable procurement reforms:

- Increased utilization of commercial products, practices and processes;
- Creation of a performance-based profit policy;
- Elimination of barriers to innovation;
- Reform of oversight functions; and,
- Reform of the regulatory promulgation process.

In this report, AIA raises a red flag, cautioning DOD against a "one size fits all" regulatory regime based on overly proscriptive, government-unique regulations. to ensure a competitive defense acquisition environment and sustain a healthy defense and aerospace industrial base, AIA strongly recommends an abandonment of risk-averse acquisition reform paths that enshrine direct cost savings as the ultimate barometer of success. The reform approach — as reflected in the *Efficiencies Initiative* — will do little more than maintain the status quo. A new approach is required that liberates DOD from continued reliance on complex processes that offer little flexibility and create too many barriers for federal program managers to buy what they need for U.S. forces facing new and emerging threats.

HISTORICAL PERSPECTIVE

Since the first Hoover Commission was created by President Truman to study and recommend administrative changes in the Federal Government, there have been many efforts to restructure and modify Executive Branch organizations — most visibly in the Department of Defense (DOD). The following is a partial list of the various acquisition policy-related commissions created since the 1940s:

- Hoover Commission – 1949
- Steadman Review – 1977
- Carlucci Initiatives – 1981
- Packard Commission – 1986
- Defense Management Review – 1989
- National Performance Review – 1993
- Defense Acquisition Performance Assessment – 2006
- Fitzhugh Commission – 1970
- DeLauer Panel – 1978
- Grace Commission – 1983
- Goldwater/Nichols Act – 1986
- DSB Streamlining Study – 1990/93/94
- Defense Reform Initiative – late 1990s
- DOD Efficiencies Initiative – 2010

Over the past seven decades, the common goal of these high-level commissions and task forces was to reduce the costs of new weapons. In so doing, they hoped to drastically cut system development and production times (and thereby costs) by reducing management layers, eliminating certain reporting requirements, using commercial off-the-shelf systems and subsystems, reducing oversight from within as well as from outside DOD, and eliminating perceived duplication of testing, among other initiatives. In some cases, they were in response to egregious mismanagement and acquisition horror stories.

Experience has convinced many observers that the fundamental shortcoming in the procurement process has been and continues to be the failure of the acquisition community — from program managers to senior decision-makers and their advisors — to implement the letter and intent of DOD's existing acquisition directives and guidelines. These include many critical findings and recommendations generated by the reform efforts mentioned above.

Presidential blue ribbon commissions and task forces have debated the merits, means, consequences and missteps associated with acquisition reform. Reform efforts and priorities have evolved as a direct consequence of changing national security threats, technology-driven product life cycles and workforce adjustments. Public and private sector acquisition professionals have joined the debate, seeking to gauge the potential for a successful implementation of each commission's particular vision for change. While DOD adopted some of the most substantive findings and recommendations of these reviews, it is unfortunate that the personnel charged with managing the process too often lacked the will or senior-level support necessary to implement them during the course of program decisions.

Like most red tape[1], the government's procurement rules were adopted with the best of intentions. Unfortunately, today's acquisition process does not reflect a coherent design. Instead, it is a collection of salutary incremental measures intended to fix narrowly-defined problems. The

unintended consequence of these additional layers of statutes, regulations and policies has been an increasingly complex process that is, in the words of one acquisition report author, "proving to be less than the sum of its parts." Rather than simplifying the process, rigid safeguards have been adopted that give federal managers little flexibility to buy what they need.

A 1994 Coopers & Lybrand study, "*The DOD Regulatory Cost Premium: A Quantitative Assessment*," surprised even the harshest critics of the Pentagon's regulatory regime. This survey, commissioned by DOD, analyzed the impact of DOD's regulations and oversight requirements on contractors, and identified more than 120 regulatory and statutory cost drivers that added a jaw-dropping 18 percent cost premium to DOD procurements.

Most would agree with President William Henry Harrison's assertion that "a decent and manly examination of the acts of government should be not only tolerated, but encouraged."[2] In that spirit, it is fair to question which of the government's efforts have reduced the impact of the cost drivers identified in the Coopers & Lybrand report. Over time, many have reached the conclusion that the findings of the various acquisition reform commissions were, while well-considered, generally repetitive and resulted in few significant changes in the defense acquisition process.

Virtually all attempts at acquisition reform have fallen short, not due to a shortage of ideas, but from the difficulty in identifying and changing counterproductive government and industry incentives. DOD must realize the enormous impact of its policies on small- to mid-size companies that represent the majority of its contractors. Rather than enabling innovation and productivity through best commercial practices, DOD has reverted to a "one size fits all" oversight regime based on government-unique regulations. It is unfortunate that the acquisition reform successes and lessons learned in the 1990s are now only a fading memory. Due to their narrow focus on escalating costs associated with contingency operations (a small and unique subset of DOD acquisition), the Bush administration abandoned many successful cost efficiency programs.

In his opening remarks on the *Efficiencies Initiative,* Secretary of Defense Robert Gates stated, "This department simply cannot risk continuing down the same path — where our investment priorities, bureaucratic habits, and lax attitudes towards costs are increasingly divorced from the real threats of today, the growing perils of tomorrow, and the nation's grim financial outlook." He stressed that DOD's reform efforts were only possible "if followed through to completion."[3]

However, a flood of new knee-jerk regulations will negatively impact the entire DOD acquisition process despite the fact that the issues being addressed may be unique to contingency contracting operations.

Fair acquisition policies are required to maintain a competitive defense acquisition environment and sustain a healthy defense and aerospace industrial base. To do so, the government must focus on developing contracting and financial policies that encourage and reward efficiency and good performance, promote fairness and stability, incent cost savings and establish balanced and equitable risk/reward financial relationships.

BETTER BUYING POWER

In May 2010, in the face of unprecedented economic turmoil and declining budget dollars, the Defense Department undertook a comprehensive effort, primarily focused on cost savings, to increase efficiencies, reduce overhead costs and eliminate redundant functions in order to improve the effectiveness of the DOD enterprise. This effort — known as the *DOD Efficiencies Initiative* — focused on reprioritizing how DOD uses resources to more effectively support and sustain the force and, most importantly, the warfighter.

When the Defense Department announced its "*Efficiencies Initiative*," it was said to embody the department's imperative to "do more without more."[4] This catchphrase encapsulates the thrust of the DOD *Initiatives*. DOD has not shied away from the notion that their reform efforts are based less on acquisition reform and more strictly on the elimination of "duplicative, unnecessary overhead costs." It is DOD's intention to plumb these savings through the elimination of "unneeded programs and activities" and the consolidation or closure of excess bases and other facilities. The ultimate beneficiary: force structure and modernization.

A few months following the announcement, Under Secretary of Defense (AT&L) Ashton Carter published a memorandum for acquisition professionals entitled, "*Better Buying Power: Guidance for Obtaining Greater Efficiency and Productivity in Defense Spending*" (Appendix A), that provided specific guidance for addressing a June 8, 2010, mandate to "deliver better value to the taxpayer and warfighter by improving the way the Department does business."

Target Affordability and Control Cost Growth

"Mandating affordability as a requirement and controlling cost growth" properly kicked off the *Initiatives* by pursuing ways in which the Department would conduct future business within ongoing cost constraints. In so doing, DOD recognized the "need to improve the Department's capability to perform this kind of engineering tradeoff analysis, but the ability to understand and control future costs from a program's inception is critical to achieving affordability requirements." This recommendation had also been offered by AIA in its initial input to DOD in which it was recommended that DOD more adequately and thoroughly define requirements at the outset of a contract, based on cost/schedule/performance tradeoffs.

Incentivize Productivity and Innovation in Industry

This *Initiative* is intended to emphasize the relationship between contractor profit and performance (*i.e.,* rewarding contractor performance and successful supply chain and indirect expense management through profit incentives).

Promote Real Competition

Acknowledging that DOD's competition rates are the highest in history, DOD noted that there have been many "ineffective competitions." In order to leverage small business participation in DOD programs, this *Initiative* directs CAEs to "institute in all competitive and non-competitive procurement actions emphasis on small business utilization through weighting factors in past performance and in fee construct."

Reduce Non-Productive Processes and Bureaucracy

Acknowledging that industry is encumbered by "excessive overhead expenses based solely on non-value-added mandates and reporting requirements which may have been relevant at some point in time, but have little relevance in the world in which we now find ourselves," the DOD Director of Industrial Policy has been tasked to work with DPAP to "identify, prioritize, and recommend a path forward to unwind duplicative and overly rigorous requirements that add to costs, but do not add to quality of product or timeliness of delivery."

Improve Tradecraft in Services Acquisition

The final *Initiative* deals with creating a "cohesive and integrated strategy" with regard to the acquisition of services. Contract support services' spending now represents more than 50 percent of DOD's total contract spending, which "demands a management structure to strategically source these goods and services."

Conclusion

Knowledgeable acquisition observers and participants have already identified most problems and proposed solutions for them. Pointing fingers does not address the root causes of schedule slips, cost overruns, or technological obsolescence. Nor does the cyclical reinvention of cleverly-titled acquisition strategies adequately address these root causes.

Hard-nosed discipline on the part of decision-makers at the beginning of an acquisition should rein in the appetite of the requirements community and preclude the launch of a major system development that rests on immature technologies and overly optimistic projections. Realistic, independent cost estimates and technical risk assessments — developed outside the chain of command for major programs — should inform the defense acquisition executive about the viability of a new program's cost, schedule, and performance projections.

In summary, more informed management attention and discipline at the front end of the process should go a long way toward solving many of the problems plaguing defense acquisition. Time and again, major defense management reviews have reached the same conclusions. It is high time that decision-makers take seriously these findings, most of which are embedded in existing directives

and instructions that govern the acquisition process, and make them an integral part of their program-review and decision processes.

The success of DOD's *Efficiencies Initiative* will depend to a large extent on whether the department has broken through the acquisition reform barrier. Or are we more likely to see the same results as in past efforts: new rules but the same outcome? In other words, when implemented, will the *Initiatives* result in quantifiable and empirically verifiable improvements in cost performance for DOD acquisition programs that will also sustain the defense industrial base? Are direct cost savings the best barometer of the success of acquisition reform? Can the success of acquisition reform stand on its own even without proven cost savings?

When prescribing modifications to the existing system, it is important for the government to recognize that defense procurement does not lend itself to a "one size fits all" approach. Some acquisitions contain more risk or are more time-critical than others. Some cost more than others, and some have fundamentally different characteristics (*i.e.*, product upgrades, commercial items or services, information technology and international programs). Each acquisition needs to be treated in a fashion suitable to its character. Without a commitment to remove the burdens and impediments to sound contracting principles, we will find ourselves repeating a costly history of unrealized efficiencies.

IDENTIFYING THE KEY ELEMENTS OF AN EFFICIENT ACQUISITION SYSTEM

In November 2008, AIA published a special report focused on the proliferation of acquisition reform initiatives, reductions in the federal acquisition workforce, and additional cost burdens to industry related to contractors' efforts to ensure full compliance with the proliferation of new laws and regulations. Entitled "*U.S. Defense Acquisition: An Agenda for Positive Reform*," the AIA report detailed the ways in which "imbalances in the defense acquisition system" needed to be recalculated to "ensure that the policies and processes that govern it are fair, reasonable and flexible." In summary, the report concluded:

> *Legislation, regulations, rules, processes, procedures and practices that comprise the defense acquisition process must be designed to foster a responsive industrial base and provide the tools and predictable approaches necessary to meet the difficult task of inventing, developing, producing and maintaining the most complex of defense products.*[5]

Following DOD's roll-out of the DOD *Efficiencies Initiative* in the spring of 2010, AIA responded to Secretary of Defense Robert Gates' call for industry ideas to restore affordability and productivity in defense spending. AIA provided 97 initiatives that will sustain and maintain a competitive defense acquisition environment and a healthy aerospace and defense (A&D) industrial base while reducing costs. These policies should encourage and reward good performance, promote fairness and stability, incentivize cost savings and establish balanced and equitable risk-reward financial relationships. The following five actions serve as the foundation of an efficient, meaningful and actionable procurement system:

- Utilizing commercial products, practices, and processes;
- Creating a performance-based profit policy;
- Eliminating the barriers to innovation;
- Reforming oversight functions; and
- Reforming the regulatory promulgation process.

Utilizing Commercial Products, Practices and Processes

The argument for cultural change and defense industrial base sustainment has moved from the front to the back burner — from a churning boil to a slow simmer — and back again. A benefit arising from the churn phase is recognition of the need to expand the government's use of commercial contracting products and techniques, and outcome-driven performance improvements — resulting in more performance-based contracts, an expanded use of commercial business practices, and flexible responsibility at the program management level.

Unfortunately, the process for acquiring goods and services from the commercial marketplace, as established by the Federal Acquisition Streamlining Act (FASA) of 1994, has been sub-optimized by many legislative and regulatory changes made in the recent years. Most FAR Part 15 contracts include hundreds of clauses that impose costly government-unique requirements, thus increasing the overall cost of acquisition. The government had made progress in this area by simplifying and streamlining its terms and conditions for commercial products and services through the adoption of FAR Part 12 contracting principles. However, the trend seems to be gravitating back to the increased use of FAR Part 15 contracts, which are inconsistent with commercial practices. The result is that the government's costs have increased while company investments in expensive technology improvements have decreased. This represents a lose/lose situation for DOD and the defense industrial base.

The FASA policy changes emphasized commercial contracting practices. As a result, commercial companies were able to begin participating in government programs as prime contractors or subcontractors, using common product lines and work forces to provide products and services for both commercial and military customers. Private sector investments made to develop commercial products benefit both commercial and military customers while also creating a larger production base and lower prices due to economies of scale. With the adoption of policies in the mid-2000's requiring more stringent contract governance, the government is no longer seeking commercial items to fulfill requirements on major defense programs. As a result, economies of scale and internal investment advantages are lost to the military customer.

Benefits/Savings

The benefits of employing commercial acquisition processes are numerous and widely recognized. FASA enabled the government to gain maximum access to more competitive commercial markets and cutting-edge commercial technologies. In addition, it simplified the process for acquiring goods and services, with the goal of reducing acquisition costs and gaining efficiencies by providing a larger production base and lower prices due to economies of scale.

Based on the FASA-era reforms, many small to mid-tier companies were able to consolidate operations into a single commercial/military enterprise. These synergies reduced costs and were a win-win proposition for both contractors and their customers. No longer were separate divisions or facilities required to fulfill government contracts. Contrary to the well-documented difficulties DOD experienced acquiring commercial products during the Gulf War, there have been no publicized incidents where the Pentagon has been unable to meet its requirements for current wartime operations. This likely would not be the case without the commercial item procurement procedures of FAR Part 12.

In many cases, DOD has enjoyed access to commercial products and services when they are introduced in the commercial market. Even in cases where modifications are made to meet specific government requirements, these products and technologies can be produced on the same supply chain as similar products produced for commercial customers.

There have been many studies and reports documenting the benefits of commercial item contracting. The DOD Inspector General's office identified the benefits of commercial acquisition in its audit report *Commercial Contracting for the Acquisition of Defense Systems*[6].

Those benefits are identified below:

- Leverage state-of-the-art technologies developed in the commercial marketplace;
- Utilize open industry standards;
- Suppliers manage parts obsolescence;
- Savings of R&D funds;
- Establishment of a market price as a price analysis tool;
- Integration of the defense and commercial industrial bases benefits national security and the economy;
- Reduced economic risk associated with developing new items;
- More rapid deployment of state-of-the-art technologies;
- Access to proven advanced technologies; and,
- Opportunities for increased competition.

Industry Concerns

Commercial companies are troubled by a steady erosion in the government's use of a streamlined approach to commercial item acquisition. Regulatory creep in the form of additional government-unique requirements will negatively impact DOD's ability to obtain the latest commercial technologies at the lowest possible prices.

Examples of regulatory creep include:

- Requiring certified cost or pricing data for "noncommercial" modifications to commercial items;
- Increased documentation requirements for commercial item determinations that may discourage buying commands from using commercial items;
- Increased use of government-unique specifications when alternate commercial products will meet government needs;
- Increased pressure to report Small Business Plan results at the contract rather than enterprise level, which entails more administrative efforts and increases costs;
- Increase in the number of contract clauses that are not customarily used in the commercial marketplace; and,
- Requiring information other than cost or pricing data for commercial items.

If left unchecked, regulatory creep will cause many current and potential suppliers of commercial items to withdraw from the government marketplace. Or, it will cause suppliers to re-establish separate government and commercial accounting, engineering, and production organizations at a considerable additional cost to government customers.

Recommendations

DOD should establish a focal point for acquisition excellence, similar to initiatives undertaken during the Clinton administration. The concepts put forth by DOD (*i.e.,* Single Process Initiative, Management Councils, and Civil/Military Integration) created many opportunities to realize efficiencies and cost savings for both government and industry. These initiatives provided a forum for the government and industry to work together to best support the needs of the warfighter. They should be revived and reinvigorated.

A more efficient system would reflect FAR Part 12 commercial contracting and require the submission of "other than cost or pricing data" for commercial and certain other items — without the resource-intensive steps of repeatedly updating proposals in order to generate TINA certifications. Raising the TINA threshold from its current $700,000 to a more reasonable $1 million or $2 million would also promote efficiency.

Eliminating the Barriers to Innovation

The United States has relied in large part on the private sector's ability to fund efforts that transform innovative concepts and technologies into enhanced national security capabilities to support the warfighter. Unfortunately, it appears that barriers to innovation are being erected just as the demand for innovation is on the rise. Much of industry's innovations derive from DARPA and NASA funding of pre-competitive, cutting-edge and risk-inherent technologies. While some of these technologies fail, many develop into products vital to the government's mission and eventually seed follow-on industry advancements.

A substantial barrier to innovation resides in regulatory and administrative policies and processes that discourage investment in innovation. Rather than imposing overreaching regulations that hobble private industry and increase costs, DOD's acquisition policies should reward creativity and performance, promote fairness and stability, and create incentives for cost savings and equitable risk-reward relationships. Former Defense Secretary Robert Gates and Under Secretary (AT&L) (now Deputy Secretary of Defense) Ash Carter deserve credit for their efforts with the *Efficiencies Initiative*, but more needs to be done to make doing business with DOD a sound value proposition, especially in today's challenging economic environment.

For instance, DOD often declares its intention to accelerate innovation and encourage entry of new competitors, but issues Requests for Proposal (RFPs) that require contractors to provide technical data and software that has been developed at private expense, thus undermining the incentive for contractor innovation.

DOD has a longstanding policy of treating indirect costs as independent private expenses, thus encouraging companies to invest in dual-use technologies, a practice that encourages private sector

innovation and attracts cutting-edge commercial technology developers to the defense industrial base. In fact, DOD's policies have led to more competition and lower costs, and enabled the department to leverage commercial technologies and innovation without undermining a contractor's ability to retain the competitive advantage associated with such breakthroughs.

Industry Concerns

DOD has effectively used a long-term contracting approach to encourage contractor investment, obtain better pricing, and secure a more stable supply of products and services. However, under the *Efficiencies Initiative* there is a bias toward short-term contracting. We recommend a DOD reassessment of the value associated with medium and long-term contracting and encourage "right length" contracting.

Indirect costs such as Independent Research and Development (IR&D) and Bid and Proposal (B&P) costs have *not* been considered "federal funds" for purposes of determining whether an item was developed exclusively with government dollars. Despite the insinuation in the proposed DFARS rule, the vast majority of *independent* R&D projects are not "sponsored" by DOD. In fact, all indirect costs have been considered private expenses for purposes of establishing the government's rights in technical data, even though such costs were allocable across government contracts *via* indirect cost pools, and contractors recouped a portion of their R&D expenditures in the price of products and services sold to the government. [Indirect costs, by definition, do not directly benefit specific contracts. For example, IR&D projects begin and end at different times and change direction in response to breakthroughs in technology, further underscoring the independent nature of such investments.]

Recent technical data legislation (*i.e.*, Section 824, FY 2011 National Defense Authorization Act) represents a radical departure from earlier government policies and is expected to have a chilling — and expensive — effect on contractor investments and innovation. Given the independent nature of IR&D, its ever-changing developments, and the historical practice of allocating IR&D costs to government contracts *via* indirect cost pools, it will be virtually impossible (and administratively burdensome) to demonstrate that such indirect costs were not allocated to any government contract.

The practice of allocating indirect costs to government contracts *via* indirect cost pools will present significant challenges to funding determinations for all technologies that have been developed or partially developed prior to the statutory changes. One possible outcome is that under future contracts the government will receive unlimited rights to all technical data pertaining to pre-existing items or processes developed or partially developed with IR&D prior to the statutory change. This poses an alarming result that does not sufficiently consider or balance the interests of contractors in protecting the intellectual property resulting from previous private expense investments.

Recommendations

DOD benefits from industry competitors who will take the risks of innovation by developing technologies and solutions at private expense. In September 2010, DOD issued a proposed DFARS rule to rewrite Part 227 and associated clauses. While the stated purpose of the rule was to "simplify and clarify" these Parts, the rewrite substantially changed the rules of the game. The rewritten rule would effectively inhibit industry's willingness to assume risk. Instability and unpredictability make

it difficult for businesses to plan operations efficiently, to forecast hiring needs and to invest in modernization of facilities and new technologies.

The 1995 data rights rules reflected a clear balance between items, components, and processes developed at private expense and those developed entirely with government funds or mixed funding. The allocation of rights correctly "followed the money." In 2001, DOD published a comprehensive guidebook entitled "*Intellectual Property: Navigating Through Commercial Waters*." The 1995 regulations and 2001 guidance have facilitated the acquisition of new technologies while enabling the developing party to retain the rights in technical data and computer software. Changing the rules of the road will have many unintended consequences and will undoubtedly complicate the acquisition of commercial products and technology.

It is critical that we create and sustain incentives for innovation and research investment by implementing the following steps:

- Review U.S. laws, regulations and policies to determine positive or negative impact on innovation;
- Address inhibitors to innovation;
- Develop innovation indicators and metrics for knowledge-based economy;
- Use indicators to drive policy and strategy; and
- Create and provide support for better government analysis of U.S. and foreign innovation systems.

Reforming the Oversight Process

The oversight process makes multiple and sometimes contradictory demands on contractors that ultimately drive up overhead costs. The value of skillful auditing goes without saying — it provides the transparency and accountability that those in government and industry require to ensure lawful, ethical, and highest-value use of taxpayer funds, as well as the sustainability of our industry. However, as identified in the Final Report to the president by the President's Blue Ribbon Commission on Defense Management ("Packard Commission"), as well as the Report of the National Performance Review, audits should adhere to certain principles that promote greater efficiency and productivity.

Today's system suffers from unclear, overlapping government oversight responsibilities, inflexible guidance that fails to properly consider materiality and risk, and a lack of measures to determine whether the costs imposed by the system result in better outcomes for its customers.

In 2008 and 2009, the Defense Contract Audit Agency (DCAA) was accused by both the Government Accountability Office (GAO) and Congress (House Armed Services Committee Defense Reform Panel, Commission on Wartime Contracting, Senate Committee on Homeland Security and Governmental Affairs) with not following the Generally Accepted Government Auditing Standards (GAGAS). Specifically, it was found that DCAA audit documentation did not support the reported opinions, DCAA supervisors dropped findings and changed audit opinions without adequate audit evidence for their changes, and that DCAA work papers did not show that sufficient work was performed to support audit opinions. In hearings before the Wartime

Commission, DCAA and DCMA were further charged with failure to work together to support audit recommendations.

Industry Concerns

As a result of the charges, hearings, and changes in leadership, DCAA has adopted a more aggressive audit approach including: refusals to meet with companies to discuss audit findings in advance of issuing a report, requests for additional low-level evidence, and actions to withhold payments until auditor requests for documentation are satisfied and audits are completed.

One factor that hinders the efficient award of DOD contracts is the variation associated with DCMA and DCAA audits of contractor proposals. Audits are currently taking much longer to complete, and there has been an influx of new auditors. As a result, contractors are required to repetitively train government personnel on the complex workings of their cost estimating systems. For example, recent DCMA/DCAA audits have led to a requirement that contractors provide copies of canceled checks and labor vouchers, despite the fact that the associated contractor business systems were approved by the government at the outset.

Industry is also concerned with the amount of time spent during audits and negotiations deliberating whether the contractor is required to obtain cost or pricing data for items provided by subcontractors. [For example, in at least one case, DCAA auditors have demanded that the contractor obtain cost or pricing data for a $10 washer to be purchased under an existing subcontract when the total value of the parts to be supplied by the washer subcontractor for the particular proposal exceeds $700,000.] These types of misunderstandings result in prolonged negotiations, increases in contractor and government proposal/audit headcount, and could play a role in the disapproval of contractor estimating systems.

Recommendations

Under Secretary Carter addressed one aspect of this problem in his November 3, 2010, memorandum entitled "*Implementation Directive for Better Buying Power — Obtaining Greater Efficiency and Productivity in Defense Spending.*" In that memorandum, in an effort to avoid duplication and overlap, Secretary Carter directed the Director of Defense Procurement and Acquisition Policy (DPAP) to develop guidance detailing the roles and responsibilities of DCMA and DCAA. This is certainly a good first step to address the problems that we see, but more actions are needed.

While auditors have a responsibility to protect the government's interests, DCAA's primary role is providing advice and support to the Contracting Officer. DCAA should be allowed to perform "engagements" as opposed to GAGAS compliant audits. A perfectly performed audit is of little value if it is not timely and does not support the needs of the Contracting Officer.

A more efficient system would include the assignment of dedicated auditors to contractors with complex estimating systems and proposals. Government personnel would focus on the particular proposals being audited rather than expanding them into overall contractor business system audits. There would be more training of new audit personnel and more stringent guidelines with respect to the types of documentation required of contractors.

In order to properly address the subcontractor issue, the FAR should be revised to clarify the requirements for obtaining subcontractor cost or pricing data. The revision should include a clear distinction between: (1) the process of supporting subcontractor costs with the prime contractor's proposal to the government, and (2) the process of obtaining cost or pricing data prior to the contractor's award to its vendors of subcontracts for supplies or services.

Reforming the Regulatory Promulgation Process

There are costs involved with implementing each of the numerous regulations promulgated by the government. Contractors must track and remain aware of proposed changes, and implement them when finalized. The costs of compliance with individual rules may be relatively small, but compliance with numerous regulations may represent death by a thousand cuts[7] and is certainly not in keeping with the goals of acquisition reform. The 1994 Coopers & Lybrand study determined that DOD's acquisition regulations and oversight requirements added an 18 percent cost premium — not including DOD's direct oversight costs (e.g., government auditors). That percentage is likely to rise. DOD should take into consideration the impact of multiple *Federal Register* releases in a week and determine if they are all necessary or if there is a more efficient way to implement significant changes.

In June 2011, AIA joined the other members of the Council of Defense and Space Industry Associations (CODSIA) in expressing our concerns and objection to the increased reliance on interim rules to implement regulatory actions by the federal government. In an age when we are deluged every day by proposed, interim and final rules, we feel that this practice is an unnecessary deviation from the required regulatory promulgation process and is contradictory to this Administration's commitment to transparency, openness and public engagement.

At a minimum, the ever-increasing reliance on the use of interim rules violates the spirit of the Office of Federal Procurement Policy (OFPP) Act, and misuses the "urgent and compelling" exception to the standard notice and comment process outlined in the FAR. Section 418b(a) of the OFPP Act and FAR 1.501 require that procurement regulations that create a significant cost or administrative impact on contractors or offerors be published for public comment unless a waiver is approved or an exception applies. The OFPP Act states further that if compelling circumstances do exist, and a temporary regulation is issued, "in no event may that effective date be less than 30 days after the publication date."

The FAR does provide for the issuance of an interim rule, effective immediately, when *urgent and compelling* circumstances exist, and cites as an example where "a new statute must be implemented in a relatively short period of time." While we can appreciate the desire to complete action on rules, in some specific cases we have been assured by the Administration that a particular initiative would be implemented using a phased approach only to find out that they have published the acquisition requirement "effective immediately" without explanation or apparent reason. Given the significant cost and administrative impact of these rules on both the government and supplier community, there is ample reason to allow comment before finalizing these rules.

AIA'S EVALUATION OF DOD'S EFFICIENCIES INITIATIVE

In response to the Defense Department's initial request for industry recommendations on changes to the acquisition system that could eliminate cost drivers, AIA provided nearly 100 ideas focusing on four areas: improving requirements definitions and ensuring requirements and program stability; streamlining export controls; promoting efficient use of government and contractor resources; and eliminating unnecessary government- unique requirements. On the last point, AIA has repeatedly stressed that as government contractors, aerospace and defense companies work in an alien environment based on a monopsonistic business model that is ruled by a unique set of laws and regulations virtually unknown in the commercial market.

A fundamental deficiency in the overall acquisition process occurs at the front end of the process. The development and finalization of requirements, both technical and operational, have sown seeds for future problems. Among the proposed remedies — most of which are embedded in existing directives and instructions that govern the acquisition process — has been a repeated call for attainable, affordable, and testable requirements based on realistic threat projections and performance/cost tradeoffs that, in turn, rely on projections of realistic system life-cycle costs and force levels. These elements must be made an integral part of the program-review and decision process.

AIA has repeatedly emphasized that DOD should address systemic cost-drivers and recommended specific changes in policies and regulations to eliminate unnecessary, duplicative and non- or low-value-added activities. A number of DOD's proposed *Initiatives* reflect an understanding of and support for industry's positions and recommendations.

Enabling the military to keep pace with technological developments has been hindered by a cumbersome acquisition process that is exacerbated by an entrenched culture of resistance to change and a distrust of their industry counterparts. Innovation is also dampened by disinterest among commercial companies in clearing the numerous hurdles associated with government acquisitions. If the needs of the government are to be served via the commercial marketplace, many in the federal acquisition workforce will be asked to adjust the velocity and pace of their efforts to match the accelerated tempo of the commercial market. This is a laudable goal because, as the Defense Contract Management Agency (DCMA) has noted, progression toward the expanded use of commercial items and services will reach the desired result of "reduc[ing] government oversight in procurement of items readily available to the public, thereby cutting the time and cost of obtaining such items."[8]

Target Affordability and Control Cost Growth

Mandate Affordability as a Requirement

Instability and unpredictability make it difficult for businesses to efficiently plan operations, forecast hiring needs, and invest in modernization of facilities and/or innovative technologies. Controlling

costs is crucial, and industry remains committed to ensuring that every action under its control is taken to help achieve this goal. Over the course of the last few years, companies have:

- Reduced overhead by restructuring corporate structures;
- Made substantial investments in business systems improvements; and,
- Streamlined processes and procedures.

However, some of the greatest cost drivers are directly attributable to the continuous evolution of government requirements during program performance. AIA has recommended that the government adequately define requirements at the outset of a program or contract in order to reduce demands for repetitive proposal updates. For example, on the Air Force Corporate Contract (a multi-year/multi-item contract) a "market basket" pricing approach was utilized. This approach ensured unit price integrity in years when part numbers are not forecasted and also kept prices low based on supply chain management efficiency.

In its March 2008 report on selected weapon programs, the Government Accountability Office (GAO) found that changes in program requirements were still having a significant adverse impact on cost and schedule. According to the GAO:

> *Unsettled requirements in acquisition programs can create significant turbulence. Sixty-three percent of the programs we received data from had requirement changes after system development began. These programs encountered cost increases of 72 percent, while costs grew by 11 percent among those programs that did not change requirements.*

Industry supports initiatives that emphasize stability and affordability as fundamental and manageable elements of government contracting. Effectively defining requirements at the outset of a program or contract in order to reduce demands for repetitive proposal updates is essential to AIA.

We recommend that DOD require all future regulatory mandates be accompanied by a cost-benefit statement, allowing informed judgments about the cost *versus* the benefit of program implementation. Some policy decisions that have had unintended consequences and warrant re-examination include:

- DOD wants to increase competition, but bid and proposal costs are being cut.
- DOD wants to accelerate innovation and encourage entry of new competitors, but contractors are required to provide the government with tech data/software rights developed at private expense.
- DOD wants increased productivity, in part through increased automation, but automation costs are included in overhead costs, which are being reduced.
- DOD wants to cut subcontract costs by eliminating profit, but this skews the "make or buy" decision and encourages vertical integration.

- DOD wants to benefit from increased cash flows, but the 3 percent mandatory withhold on payments reduces cash flow and drives up costs for the development of new systems and processes for both DOD and contractors.

Drive Productivity Growth Through Will Cost/Should Cost Management

Managing costs is an important part of the *Efficiencies Initiative,* but industry is concerned that DOD's emphasis on "scrutinizing every element of program cost" misses the point and will ultimately lead to the "can't see the forest for the trees" syndrome. Rather, AIA has recommended to DOD that it scrutinizes total cost. DOD should focus negotiations on total cost savings rather than on reducing individual elements of cost (some of which may have already been incurred). This approach ensures unit price integrity in years when part numbers are not forecasted and also keeps prices low based on supply chain management efficiency.

AIA has repeatedly expressed concerns to DOD about their attempts to drive down costs by arbitrarily reducing elements of cost and corresponding profit. By squeezing profits, the *Initiative* threatens to undermine industry's ability to invest in new technologies. As with other industries, defense contractors must compete in the marketplace for labor, capital and other resources. Overall, the defense industry's profitability lags significantly behind its industrial peers. Maintaining a fair margin on contracts allows industry to compete for needed resources, provide economic value to its investors, cover legitimate business costs that are not recognized as allowable by the government, and continue to provide its customers with the best defense systems in the world.

In February 2009, the Institute for Defense Analysis (IDA), under contract to the DOD, released a report entitled, "*Defense Department Profit and Contract Finance Policies and Their Effects on Contract and Contractor Performance*." The report finds that the margins for the defense industry are lower than companies in other sectors. As depicted in the following chart, recent history demonstrates that the defense industry has had the lowest profit performance (operating margins) of any major industry, including public utilities.

Defense Industry Operating Margin—the Lowest Returns Amongst Its Peers[9]

Industry	2006	2007	2008
Telecommunications	**35 percent**	**37.5 percent**	**37 percent**
Energy	31.5 percent	32.5 percent	32.5 percent
Information Technology	25 percent	26.5 percent	27.5 percent
Health Care	26 percent	26.5 percent	27 percent
Utilities	**25.7 percent**	**25.5 percent**	**25 percent**
Materials	22.7 percent	23 percent	22 percent
Consumer Staples	21 percent	20.5 percent	20 percent
Industrials	17.5 percent	17.5 percent	17 percent
Consumer Discretionaries	17 percent	17.5 percent	16 percent
Aerospace/Defense	**12.5 percent**	**13 percent**	**13 percent**

Over the years, the government's buying trend and regulatory posture have become increasingly difficult to predict. Programs are terminated or changed, single-source selections have shut contractors out of portions of the market, regulations introduce additional costs, evolving national security threats cause a rapid change in priorities, and spending cuts impact the viability of an entire market segment. At the same time, research and development (R&D) funding increasingly favors cost-share, no-fee or firm-fixed-price contracts, making full reimbursement for development of custom technologies virtually impossible.

Reducing cycle times not only saves money, but produces more timely results, and keeps pace with technological innovation. The United States faces new, asymmetric threats from enemies that improvise to an extent unseen among our adversaries during the Cold War. The *"Lean Aerospace Initiative"*[10] was an attempt to create metrics that would lower cycle times. Its findings should be re-examined, updated, and extended. Time is not only money — it is also lost industrial capability.

Some actions recommended to increase productivity include:

- Reinstituting timely enterprise-wide negotiation of forward pricing rates;
- Leveraging established supply schedules and corporate agreements and forward pricing rate agreements;
- Reducing bid and proposal costs by reducing volume of cost and pricing data required to support negotiations;
- Restricting agency-unique rulemaking that drives inefficiencies and costs;
- Providing incentives (*e.g.,* tax incentives, cost sharing) for closing and combining contractor facilities and closing uneconomical government facilities; and
- Reducing reporting and flow-down requirements for subcontractors.

Make Production Rates Economical and Hold Them Stable

Industry enthusiastically supports the stabilization of production rates as well as limiting variations in quantity provisions to "reasonable quantities" that will not adversely impact the supply chain.

Set Shorter Program Timelines and Manage to Them

AIA supports the establishment of concrete program timelines and recommends the increased use of block upgrades as a tool to help streamline the process. It should be noted that implementation of this *Initiative* will require a willingness on the part of DOD to accept mature technology and establish requirements in increments. Setting stringent program timelines has been DOD policy but it has been used on only a handful of programs (*i.e.,* F-16 Fighting Falcon, Virginia Class submarine), and there seems to have been little appetite for adopting the discipline to implement it on a wider basis.

Incentivize Productivity and Innovation in Industry

Reward Contractors for Successful Supply Chain and Indirect Expense Management

DOD's assertion that the intent of this *Initiative* is to reward cost management performance appears to be based on the debatable premise that prime contractors are not currently managing the cost behavior of their subcontractors. While the former DPAP Director said publicly that DOD does not care about profits as long as costs are lower, PCOs and auditors often focus solely on profit as elements of cost. The consequence, whether intended or otherwise, will likely be a reduction or elimination of profit on major subcontracts.

Basing a contractor's profit on subcontract management abilities — apparently the "carrot" meant to entice prime contractors to oversee their subcontractors — will not only affect "make or buy" decisions but will also encourage prime contractors to vertically integrate, resulting in dire, albeit unintended, consequences for the industrial base.

We recommend that the government consistently provide adequate recognition of contractor efforts associated with subcontract management and performance as part of the program performance and technical risk factors of the Weighted Guidelines Model (WGL).

Increase the Use of Fixed-Price Incentive Firm Target Contract Type

The government's decision to choose Fixed Price Incentive (firm target) Contract (FPIF) types in lieu of Cost Plus Award Fee (CPAF) in late-development or early-production contracts will have a significant adverse impact on a company's working capital.

Increases to working capital balances will have a detrimental effect for both industry and the government, with visible impacts seen in reduced availability of capital dollars for capital improvements, reduced dollars available for application to IR&D initiatives, and higher costs associated with reduced working capital to sustain on-going operations. Each of these impacts is envisioned to have long-term implications that will impede industry's ability to support the government's mission.

The required increase in investment will certainly serve as a barrier to new businesses wishing to enter the DOD marketplace, and will lead to a reduction in the number of businesses willing to serve as primes. We believe that the intent of the Under Secretary of Defense (AT&L) November 2010 memorandum was not to create a major shift in working capital investment levels, but rather to establish better controls over contract prices.

There is a history of substantial cost savings accruing to the government through the use of fixed price contracts. For instance, a large four-year, long-term, firm-fixed price contract with a prime contractor for government and commercial launch vehicle products resulted in performing one versus four separate fact-finding and negotiation sessions, thus reducing negotiation costs and cycle time.

Allowing interim cost billings by the Defense Department would achieve the price controls sought by senior leadership without positively or negatively impacting working capital investments required.

The FAR should be modified to formally add late-development or early-production FPIF efforts to the list of contract types eligible for bi-weekly interim cost billings. This recommended change would more equitably balance the increased technical, schedule, and cost risks assumed by the contractor under FPIF contracts, with a financing option that would be more appropriate for late-development and early-production efforts targeted by the new DOD pricing strategy.

This *Initiative* does not allow for any variation in setting share lines and ceilings. The "default" arrangement of a 50/50 share ratio and 120 percent ceiling does not always provide the best pricing solution. Every procurement is different and must be evaluated on its own merits. The government should provide adequate training to contracting officers regarding the establishment of costs and share ratios based on contract-specific risks. Industry does not believe that solicitations should specify the FPIF arrangement, but rather enable the offeror to propose an arrangement that provides the best incentive for contract performance. Also, FPIF contracts will impact company working capital. Contract type and share lines should be based on risk in the program.

Adjust Progress Payments to Incentivize Performance

The *Initiative* states that the basis of negotiation shall be the use of customary progress payments versus performance-based payments (which have been the preferred method of financing since enactment of the Federal Acquisition Streamlining Act of 1994). The directive does allow for alternate payment arrangements; however, the expectation is that the contract price would be adjusted downward as consideration for a more favorable payment structure.

Industry estimates that the adverse working capital impact of the directive will range from $13 billion to $20 billion. In order to avoid the adverse impact, industry will be expected to provide $1 billion in price considerations based on the *Initiative* and preliminary cash-flow model released by DOD.

In 1995, the FAR was revised to create performance-based payment financing as a means to create new competition in the marketplace and stabilize the health of the industry, which was facing serious financial challenges as a result of the Department of Defense budget outlook. The DOD budget environment today is similar to that of the mid-90s and the defense industry faces the same types of challenges.

In order to avoid the unanticipated and significant adverse consequences of this *Initiative*, industry encourages DOD to either remove the guidance on fixed price financing from the acquisition efficiency strategy, or seek industry input on more equitable options that do not gravely harm the health of the industry.

According to the Federal Acquisition Regulations (FAR), contract financing is provided to the extent required to ensure prompt and efficient performance. Historically, progress payment rates have been adjusted by regulation to reflect economic conditions and outlook (budgetary and cost of capital). Progress payment rates since 1970 have been as low as 75 percent and as high as 99 percent. The timing of this particular *Initiative* could not have come at a worse time considering that the economy is still struggling, the impact of the deficit reduction efforts is unknown, and recent regulatory changes impacting contractor working capital have not been factored into the equation. Clearly, profit consideration or the cash flow impact on the order of the magnitudes noted above would have a significant adverse effect on the overall health of the industry and valuation in the marketplace.

Another concern with this *Initiative* is the inconsistencies it creates with current regulations on contract price negotiations. Both the Carter directive and the preliminary version of the Defense Department cash flow model require negotiation of price, including profit, to be based on the assumption that progress payment financing will be provided. Once price has been negotiated, the contractor would then be able to provide consideration for "improved cash flow." What both fail to recognize is that the current Weighted Guidelines Profit Objectives *(DFARS 215.404-71)* consider performance-based payments a key risk element that warrants an *increased* profit rate of up to 1.5 percent higher than contracts financed with progress payments.

Performance-based payments are based on actual performance, and more favorable cash flow is not guaranteed. Requiring price consideration for performance-based payment financing instead of progress payments is the exact opposite of the Weighted Guideline Profit Objectives. If the directive stands, the baseline negotiated contract price in the cash flow model should be increased to reflect the higher profit rate associated with the inherent increased risk of performance-based financing before any cash flow improvement "consideration" adjustments are contemplated.

Profit negotiations are often subjective and contentious. One of the root causes is ambiguity within sections of the DOD Profit Weighed Guidelines. These guidelines should be revised to reflect more objective criteria and promote consistency in their interpretation. These regulations should also promote the establishment of short-term profit agreements that would apply to groupings of similar products or services rather than requiring potentially thousands of individual profit negotiations for contracts and orders that are awarded each year. Additionally, there should be recognition of the substantial effort required of large, complex businesses with highly technical products to manage subcontracted items. This is particularly vital in the current economic environment that is marked by limited subcontractor resources and stringent government standards regarding the manufacture and delivery of high-quality parts.

In their 2000 study, DOD (AT&L) Under Secretary Jacques Gansler's working group was tasked with evaluating performance-based payment (PBP) financing. The group found that PBPs are beneficial to both contracting parties because they permit streamlined administration and reduced oversight. A Gansler memo identified the following advantages of performance-based payments versus progress payments:

- PBP financing drives program focus on performance;
- PBP financing help maintain or exceed program schedule;
- PBP financing provides the contractor an opportunity for increased cash flow, especially when milestones are completed ahead of schedule;
- PBP financing reduces administration, systems, and oversight expense;
- PBP financing enables companies without costly systems designed for federal contracting to compete for federal awards; and,
- PBP financing provides better outlay predictability for both U.S. and Foreign Military Sales (FMS) customers.

As former ITT CEO Harold S. Geneen once stated, "It is an immutable law in business that words are words, explanations are explanations, promises are promises — but only performance is reality."

Other significant negative consequences of this *Initiative* include:

- Increased administrative expense to conduct two negotiations for each contract *(first for price and second for financing);*
- Increased number of Undefinitized Contract Actions (UCAs) as a result of the second negotiation for financing increases *price risks;*
- Less favorable financing available for subcontractors, many of which have no other avenues to ensure liquidity;
- Adverse impact related to increased working capital balances on contractor debt ratings and market valuation;
- Increased investment requirement will drive companies out of the defense marketplace and serve as a disincentive for attracting new companies to compete for future defense contracts; and,
- Requirement to revise the FAR to provide contractors with damages and Prompt Payment Act interest when delays in receiving negotiated financing are encountered.

Expand the Navy's Preferred Supplier Program into a DOD-wide Pilot

The referenced Navy Preferred Supplier Program (PSP) would reward contractors based on the contractor's demonstration of exceptional corporate-level performance in the areas of cost, schedule, performance, quality, and business relationships. Preferred Supplier Status (PSS) would entitle contractors to special contract terms and conditions, such as:

- More favorable progress payments;
- Recognition of PSS in development of profit or fee, based upon Weighted Guidelines.
- Tailored contract reporting requirements; and
- Special award fee pools.

One of the favorable terms noted above relates to "progress payments." This term should be expanded to include "performance-based payments." Another favorable term available to PSP contractors is recognition of their PSP status in developing profit or fee, based upon the Weighted Guidelines. The DOD PSP should make it clear that contracting officers may award profit or fee in addition to the profit/fee that would otherwise have applied. However, we question whether this will be done consistently and in accordance with Weighted Guidelines policy given the varying interpretations related to Weighted Guidelines and profit.

If DOD determines that a contractor should not be placed on the Preferred Suppliers List, there must be an administrative or legal process through which the contractor can challenge their exclusion from the program. Industry is also concerned that the Navy's preferential treatment

for PSP-approved contractors will inevitably lead to a *de facto* nullification of the Competition in Contracting Act's (CICA) standard of "full and open competition." If the contracting officer believes that PSP participants will bid on a contract, he/she can include more favorable terms in the solicitation that will be applicable after award (assuming that the PSP participant is the awardee). If PSP status is not an evaluation criterion, the fact that program participants might be submitting proposals based on assumptions of different contract terms creates a flawed and unequal playing field. Dividing the contracting community into "haves" and "have nots" will only stratify the competitive process.

We understand that the PSP was intended to capture the benefits of commercial preferred-supplier programs. Commercial programs are based on long-term agreements and preferential treatment. Given the current government contracting environment, we question whether the Preferred Supplier Program can truly prove more effective in improving contractor performance than the current practice of contract-by-contract negotiation. While the proposed pilot program may result in some slight improvements to the department's acquisition process, we believe that implementation of the DOD pilot program should be postponed until its impact on the Navy acquisition process is more fully measured and understood.

Reinvigorate Industry's Independent Research and Development (IR&D) and Protect Contractor's Technical Data Rights

DOD has repeatedly called for increased competition while at the same time cutting bid and proposal costs that actually increase as contractors submit more proposals. DOD wants to accelerate innovation and encourage entry of new competitors, but RFPs often insist that contractors provide proprietary technical data and software developed at private expense, thus undermining the incentive for contractor innovation.

DOD has had a longstanding policy of treating indirect costs as independent private expenses, thus encouraging companies to invest in dual-use technologies. This policy is intended to encourage private sector innovation and attract cutting-edge commercial technology developers to the defense industrial base. In fact, DOD's policy has led to more competition and lower costs, and enabled the Department to leverage commercial technologies and innovation without undermining a contractor's ability to retain the competitive advantage associated with technological breakthroughs.

Until the advent of Section 824 of the FY 2011 National Defense Authorization Act, indirect costs such as Independent Research and Development (IR&D) and Bid and Proposal (B&P) costs were *not* considered "federal funds" for purposes of determining whether an item was developed exclusively with federal funds under 10 U.S.C. § 2320(a)(2)(A). Historically, all indirect costs were considered private expenses for purposes of establishing the government's rights to technical data, even though such costs were allocable across government contracts via indirect cost pools, and contractors recouped a portion of their R&D expenditures in the price of products and services sold to government customers. (Indirect costs, by definition, do not directly benefit specific contracts. For example, IR&D projects begin and end at different times and change direction in response to breakthroughs in technology, further underscoring the independent nature of such investments.)

Under Section 824, it appears that indirect costs such as IR&D and B&P must be considered "federal funds" — and *not* private expenses — for purposes of determining the government's license rights to a contractor's technical data. As modified, 10 U.S.C. § 2320(a)(2)(A) enables the government to obtain "unlimited rights" in technical data pertaining to items or processes developed with IR&D and B&P costs. In the past, such technical data would have been provided with "limited rights" or "government purpose rights."

Section 824 represents a radical departure from earlier government policies and will have a chilling — and expensive — effect on contractor investments and innovation. Given the independent nature of IR&D, its ever-changing developments, and the historical practice of allocating IR&D costs to government contracts via indirect cost pools, it will be virtually impossible, and a costly administrative burden, to demonstrate that such indirect costs were not allocated to any government contract.

The historical practice of allocating indirect costs to government contracts *via* indirect cost pools will present significant challenges to funding determinations for all technologies, which have been developed or partially developed prior to the statutory changes. One possible outcome is that the government will receive, under future contracts, unlimited rights to all technical data pertaining to pre-existing items or processes that have been developed or partially developed with IR&D prior to the statutory change.

This proposed requirement will increase the government's costs and could slow technological innovation.

In response to the Under Secretary of Defense (AT&L) November 2010 memorandum, a proposed rule was issued that revises requirements for reporting IR&D projects generating annual costs in excess of $50,000. DOD claimed that if this information is not collected, it will be unable to maximize the value of Department IR&D funds without infringing on the independence of contractors to choose technologies to develop as part of IR&D programs.

We believe that the proposed rule is so broad in scope that it places defense and space contractors in jeopardy of losing all of their data and rights acquired under other statutes and regulations, or having their IR&D/Bid and Proposal (B&P) costs declared unallowable. This proposed requirement would have a costly and chilling effect on technological innovation, and have the unanticipated consequence of innovations being withheld from the government.

OUR VISION OF A MORE EFFICIENT SYSTEM

A number of the DOD *Efficiencies Initiatives* represent positive steps forward toward achieving the government's goal of better buying power. In addition, consideration of the following recommendations and/or modifications to current DOD *Initiatives* would result in a more efficient DOD acquisition system.

- **Superior Supplier Incentive Program:** DOD should provide criteria for its newly launched program to enable industry participation.

- **Technical Data Rights:** DOD should ensure that the *Efficiencies Initiative* guidance on acquiring technical data rights does not become so overreaching as to discourage contractors from investing in new technologies.

- **Cash Flow:** The cash flow guidance under the *Efficiencies Initiative* should be rewritten to address the following concerns:

  - The *Initiatives* dictate that contracts be negotiated assuming customary progress payments will apply regardless of whether the contractor plans to request such progress payments;

  - If the contractor instead plans to request performance-based payments, the new DOD Cash Flow model requires that estimated cash flow profiles be developed and input be made for both progress-based and performance-based payment scenarios. This creates a considerable administrative burden on contractors and the government.

  - The *Efficiencies Initiative* does not describe the upward profit adjustment that should be made in the event that a contractor agrees to payments subsequent to delivery rather than requesting financing payments. The FAR should be modified to formally add late-development or early-production FPIF efforts to the list of contract types eligible for bi-weekly interim cost billings. The FAR change recommended above would more equitably balance the increased technical, schedule, and cost risks assumed by the contractor under FPIF contracts — with a financing option more appropriate for late-development and early-production efforts targeted by the new DOD pricing strategy.

- **DCMA/DCAA Audits**: Seasoned auditors possess a highly technical and unique experienced-based skill set in regulatory requirements associated with federal government contracting. Due to widespread inexperience in the workforce, audit reports are taking an inordinate amount of time to be published, often requiring rework by auditors and contractors. A more efficient system would assign dedicated auditors to contractors with complex estimating systems and proposals. Government personnel would focus on the particular proposals being audited rather than expanding them into overall contractor business system audits. There would be more training of new audit personnel and more stringent guidelines with respect to the types of documentation required of contractors.

  The government should take several actions to remedy this situation:

- Provide auditors with intensive training in Generally Accepted Government Auditing Standards (GAGAS) to provide working knowledge prior to field work;
- Provide auditors with training and updates regarding current regulations being promulgated to provide consistent interpretation;
- Provide auditors with intensive training in Federal Acquisition Regulations (FAR) to provide consistent interpretation; and,
- Provide auditors with intensive training in Cost Accounting Standards (CAS) to provide consistent interpretation.

- **DCMA/DCAA Realignment**: In recent years, industry has provided countless examples of miscommunication or misunderstanding between the Defense Contract Audit Agency (DCAA) and the Defense Contract Management Agency (DCMA). DOD has made attempts to define roles and responsibilities through policy changes, but confusion remains at the field level. Additional training is needed to supplement the policy changes, including:
  - Standardized contracting officer training in overhead rate development and application;
  - Consistent contracting officer training on Forward Pricing Rate development and application;
  - Uniform training for personnel at DCAA and DCMA regarding their agencies' respective roles, responsibilities and jurisdictions; and,
  - To facilitate consistent application and interaction with industry, provide each of the organizations with training to help address miscommunication of audit findings and deficiencies.

- **Inexperienced DCAA Workforce Impact on the Acquisition Community:** Since the end of 2007, there has been a 15 percent net increase in the DCAA workforce as the agency strives to replace experienced personnel who are approaching retirement. Seasoned auditors possess a highly technical and unique skill set associated with government contracting. New, less experienced workers are replacing those with a proven ability to exercise audit judgment based on comprehensive regulatory knowledge. The loss of experienced auditors will result in less efficient oversight and contract administration.

- **Subcontractor Cost or Pricing Data**: In order to properly address the subcontractor issue, the FAR should be revised to clarify the requirements for obtaining subcontractor cost or pricing data. The revision should include a clear distinction between: (1) the process of supporting subcontractor costs with the prime contractor's proposal to the government, and (2) the process of obtaining cost or pricing data prior to the contractor's award to vendors of subcontracts for supplies or services.

- **Indirect Rate Agreements**: The timely audit and negotiation of indirect rate agreements is essential for efficiency. A more efficient system would include an appropriate number of experienced government personnel dedicated to auditing and negotiating indirect rate agreements with contractors. Additionally, for larger contractors with relatively complex proposals, it should

be clearly recognized that a structured FPRP/FPRR/FPRA process is essential to maintaining the continuous support of end customers through timely contract awards.

Auditors audit to facts. Indirect rate forecasts are based on business judgment. Therefore, DOD should allow DCMA to perform its business role and control the rate function, rather than moving that function to DCAA. DOD should also allow DCAA to perform its audit role and review incurred costs.

- **Profit:** Profit negotiations are often subjective and contentious. One of the root causes is ambiguity within certain sections of the DOD Profit Weighted Guidelines regulations. A more efficient system would include a rewrite of the Guidelines to reflect more objective criteria and promote consistent interpretation. These regulations should promote the establishment of short-term profit agreements that would apply to groupings of similar products or services, instead of requiring potentially thousands of individual profit negotiations for contracts and orders that are awarded annually.

  Additionally, there should be recognition of the substantial effort required by large, complex businesses with highly technical products to manage subcontracted items. This is particularly important in the current economic environment that is marked by limited subcontractor resources and stringent government standards regarding the manufacture and delivery of high-quality parts.

  Requiring price consideration for performance-based payment financing instead of progress payments contravenes the Weighted Guideline Profit Objectives (DFARS 215.404-7). The baseline negotiated contract price in the cash flow model, at a minimum, should be increased to reflect the higher profit rate associated with the inherent increased risk of performance-based financing before any cash flow improvement "consideration" adjustments are contemplated.

- **Terms and Conditions:** FAR Part 15 contracts include hundreds of clauses, many of which place significant administrative burdens on contractors and increase the government's overall acquisition costs. DOD had previously made progress in this area by simplifying and streamlining its terms and conditions for commercial products and services through the adoption of FAR Part 12 contracting principles. AIA recommends an approach that would require the submission of "other than cost or pricing data" for more commercial and certain other items but would not require the resource-intensive steps of updating proposals multiple times in order to generate TINA certifications.

  Another way to promote efficiency would be to raise the TINA threshold from its current level of $700,000 to $1 million or $2 million, thereby eliminating multiple proposal updates. Alternatively, a hybrid approach could be adopted whereby "other than cost or pricing data" would be required for proposals between $700,000 and $2 million, but the full array of TINA certified cost or pricing data would be required for proposals exceeding $2 million.

- **Long-Term Contracting**: DOD has effectively used a long-term contracting approach to encourage contractor investment, obtain better pricing, and secure a more stable supply of products and services. However, there appears to be a disappointing movement related to the

DOD Efficiencies Initiative that would return contracting to the days of short-term contracting. An efficient system would reflect a reassessment of the value associated with medium- and long-term contracting. The outcome would be a revision to the current *Initiatives* that would encourage "right length" contracting.

- **Contract Financing:** Complex contract financing regulations can trigger compliance-related challenges. In fact, some contractors do not even request progress payments given the degree of difficulty involved in tracking incremental procurement and assembly costs. Performance-based payments represent a notable improvement over progress payments, but there is still room for additional regulatory simplification to establish a more streamlined and simplified approach.

CONCLUSION

DOD's ability to transform the process and internal culture is integral to this effort, and will require momentum driven by DOD leadership. A sustained commitment and clarity of purpose will result in future progress. As Norm Augustine humorously opined in "Augustine's Laws":

> *There is little reason to doubt George Santayana's admonition that 'those who cannot remember the past are condemned to repeat it' … in this case, the past goes all the way back to the building of the Suez Canal (200% overrun), the Panama Canal (70%) and even the Roman Aqueduct (100%). Mercifully, the pharaohs kept only sparse records on the pyramids.*

In an age when all reform roads lead to transparency and accountability, we would stress that any reform decisions arising from the *Efficiencies Initiative* must be met with proper oversight, rigorous analysis, and careful weighing of options. The potential impact of the *Initiative* is of such a magnitude that deliberate decision-making and full transparency are required.

As the chair and vice chairs of the Task Force on Defense Acquisition Law and Oversight wrote in the foreword of their report, *Getting to Best: Reforming the Defense Acquisition Enterprise,* "Well-intentioned solutions have sometimes sown the seeds of unforeseen future problems. Anyone familiar with the unintended consequences of the accumulated complexity of law, regulation, policy and custom over the past quarter century sees the pressing need to simplify a process that has become much less than the sum of its parts."[11]

We hope that with industry's continued input, the DOD Efficiencies Initiative will be, in the words of former Deputy Secretary of Defense Paul Wolfowitz, "conducive to an acquisition environment that fosters flexibility, efficiency, creativity, and innovation." To quote David Packard, who conducted the seminal acquisition reform study, "We all know what needs to be done. The question is why aren't we doing it?"

APPENDIX A

The 23-point plan contained in the Efficiencies Initiative (covering five major policy areas) incorporated recommendations from the DOD acquisition workforce and industry, including strategies to control costs, improve "creative competition," and provide incentives for innovation and productivity. In the face of a significant redirection of defense budget dollars, industry was encouraged by Secretary Carter's affirmation that "a strong, technologically vibrant and financially successful defense industry is … in the national interest.[12]

The five major policy areas encompass the following:

- Target affordability and control cost growth;
- Incentivize productivity and innovation in industry;
- Promote real competition;
- Improve tradecraft in services acquisition; and,
- Reduce non-productive processes and bureaucracy.

Endnotes

1 Webster's Dictionary Definition: "official routine or procedure marked by excessive complexity which results in delay or inaction"

2 Inaugural address of President William Henry Harrison, March 4, 1841.

3 Statement on Department Budget and Efficiencies, Delivered by Secretary of Defense Robert M. Gates, The Pentagon, January 06, 2011.

4 Dr. Ashton B. Carter, Under Secretary of Defense for Acquisition, Technology and Logistics, in a speech ("Doing More Without More: Obtaining Efficiency and Productivity In Defense Spending," at the Center for a New American Security, February 22, 2011.

5 Aerospace Industries Association, *"A Special Report, U.S. Defense Acquisition: An Agenda for Positive Reform,"* November 2008.

6 DOD Inspector General Audit Report D-2006-115, "Commercial Contracting for the Acquisition of Defense Systems," September 29, 2006.

7 The *lingering death*, or *death by a thousand cuts*, was a form of execution used in China from roughly 900 AD until its abolition in 1905.

8 DCMA Guidebook re. Changes made in October 1995 to FAR Part 12, Acquisition of Commercial Items, Part 13, Simplified Acquisition Procedures, and Part 32, Contract Financing, implement acquisition policies addressed in the Federal Acquisition Streamlining Act of 1994.

9 Source: CapitalIQ, Note: (1) Analysis includes publicly-traded, US-based companies with revenues >$1B in CY2008.

10 The *Lean Aerospace Initiative* is a research program headquartered at MIT, whose aim is to transform the aerospace industry by applying best practices at all levels of a corporation.

11 Norman Augustine, Senator Gary Hart & Senator Warren Rudman, Business Executives for National Security Task Force on Defense Acquisition Law and Oversight, July 2009.

12 Dr. Ashton B. Carter, Under Secretary of Defense (AT&L), Memorandum for Acquisition Professionals, September 14, 2010.

Aerospace Industries Association

The Aerospace Industries Association was founded in 1919, only a few years after the birth of flight. The nation's most authoritative and influential voice of the aerospace and defense industry, AIA represents more than 150 leading aerospace and defense manufacturers, along with a supplier base close to 200 associate members.

AIA represents the nation's leading designers, manufacturers and providers of:

- Civil, military and business aircraft
- Homeland and cybersecurity systems
- Helicopters
- Materiel and related components
- Unmanned aerial systems
- Equipment services
- Space Systems
- Missiles
- Aircraft engines
- Information technology

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Jabil Defense & Aerospace Services LLC
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CDG

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Samuel Aerospace Metals

Scot Forge Corporation

SDL (formerly XyEnterprise)

Sea Air Space Machining & Molding (Formerly named North Cape RIM Manufacturing)

SEAKR Engineering

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Sechan Electronics, Inc.

SELEX Galileo Inc.

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