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DEFENSE INDUSTRIAL BASE: DEPARTMENT OF DEFENSE PROFIT '76 STUDY

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HEARINGS

BEFORE THE

JOINT COMMITTEE ON

DEFENSE PRODUCTION

CONGRESS OF THE UNITED STATES

NINETY-FOURTH CONGRESS

SECOND SESSION

NOVEMBER 18, 1976

PART II

Printed for the use of the
Joint Committee on Defense Production



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DEFENSE INDUSTRIAL BASE
DEPARTMENT OF DEFENSE PROFIT & STUDY

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HEARINGS

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JOINT COMMITTEE ON DEFENSE PRODUCTION

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(II)

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DEFENSE INDUSTRIAL BASE: DEPARTMENT OF DEFENSE PROFIT '76 STUDY

THURSDAY, NOVEMBER 18, 1976

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON DEFENSE PRODUCTION,
Washington, D.C.

The committee met, pursuant to recess, at 10:06 a.m., in room 5302, Dirksen Senate Office Building, Hon. William Proxmire, vice chairman of the committee, presiding.

Present: Senator Proxmire and Representative Mitchell.

Senator PROXMIRE. The committee will come to order. The hearings today are for the purpose of reviewing the new Defense Department profit policy and its effect on the defense industrial base, as part of the Joint Committee's examination of industrial readiness plans and programs.

The committee has been following the development of this new profit policy since the supporting studies were announced over 1 year ago. In looking at the outcome, I think there is much in the Defense Department approach that deserves praise.

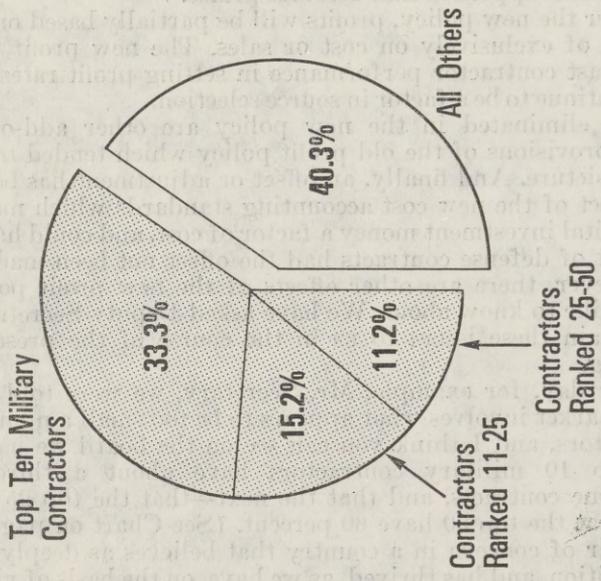
Under the new policy, profits will be partially based on investment, instead of exclusively on cost or sales. The new profit policy eliminates past contractor performance in setting profit rates, although it will continue to be a factor in source selection.

Also eliminated in the new policy are other add-on or special profit provisions of the old profit policy which tended to confuse the profit picture. And finally, an offset or adjustment has been made for the effect of the new cost accounting standards which made expenses for capital investment money a factor of cost, and could have increased the cost of defense contracts had the offset not been made.

However, there are other effects of the new profit policy that we would like to know about. We have asked Deputy Secretary Clements to explain these issues to us in the course of the presentation this morning.

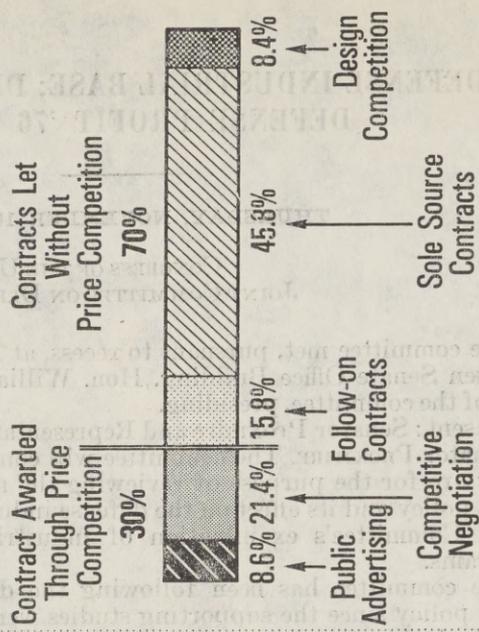
Yesterday, for example, Mr. Secretary, we were told that the defense market involves what appears to be too small a number of prime contractors, and I think you can see on the board we have here that the top 10 military contractors have about a third of all of the prime contracts, and that the next—that the top 25 have almost half, that the top 50 have 60 percent. (See Chart on page 2.) That is a matter of concern in a country that believes as deeply as we do in competition, and has thrived, as we have, on the basis of vigorous competition. Obviously there are some areas which you know well, the

50 Contractors Get 60% of Procurement Dollars



Source: Department of Defense

Less Than One Third of Military Purchasing Dollars are Awarded Through Price Competition



Source: Department of Defense

TABLE A
PROFITABILITY DATA BY YEAR, DEFENSE INDUSTRIES, 1970-74

PROFIT BEFORE TAXES	PERCENT PROFIT				ANNUAL AVERAGE
	1970	1971	1972	1973	
On Sales					
Commercial Profit Centers	16.0	12.6	17.3	18.6	17.1
Government Profit Centers	4.6	4.7	4.1	5.0	4.7
FTC Durable Goods	5.7	6.2	6.9	7.3	7.0
Fixed Price Contracts (all DOD)	4.7	4.3	3.1	5.5	4.7
Cost Type Contracts (all DOD)	4.5	5.3	4.9	4.1	4.4
Negotiated Profits (all DOD)	8.8	8.8	8.5	8.7	8.8
Realized Profits (all DOD)	4.6	4.7	4.1	5.0	4.7
On Total Assets					
Commercial Profit Centers	16.3	12.6	17.8	19.7	17.6
Government Profit Centers	13.1	12.6	11.3	15.5	13.5
Government Presuming Contractor					
Furnishes All Equipment & Facilities	12.6	12.2	10.9	14.9	13.0
FTC Durable Goods	8.4	9.2	10.9	12.5	11.7

Source: DOD, "Profit '76" Project

PROFITABILITY DATA BY PRODUCT, DEFENSE INDUSTRIES, 1970-74

PROFIT BEFORE TAXES	PERCENT PROFIT			TOTAL
	AIRCRAFT	ELECTRONICS	MISSILES	
On Sales				
Government Profit Centers	3.7	5.4	6.1	4.7
Commercial Profit Centers	7.5	5.8	17.7	17.1
FTC Durable Goods	4.2	6.3	4.2	6.7
On Total Assets				
Government Profit Centers	11.2	15.3	20.0	13.5
Commercial Profit Centers	9.0	9.5	27.8	17.6
FTC Durable Goods	6.9	10.0	6.9	10.7

Source: DOD, "Profit '76" Project

Some of the other interests of the committee involve special features of the new profit policy. For example, why won't the productivity reward clause tend to encourage high initial costs on defense contracts so that the contractors can later demonstrate alleged productivity improvements? Second, are the subcontractors correct in claiming that the new profit policy does not benefit them but will expose them to Defense Department contract scrutiny from which they have been exempt? What will be the different effects of the profit policy on high capital investment industries, such as shipbuilding, as opposed to low investment industries such as airframe makers or research and development (R. & D.) firms?

We don't expect final answers on a policy that was issued so recently. But we do want to know what expectations the Defense Department has and what it hopes to achieve by its new policy, and after 6 months or a year or even longer we can measure what is happening in defense industry against these goals that you may help us look for this morning.

Secretary Clements and General Stansberry, I want to thank you both for the open and cooperative attitude that you have shown to the committee and the staff in the development of this new profit policy. We appreciate your taking the time again today to answer our questions.

I see that you have a very short prepared statement, and I understand that you will deliver it orally, and a much longer statement.

The full longer statement will be printed in the record, and then I understand that General Stansberry has a brief statement he would like to make, too, when you conclude yours. So we are happy to have you proceed that way.

Mr. CLEMENTS. Thank you, Senator Proxmire. I also have with me Frank Shrontz, who is Assistant Secretary of Defense for Installations and Logistics under whose auspices this study was undertaken by General Stansberry. Also Dale Babione, who is the principal Deputy in Installations and Logistics, who has followed this study through the entire course during the past several months.

So I think that between the four of us who have been so intimately involved, we will be able to answer all of your questions and give you the information that you want.

I agree with you that in principle the final result remains to be evaluated. We will not have the answers as to how successful or unsuccessful the program will be probably for 2 or 3 years, and that is part of the plan, that we will monitor the results and see if we are obtaining the results that we had hoped for.

And I think your statement in that regard is exactly right. I know that you will continue to follow it in that regard, even though some of us won't be here, you will be. [General laughter.]

Senator PROXMIRE. I am glad to say that the people in Wisconsin have pretty good judgment. [General laughter.]

No; I was very lucky.

Mr. CLEMENTS. Particularly in the sense that there was no opponent, as I understand. [General laughter.]

Senator PROXMIRE. One of the best aspects of that election, since we have gotten into it, is I did have a good opponent. But this was an unusual election. You know, in the average campaign I have found

that the average incumbent spends about \$500,000. I spent \$177.23. I accepted no contributions at all. So it shows that it pays to be somewhat critical of the Pentagon. [General laughter.]

Mr. CLEMENTS. In Wisconsin. [General laughter.]

Senator PROXMIRE. Maybe not in Texas.

Mr. CLEMENTS. I insist on the last word, Senator.

Senator PROXMIRE. Maybe not in Texas. [General laughter.]

STATEMENT OF HON. WILLIAM P. CLEMENTS, JR., DEPUTY SECRETARY OF DEFENSE; ACCOMPANIED BY FRANK SHRONTZ, ASSISTANT SECRETARY OF DEFENSE FOR INSTALLATIONS AND LOGISTICS; DALE BABIONE, DEPUTY ASSISTANT SECRETARY OF DEFENSE FOR INSTALLATIONS AND LOGISTICS; AND BRIG. GEN. J. W. STANSBERRY, DIRECTOR, PROFIT 76 STUDY

Mr. CLEMENTS. Senator Proxmire, I am pleased to appear before this committee to discuss the new Department of Defense profit policy. This policy came about as a result of a 1-year study on the general subject of defense contractor earnings. The study, known as Profit 76, was chartered by me and was led by Brig. Gen. James W. Stansberry who is with me this morning.

We have been mindful for some time of the need to improve our profit policy. Many informed observers, including members of this committee, have pointed out what they believed to be shortcomings. The problems most consistently identified were overemphasis in our weighted guidelines on estimated contract cost as a profit factor and the absence of contractor investment as a meaningful profit determinant. We agreed that these problems might contribute to high cost and less than optimum investment levels by defense contractors. Thus, the overall goal of our profit study was to develop revisions in policy that would help achieve proper investment levels and associated reductions in cost.

In order to come to grips with these issues, we needed reliable data on actual defense contractor investment levels and earnings. We also needed to determine how these considerations were related to each other and to comparable commercial endeavors. Defense contractor financial and investment data was collected at the profit center level over a recent 5-year period and compared to Federal Trade Commission data on commercial durable goods manufacturers. We also sought informed judgment on profit issues across a wide spectrum of government and industry. We met with representatives of the accounting profession, the academic community, the General Accounting Office, the Cost Accounting Standards Board, the Office of Federal Procurement Policy, and many others. Throughout the course of the study we took great care to maintain a completely visible and open approach, culminating in a special advisory group review of our findings.

I would now like to briefly highlight what we have learned. Defense contractor profits, when measured on the basis of sales, are on the average lower than those generated in commercial endeavors; however, when measured on an investment basis they are somewhat higher. This relationship is traceable to a markedly low level of investment by defense contractors. In terms of production facilities, for example, commercial firms, on the average, invest more than twice the amount that defense contractors do on the basis of sales dollars. While there

are many reasons for this lack of investment, some are traceable to our procurement approach. In the past, we have not related profit to investment in a satisfactory way; nor have we allowed the cost of the capital requirement for investment to be reimbursed as a cost on defense contracts.

We have now set forth two important changes addressing this matter. The first provides that the amount of facilities investment will be recognized in the contracting officer's prenegotiation profit objective. The relative weight of this factor in the profit objective calculation is modest. In the future it will likely be increased after industry has had some opportunity to adjust its investment patterns. The second change provides for the imputed cost of capital for facility investment, measured in accordance with Cost Accounting Standard 414; that is, the risk-free element of the total cost of capital will be considered an allowable cost on negotiated Department of Defense contracts. Procedures have been established so that on the average in our negotiated contracts, the prenegotiation profit objective takes into account and offsets the cost increase attributable to the imputed cost of facility capital. This offset provision is in line with the view expressed in Senator Proxmire's letter to Secretary Rumsfeld of May 27, 1976, on this subject.

We have taken special care in assuring successful implementation of our revised policy. General Stansberry and his team have briefed each of the service commanders charged with acquisition, and detailed training has been provided to over 3,000 government and industry personnel.

We believe that our policy changes are an important step forward in achieving our goal of encouraging contractor investment in cost-reducing facilities. Our new policy, combined with other procurement initiatives under way should act to strengthen the competitive industrial base and reduce Department of Defense acquisition costs.

Thank you very much, Senator, and we will explore these various aspects with you in whatever detail you want, and General Stansberry has a short statement.

[Complete statement of Secretary Clements follows:]

STATEMENT OF WILLIAM P. CLEMENTS, DEPUTY SECRETARY OF DEFENSE

Senator Proxmire and members of the committee, thank you for the opportunity to discuss with you the new Department of Defense (DOD) profit policy.

We have been mindful for some time of the need to improve our profit policy so as to help us accomplish a key objective of the Department of Defense—that we strengthen the defense industrial base. Today's sophisticated weaponry is expensive; therefore the industry which serves our defense needs must be as efficient and cost-effective as possible.

We have suspected for some time that the defense industrial base was suffering from a low level of private investment, and have suspected that low level is in part traceable to a relatively low level of profitability. It is axiomatic that business flourishes in an atmosphere which makes it possible to earn a fair level of profit. The rule is equally valid when business deals with the DOD, and it works to the Government's advantage for a number of reasons:

It attracts good performers to do business with the Government.

It makes for a healthy and competitive environment.

It enables contractors to invest in new and efficient plant equipment with ultimate reduction in cost.

In order to gain a detailed understanding of this matter, in May 1975 the Profit 76 study was chartered by me and led by Deputy Assistant Secretary Dale R. Babione and Brig. Gen. James W. Stansberry under the supervision of Assistant Secretary Frank A. Shrontz. The goal of the study was to develop any policy revisions considered necessary to encourage private investment in

cost-reducing equipment. The basic approach was to compare earnings and investment data between defense and commercially oriented companies.

We sought widespread participation in the study throughout Government. The Military Departments became actively involved as did the Joint Logistic Commanders (JLCs). A high-level steering committee consisting of the Assistant Secretaries of Defense for both Installations and Logistics and Comptroller, as well as the Assistant Secretaries (I&L) of the Military Departments, exercised guidance and surveillance throughout the course of the study. We dealt extensively with representatives of the General Accounting Office (GAO), the Cost Accounting Standards Board, the Office of Federal Procurement Policy, and many other interested offices.

In any evaluation of investment and earnings, the key to success is reliable data. Our collection and analysis of data was a carefully phased effort. First, we discussed in detail with industry, the GAO accounting firms and others the data elements required. We requested the participation of 133 major defense contractors that supply weapons systems and hardware. The data from the participating contractors was submitted to their certified public accountants (CPAs). The accounting firms of each participating company made a thorough, independent check of the collected data. Finally, the figures were further reviewed and analyzed by a CPA firm working under contract to the DOD. Ultimately our CPA firm received data from 76 companies. They rejected the data from 12 of the companies based on either their own review or that of the company's own CPA firm. The final analysis was then based on data from 64 companies (147 defense oriented profit centers) with an aggregate sales data for government business averaging \$15.5 billion annually during the five year period from 1970 through 1974. As a result of the close coordination and comprehensive reviews, we obtained a high level of confidence in the data developed.

We also collected considerable data (8.5 billion annually) on the commercial operations of companies doing business with the DOD. This data, while valuable for certain purposes, was not considered sufficiently typical for all commercial endeavors for us to base prime earning comparisons on it, and it alone. Therefore, a second set of figures was constructed from the same five year sample period utilizing data routinely gathered by the Federal Trade Commission (FTC) on 5,000 corporations producing durable goods with aggregate average sales of \$450 billion annually. We believe that the FTC data offers the best overall reflection of profitability in the commercial business world; for that reason, our comparisons are based primarily on that data.

I would now like to turn to our data analysis results. Looking at the return on sales, figure 1 displays the time trends of pre-tax profitability for commercial and Government profit centers and for the FTC durable good producers. As noted on the chart, the commercial profit centers reported a 5-year average of 17.1 percent, which is roughly 2½ times the FTC durable goods average of 6.7 percent. The 5-year average of the Government oriented profit centers was 4.7 percent, which is 2 percent below the FTC average. This relationship of lower earnings on sales has also been noted in past profit studies.

PROFITABILITY - RETURN ON SALES PROFIT BEFORE TAXES/SALES

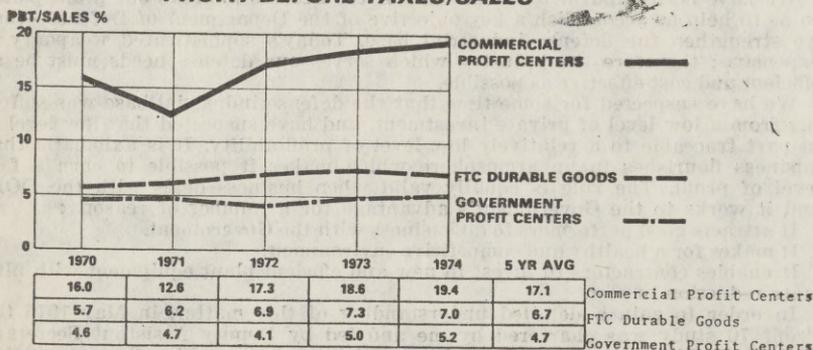
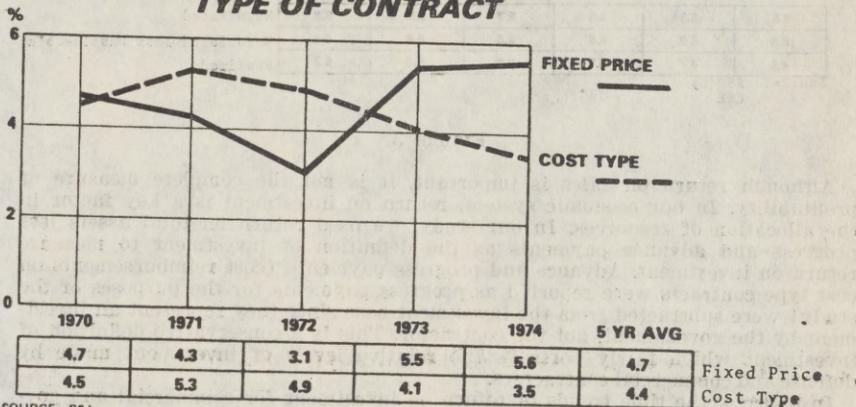


FIGURE 1

We also collected profit data by type of contract. Figure 2 compares the profitability of fixed price with cost type contracts. The fixed price type of contract, which includes fixed price incentive, averaged 4.7 percent over the five year period. The cost type contract 5-year average was 4.4 percent, which is only 0.3 percent lower than the fixed price average. This relationship appears disproportionate since a contractor with a fixed price contract assumes a significantly greater risk and should be able to earn more profit than a contractor with a cost type contract. We have recognized this is a problem to be dealt with in our revision to the profit policy. Of course, proper selection of contract type is also essential in order to improve the spread in realized profits between cost type and fixed price contracts. We feel that we are doing a better job now and that is reflected in the data for 1974.

PROFITABILITY — RETURN ON SALES
PROFIT BEFORE TAXES/SALES BY
TYPE OF CONTRACT



SOURCE: C&L

FIGURE 2

Up to this point, we have focused on realized profits; however, it is important to note that there is a difference between realized profits and negotiated profits. This difference is reflected in figure 3 which displays the negotiated vs. realized profits for the five years covered in the study. The principal elements are as follows:

Negotiated.—The average profit for all types of DOD contracts during the 5-year period was 8.8 percent of sales.

Negotiated less unallowables.—One of the objectives of the profit study was to determine the impact of unallowables on earnings. The data indicated that ASPR XV unallowables (interest, contributions, IR&D/B&P in excess of ceiling, etc.) average about 2 percent of sales; consequently, if defense contractors could realize the negotiated profit rate less unallowables, the earnings of 6.8 percent would be very close to the FTC average of 6.7 percent.

Realized.—The average realized profit rate is 4.7 percent. This indicates that there is a substantial erosion of the profit rate during contract performance. This problem must be addressed by both Government and contractors in more realistic initial pricing of the contract. Improvements in cost control by contractors are also needed in order to improve the realized profit rate.

PROFITABILITY — RETURN ON SALES
PROFIT BEFORE TAXES/SALES
NEGOTIATED VS REALIZED

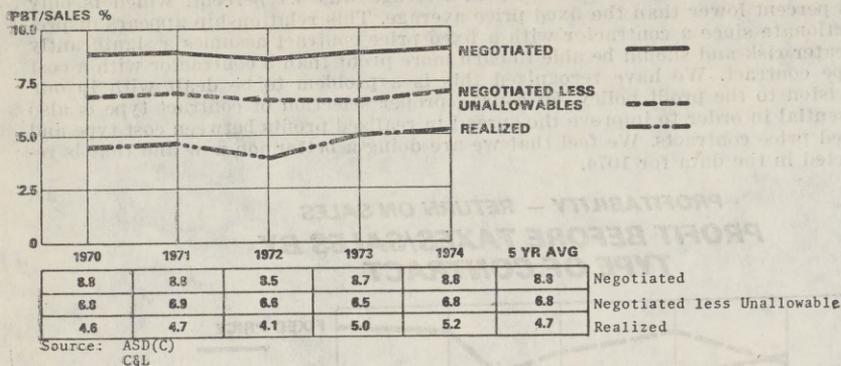


FIGURE 3

Although return on sales is important, it is not the complete measure of profitability. In our economic system, return on investment is a key factor in the allocation of resources. In our study, we used return on total assets less progress and advance payments as the definition of investment to measure return on investment. Advance and progress payments (cost reimbursements on cost type contracts were reported as progress payments for the purposes of the study) were subtracted from the investment base since they represent an investment by the government, not the contractor. This is a conservative definition of investment which fairly portrays the relative levels of investment made by defense and commercial contractors.

In figure 4, the time trends of return on investment for commercial and government profit centers, and for the FTC durable goods producers are shown. Commercial profit centers averaged 17.6 percent for the 5-year period, which is close to their 17.1 percent return on sales. Government profit centers averaged 13.5 percent, which is 2.9 times the return on sales. However, the FTC durable goods producers averaged only 10.7 percent for the 5 years, which is 1.6 times the return on sales. We thought that the amount of Government owned facilities might have contributed to the relatively healthy return on investment for Government profit centers.

To assess the impact of these facilities, we computed their net book value so as to approximate the investment that the contractors would carry on their books. Inclusion of Government owned facilities at a depreciated value would only decrease the return on investment for these profit centers from 13.5 percent to 13 percent. Therefore, the return on investment for Government profit centers is somewhat more than for the FTC data, and inclusion of the depreciated value of Government owned facilities makes little difference in the rate of return.

PROFITABILITY — RETURN ON INVESTMENT
PROFIT BEFORE TAXES/TOTAL ASSETS
(Less Progress and Advance Payments)

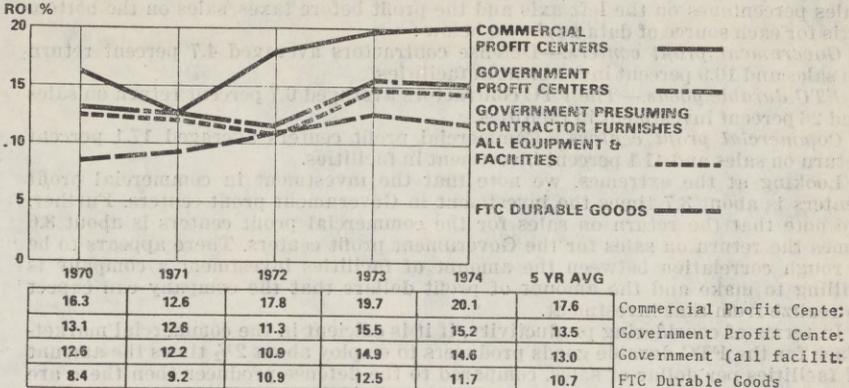


FIGURE 4

To better understand how the Government return on investment is being realized, we compared the level of investment for Government and the FTC. This comparison is shown in figure 5. The FTC data indicates that commercial contractors invest an average of 63 cents for every dollar of sales. Government contractors, on the other hand, invest an average of 35 cents for every dollar of sales. We consider this difference of 28 cents on the sales dollar to be significant. To examine the reasons for this difference, the investment was analyzed in terms of facilities capital (net book value of land, buildings, and equipment) and operating capital (current assets less progress and advance payments). It was found that 15 cents of that difference is the result of a lower level of facilities investment by Government contractors, which is noted on figure 5 as the "delta" for facilities capital. The remaining difference of 13 cents is the "delta" for operating capital, which is caused by the difference in financing of Government and commercial contracts (that is, Government progress payments). We were also concerned with the effect of Government owned facilities on the level of investment; however, we found that by adding the net book value of these facilities the overall investment would only increase 1 cent (35 cents to 36 cents). Thinking in terms of a profit policy that would stimulate investment and productivity, the potential impact is reflected in the "delta" for facilities capital (cross hatched area between the 36 cent level and the 50 cent level).

PROFITABILITY — RETURN ON INVESTMENT
ASSETS/SALES

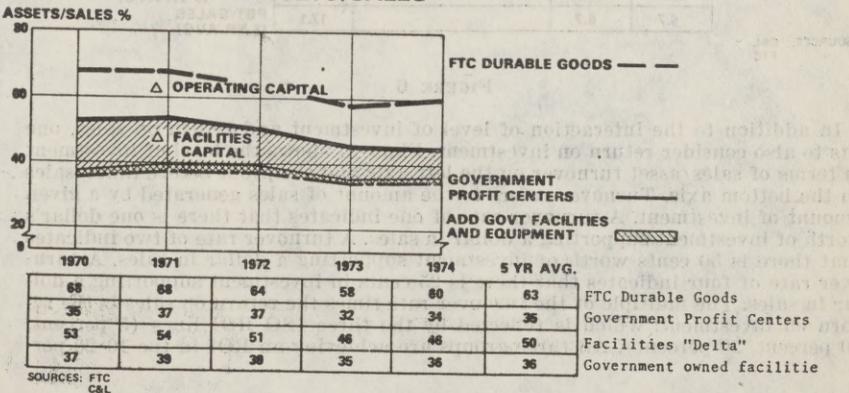


FIGURE 5

The level of investment is greatly influenced by the sources of capital available. Although debt is an important source of funds, the major source is from internally generated funds, which is a function of the return on sales. To determine the significance of this relationship, we have examined the interaction between facilities investment and return on sales. Figure 6 shows facilities capital/sales percentages on the left axis and the profit before taxes/sales on the bottom axis for each source of data as shown below:

Government profit centers.—Defense contractors averaged 4.7 percent return on sales and 10.9 percent investment in facilities.

FTC durable goods.—The FTC contractors averaged 6.7 percent return on sales and 26 percent investment in facilities.

Commercial profit centers.—Commercial profit centers averaged 17.1 percent return on sales and 41.1 percent investment in facilities.

Looking at the extremes, we note that the investment in commercial profit centers is about 3.7 times the investment in Government profit centers. Further, we note that the return on sales for the commercial profit centers is about 3.6 times the return on sales for the Government profit centers. There appears to be a rough correlation between the amount of facilities investment a company is willing to make and the amount of profit dollars that the company can expect to realize from that investment.

In terms of considering productivity, if it is efficient in the commercial marketplace for the FTC durable goods producers to employ about 2½ times the amount of facilities per dollar of sales, compared to the defense producer then there are probably productivity gains that could be made if defense contractors increased their investment. An increase in investment should decrease the production cost and the price to Government.

INTERACTION BETWEEN FACILITIES CAPITAL INVESTMENT AND RETURN ON SALES

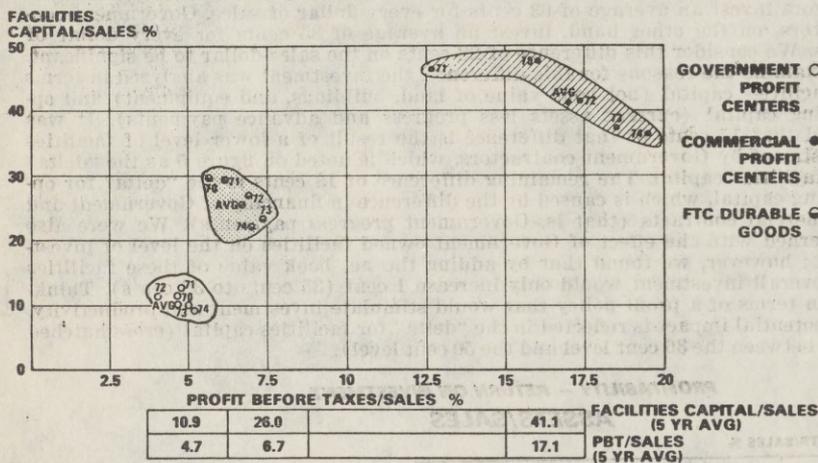


FIGURE 6

In addition to the interaction of level of investment and return on sales, one has to also consider return on investment. Figure 7 shows the level of investment in terms of sales/asset turnover on the left axis and the profit before taxes/sales on the bottom axis. Turnover refers to the amount of sales generated by a given amount of investment. A turnover rate of one indicates that there is one dollar's worth of investment supporting a dollar in sales. A turnover rate of two indicates that there is 50 cents worth of investment supporting a dollar in sales. A turnover rate of four indicates that there is 25 cents in investment supporting a dollar in sales. The multiple of the turnover rate times the return on sales is the return on investment, which is reflected by the three ISO-ROI lines (5 percent, 10 percent, 20 percent). All three groups are achieving an ROI in the 10-20 per-

cent range, but it is important to note how they realize these returns. The commercial profit centers maintain a turnover rate of approximately one by realizing a 17.1 percent return on sales; however, government profit centers with a relatively low return on sales have to achieve a significantly higher turnover of assets. They do this by minimizing their level of investment.

INTERACTION BETWEEN ASSET TURNOVER AND PROFIT ON SALES

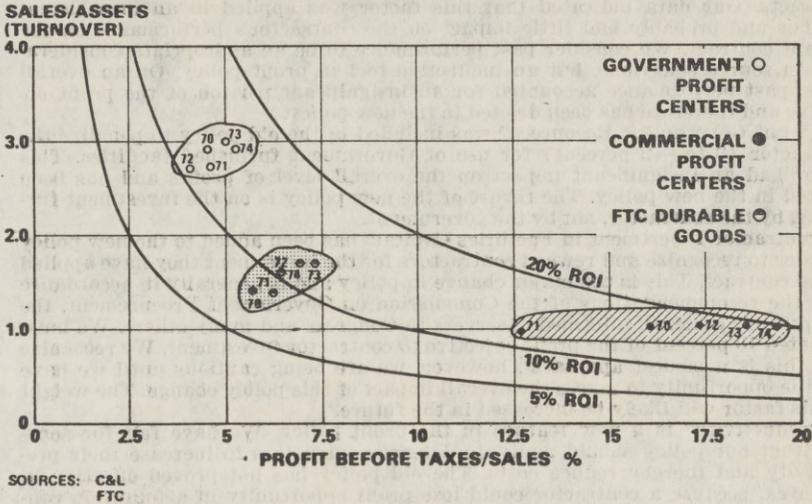


FIGURE 7

While all of the data we have analyzed was very important in shaping our revised policies, we also paid a great deal of attention to the opinions expressed by our contracting officers and representatives of industry. Over 300 contracting officers were surveyed, as were some 200 companies. We noted that there was strong support for basing profit potential somewhat on investment; also that both government and industry felt that the cost of capital should be more adequately recognized as an element of product price. We also contracted for the conference board, an independent research association to examine the question of business risk and investment determinants. The conference board interviewed 53 account executives of 31 financial institutions. They reported that these financial institutions, an important source of funds for defense industry, felt that defense business was not sufficiently profitable for the risks involved. Whether or not one agrees or disagrees with this opinion, it must be noted that these firms have heavy influence over the availability of funds for defense industry investment.

From the facts and opinions gathered during the course of the study, it became clear that we should shape our profit and pricing policies to more directly encourage investment; and that such investment carried with it the potential for significant productivity gains and price reductions. The detailed changes we have made are shown in figure 8.

Turning to our new profit policy, figure 8 shows the changes in emphasis on the various profit factors as noted below:

"Contractor Input to Total Performance (CITP)" is a measure of the estimated cost of and represents the effort required to perform the contract. This was the dominant element in the profit objective in the old policy, and accounted for about 65 percent of the negotiated profit rate. To shift the emphasis from a cost-based profit policy, we have reduced this factor significantly.

Under the old policy, "Contract Cost Risk" recognizes the contractor's assumption of risk with a minimum weight (0 percent) for cost plus fixed fee contracts and a maximum weight (7 percent) for firm fixed price contracts. On the average, this accounted for 30 percent of the profit objective in the old policy. Our Government procurement personnel indicated in the opinion survey that there should be

a greater difference in cost risk between cost type and fixed price contracts. These opinions appear to have been validated by our profit center data, which indicated a very small difference in realized profits between cost type and fixed price contracts. Accordingly, we have provided for a 1 percent increase in the risk ranges for fixed price contracts, which will increase the emphasis for contract cost risk to 40 percent of the profit objective in the new policy.

"Past Performance" was included in the old profit policy as a subjective factor to reward or penalize a defense contractor for his performance on prior defense contracts. Our data indicated that this factor was applied in an inconsistent manner and probably had little impact on the contractor's performance on the instant contract. We consider past performance to be an appropriate consideration in source selections, but an ineffective tool in profit policy. On an overall basis, past performance accounted for an insignificant portion of the profit objective and therefore has been deleted in the new policy.

"Use of Government Resources" was included in the old policy to penalize the contractor (0 to -2 percent) for use of Government furnished facilities. This factor had an insignificant impact on the overall level of profits and has been deleted in the new policy. The thrust of the new policy is on the investment furnished by the contractor, not by the government.

"Contractor Investment in Facilities Capital" has been added to the new policy in order to recognize and reward contractors for the investment they have applied to the contract. This is the major change in policy and is generally in accordance with the recommendations of the Commission on Government Procurement, the Comptroller General, informed observers in Congress and many others. We have allocated 10 percent of the profit objective to contractor investment. We recognize that this is a modest approach; however, we are being cautious until we have had the opportunity to assess the overall impact of this policy change. The weight of this factor will likely be increased in the future.

"Productivity" is a new feature in the profit policy. We have felt for some time that our policy should motivate defense contractors to increase their productivity and thereby reduce costs. The old policy has not proved effective in this area, because a contractor could lose profit opportunity in a follow-on contract if he had made significant productivity gains since the profit objective was based on estimated cost. Accordingly, the new policy provides for consideration of profit on demonstrated unit cost reductions resulting from productivity improvements. This approach emphasizes that it is our objective to reduce contract price and that we are willing to reward productivity when it yields lower prices.

"Other Factors" that may be used in the profit objective are essentially unchanged in the new policy. These factors include consideration for Foreign Military Sales (FMS), Independent Development, Small Business and minority business participation.

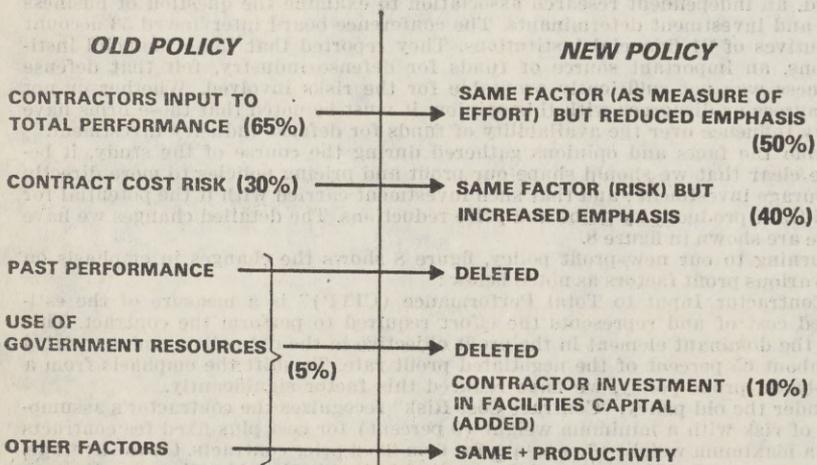


FIGURE 8

A corollary effort has been made in the development of cost objectives to recognize contractor investment. The Cost Accounting Standards Board has taken a positive step forward with Cost Accounting Standard (CAS) 414, which is entitled "The Cost of Money as an Element of the Cost of Facilities Capital". CAS 414 provides the methodology to estimate, accumulate and report a cost of capital that is imputed to the contractor's investment in facilities at an interest rate published by the Secretary of the Treasury. We have made this cost allowable on most negotiated contracts which are priced on the basis of cost analysis. Procedures have been established so that on the average, the prenegotiation profit objective takes into account and offsets the cost increase attributable to the imputed cost of facilities capital. This offset provision is in line with the view expressed in Senator Proxmire's letter to Secretary Rumsfeld of May 27, 1976, on this subject.

We feel that our new profit policy and the allowance of the imputed cost of capital will help remove obstacles to cost-reducing facility investment decisions by industry. These policy changes are a step in the right direction and should reduce the DoD acquisition cost by improving the viability and productivity of our defense industrial base.

Senator PROXMIRE. General Stansberry, go right ahead.

General STANSBERRY. Thank you very much, Senator Proxmire. It is a privilege, indeed an honor, for me to come here and talk to you about what we have been doing for the last year or so on the subject of profit.

In the next several minutes I would like to characterize for you how we went about doing the study and what we think the main results were.

First off, as Secretary Clements pointed out, we took great pains to be sure that our entire study project would be conducted in as open and as objective a manner as possible. At the outset we communicated our plans for the conduct of the study to the GAO, the Office of Federal Procurement Policy, and concerned congressional committees, industrial associations, and just about everybody who would be affected by policy changes. To be sure that we were on the right track, we asked them if they had better ideas for approaching it, and we took these ideas into account.

One of the very first things that we did, as should be true in any research effort, was to go to the library. We looked at the past studies that have been conducted over the past 10 years, some of which have been very authoritative and useful pieces of work. There have been over 50 rather detailed scrutinies of defense profits and profit policies in the last decade. Secretary Clements noted two main criticisms, and these flow from our analysis of all the past studies that have been conducted.

That is to say that the defense profit policy seems to be too heavily oriented toward cost, and it may carry a message to contractors that the way you keep your profit potential high is to keep your cost high, exactly the opposite of what we want to have happen; and second, most informed observers have noted that our policy failed to discriminate sufficiently among contractors based on the level of investment. That is, the contractor putting up twice as much in facilities investment might not realize any additional negotiated profit in dealing with the Government, and that, we think, is a serious deficiency and one that needs to be corrected.

So those are the sort of biases we had as we approached the problem.

Now, the key to a study of this nature, although there are lots of bits and pieces, are the numbers, that is credible data that people believe

are reliable and useful for management decisions. So, in structuring our approach to get good data, we decided we needed some independent reviews of whatever numbers were submitted. The main review and validation technique that we used was to have the defense contractors that participated submit the data on sales, investment, and cost to their own CPA firm. And their CPA firm did a review program in which they checked such things as, for example, is this contractor reporting to the DOD the same kind of profit picture that he reports to the stockholders, and other various checks.

Then that CPA firm forwarded the data to a CPA firm, Coopers & Lybrand, under contract to DOD. Our CPA firm then did further quality assurance checks before the data was used to arrive at any conclusions.

To indicate to you perhaps the extent to which we went to assure high quality data, some 76 companies participated in our study. Of those 76 submissions of data, either the company's own CPA firm or our CPA firm threw out 12 sets of data because it was not sufficiently reliable in their view for us to use. So we think we have pretty good quality assurance on the data that was ultimately aggregated and provided to us.

I would like to comment briefly on what the data shows. In terms of profit before taxes on sales, over the last 5 years defense contractors averaged 4.7 percent compared to an overall commercial average derived from the Federal Trade Commission of about 6.7 percent.

Now, there is one other interesting feature—

Senator PROXMIRE. Now, that is profit on sales.

General STANSBERRY. Profit before taxes on sales. The defense contractors show a couple of percent lower than the FTC numbers.

Senator PROXMIRE. The FTC is about 50 percent higher.

General STANSBERRY. Yes; 6.7 versus 4.7.

Senator PROXMIRE. Roughly.

General STANSBERRY. I think there is another interesting feature to the data we collected that I would like to bring up. We collected profit data on how defense contractors did when they were operating in the commercial marketplace, that is when they sold commercial products. That data showed that defense contractors earned about 17 percent profit before taxes on sales.

Now, we were rather suspicious of that data. We knew the numbers were real because they had been checked by two levels of CPA, but we were not at all sure that those numbers were typical. We think that there might have been some feeling within the contractor world that it would be desirable to report their bright and shining star when it came to commercial ventures. We had good control over what they reported on defense sales but we didn't have as good a control over what they reported on their commercial sales, so we did not use that 17-percent figure as the baseline for policy judgments. However, it is useful in some respects when you look at the amount of investment that defense contractors are willing to put into commercial ventures, and it is much higher than what they characteristically have been willing to put into defense efforts.

Still on the subject of profit before taxes on sales, one of the things that we learned is that over the last 5 years, realized profits on cost-type contracts have been almost as good as on fixed-price type con-

tracts. That is disturbing, obviously, because a contractor operating on a fixed-price type contract, which carries with it, obviously, more risk, should have the opportunity to earn significantly more profit.

It was interesting to us that our contracting officers, when we talked to them, sensed the same thing was going on, and their advice to us was you ought to spread the range a little bit between cost and fixed-price type contracts, and the numbers bore that out.

Possibly the most interesting part of the profit picture on sales is how did the contractors do, how did their earnings compare to what they hoped to earn, what they negotiated.

The negotiated profit rate between the Government and the contractor averaged 8.8 percent on sales. Now, both parties to these negotiations understand full well that there are disallowed costs which either by policy or by law we cannot reimburse, and those run about 2 percent of sales.

So if you mentally take that 8.8 percent and subtract the 2 percent on unallowables, it says that both parties understand that the real target profit that they are trying to make is about 6.8 percent. However, they didn't realize that. If they had, they would be very close to the FTC number, 6.7. They actually averaged a couple of percent less, about 4.7 percent.

That particular problem, while of great importance, is not a problem that you can really solve with profit policy. It has to be solved with steps taken to assure more realistic pricing at the front end of the systems as we go into these big programs.

Profits on sales are important but they are certainly not the whole picture. We were very concerned to be sure that we got good data on return on investment. When we looked at return on investment, we saw a flipflop in the relationship. These defense contractors that were earning less on sales than commercial turned around and make slightly more on an investment basis than a comparable commercial producer. They made about 13.5 percent on investment compared to an overall commercial rate of 10.7 percent.

You say to yourself, how can this be, and the answer, of course, becomes very clear. Defense contractors are not putting up as much investment as their commercial counterparts. Thus, their return on investment rate tends to look pretty healthy. This was the relationship that concerned us most, and when we tried to analyze the difference in levels of investment, the picture shook out this way.

Commercial contractors overall are putting up about 63 cents per sales dollar in investment. Defense contractors are putting up about 35 cents investment per sales dollar.

Senator PROXMIRE. What was the first figure again?

General STANSBERRY. Sixty-three.

Senator PROXMIRE. So about twice as much.

General STANSBERRY. Yes; about twice as much. Some of the difference is understandable because we finance defense contractors through progress payments, and that is our investment, so it is understandable that their working capital needs would not be as high as the average commercial guy, but when we got behind these numbers and looked specifically at the amount of facilities capital that was being put up, we found that the average defense contractor was putting up a dime in facilities capital per sales dollar as compared to about a

quarter per sales dollar for commercial, and that, of course, is what rightly concerns us because it suggests that defense contractors are underfacilitized, and that there is great room for productivity improvements through investment in cost-reducing equipment.

I might add that within these numbers I have given you, obviously those are averages, there are some swings. There are people that make better profits than other people. Overall, shipbuilders are by far the least profitable product group that we looked at, and they averaged 2.9 percent on sales, 5.8 percent return on investment, and those numbers, even those relatively modest numbers, dropped dramatically when you started looking at shipbuilders with large claims. Missile manufacturers were at the top of the heap. On a sales basis they made 6.1 percent. On an investment basis, about 20 percent. Everybody else tended to fall in between.

We noted also—and I think it has been noted before in prior studies, that there tended to be lots of winners and lots of losers in the average, quite a spread. When we tried to make some distribution analysis of this spread, we found it was very difficult to do. The distribution is multimodal and I would characterize it as all over the ballpark.

These numbers we thought were pretty important, but of equal importance to us was informed judgment. We surveyed 327 of our own contracting officers and said to them, what do you think we should do. You are the fellow that sees the contractor out there, and your job is to negotiate a fair and reasonable profit. Two hundred and nineteen of them gave us very detailed written ideas, and these ideas were very important to us. We found from our contracting officers that basing profit to some degree on investment was highly acceptable to them, the people that had to do the job. They thought it was a good idea. They thought it was time that we did it.

We found out another thing that surprised us a little bit, a very useful outcome. Our contracting officers were very concerned about the apparent growing cost of capital. They believed that the Department of Defense should some way or another recognize the cost of facilities capital when we deal with a contractor on a negotiated basis. You will recall that interest expense has historically been unallowable, and they were in essence saying, some way or another, you have to treat that cost of money better.

Industry tended to reinforce these opinions. We asked and solicited advice from some 200 companies, and their opinions formed a very important part of our judgments of what to do.

So there we were, we had opinions, we had a lot of numbers that suggested that we had a problem, that we ought to make some moves, and so we did.

The two most important changes that we have made to our profit policy are first off to move modestly toward an investment based policy, and obviously away from a cost-based policy, thereby we hope setting the stage for encouraging investment and increased productivity, thereby lowered cost.

In addition, and second, our treatment of CAS 414 is a very important step forward. That cost accounting standard deals with the cost of facilities capital. Secretary Clements made the decision that within the Department of Defense we would treat that as an allowable cost, we

move that item into the cost column where it is visible, auditable, manageable, where we know what we are getting, and hereafter reimburse that as allowable cost, not only on CAS covered contracts, but as a cost principle applicable to all contracts subject to cost analysis.

In conclusion, I would like to say that we have worked very hard throughout the past year to secure the support—and I think we have got it—of people that are vitally concerned with profit, and I include there the Army, Navy, Air Force, Defense Supply Agency, the Office of Federal Procurement Policy, the CAS Board Staff, and others. The GAO was particularly helpful to us throughout the study. They reviewed our work constantly, and I think they support what we are trying to do.

Our policy was promulgated and became effective on October 1. We will track very closely as to whether or not we achieved success during the implementation.

Thank you very much.

Senator PROXMIRE. Well, thank you, General, and thank you, Mr. Secretary, two very, very competent statements, and very helpful statements.

First let me say that I think we ought to recognize that the controversy shouldn't be over profit. Profit is the driving force that makes our system work. Profits are good news, not bad news. Profits are something that industry seeks, and that is the reason that—the basis for achieving efficiency. So that there will be no difference of opinion between ourselves, I know that you feel that way, and I certainly feel that way, that profits are something that we have to have adequate profits, encouraging profits, if you are going to get efficiency, if you are going to get your costs down, if you are going to get the right kind of operation.

Having said that, let me just say also that I think that any sensible chief executive officer of a corporation is interested in return on his investment. That is the fundamental return he is looking for. It is the investment that counts. He wants to maximize his return on his investment. That is his mission as the head of his corporation.

Mr. CLEMENTS. I am delighted to hear you say that, Senator Proxmire.

Senator PROXMIRE. I think that is essential when we look at what has happened here because you tell us now that the defense contractors are doing better in terms of return on investment than the nondefense contractors are doing, and it would seem to me that under these circumstances we shouldn't have this kind of a situation where we have a relatively small number of the great number of American corporations engaged in defense contracting. I can't understand why there is not more effort on their part to get into this. It is a good thing. They can get a good return.

Why is it that we have the relatively small number of firms that are active in providing what we need for our defense establishment?

Mr. CLEMENTS. Go ahead.

General STANSBERRY. Senator Proxmire, we feel that you should never look at a profit level without looking at the risks incurred. One of the things we tried to do during the past year was to assess to some degree the subject of how risky is defense business, because it goes to the heart of your question.

A slightly better than average return on investment is fine unless there is very great risk attached to it, and then it might slow you down from getting into that business.

We asked the conference board, which is a nonprofit research outfit operating out of New York to try to come to grips with just how risky is defense business. Some will allege that there is no risk, and others, particularly the ones in the business, will allege that it can be very risky indeed, particularly if a big program is suddenly killed, for example.

The conference board went to 31 financial institutions, the people that loan the money needed for contract performance. They interviewed 53 account executives, and they asked them, how do you perceive the risk of defense contracting as related to average commercial endeavor. The answer in a nutshell was that they thought that defense contracting was indeed very risky, and although they gave lots of reasons, the main reason came down to program instability and perception of the market. They noted the defense business has its ups and downs. Programs grow, they get cut. Today it is 2,000 airplanes, tomorrow it might be 1,000.

So to move into that market based on what looks to be a relatively healthy return on investment, you also must assess very carefully the risk.

Now, I don't think that we have to necessarily agree with all of the opinions that these account executives gave, but I think it is important that those opinions are held by them, and they perceive the defense business as being rather risky.

Senator PROXMIRE. What can we do, if anything, to reduce that risk, or at least the perception of that risk so that we can secure a greater degree of competition?

Mr. CLEMENTS. Well, Senator Proxmire, I don't think that it really is a matter of perception. I think that risk is very real, and when you talk in terms of these multi-hundreds of millions of dollars contracts and you put at risk the health of a major corporation under one of those extremely large contracts, there is indeed a risk. There is a risk for that company, and we have seen the examples of this in the last several years.

And so I don't want to leave the impression that I think that this risk is a perception. It is a very real thing.

Now, one of the things that General Stansberry mentioned I certainly think is a contributing factor to the question that you asked with respect to the small base from which we operate. I think that is really what you are asking, why can we not broaden that base, and the reason beyond the one of risk—and that would be No. 1—has to do with Government interference within those contracts itself. There is an enormous amount of paperwork involved in this, and you ask what can be done. We are trying to do something about this and reduce the amount of paperwork, and we have made good progress.

Those pieces of paper, those kinds of reports, those audits that are in fact needed we must have, and we want them, and we want them even better and in more detailed fashion perhaps than they have been in the past, but those that are not used and that do not serve a useful purpose we want to eliminate, and we constantly hear from defense contractors that they are overwhelmed by people and reports, and we are working hard on this.

The other has to do with the stability that General Stansberry mentioned, and I want to comment on that.

I use a different word. It is continuity. And we have a system that has evolved here within the Government where our budget procedures are on a year-by-year basis with starts and stops and extensions of the production runs, and cutting production runs off, terminations, starting up again after termination, and these kinds of discontinuity in defense contracting certainly do not make for a stable situation and are most unsettling to defense contractors, particularly on these very large contracts. They can't plan their work, it affects their employment cycles, it affects their training programs, and certainly it affects their corporate budgets.

Then that becomes probably the second most driving factor that detracts from these corporate bodies, making the kinds of investments in product improvement, in manufacturing technology that we want them to make in order to reduce our unit cost and modernize their plants.

So that this very, very fundamental thing, continuity of program, probably has as much to do with this plant investment issue as any single thing, and makes defense work very unattractive.

Senator PROXMIRE. Well, that's a very helpful response. I might point out that Smith Barney, which is considered to be a highly competent securities firm, concludes after analyzing technologies of various industries, the review of performance on all nontotal package defense contracts let since 1970, found that risk to defense industries producing all products but ships have been reduced to a low level.

Now, I might also point out that there is another advantage that seems to be here, and General Stansberry, I was very surprised at what I think was the most astonishing statistic that you gave us, that the return on sales for defense industries in their nondefense operations were 17 percent, or about 200 percent higher than the return on sales for the nondefense contractor. That suggests to me that there may be an enormous advantage here in using Government-supplied equipment, perhaps, or in shifting costs from defense contracts—or I should say from commercial operations—to defense operations and so forth.

It is a very, very surprising figure, and a very big one. Isn't that a suspicious figure? Doesn't that lead you in that direction, too, to wonder whether or not the defense contractors are taking advantage of the Government?

General STANSBERRY. Well, to begin with, with respect to Government-furnished equipment, no, not at all. In fact, when we look at the investment that they make in those endeavors where they make 17 percent, they make four times the amount of investment of their own than they do on defense contracts.

Senator PROXMIRE. How about the allocation of overhead? Isn't that a matter of judgment where there is an enormous temptation on the part of the defense contractor to move his allocation over to the Government business?

General STANSBERRY. Our overhead accounts are audited. I might add, too, that L.M.I. (Logistics Management Institute) when they looked at commercial opportunities available to defense contractors a few years ago came up with a similar relationship.

Now, I have cautioned the use of that figure, though, because I will not say that it is an average. I just say that it is a real number and that it was reported to us, but I am not sure at all that it is typical.

Senator PROXMIRE. Well, anytime any industry can make 17 percent return on their sales, there has got to be some unusual reason for it, it would seem to me.

And this would suggest that some of the accusations that people who have been critical of defense industries have made, and as a monitoring of defense costs, might have a pretty good point because, as I say, there is a very powerful temptation, if I were running a defense contracting firm, most of whose business—which is true of almost all defense contractors—most of whose business is in the commercial area, I would be doing everything I could to get my overhead into the defense operation. That is the way you maximize your profits, doing everything legitimately, of course, but doing everything I could to do that.

Mr. CLEMENTS. There isn't any way he can do that legitimately, Senator PROXMIRE, and I don't want to leave us in this wilderness that we are wandering around in because believe me, he cannot do what you said legitimately. There isn't any way he can do that, and that is what our defense audit section is for. He has to certify those charges and those books, and they are audited both in plant and by spot checks by control audit.

Senator PROXMIRE. Mr. Secretary, you know that those are all judgment calls, that those are all auditing by people who are human beings who want to be as fair as they can, but the fundamental decision is made by management, and they have to challenge and be able to prove. The burden of proof is on them if they are going to disagree with a decision of management.

Mr. CLEMENTS. Well, I don't want to leave the inference that I think our defense industry is dishonest and doing something they are not doing.

Senator PROXMIRE. No; I don't say they are being dishonest. I just say they are doing everything they can to increase their profits, and that is what their job is. That is what they are supposed to do.

Mr. CLEMENTS. Now, I think there is confusion here. We are talking in terms of some very, very large corporate bodies when we speak of this number, and there is hardly any way that I can in my wildest imagination think how this particular company that is making toasters and iceboxes, and even automobiles, for instance, for the consumer market, how he is going to get that confused with a jet engine for a fighter. I just don't believe that, and I don't want to leave that inference. I think that is a mistaken thought process.

Senator PROXMIRE. My time is up.

Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman.

Good morning, General. Mr. Secretary.

Mr. Secretary, you spoke about the matter of risk and the lack of continuity in programs making up a part of that risk; is that correct?

Mr. CLEMENTS. That is true.

Representative MITCHELL. In your opinion, is any part of the research and development operation of the Department of Defense re-

sponsible for the lack of continuity in programs? Let me embellish that just a little bit more.

Mr. CLEMENTS. Please.

Representative MITCHELL. We have had some products approved, some designs approved by R. & D. in the military. They have come out after apparently being approved, and then later on it is found that they were not working as well as we would have assumed.

Therefore, it is incumbent on the Congress to scrutinize those programs and perhaps cut them off. That breaks the continuity; right?

I am asking, in your opinion, to what extent does your R. & D. program really become a part of contributing to the lack of continuity of programs by inadvertently approving some things that should not be approved, or approving them too early on in the game?

Mr. CLEMENTS. Well, Mr. Congressman, if you are saying that we make mistakes occasionally in some of the programs that we bring forward and subsequently either we decide or Congress decides to terminate those programs, and that then makes for an unstable condition, you are exactly right. There are those programs, and we are searching diligently for those programs that do not indeed measure up to our expectations and ought to be eliminated, and we would like to do that. I am looking all of the time for those kinds of programs that we can stop.

But I think that that is a very small factor in what we are talking about. It is the very large programs that are multibillion dollar programs and have a serious effect with respect to employment and capital investment decisions and so forth that I am talking about, and stretching those programs out and disturbing the normal milestones that we would have looked for in those production runs. Those are the kinds of discontinuities that I am talking about.

Do you want to add anything to that, Frank?

Representative MITCHELL. And there are more, it seems to me, Mr. Secretary, but let me treat the other phase of it.

If I were a businessman and I got word that there was R. & D. being done on the C-5A, I might start looking at the possibilities of my company going into production of C-5A's; right?

Mr. CLEMENTS. You would make a bad mistake if you did that. [General laughter.]

Representative MITCHELL. You are absolutely right, and yet any sensible businessman is going to do at least the preliminary work if there is a good shot, he thinks, of something coming, being approved through R. & D., and being put into production.

If you approve it, no company is going to be ready, no company wants to be waiting a year later to get into the active bidding on it. They are going to be putting out some money in advance, even while you are in the research phase.

Mr. SHRONTZ. Well, I think we can acknowledge there are risks in the type of high technology efforts that you are referring to, but the kind of continuity the Secretary is addressing is the continuity on those programs which are approved for go-ahead in terms of rate of production, in terms of funding, in terms of buy-out of the quantity of the original program.

Our emphasis is to try to get those contractors which have approved programs to invest in those kinds of improvements in their facilities which will cut costs downstream. It is very difficult to motivate them to do that when the program quantities, fundings, and rates change frequently.

Representative MITCHELL. As long as the record will show very clearly that the research and development aspect of DOD does contribute in some way to a lack of continuity of programs, I am satisfied.

By your own admission you have stated that you try very hard to bring them out carefully, but it just doesn't work, whether it is a 10-percent or a 5-percent failure, it doesn't matter. I am trying to isolate out the causes for lack of continuity in programs.

Mr. CLEMENTS. That is certainly a contribution, Mr. Mitchell. I don't argue that point at all.

Representative MITCHELL. All right.

In your testimony, in your prepared statement on page 14 you obliquely mention your efforts vis-a-vis minority businessmen in defense contracting.

Mr. Gansler yesterday indicated that it is almost impossible now to get subcontractors to come in to do contracting work because of many risks that he spelled out.

On the other hand, you have got a group known as the National Association of Black Manufacturers with good capability in defense production and production across the line. As I deal with those men, they constantly come to me indicating the absolute impossibility of their getting a subcontract. The last figures that I read indicated that maybe minority contractors are getting about 1 percent of the total procurement and contractual efforts to DOD. Now, I will stand corrected if that figure is off. The last I read it was 1 percent.

What are the impediments, then? What are the impediments which do not permit you to fully utilize minority contractors with good capability, those that are used by the private sector?

Mr. CLEMENTS. Mr. Mitchell, I am going to have Dale Babione, who works with this all of the time, to respond more fully, but I want you to know that the Department of Defense policy in this regard is to encourage and to expand and to enhance our relationship with minority contractors, not just subcontractors, but contractors generally, and we have been, without any question whatsoever, the most successful department in this Government in this regard. We have taken the lead and the other agencies within the Government have acknowledged our lead, and have adopted in large measure the procedures that we have underway to expand this particular type of operation.

I am totally sympathetic to it, and we work hard at it.

Representative MITCHELL. Thank you very much, Mr. Secretary.

Before you respond, let me indicate that is quite true, that is the official policy of DOD, that is the official policy of the Federal Government, that is the policy which was enunciated under the Nixon administration, and further articulated under Ford last year. The problem occurs not in terms of the philosophical base of the policy. The problem occurs in that middle management thicket, in all of these agencies which often obstruct, and thwart, and pervert and distort and block official policy, and that has been my experience, not only in DOD, but across the board.

Mr. BABIONE. Let me, Congressman Mitchell, respond to your question more fully.

One of my responsibilities is for implementation of this policy within the Department of Defense. I would like to point out that in fiscal year 1975, we awarded about \$72 million in subcontracts to minority firms.

Representative MITCHELL. How much?

Mr. BABIONE. \$72 million in 1975. In 1976 it was \$102 million. So that is an increase of \$30 million from one fiscal year to the next.

I would like to first say that we have 8-A programs which I think you are familiar with. The Department of Defense awarded \$230 million in 8-A awards in fiscal 1976 alone. We awarded, as I said, \$102 million to minority and subcontracting. Minorities won through normal competitive bidding approximately \$26 million. Now, I am sure it is more than that, but we will not have precise figures on this until next fiscal year when it is expected that procurement forms will record minority awards.

Now, you say that is not very great, it is about 1 percent, is that what you said?

Representative MITCHELL. About 1 percent.

Mr. BABIONE. Let me explain what the problem is.

The problem is as the Small Business Administration has testified, that the number of minority firms in America make up about 4 percent of all businesses in our country. Further, the Office of Minority Business Enterprise (OMBE) has reported that out of an estimated total of 450,000 minority-owned businesses, only 89,000 have paid employees. The balance constitute what we call family-run organizations. They are either family grocery stores, they are—

Representative MITCHELL. I am not concerned with that aspect of it at all.

Mr. BABIONE. I will try to explain it.

Representative MITCHELL. Excuse me. I am concerned with an organization such as the National Association of Black Manufacturers which does the job that you want. I am not here concerned about the mom and pop stores. I am concerned about the non-utilization of those companies.

Mr. BABIONE. Yes, sir, I am familiar with the organization. I have met with the organization on several occasions and several other minority forums such as LAMA and many others. In order to enhance procurement opportunities for minority firms, we have developed a computer program to identify all minority-owned companies in America, both by region and nationally. That is being put on a computer program in cooperation with the Department of Commerce, which is the lead agency for this. That information is being made available to all of our principal prime contractors, and it is being made available to all of our procurement organizations.

In addition—and that is the big problem, what I was trying to tell you before, the big problem is identifying where they are and what their capability is. We are now in the process of developing a system that gives us this information.

In addition to that, within the last month, I have written approximately 600 letters to major defense prime contractors giving them a

goal of increasing the amount of dollars awarded to minority firms at least 5 percent from the fiscal 1976 number, which, as indicated to you, was a \$30 million increase from the previous year. I have responses from most of those contractors and I have overwhelming acceptance of this program. I am confident that next fiscal year we will increase the amount of minority in the subcontracting area to major primes by approximately \$50 million more.

Now, while that may sound small when you compare it to a percentage of all of our awards, it is still a lot of money. The difficulty we have is identifying them, finding them and matching them up to where there is an ability to perform the contract.

Now, on the 8-A program, each year approximately \$33 million worth of contracts that we have identified to be placed with minorities are not placed with minorities because SBA is unable, as good a job as they do, to match up minority firms that could perform those contracts for us.

So I think we are moving on both the 8-A, the subcontracting and the normal competition fronts, and I feel that if you look at the trend, which we can provide for the record, the last 8 years, you will find that we have a very good progressive trend line. We are doing everything we can. We are talking to all those organizations to submit names of minorities, what their capability is, and in what geographical areas they desire to provide their services. We are doing everything we can to increase that percentage.

We are not satisfied where we are, but we are going to do a better job, and I think we are on top of it.

Representative MITCHELL. I certainly don't want to turn this into a civil rights, human relations discussion, but let me just indicate that 5 years ago, in 1971, when I came to the Congress, I took the responsibility of identifying every minority contractor with capability. Those lists were submitted to SBA, OMB and every agency in Government, Interior, DOD and so forth, so 5 years ago identification had taken place.

We will get a chance to talk about this a little more. My time is up, Mr. Chairman.

Senator PROXMIRE. Go ahead if you would like.

Representative MITCHELL. I wanted to explore one more area that you had opened up.

Let's say you have a little operation someplace in some city that wants to run a day care center, say it is a church, and they take their day care center and run it with three people. Then a policy comes out from the Federal Government in which the Federal Government is going to supply funds for day care centers. It is quite possible that that day-care center that was run by three people then transfers over to get Government funds, and in some instances, the staff increases from 3 to 10.

What I want to pursue is the possibility of what is best called featherbedding when we get into defense contracts.

You say there can't be any transfer over of funds—that you can't mix up motors for refrigerators with your airplane motors. On the other hand, there is a possibility that a corporation, knowing that it has got a defense contract, knowing that it has the expertise vis-a-vis that contract, might have a tendency to overload in terms of staff and personnel in the performance of their contract.

Have you had any experience along those lines?

If you have had such experience, I want to know what you have done about it. If there has not been what do you do to protect against what essentially is featherbedding?

Mr. BABIONE. Mr. Congressman, and this committee, I believe, knows that on the major programs where we are negotiating the price based on elements of cost plus a negotiated profit, we do perform a complete audit of the contractor's projected cost which has to be certified. In addition to that we do perform a should cost study, which determines what the product should be selling for regardless of what the contractor is proposing, and that is a requirement on all of our large procurements, where we do not have the competitive market price to depend on to perform that function for us.

As you probably know working closely with the CAS Board, the CAS Board mission is to define accounting standards that are used in Federal Government procurements of all types. In the Department of Defense, the Cost Accounting Standards Board has issued a number of standards to insure uniform treatment and to insure trackability and to insure and guard against the very thing you are concerned about. I think that program is well under way, and we do have the capability in the audit of the Department of Defense to insure those accounting principles are being followed to the letter.

Representative MITCHELL. Then in your response you are assuring me that there is no featherbedding in any defense contract.

Mr. BABIONE. Congressman Mitchell, we awarded 10,100,000 contracts last year. I would say to you, to the extent that management visibility is possible on that great a number, we are doing a very credible job in assuring the taxpayers' dollars are properly spent.

Representative MITCHELL. Well, with the absence of staff to do the oversight, the follow-through might cause featherbedding to exist and you would not even be aware of it, is that correct?

Mr. BABIONE. I am not aware of any absence of staff. The Secretary was just discussing the case of where we thought the staff was more than adequate. We are making whatever economies would make good sense.

Representative MITCHELL. How many contracts did you let last year?

Mr. BABIONE. Last year 10,100,000 contracts. Now, 90 percent of those are under \$10,000.

Representative MITCHELL. And you have been able to do a firsthand look-see on each one of those contracts?

Mr. BABIONE. What we are saying is 90 percent of those under \$10,000 are awarded under price competition, and while the dollars are small, the number of actions awarded through the marketplace are very large, and we are concentrating our efforts on the high dollars awarded on a negotiated basis.

Representative MITCHELL. Thank you very much.

Mr. CLEMENTS. Mr. Mitchell?

Representative MITCHELL. Yes.

Mr. CLEMENTS. I would like to say to you that I am not in any sense satisfied that there isn't some featherbedding among defense contractors.

Representative MITCHELL. Mr. Secretary, you cause me to heave a sigh of relief, because it is inevitable that that is going to take place.

Mr. CLEMENTS. I agree with you.

Representative MITCHELL. Sure.

Mr. CLEMENTS. And we have this constantly on our minds, we are trying to evolve the best possible controls that we can to do the best job for the taxpayer and this Government in a fiduciary sense of looking after the money that the Government gives us on these contracts, but for me to say to you that no, there are not excesses in the overhead category, there are not excess people, that everything is cut right down to skin and bones, so to speak, I am not going to do that because I know better than that.

Representative MITCHELL. Thank you, Mr. Secretary. Thank you very much, Mr. Chairman.

Senator PROXMIRE. In your prepared statement, Mr. Secretary, you say the average realized profit rate for defense contractors is shown as 4.7 percent compared to an initial negotiated profit of 6.8 percent. You therefore conclude there is a substantial, and I quote, "a substantial erosion of the profit rate during contract performance." You also say that this problem must be addressed by both Government and contractors in more realistic initial pricing of the contract, which means that we ought to have a higher settlement, apparently, at the initial level, a higher price, a higher cost to the Government, and yet one conclusion of the Profit 76 study group was that based on investment, realized profit margins were probably adequate, although not distributed in the most rational manner.

So if you stress more realistic initial pricing, which means higher prices, you are going to pay higher prices, when you are negotiating profit rates, won't this have the effect of raising actual profits above the adequate level?

General STANSBERRY. We have a complex problem that we are trying to address, and one part of the problem is clearly to try to establish a realistic cost in major systems, often it is something that has never been produced in numbers early in the game. The data suggests that more often than not there have been pressures which have caused us to underestimate what that cost will be as opposed to overestimating.

Now, there may be many reasons for this. It might be unanticipated inflation, for example. That has happened.

To the degree that we can, I think it is of great importance that both parties achieve the very best estimate of costs that, during the negotiation process, that they possibly can.

Now, I think we now ought to turn—

Senator PROXMIRE. Well, let me just interrupt to say that we are all also concerned with the possibility or the likelihood of buy-ins or trying to sell a program to Congress by making it unrealistically lower in cost than it really is.

Mr. CLEMENTS. Absolutely, that's right.

General STANSBERRY. That potential exists. There is pressure on both sides of the table to do that.

Senator PROXMIRE. Well, wouldn't it be a good policy to be a lot tougher than you have been on your price and not permit the price to be renegotiated or be allowed to go higher than the initial agreement?

I get the feeling that again and again and again the Defense Department is pretty soft when it comes to sticking by the initial contract price.

Mr. CLEMENTS. You have the wrong feeling, Senator.

Senator PROXMIRE. Well, we have had it documented a number of times.

Mr. CLEMENTS. Well, I would argue the point, and I think we are getting back into the perception thing again. I don't think that is really based on fact.

I don't want to leave it on the basis that we are not as tough on our contractors and we don't negotiate as hard from the Government side as we should. I think we do, and I think that we can prove that, and the best proof of all is that industry in a large measure resists doing business with the Government. There is a solid mass out there in our industrial base who do not want to do business with the U.S. Government, and one of those reasons is the toughness of our policies, both contractually as well as in the bargaining relationship area.

So I disagree with you.

Senator PROXMIRE. Well, it is a strong argument.

You see, my problem is I got an amendment adopted requiring the GAO to report on overruns and the cost of contracts every 6 months, and since then, every 6 months they come in with big overruns on contractor to contractor to contract.

What is an overrun? An overrun is when the price that has to be paid is higher than the original contract cost was supposed to be. It seems to me that is documented repeatedly, year after year after year, every 6 months.

Mr. CLEMENTS. That's right. Senator Proxmire, as an economist, you understand better than I do one of the largest factors in that type of an evaluation of contracts has been inflation and we have gone through a double digit inflation period that no one anticipated. Certainly I, not being an economist, did not anticipate it. I don't think you as a professional economist anticipated it. I don't think anybody did.

So that can also greatly affect the thing that you are talking about and has contributed more than any single factor to this overrun quote that you are talking about.

Senator PROXMIRE. Well, there is something to that. There isn't quite as much as you imply, however, Mr. Clements. The fact is that there is, as you know, an allowance for inflation in every contract and that allowance has by and large, been fairly accurate most of the time—although that is right, that is certainly one of the elements, but certainly not the whole element.

Now, let me ask you this: It seems as though the Government winds up paying for production equipment a few too many times under the new profit policy. First the contractor will receive an advantage or additional aftertax profits on depreciation, which is allowed in the cost. Then the contractor will be able to take a standard imputed interest rate for the same equipment as the cost on contract and receive a corresponding profit under the provisions of Cost Accounting Standard 414.

Finally, under DPC 763—the new profit policy—the contractor will receive still another share of profit for the capital investments that he makes.

Now, isn't that a lot of benefit from buying equipment? Isn't it possible that we might be giving such an incentive in buying equipment that we are going to be over- rather than undercapitalized?

General STANSBERRY. The worry is that we have over-incentivized and there will be too much investment.

Senator PROXMIRE. Yes; that is right.

General STANSBERRY. That is a good question. The GAO thinks we have not gone far enough, for example. The analogy that you draw I don't think is exactly the correct way to look at it. I would like to draw a comparison in direct labor. We pay for direct labor as a cost, and we also use that as a profit determinant.

Our policy in essence is that we will now pay the cost of capital as a cost just as with direct labor. The CAS Board showed us how to estimate, accumulate, and report this amount, and we are also using that as a profit determinant. Every concerned critic that I know about in the last several years who has wanted a change has recommended that, so that a contractor that puts up more investment will achieve more return, and that seems fair and equitable.

Now to the question of have we perhaps overincentivized. We think that the step that we have taken is quite modest. We are actually saying that facility investment will account for about 10 percent of the negotiated profit. We believe this to be a proper step in the right direction. If we have any concern, it is that we will probably have to raise that percentage higher after industry has had a chance to make some adjustment in their plants. So we don't really see that as a problem, Senator Proxmire.

Mr. CLEMENTS. And Senator Proxmire, as we are now going forward with some of our contracts—and I could get specific about this, but I prefer not to—in our larger programs where we are currently negotiating with particular contractors to make additional investments in their plants which will lower unit costs of production and at the same time provide a more modern industrial base from a surge standpoint on a national security basis, we are having great difficulty in getting these contractors to do this for the reasons that General Stansberry is talking about.

I suspect that Elmer Staats and the GAO people would tell us that we told you so, that you need to go further than you now have gone to bring about this plant modernization as well as the lower unit cost from an incentive standpoint.

So I think we are just going to have to do what you and I talked earlier about, that is, evaluate these results over time and look at them and see whether we have achieved the results we want. And where we have not, make an evaluation of what to do at that point. It is too early to do that now.

General STANSBERRY. Could I add, sir, too, I think on the subject of depreciation, that really is not a return on investment. That is the way you get your investment back.

Senator PROXMIRE. The central benefit of this new profit policy is supposed to be an increase in productivity. That is one of the principal purposes of it, I think, due to investment in cost-saving equipment.

The executive vice president of TRW, Dr. DeLauer, said in a letter to the committee, and I quote:

We also suspect that the new DOD policy may have some adverse effect upon the competitive nature of the Defense business in that a contractor with a large amount of under or unused capacity could be in a position to receive a larger going in profit than a competitor who is operating at full capacity who would have a lesser total capital base.

I, like Dr. DeLauer, am concerned about the Defense Department subsidizing excess capacity.

What assurances do we have that only needed investment will be made, will be used as the basis for profits? Can we keep from stimulating investment in excess capacity and equipment in order to reach the higher profit levels?

Mr. SHRONTZ. Mr. Chairman, I think the answer is yes, I think Dr. DeLauer either misinterpreted our intent or misread the policy. The amount of investment that will be given credit is only that amount of investment that is applied directly to the contract, and if there is excess plant and capacity in that particular company or any other company, that will not count toward the amount determination.

We also think that to the extent that our contracting officers exercise prudent judgment in reviewing the amount of input that a contractor puts into that contract, both in terms of people and capital investment, we can control the amount of capital so that it is profitable.

Senator PROXMIRE. My time is about up.

Let me just ask one more question. My concern is, under the new profit policy, contractors will tend to maximize their investment in order to keep the profit levels up, but the productivity improvements as the primary goal, will become of secondary importance and may even be lost. Is there any way of preventing that kind of development?

Mr. CLEMENTS. Well, I just don't believe, Senator Proxmire, that that is going to happen, and of course, our objective here is to lower unit cost, and that is exactly why we would approve these investments and let them become a factor in the equation, in order, as we go into the production cycle, to lower the manufacturing cost per unit.

Now, that would be proved over time, and the contractor's real return ultimately is going to be on a share line basis as we have an incentive built in and he shares on the lower unit cost.

So I think that we can control that. We can control it by inspection in plant management, which we certainly have, but also by audit, and he is going to have to prove in time how the more effective and efficient use of that investment is being made to validate and authenticate his sharing of the increased productivity.

So that is exactly the exercise that we intend to go through.

Senator PROXMIRE. Well, that is certainly good to hear. If you hold them to that, that will very helpful.

I might just say before I yield to Congressman Mitchell that in our discussion of overruns and your argument that those are mostly inflationary, one of the examples I had in my mind is the B-1 bomber that was supposed to cost \$20 million in 1969, now is costing about \$100 million per copy, and that is a fivefold increase in 8 years. There is no way you can explain any substantial part of that through inflation—some, but nothing like 500 percent.

Mr. CLEMENTS. Senator Proxmire, I am delighted you brought that subject up, and may I comment?

Senator PROXMIRE. Yes, sir.

Mr. CLEMENTS. We started out in about 1970 or 1971 I believe is the correct time frame, with a cost factor in our program, as submitted to Congress on the B-1 bomber, of about \$42 million in constant fiscal year 1970 dollars, as I recall. At the current level in 1976, in escalated dollars, 5 years later, our SAR estimate coming in—the reporting device we use to Congress—that number is about \$85 million as I recall. The amount has about doubled for any practical purpose, and out of that 100 percent or so increase that we are talking about, all but 16 percent of that is indeed inflation; 16 percent is real growth, 84 percent of that is inflation. So you have just proved my point for me.

Senator PROXMIRE. Well, I would challenge you all along the line. In the first place, you took different dates than I took. I took 1969, you took 1971, and I would certainly challenge the \$84 million. I think it is substantially higher than that. But I don't—and furthermore, I don't see how you can argue that there has been 100 percent inflation.

What index has gone up 100 percent between 1971 and 1976? Find one.

Mr. CLEMENTS. I will be happy to have another hearing with you on this particular subject and document those numbers because in a very careful analysis on the numbers that figure I used of \$85 million per unit program cost over the production run—you see, that includes the entire program—and through the outyears through 1984 we are estimating that the unit cost per copy will be approximately \$85 million, and of that number, compared to the original estimate, 84 percent of the increase is due to inflation and only 16 percent is real growth.

Senator PROXMIRE. Well, as I say, I took the original, the 1969 date, which was when the program was originally begun. You took 1971, and then you just skipped over that 100 percent increase in the cost between 1969 and 1971. I took that \$20 million figure in 1969. You took the \$41 million or \$42 million in 1971—

Mr. CLEMENTS. I think, Senator, those were our original estimates. I may be mistaken, but that is my recollection.

Mr. SHRONTZ. Mr. Chairman, just one comment. I think there is a misperception here. The inflation projections that are being made today are not just for the historical period between 1971 and now. They are for the life of the development and manufacturing production program. So that is over a much longer time period. So it is not 100 percent in the last 5 years. It is a projection of 100 percent over the life of the program.

Mr. CLEMENTS. Am I making that clear? You see, it is the \$85 million projected unit program cost over the life of the program. So that number in escalated 1971 dollars of \$45.6 million, over the life of the program by 1984, and taking the total program escalated cost divided by the units of 244, we come back to about an \$85 million estimated program unit cost now.

Senator PROXMIRE. Well, we can go on in this, and of course, I am sure it is going to be adjusted again and again and again, if you go on with this.

Mr. CLEMENTS. I am sure of that, too.

[Additional material submitted by Secretary Clements follows:]

Mr. Clements' testimony on B-1 unit costs was based upon 30 June 1976 SAR data. For the record, the pertinent page from the 30 Sep 1976 SAR is included

to provide the latest information. Notice the changes in the unit program costs in item 3 between the time of the Development Estimate approval (fiscal year 1970) and the Current Estimate. The Development Estimate was based upon 246 aircraft and covered the period fiscal year 1970-fiscal year 1979. The Current Estimate is based upon 244 aircraft and covers the period fiscal year 1970-fiscal year 1984. In constant fiscal year 1970 dollars, the Development Estimate unit program cost was \$40.1 million; the Current Estimate is \$45.3 million or an increase of 12 percent using constant fiscal year 1970 dollars. In escalated dollars, the Development Estimate was \$45.6 million; the Current Estimate is \$93.8 million or an increase of 105 percent, using escalated dollars.

SYSTEM: B-1		UNCLASSIFIED PROGRAM COST SECTION (Dollars in Millions)			AS OF DATE: 30 September 1976 BASE YEAR: FY 1970					
E.		1	2	3	4	5	6	7	8	
PROGRAM ACQUISITION COST		DEVELOPMENT ESTIMATE (FY70-79)	CHANGES	CURRENT ESTIMATE (FY70-84)	FUNDING	CURRENT & PRIOR YRS	BUDGET YEAR (FY77)	BALANCE TO FY07	TO COMPLETE BEYOND FY07	TOTAL
DEVELOPMENT		\$ 2431.0	+\$ 443.4	\$ 2874.4	DEVELOPMENT	\$ 2752.8	\$ 482.7	\$ 941.4	\$ 45.1	\$ 4222.0
PROCUREMENT		7422.8	+ 753.0	8175.8	PROCUREMENT	87.0	1049.5	10012.2	7518.8	18667.5
Airframe		4345.7	-	4366.0	CONSTRUCTION	-	-	-	-	-
Engine		796.5	-	1124.0	Total	\$ 2839.8	\$ 1532.2	\$ 10953.6	\$ 7563.9	\$ 22889.5
Avionics		894.0	-	1215.0	QUANTITIES	-	-	-	-	-
Regular Support		671.4	-	409.0	DEVELOPMENT	4	-	-	-	4
Initial Spares		715.2	-	562.0	PROCUREMENT	-	3	104	133	240
CONSTRUCTION		-	-	-	Total	4	3	104	133	244
Total (FY70\$)		\$ 9853.8	+\$ 1196.4	\$ 11050.2	Estimates					
ESCALATION		1365.0 + 10474.3		11839.3	Column 1 reflects the estimate of program cost at the time of development estimate approval (FY 70), at which time the provision for escalation was \$1365.0M based on a rate of 2.57% annually through FY 78 for the RD&E program and 1.94% annually through FY 81 for the Procurement program. The Current Estimate, Column 3, includes adjustments for program changes and economic change greater than initially assumed. For FY 77, annual rates of 7.7% for RD&E and 7.0% for Procurement are assumed, with average annual rates of 7.4% through FY 83 for RD&E and 5.1% through FY 88 for Procurement. The table below indicates the change to the Current Estimate of \$22889.5M which would result from other rate assumptions.					
TOTAL PROG COST		\$11218.8	+\$11670.7	\$22889.5 (Ch 1)	Escalation Rate		\$ Millions			
2. QUANTITIES		5	-1	4	4%		- 2287.5			
DEVELOPMENT		241	-1	240	6%		- 140.4			
PROCUREMENT		246	-2	244	8%		+ 2244.8			
Total					10%		+ 4899.7			
3. UNIT COSTS										
PROCUREMENT										
Constant FY70\$		\$ 30.8		\$ 34.1						
Escalated		\$ 35.4		\$ 77.8						
PROGRAM										
Constant FY70\$		\$ 40.1		\$ 45.3						
Escalated		\$ 45.6		\$ 93.8						
4. APPROVED DESIGN TO COST GOAL:		Radio frequency surveillance/electronic countermeasure avionics: \$1.4M average unit cost for 241 units, expressed in FY 72 dollars.								

UNCLASSIFIED

Source: SAR, WS-139A, Submission Date 4 October 1976

Senator PROXMIRE. And it is my hope that the Proxmire amendment, which was accepted by the Congress last year, postponing the decision until February, will result in this argument being pretty moot, as President Carter I hope will make the right decision in February.

Mr. CLEMENTS. I hope he will, too, and I am reasonably confident of that.

[General laughter.]

Senator PROXMIRE. Congressman Mitchell.

Representative MITCHELL. Now that we have vented our spleen on the unworkable B-1 bomber, certainly you need to be commended, any agency needs to be commended when it moves to increase productivity, and I do indeed commend you for it, and I am sure the chairman does.

I want to make sure that I understand what the productivity reward clause means. It means the contractor starts out in the initial performance of the contract, and as he improves his performance throughout the life of the contract, you reward him. Essentially is that it?

Mr. CLEMENTS. Yes, sir.

Representative MITCHELL. That certainly is a laudable objective, but it seems to me that is just littered with all kinds of problems. For

example, early on we talked about risk-taking, and you mentioned some of the problems that the private sector has associated with risk-taking.

What about a design change? What about a change in the quantity of a thing that you order? What about inflation, and what about a contractor's change in his own business base? Those are just four or five of the variables that you have to contend with if you want to measure whether productivity has indeed increased from the initial stage throughout the life of the program.

Now, how have you weighted for all of these intervening variables which normally occur during the course of the life of a contract? How have you done that?

General STANSBERRY. Those are very real problems, and I would like to spend just a moment or two to tell you the metamorphosis that we went through as we tried to address this.

First off, we had a very real problem and the problem went like this. A contractor on a production contract in year one, who made solid productivity improvements, found that he had eroded his follow-on profit potential, so there was a great motivation not to do it, and we said, we have to get away from that sort of a policy. So we structured a method of approaching each of those variables that you mentioned, the change in configuration, a change in inflation, a change in quantity, because we recognize that these are all problems that impact unit cost, and by the way, the suggestion to do this came from both sides. Both industry and Government wanted to get some mechanism for seeing to it that when the price went down profit went up, not just the opposite.

We took that method out to a large number of contractors and a large number of contracting officers, and they spotted problems with it. Mr. Fitzgerald, who I think is scheduled to testify later today spotted some problems with the mechanism. Nevertheless, everybody was unanimous in their view that it made sense to try to do it, even though we had not solved all of those problems yet.

The advice from our contracting officers and industry was, give us an open door to try it for a few years to see if we can work out methods where contractors can demonstrate actual savings after adjustment for changes in quantity, changes in configuration, changes in inflation, et cetera, to the satisfaction of the Government so the Government can pay some modest additional profit for that increased productivity. Let us try that for a while, keep the policy somewhat generalized, and list only the criteria that must be met.

We decided to go ahead on that basis, and we are not certain that it will work for many of the reasons that you have mentioned.

Representative MITCHELL. It is on a trial basis only?

General STANSBERRY. Yes, and if it doesn't work, we will change it. We think after a year or two, after we have gained some experience, after several contractors have tried this out in several different ways and we have had a chance to react, at that time we will probably want to make some adjustments.

Mr. CLEMENTS. Mr. Congressman, you see, as it was before, when there was such emphasis on cost, the whole system was working in a negative sense against productivity. In the theory that was broadly used in contractual matters, as a contractor would reduce his cost by

efficiencies and productivity improvements and all, he would, at the same time he was reducing costs, be reducing his own profits, so there was a disincentive for him to make the kind of investments in modernized plant equipment and so forth that we are talking about.

Representative MITCHELL. Oh, I understand the rationale behind it and I think it is workable, and I think it makes sense to try it. I am just trying to lay out some of the very pragmatic problems that I see. And here is another one.

Mr. CLEMENTS. We agree with you.

Representative MITCHELL. Here is another very practical problem. It was my experience, based on my service on the Subcommittee on Renegotiation in the House, that when contracts come into the Government the assumed reasonable level is almost assumed industrywide. You don't get much variation in terms of cost.

Now, it would seem to me that cost standards are assumed to be at proper and reasonable levels only because those are the levels that have been experienced. Therefore any subsequent change in the direction, in the right direction, are interpreted as economies or improvements, but such improvements have no reference at all to whether or not the original performance baseline was reasonable.

What I am trying to get at is, is it possible that the productivity reward can unwittingly become a method of rewarding people simply for ceasing unnecessary inefficiencies?

Mr. CLEMENTS. No, sir, I don't think so. It is possible but not under the types of disciplines and controls that we exercise in our contractual matters. They are currently audited. We have our project managers and our plant representatives, and these items that for the most part we are talking about in a production sense are well known items, and we have a good cost data base from which to work. We are not taking Government averages, as you mentioned. We are using parametric methods on a good solid base of an historical nature.

Representative MITCHELL. What is the source of your data?

Mr. CLEMENTS. Of our what?

Representative MITCHELL. Your data.

Let me explain what I am trying to get to. I am going back to whether the original cost estimates are reasonable.

Mr. CLEMENTS. I understand.

Representative MITCHELL. It is my experience on the Renegotiation Committee in the House, that when contracts and cost standards came in and bids were submitted by various companies and corporations, there was very little variation in terms of the predicted costs, 1 percent up or down—very little variation.

Now, if that is true—and I am not accusing the defense industry of being one huge monopoly—but if that lack of variation is there, then it suggests to me that you have almost built in from the beginning what represents a reasonable cost, and the source of your data must have come from the defense industry itself.

So you are building on to an advantage that the defense contractors already have.

Mr. SHRONTZ. Let me comment in general, and then if you would like to pursue it, perhaps Dale Babione can talk specifics, but the way we approach certain major procurements is to do cost studies to determine what the cost should be. That enters into our negotiation with

the contractor. You try to reach a final cost estimate as you do in any other negotiation, a reasonable settlement.

Certainly the approach we try to take in changing profit emphasis from strictly cost-to-cost-plus investment would seem to me to work against any charge that the initial cost should be built in high in order to achieve a reduction later on. We think we have reasonable controls to ensure that the going-in cost that is finally negotiated and settled upon is reasonable. To the extent that we push too hard, we do get the problem of the overruns that the chairman has spoken about, but I am not really concerned that the contractors will come in initially very high in order to show significant savings downstream. We think we have controls to prevent that.

Representative MITCHELL. I thank you for your explanation. I still would insist that you have an area where costs have been based on what the experience has been in the defense industry. Your reasonable costs are based upon that industry experience. Therefore I am not saying that contractor Y comes in with a figure high within that bracket, I am saying that this whole bracket is a built-in advantage for the contractor because your data must necessarily rest upon that base.

Mr. SHRONTZ. Well, our data will rest upon both an industry analysis and the parametrics that the Secretary spoke of and that particular contractor's performance. To the extent that both the contractor and ourselves are estimating what it would cost, there is room for error, but we do not base that estimate entirely on an industry base rather than that contractor's own performance.

Representative MITCHELL. Thank you very much.

My time has expired, Mr. Chairman.

Mr. CLEMENTS. Mr. Congressman, I would also add to that that we make a practice of what we call second-sourcing these production items so that if we get a feel that a particular contract has been miscalculated by audit or by experience or otherwise, if we feel that those profits might be excessive or that we can get a higher efficiency and productivity from another contractor, we will go second source on those items and put them out for bid with other contractors in a highly competitive environment.

We do this all the time, and I just don't believe that the generalization that you are talking about within a wide bracket or a band, as you referred to it, I really don't think that that is a true analysis of how we go about our contracting costs.

Representative MITCHELL. Well, thank you very much, Mr. Secretary. You can understand my suspicions, of course.

Mr. CLEMENTS. I do—I can.

Representative MITCHELL. If indeed all bread companies level our bread prices at one price, steel companies level out their prices at one price, defense contractors establish at least a hypothetical, a gentleman's high-low band, that is my concern.

Mr. CLEMENTS. I understand, but one of the differences is that under Government regulations which you and Senator Proxmire understand very well, all of those records are subject to Government audit, and we do this. We do it consistently, and that bread manufacturer or that milk manufacturer that you referred to is not exactly in that position.

Representative MITCHELL. Well, of course he is not, but I think if we dig down a little bit, we could find some illustrations in terms of Government contracts where this would happen.

Mr. CLEMENTS. If you could, we would put them in jail.

Representative MITCHELL. I am not saying in DOD you might not have the authority. It is in another area.

Mr. Chairman?

Senator PROXMIRE. Mr. Secretary, I want to thank you very much for your testimony—you and the general and your other colleagues. You and I, even when we agree, we always seem to find a way to fight, and maybe that is a good thing.

At any rate, would you respond to additional questions for the record, and also will you report once a year from now on to the committee on your experience with implementing the profit policy, including the productivity and reward clause, the impact on cost and so forth?

Mr. CLEMENTS. We certainly will, and I will pass your request on to my successor, Senator.

[General laughter.]

Senator PROXMIRE. Well, you never know. There have been some unusual actions taken, and I must say, that would be very unusual.

Thank you very much.

Mr. CLEMENTS. Thank you. It is a pleasure to be here.

General STANSBERRY. Thank you very much.

Senator PROXMIRE. Thank you, General.

We are delighted now to have as our next witness Mr. Ernest Fitzgerald, who has testified before various committees this Senator has chaired in the past.

Mr. Fitzgerald. I welcome you in your first appearance as a witness before this committee. In your appearances before other committees on which I serve, your testimony has always been refreshing and lucid, and you haven't always benefited personally from that testimony, as we all know, but the committee also appreciates your rather unusual position here today.

You were invited to appear before this committee as the Air Force Deputy for Productivity Management.

Do I understand correctly that the Air Force has not approved your appearance in your official capacity?

STATEMENT OF A. ERNEST FITZGERALD, AIR FORCE DEPUTY FOR PRODUCTIVITY MANAGEMENT

Mr. FITZGERALD. Mr. Chairman, that is uncertain. I have, and I have given to the staff, copies of 11 sheets of correspondence, starting with a memorandum from me to my boss, Mr. Bueter, on November 9 trying to clarify that, and I must say that the total body of correspondence is an absolute masterpiece of bureaucratic obfuscation. I can't tell, to be honest with you.

As near as I can decipher this, anything that I say that is in agreement with what has been said before or is in the DPC 76-3 is official, and I am authorized to say that. If it differs in any way, then I am on my own.

So I really think this may be a job for the newly elected Senator from California, Senator Hayakawa, who I understand is a semanti-

cist. We may have to turn it over to him. But I am concerned about this because I had submitted certain memoranda which I thought represented the Air Force position, and I still think that. I think that because I was told it, and I have discussed it with my colleagues just this morning, as well as with our counterparts in the Office of the Secretary of Defense. But for some reason, our intermediate levels have gotten cold feet on taking that stand. I had attempted to draw out any objections to the positions stated in the memorandum prior to my appearance.

As you may recall, 8 years ago last Saturday, I appeared before one of your other committees and sinned. I committed truth on the cost overruns of the C-5, and as a matter of fact, what I was testifying to were the official, authorized, "staffed" and staff-coordinated cost estimates of the Air Force. What happened later was that some rascal between my office and yours changed the numbers, and I wanted to make sure that didn't happen again.

I apologize for taking the committee's time on this, but it can be an important problem for me. But I am perfectly willing to give you my personal views, and to the extent that they coincide with the official positions, say that they are official.

I am embarrassed by the lack of clarity, but there is nothing I can do about it.

Senator PROXMIRE. Well, certainly no apologies are in order. While the substance of your testimony will be invaluable, it is far more important that the Congress will be sure that we will hear a witness who speaks his mind, speaks what he thinks is the truth, even though that position or that testimony may contradict the position of others in the Department. We want to know exactly how you feel. On the basis of your record, you have a long record of service to the Government as one who has been honored, decorated as having done an outstanding job in the Air Force, I guess the outstanding job in 1968, and of course, before that you had substantial experience in private industry. So you are eminently qualified to speak to us honestly and critically, and Congress certainly isn't served by people coming in and simply repeating what they have been told to say.

Nevertheless, you are saying that though some of what you say has been approved as the policy of the office you represent, that still you are not permitted to appear fully in the position in which you operate; is that right?

Mr. FITZGERALD. That's my understanding, Mr. Chairman.

Senator PROXMIRE. You are the senior official in the Department of Air Force in charge of matters relating to productivity of contractor operations.

Mr. FITZGERALD. Productivity, period, Mr. Chairman. I have been specifically forbidden to look at contractor operations, which I did before.

Senator PROXMIRE. Well, the effective policies on productivity.

Mr. FITZGERALD. The effective policies on productivity generally. As a matter of fact, my official policy statement or duty statement does carry no restriction. In fact, though, I have been kept away from the big contractors because of previous problems that I mentioned.

Senator PROXMIRE. Congressman Mitchell?

Representative MITCHELL. If the chairman would yield for just a minute, I am constrained to say that this is the height or depth of asinineity, it seems to me, on the part of the military. I think it is just silly to have a man in your position come before this committee and then be bound by some gobbledygook rule so that you end up speaking as a private citizen and not as a person in your official capacity in the Air Force.

I didn't mean to take your time, but I just think that—I will hold at that point before I use some language that may not be appropriate for this committee.

Mr. FITZGERALD. Well, I would like to state that I didn't start out with any intention of presenting anything that I knew to be different from the stated policy, and I have heard this morning that Mr. Babione and Secretary Shrontz both endorse the should-cost approach, which was one of my recommendations, and basically the one that was rejected by OSD. But as I say, I am embarrassed. I agree with you, Mr. Mitchell, but there is nothing I can do about it, and I think there are important matters; there are billions of dollars of taxpayers' money at stake, and the safety of the Nation, I suppose, in the final analysis depends on how well we do this.

So with that in mind, I am perfectly willing to give you my thoughts on the profit policy and respond to your questions.

Senator PROXMIRE. Well, do your views on productivity differ from official Air Force policy?

Mr. FITZGERALD. We don't have an official Air Force policy on productivity. I have drafted an official policy and have tried to get it approved. It has been in circulation for more than a year. It has not been approved yet. One of the things I heard earlier in the hearing was encouraging to me because I heard Secretary Clements say that our objective is to reduce the unit costs of necessary products we buy. That is one of the sticking points we have had in the productivity program. We have been unable until now to get the Secretary of Defense's office or anyone in authority in the Air Force to state as a policy that objective.

The objective, Mr. Chairman, has been oriented more toward filling out the reports, the forms. So I think we made progress just this morning. Secretary Clements' statement of objectives is a very sound one, and if we have that as our goal, then many of the questions that arise can be clarified, because the goal is not clear to the lower levels of the Department of Defense, particularly as regards large contractors. As I listened to the testimony this morning, it seemed unreal to me that we would assume that these regulations, like 76-3 and any other, apply with equal force to the small competitive contractors that Congressman Mitchell had in mind and Lockheed. They simply do not, and there is no point in pretending that they do.

My concerns here are related to the impact on the giant favored firms such as Lockheed, General Dynamics, Rockwell, those people that in some cases we have literally designated as wards of the State.

Not many people know—Senator Proxmire is one of the few who understands completely, I think—that when Lockheed was bailed out, they were not bailed out with \$250 million loan guarantee entirely. They were given a grant of more than \$1 billion under Public Law 85-804. In order to get that, according to the GAO, the corporation

itself is pronounced essential to the national defense, and is, in effect, guaranteed to be kept in existence.

So these are the kind of firms that I am concerned about, plus the impact of "infection," as I call it, on our own internal activities, and that is what I would like to focus my remarks on.

Senator PROXMIRE. On the series of memorandums submitted in lieu of a statement, you single out contractor productivity reward clause and the new profit policy.

Mr. FITZGERALD. Yes, sir.

[The memorandums referred to follow:]

12 July 1976

MEMORANDUM FOR MR. BUETER, SAF/FMA

SUBJECT: Productivity Rewards

I recently received a copy of the proposed "Profit Policy" to be incorporated into the ASPR. It is my understanding that public hearings will be held on this proposed policy beginning July 19, 1976.

I recognize that I am specifically excluded from this area by earlier decisions restricting my activities. However, since the matter is to be discussed in public hearings, I wish to comment on one aspect of the new policy which I believe will cost our taxpayers billions of dollars, if implemented. I refer to the section of the policy labeled "Productivity" beginning on page 23 of the document, 3-808-8(b). This productivity paragraph describes a special "Productivity Reward" which may be included in pre-negotiation profit objectives of pending procurements. One of the criteria for giving the "Productivity Reward" for reduced unit cost of the instant contract is that "reliable actual cost data is available to establish a fair and reasonable cost base line". This criterion illustrates a fundamental misconception which is already costing us billions. The notion that "actual cost" equates to "fair and reasonable cost" is the most costly myth of our generation. It is particularly inappropriate with respect to operations of our major aerospace contractors.

I and others have written extensively about the ^{abysmally} low efficiency of our major contractors. To my knowledge none of the well-documented writings I have in mind have ever been factually refuted, just ignored by the big spenders. However, I believe evidence of low efficiency in major aerospace contractor operations becomes more difficult to ignore when received in official Air Force documents. I have in mind especially the

Air Force Contractor Management Division Manual, AFCMDM 84-1, titled "Manufacturing Operations", dated 2 August 1974, reprinted 3 February 1975.

Among other things, this manual comments on studies made of production phases of major programs in the big contractor plants. The manual states:

"...Universally, these studies found hard-to-believe low levels of manufacturing efficiency in major aerospace contractor plants."

"They found, for instance, that 42% of total direct costs on a typical production contract are traceable to manufacturing labor, and that half of this labor is nonproductive because of inefficiencies of one kind or another. Just a 20% improvement in labor productivity would save literally billions of dollars. They found that more than 30% of total manufacturing costs are attributable to joining and assembly, and that use of new techniques would reduce weight, improve reliability, and lower joining and assembly costs by one third. They found that tremendous savings could be achieved in material costs by improving metal removal operations, and that similarly spectacular savings lay in adopting new tooling and cutting techniques. Many additional areas were found where major cost savings could be achieved if contractors produced an Air Force product the way they should."

Later on in this manual CMD notes that the big contractors avoid capturing these savings "for reasons of their own".

Rewarding reductions in unit cost from past actual cost will not necessarily change this situation. In fact, the easy way to win the "Productivity Reward" as described under the proposed ASPR criteria is to further inflate initial so-called actual costs. The incentive to do so will be as powerful as it was for Lockheed under the misbegotten repricing formula in the original C-5A contract. As you will recall, this produced the so-called "reverse incentive" that compounded the problems of the unhappy C-5A program.

I suggest that the base line from which cost reductions should be measured for granting "Productivity Rewards" should be the should-cost base line rather than recorded actual cost. I should emphasize that I am referring here to the old fashioned should-cost approach which emphasized incisive quantification of fat rather than the vague qualitative approach which has come to be called should-cost in more recent times.

I believe the suggested new base line would give greater assurance that any so-called "Productivity Rewards" would be based on exceptional performance rather than manipulation and benign neglect to produce inflated initial costs.

~~SIGNED~~

A. E. FITZGERALD
Deputy for Productivity Management

DEPARTMENT OF THE AIR FORCE
WASHINGTON 20330

OFFICE OF THE ASSISTANT SECRETARY

6 August 1976

MEMORANDUM FOR MR. BUETER, SAF/FMA

SUBJECT: Productivity Rewards

Attached is the suggested language for including should cost baseline for the productivity reward in the profit policy statement to be incorporated in the ASPR.

You will notice I suggested deletion of subparagraph (4), "Illustration". I am suggesting this because it appears that the effect of this illustration is to exclude indirect costs, which are usually a majority of in-house contractor costs, from the productivity incentive. The writers of the proposed policy stated on page 26 of their draft that "... fixed costs may be deemed to be total costs less direct labor plus material costs." We know from experience that the remainder, predominantly overhead and G & A for in-house costs, need not be "fixed". Such costs are at least as susceptible to improvement as direct labor and material costs. In any event, I don't think the illustration is essential to a policy statement.

If the general policy I have suggested is adopted, I would suggest that the effect of quantity changes be dealt with comprehensively as part of the should cost instruction.

A handwritten signature in cursive script, appearing to read "A. E. Fitzgerald".

A. E. FITZGERALD

Deputy for Productivity Management

Attachment

August 16, 1976

MEMORANDUM FOR COLONEL ELLIOTT

SUBJECT: Productivity Rewards

This refers to our telecon today on the above subject in which I told you that Mr. A. E. Fitzgerald, Deputy for Productivity Management, SAFFM, has expressed concern on one aspect of the proposed ASPR revision to DOD Profit Policy.

Specifically, Mr. Fitzgerald's concern centers on para. 3-808-8(b) which describes a special "Productivity Reward" which may be included in pre-negotiation profit objectives of pending procurements. One of the criteria for giving the "Productivity Reward" for reduced unit cost of a particular contract is that "reliable cost data is available to establish a fair and reasonable cost base line". Mr. Fitzgerald has pointed out that it is erroneous to assume that - as implied in the draft ASPR - "actual cost" equates to "a fair or reasonable cost base line". He has suggested that a more appropriate base line from which cost reductions should be measured for granting "Productivity Rewards" is a "should cost" base line rather than recorded actual cost.

In response to my request for suggested ASPR language, Mr. Fitzgerald has written me the attached memorandum. Since your office is the OPR for OSD on Profit '76, I am sending this material to you for your consideration in formulating DOD policy on this important subject.

signed

ARNOLD G. BUETER
Principal Deputy Assistant Secretary
(Financial Management)

Attachment

SAFFMA
SAFFMM
AF/CVAE

3-808.8 Special Factors

(a) Foreign Military Sales Effort. Contractors actively engaged in the development of foreign markets for military items frequently exert sales efforts and assume risks beyond the normal risks recognized in the weighted guidelines method. In such cases in connection with procurements for Foreign Military Sales (FMS), it is appropriate to recognize outstanding sales effort in the Foreign markets and attendant risks by a special profit factor to be considered within the weighted guidelines in arriving at a profit objective. 1 to 4 percent of the value of the FMS order is established as the normal range of value for this profit factor. The criteria for selection of the specific percentage shall be based upon such factors as the contractor demonstrating that he has (i) initiated the sale or expended efforts in furthering the sale, (ii) assumed responsibility for the product after delivery beyond that which may be priced in the contract, or (iii) assumed other risks associated with foreign military sale.

(b) Productivity.

(1) General. A key objective of the Department of Defense profit policy is to reduce the cost of defense preparedness by incentivizing investment in modern cost-reducing facilities and other efficiencies. However, to the extent that costs serve as the basis for pricing (both cost and profit), success in reducing costs could serve, in turn, to reduce profit opportunity. For example, a fixed price incentive type

contract is typically used for the first production contract of a major weapon system program. The incentive to increase productivity and reduce cost within one contract works against a contractor on follow-on production contracts because the reduced level of cost becomes a part of the basis for pricing subsequent contracts. In order to mitigate the loss of profit opportunity that occurs when costs are reduced due to productivity gains, a special "Productivity Reward" may be included in the pre-negotiation profit objective of a pending procurement under certain circumstances.

(2) Applicability Criteria. The "Productivity Reward" may be applied when the following criteria are met:

(i) The pending procurement action involves a follow-on production contract.

~~(ii) Reliable-actual-cost-data-is-available-to-establish a-fair-and-reasonable-cost-baseline.~~ Reliable should cost data is available to the level of indentured parts list for the manufactured unit, to include as a minimum validated labor standards for each part, lowest attainable material prices for each part and lowest attainable rates and factors.

(iii) ~~No-substantial~~ Changes which have been made in the configuration of the item being procured compared with the base item have been incorporated into the should-cost baseline.

~~(iv)-The-current-purchases-quantity-is-at-least-equal to-the-purchase-quantity-under-the-base-contract.~~

(iv) ~~(v)~~ The estimated unit cost of the instant contract is less than the base unit cost.

(v) The projected unit cost reduction is a direct consequence of specific productivity enhancing actions by contractor management.

(3) Implementation Procedures. The amount of productivity reward for a given contract is based on the estimated cost reduction which can be attributed to productivity gains. Set forth below are principles and procedures which apply to estimating cost reductions and calculating the productivity reward.

(i) The contractor shall prepare and support the cost reduction estimate.

(ii) The overall contract cost decrease shall be based on estimated decreases measured at the unit cost level.

(iii) The lower of should cost or lowest unit cost (exclusive of profit) for a preceding ~~production~~ manufacturing run shall serve as the unit cost baseline.

(iv) A mutually acceptable technique must be employed to determine that portion of the cost decrease which is attributable to productivity gains. ~~as opposed to the effects of quantity differences between the base contract and the pending procurement~~ action.

(v) When the parties agree that the estimated overall contract cost decrease is materially affected by price level

differences between the base period and the current point-in-time period, an economic price adjustment may be applied to the estimate.

(vi) The productivity reward shall be calculated by multiplying the contract cost decrease due to productivity gains by the base profit objective rate.

(vii) The degree of review and validation of the data supporting the productivity reward calculation should be commensurate with the materiality of this profit element in relation to the overall price objective.

Senator PROXMIRE. Now, could you explain more fully to the committee why you are concerned about the effects of that particular clause.

Mr. FITZGERALD. Yes, sir, that clause in general starts out very well. It recognizes for the first time, I believe, in an official Department of Defense document that we have had until now, and I think still do, unfortunately, reverse incentives particularly on the part of the big contractors. The more money you spend, the more you make is the general proposition. And DPC 76-3 in effect says this.

Senator PROXMIRE. The higher the cost, the more you make. The less efficient you are, the more you make, the more people you hire and featherbed, the more you make.

Mr. FITZGERALD. Whatever the costs are.

Now, we have added another category of costs which we are going to incentivize such as we do with utilities, but this circular recognizes the reverse incentive for the first time in an official document. We have had some Rand studies which criticize what is called cost based pricing, and they have received attention though not acceptance. But this is the first time it has been done officially and I think it is very good.

On the other hand, the mechanism and the ground rules set up for giving the productivity rewards are faulty. Congressman Mitchell touched on that in his question. What we are incentivizing, as you read the literal words in this document, are the differences between one contract and the follow-on contract. I don't want to contradict Secretary Clements in a general sense saying that manipulation does not happen.

I don't know how common it is, but I would say that with regard to large contractors on large programs, it does happen, and we saw that on the C-5A. There was a plan which was uncovered to shift costs from one production run to another to avoid the appearance of excess profit on run B, the second run of aircraft. That is a documented fact. I think it was thwarted by publicity and the sheer cost of the scheme.

We had for many years, and I suppose still do in the Air Force, a routine that was called the 3020 shift. It was used on missile procurement, 3020 being the missile procurement appropriation number. Minutemen missiles were worth much more than their cost, their true cost, so the contractors charged us much more. I think any time the Congress and public display a willingness to pay any price, somebody is going to come along and charge them any price, and so they found that they could get away with any level of cost on these production contracts.

So the administrators of the program would stash money in the 3020 accounts, inflate the costs, and recapture it if they needed it later. They obligated the money, and if they later needed it, would deobligate the money and either shift it to other production accounts or request a reprogramming to the R. & D. accounts. So this does go on.

So the incentive here is going to be to show a difference between the first and the second run, if that is the point that is applied, and there is more than one way to do it, as Congressman Mitchell is suggesting. You can inflate the first run, and this problem is accentuated by the criterion given for what constitutes "good costs," and I will read this from the DPC 76-3: "Reliable actual cost data is available to establish the fair and reasonable cost baseline."

Now the assumption there, and it is a universal assumption in the installations and logistics community in the Pentagon and contractors,

is that actual costs are good costs. That is the most expensive fallacy of our time. It has cost us literally tens of billions or perhaps even hundreds of billions of dollars. I think it has cost more money than any single fallacy that has ever been foisted on the American public.

Now, quite aside from what has been going on all along in our contractor operations, particularly the major ones, this concept has for the first time in recent years begun to infect the industrial operations of the Department of Defense itself, our organic aircraft depots.

Ever since I have been back in the Pentagon, I and some of my associates have been fighting off a scheme which is part of the ALS—the Advanced Logistic System—which would be based on the same concept in that we would shift to an “actual” incurred cost baseline, from a measured cost of what the jobs ought to cost. We don’t do that too well, but we try.

The should-cost referred to by Mr. Babione and Secretary Shrontz is an approach that Senator Proxmire in his other committees has endorsed. I have been in favor of it all of my working life, and in 1969 the Joint Economic Committee issued a report which recommended that should-cost be the way of life.

Unfortunately, they kept the name but changed the scheme. The original should-cost approach was a quick, incisive, quantitative evaluation of fat that could be removed from contracts. This is hard to argue with as a philosophical or logical approach. So they kept the name but changed the procedure so that it emphasizes to a greater extent now procedural reviews and has less quantification of available fat than the original approach.

Comptroller General Staats in 1973 testified that he was unable to quantify the fat as a result of spending several years doing so-called should-cost studies.

Senator PROXMIRE. Now, as I understand it, you are telling us that the new policy, the new productivity policy, will result in the deliberate arrangement of production so the productivity will be low in the first stages and costs will be high.

Mr. FITZGERALD. It will permit that.

Senator PROXMIRE. It would permit that and an enormous temptation to take advantage of that because that means in later stages they can show an improvement based on the artificially deflated productivity figures that they start off with; is that right?

Mr. FITZGERALD. That is certainly possible as written. Now, the people defending this—

Senator PROXMIRE. Now, you say as written.

What can you do to overcome that? Is the should-cost the answer to it?

Mr. FITZGERALD. Sir?

Senator PROXMIRE. Is the should-cost approach part of the answer to that?

Mr. FITZGERALD. Well, it is an answer, assuming your intention is to drive costs down. We must always come back to that, particularly with respect to the giant contractors.

Senator PROXMIRE. Well, why isn’t that a perfectly proper assumption? As you say, Secretary Clements said that that is his purpose.

Mr. FITZGERALD. Well, I was delighted to hear that. This is the first time I have been able to get a statement saying that our objective is

to reduce unit costs, and I am delighted to hear it, and I am going right back home and try to get my regulation approved.

Senator PROXMIRE. So what you are saying is you start off with a should-cost study to establish the basis for your initial contract.

Mr. FITZGERALD. Yes, sir.

Senator PROXMIRE. And then because you have a solid basis for us, then any improvement in productivity would be really earned and legitimate and proper.

Mr. FITZGERALD. Assuming the should-cost is done correctly.

Let me go back, though, to the objective. Sometimes, particularly with the giant firms, other considerations overwhelm any desires which might be present to drive down unit costs. Mr. Chairman, I am certain you remember in this very room in 1971 having an exchange with Secretary Connally in the Lockheed bailout, and you suggested that this was a new welfare program for giant firms and said that they would have no incentive to produce, and Secretary Connally agreed with you. He said, "What do we care whether they produce. What we are trying to do is to make jobs for 74,000 people."

Now, that was a very candid, rare expression of political intent, and I just think you have to face that sometime, and that is why I say in dealing with these matters you must draw a distinction between the giant favored firms and the providers of nuts and bolts and boots and bullets and things of that sort.

Now, I think that the productivity reward section could be fixed, and I think it would be fairly easy to fix it, and we don't need to wait 2 or 3 or 4 years and learn the hard way. When you can see logically and from past experience that certain approaches are likely to be costly, you can fix them now, and based on what I have heard here today, I am hopeful that we can fix them. In my inquiries about where I stood with respect to my compatriots in the Pentagon, I was told that most everyone agreed with the intent of what I was suggesting, but that the issue had never been brought to Secretary Clements' attention, and this puzzled me because I thought it should have been.

I detected here this morning a difference between the three witnesses: Mr. Babione and Secretary Shrontz stated that they used should-cost studies, if you recall, and Secretary Clements said earlier they used parametric pricing, which is fundamentally different. That is the will-cost approach which is described in the document DPC 76-3.

So I think that should be fixed.

Senator PROXMIRE. But in order to fix it, do you think it would require or should require legislation?

Mr. FITZGERALD. I don't think so, Mr. Chairman. One of the problems right now, to be perfectly candid, in the financial management area—

Senator PROXMIRE. Well, let me just say, regardless of who is President of the United States and who is Secretary of Defense, as you know, there is a tremendous pressure on the Defense Department to take it easy on defense contractors. That is understandable, it is predictable, it is certain.

Is there any kind of legislative action we can take that would provide the framework for securing greater efficiency?

Mr. FITZGERALD. Well, the basic problem that has been with us for a long time is the rewards and punishment system for both contractors

and administrators of contracts is upside down. The Lockheeds of this world are rewarded for bad performance, to be honest about it. People administering contracts seem never to get fired for cost overruns. The only people I know of any high rank in the Pentagon who seem to get in trouble are those who try to prevent them. So it is perfectly obvious that we have an upside down rewards and punishment system. Anything Congress can do to fix that would be helpful.

The current problem, though, is one that ought to be stated. The financial management problem, speaking strictly from an organizational, FM point of view in the Pentagon right now, is spending money too slowly. You can't solve that problem by tightening up on unit costs and getting rid of supernumerary personnel and things of that sort, and we need to take a hard look at where we stand on that problem. Somebody does undoubtedly stand for changes in the acquisition programs, but we need to take a hard look at that because any time your basic financial problem is getting rid of money, it is very difficult to convince people down the line, just after they have received a memorandum commanding them to spend, that we want to be tightfisted.

Senator PROXMIRE. Mr. Fitzgerald, what would you recommend to the committee? I have asked the Defense Department establish a policy of reporting regularly to this committee on the progress under this new system that they have to encourage greater efficiency and to reduce costs.

What else can you think of that we might be able to do to achieve the end that you perceive?

Mr. FITZGERALD. I think there should be some studies made, and I see no reason the Department of Defense itself shouldn't undertake them right now, case studies to clarify some of the issues that have been raised here. Some of them that are, very frankly, not only in my mind, but in the minds of others that I work with in the Pentagon regarding the general workability of the approach outlined here. I have forgotten whether it was Chairman Proxmire or Congressman Mitchell who brought up the question of the shift of costs. I think perhaps both of you did. One of the very fundamental problems that seems to be unrecognized is the propensity of contractors to bring about cost shifts through overhead absorption. You don't have to do anything—

Senator PROXMIRE. Let me say I brought it up because there was such a conspicuous figure offered by General Stansberry. He pointed out that profit on sales of defense contractors were more than 16 percent, or about 2½ times that of the profit of nondefense people operating in commercial areas. Their profits were somewhat lower on defense sales, and of course, that immediately suggested to me that they were shifting their costs from their commercial operations to their defense operations and the taxpayer was having to pay part of their commercial operations.

That was denied emphatically and flatly by General Stansberry and by Secretary Clements, but it seems to me that this is something that is relatively easy to do.

How is it done and what can we do to prevent it?

Mr. FITZGERALD. All right, sir, it can be done in a number of ways. It can be done by just bad timekeeping and materials charges which

ought to be caught. I don't think they are, I don't believe that the audits are that thorough as has been suggested.

For example, none of the bribes, kickbacks, and that sort of thing have been discovered by these thorough audits, to my knowledge, until they had already surfaced.

Senator PROXMIRE. I might point out that 16 percent was $2\frac{1}{2}$ times the profits that are earned by nondefense people. So there is an enormous difference.

Mr. FITZGERALD. Yes, sir, and let me describe how this can be done and is often done by semilegitimate means. Overhead absorption is the name of the game. If a contractor has, let's say, 50 percent of his business is cost-plus Government business, any sort, and the other 50 percent is commercial business, where the money he makes is the difference between the cost and sales, he keeps 100 percent of the difference on commercial business rather than some fraction that he might under an incentive contract. His overruns on the base for absorbing overhead on the defense side will take away costs from the commercial side and shift costs by means of allocation without doing anything crooked in the usual sense of the word.

So all he has got to do is not control the costs, just let nature take its course, on the cost-plus side, and if the costs, the overhead costs, were allocated equally on a 50-50 basis previously, let's say the cost-plus business doubled in the direct cost base, then that would absorb two-thirds of the overhead rather than one-half, as previously.

Now, you might expect some increase in the total amount of overhead, but in general they will make more profit on the commercial business by so doing.

I have illustrated this with the case which I used to support the concept in testimony on the Lockheed loan, which I call the Ajax Aerospace & Coathanger Corp. case, showing how the Coathanger Corporation could make millions through cost overruns on cost-plus business. That is the basic technique for doing it, and I don't think—

Senator PROXMIRE. Through cost overruns on the defense side.

Mr. FITZGERALD. On the defense side, yes, sir, as long as he gets reimbursed the total amount, and I don't think that has been recognized in the profit policy. I don't think that we have thought through the real impact of simply incentivizing investment.

Let me give a couple of cases that I would suggest, Mr. Chairman, that might be looked at. There is the case of Laguna Niquel El Segundo plant swap with Rockwell International Corp.

Now, this resulted, as I would perceive it from news stories, what I have seen and general descriptions in the Pentagon, in an increase in investment for the division of Rockwell International working on the B-1, I think. That is the El Segundo plant adjacent to the Los Angeles Airport. I don't believe anything changed there as a result of the change of ownership. Their investment went up, and they will be able to depreciate the value of the plant, charge it to the Government, and get profit on it, even before the Profit 76 study.

Now, I don't think that did a thing for productivity. It increased our cost. It didn't do a thing for productivity. As a matter of fact, in that case we took off their hands a white elephant at Laguna Niquel. It was a pyramid shape building which we bought to store President Nixon's papers in. We swapped for it, as a matter of fact. I think that is a good case in point.

We ought to look at that and see if simply incentivizing investment does anything for costs.

We have the case of plant 14, Air Force plant 14, which was sold to Lockheed at Burbank. I believe that their investment went up. I don't think we improved productivity by doing that. I think there are dozens of cases we could look at, and this would illustrate to people in a case study form, which I think is easier to understand than arithmetic or mathematics, concepts we have been discussing; that if we want lower costs, we want to incentivize lower costs, period.

We have found with the utilities that incentivizing investment, total investment, does not necessarily give us lower costs.

Now, even if we were getting investment in potentially cost-reducing, labor-saving equipment, we have no assurance that cost reduction would actually take place. There is no requirement in the general body of the DPC 76-3 for that, simply for making the investment. We have found instances where contractors were vastly overfacilitized. One which has been discussed before Senator Proxmire's Joint Economic Committee is the should-cost study at Pratt & Whitney, which was one of the first big ones. One of the costs that was knocked down there was the request for additional facilities money by Pratt & Whitney.

On examination, they were found to have far more modern tape control led machines, for example, than they needed. So we would accomplish nothing there except additional facilities costs by buying equipment, particularly because they at that time, and others to this day, among the large military contractors, control their work force on what is called a level of effort basis. They do not maintain a running balance between measured, necessary workload and the number of people on the payroll. They spread their prices over the number of people they have to support. It is administered pricing in the classic sense, and you would expect that in companies that have long continuity in the same kinds of programs with the same customers.

I don't agree that there is a problem of continuity. I can think of programs that have been in R. & D. and production with the same contractors for 20 years and the same general product. There have been improvements and changes in them, of course, but that kind of continuity is very difficult to find in commercial business.

The C-130 has been in production since the 1950's. The A-4 was in production for many, many years. The Minuteman missile series was started in 1958 with essentially the same contractors. The fleet ballistic missile program has been with the same prime contractor since the late 1950's. So these guys have a pretty good lock on that business, and I think, Mr. Chairman, in answer to your question of why people don't break into it is they are not allowed to in many cases. These folks are homesteaders.

Now, one of the other things that would arise from the case studies I suggested is an assessment of true free market motivations, I think then you might want to rethink the desirability of having the contractors buy large expensive facilities which are one of a kind. And let me give an example. At the time Lockheed was threatening to die and befoul the economic air with their carcass, proposals were advanced by me and by a number of other people to have new management come in to operate Air Force plant 6, where the C-5A was being

assembled. The Government at that time owned practically all of the productive equipment, the plant itself, and was furnishing operating capital. We had learned from previous exercises along that line that it would be possible to bring in new management with the change of, perhaps, 20 or 30 or at most 100 people, sort of like bringing in a new national administration. You know, you don't need to change all of the people who work for the Government.

This was seriously considered for a time, I think, but was rejected for political reasons. Mr. Packard, then Deputy Secretary of Defense, testified in testimony contained in Mr. Patman's report on the Lockheed loan guarantee, that he would have had no problems getting new management in to run that plant—AF plant 6—but he decided not to for other reasons.

If we had Government-owned contractor operated—GOCO's, as they call them in the trade—situations for sole source, one of a kind activities, this would permit, at least theoretically and I think practically the injection of real competition in cases where we could not practically move the tooling in the plant. We have a case like that with the aircraft carrier.

I think it is entirely possible that in a Government-owned yard, operated by a contractor, it would be possible to get a new firm to manage it. I am not certain that we are doing the right thing, is what I am saying, if we want to really drive down costs on these unique, one-of-a-kind situations.

Senator PROXMIRE. Congressman Mitchell?

Representative MITCHELL. Thank you, Mr. Chairman.

I have just one question. I tried to pursue with the Secretary and the general what I think might be a built-in weakness, a structural deficiency in the way that the Defense Department operates, and that structural deficiency would at least leave the productivity reward issue in question. What I tried to suggest was that, if indeed we need a new tank and we go to 15 different companies to get an estimate as to the cost of that tank, those estimates would not vary too much. There is going to be very little variation. If we accepted that, then we would have accepted really what amounts to cost standards assumed to be at reasonable levels. All that I wanted the Secretary and general to respond to was whether or not within the industry itself the reasonable cost standards are not in and of themselves artificially created by the defense contractors.

Mr. FITZGERALD. By their own past history.

Representative MITCHELL. That's right. Am I making my question clear to you?

Mr. FITZGERALD. I understand perfectly.

Representative MITCHELL. Would you then respond to it?

Mr. FITZGERALD. Yes, sir, that is exactly the basis for my objection to using actual costs as the basis for establishing fair and reasonable costs. And it goes beyond that, though, in the case—in the example that you give. If I may—I don't know anything about tanks. I have never worked in the Army except very briefly as a consultant, but the same examples can be given, I think, from my Air Force experience.

First off, remember, I am talking about giant firms now, the semi-captive contractors. I am not sure who is whose captive. I think we

may be theirs. But nevertheless, the Lockheeds, the General Dynamics, the Boeings, the Rockwells, those people. In the first place, they mirror one another. Their organizations are similar, their staffing levels are similar, they swap data on numbers of accounts payable, clerks per thousand documents processed, and things like that. They tend to be pretty similar. All of them are mirror images of their Government counterparts in the program sector. So there is a natural tendency for them to be fairly close in costs.

There are two other factors that cause the closeness of the estimates that you talk about. In the first place, we are dealing with companies that are extremely fat, and that comes from my personal experience plus looking at recent reports in DCAA. The DCAA reports typically say, and I will quote you an example: "Our review shows that standard hours one contractor used for various production processes were 60 percent greater than the actual time needed." In other words, they were allowing much more time than they actually needed. This is typical. It is not an unusual case at all.

So we have a case that would be analogous, Congressman Mitchell, to a track meet in which participants in the 100 yard dash were restricted to people weighing in excess of 350 pounds, and a real sprinter attempting to enter the race, would be judged, unrealistic, because all the past history was based on folks who weighed over 350 pounds and had rather slow times.

And that is the truth. People are thrown out on unrealistically low bids because their bid doesn't match past experience.

Now, let me mention something else that I am sure the Secretary is not aware of because he came into the Department of Defense at a very high level. He did not have the advantage or disadvantage, however you view it, that I had of working up through the bottom of the process. That is market intelligence.

Senator PROXMIRE. What was that again?

Mr. FITZGERALD. Market intelligence.

Senator PROXMIRE. Market intelligence.

Mr. FITZGERALD. That is the euphemism, Mr. Chairman, for finding out how much money the Government has got to spend, and good sales organizations always do that. Through one means or another, they find out what the Government estimate is.

I have personally seen the Government estimate announced to the various contractors. That way you don't have any unpleasant surprises. So, there is no mystery about why the estimates are close together. Sometimes the estimates are very, very close together, but the components of cost are quite different. There is a game playing that goes on amongst contractors—all of whom know the total amount that the Government expects to spend—between allocations to R. & D. and subsequent production. The strategy would depend on the saleability of one appropriation versus another.

So very often they just happen to know what the Government expects the bill to be.

Representative MITCHELL. Then in essence the productivity reward clause could in fact be a doubledip for a contractor who comes in with his reasonable cost—and that is in quotes—which is not really reasonable at all because it is based on industry experience. Using those rea-

sonable costs, he improves his productivity and then gets actually a second dip of Government money.

Mr. FITZGERALD. Yes, sir, that is possible.

Representative MITCHELL. Thank you, and thank you, Mr. Chairman.

Senator PROXMIRE. Well, thank you very, very much, Mr. Fitzgerald. I have a number of questions. We have another witness, and I just can't thank you enough for giving us your experience. On the basis of hindsight, you have been right a very great deal. So we want to express our gratitude.

Mr. FITZGERALD. Thank you.

Senator PROXMIRE. Our next witness is Mr. David G. Soergel. Mr. Soergel is president of DGS Associates, a policy and research firm in Washington, D.C.

We are happy to have Mr. Soergel present.

Mr. Soergel, go right ahead.

I might say, Mr. Soergel, you have a 16-page statement. The hour is now 12:15, so we would appreciate it if you could summarize.

Mr. SOERGEL. I don't intend to read it.

Senator PROXMIRE. The full statement will be printed in the record.

STATEMENT OF DAVID G. SOERGEL, PRESIDENT, DGS ASSOCIATES AND MEMBER, FEDERAL PROCUREMENT COMMISSION

Mr. SOERGEL. Let me abstract from the paper, hoping that I don't lose some of the thrust and intent I wrote into it.

I have a problem with the defense profit circular, but I would say from a different viewpoint than has been presented so far. I think it is important that profit policy be structured so that it relates to the markets within which profits are to be earned. I don't see in DPC 76-3 any market descriptions against which the circular's profit policy statements can be collated.

I would like to say a few words about how I see defense marketplace characteristics, and a few words about how I would visualize future-profit policy changes.

Representative MITCHELL. Excuse me. I am having just a little bit of difficulty in hearing you.

Mr. SOERGEL. I will talk closer to the mike.

OK, now, the first question which can be asked starting from the top is, are there any markets at all? There is an overall Federal policy which gives direction in answering that. It is called Executive Circular A-76. It is a general policy. It says that agencies should rely on private enterprise to supply the agency's needs for commercial or industrial products or services. This is a 20-year-old policy, and over that time period no changes have been made in it.

Now, there are some exceptions drawn, one particularly for Defense, and that has to do with national security matters. On occasion the Government can make its own products based on that kind of an argument.

There are a lot of issues surfacing about Federal make or buy actual practice in relationship to the policy for it. I don't want to get into those issues here but this, like most things in life, are connected.

Now, there is a marketplace that I think suppliers up in Wisconsin could understand, and there is a policy statement about it in the DPC 76-3, which I think they can read and understand and be attracted to.

It comes in about the second paragraph. It says that there are some markets for Defense supply that are priced competitively and if a responsible offer is a low offer, he can make as much profit as a normal reward for efficiency as he can be efficient about. That is pretty clear and it is including standard profit policy in relationship to the market defined for it.

I think the people around the country will clip that paragraph out of the policy statement and put it under the glass on their desks and probably throw the rest of it away.

Suppliers don't view profit in isolation from the costs incurred to obtain it. These costs come in two parts: Costs incurred to enter the market and costs incurred to deliver what is contracted for. If you are a commercial consumer, industrial supplier in a price competitive marketplace, you will avoid buyers who cause you more cost input as an element of sales price than the other market. So if you are going to deal with a usual buyer who causes additional cost for the same product not incurred by other buyers, you will avoid him.

So an attractive profit policy doesn't necessarily attract a new supplier, and the real problem is not found in profit possibilities. It is found in the interface, procedural, legal and so forth, between Federal market buyers and commercially price-competitive suppliers. This is a very, very big problem.

Now, there is another Federal market of large dimensions, and this is the self-generating market. From time to time, DOD, ERDA, NASA, and others may find that they need products that the private sector won't supply to them because they are not available. As a matter of fact, the agency itself may not know what these products should be, and worse yet, private initiative will not produce information about product possibilities.

And why is that so? Well, it is because DOD is usually a single buyer of information about the products, and later on the product itself. Devoting scarce resources to help a single buyer who is sometimes labeled as fickle is just too risky. So the agency still has to do something to fulfill a need—a future need from an investment point of view.

So what the agency needs is information about diverse future investment possibilities. Now, this is a big market and it has a very dominant characteristic to it. The market is characterized by two kinds of uncertainty that are independent of each other. First, there is uncertainty in the need for a new investment remaining important and unchanged over the time to develop information about it, and second, the uncertainty of potential investment ideas proving out as expected.

Thus, this marketplace is characterized by uncertain demand, and so the supply is uncertain.

It is a big business, the \$24 billion in Federal R. & D. expenditures, the so-called Federal R. & D. budget. I say "so-called" because we don't purchase R. & D. as an end unto itself. We purchase information about future investments through the use of these resources. Sometimes we lose sight of this. There is no such thing as the purchase of R. & D. It is only the resources to get information about investment possibilities.

Now, you can have fixed price competition to deliver information, and in those cases, the profit policy's second, clear and easily understandable paragraph should apply. In other words, after a bidder has

submitted his price, is awarded the contract, and has supplied all the information, he should make all the profit he can, particularly as a consequence of the setting up of acquisition policies of monopoly suppliers of information in 1960.

This is a very dangerous national strategy because it ignores market demand uncertainties. We can't hedge our bets if the international marketplace changes of the agency they serve. They in turn [inaudible] in unpredictable ways.

The 1960 acquisition policies most often converge at a single investment too early in the process. The monopoly information supplied from within the agency is later transferred to a contractor. To continue, he cannot be supplied without a single investment policy.

So in diversity of investment choice, the hedge against the future was lost, and then we had other problems, as a consequence; namely, unenforceable contracts.

Now, how do you regulate monopoly? You regulate it as it occurs within the agency and later as it is transferred to a contract monopoly situation. What you do is write laws. There are 4,000 procurement-related statutes on the books today. These go into 3,000 pages of regulatory procedures, and can be applied to the interrelationship between the States and administrative law procedures.

Well, that will not do anything to reduce nonproductive costs without any improvement of the quality of delivered information.

We have resorted to the necessity of monopoly controls through the cost, which I believe is a significant factor in our decreasing national productivity.

During that period of time we had this kind of a linkage, single-choice investment development about future large scale development; the F-111, the C-5, the F-14 came out of the 5- or 10-year tools, the flow of information on a single charge basis.

I use contractual techniques in this, too. You start the information pullouts within the agency, put it in a procurements book and then have a brochure competition with a supplier, and later on supply the rest of it. If something goes wrong, either in the price or performance or schedule, no one, but everyone, is responsible. So you cannot enforce contracts by starting out information in a monopoly sense and then transferring it to the private sector.

There are two contemporary situations today which are the outcome of the 10-year flow pipeline. One is the shipbuilding claims. You have no choice. You want that ship? You have to pay the producer's price. There is another, and that is in the supply of information—investment information to meet the capability for Strategic Offense Triad Mission. That program started out after the B-70 cancellation by picking and choosing from R. & D. outputs from various contractors, the concept of the absolute mover through the system. It later came out with the price in 1969, and the refinement has continued through to today. The output of this 10-year-long pipe is the B-1 bomber.

And if you believe in the importance in priority of the Strategic Triad Mission, you have no choice. And so that is what I mean by loss of investment versus the options.

These are remnants of the 1960 acquisition policies. Now, what I have gone through here is no news to the defense people. They know this and so do the industry suppliers, and DOD is in the process of

revising their top-level acquisition policy. They have a policy directive, 5000.12, which is undergoing a massive overhaul, and you can't have a proper policy without having a massive overhaul in higher levels.

The current 76-3 was written without blending in these changes which are imminent. I will come down on this and say that the Profit 76, on the DPC 76-3, there is no correspondence in the profit implications of the revised policy.

The DOD is not going to call this the policy for the acquisition of information about diversified investment choices, and I don't think I would either, but that is the sense and thrust of these revisions. They are probably going to call it the policy for acquisition of major systems. That is an arbitrary system. That is a major system, while in the current time, we spent 2½ years trying to make a definition and never did, nor did the agency studies.

As a major system for defense, the same as DOD and NASA, the answer is no. Well, what are the differences?

I don't believe the policy which is about to be issued has as broad an applicability in buying information. Nevertheless, I think that there is progress because the understanding of the lock-ins of the monopoly supply of information, you find the monopoly supply production is pretty clear. You can probably apply what I am saying to massive institutional reforms. I don't, and there is no way around it.

This all started from an executive circular issued from the Office of Federal Procurement Policy, and it is almost unbelievable that they have been able to push this across all 41 agencies to get an excellent response to it. Keeping in response the sense or the thrust of it is to produce information about diversified investments. That is what it is all about. We have a B-1 at the end of the pipe, or a ship at the end of the pipe on order. That is what this is all about.

So this is that so-called R. & D. area. If you want to call it R. & D., you can, but you can sometimes decide what it is all about if you call it that. You spend money to buy information.

I just project here briefly what the main thrust of A-109 would be on the profit policy. For example, if you want to buy the best industrial capability to supply information, I don't know what industrial capital investment policy has to do with it. Most of these people who supply information are labor-intensive. What they are interested in is operating capital, not facility, plant and equipment, and a lot of them will run out test programs and so forth using somebody else's capital.

So if you take a look at this defense profit policy in conjunction with DPC 414, which treats the allocation of the cost of money for capital facilities, you come down to say there is a disincentive for anybody to supply information to the United States of America. That is about what it says because the best you can do is hit the bottomside of any profit objective unless you perform perfectly in an area of uncertainty. That is not going to attract new entries. The idea is to challenge the ideas of other companies.

If you want to get into some real competition, get into a competition between ideas and buy information about them, and then when you get to investment choice you can logically pick the right one. We will see how this information grew and evolved over the years.

This problem of uncertainty in the marketplace is a very real one, and I will jump over here to say that in Executive Circular A-109, they say that contracts under these conditions of high uncertainty should be short timespan and fixed level contracts. Here is a new contract innovation that I don't think Defense is working on.

This is a new procurement form and type of contract. It says it has fixed price applications and cost application. The fixed prices is included because when the contractor signs up for it, he is going to deliver information, but when the time is past, he is not going to get any more money. But the contract is only going to be over a short timespan for some critical test for the buy. The cost feature is you can come in and cost it, and he can come in when the critical test is run and observe it just like the engineers that run the test.

So this is a new kind of contract to responsibly implement A-109 as a defense policy revision. A new kind of contract has to be tested, experimented with and tried.

Now, the third market—and I am shortening up some of these things here—is choosing from this diversified information that is purchased; what to buy, what to invest in. And I am afraid that as I understand some of these policy revisions going on, we still brought them out of a monopoly supply. This means that the 4,000 statutes and the 3,000 pages of AFPRs will still be there. We are will going to be dealing with monopoly producers, and here is where I put up a plea more than anywhere else. I think competitive procurement of production items or machines or items, whatever they are, are different in significant ways, and it would be to the interest of the taxpayer. We can't do this for all programs. We can't have two companies price competitively producing the identical B-1 bomber. It is absurd. It was tried on the F-14.

Every major contractor turned it down for very good reasons. We can't have two contractors competitively producing—now, there can be some exception. There are many cases where Congress could take a more important role in this, to recognize the production motivation, to reduce price, and to improve the performance of an arms run, from year to year—this is only done by competition. It is not done by renegotiation. There is no way better. I think Mr. Fitzgerald proved that.

I think—I personally experienced this, and I know what I am talking about. In the 1950's we had to compete year to year on a repeat production order in building the F-86 fighter airplane. We were in direct, head-to-head production and competition with the F-84, which didn't look like the F-86, nor did they perform the same way, nor did they cost the same amount. But we had to demonstrate by subjects, unit cost reductions from year to year and performance improvements to get our next year's order. This is when you get high productivity, because we had people working 80 hours a week and getting paid for 40 so that the data submitted was competitive with that submitted by Republic.

You really want defense economy? This is the way to get it. There isn't any other way.

The A-9 cancellation and allocated to the NASA research program was a mistake. That airplane wasn't that much different from the A-10, which was monopoly produced. You could haul that back out

to NASA, put it back into production, and you will find Fairchild up in Long Island behaving quite differently.

You might recall Grumman saying that they were not going to build any more F-14's. You might recall the president of Newport News recently saying he would like the Navy to get this stuff out of his plant. Well, that is what you get into with monopoly supply.

So I think there is much more that can be done in production competitive procurement for the ordering, when the ordering from year to year is based on the last year's performance.

Now, why is that a good idea? Well, take the F-84, F-86. Here is what you hear from financial people, like the one just discussed here, and the costing people. They will say that you have got two different engines, you have got two different airplanes, you have got two different training sets, you have got two different shop sets of equipment, and a man like Mr. Fitzgerald can lay that out in six significant figures as to the cost of competition, but he can't in any way price all the benefits. You can't run a computer program involving so much design and cost reduction of competitive motivation. You have to believe in the value of competition increasing productivity and delivering better products at cheaper prices or you don't. It's that simple.

Competition should be proving the cost more, but it is the benefits that are incalculable and Mr. Fitzgerald and others like him will always win.

In my opinion, both the taxpayer and national security lose.

And that is the end of my summary statement, sir.¹

[Prepared statement of Mr. Soergel follows:]

STATEMENT OF DAVID G. SOERGEL

Mr. Chairman and Members of the Committee, I am David Soergel, President of DGS Associates, Inc., a small policy research firm located in Washington, D.C. Our specialty is assisting agencies in review of their acquisition policies with objective to gain increased economy and effectiveness in their spending activities. We span the total innovation process; from the creation of ideas to their introduction into our domestic economy.

I have the following general comments about DPC-76-3.

It is clear as to profit objectives for only one of three defense markets for private supply.

Its implementation will not achieve its objectives—motivate industrial plant modernization and attract the "best" industrial suppliers.

It will have to undergo significant change to be consistent with a higher level policy revision which is imminent.

DEFENSE MARKETS

Breaking down defense markets to three component parts we find:

The market for private supply of standard commercial or industrial price competitive products and services.

The market for private supply of information about future investment choices.

The market for private supply of products and services chosen from Defense sponsored information.

Each of these have different marketplace characteristics and it is not obvious how DPC-76-3 relates to the latter two markets.

¹ Mr. Soergel subsequently asked to submit the following revision of his oral opening statement.

CHARACTERIZATION OF MARKETS

DPC-76-3's stated profit objective policy for the first market matches to the market's characteristics—namely, if a low responsible offeror earns a large profit, it will be considered a normal reward for efficiency.

A clear and understandable profit policy, however, on its own, will not necessarily attract the "best" industrial suppliers. Those who have not been in this market will have to spend some money learning about it, making a bid, and waiting for source selection. The question which is not answered by profit policy alone is: What is the cost to enter the market, and if successful what are the benefits? Other procurement regulations, directives, and practices can discourage new entries.

The second market, private supply of information about future investment choices, is a big market. Overall it amounts to most of the \$24 billion federal R&D expenditure. We don't buy R&D per se, but only information through the use of R&D resources. Nor do we buy things, only information about things.

This market has the dominant characteristic of uncertainty in both the "demand" for information and its "supply."

Care must be taken that when the R&D money is spent it produces information about a diversity of investment choices—not information about only one choice. This is because the future is uncertain and investment information must permit us to "hedge our bets."

Also important, purchase information about only one investment choice will set up a monopoly supplier. Monopoly controls will have to be instituted. These controls generate non-productive regulatory costs which add nothing to product quality or performance, but only increase its costs.

WHERE WE HAVE BEEN

For example, 1960 acquisition policies almost always yielded information about a single choice, a Hobson's choice. The F-111, C-5A, F-14, and others, are examples. 1960 acquisition policies also shaped information about the Strategic Triad mission investment to the B-1 bomber—it is the only choice to meet the need.

These same policies penalized contractual integrity—the earliest information was created within government and subsequently refined by a contractor selected after a "brochure" type competition. If investment costs escalated, deliveries were not met, or the product did not perform properly, who was at fault—the buyer or the seller? And finally, monopoly investment suppliers came out of the 1960 future investment informational process.

So now we have 4,000 procurement related laws and 3,000 pages of ASPR's to regulate the monopoly producers of information, private or public, and the producers of the single choice products which were defined. This is where we are today.

The last market, the production of products and services which are selected from the outcome of the previous market, is usually where the big money is. I have already pointed out the 1960 policy convergence to monopoly supply. This is the biggest problem of all from an overall economy and effectiveness viewpoint. The answer is to competitively procure products which are not the same, to maintain a hedging strategy and motivate product price reduction and improvements through the use of competition.

Now this concept, to maintain competition between dissimilar products through production, has some obvious limitations—we can't have two contractors competitively racing to the moon, or building an identical B-1 bomber. But I believe production competition can be used more often—even on major equipment and system's levels.

Financial and cost experts usually defeat this approach because the cost of competition is calculable, but its benefits are not. One has to believe without proof that designers and production people will, at times, work 80 hours for 40 hours pay when they are designing and producing for competitive supply. Without competition, I can assure you, they will demand more than 40 hours pay for no more than 40 hours work. I don't believe I have to elaborate on the economic and social differences between monopoly and competitive supply.

THE SMALL R. & D. FIRM

Information about future investments starts with ideas or design concepts. The research literature sponsored by NSF, and others, proves that ideas which were subsequently introduced with economic and social benefits rarely came from current producers. The inventor of Xerox, Chester Carlson, attempted to sell his idea

to 20 office equipment producers, was turned down, and finally financed by Battelle Memorial Institute. The ball point pen was not introduced by the Parker Pen Company, rapid processing of film, not by Eastman Kodak, etc. The list is extensive.

I strongly believe that small R&D labor intensive firms are equally able to conceive of new ideas and designs as large heavily capitalized firms.

Does DPC 76-3 attract such suppliers to defense markets? My opinion is that it does not. Labor to produce information, not products, is rewarded less than rewards for production. This means to me that attracting capital wealth to defense markets is evidently more important than attracting ideas to challenge established wealth. This kind of thinking encourages oligopoly and when established, maintains it.

The small firm's problem is more likely operating than facility capital—and it will have to pay much more for either capital type than large firms, if it can get any at all.

So a profit policy based, in part, on allocating and allowing an "imputed" cost of facility capital announced by the Secretary of the Treasury discriminates against the interests of small firms. The small firm may have to pay 15-20% for its facility money but the imputed allocated cost may be, say, 8%. The small firm will have to "eat" the difference out of profit. I hope that any CASB promulgation on allocability of the costs of operating capital takes this reality into account. CAS 414, the treatment of the cost of facility capital, did not.

Finally, the management of a small firm, not having been in defense markets but desiring to try, would not be able to understand the DPC 76-3's computation of profit objective without hiring \$100 per hour legal help and some expert procurement counseling. So those small firms who have already entered, and those desiring to enter, are on the bottom side of profit potential compared to capital intensive large firms who are already established. This will do little to challenge oligopoly—in fact, enhance it.

WHERE WE ARE HEADING

Finally all of the above is well recognized by Defense policy people—there are no surprises. They are changing their "top level" acquisition policy, DD5000.1 to implement an overall policy issuance from the OMB, Executive Circular A-109, Acquisition of Major Systems.

This circular concentrates on the acquisition of competitive information about future investment choices, the second market which I described.

It is designed to permit small firms to challenge large firms through the competitive power of their ideas and design concepts and permit a small firm's growth based on competitive merit. Overall federal procurement policy will need to be changed so that ideas and design concepts are purchased, not partially completed government designs.

We will have to wait and see if Defense has captured this thrust in their implementation plans. With regard to profit, DPC 76-3 will have to undergo massive change to be responsive. So will many other subsidiary policies, such as IR&D/B&P policy.

My last thought is that profit policy is not the way to motivate private plant modernization. Long term investments directed solely towards uncertain defense markets will always be shied away from. The big money is the capital investment, the lesser money is the cost of capital. Allocating the cost of capital into defense contracts is realistic and laudable, but the big money, the capital investment, may not be recovered if the program is unpredictably canceled due to unpredictable "demand" changes. This is the problem and it is not a new one.

A stark example of "demand" uncertainty is whether the B-1 will be produced. Private capital facility investment decisions required to produce the B-1 were made long ago—not just within the prime contractor's corporate office, but corporate offices of companies which make the major parts, such as engines and avionics, all the way down to the smallest component producer. Did profit policy factor into those decisions, would DPC 76-3 make any difference in the future? I doubt profit policy discussions determined the decisions. More likely, the companies management spent most of their time in figuring out how to "hedge their bets" in the face of B-1 production demand uncertainty and, in the main, picked plant and equipment investments useful for more than B-1 production purposes.

Maybe a way to realistically link private capital plant modernization motivations to "demand" uncertainties will come—but, in my opinion, through DPC 76-3, little progress has been made.

Thank you.

SUMMARY STATEMENT OF DAVID G. SOERGEL

Mr. SOERGEL. Let me abstract from the paper, hoping that I don't lose some of the thrust and intent I wrote into it.

I have a problem with the Defense profit circular, but I would say from a different viewpoint than has been presented so far. I think it is important that profit policy be structured so that it relates to the markets within which profits are to be earned. I don't see in DPC 76-3 any DOD market descriptions against which the circular's profit policy statements can be collated.

OK, now, the first question which can be asked, starting from the top, is, are there any markets at all? There is an overall Federal policy which gives direction in answering this question. It is called Executive Circular A-76. It provides general policy guidance that agencies should rely on private enterprise to supply their needs for commercial or industrial products or services. This is a 20-year-old policy, and over that time period no changes have been made to its basic thrust and intent.

Now, there were some exceptions to general policy instituted in 1967, some particularly related to Defense markets. On occasion Defense can choose to make its own products and supply its own services based on national security or urgency arguments.

There are several important governmentwide issues surfacing about Federal make-or-buy actual practice. Some claim that agency practice is in the main not in compliance with general policy. These are essentially marketplace arguments and issues and their future resolution may cast some different viewpoints on what I have to say today.

For the moment, I would like to characterize Defense markets as I understand them. The first marketplace is one which I think commercial suppliers will recognize and understand DPC 76-3's profit policy which pertains to it. It comes in about the second paragraph. It says that there are some Defense markets for private supply which are price competitive and if a responsible offeror makes a low bid, he can make as much profit as his performance efficiency will permit. Defense will consider high profits as a normal reward for efficiency and no questions will be asked. This market/profit connection is pretty clear.

I think the managers of companies which mainly produce for commercial supply will clip that paragraph out of DPC 76-3 and put it under the glass on their desks.

But suppliers don't view profit in isolation from the costs incurred to obtain it. These costs come in two parts: Costs incurred to enter the market and costs incurred to deliver what is contracted for. A commercial or industrial supplier in a price competitive marketplace, will avoid buyers who cause more cost input to a particular product than other buyers. By supplying this one buyer, the supplier may have to mark up his prices to all. So a complex buyer who causes additional incurred cost for delivery of the same product which is purchased by other buyers will generally be avoided.

I believe that an attractive profit policy doesn't necessarily attract the best suppliers, and the real problem is not found in profit policy. It is found in the complex Government and industry interface; proce-

dural, legal, and so forth, between agency buyers and price competitive suppliers. These complexities incur costs which are not incurred in selling to other buyers. Attracting the best industrial suppliers to this market is a big problem which, in my opinion, is not remedied by profit policy alone.

Now, there is another defense market of large dimensions. From time to time, DOD may perceive a future problem for which available products are deficient and new products will have to be introduced when needed. What Defense needs is information about future weapons investment possibilities. DOD will receive some ideas and early designs from contractors on a "no direct cost" basis but the information will not have enough credibility to be a basis for a multi-million-dollar investment decision. More information will have to be purchased before an investment decision can be substantively made.

The purchase of information about future investment choices is a big market and it has a unique characteristic as compared to the first market. This market is characterized by two kinds of uncertainty. First, there is the uncertainty that the need for a new investment will remain important and unchanged over the time required to develop credible information about investment choices, and second, the uncertainty that a potential investment idea will prove out as expected.

So this marketplace is characterized by an uncertain "demand." But at the outset, so is "supply" uncertain.

Industry supplied \$10 billion of information to several Federal agencies during fiscal 1975. The money for this expenditure came out of the so-called Federal R. & D. budget. I say "so-called" because agencies don't purchase R. & D. as an end unto itself. They purchase information about future investments through the use of R. & D. resources. We sometimes lose sight of this important difference.

Policies for purchase of future investment information are especially critical in determining the ultimate economy and effectiveness of overall agency acquisition expenditures.

Sometimes, particularly during the 1960's, investment information described only one investment choice. This was a dangerous national strategy because it ignored agency "demand" uncertainties. The agency was not able to "hedge its bets" when needs changed in unpredictable ways.

The 1960 DOD acquisition policies most often converged to information about a single investment choice too early in the informational process and set up a monopoly information supply. Monopoly supply of anything is always more expensive than supply under competitive conditions because the cost of monopoly controls are nonproductive costs which add nothing to the products quality or performance. These costs only increase the product's price.

So, during the 1960's, we not only lost an investment choice but we also paid much more for information and subsequent investments than we should have.

Today, there are 4,000 procurement related statutes and 3,000 pages of regulatory procedures to control monopoly information and investment suppliers. This is the legacy of the 1960's.

There are also two contemporary situations which had their start during the middle 1960's and were shaped according to policies of that time. One is shipbuilding claims. Here we have a situation of

Navy ship design transferred to a single investment supplier after a brief competition. The information about the ship was monopoly supplied by Navy and the ship itself supplied by a monopoly private supplier. The only way to get the ship is to pay the price. The supply of investment information to meet the capability for the Strategic Offense Triad mission is the other contemporary situation shaped by 1960 policies. This acquisition program started out after the B-70 cancellation in 1960 and immediately focused on a B-52 bomber replacement. Information about a future investment was contained to a new bomber choice during the 10 years before a design competition. We now know the name of this "Hobson's choice," the B-1 bomber.

The Strategic Triad Mission has maintained importance and priority over the last 6 or 7 years and so there is no investment choice—either the B-1 is produced or a high national security risk will be taken.

These two current situations are remnants of 1960 acquisition policies.

DOD policy people are well aware of the problems such policies have created and are in the process of major revisions which I believe are imminent.

One of my problems with DPC-76-3 is that it evidently was written without a careful consideration as to whether it would be in harmony or conflict with higher policy level revisions.

The new overall Defense acquisition policy probably will not be called "acquisition of information about diversified investment choices." It will probably be labeled policy for "acquisition of major systems." A policy which applies to the acquisition of a major system can only be arbitrarily applied because what is "major" and what is "minor" denies anything but an arbitrary standard. We found that out over 2½ years of procurement commission studies.

So I don't believe the policy, which is about to be issued, has as broad an applicability as a policy for the acquisition of information about future investments. Nevertheless, I think there is progress being made.

DOD's top-level policy revision started from an OMB executive circular issued last April from the Office of Federal Procurement Policy—Executive Circular A-109. The sense and thrust of A-109 is to change the way in which agencies go about acquiring information so that prudent investment decisions can be made later. This is what it is all about and DOD's policy revisions will be in conformance.

Executive circular gives guidance on the beginnings of innovation: The creation, communication, and selection of ideas for R. & D. resource commitments. Competitive information about selected ideas, as they take shape for investment judgments, follows and is a subsequent thrust of the circular.

Now when we are changing policy to motivating the creation of competitive ideas and information, we have to back this up with incentives applied to people, not capital facilities. People create ideas, not plants or machines. This focus is lacking in Defense's profit policy. For example, A-109's thrust is to motivate the best industrial capability to supply ideas and information. I don't know what a profit policy designed to motivate plant modernization has to do with Executive Circular A-109. Most of the organizations which supply ideas and

information are people-intensive, not capital-intensive. What these organizations are interested in is the cost of operating capital, not facility capital costs. Labor-intensive organizations are on the bottom side of profit potential as compared to the wealthier facility-intensive organizations.

DPC 76-3 is clear on that. So if you take a look at this revision to defense profit policy in conjunction with Cost Accounting Standard 414—which treats with the allocation of the cost of money for capital facilities—it is inescapable that there is a disincentive for labor-intensive firms to supply ideas and information to the Defense Department. Evidently it is more important to attract capital wealth to defense business than ideas. This obvious thrust of DPC 76-3 is not going to attract new entries to challenge oligopoly—in my opinion, it will tend to solidify large firm defense market positions and keep out those who would like to challenge them.

One of A-109's key features is its treatment of "supply" uncertainties. To financially cope with such uncertainties, agencies should issue short timespan and fixed level contracts. This contractual approach requires a new contract innovation, one which I don't think Defense is working on. It will have fixed price and cost type features. Fixed price features because only a fixed level of funds is to be obligated by Government, and the cost feature so that costs and critical tests may be audited and observed.

This is a new contract type which has to be tested before Defense-wide adoption. I find nothing in DPC 76-3 profit policy which would be an appropriate profit policy for this contract type. So for this second DOD market, the supply of competitive information about investment choices, I see only profit disincentives for new labor-intensive entries and a furtherance of defense supply oligopoly.

Now, the third market—and I am shortening up some things here, is producing an investment selected from competitively derived information. I am afraid that we are still going to be dealing with monopoly producers. But I strongly feel that production competition can be used more often than it is. It stands to reason, however, that we can't do this for all programs. We can't have two companies price competitively producing the identical B-1 bomber, for example, or two company's competitively racing to the moon. However, there are many agency program cases where Congress could take a more important role in this, to recognize that production motivations, to reduce price and improve performance, are only effectively instituted by competition between producers. It is not done by "should cost" concepts, a further proliferation of laws, or productivity provisions in a profit policy.

Let me depart from my statement for a moment to illustrate my point. In the 1950's the company I worked for had to compete year to year on production orders for the F-86 fighter airplane. We were in direct, head-to-head production competition with the F-84. The two airplanes were produced for the same tactical air missions but they didn't look alike, perform the same way, nor did they cost the same amount. We had to demonstrate each year that we had taken action to reduce the F-86's unit price and engineered performance improvements to get our next year's order. Productivity improvements were automatic because we had people working 80 hours a week and getting paid for 40.

If you really want defense economy, this is the way to get it. There isn't any other way without increasing cost more than its worth.

The Air Force's A-9 cancellation and allocation to a NASA research program was a mistake. The A-9 wasn't that much different from the A-10 which is now being monopoly produced. If the A-9 were taken out of NASA and put into low rate production you would find A-10 productivity, performance, and price improvements in next years production order. Next year's A-9 would show significant improvements.

You might recall a few years back Grumman saying they were not going to build any more F-14's. You might recall more recently the president of Newport News asking the Navy to get their inventory out of their plant. Well, that is what you get into with monopoly supply.

So I think there is much more that can be done in the Nation's interest by reinstating competitive procurement.

My assessment is that Congress still believes that it can legislate economy and productivity as a substitute for competition. It rhetorically talks about competition but then legislates it away.

But congressional Members have some like-minded friends in the executive. These are the financial and cost accounting people. In the F-84/F-86 example they would say that two different engines aren't needed, two different training syllabuses, two different shop test equipments, and two different avionics arrangements. Now they can estimate the cost of competition to three significant figures but they can't compute its benefits to taxpayers and national security. A computer program hasn't been written which simulates design improvements and cost reductions brought about by competitive motivations. We have to believe without proof that competitive motivations will increase productivity and deliver better products at cheaper prices. It's that simple. Or, in another way, we have to believe that competitive free enterprise will deliver better and cheaper products than monopoly supply.

That is the end of my summary statement, sir.

Senator PROXMIRE. Thank you very much, Mr. Soergel.

Mr. Soergel, you say the new profit policy will probably not realize its desired effect. You say in effect instead the uncertainty of the defense market is the main deterrent.

Mr. SOERGEL. That is the institutional problem, yes, sir.

You can rewrite profit policy next month, double the profit amounts on paper, it won't make any difference. You see, the big cost recovery problem is the cost of the plant and, if next year, the program is redirected or canceled, a company can be left with a "white elephant."

Senator PROXMIRE. But I think that an equally strong case can be made for the argument that because of follow-on contracts, the monopoly nature of the Defense industry—

Mr. SOERGEL. That is the part to stop.

Senator PROXMIRE. The bail-outs and other protections, the defense market is really rather stable and relatively risk free for the big boys.

Mr. SOERGEL. Well, that is the end of the 10-year pipe of the 1960's. You are looking at it, and we are talking about it. These reformations

that are involved here I think will give us a viewpoint that is really different.²

Senator PROXMIRE. Are we just talking about different levels of contractors?

Would you agree that there is at least in terms of survival, that there is a—the big defense contractors seem to go on and on, year after year after year?

Mr. SOERGEL. Sure, I think that is right.

Senator PROXMIRE. So there is a stability there.

Mr. SOERGEL. Well, I think there is a general understanding in the defense industry that if you were awarded one program this year and you can recover your big costs for another program next year, you probably won't get it and someone else will. It keeps your engineering team going pretty nicely.³

Senator PROXMIRE. You see, one of the problems that you seem to say that the uncertainty of the defense market is the major concern to investment, and then you also seem to be suggesting that a higher risk marketplace would be beneficial. You say that greater reliance on smaller firms with possibly more creative solutions to defense problems seems to suggest a greater utilization of short term contracts with limited Government liability, and you say that, and I quote:

If the contractor can't produce the contracting information he is supposed to for the money provided, he can choose to continue on his own resources or leave the market.

Now, I am sure that that would send a shiver through major sectors of the defense industry, and probably the Defense Department as well; maybe they ought to get that kind of a shiver, but are you telling us that a greater use of the Department of Defense as a source of venture capital for unproven technologies would be a good idea?

Mr. SOERGEL. No; what I am saying is if you treat it with a certainty, a certain demand and supply, both sides of the fence, you have got to use short timespan, fixed-level contracts. In my statement I pointed out that that is exactly the way that private industry had to do in a certain market. It picks away at it, and never commits to the engineering people—the total price of production.⁴

Senator PROXMIRE. What basis do we have for assuming that kind of policy would be less expensive than our present policy and more beneficial?

Mr. SOERGEL. Well, for one thing, competition is used throughout the process. There is competition in information and supply about Defense choices. That is one way.⁵

² Mr. Soergel subsequently asked to amend this paragraph to read as follows: "Well, that is what 1960 acquisition policies led to. You are concerned about it, and we are talking about it. The imminent policy reformations which I mentioned should reinstate competition from the very beginnings of design. We will still have to be careful that even these changes don't lead us to monopoly production supply."

³ Mr. Soergel subsequently asked to amend this paragraph to read as follows: "Yes, a stability brought about by overemphasis on 'capital wealth' and less on the competitive value of a companies ideas and early designs which are labor intensive. The stability lies in stabilizing capital wealth rather than destabilizing it with ideas."

⁴ Mr. Soergel subsequently asked to amend this paragraph to read as follows: "No: what I am saying is that professional program advocacy ignores uncertainty. One must act assured in order to get any money. It's a tongue-in-cheek advocacy. Now short timespan, fixed-level contracts to be embodied in Defense's policy revisions admits to uncertainty. In my statement I pointed out that is exactly the way private industry ventures a new product using its own money. It picks away at it, and never commits to the engineering people—the total estimated cost of the product development. Marketplace and technical uncertainties are sequentially handled minimizing financial risk as the idea matures."

⁵ Mr. Soergel subsequently asked to amend and amplify this paragraph to read as follows: "Well, for one thing, competition is used throughout the process from the idea, or conceptual design stage, and I hope, through production. There is competition between informational suppliers, each clearly responsible for success or failure of his idea. As you know, presently no one, but everyone, is responsible. This revision has a great bearing on contractual integrity."

Senator PROXMIRE. You would have a change in that right up to the second part of it that shows that 8.6 percent on advertised competitive bidding, and 30 percent on all price competition, including competitive negotiation, do you think that would be changed?

Mr. SOERGEL. Well, I am suggesting a new contract form. If we use fixed-level funding which has fixed-price features, plus add in the cost type features of buyer access, that chart will change dramatically. In other words, price competition is involved I would say for a major segment from the very earliest part of innovation. The gathering of ideas and the initial design work just are the proof of it.

I have some experience in taking an American chrome machine idea in 1950, when Dutch Kilmer used to be one of the guys. I laid out a \$250,000 program to do this and he said, "Look, what is the trickiest part of this design?" And I said, "Well, it is an etched glass rod. We have to lay it on the milling machine and it has to have striations every 1/10,000 of an inch. We put an optical head on it to pick up the striations and moved the tool." He said, "Do you have one of those rods," and I said, "No; but I know where to get one." He said, "Where do you get it?" And I said, "From Ferranti up in Canada." He said, "What's the price?" And I said, "\$10,000." And he said, "Well, if I let you buy it, could you hook it up and I will come down and see it work?" And I said, "Sure." And he said, "Well, I'll give you \$17,000." And we did that. We hooked it up, brought it out and showed it if we wound it over, and we made the machine tool move around through this very expensive rod, and we got a little more money. The next money we got was to program the computer to drive the whole system, and we had to test that out and they came down and looked at that.

This is a pragmatic way to handle uncertainty. This is the way innovation and new things actually occur. What I have described is the financial relationship to the introduction of new ideas. This is the way I believe new introductions should be handled when you deal with Federal money.⁶

Senator PROXMIRE. Well, that is a very good example and I am glad you gave it, but you see, I have trouble with another one of your very attractive proposals.

You say you suggest placing two contractors in head-to-head competition.

⁶ Mr. Soergel subsequently asked that this and the preceding two paragraphs be amended to read as follows: "Well, I am suggesting a new contract form which doesn't appear on your chart. If we use short timespan, fixed-level funding this will introduce fixed-price features, plus add in the cost type features of buyer access, that chart will change dramatically. In other words, fixed-price type contracts will increase from the very earliest part of innovation. The creation and communication of ideas and the initial design work would be performed within a fixed-price feature."

"I can give you an example of short timespan, fixed-level commitments from my own experience. Many years ago I laid out a \$250,000 program to develop a computer controlled three-axis milling machine. The company's president asked, 'What is the trickiest part of this design?' And I said, 'Well, it is an etched glass rod which we have to lay on the milling machine and use as a feedback sensor. We need etched striations every 1/10,000 of an inch. We planned to use an optical head to pick up those striations and move the tool according to the computer.' He said, 'Do you have one of those rods,' and I said 'No; but I know where to get one.' He said, 'Where do you get it?' And I said, 'From Ferranti up in Canada.' He said, 'What's the price,' and I said '\$10,000.' And he said, 'Well, could you order one, hook it up, and demonstrate to me how it works?' I said 'Sure.' He said, 'Well out of the \$250,000 I'll give you \$17,000.' We bought it, hooked it up, and demonstrated it to the boss. He was pleased and wanted to know what we had to do next. I told him that we had to write a computer program and design the control circuitry. He gave us some money for that, and, by this sequential commitment process, all of it fixed-price, we displayed the Nation's first computer controlled three axis milling machine about a year later."

"This is a pragmatic way to handle uncertainty. This is the way innovation and new things actually occur. What I have described is the financial relationship to the introduction of new ideas. This is the way I believe new introductions should be handled when the financial resource is Federal money."

Mr. SOERGEL. It would work wonders.

Senator PROXMIRE. For products that they design and which are different in important ways from each other.

Mr. SOERGEL. To maintain demand uncertainty; yes.

Senator PROXMIRE. You say this would maintain a hedging strategy even into production.

Mr. SOERGEL. Yes.

Senator PROXMIRE. One problem, of course, is the Defense Department can't seem to make up its mind and wants to get both of them. That has happened again and again and again.

Mr. SOERGEL. Well, you have to split the inventory balance. You see, you take the A-10 as an Air Force market of 600. The financing guys were saying, "Well, you can't split that marketplace up. It is going to cost you too much."⁷

Senator PROXMIRE. So they opt for both.

Mr. SOERGEL. No; they opt for one and go monopoly. That is the way they do it.⁸

Senator PROXMIRE. Well, in close air support they opted for both on tactical—

Mr. SOERGEL. No; Air Force's close air support is the A-10. A-9 is allocated to NASA research, although there may have been some changes I am not aware of.

Senator PROXMIRE. You have the A-10, Harrier, Cheyenne—they are all close support.

Mr. SOERGEL. Well, the Harrier is a sea-based airplane and there are important differences between land and sea-based designs. But your point is a good one. If they are competitive for the same mission, one wouldn't know it by looking at the budget.

Senator PROXMIRE. Wouldn't this strategy be prohibitively expensive because of the higher unit cost of today's weapons systems, especially at the competitive design stage, because the services would choose to keep everyone happy by buying a smaller number of each model?

Mr. SOERGEL. Well, I don't think—there is a characterization here that Defense people really don't want to buy good products at economical prices. I don't believe that. I think they are stuck, literally stuck, by the flowdown of 4,000 procurement-related laws. There isn't much they can do, you know, to come up with this kind of a policy reformation that is going to reflect on lawmaking; Congress will have to rescind about 3,000 of these laws, just to get them out of the system. The Armed Forces Procurement Regulations have to go down to about 100 pages like it was in the 1950's.

If you want to talk about paperwork, nonproductive costs, this system that has been generated since the 1950's up to when the B-1 pops out. The conflicts of contract obligations and the ships and so forth—the outcomes from those policies and the nonproductive costs to do

⁷ Mr. Soergel subsequently asked that this paragraph be amended to read as follows: "Well, they evidently know that competition will provide benefits to them even though they can't specify how much. Because they can't be specific I suppose they get turned down on the false argument that buying one weapon is cheaper than two for the same purpose. I think that is unfortunate. Both a hedging strategy and economy will be lost."

⁸ Mr. Soergel subsequently added to this response the following: "No; at present they opt for one because that is all they can get through the system. Financial, procurement, and costing experts are very powerful these days even though not any of them are responsible to move an idea into a fully introduced item."

business with the Defense Department, with NASA, or any Federal agency, will not attract the best suppliers in the United States of America—suppliers of ideas, suppliers of technology, or standard products. There is no way.⁹

Senator PROXMIRE. Now, when you refer to the small labor-intensive R. & D. firm.

Mr. SOERGEL. Yes, sir.

Senator PROXMIRE. I take it you are agreeing with Mr. Fitzgerald. He is saying that most of the investment this policy change would do nothing to improve productivity.

Am I correct in drawing that parallel?

Mr. SOERGEL. It would be improved, sir, by competition. That is the only way productivity can be improved. There isn't any such thing as a "should-cost" concept. Anybody who wants to sit in the Pentagon and generate a "should-cost" number had better be responsible to bring the item in at the price he puts on it.

A "should-cost" number should not be used as a lever on the guy that is going to be responsible to produce against some numbers produced by people not responsible to the producer. That doesn't make any sense. That is a good way to put an awful lot of authority in one area with no responsibility for the outcome. That is just a poor management principle.¹⁰

Senator PROXMIRE. Let me ask your views on another issue, particularly with regard to Mr. Fitzgerald.

Mr. Fitzgerald said that by rewarding quality improvements over the life of the contract, the Government is actually encouraging artificially low levels of efficiency during the early stages of a contract by firms anxious to guarantee receipt of the reward.

Do you think that is a realistic view of what might happen?

Mr. SOERGEL. Well, it doesn't make much difference if Defense moves toward short timespan contracts. I have to talk to you, sir, in terms of my reference, my reference in Procurement Commission work, the Executive Circular A-109, and what I happen to know is going on in the Defense Department regarding compliance with A-109.

The profit policy, as issued, is not relevant to the reformation of a higher level of policy which the changed policy has to mesh to. A profit policy hearing is irrelevant. What you really should be talking about—it is irrelevant. What you really should be talking about are the institutional forms I am alluding to, which are not the subject of

⁹ Mr. Soergel subsequently asked that this paragraph be amended as follows: "Well, I don't think—there is a characterization here that Defense people really don't want to buy good products at economical prices. I don't believe that. I think they are stuck, literally stuck by the flowdown of 4,000 procurement-related laws. There isn't much they can do, you know, to come up with policies directed toward effective use of competition if Congress don't want it. Congress will have to rescind about 3,000 of these laws, just to get them out of the system. Armed Forces Procurement Regulations keeps pace with statutes and it has to go down to about 100 pages like it was in the 1950's. Then ideas can start to flow, be competitive, and nonproductive paperwork costs reduced. I believe I described what happens when innovation is overregulated: the B-1 pops out as a single choice and contract disputes, such as shipbuilding, can't be easily resolved."

¹⁰ Mr. Soergel subsequently asked to amend this paragraph to read as follows: "A should-cost number should not be used as a negotiating lever on the company that is going to be responsible to turn out results. Besides should-cost can only be estimated according to past experience. But what about new technology—neither the buyer or seller can accurately estimate something which has never been done before. The should-cost concept places an awful lot of authority in one area with no subsequent responsibility for the outcome. That is just a poor management principle. New technology has to be learned about without overextending us financially."

these hearings, which are much more important in getting efficiency and economy and effectiveness into Defense procurement. That is what the issue is.¹¹

Senator PROXMIRE. And your stress consistently is on more competition.

Mr. SOERGEL. Competition between ideas and conceptual designs, Senator.

Senator PROXMIRE. I understand.

Mr. SOERGEL. And the ability for a small R. & D. firm to grow, based on competitive merit. We don't have that system today. Now, if somebody wants to say the big contractors have blocked out the little ones, well, I don't say they did it purposely. This is the outcome of 10 years of rulemaking.¹² There they are.

The way to hit Lockheed is not to come out and tell them the price that the Government is paying for the C-130 is so much and it should cost so much, and therefore we penalize you. That is ridiculous.

If you want to get to Lockheed, you kill them with ideas. And this is the most important resource we have in this Nation—the people who have ideas, and these people who have ideas are not attracted to Federal business.¹³

Senator PROXMIRE. Well, I want to thank you very, very much, Mr. Soergel. You are a most impressive witness, and we appreciate your contribution very much.

The committee will stand in recess until next Wednesday at 10 a.m. [Whereupon, at 12:47 p.m., the committee recessed to reconvene at 10 a.m., Wednesday, November 24, 1976.]

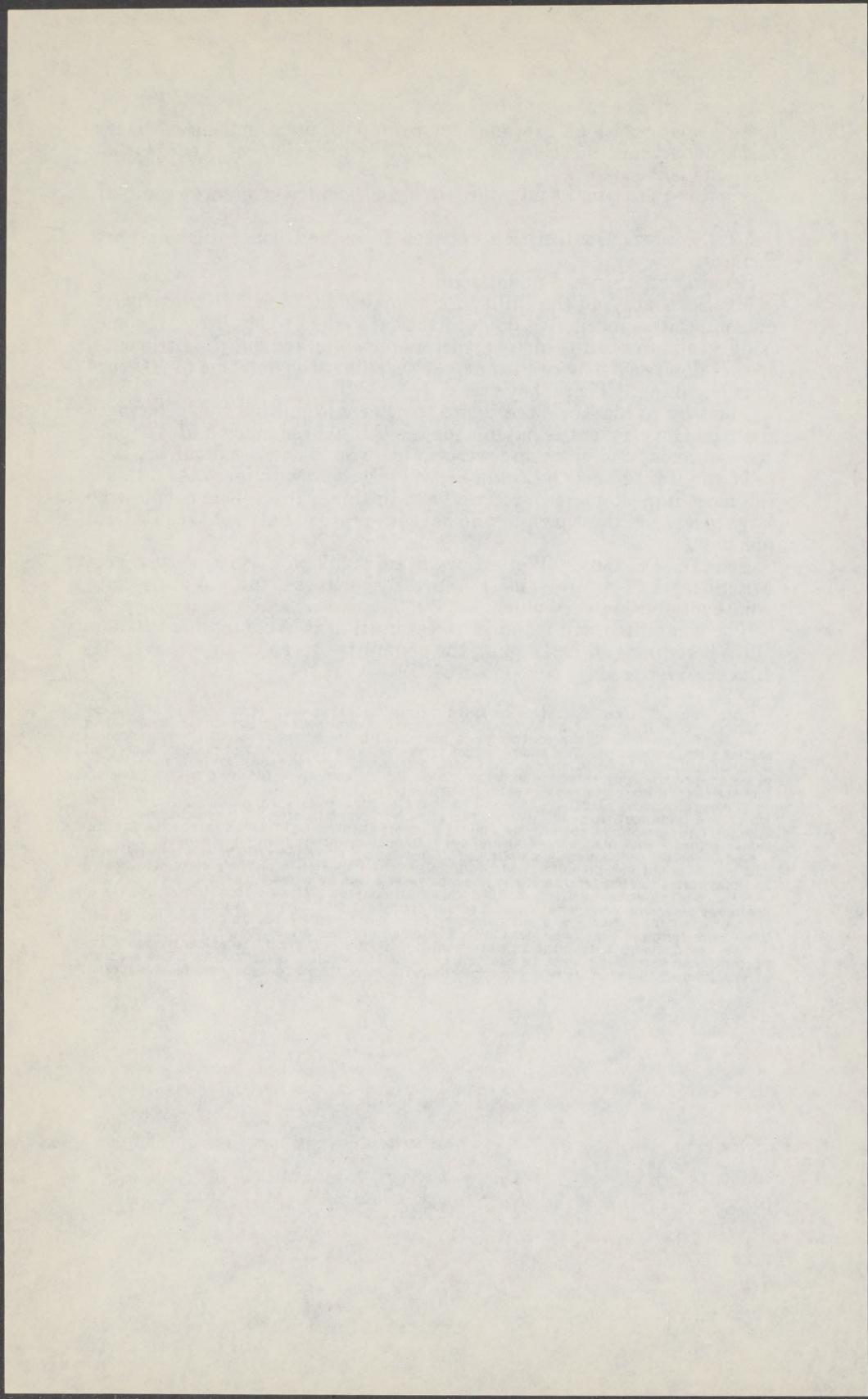
¹¹ Mr. Soergel asked that this and the preceding paragraph be amended to read as follows: "Well, it doesn't make much difference if Defense moves toward short timespan fixed level contracts. If the contractor is purposefully inefficient, that will become known earlier than current practice where longer term contracts are used. And besides, there will be competition. I have to answer that, sir, in terms of my reference. My reference is 2½ years of procurement commission work which led to Executive Circular A-109, plus my industrial experience of over 20 years."

¹² "The profit policy, DPC 76-3, is not relevant to higher level acquisition policy changes which are imminent. A profit policy hearing is irrelevant in view of these changes. What I suggest congressional committees should be more intimately involved in are the institutional reforms embodied in A-109 and their impact on profit policy revisions."

¹³ Mr. Soergel subsequently amplified this testimony as follows: "I'm not sure if large companies would accept policy which minimizes the importance of their corporate wealth and maximizes the importance of their inventiveness. But we will see."

¹⁴ Mr. Soergel subsequently amplified this testimony as follows: "If Congress wants to challenge economic concentration of Federal supply, it will have to pay more attention to the power of ideas which are not correlatable to corporate wealth. In my opinion, it will have to understand that only ideas are a challenge to 'economy of scale' arguments."

"At the moment, attracting capital wealth to Defense markets is evidently more important than attracting ideas to challenge established wealth. DPC 76-3 is a fine example of this kind of thinking. It rewards capital wealth more than it does labor-intensive ideas."



APPENDIX I

WILLIAM P. CLEMENTS, JR., DEPUTY SECRETARY OF DEFENSE

William P. Clements, Jr., was nominated by President Nixon to be Deputy Secretary of Defense on January 4, 1973, and was confirmed by the U.S. Senate on January 23, 1973.

Deputy Secretary Clements previously was Chairman of the Board of Sedco, Inc., a company whose major activity is oil well drilling.

Mr. Clements was born in Dallas, Tex., on April 13, 1917, and received his education in Dallas public schools and at Southern Methodist University.

He was Chairman of the Board of Governors of Southern Methodist University from 1965 until 1973. He has been a trustee of the Southwestern Medical School of the University of Texas, a trustee of the Texas Research Foundation, and has been a member of the Advisory Council on the Southwest Center for Advanced Studies.

Mr. Clements has served as president of the five-state South Central Region of the Boy Scouts of America and is a member of the National Executive Board.

He is married to Rita Crocker of Brady, Tex., whose family background is ranching.

A. ERNEST FITZGERALD, DEPUTY FOR PRODUCTIVITY MANAGEMENT OFFICE, ASSISTANT SECRETARY (SAF/FM)

SERVES AS THE DEPUTY FOR PRODUCTIVITY MANAGEMENT IN THE U.S. AIR FORCE

Following service as an enlisted man in the U.S. Navy, attended the University of Alabama and received a B.S. in Industrial Engineering in 1951. At the University of Alabama, he was elected to a number of honor societies, including Tau Beta Pi, Alpha Pi Mu and Phi Eta Sigma. He received the American Foundrymen's Scholarship. Upon graduation from college, Mr. Fitzgerald joined Stockham Valves and Fitting Company in Birmingham as quality control engineer. In 1953, he joined Hayes Aircraft Corporation as an industrial engineer and was soon appointed quality control engineer. From 1954 to 1957, he was senior plant industrial engineer for Kaiser Aluminum and Chemical Corporation. In 1957, Mr. Fitzgerald joined the auditing firm of Arthur Young and Company. Successively, he worked as an associate, managing associate and principal. He supervised management consulting engagements with large military contractor and commercial clients. In 1962, he became head of a consulting group which subsequently became Performance Technology Corporation (PTC). PTC was involved primarily in military program management and cost control for commercial clients. In 1965, he accepted an appointment as Deputy for Management Systems in the Air Force, where he served until January 1970. From January 1970 until December 1973, he also served as consultant to the Joint Economic Committee of the Congress, to the House Post Office and Civil Service Committee, and to Rockland Industries, where he was elected a corporate director.

Mr. Fitzgerald is a registered professional engineer. He has worked on several successful patents, including one currently issued in his name. He is the author of *The High Priests of Waste*, published by W. W. Norton in 1972. The ACLU awarded him the Judge Henry T. Edgerton Award for outstanding contributions to civil liberties in 1973.

Married to the former Nell Burroughs of Tuscaloosa, Alabama; they have three children: Nancy, Pat and Susan.

D. G. SOERGEL

Mr. Soergel was employed by high technology industry for 25 years in various line management and corporate staff positions.

In 1970 he joined the commission on government procurement staff and was assigned major system acquisition study responsibilities.

Since 1973 he has consulted with various agencies and performed contracted policy research studies about the new product innovative process and government's relationship to industry during the process.

He is a graduate engineer and holds a master of science degree in applied mathematics.

He has previously testified before other congressional committees concerning the general area of federal research and development policy and its relationship to federal spending efficiencies.

APPENDIX II

DEPARTMENT OF THE AIR FORCE
WASHINGTON, D.C. 20330



OFFICE OF THE ASSISTANT SECRETARY

21 December 1976

Dear Senator Proxmire:

This letter is in response to the additional questions submitted to me following my testimony before the Joint Committee on Defense Production on November 18, 1976.

Question No. 1:

"1. The witness who followed you made some remarks which related to your earlier testimony. Copies of the remarks are attached as enclosure A. In the interests of having the fullest and most complete discussion possible, I would appreciate it if you could respond to the point he made concerning the desirability of increased competition as the most effective way to improve contractor productivity."

The witness who followed me, Mr. David E. Soergel, made a number of remarks relating to me or my testimony which puzzle me. Let me take a few examples. On page 2-100 of the stenographic transcript Mr. Soergel is recorded as saying:

"There are many cases where Congress could take a more important role in this, to recognize the production motivation, to reduce price and to improve the performance of an arms run, from year to year, is only done by competition. It is not done by renegotiation. There is no way better. I think Mr. Fitzgerald proved that."

From this remark by Mr. Soergel, I gather that he has somehow come to believe that I think "renegotiation" is a substitute for competition. I have searched my memory, my published writings, and my Congressional testimony, and can find no hint of any such conviction on my part, now or in the past. The renegotiation approach is primarily concerned with recapturing

excess profits. My own approach has been to focus on total price paid by the government. I would be perfectly willing to pay greater profits to the big contractors if I could be convinced these profits were earned by exceptional performance, especially in reducing costs. In fact, my whole career in the military acquisition business was concentrated on cost control and reduction.

As you know, renegotiation focuses on a contractor's total business with the government in a given year rather than on individual contracts. There has been a running dispute as to whether renegotiation examiners can dig into individual contracts to determine whether excessive profits on one contractor's program were offset by losses on others. In contrast to the renegotiation approach, I have looked at direct costs on a contract-by-contract basis. Even on overhead and general and administrative expenses, I have been primarily concerned about their effect on contract cost.

Finally, renegotiation takes place after the fact of performance and expenditure. My own strong preference has been to try to define contractual work and assure its control as early as possible. For example, a number of the cases of successful application of the should cost-approach on which I testified to before the Joint Economic Committee on November 15, 1973, involved application of the should-cost approach to research and development effort.

Since there seems to be so much confusion in Mr. Soergel's mind regarding my suggestions and attitudes, I should like to include by reference the testimony of November 15, 1973 before the Joint Economic Committee as part of my response. (The Acquisition of Weapons Systems - Hearings before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, Congress of the United States, Part 7, Nov. 14, 15, and 16, 1973, pages 2591 through 2814.)

At the bottom of page 2-101 and top of page 2-102, stenographic transcript, Mr. Soergel is recorded as saying:

"Well, take the F-84, F-86. Here is what you hear from financial people, like the one just discussed here, and the costing people. They will say that you have got two different engines, you have got two different airplanes, you have got two different training sets, you

have got two different shop sets of equipment, and a man like Mr. Fitzgerald can lay that out in six significant figures as to the cost of competition, but he can't in any way price all the benefits. You can't run a computer program involving so much design and cost reduction of competitive motivation. You have to believe in the value of competition increasing productivity and delivering better products at cheaper prices or you don't. It's that simple.

So because competition should be proving the cost more, and its elimination, but it is the benefits that are incalculable and Mr. Fitzgerald and others like him will always win.

In my opinion, both the taxpayer and national security loses."

I simply do not know what Mr. Soergel is talking about here. Generally speaking, I have always believed that true competition was so beneficial that whatever costs were involved in bringing it about would be repaid many times over in savings, especially in dealing with large contractors. I don't recall ever having made any significant efforts to price out preparations for competition, much less lay out the cost "in six significant figures" as Mr. Soergel states.

The previously referenced testimony before the JEC contained an excellent study of the benefits of competition made by Mr. Larry Yuspeh which I supported strongly. Specifically, I stated as part of my testimony:

"First I would like to say that I think that Mr. Yuspeh's study is one of the most revealing and potentially useful studies ever presented to this subcommittee. I think the facts in his study demonstrate conclusively that there is enormous potential for cost reduction in military procurement. And I would hope that a majority of the Congress and the proponents of good stewardship in the administration will concentrate on ways of capturing this saving potential, and not be deterred or become preoccupied with the obstacles, genuine or contrived, to wider use of competition."

I went on from there to suggest means of reducing and removing obstacles to regular use of competition, one of which, incidentally, was essentially to buy information, which I perceived to be a major thrust of Mr. Soergel's proposals in his prepared testimony.

Another suggestion for enlarging competition which I made in the November 15, 1973 testimony is one I had made many times before and repeated in my testimony of November 18, 1976, which I believe Mr. Soergel heard. That was the possibility of competing tenancy and management of government-owned contractor-operated (GOCO) plants. I believe this could open up new areas of competition perhaps not even envisioned by Mr. Soergel. On several occasions in his testimony, he used the phrase, "You have no choice" to characterize the situation we find ourselves in once we have settled on a type and model of weapons system. I think in some past situations, notably the C-5A, we had a choice of inviting bids for new management of the on-going program in government facilities. We simply did not avail ourselves of the choice. I believe these choices can be widened in the future by aggressive use of competitions for tenancy and management of "unique" facilities.

On page 2-109 of the stenographic transcript, Mr. Soergel states regarding productivity management prospects:

"It would be improved, sir, by competition. That is the only way they can improve it. There isn't any such thing as a should cost concept. Anybody who wants to sit in the Pentagon and have a should cost number had better be responsible to bring that cost in at the price he puts out.

You can't cost a should cost number as a lever on the guy that is going to be responsible to produce against some numbers produced by people not responsible to the producer. That doesn't make any sense. That is a good way to put an awful lot of authority in one area with no responsibility for the outcome. That is just a poor management principle."

As I testified on November 15, 1973, I realize that the should-cost concept troubles many traditionalists in the military spending coalition. However, the concept cannot be

made to go away simply by denying that it exists. It is fundamentally different from the now-dominant "will cost", or parametric estimating approaches. The November 15, 1973 testimony previously referred to explains the should cost both graphically and in the text.

Mr. Soergel's remarks also lead me to suspect that he confuses the should-cost figure with negotiated contract cost. The should-cost approach is a method of arriving at a negotiating position for the government. It may or may not be the same as the negotiated cost. The cost figure agreed to in negotiations between the big contractor and the government is the negotiated cost. This is illustrated graphically in Exhibit 2, p. 2631 of the previously referenced testimony.

Continuing on page 2-109 of the transcript, Senator Proxmire asked Mr. Soergel the following question:

"Let me ask your views on another issue, particularly with regard to Mr. Fitzgerald.

Mr. Fitzgerald said that by rewarding quality improvements over the life of the contract, the government is actually encouraging artificially low levels of efficiency during the early stages of a contract by firms anxious to guarantee receipt of the reward.

Do you think that is a realistic view of what might happen?"

Mr. Soergel's response was restricted to what he called a "short timespan" contracts where he said it did not make much difference. However, he went on to add that the hearings in which he was testifying were "irrelevant" and that, "If you want to get to Lockheed you kill them with ideas." I wish to dispel any notion that my comments were designed "to get to Lockheed" per se. My concerns about Lockheed and the other giants are focused on the fact that we so often pay exorbitant prices for substandard products of these politically-favored firms. I personally favor using any fair, legal and honorable means to obtain more or better goods and services for our military acquisition dollar. I further believe that the committee's hearings were relevant to this objective.

One of Mr. Soergel's problems with the focus of the hearings appeared to be lack of clarity on the specific nature of the subject matter. Competition, whether for ideas, paper studies or hardware, is extremely important, and we should have more of it. However, as I understood my invitation to appear before this Committee, we were to focus on the Profit '76 Study and the resulting Defense Procurement Circular #76-3. On pages 3 and 4 of the DPC 76-3, the point is made that we are dealing with negotiated contracts not those involving "adequate price competition."

Unfortunately, the great bulk of our money is spent without "adequate price competition." We need to increase the incidence and coverage of genuine cost reducing competition. Meanwhile, as long as there is any significant amount of negotiated contracting, particularly with the expensive and influential giant firms, we cannot ignore opportunities to be more effective in negotiations. By no means should we consider approaches such as should cost and competition as mutually exclusive tools, especially when dealing with giant firms. I can't say for sure just what is the most effective way for improving contractor productivity. This doesn't worry me, though, because I don't believe we are now in an "either-or" situation in using should cost and competition in the community of giant contractors.

If I must take a stab, I believe aggressive use of the should-cost concept would provide the fastest and biggest short-term payoff just because it can be more quickly applied to giant companies working on major programs. Competition, or even a credible threat of competition, could help persuade the big fellows to agree to more reasonable prices. Moreover, once we demonstrate both the ability and the willingness to take our business elsewhere, our choices for holding the giants to their agreements will be improved. For the long term, I would agree that real competition, that is competing for the favor of frugal customers in order to survive, is probably the most effective good known to man. The trick is creating such a climate.

Both competition and genuine should-cost pricing have served us well in the past and can do so again. As I have testified, I believe we should focus in removing obstacles to competition, promoting any and all ideas for more effective

negotiation, and, most important for all, setting right the rewards and punishment system for both contractors and government officials so that efficient and effective operators prosper and the others come on hard times.

Question No. 2:

"2. The bulk of your remarks were devoted to an explanation as to why the new profit policy would not have the stated effect of improving contractor productivity. However, there is a separate, and more limited question. Granting that it will not be a panacea, do you believe that profits should properly be based at least partially on investment rather than exclusively on cost? Is it possible that it might at least have the effect of removing some of the incentive which DOD acknowledges has existed for contractors to maximize costs in order to maximize profit?"

The first of these two questions is somewhat confusing as stated. It seems to imply that "investment" is entirely separate from "cost." Investment obviously is part of the cost of producing goods and services. The public relations effort surrounding the Profit '76 Study and DPC #76-3 has lead some to believe that we are for the first time allowing recovery of capital investment. For as long as I can remember, we have had provisions for recovery of contractor investment through depreciation and have included allowable depreciation charges as part of the cost basis on which profits are calculated for negotiated contracts (see attachment #1).

Our stated purpose in issuing DPC #76-3 is "to stimulate efficient contract performance." Therefore, we should plan our incentives to stimulate "efficient contract performance" directly rather than placing incentives on secondary factors which may or may not stimulate "efficiency".

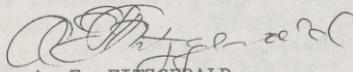
Let's take a look at what DPC #76-3 really does. For purposes of this discussion, I would like to divide DPC #76-3 into two parts: Productivity (Section 3-808.8(b)) and the rest of the DPC.

To aid discussion, I have reproduced Exhibit 1 from the November 15, 1973 hearings (attachment #2). A literal reading of the productivity section of DPC #76-3 would pay a higher

profit for the steep ("good") curve in Exhibit #1 than it would for the flat ("bad") curve for manhours per unit of the same item of hardware. This part of the DPC #76-3 certainly does nothing toward requiring contractors to minimize costs.

Having dealt with the productivity section of DPC #76-3, the rest of the circular's emphasis on investment simply incentivizes increases in investment. In other words, rather than rooting out cost-plus attitudes, we are simply placing greater emphasis on the investment category of costs to which we will add the plus. It is cost-plus just the same. Therefore, in the context of the present inquiry, I do not believe that DPC #76-3 will necessarily remove any of the incentive for contractors to maximize costs in order to maximize profit.

Sincerely,



A. E. FITZGERALD

Deputy for Productivity Management

2 Attachments

1. ASPR 15-205.9
2. Exhibit 1, Learning Curve Comparison

Honorable William Proxmire
Vice Chairman
Joint Committee on Defense
Production
Washington, D. C. 20510

CONTRACT COST PRINCIPLES AND PROCEDURES

15-205.9 Depreciation. (CWAS-NA)

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life and shall be evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost *provided* the contractor is able to demonstrate that such costs are reasonable and properly allocable to the contract. Subject to (e) and (f) below:

- (i) Depreciation will ordinarily be considered reasonable if the contractor follows depreciation policies and procedures which:
 - (A) are consistent with the policies and procedures he follows in the same cost center in connection with his business other than Government business;
 - (B) are reflected in his books of accounts and financial statements; and
 - (C) are used by him for Federal income tax purposes, and are acceptable for such purposes;
- (ii) Where the depreciation reflected on a contractor's books of account and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based upon the cost of the asset to the contractor amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center in connection with his business other than Government business.

15-205.9

ARMED SERVICES PROCUREMENT REGULATION

1 JULY 1976

15:23

CONTRACT COST PRINCIPLES AND PROCEDURES

(iii) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis outlined in (ii) above.

(c) Special considerations are required for assets acquired prior to the effective date of this principle where, on the effective date of this principle, the undepreciated balance of such assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance of such assets on the books and financial statements. Generally, the undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation on any asset allowable after the effective date of this 15-205.9 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior procurement regulations.

(d) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (a) above, vary with volume of production or use of multishift operations.

(e) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation" or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board. The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in (b) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation:

- (i) with respect to the emergency period (five years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and
- (ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life *provided* the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(f) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary or affiliate of the contractor under a common control.

(g) The depreciation on any item which meets the criteria for allowance at a "price" in accordance with 15-205.22(e) may be based on such price, *provided* the same depreciation policies and procedures are used for costing purposes for all business of the using division, subsidiary or organization under common control.

(h) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary or affiliate of the contractor under a common control; however, a reasonable charge for the use of fully depreciated

15-205.9

ARMED SERVICES PROCUREMENT REGULATION

15:24

1 JULY 1976

CONTRACT COST PRINCIPLES AND PROCEDURES

property may be agreed upon and allowed (but see 15-107). In determining this charge, consideration should be given to cost, total estimated useful life at time of negotiation, effect of any increased maintenance charges or decreased efficiency due to age and the amount of depreciation, if any, previously charged to Government contracts or subcontracts.

15-205.11

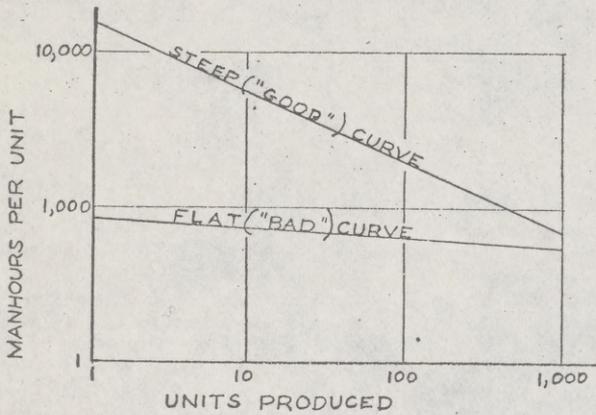
ARMED SERVICES PROCUREMENT REGULATION

THE ACQUISITION OF WEAPONS SYSTEMS

Hearings Before the Subcommittee on Priorities and Economy
in Government of the Joint Economic Committee, 93rd Congress
Part 7, November 15, 15 and '16, 1973

2630

EXHIBIT 1

LEARNING CURVE COMPARISON
LOGARITHMIC SCALE



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

INSTALLATIONS AND LOGISTICS

8 DEC 1976

Honorable William Proxmire
Vice Chairman
Joint Committee on Defense
Production
Washington, D. C. 20510

Dear Senator Proxmire:

I have been asked to respond to your letter to Deputy Secretary of Defense Clements of November 26, 1976 regarding the new Department of Defense profit policy.

On behalf of Secretary Clements, I would like to express our thanks for your kind remarks concerning our testimony and the useful exchange of information it provided. We appreciate your forthright interest in the new policy and your support of its objectives.

In response to your request, we are pleased to provide the enclosed answers to the additional questions raised in your letter.

Sincerely,

A handwritten signature in cursive script, reading "Dale R. Babione".

DALE R. BABIONE
Acting Principal Deputy Assistant
Secretary of Defense (I&L)

Enclosure

Additional Questions for Deputy Secretary Clements

Q 1. What mechanism will be used to screen contractor investments to assure that only necessary investments are credited?

A The applicability of contractor facility investments is determined by using the criteria in Cost Accounting Standard 414. Facilities Capital values should be the same values that are used to generate depreciation or amortization that is allowed for Federal Government contract costing purposes. If a contractor is planning to significantly increase the facility investment, our procurement personnel have been instructed to evaluate the cost effectiveness of these investments before they are recognized for pricing purposes. Steps have been taken to assure that idle facilities will not be allocated.

Q 2. What is the likely effect of the new profit policy on firms, such as research and development of studies and analysis firms, which presumably would not have the ability or need to invest in labor saving equipment?

A The new profit policy will not penalize such firms because this type of contract effort is exempted from application of the new weighted guidelines. See 3-808.2(b)(1).

Q 3. Have any steps been taken to assure that such firms will not suffer from undue erosion of their profits due to the new profit policy and to assure that the industrial base will not erode further due to increasing unwillingness of such contractors to engage in studies for the Department of Defense?

A We have clarified the circumstances that are excepted from application of the new weighted guidelines. We have indicated that there are procurements where an insignificant amount of facilities are required for efficient contract performance and application of the new weighted guidelines could result in an inequitable profit objective. It is not our intent to penalize these types of labor intensive contracts for studies, reports, engineering or logistic support services, professional services and the like.

Q 4. Has any consideration been given to increasing the use of fixed-price contracts as an alternate means of improving contractor productivity?

A No. We believe it would be unwise to over emphasize fixed-price contracting as a means of improving contractor productivity. This could create problems early in development programs where it is difficult to estimate final costs.

Q 5. The final witness argued that risk, rather than limitations on profit, was the primary factor which discouraged contractors from increasing their investment, and that the new profit policy would have little or no effect. Do you have any comments?

A We feel that the combined effect of allowability of the cost of facilities capital and recognition of facilities investment and productivity in the profit policy will remove obstacles to cost-reducing facility investment decisions by industry. Consequently, the overall level of investment should increase in the future. There are situations, however, where business risk due to program instability may still seriously impede investment. Other contractual approaches have and will be undertaken in those circumstances.

Q 6. The same witness also suggested that the best incentive for productivity improvement would be increased competition which would continue on into production. He cited as an example the F-84 and F-86 aircraft, wherein contractors were locked in competition with another even after award of the production contract, and wherein a contractor's order for subsequent years depended on genuine productivity improvements. Do you have any comments on this proposal?

A OMB Circular A-109 requires that we maintain competition as long as practicable and we attempt to do so as long as the economics of the situation permits. For example, the A-9 vs the A-10 and the F-16 vs the F-17 were competed through the prototype stage, at which point it was judged uneconomical to continue the competition. However, we have contract provisions which allow us to obtain data that would enable us to reinstitute competition, if appropriate, at a later date during production.

APPENDIX III

SHIPBUILDERS COUNCIL OF AMERICA

WATERGATE SIX HUNDRED | WASHINGTON, D. C. 20037

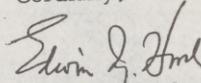
November 24, 1976

Dear Mr. Vice Chairman:

Pursuant to the invitation extended by your letter of October 19, there is submitted herewith a statement to the Joint Committee Committee on Defense Production regarding recent Department of Defense profit changes. The opportunity to record our views on this important topic is appreciated.

With highest regards always, I am

Cordially,


Edwin M. Hood
President

The Honorable William Proxmire
Vice Chairman
Joint Committee on Defense Production
Congress of the United States
Washington, DC 20510

STATEMENT
OF
EDWIN M. HOOD
FOR
SHIPBUILDERS COUNCIL OF AMERICA
TO
THE JOINT COMMITTEE ON DEFENSE PRODUCTION
ON
DEPARTMENT OF DEFENSE PROFIT POLICY CHANGES

— This statement is submitted on behalf of the Shipbuilders Council of America, of which I am President and Chairman of the Board of Directors, pursuant to the opportunity afforded by October 19, 1976 letter from Committee Vice Chairman, Senator William Proxmire. Our members are vitally interested in the viability of the shipbuilding industrial mobilization base and in the Defense Department's profit and contracting policies which so significantly affect the strength of that base.

The Shipbuilders Council of America is the national trade association for the shipbuilding and shiprepairing industry of the United States. It is comprised of private shipyards in all areas of the nation that construct and repair major ships including those for various Departments and Agencies of the Federal Government. A list of the membership will be found on the last page of our most recent ANNUAL REPORT, a copy of which is submitted herewith to provide background information on the Council as well as the structure of the private shipbuilding and shiprepairing industry of the United States.

We most heartily agree with the Vice Chairman's thought, expressed in his October 19 letter in this way: "it is important that profit rates be set as realistically as possible to allow contractors a fair rate of return

while avoiding excessive cost to the Government."

We also agree with and support the objectives of the Deputy Secretary of Defense in initiating the Defense Department Profit Study, popularly identified subsequently as "PROFIT '76" - an objective he stated on June 18, 1975, as follows:

"Our goal is to develop policy revisions needed to motivate defense contractors to make investments which will reduce Defense Department acquisition costs."

We also applaud the scope and depth - the thoroughness - of the Primary and ancillary studies made by the Defense Department pursuant to the Secretary's initiative as forming a rational foundation for any new policies which might be developed therefrom. Further, the first-emerging results of these studies - the promulgation of Defense Procurement Circular (DPC) 76-3 containing revised guidance to government contract negotiators for the establishment of contract profit objectives, and the simultaneously promulgated Cost Accounting Standard 414 which permits the imputed cost of facilities capital to be treated as "allowable" in Defense contracts - offer the promise of stepping stones toward rationality in Department of Defense contracting policies.

But, both the Committee's inquiry into profit policies and the DoD's promulgations on the same subject to date imply to us that there exists a concept that "profit policies" may be treated as discrete elements, separate and clear from contract prospective costing and subsequent contract administration actions; and that, if "profit policy" questions are only resolved, solution of the problem of assurance of viability of the shipbuilding, indeed

the whole of the defense industrial base, is thus ensured. Assuming the accuracy of our reading of these implications, we must insist that the concept of profit policy solution to the existing real problem is, on most generous appraisal, superficial in the extreme.

Profit policy, as treated in DPC 76-3, addressed only "the top of the iceberg." It cannot, realistically, be thought of as an item to be considered separate from the mass which lies beneath the surface. This is because "profits" so treated are really advance PROSPECTIVE profits based on apparent PROSPECTIVE costs and, on the record, apparent prospective costs - so-called target costs - are entered at unrealistically low levels. And, target costs make up roughly 95 percent of the iceberg.

There is mutual government/contractor unrealism in arriving at target cost and time schedule of performance, stemming largely from statements by the Government, subsequently unfulfilled, regarding technical characteristics and time-of-delivery schedules of Government-furnished subsystems which must be integrated into the total ship system - statements on which both cost forecasts and time of ship delivery commitments are mutually made.

Once the contract has been signed, there is further Government unrealism in its recognition of the cost and schedule effect of reconciling the real world of inaccuracy of Government-furnished information regarding technical performance and time of delivery of Government-furnished subsystems, and of other Government specifications, with those promised by the Government in the contract - promises on which the initially agreed-to target cost was based. The currently outstanding large volume of claims

against the Government is symptomatic of this Government unrealism.

Further illustrative of the foregoing, in the course of its study, DoD examinations of prospective profits negotiated by the Navy on Fixed Price Incentive type contracts (most shipbuilding contracts are of this type) for the five year period FY 1969-1973 revealed that they were 11.8 percent of prospective costs. Yet, the actual shipbuilding profit returns from contracts during 1970-1974 period were 2.9 percent, before taxes, of costs actually experienced.

And, according to testimony of Secretary Clements, before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee, on June 25, 1976, the Navy estimates that for 11 contracts now in force, involving 70 ships and a cost of \$8.65 billion, the shipbuilders will incur LOSS of nearly \$500 million (loss of 5.8 percent). These 70 ships represent approximately two-thirds of the value of all major naval vessels under construction and reflect a 14-year time span of performance, from commencement of the first ship (1968) until scheduled delivery of the last (1981).

Thus, for naval shipbuilding, we are not witnessing a transient phenomenon of minimal to negative realized profits - we see a malaise extending well over a decade. And, all the while, "prospective" profits have hovered in the 12-percent-of-prospective-cost range.

On the record of performance, the Government is making and administering shipbuilding contracts in which there is a consistent unrealism of cost prediction in the order of 10 percent of costs. However sound or unsound the profit policies enunciated in DPC 76-3 may be, they

will affect historical profit patterns little if at all - a range of perhaps plus or minus one percent of costs.

If the pattern of non-profit within the naval vessel building segment of the shipbuilding industry persists, the question is not one of opportunity for cost-reducing investment, it is one of mere survival. The areas requiring policy revision are in cost predictions and reasonableness of Government actions during administration of the contract.

As shown by the DoD Profit Study, the shipbuilding segment of the defense industry has the highest ratio of capital assets to sales of any defense group - 49.5 percent as compared to 35.0 percent of all defense industry. Perhaps the primary contributing factors are that there is only a negligible amount of Government-owned capital equipment or other assets in use by private shipyards, and that during the past ten years, U.S. yards have collectively invested more than \$1.0 billion in new and modernized facilities - largely by long-term borrowings. It follows without saying that, with the highest of all capital/sales ratios and the lowest of all profit on sales, the industry has by far the lowest return-on-investment of any U.S. industry, commercial durable goods or defense, now operating and presumably viable.

In its excellent report "THE DEFENSE INDUSTRY: Some Perspectives from The Finance Community", made as an element of the Defense Department Profit Study, The Conference Board noted: "Defense contractors are perceived as less attractive risks among the corporate clients of banks and other financial institutions. . . defense contractors profits are too low for the risks defense contractors face and for their long-term viability." If

this be true for the defense industry, it is even more true for the shipbuilding segment.

The report noted that among the chief problems affecting defense contracts was "Certain Department of Defense (DoD) policies, procurement regulations and tactics, and administrative practices that have untoward effects on defense contractors - for example, excessive management and policy changes, a propensity to alter specifications in mid-contract, adoption of an adversary posture toward suppliers."

Interestingly, another element of the DoD Profit Study "(DoD) Procurement Personnel Opinion Survey" indicated: "Obviously the (DoD) respondents view the defense contractors as an adversary who must be managed and/or controlled at the bargaining table. . . . procurement personnel see the goal of the system as the control and/or reductions of negotiated profits. These attitudes may pose a difficult hurdle in trying to reshape procurement policy to new or different objectives."

These are some of the parts of "the iceberg" which lie beneath the surface. Until the problems those parts reflect are addressed and reconciled "the iceberg" will remain. DoD profit policies cannot be considered to be realistic unless the problems are affirmatively attacked.

The financial-institution executives interviewed by The Conference Board suggested, as one remedy, "more benign and realistic (overall) contracting posture by the DOD." We agree.

Slightly more than two years ago, an ad hoc committee of our organization, following a careful study of many months duration, cited,

in "A Discussion of Navy/Shipbuilding Industry Business Relationships" ten problem areas, and offered 39 recommendations toward solution. We believed then - and believe now - that those recommendations are practicable of adoption and that unless these problem areas are fully addressed and appropriately reconciled there can be said to be no affirmatively realistic DOD profit policy with respect to the shipbuilding industry. And, absent these actions, the naval ship construction industrial base will continue to be needlessly circumscribed.

These problem areas and recommended solutions might be simplified and summarized as follows:

Problem Area: Improving Overall Buyer/Seller Relationship

- continue progress payments on basis of physical progress
- authorize interest cost of borrowed funds as allowable expense items
- resolve outstanding claims quickly and take all steps to minimize future claims
- pending affirmative action in cited problem areas, adopt some type of cost-reimbursement, assured fee, contract and if appropriate, restructure existing fixed price type contracts as cost type contracts
- recognize that through Government action or inaction financial and performance risks are being imposed on contractor resulting in costs that exceed impact from inflation

Problem Area: Definition of Ship to be Built

- recognize that primary specifications inherently contain errors and inconsistencies
- provide for prompt corrective changes
- ensure that changes are essential and will minimally affect production schedules
- accelerate efforts to simplify primary and subordinate specifications

Problem Area: Realism in Pricing and Scheduling

- improve accuracy of definition of ship to be built
- eliminate requirements of doubtful value and uncertain cost

- improve accuracy of forecasting probable costs
- provide reasonably for known and unknown contingencies
- outlaw "auction type" bidding techniques as basis for contract negotiation

Problem Area: Availability of Government Furnished Information (GFI) and Government Furnished Material (GFM)

- improve accuracy of GFI
- recognize cost and production consequences of erroneous and incomplete GFI and delayed delivery of both GFI and GFM
- issue change orders promptly to rectify delays, defects and omissions

Problem Area: Recognition of Cost Impact of Delays

- accept full cost responsibility for deficient specifications, GFI and GFM
- accept full cost responsibility for schedule and production delays caused by Government action or inaction

Problem Area: Relationship of Change Orders

- defer change in primary specifications until after delivery of ship
- if impossible, issue instructions for change early in construction cycle
- arrange for provisional pricing of change orders of obvious high dollar value
- finalize pricing of these major change orders with dispatch
- issue change orders promptly to rectify effects of Government action or inaction

Problem Area: Proliferation of Management Information Reporting Systems

- examine governmental organizational structure bearing on ship procurement and production
- rely on contractor informational systems to maximum practicable extent
- reduce government-imposed reporting requirements
- eliminate superfluous and nonproductive requirements

Problem Area: Reasonableness of Quality Assurance (QA) Requirements

- ensure that QA requirements are compatible with primary specifications
- minimize redundant QA standards

- administer QA programs with professional judgment and reasonableness
- accept full cost responsibility for introduction of new QA inspection techniques during construction cycle
- limit QA actions to requirements of contractual agreement

Problem Area: Role of Defense Contract Audit Agency (DCAA)

- limit role of DCAA to financial accounting
- restrict DCAA activities to verification of contractor's costs and forecasts of costs
- consolidate DCAA functions and those of Navy Supervisor of Shipbuilding in contractors plant

Problem Area: Needless Monitoring of Contractor Purchasing Actions

- revive practice of reliance on approved contractor purchasing system
- eliminate review and prior approval of each proposed subcontract
- cancel NAV MAT Notice 4330, dated November 1973, titled "Surveillance of Sub-Contracting Operations"

For the record, a copy of our document entitled "A Discussion of Navy/Shipbuilding Industry Business Relationships" is enclosed. The rationale of our position is explained therein in detail. In the months since first presentation, we understand that some few of our recommendations have been visibly and positively addressed in whole or in part - by means of terms and conditions of certain shipbuilding contracts signed since early 1975. We sincerely trust that in the interest of viable DoD contract policy, indeed the national interest, that all will be adopted in the near future.



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President

23 November 1976

The Honorable
William Proxmire
Vice Chairman Joint Committee
on Defense Production
Room A-421, Senate Annex III
Washington, DC 20510

Dear Mr. Chairman:

The National Security Industrial Association appreciates your invitation to submit a statement on the Department of Defense profit policy in connection with the Committee's hearing thereon on 17 November.

NSIA is a non-profit association of approximately two hundred fifty American industrial and research companies of various types and sizes, from large to small, representing all segments of an industry which provides products and services to the United States Government. The Association's essential purpose is to foster an effective working relationship and good two-way communications between the Government and the industry in the interest of the national security.

We share your view that profit rates have significant impact on maintaining a healthy and capable industrial base and it is important that profits should be set to provide a fair and reasonable rate of return while avoiding excess cost to the government.

We continue to support the long-standing "weighted guidelines" approach as the procedural framework for the practical application of DoD's profit policy.

We also support the DoD objective behind the recently promulgated revision to its profit policy to provide an incentive to contractors to invest in higher-productivity plant facilities and equipment in order to reduce the cost of defense systems.

However, we believe that there is a real question whether the revised policy will promote achievement of these goals. Apparently it was not the intent of DoD in promulgating the revised policy to achieve an overall increase in industry profits, but rather to shift the percentages applicable to the various weighted guidelines so as to give more recognition to facility investment. Our review of the new policy based on application to individual contracts indicates that the likely result of the application of the revised factors will be an overall reduction in profit rates in the order of 1 to 2 percentage points in negotiated contracts.

We do not think that the shift in applicable percentages will provide sufficient incentive to contractors to increase their investment in facilities and equipment. Indeed, with the overall reduction in profit which will occur, we believe it will likely further inhibit such investment. We believe that in most cases the financial incentives provided by this shift in factors will not be enough in management's eyes to outweigh the high risks involved under defense systems contracts in the recovery of the additional capital investment required.

In our view, a more potent investment incentive than "going in" profit margin would be reasonable assurance to the contractor of recovery of his investment in the event of program termination or cut-back. We note recent indications that DoD is alive to this problem and is giving consideration to possible remedies. One such remedy would be through accelerated depreciation, or shortened life of equipment; unfortunately, the trend is in the opposite direction, as evidenced by Cost Accounting Standard 409, which actually extends the life of equipment. We believe that a combination of such remedies and an overall profit level sufficiently high to enable contractors to invest the very substantial amounts of capital needed to update and improve their facilities is what is really needed to meet the problem.

We also wish to emphasize that, in addition to motivating investment for greater efficiency, another prime objective of DoD profit policy, of equal if not greater importance, must be the incentivizing of investment to maintain a high level of technological capability in the defense industrial base. As recognized in the DoD policy, the maintenance of such technological capability requires an overall compensation level, direct and/or indirect, which will support a proper level of company research and development.

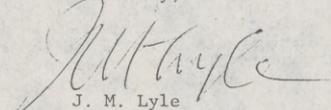
The prior weighted guidelines provided profit margins for labor-intensive companies, such as those involved in defense research and engineering and in providing professional services in highly technical areas, which would permit the employment and development of highly talented and creative scientific people required for their work. The revised guidelines reduce the profit in this area by 30% to permit shifting of the weighting to provide incentives for new capital investment. To the extent that defense contractors are research, development and/or professionally oriented, they are unable to participate in the rewards for capital investment.

This penalty will have a significantly deleterious impact on research and development capability and we believe that special provisions should be made for these specialized labor-intensive companies.

Finally, we wish to observe that, based on our member companies' experience as borne out by the data collected in the DoD "Profit '76" study, defense industry profit margins are too low in relation to those of other sectors of industry. Absolute dollars in profit and retained earnings, not return on investment ratios, are the required incentives for a company to invest in new higher productivity machinery and modern facilities. In order to attract the best industrial capabilities to perform defense contracts, the profit guidelines should recognize and permit the negotiation of profit levels commensurate with the risks involved. The Conference Board's recent report, "The Defense Industry - Some Perspectives from the Financial Community", which was a part of the DoD Profit Study, indicates that in the eyes of the investment community defense contractor profits are too low for the risks they face as compared with the profits and risks in the commercial market. On this basis, we believe that DoD negotiated contract profit margins should be raised to a level above that for comparable commercial sectors.

These changes in profit policy as outlined above are essential to maintain a properly healthy, innovative and competitive defense industrial base, which of course is an essential component of our national security.

Sincerely,



J. M. Lyle
President

MENASCO

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November 5, 1976
TGM 5201

Senator William Proxmire
Vice-Chairman - Joint Committee of Defense Production
Congress of the United States
Room A-421, Senate Annex III
Washington, D. C. 20510

Dear Senator Proxmire:

I understand that the Joint Committee will be holding hearings on November 17 and 18 to examine the status of the industrial base and mobilization programs and federal policies that have an effect on the nation's capacity to provide for an adequate defense.

I am pleased that you are scheduling hearings on this matter so vital to our national security. The profit policy changes recently announced do have a significant impact on defense contractors' ability to facilitate to meet mobilization requirements.

The matter is most complex and is tied directly not only to government procurement policies (ASPR), but also government policies on the use of government owned facilities by defense contractors. The latter problem was probed by the GAO in the late 1960's and resulted in considerable activity by defense agencies to phase-out the use of government equipment in the possession of defense contractors. It is my understanding that this program has, for the most part, been completed except for a few suppliers considered essential to support mobilization planning requirements.

The policies of the Defense Department with regard to the commercial use of government owned facilities by Defense contractors were examined by the Sub-Committee on Procurement and International Trade of the Permanent Select Committee on Small Business on March 7, 1973, and its findings published in House Report #93452. Representatives of the National Tool and Die and Precision Assn. and the Machinery Dealers National Assn. testified as to the need for the government to remove government facilities from the hands of defense contractors. In my judgment, they misrepresented and distorted many facts to serve their own special interest. These distortions found their way into the findings and recommendations of the Sub-Committee and to my knowledge have never been corrected although I have written at length regarding these misrepresentations to the AIA and the Defense Department.

The shocking fact is that the phase-out policies of the government amounted to unilateral destruction of our industrial base at a time when industry was not prepared financially to replace government owned facilities with more modern and more productive facilities of their own. This, too, has been covered at length by reports published by the Aircraft Industries Assn. Many defense industries, particularly the aircraft industries, are still in financial straits and unable to replace government owned facilities with privately owned equipment. An examination of the age and condition of our industrial base will reveal that it is, for the most part, over 20 years of age and in need of immediate replacement.

There is a significant difference in policy statements by the Defense Department regarding the phase-out policies for defense contractors supporting mobilization requirements. The Department of Defense and certain individuals in the Air Force have said that government facilities required to support mobilization requirements should not be phased out, while lower echelon of command are directing that all government facilities be phased out even though they are supporting mobilization plans. This conflict in policy and direction has existed since the phase-out plans were announced in the late 1960's. Defense Department officials with whom I have talked say that the phase-out policy is being pressed by certain members of Congress who in turn are pressured by some special interest groups. The point is that government policy should be designed to keep our industrial base "warm" and capable of meeting "surge" demands when called upon. This would cut lead times for delivery of long lead time hardware in half and would strengthen our peace-keeping efforts throughout the world.

I am well aware of the rising cost of providing a modern and efficient industrial base and of the fact that the mood of Congress, reflecting the will of their constituents, is against increased spending for defense purposes. Yet, I have not forgotten the lessons of World War II when our Russian allies lost 20 million men and our other allies hundreds of thousands of lives while we first rebuilt our industrial base and then the modern weapons required to win the war. The lack of preparedness by the allies was paid for with lives - a fact that few seem to remember now.

The problem can be boiled down to two basic points. First, we need to modernize our industrial base at government expense because defense contractors do not have the resources to invest in "stand by" production facilities. If we wait until the need arises, it will be too late. Landing gears for some military aircraft have a lead time of approximately one year, while the additional time required to procure necessary facilities is from 12 to 18 months. Thus, the lack of facilities in place could delay deliveries of this hardware from 24 to 30 months after M-Day. Secondly, until we are able to modernize our industrial base, I recommend that the government stop any further phase-out of government equipment in the possession of essential suppliers. Even old production facilities "in place" and "on line" will help reduce lead times. This could save valuable time and would help to keep viable many suppliers needed to support our industrial base.

The industrial base does not consist solely of concrete, steel and production facility, but also contains human resources. The truth is that this human technology and management competence has a longer lead time to develop than the replacement of essential facilities. Production facilities alone do not constitute a capability without the human technology, skills and management expertise necessary to employ these facilities.

In view of the financial condition of many defense contractors, particularly in the aircraft industry, it is important for government procurement policies to provide sufficient profits and incentives for defense contractors to improve their productive facilities to the maximum extent possible, thus reducing their reliance on government owned facilities. It would be a mistake, however, to assume that industry can and will provide all the essential facilities required to support mobilization planning requirements. Historically and the economical facts of life tell us that this will not be sufficient in time of need.

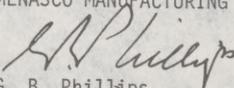
As I said in the beginning, this is a complex problem and my comments only skim the surface. The matter is real and needs attention. In my judgment it is better national policy to spend tax dollars in preparedness efforts, while concurrently creating jobs and developing skills in our work force than to spend similar amounts in "make work" and on welfare expenditures which add nothing to our national security or our gross national product.

I sincerely hope that the hearings and findings of the Committee will result in new government policies which will deal effectively with this timely and complex problem for it is one which requires constant surveillance, if we hope to escape the price again of unpreparedness.

If I can contribute further, please feel free to call on me.

Very truly yours,

MENASCO MANUFACTURING COMPANY


G. B. Phillips
Director of Administration

GBP:dms/25

cc: All members of the Joint Committee on Defense Production
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November 17, 1976

The Honorable William Proxmire
Vice Chairman
Joint Committee on Defense Production
Room A-421, Senate Annex III
Washington, D.C. 20510

Dear Senator Proxmire:

We appreciate your letter of October 19 extending us an invitation to submit a statement to the Joint Committee on Defense Production regarding Profit '76.

We will be represented at the hearings by an observer and then will determine whether the Institute can make a useful contribution to the record. I hope that the hearing record will be available for reading by interested parties in the Committee office without delay after the hearing on this subject is concluded. Even though, as already indicated, we will have a person present during the public hearings, it is always helpful to read the complete record. We realize that some committees follow a practice of not making the record available for examination until after it has been edited by witnesses. In this instance, we hope that an exception to this policy will be made.

As you may recall from prior hearings in which we have participated before various congressional committees, the Institute does have a substantial interest in federal procurement policy. However, our orientation to this important public policy area is primarily from the standpoint of companies which are largely commercial in their focus as distinguished from those companies which devote the great majority of their production to products sold to the federal government or prime contractors.

Respectfully,

Charles Stewart
President

CWS:d

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November 26, 1976

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The Honorable William Proxmire
Vice Chairman
Joint Committee on Defense Production
Room A-421, Senate Annex III
Washington, D.C. 20510

Dear Senator Proxmire:

New Defense Department Profit Policy

This statement is transmitted in response to your letter of October 19 inviting us to present our views on the new profit policy recently announced by the Department of Defense (DOD) in Defense Procurement Circular (DPC) 76-3.

As you know, the Machinery and Allied Products Institute represents the capital goods and allied products industries of the United States. Although the companies in these industries are strongly oriented toward the commercial sector for the most part, many of them have had a substantial and continuing role in providing goods and services for the defense effort at both the prime contract and subcontract levels. Thus, they will be affected both by the new profit policy and the ultimate implications of that new policy on the defense industrial base, a matter which we know is also of concern to the Joint Committee. Our comments on the new policy which follow reflect MAPI staff study and the reaction of member companies to the new policy. They also take into consideration the statements presented by witnesses in the Joint Committee's hearings on this subject.

The new DOD profit policy, as has been noted, is incorporated in DPC 76-3 which transmits changes, effective on October 1, 1976, in the Armed Services Procurement Regulation (ASPR) weighted guidelines which are used to determine "going in" profit objectives in negotiating defense contracts. In general terms, the changes affect the major profit determinants and their relative significance in the weighted guidelines in the following ways: credit for contractor past performance is eliminated; that for contractor effort is reduced; credit for contractor cost risk is increased; and profit recognition is extended to contractor facilities investment. In addition, the cost of such facilities investment, the allocability of which is now provided for in Cost Accounting Standard

No. 414 issued by the CAS Board, is treated as allowable for defense contract purposes. However, DOD has made it clear that the aggregate amount of the allocable cost of facilities is to be offset, in accordance with your letter of May 27 to Secretary Rumsfeld, against DOD prenegotiation profit objectives so that there will be no resulting increase in overall defense contract profits. In essence, DOD has rearranged the profit factors in the weighted guidelines with the primary objective of increasing contractor investment in private facilities, while leaving the total amount of defense contract profits the same presumably on the theory that no increase in aggregate profits is needed.

In our view, the new DOD profit policy, by itself and without more, is not likely to achieve its stated objective of increasing contractor investment in private facilities. But more broadly, we fear that the new policy will do absolutely nothing to increase participation in defense work by companies which have both substantial defense and commercial work and some degree of flexibility between the two. This seems clear to us, as we shall discuss later, from the testimony before this Committee of Brigadier General Stansberry, the Director of "Profit '76," the research effort which led to the new profit policy. In addition, there is no reference in either Deputy Defense Secretary Clements' or General Stansberry's testimony on the significance to this discussion of defense contractors whose business is predominantly commercial and who were not included in the profit-center survey nor of those companies whose participation in defense work is at the subcontract level. This seems somewhat unusual because Jacques Gansler, Deputy Assistant Secretary of Defense for Materiel Acquisition, has testified at these same hearings as to the increasing Defense Department concern over the defense industrial base, and both subcontractors and predominantly commercial prime contractors are an important part of that base.

In sum, we think that the new profit policy will do little toward encouraging defense contractor investment in new facilities, and nothing toward encouraging contractors with viable options between commercial and defense business to maintain or increase their present level of participation in defense business. Indeed, it is our judgment that, given the substantial publicity attending Secretary Clements' announcement of the undertaking of the defense contractor profit study in the spring of 1975 and the widespread expectations within the defense contractor community for improved profitability in defense business, the disappointment of many contractors with how little was accomplished may tend to confirm tentative decisions made prior to Profit '76 to cut down on or completely withdraw from defense business.

At this point, we will deal with Profit '76; our recommendations concerning what we think ought to be done now follow these comments.

Profit '76 and the Contractor Profit-Center Survey

As you know, probably the principal element of the study of defense contractor profits--carried on under the direction of General

Stansberry and named "Profit '76"--was a survey in which contractors were asked to furnish information on relative profitability in terms of both sales and capital investment, by profit centers and product lines, for both their defense and commercial business. The survey covered five years, 1970-1974, and, as we understand it, was to be based on the top 300 prime contractors with DOD, identified in terms of dollar value for 1974, with only those included who had at least \$2,000,000 in negotiated contracts. Approximately 156 companies were asked to participate in the survey, and the survey questionnaires were sent out to 133 companies in the fall of 1975. According to General Stansberry's testimony, responses were received from 76 of these companies but data from only 64 were included within the analysis of profits which constituted the basis of the information and tables to which General Stansberry referred during the course of his testimony.

This means that from a list of 156 contractors from among the 300 largest defense prime contractors for 1974, only 64 (41 percent) were included in the profit analysis. A cursory examination of the companies which did participate indicates an extraordinarily heavy weighting in terms of the 100 largest defense prime contractors; indeed, 36 of the 64 participants were among the 50 largest contractors.

The point we are making here should not be misunderstood. Even if it is assumed that the original sample was adequate, we do not think that the profit analysis should be based upon only 41 percent of that sample. But we are not criticizing companies who, although asked, declined to participate in the profit-center survey. In the light of the difficulties which industry in recent years has had with the product-line surveys conducted by the Federal Trade Commission and also in the light of what we know many of these companies believed to be inadequate assurances from DOD regarding the confidentiality of any profit center product line data submitted, we can understand why some companies chose not to participate. Moreover, there may have been other reasons over which DOD had no control but, whatever the reasons, the ultimate sample was, in our judgment, inadequate.

Beyond this however, we do not think that the original sample was adequate. It was based only on the top 300 defense contractors. There apparently was no representation of contractors with less prime contract work regardless of how important that prime contract work might be to the defense effort. Further, and perhaps even more significantly, no subcontractors were included. The only subcontract data included in the analysis apparently is from subcontract work done by the 64 companies which ultimately participated. We have little doubt that the inclusion of companies under the top 300 or those which are predominantly subcontractors would probably have tended to accentuate the difference between defense and commercial profits, more clearly highlighting the inadequacy of the former.

Overlooking for the moment our objections to the sample used in the analysis, let us look more clearly at the data derived from the survey of the 64 companies. The following table highlights the findings of Profit '76 on profitability for defense and commercial business, and compares it with earlier comparable findings by the General Accounting Office (GAO):

	<u>Percent</u>	
	<u>"Profit '76"</u> <u>(1970-1974)</u>	<u>GAO ¹</u> <u>(1966-1969)</u>
<u>Profit as Percent of Sales</u>		
Defense Contracts	4.7	4.3
Comparable Commercial Business	6.7	9.9
<u>Profit as Percent of Total Capital Investment</u>		
Defense Contracts	13.5	11.2
Comparable Commercial Business	10.7	14.0

Presumably it is the 2.8 percent excess of defense contract profits over those in commercial business, measured as a rate of return on total capital investment, which was the principal reason against increasing contractor profits in the new profit policy. However, General Stansberry's testimony indicates that the crucial figures for "comparable commercial business" were those based on the data from the Federal Trade Commission on 5,000 corporations producing durable goods. The data on profitability for the commercial profit centers of the companies which participated in the Profit '76 profit-center survey were not used as the basis for comparison here. Figure 1 from his testimony indicates that the participating companies earned 4.7 percent, pre-tax, on sales in their government profit centers as distinguished from a rate of 17.1 percent in their commercial profit centers. Measured as a rate of return on total capital investment (less progress and advance payments) these same companies, according to Figure 4, earned 13.5 percent on their business in government profit centers and 17.6 percent on their business in commercial profit centers. Clearly, their rate of return was higher, both on sales and on total capital investment, in their commercial profit centers. It seems evident to us that this marked disparity in the rate of return on either basis is a substantial inducement for these companies to increase participation in commercial business as distinguished from defense business whenever there is a suitable opportunity

1/ Defense Industry Profit Study, Report to the Congress by the Comptroller General of the United States (B-159896), March 17, 1971, pages 15-16.

to do so. And we think that there is nothing in the new profit policy which is likely to change this outlook on relative profitability as between defense and commercial business.

To recap, the sample of defense contractors on which the profit analysis is based is inadequate. It includes only 64 companies heavily weighted toward the 50 largest defense contractors, and includes none either from below the largest 300 DOD prime contractors in 1974 or from those which are exclusively or primarily subcontractors. Even within this inadequate sample, the profit rate on sales from commercial centers, measured either as a rate of return on sales or a rate of return on total capital investment, significantly exceeds their profits on their defense profit centers.

There is nothing in the new profit policy which is likely to encourage any company engaged in defense business--those who participated in the profit-center survey as well as those who did not--to increase or perhaps even maintain their current level of participation in such business. Further, to the extent that the new profit policy represents a completely ineffective response to the problem of shrinking defense contract profits, we think it may act to discourage continued participation in defense work.

Recommendations as to DOD Profit Policy

At this point, we include our basic recommendations concerning what we believe government should do with respect to profit policy for the purposes of maintaining an adequate defense industrial base.

Contractor Effort--Research and Development

The restructured weighted guidelines included in DPC 76-3 have diminished the proportionate weighting for "Contractor Effort" as a profit element from 65 percent of profit to 50 percent. This, in our judgment, creates a serious problem for those contractors which are primarily research and development firms and whose capital is primarily in the brains of its employees rather than the value of its physical facilities. These firms are no different from other defense contractors in having profit problems at the present time and it would appear that, since their R&D work is recognized as a part of their contractor effort, their profitability is likely to decline under the new profit policy. Accordingly, we urge that the weighted guidelines, whether through retention of the former weighting for "Contractor Effort" or through some new and express recognition of R&D effort, be revised so as to preclude a reduction in the profit weighting for R&D work.

Cost Allowability for
Operating Capital

Cost allowability should be extended to operating capital employed in defense contracts as well as facilities capital so employed. Since cost allowability has now been extended to facilities capital, we think that in logic and justice the same treatment should be accorded operating capital. We realize that the CAS Board has not as yet established a Cost Accounting Standard which would establish the criteria for the allocability of operating capital for defense contracts as it has done with respect to facilities capital. But there is little reason why the lack of prior CAS Board action should inhibit DOD from taking the initial step of establishing the principle of allowability for operating capital. Indeed, we think that there may be an increasing tendency for DOD policy makers to defer completely to the CAS Board in areas where DOD has the legal authority to make policy on its own. It should be pointed out that such a tendency may now be more pronounced since, as we understand it, neither DOD nor any other Executive Branch department or agency is represented by membership on the CAS Board. We acknowledge that this is due to a resignation and assume that the place will be filled.

With respect to the cost allowability of operating capital, in our view there is a growing need to encourage contractors to invest additional capital--in all forms--in their defense work. Moreover, if contractors devote greater amounts of operating capital to their defense work, it will lessen the need for guaranteed loans, higher rates of advance payments and progress payments, and other forms of financial assistance provided by the government under the defense contract financing regulations.

New Capital Cost Allowances Should
Not Be Offset Against Profits

Frankly, we think that your recommendation to Secretary Rumsfeld that any new cost allowances for contractor capital investment should be offset against profits, was in error because it reflected a misunderstanding of the current need to increase defense contract profits. We urge that DOD be permitted to remove any profit offset for the cost of facilities capital, and that it not be required to offset against profits what we hope will be a new cost allowance for operating capital. To remove the offsets for any such new cost allowances would at least allow a perceptible increase in contractor profits at this point. Whether this increase would ultimately prove to be adequate will have to be determined in the future but, at least, it would be a start in the direction of recognizing the inadequacy of contractor profits in relation to the problem of establishing and maintaining a defense industrial base sufficient to the needs of national security.

In our view, as we have already indicated, the profit-center survey of defense contractors in Profit '76 clearly indicates that profits on defense business are inadequate as compared to profits on commercial

business. We think that it is imperative that prompt action be taken to redress this inadequacy in defense contract profits.

Indeed, an element of Profit '76, a study entitled The Defense Industry: Some Prospectives From the Financial Community by The Conference Board, recently became available. This Conference Board study makes it clear that defense contractor profits, as seen by executives in major commercial banks, life insurance companies, investment banking firms, rating services, and a public accounting firm, "are too low for the risks defense contractors face and for their long-term viability." This perception by the financial community as to the inadequacy of defense contract profits is, of course, basic to the difficulty which defense contractors typically have in obtaining outside funds. Apparently it was disregarded in the DOD decision in DPC 76-3 that defense contractor profits need not be increased.

Other Aspects of Government Policy,
Including Renegotiation, Should
Recognize Inadequacy of Defense
Contract Profits

Even if DOD's profit policy finally should be revised in such a way as to increase defense contract profits, we think it is imperative that the Congress and other agencies of the government recognize the importance of having other statutes, regulations, policies, and the like, conform to the decision that such profits should be increased in the interest of maintaining a defense industrial base necessary for national security. This recommendation, for example, should extend to the question of further extension of the Renegotiation Act which expired on September 30 and presumably will be one of the first items of business in the 95th Congress after it convenes in January. As you know, the proposed extension of the Renegotiation Act passed by the House earlier this year would not only make the renegotiation process permanent in nature, but it would also require renegotiation to be conducted on a product-line basis and it would severely restrict the availability of the exemption for standard commercial articles. Further extension of renegotiation, particularly along the lines of the legislation approved by the House, is obviously inconsistent with any basic policy decision to improve defense contract profits.

Conclusion

What our recommendations ultimately come down to is this. The fundamental problem posed for our national security is the maintenance of an adequate defense industrial base, a matter that is of very special concern to you and this Committee since it lies squarely within your jurisdiction. It seems evident to us that one of the major problems with respect to maintaining the base is the persistent inadequacy of defense contractor profits, a point which we think is reasonably documented by Profit '76 and earlier studies on the same subject. The time for new

and additional profit studies is now past; prompt action should now be undertaken to increase defense contract profits and to make sure that other governmental policies conform to this basic decision. Further, we trust that as this vital subject is given further consideration throughout government--and as the implications of the shrinking defense production base become more apparent--the "politics" of the contractor profits issue will be defused.

This completes our recommendations on the new DOD profit policy embodied in DPC 76-3. If we can be of any further assistance in connection with the Joint Committee's work in this area, please let us know.

Respectfully,

Charles Stewart

P r e s i d e n t

Hazeltine

Corporation

Greenlawn, N.Y. 11740 (516) 261-7000

David Westermann
President

November 4, 1976
Serial XXX-76-CM219

The Honorable William Proxmire, Vice Chairman
Joint Committee on Defense Production
United States Congress, Room A-421
Senate Annex 111
Washington, D. C. 20510

Dear Senator Proxmire:

Reference is made to your letter dated October 19, 1976, addressed to the National Security Industrial Association in which it is indicated that your committee would welcome a statement from any NSIA member with respect to the profit policy changes recently announced by the Department of Defense, growing out of the Department's study called "Profit 76."

Hazeltine believes that the initiative of the Department of Defense in undertaking the Profit 76 study is to be commended. Hazeltine believes that the problem of whether the defense of the United States is to continue to be affordable is closely related to issues which affect expectable return on capital employed in the defense industry.

Hazeltine is, of course, concerned with the profit margin on selling price which is permitted to be negotiated under defense procurement conditions and practices, such as the profit factors involved in determinations under so called "weighted guidelines." Looking at margin or profit in this aspect, Hazeltine believes it important to at least maintain or raise overall profit rates. We are concerned that the revised profit policy may not maintain or increase overall negotiated profit rates, and that proposed shifts in

the weighted guideline factors will not meet all of the objectives of the Government with respect to incentive to industry to invest in higher productivity capacity. We believe that those points will be dealt with in other responses that you will receive.

With respect to profit margin, we consider it of greater importance to establish Government procurement conditions and practices under which all proper costs of a defense contractor are in fact recoverable.

We also believe it of great importance to recognize that return on capital employed to the defense contractor is affected not only by the actual realizable profit margin on selling price, after proper allowance of real costs, but is equally affected by the opportunity for capital turnover afforded the contractor. For example, defense contractors can be expected to invest in expectation of a profit margin on defense business somewhat lower than some other businesses, because of the progress payment policy in defense procurement, which helps contractors achieve high turnover. It is also important, however, that Government procurement conditions and practice not interfere with the contractor's opportunity for efficiency, because by efficiency in management the effective contractor can also significantly help his capital turnover.

Beyond those points, we would like to make two specific additional comments which are of high importance to Hazeltine as a small-to-medium-size, high technology, defense contractor, which we believe makes an effective contribution to the defense through its highly competitive pursuit of business based on the effective advance of defense technology:

- (1) The Profit 76 study, and resulting proposed

policy, seem to be directed at improving incentives to invest in new, or modernized, or improved capital facilities. Hazeltine believes that the focus of attention should be equally or even primarily upon conditions that are incentives, or disincentives, to industry to advance technology to make weapon systems more effective, more reliable, more maintainable, less costly because of less expensive designs and higher productivity, and characterized by longer life cycles. This should be done primarily by encouraging competition. Competition should be encouraged by the establishment and maintenance of government procurement conditions under which competition is fair, open, and free of government interference. Conditions established by statute, or regulation, or government practice, should be such that the direction, and expenditure level, of industry independent research and development is determined by the individual industrial enterprise and controlled by its evaluation of the forces of competition. That is, if it does not do enough independent research and development, reasonably related to government requirements, its business will deteriorate; and if it spends too much, those costs charged into the prices of its current products will cause those prices to be non-competitive. The direction and level of expenditures for such independent research and development should not be constrained by bureaucratic controls, or by ceilings established by government. This is our view as to the national interest in an affordable defense.

(2) Those involved with Profit 76 have, according to our understanding, properly given attention to the fact that in the defense industry a proposed company investment must be evaluated, not only from the standpoint of forecast level of profit return, but also from the standpoint of risk of contract termination for the convenience of the government. However, it is our view that a weapon system program, significant to a particular company in the light of its capital

investment or investment in the advance of technology, can be discontinued in circumstances which often do not involve the termination of an existing contract. For example, an expected follow-on contract may not be procured. That may be because the weapon system has become technologically obsolete, or is no longer required to meet expected military situations, or for political reasons such as budget or force level cutbacks. To some extent, the Nation cannot expect to eliminate that type of program discontinuance, although protection of the investing contractor might be worked out in the same way as protection for a contractor whose current contract is terminated for convenience.

The weapon system program of a particular contractor may also be discontinued because it fails to win a follow-up contract in competition, either in a negotiated procurement or in an advertised procurement. If that competition is free, fair, open and free of government interference, and the other bidders are really responsible, that risk should be accepted by industry in a free enterprise society, and it should be accepted if a more effective competitor takes over the program. However, that is not the case where the competition is not free, fair and open.

In our opinion, the pervasive practice of so-called "best and final offer parallel negotiations", in negotiated procurements, is not consistent with fair and open competition, free of improper government interference. The "best and final offer" practice is conducted in military procurement under Armed Services Procurement Regulations 3-805.1, .2 and .3, which are a purported implementation of certain language in 10 U.S. Code Annotated Section 2304(G).

A fair reading of the language of the regulations which covers discussions with responsible offerors who are "within the competitive range," with such discussion being held "in parallel," shows that it is not reasonable to expect the

practice to be fair, to be free of price leaks to competitors, or to be free of technological transfers in which innovative ideas from the low cost, best technology, most effective competitors are handed to less effective competitors.

As a result of these, a bidder may promise to use a technology which is not his, at a cost which he may not be able to meet, in the hope that his "buy in" may be resolved later in a "bailout" at the expense of the government.

It of course can be argued that in any instant procurement situation the government gets the best bargain by that type of practice. It is submitted that such bargains may not be real even in the immediate sense when the less effective competitor is helped to "buy in".

But as compared with "immediate bargain," it is submitted that there is a much greater loss to the government in the defeat of its long-run interest in the integrity of government procurement.

The matter appears to have been given some realistic attention in the drafting of Title III of the proposed Federal Acquisition Act of 1976 (S. 3005), called The Chiles Bill.

From the standpoint of the objectives of Profit 76 and the proposed policy, it would be our view that it would be of the highest importance to immediately and totally eliminate the practice of "best and final offer parallel negotiations," which so often defeat the legitimate expectations of the effective high technology competitor.

We submit that it is urgent and vital to the integrity of defense procurement based on free and open competition that the statute and the regulations be amended

sharply and decisively, on ethical principles, so as not to require parallel discussions with all those in the competitive range, and not to require that all bidders in the competitive range be permitted to revise their bids, and to affirmatively require that the representatives of the government in any negotiated procurement make every effort to conclude a contract, in the best interest of the government, in the reasonable judgment of the contracting officer, with the responsive and responsible bidder whose bid is lowest, or most advantageous to the government in accordance with the request for proposal, in the first instance, and, pending that effort, abstain from negotiation and discussion on that matter with other bidders.

We again wish to state that we believe the efforts in the Profit 76 study have been highly professional, and highly commendable, and our suggestions for additional considerations on these major points are not intended to imply any criticism.

We also wish to express our appreciation for your interest in affording us an opportunity to express our views on these matters which are so important to this Company as a small to medium-sized, high technology, highly competitive corporate member of the defense mobilization base.

Sincerely,



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AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

1725 DE SALES STREET, N.W., WASHINGTON, D. C. 20036 TEL. 347-2315

OFFICE OF THE PRESIDENT

November 24, 1976

The Honorable William Proxmire
Vice Chairman
Joint Committee on Defense Production
Room A-421, Senate Annex 111
Washington, D. C. 20510

Dear Mr. Vice Chairman:

Pursuant to your invitation of October 19, 1976, a statement by the Aerospace Industries Association concerning the Department of Defense Profit '76 Study is enclosed for the record of the recently concluded hearings on this subject. Thank you for the opportunity to comment.

Yours very truly,

S. L. Wright
for Karl G. Harr, Jr.

Enclosure (3 copies)

STATEMENT
OF
AEROSPACE INDUSTRIES ASSOCIATION
OF AMERICA, INC.
FOR THE RECORD OF HEARINGS
ON
THE DEPARTMENT OF DEFENSE
PROFIT '76 STUDY
PRESENTED TO
THE JOINT COMMITTEE ON DEFENSE PRODUCTION
U. S. CONGRESS

November 26, 1976

The Aerospace Industries Association of America, Inc. (AIA) is the national trade association representing the major manufacturers of aeronautical and astronautical vehicles, both manned and unmanned, as well as the power plants and components thereof.

We are pleased to accept the invitation of the Committee Vice Chairman to present a statement on Profit '76 for insertion in the record of the hearings of November 17, 1976, on the subject of the Profit '76 Study and Revised Weighted Guidelines for Negotiating Profits and Fees.

Profit '76 reflects a decision we endorse: recognition of the cost of facilities capital. It also reflects a decision we deem ill-advised: reduction of profit levels to offset the newly recognized costs. Before addressing these specific actions, however, we propose to view Profit '76 within the framework of one of the fundamental problems facing all of American industry, that of capital formation. Put in simplest terms, the problem is how and from where to raise the money needed to maintain and expand productive capacity, namely machinery, tooling, plant and equipment. This problem is of particular concern to the civilian and defense

segments of the aerospace manufacturing industry. Substantial capital is needed to maintain a competitive technological position in the world in civil as well as national security areas. Our industry faces particular difficulties with respect to obtaining funds from any of the four principal sources of capital: equity, debt, depreciation or profits.

A report issued by the Conference Board as part of Profit '76 ("The Defense Industry -- Some Perspectives from the Financial Community") addresses these four sources, especially the first two, equity and debt. On the basis of comprehensive interviews with 56 financial institution executives, the Conference Board concludes that, "Defense contractors are perceived as less attractive risks...." Earlier studies conducted in 1968 by the Logistics Management Institute for the Department of Defense and in 1971 by the Comptroller General of the United States at the request of the Congress demonstrate that profits as a percent of sales were significantly lower on defense work than on comparable commercial work. The Profit '76 Study draws the same conclusion. Although these studies show that rate of return on invested capital for defense work is comparable with, or perhaps somewhat higher than, equivalent commercial business, this factor is not sufficiently compelling to investors who view defense companies as a less attractive option in deciding where to invest or lend money. The unattractiveness of defense business is also indicated by a DOD study which shows that defense business as a percentage of total business of the top 25 defense contractors has declined from 17 percent in 1968 to 14 percent in 1970 to 11 percent in 1973 and to 10 percent in 1975. It is manifest, therefore, that the aerospace/defense industry faces and will continue to face significant problems in pursuing capital formation via equity

or debt.

Current difficulties with depreciation, the third source of capital, are expressed in a recent study conducted by Dr. Klaus P. Heiss, Econ Incorporated, for AIA. The study indicates that depreciation costs in the aerospace industry for the decade of 1965 through 1974 were understated by \$1.1 billion and corporate income taxes overstated by \$540 million due to the difference between the nominal depreciation based on original costs and real depreciation based on replacement costs adjusted for the effect of inflation. The report concludes that the need for investment capital for U. S. industry, and in particular the aerospace industry, may present a problem of greater dimensions than the energy shortage.

The depreciation problem is compounded by Cost Accounting Standard (CAS) 409 -- Depreciation of Tangible Capital Assets, which will eventually result in a stretchout of the depreciation charges allocated to Government work, thus adversely delaying recovery of costs and affecting cash flows.

The potentially adverse impact of CAS 409 on industry was of such deep concern that industry sought and was granted hearings by cognizant Congressional committees, namely the Subcommittee on Production and Stabilization of the Senate Committee on Banking, Housing and Urban Affairs and the Subcommittee on Economic Stabilization of the House Committee on Banking, Currency and Housing, on the question of whether CAS 409 should be rejected by the Congress. At those hearings, the Chairman of the Cost Accounting Standards Board stated that the impact of CAS 409 would be ameliorated by the issuance of Standards on the Cost of Capital and Inflation. Both of these Standards were to be developed on a priority basis; promulgation was expected within months. The first of these Standards was intended to promote recognition of the cost of

all capital requirements; the second to address the problem that asset replacement costs, pushed by inflation, are growing much more rapidly than the recovery of funds via depreciation.

A draft Cost of Capital Standard was published for comment; prior to promulgation (as CAS 414), the CAS Board narrowed the Standard so as to cover only the cost of facilities capital (excluding operating capital). After preliminary work on a Standard on Inflation, that project has been set aside. Thus, only a fraction of the promised compensating amelioration of CAS 409 has materialized and most of the problems which preclude appropriate depreciation recoveries remain.

Turning to the fourth source of capital, profits, we were disappointed that the principal thrust of Profit '76 turned out to be a decision to lower profit objectives to offset the newly recognized costs. Profit '76 had been expected first to address the question of whether or not current profit levels were adequate and then to revise policies accordingly. Those inside the defense industry -- not surprisingly -- view present profit levels as too low. However, as previously noted, there are also strong indications from outside of the defense industry, i.e., from the financial community, that present defense industry profits are inadequate.

Profit '76 has been implemented in the Armed Services Procurement Regulation (ASPR) by a revision (Defense Procurement Circular 76-3) to the Weighted Guidelines (ASPR 3-808) which are used by contracting officers in establishing pre-negotiation profit objectives for negotiated contracts. The revision changes some of the factors considered in determining profit objectives and changes the weightings of some of the factors carried over from the prior system. Contractor past performance has been deleted as a profit consideration. The

weight given contractor assumption of risk and investment in production facilities has increased and the weight given cost input to performance decreased. The revisions are structured to specifically offset the allowability of facilities capital cost in order to maintain an overall before taxes profit rate on sales of 4.7 percent. Also, the revised Weighted Guidelines do not consider other forms of contractor investment such as expenditures to develop and improve high technology capabilities; therefore, there is some question as to whether the new Guidelines will prove equitable in contracts involving complex high technology products and services.

The implied conclusion of Profit '76 is that current overall profits are appropriate but that a redistribution of those profits is desired. DOD data indicate that a leveling of earnings rates between industries is expected to result from the new policies, e.g., shipbuilders (with "before" earnings approximating 2.9% of sales) are expected to experience a 1.7% profit increase; while aircraft manufacturers (with "before" earnings approximating 3.7%) are expected to experience 0.4% decrease. Further, the deletion of past performance as a consideration in profit negotiations eliminates profit rewards for past excellence -- and penalties for past deficiencies. This will tend to level earnings between the individual members of given industries. Policies which level earnings both between segments of the defense industry and between the members of individual industries can, in the long run, weaken the defense base by eroding long term incentives for excellence and denying potential investors the possibility of above-average returns.

In summary, the Profit '76 decision to recognize a part of the cost of capital as an allowable cost is one which AIA endorses. We are concerned,

however, with the implied conclusion of Profit '76 that current defense industry earnings rates are adequate; and we are also concerned with actions which, deliberately or inadvertently, tend to level earnings. Believing that these concerns will also be shared by the financial community, we see no present reason to believe that policy revisions stemming from Profit '76 will be of assistance in solving the capital formation problem of the aerospace/defense industry.

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