

July 2001

CONTRACT MANAGEMENT

DOD's Profit Policy Provision to Stimulate Innovation Needs Clarification



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United States General Accounting Office
Washington, DC 20548

July 26, 2001

The Honorable Tom Harkin
United States Senate

Dear Senator Harkin:

In negotiating profit on contracts, the Department of Defense (DOD) requires contracting officers to set negotiating objectives by relying on guidelines contained in defense regulations. Congress mandated in the National Defense Authorization Act for Fiscal Year 2000 (P.L. 106-65, Oct. 5, 1999) that DOD review its profit guidelines and consider whether modifying those guidelines would provide an increased incentive for contractors to develop and produce complex and innovative new technologies for weapon systems. After completing its review, DOD issued a final rule in December 2000 that added a technology incentive to its guidelines for setting profit objectives on negotiated defense contracts. At your request, we reviewed DOD's change to its profit policy to determine whether the new policy is (1) likely to achieve its intended objective of stimulating increased innovation and (2) consistent with its revised policies for acquiring weapon systems.

Results in Brief

Although the rule is new and has not yet been widely used, the new profit policy may have limited effect on incentivizing additional innovation for two reasons. First, the policy has limited reach during research and development when technology innovation is a high priority. Most research and development contracts either do not fall under the profit guidelines containing the incentive or are appropriately excluded from the incentive. Second, the rule does not provide adequate guidance on when to apply the incentive. And the definition of innovation is so broad that it could be interpreted to apply to almost any program with more demanding performance characteristics than the system being replaced. This creates a risk that contractors may be paid more for their current level of innovation and may not reach for the technology incentive's additional profit dollars by introducing new, significant technological innovation.

The new profit policy may not reinforce DOD's emphasis on technology maturity in its revised guidance on the system acquisition process.¹ The linkage between the technology incentive and the new system acquisition process is unclear. The technology incentive encourages innovation while the acquisition process stresses technology maturity. This sends mixed signals to contractors and DOD's own contracting and program management staff about when innovation should be rewarded.

We are recommending that DOD clarify the definition of innovation used in the new profit policy and define the policy's relationship to DOD's new acquisition process. DOD stated it will re-examine the types of innovation that may be rewarded with the technology incentive to determine if they can be stated more clearly. However, DOD disagreed with the need to define the relationship between the new profit policy and DOD's new acquisition process, saying that the two policies are not inconsistent. We believe the potential for conflict exists if clear guidance is not provided to support implementation. The best way to minimize the potential for conflict is to articulate the relationship between these two policies in the profit policy regulation.

Background

DOD contracting officers use a structured approach called the Weighted Guidelines Method to develop profit objectives for use in contract negotiations.² Using these profit guidelines, contracting officers address a contractor's (1) risk in fulfilling the contract requirements, known as performance risk; (2) degree of cost risk because of the type of contract (e.g., fixed-price versus cost contract); and (3) investment in facilities that benefit DOD. Prior to the profit policy change, the performance risk factor consisted of three elements:

- Technical—the technical uncertainties of performance.
- Management—the degree of management effort necessary to ensure that contract requirements are met.
- Cost control—the contractor's efforts to reduce and control costs.

¹ This guidance is in DOD Directive 5000.1, DOD Instruction 5000.2, and DOD Regulation 5000.2-R.

² Generally, these guidelines would be used in negotiating sole source contracts, where price is negotiated using certified cost or pricing data. Cost or pricing data means all facts that prudent buyers and sellers would reasonably expect to affect price negotiations significantly.

In the National Defense Authorization Act for Fiscal Year 2000, Congress included provisions to stimulate technical innovation in military research and development. Section 813 required DOD to review its profit guidelines to consider whether modifications to the guidelines—such as placing increased emphasis on technical risk as a factor for determining appropriate profit margins—would provide an incentive for contractors to develop and produce complex and innovative new technologies. After completing its review, DOD reported to Congress that it planned to make two changes to the guidelines.

As shown in table 1, the first change was to increase the weight contracting officers would likely assign to technical risk by reducing performance risk from three to two elements. The second was to add a special incentive for contractors that propose significant technological innovation. Using the technology incentive, contracting officers can assign a profit range of 6 to 10 percent for the technical element instead of the standard range of 2 to 6 percent. On December 13, 2000, DOD published a final rule in the Federal Register to implement the two changes. (Appendix I presents an example of the application of the incentive to a contract.)

Table 1: Changes in Profit Policy

Before		After	
Performance risk element	Profit range	Performance risk element	Profit range
Technical	Standard range ^a of 2-6 percent	Technical	Standard range of 2-6 percent Technology incentive range of 6-10 percent
Management	Standard range of 2-6 percent	Management/cost control	Standard range of 2-6 percent
Cost control	Standard range of 2-6 percent		

^aThe standard range is used to price most contracts.

Source: Defense Federal Acquisition Regulation Supplement.

During the same time period, DOD sought to realize the benefits of best commercial practices³ by revising its policies that guide the system

³ Commercial best practices are discussed in several GAO reports: *Defense Acquisition: Employing Best Practices Can Shape Better Weapon System Decisions* (GAO/T-NSIAD-00-137, Apr. 26, 2000); *Best Practices: Better Management of Technology Development Can Improve Weapon System Outcomes* (GAO/NSIAD-99-162, July 30, 1999); *Best Practices: Successful Application to Weapon Acquisitions Requires Changes in DOD's Environment* (GAO/NSIAD-98-56, Feb. 24, 1998).

acquisition process. The result was a new system acquisition life cycle⁴ that separates technology development and system development. The technology development phase generally begins with paper studies of alternative technology concepts for meeting a mission (concept exploration) and ends with the demonstration of component technology in a relevant environment to reduce the risk of integrating the components or subsystems into a full system (component advanced development). A program is usually initiated at the beginning of system development, at which point the system's technology should be mature. During system development and demonstration, the subsystems and components are integrated into the system, the design is stabilized, and the system is demonstrated in a realistic environment. The system then enters low-rate initial production, during which the manufacturing capability is established. By the time the system reaches full-rate production, the technology should be mature, the design stable, and the manufacturing processes established.

Technology Incentive May Not Achieve Intended Objective

Incentive Has Limited Reach Where Innovation Is a High Priority

The profit guidelines containing the technology incentive do not apply to most research and development contracts and, therefore, the incentive has limited reach in the phases of DOD's acquisition cycle where technology innovation is expected to be high. Many contracts awarded in these high innovation phases have technical reports as contract deliverables, and these are appropriately excluded from the incentive. The profit guidelines containing the incentive do not apply to contracts awarded with competition, which is commonly the case for research and development

⁴ DOD's system acquisition process begins when technology concepts are still in research and development. During the process, technologies, designs, and manufacturing processes are established and matured, and a system is ultimately produced, deployed, sustained, and eventually retired. This process is referred to as the system acquisition life cycle.

contracts. Also, contracting officers already have available another mechanism—award fees⁵—to reward innovation.

Table 2 shows the expected level of innovation and the typical contract deliverable for each phase of DOD’s system acquisition cycle. It also shows what type of profit (fixed/incentive fee versus award fee) is used to reward contractors during each phase—the profit guidelines only apply to fixed/incentive fee contracts. For fixed/incentive fee contracts, the percentage and dollar value of awards made without competition is shown—the profit guidelines only apply to these awards. The table shows that the guidelines (and therefore the technology incentive) do not apply to many contracts in early research and development where innovation is a priority.

Table 2: Innovation, Deliverables, and Profit Method in Acquisition Cycle

Phase	Innovation	Typical contract deliverable	Type of profit and percent of dollars awarded in phase (fiscal year 2000)	Percent and dollar value of fixed/incentive fee awards without competition ^a (fiscal year 2000)	
				Percent	Dollars
Concept exploration	High	Paper	Fixed/incentive fee 40 Award fee 46 Unknown ^b 14	26	\$0.5 billion
Component advanced development	High	Hardware	Fixed/incentive fee 48 ^c Award fee 48 ^c Unknown ^b 4 ^c	57	\$2.3 billion
System development & demonstration	High	Hardware	Fixed/incentive fee 88 Award fee 5 Unknown ^b 7	60	\$32.0 billion
Low-rate initial production	Moderate	Hardware			
Full-rate production & deployment	Low	Hardware			

^aThe dollar values represent an estimate of the value of contracts to which the profit guidelines apply.

^bThe specific type of fee could not be determined from information in DOD’s contracting database (DD350).

^cSome of the contract funds in this category were used to conduct initial operational test and evaluation and live fire test and evaluation, which normally occur during low-rate initial production.

Sources: DOD acquisition officials and DOD’s fiscal year 2000 contracting database (DD350).

⁵ Profit can take the form of fixed fees, incentive fees, or award fees. Fixed fees are negotiated and fixed at the time of contract award and are not subject to change regardless of a contractor’s performance. Incentive fees are adjusted throughout contract performance based on the extent to which the contractor achieves cost or performance targets set at contract award. Award fees are earned based upon a government panel’s periodic assessment of the contractor’s performance against qualitative evaluation criteria.

The profit policy excludes many contracts awarded during technology development (concept exploration and component advanced development). Concept exploration commonly consists of paper studies of alternative concepts for meeting a mission and, therefore, contracts generally have a technical report as their primary deliverable. The technology incentive range does not apply to efforts restricted to studies, analyses, or demonstrations that have a technical report as their primary contract deliverable. Technical reports were excluded from coverage because these efforts do not involve the risk inherent in producing and fielding weapon system hardware.

Technology development contracts are typically awarded through competition. DOD's profit guidelines do not apply to competitively awarded contracts because price reasonableness is established through price competition rather than through use of the guidelines.

Contracting officers have available another contracting mechanism—award fees—to reward innovation in research and development. Award fees are used to motivate contractor performance in those areas critical to program success, such as technical, logistics support, cost, and schedule. Contracting officers can use the award fee to encourage contractors to develop innovative new technologies by including these objectives in the criteria for evaluating how much of the award fee the contractor has earned.

Rule Does Not Provide Clear Guidance for Applying Technology Incentive

The definition contained in the policy guidelines of what qualifies for the technology incentive is so broad that it could be applied to almost any contract with enhanced system performance. Our discussions with contracting officials indicate that there is confusion over how and for how long the incentive should be applied. This confusion may lead to inconsistent and possibly inappropriate application of the incentive and could result in contractors being paid more profit for their current level of innovation, not for the intended new technological innovations that significantly enhance performance, improve reliability, or reduce costs.

The rule states that contracting officers may use the technology incentive range when a contractor proposes to develop, produce, or apply innovative new technologies during contract performance. It further states that contracting officers are to use the incentive only for the most innovative efforts. The rule defines innovation as

- “Development or application of new technology that fundamentally changes the characteristics of an existing product or system and that

results in increased technical performance, improved reliability, or reduced costs; or

- New products or systems that contain significant technological advances over the products or systems they are replacing.”

Although the rule describes in broad terms when the application of the incentive is appropriate, it leaves many questions unanswered in defining key terms. For example, how “new” must a technology be to qualify? Does “new” mean it is just out of the laboratory and has never been used before on any system, or does it refer to a recently developed technology that has been used on other products but not on the product in question? Should the incentive apply to demonstrated technology or to the promise to develop technology? And if a contractor is awarded additional profit for developing, producing, or applying new innovative technology, when should the reward stop? Should it apply only to the immediate contract, or should a contractor receive the reward throughout some portion of production contracts? By the same token, what measures are to be applied in determining whether a technological advance is “significant” or whether new technology “fundamentally changes” a product or system? Without this information, the rule could be interpreted so that the incentive could apply to almost any program with more demanding performance characteristics than the system being replaced.

Although, at the time of our review, the new rule had not been widely used, we discussed with agency officials the circumstances under which they might apply the technology incentive. Air Force, Army, and Navy officials agreed that the technology incentive could apply to both research and development and production contracts, but they did not interpret the rule’s guidance on when to apply the incentive in the same manner. For example, officials at two Air Force program offices judged that upgrades to their systems that included state-of-the-art technology used on other products would not qualify for the technology incentive, but those at an Army office said that similar applications of state-of-the-art technology to their system would qualify. In fact, contracting officials at two Army program offices told us that all weapon systems at their buying command incorporated state-of-the-art, leading edge technology and would, therefore, qualify for the incentive. On the other hand, officials for one Air Force system did not believe a future upgrade to their system that may incorporate brand-new technology developed by another military service would qualify for the incentive because the other service would have developed the new technology. Finally, the contracting officer for a Navy system that incorporated brand-new, never-before-used, technology that allowed the system to exceed performance requirements stated that the

system would qualify for the incentive. These examples point to potential confusion over how the rule’s broad definition of technological innovation should be applied.

The officials were also uncertain about how long a contractor should be rewarded with the technology incentive for significant, new innovative technology introduced in the research and development phases of the acquisition process. For example, a procurement official for an Army system currently in the latter stages of research and development stated that the system may qualify for the incentive during production, depending on how the language in the rule is interpreted. A technical official for this system at first stated that, hopefully, innovation and risk would be finished before the system enters production, and therefore, the system would not qualify for the incentive at that point. But, after reading the language in the rule (“New products or systems that contain significant technological advances over the products or systems they are replacing”), he said the system may qualify after all. Also, technical officials for the Navy system discussed previously did not disagree with the contracting officer that the system, with new technology that enhanced performance, would qualify for the incentive. However, they stated that, in general, the technology incentive should be awarded during research and development because, by low-rate production, the technology should be set, and, during production, the emphasis should be on making manufacturing processes more efficient and reducing costs.

Relationship of Profit Policy to DOD’s Revised Acquisition Policies Is Not Defined

The new profit guidelines do not identify how the incentive relates to the revised policies that guide DOD’s system acquisition process. The new acquisition process emphasizes technology maturity before committing to a program to reduce its risk, but the profit guidelines reward contractors with additional profit for introducing new technology, sending mixed signals about the relative importance of innovation and technology maturity. The new profit policy could be interpreted in such a way as to be inconsistent with the new acquisition process.

In DOD’s traditional system acquisition process, program managers matured a system’s technology throughout the weapon system phases, resulting in a system that cost significantly more, took longer to produce, and delivered less than was promised. A new weapon system was encouraged to possess performance features that significantly distinguished it from other systems. Consequently, the acquisition environment led DOD program managers to promote performance features and design characteristics that relied on immature technologies. Managers were also subject to the pressures of successfully competing for

the funds to start and sustain a DOD acquisition program. This encouraged managers to launch product developments with more technical unknowns and less knowledge about performance and production risks than best commercial practices dictate. These managers relied on attaining technology, design, and manufacturing knowledge concurrently—in the higher cost environment of product development—throughout the weapon system phases.⁶

In keeping with best commercial practices, DOD adopted a new system acquisition approach in which key acquisition and long-term funding commitments are discouraged until technology is mature and risks are far better understood than under the traditional process. DOD's new system acquisition life cycle separates technology development from system development. A system's technology should be mature and demonstrated before a program is initiated and system development begins. According to DOD Instruction 5000.2, "entrance into System Development and Demonstration is dependent on three things: technology (including software) maturity, validated requirements, and funding. Unless some other factor is overriding in its impact, the maturity of the technology will determine the path to be followed." When the system goes into full-rate production, the technology should be mature, the design stable, and the manufacturing processes established.

The technology incentive is not tied to the new acquisition cycle, and the profit policy does not address technology maturation and risk reduction, which are central to DOD's revised acquisition policies. The revised acquisition policies stress that technology be mature and demonstrated before it is integrated into a system. But, the profit policy does not discuss when in the acquisition cycle innovative technologies should be rewarded with higher profits. Nor does the profit policy address if or when contractor efforts to mature innovations should be rewarded through use of the technology incentive. As a result, the risk is created that the two policies will work against each other rather than reinforce each other.

Conclusions

The new profit policy may reward contractors for existing levels of innovation rather than incentivize additional innovation. The definition of innovation contained in the rule is overly broad and covers all programs that improve performance over systems that are being replaced—the very

⁶ For a fuller discussion of this issue, see *Best Practices: Better Management of Technology Development Can Improve Weapon System Outcomes* (GAO/NSIAD-99-162, July 30, 1999).

reason for having a program in the first place. Moreover, the rule is silent on several issues, including how long contractors should be rewarded for significant innovation. And the relationship of the profit policy to the acquisition process is not addressed, sending mixed signals to contractors and contracting officials as to the relative importance of technology innovation and technology maturation at different points in the acquisition cycle.

Recommendations for Executive Action

To assure that the technology incentive is appropriately interpreted and applied, we recommend that the Secretary of Defense

- clarify the definition of innovation contained in the profit policy rule;
- define how long contractors should be rewarded for innovations introduced during research and development phases; and
- reconcile the relationship of the technology incentive with DOD's new acquisition process, including the emphasis on technology maturation.

Agency Comments and Our Evaluation

In written comments on a draft of this report, DOD partially concurred with the first recommendation that it clarify the definition of innovation contained in the profit policy rule. DOD stated that it would examine how the policy is being used after it has been in place for a year and, at that time, determine if the types of innovation that may be rewarded with the technology incentive factor can be stated more clearly.

DOD partially concurred with our second recommendation that it define how long contractors should be rewarded for innovations introduced during research and development phases. DOD stated that, after the policy has been in place for a year, it will re-examine the regulations to determine if there are relevant factors that can be provided for contracting officers to consider in making this judgment.

DOD disagreed with our recommendation that it reconcile the relationship of the technology incentive to the new acquisition process. DOD stated that it did not believe the revised profit policy was inconsistent with its new 5000 series acquisition regulations. DOD pointed out that the 5000 series stresses the need for balance among several key factors in planning acquisition strategies and that, ultimately, DOD decides what it will buy and how much technological risk it will accept. According to DOD, after that decision is made, the technology incentive factor can be used to reward contractors for the technical risk they undertake in developing or applying new technologies or significant technological advances.

While the 5000 series discusses several factors to be considered in planning acquisition strategies, there is a clear emphasis on technology maturity to reduce program risk as a system progresses through the acquisition process. DOD Regulation 5000.2-R identifies technology maturity as a “principal element of program risk.” DOD Instruction 5000.2 provides managers with specific guidance for managing this element of program risk and makes it clear that technology should be matured and demonstrated during the technology development phase before a program is initiated and component technology is integrated into a system. The instruction states that “unless some other factor is overriding in its impact, the maturity of the technology will determine the path to be followed.” According to the instruction, “technology must have been demonstrated in a relevant environment ... to be considered mature enough to use for product development in systems integration. If technology is not mature, the DOD Component shall use alternative technology that is mature and that can meet the user’s needs.”

Although the acquisition guidance emphasizes technology maturity to reduce program risk, the profit policy rewards contractors with additional profit for undertaking technical risk in developing or applying new technology at unspecified points in the acquisition cycle. Because the profit policy does not discuss when in the acquisition cycle innovative technologies should be rewarded with higher profits, it could be interpreted in such a way as to be inconsistent with the new acquisition process. We discussed this issue with the officials in the office responsible for developing the new 5000 series. These officials were familiar with the profit policy rule and, while they noted that the two were not necessarily inconsistent, the potential for misinterpretation existed. These officials said that if innovation meant new—but mature—technology, there would be no conflict between the policies. On the other hand, they noted that if “innovation” was misread for “risk taking” or “technology immaturity,” especially late in the acquisition cycle, the policies could work against each other. They added that the technology incentive would need to be carefully managed to prevent a conflict and that this could be achieved through means such as training. We continue to believe that the best approach for managing this potential conflict is to explicitly discuss the relationship between the two policies—particularly as they relate to innovation—in the guidelines contained in the profit policy regulation on when the technology incentive should be used.

DOD comments appear in appendix II.

Scope and Methodology

To determine whether the new profit policy is likely to achieve its objective of stimulating increased innovation, we selected programs at some of DOD's highest dollar buying commands to review how contracting and acquisition officials would apply the new policy to various programs. We selected one buying command to represent each service. We discussed the profit policy rule in general, the types of contracts the rule might apply to, and the points in DOD's acquisition cycle in which it could be applied. We also talked specifically about each program selected to determine whether there were innovative technologies that would have qualified for the technology incentive if the policy had been in effect at the time of contract award. In addition, we asked representatives from some of the programs to reprice a sample contract using the new profit policy to determine whether the profit objective would have been higher.

We also analyzed DOD's fiscal year 2000 contracting database (DD350) to identify the types of contracts awarded at each phase of the acquisition cycle, the percentage of dollars awarded using the various profit award mechanisms, and the proportion of dollars awarded with or without competition.

To assess the relationship between the new profit policy and the new acquisition process, we analyzed what the acquisition guidance and profit policy say about technology development, maturation, and innovation. We also discussed these policies with DOD officials who developed them.

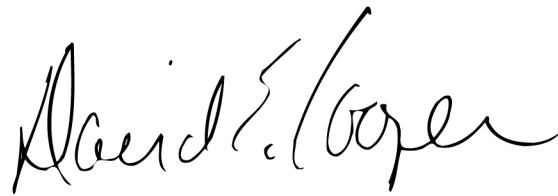
We reviewed relevant documents and held discussions with officials at the U.S. Army Aviation and Missile Command, Huntsville, Alabama; Aeronautical Systems Center, Dayton, Ohio; Naval Air Systems Command, Patuxent River, Maryland; Office of Defense Procurement, Cost, Pricing, and Finance, Washington, D.C.; and Office of the Deputy Under Secretary of Defense (Acquisition Reform) for Acquisition, Technology, and Logistics, Washington, D.C.

We performed our review between January 2001 and May 2001 in accordance with generally accepted government auditing standards.

As agreed with your office, unless you publicly announce the contents of this report earlier, we will not distribute this report until 30 days from its date. At that time, we will send copies of this report to the appropriate congressional committees; the Honorable Donald H. Rumsfeld, Secretary of Defense; and the Honorable Mitchell E. Daniels Jr., Director, Office of Management and Budget.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. Major contributors to this report are Karen Zuckerstein, Erin Baker, Julia Kennon and John Van Schaik.

Sincerely yours,

A handwritten signature in black ink that reads "David E. Cooper". The signature is written in a cursive style with a large, stylized initial "D".

David E. Cooper
Director
Acquisition and Sourcing Management

Appendix I: Impact of Using Technology Incentive on Sample Contract

The following table shows the impact of using the technology incentive on a sample contract repriced for us at one of the buying commands we visited. The actual profit objective calculated prior to the profit policy change was based on technical performance risk valued at the top of the standard range. The repricing to reflect what would likely have occurred after the profit policy change was based on technical performance risk valued at the top of the technology incentive range. No other changes were made in the profit objective calculation.

Table 3: Sample Contract

Profit objective before change		Profit objective using new method		Increase from prior method	Increase in profit rate
Dollars	Rate	Dollars	Rate	Dollars	Percent
\$ 8,472,933	13.98%	\$ 9,584,982	15.81%	\$ 1,112,049	1.83%

Appendix II: Comments From the Department of Defense



OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

JULY 12, 2001

DP/CPF

Mr. David E. Cooper
Director, Acquisition and Sourcing Management
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "CONTRACT MANAGEMENT: DoD's Profit Policy Provision to Stimulate Innovation Needs Clarification," dated June 11, 2001 (GAO Code 120026/OSD Case 4014).

GAO examined the new technology incentive factor that was added to the DoD profit policy in December 2000 based on a requirement included in the National Defense Authorization Act for Fiscal Year 2000 (P.L. 106-65). The DoD profit policy is used primarily on noncompetitive contract actions of more than \$550,000, and is designed to assist contracting officers in considering relevant factors when establishing profit objectives that will be used to negotiate contract prices.

As GAO stated in its report, the technology incentive factor is new and has not yet been widely used. We intend to examine how the policy is being used after it has been in place for a year. In accordance with GAO's recommendations, we will at that time determine if the types of innovation that should be rewarded could be stated more clearly, and if there are relevant factors that could be added related to the duration of the reward. We do not agree that the policy is inconsistent with DoD's new acquisition process. More detailed responses to the GAO recommendations are enclosed.

Thank you for the opportunity to comment on the subject draft report.

Sincerely,

A handwritten signature in black ink, appearing to read "Deidre A. Lee".

Deidre A. Lee
Director, Defense Procurement

Enclosure:
As stated



GAO DRAFT REPORT DATED JUNE 11, 2001
(GAO CODE 120026) OSD CASE 4014

“CONTRACT MANAGEMENT: DOD’S PROFIT
POLICY PROVISION TO STIMULATE INNOVATION
NEEDS CLARIFICATION”

DEPARTMENT OF DEFENSE COMMENTS
TO THE GAO RECOMMENDATION

RECOMMENDATION: To assure that the technology incentive is appropriately interpreted and applied, GAO recommended that the Secretary of Defense:

- Clarify the definition of innovation contained in the profit policy rule,
- Define how long contractors should be rewarded for innovations introduced during research and development phases, and
- Reconcile the relationship of the technology incentive with DoD’s new acquisition process, including the emphasis on technology maturation (Pg. 10/Draft Report).

DOD RESPONSE:

1. Clarify the definition of innovation contained in the profit policy rule. Partially concur. We will re-examine the examples at Defense Federal Acquisition Regulation Supplement (DFARS) 215.404-71-2(d)(4)(i) of the types of innovation that may be rewarded with the technology incentive factor to determine if they can be stated more clearly.
2. Define how long contractors should be rewarded for innovations introduced during research and development phases. Partially concur. We believe that contracting officers are in the best position to judge the amount and duration of the reward to be provided by the technology incentive factor based on the specific facts of the particular acquisition. We also believe it would be very difficult to define the length of time over which a reward should be considered. However, we will re-examine the DFARS coverage to determine if there are relevant factors that we could provide for contracting officers to consider in making this judgment.
3. Reconcile the relationship of the technology incentive with DoD’s new acquisition process, including the emphasis on technology maturation. Nonconcur. We do not believe that the revised profit policy is inconsistent with DoD’s revised 5000 series regulations. The 5000 series stresses the need for balance among key factors in planning acquisition strategies. These factors include the urgency of the operational requirement; the maturity of critical technologies; and the interoperability, supportability, and affordability of alternative acquisition solutions. Ultimately, however, DoD decides what it will buy and how much technological risk it will accept. After that decision is made, the technology incentive factor is available to provide contracting officers with a mechanism to reward contractors for the technical risk they undertake in developing or applying new technologies or significant technological advances.

ENCLOSURE

See p. 10.

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