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**THE DEPARTMENT OF DEFENSE
STATEMENT ON
INDUSTRIAL READINESS**

by

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**The Honorable William J. Perry
Under Secretary of Defense**

**For
Research and Engineering**

**Before the
Defense Industrial Base Panel
of the
Committee on Armed Services,
United States House of Representatives,
96th Congress, Second Session**

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Mr. Chairman:

I am pleased to appear here today. Improving the Defense Industrial Base is a matter of priority concern. In the past few weeks you have heard testimony from selected members of industry and other agencies of the Federal Government. In combination, they have given you a fairly comprehensive overview of what the problems are and what needs to be done. In particular, Gen Slay provided a comprehensive statement which described the symptoms of a declining industrial base and identified a menu of recommendations.

What I would like to do this morning is to briefly reiterate some of the major points which have been surfaced, then focus on specific actions which are underway or which we believe should be pursued without delay. We should also recognize that the problems identified--declining US productivity, lagging capital investment, increasing foreign dependence and rising costs--are not simply Defense problems; they are in fact national problems which will require a combination of support and work by us all.

The Defense Science Board Study this past summer provided the major underlying contribution to understanding our industrial base problems. Most significant of their findings was that the instability of our major programs has created an environment which is not conducive to stimulating capital

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investments by industry. The on-again, off-again turbulence of some Defense programs begins a chain reaction of events that often leads to uneconomical procurement rates. We believe that more liberal use of multiyear contracting will prove to be a major step toward improvement of this instability. I will return to discuss multiyear contracting in some detail.

The inadequacy of our resource base and our dependence on foreign suppliers for critical materials is also a paramount concern. I fully support the specific recommendations made by General Slay. We have, over the past months, developed proposals for imaginative uses of a combination of authorities under Title III of the Defense Production Act and the National Defense Stockpile to greatly expand capacity and supply of selected materials with minimum Government involvement and expense. We will be supporting even greater use of these techniques for raw materials and manufacturing processes in the future as a means to enhance our industrial mobilization capability. We are also giving increased emphasis to materials R&D to develop substitutes for materials which may not be readily available in the quantities needed. We will need your support to accomplish these actions.

Regulatory constraints over which we have had little or no direct responsibility--such as equipment depreciation or write off policies, import tariff decisions, and safety and environmental rulemaking--have affected the responsiveness of industry. It is time to develop a better balance to Federal

rulemaking so that national security considerations receive proper attention. We will be providing leadership to bring this about.

With regard to capital investment and productivity, it has been clearly outlined that inflation and high interest rates have, in combination, seriously reduced the sources for investment capital. The Department of Defense policy of not allowing contractors to recover the cost of paid interest on defense contracts has been questioned during this period of high interest rates. Our policy is based on uniform recognition of the cost of capital rather than singling out a single approach to financing (e.g., interest on that financing) for recovery. It is more equitable to recognize the cost of capital, without regard to how it is financed, to the extent that it can be identified to an individual defense contract.

The identification of facilities capital is accomplished through the measurement technique of Cost Accounting Standard 414. It accounts for plant and equipment used on defense contracts and computes a cost of money for facilities capital based on an interest rate published by the Secretary of the Treasury. This rate is currently 10.5 percent. We allow this cost of money related to facilities capital on defense contracts without regard to whether the facility is financed through debt or equity. Our profit policy also rewards facilities investment to further compensate for interest expense.

The identification of operating capital is more complex. There is no comparable Cost Accounting Standard to measure

operating capital. Research by the Cost Accounting Standards Board staff indicated that it was very difficult to measure operating capital on an individual defense contract. The determination of how much paid interest expense is attributable to an individual contract would create a similar problem, since borrowings are made at the contractor's corporate headquarters to finance government and commercial business investments. However, in recognition of the high cost of financing operating capital, we have examined our current progress payment policy. Preliminary review indicates a wide variation in contractor operating capital financing requirements because of contractor cash management techniques and the time government finance offices take to make payments. Thus, some contracts have minimal operating capital needs while others, especially small businesses, have significant investment requirements. To remedy this situation, we propose to design a progress payment procedure with flexible progress payment rates that will be tailored to individual contracts. The objective of this new procedure will be to reduce the need for contractors to finance operating capital and thereby mitigate the devastating effects of high interest rates.

The DoD Manufacturing Technology Program is clearly an extremely important vehicle for improving the health of industry, and one which I fully support. This program directly addresses improving the productivity and responsiveness of the industrial base by developing advanced manufacturing techniques,

processes, materials and equipment. We intend to give this program increased budget emphasis and of course your support will be needed.

There are other areas where our efforts can have a direct benefit. Industry, in general, needs to know more about our anticipated requirements. Although most large firms have full time personnel who keep a close watch on DoD hardware requests, smaller firms do not. Perhaps more importantly, second and third tier contractors have little insight into what to expect. To remedy this situation, we recently held a conference in Washington with the assistance of the American Defense Preparedness Association to inform industry of defense needs. We believe this was useful and plan to continue this program.

Let me now address the subject of multiyear contracting for procurements other than shipbuilding. For the most part, we contract on a year-to-year basis. Defense contractors are often reluctant to devote their resources (men, money, and facilities) to enhance productivity over a long-term production program under such an approach. The increasing cost of money and opportunities for greater returns from investments in commercial ventures often reduce the attractiveness of defense programs in the eyes of company management.

What we clearly need to do is to provide the motivation for a defense contractor to harness his resources towards enhancing productivity in defense programs with consequent savings to the Government. Establishing efficient and economical

production will lead the contractor to invest in labor saving facilities, purchase long lead time components and raw materials for several years, and perform assembly and subassembly production for the most effective utilization of labor.

We are convinced that year-to-year contracting will not achieve the desired efficiencies and economies. What is necessary is a longer term Government commitment with appropriate funding. We believe this entails a commitment by the Government--up front--for 3 to 5 years of a production program. This commitment and funding is the integral piece of achieving enhanced productivity through multiyear contracting for an economic procurement quantity. We have no single fixed approach in mind but are considering various approaches that could be used. A certain amount of flexibility is needed to permit the tailoring of production programs to meet individual circumstances.

We are asking the Military Departments to examine their production programs; to select long-term, stable production programs where inventory needs are reasonably clear; to determine in those selected programs whether significant cost savings can be achieved if the Government commits itself now to requirements beyond the current year; and to establish a production quantity that offers the most economical procurement not exceeding the Five Year Defense Program.

For a number of production programs, the economic procurement quantity is the annual buy that is planned and budgeted on a year-to-year basis. For others, the quantity is greater,

and committing the Government now to a longer period of production will enhance productivity and result in cost savings. Attached are those programs identified by the Military Departments as suitable for multiyear contracting.

For some programs a multiyear approach offers savings as a result of combining the annual buy with additional funding for long lead time components, raw materials, and subassembly work for the next year or two of production. However, for others a multiyear authorization and appropriation for several or more years of production awarded under one contract is the optimum and should be considered.

Yet another alternative is to contract for a multiyear quantity phased to achieve an economical production run based on an expenditure profile to be budgeted and funded annually. Let me illustrate this alternative by an over-simplified example. If we were to plan to buy 400 end items at the rate of 100 per year, we and the contractor might agree that the most efficient production approach would be to obtain raw material, subcontract for components, and perform subassembly work for all or a large part of the 400 end items during the first year or two, and deliver all end items in subsequent years. We could agree on an annual expenditure profile to accomplish this and budget and fund the annual expenditure requirement. Some might refer to this as expenditure funding (new term) or a variation of incremental funding now used in long-term research and development programs. It would have the advantage of more closely approximating annual funding of year-to-year requirements and thus does not exacerbate budget pressures.

Multiyear contracting as currently prescribed in our policy regulation, and in which the cancellation ceiling is applied, differs from the approaches described above. Current multiyear contracting policy contemplates a single level price with the price of the first unit the same price as the last unit. Contractor expenditures for start-up, preproduction, and other similar types of costs inherent in starting up a production line are amortized in the unit price of the end items. The contractor carries these investment costs until recovered through amortization in the unit prices. To protect the contractor from a Government decision not to fund future contract years, an unfunded cancellation ceiling is provided. This represents a contingent liability (termination) on the part of the Government to reimburse the contractor for the unamortized part of these costs, should the program not be funded in future years.

While this remains a viable approach, the statutory restriction of \$5 million cancellation ceiling has severely limited its use in any major dollar program where savings can be achieved, and we advocate its deletion. However, even if we had no statutory restriction on the cancellation ceiling, the use of the approach would be constrained. Few contractors would be willing to incur such investment expenditures without Government commitment to fund and pay such costs as they occur. The cost of money is just too high to make this an enticing approach in a number of programs.

Unfortunately, the perception in the defense acquisition community has been that the statutory cancellation restriction meant that Congress did not want the multiyear contracting approach to be used in major programs. Thus, there has been no request to obtain statutory relief. However, we believe the restriction should be rescinded and a legislative proposal to this effect is currently being coordinated within the Department.

However, the most pressing limitation on the use of the several multiyear approaches I have described is the existing policy on "full funding." "Full funding" is the term used to describe the principle that has been applied by Congress in providing funds for the Department of Defense programs that are covered within the Procurement Title of the annual appropriation act. The objective of this policy is to provide funds at the outset for the total estimated cost of a given item. In practice, it means that each annual appropriation request must contain the funds estimated to be required to cover the total cost to be incurred in completing the delivery of a given quantity of usable end items. The quantity usually represents twelve months of production deliveries. The "full funding" concept has several benefits which commend its continued use for a number of major weapon systems which are not stable and are subject to programmatic changes. However, for those programs considered to be stable, the funding of material, parts, and subassembly work in the current year for incorporation into

units that are to be produced in subsequent years is appropriate. Significant savings with increased productivity are possible if contractors are permitted to incur such expenditures for subsequent years of production. Contractor purchases of material can be consolidated and subassembly work can be performed on a continuous basis, thus achieving economies inherent in volume production.

However, if the systems selected for multiyear contracting are not chosen carefully, these savings could be gained with a corresponding loss of visibility and management to both the Congress and the Department of Defense. The "full funding" policy reflects the concern of one session of Congress that they not be committed to authorizing and appropriating funds to complete procurement programs started by a previous session. Maintaining an appropriate balance will require careful selection of programs with future expansion in a controlled and orderly fashion.

Other than the restriction on the cancellation ceiling, we are not statutorily constrained from requesting funding under the multiyear contracting approaches we are considering. However, we are constrained by the full funding policy and the year-to-year budget guidelines that have been adopted by the Department of Defense with congressional approval.

The Federal Acquisition Reform Act, S. 5, 96th Congress, 1st Session, introduced by Senator Chiles, contained a provision laying a statutory base for multiyear contracting. Frankly, I do not believe we need special statutory authority. The preferred course is to identify in our annual budget submissions those programs for which multiyear contracting is to be used along with a request for the authorization and appropriation by Congress for the funds required. While the several multiyear contracting approaches we are considering do not all entail the use of an unfunded cancellation ceiling, the current statutory restriction severely limits the use of an approach that contemplates a cancellation provision. To make this a workable approach, deletion of the statutory restriction is required.

Up to this point I have been speaking of production programs funded under the Procurement Title of the DoD annual appropriation act. These funds are not restricted to obligation (contracting) in the year appropriated. However, certain funds are appropriated and limited to obligation during the fiscal year in which appropriated. Generally, these funds fall under the Operation and Maintenance Title of the DoD annual appropriation act. In addition to civilian personnel costs, this Title provides funds for operation, maintenance, and support of facilities and installations; maintenance or modification of equipment; and base services. Public Law 90-378 (10 U.S.C. 2306(g)) authorizes DoD to enter into multiyear

contracts for such services to be performed outside the 48 contiguous States and the District of Columbia. There are, in our opinion, opportunities to effect savings through multiyear contracting for such services in the 48 contiguous States, and we should not have this geographic limitation. While we support this law, this geographic limitation should be removed. We will initiate a legislative proposal to delete the geographic limitation.

In summary, multiyear contracting for long-term, stable production programs offers enhanced productivity and consequent cost savings. Other than repealing the restriction on the cancellation ceiling, no additional legislation is needed. The programs selected should be stable; that is, whether they are relatively new or in production, they should have the following characteristics: the configuration should be established, the inventory quantity known, the program should be noncontroversial in need or mission, and the requirements included in the Five Year Defense Program.

Your request for my appearance at these hearings identified other items you wished addressed. These are attached.

This completes my prepared testimony. I would be pleased to answer your questions.

Multiyear Contracting

Attachment

Specific Programs, Either Planned or in Production, That Would Be Appropriate

In response to our request, the Military Departments have identified the following long-term, stable production programs as being under consideration for multiyear contracting:

Army:

Advanced Attack Helicopter

Infantry Fighting Vehicle

Navy:

Standard Missile 1, Block VI Program

LSD-41 Follow-on Ships.

VCX Carrier on Board Delivery Aircraft System

Air Force:

Global Positioning System

Defense Support Program Production Satellites 14-17

Low Level Laser Guided Bomb

The Basis of the Policy Established for Advance Procurement

Advance procurement is funding and contracting for long lead time components of a major production program in advance of the fiscal year in which the related end item is to be procured. It is limited to those components whose lead times are significantly longer than other components of the same end item. The policy is expressed in Department of Defense Directive 7200.4.

The procedure contemplates that the cost of components procured in advance be relatively low, as compared to that portion of the end item costs for which funding is deferred. Application dictates that the program must be stable; design and configuration change will not be significant; the program is unlikely to be cancelled; the components will be incorporated in next year's end item buy; and the components are usable, even if the program is cancelled. Each case is to be justified on its merits and identified in budget and apportionment submissions.

Distinction Between Advance Procurement and Incremental Funding

Incremental funding is used in contracting for long-term research and development programs. Research and development programs are contracted for under cost reimbursement type contracts where the contract contains only an estimated cost for achieving the research and development contemplated. Funds are obligated each year for the level of effort required to continue to advance the research and development towards completion. Since the funds are budgeted and obligated in annual increments, it is referred to as incremental funding. A certain portion of the funds is held back to cover the Government's exposure to termination liability, should future years not be funded.

Incremental funding violates the "full funding" policy and is not authorized for use in production programs covered

within the Procurement Title of the annual appropriation act. Several of the multiyear contracting approaches that we are considering contemplate funding similar to incremental funding used in research and development. Exception to existing policy is required to use incremental funding for these approaches in production programs.

Currently, advance procurement funding can be used only for purchasing long lead time usable components of a major production program, and incremental funding can be used only for long term research and development programs. Under advance procurement funding, usable components are obtained, even if there is no subsequent end item purchase. Under incremental funding, little of value may result if the program is not funded in subsequent years.

Examples of research and development programs incrementally funded are: M-X, C-X, and LANTIRN.