



ACQUISITION AND
TECHNOLOGY

THE UNDER SECRETARY OF DEFENSE
3010 DEFENSE PENTAGON
WASHINGTON, D.C. 20301-3010



MAY 16 2001

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
DIRECTOR, DEFENSE RESEARCH AND ENGINEERING
DIRECTORS OF DEFENSE AGENCIES

SUBJECT: Contractor Cost Sharing

In order to ensure that the companies the Department of Defense does business with are able to provide innovative, technologically excellent weapons and equipment at affordable prices, we must be concerned about the financial health of the defense industry. Financially sound companies are able to attract the resources and talent necessary to provide best value solutions to warfighters and taxpayers alike.

One of the ways to ensure these companies remain financially sound is to consider carefully the degree of investment they are making in defense programs. In today's environment of reduced defense spending and fewer new program starts, it is short-sighted to require contractor investment in defense research and development contracts. Instead, we should permit contractors to earn a reasonable return on these contracts in exchange for good performance. The only exception to this policy would be unusual situations where there is a reasonable probability of a potential commercial application related to the research and development effort.

Contractor investment in defense programs may take the following forms:

- Use of contractor independent research and development (IR&D) funds to subsidize defense contract research and development.
- Cost ceilings that in essence convert cost-type contracts into fixed-price contracts.
- Unreasonable capping of annual funding increments on research and development contracts.



- Award of development contracts at prices that are known to be less than the contractors' probable costs of performance.

None of these is an acceptable practice. Contractors should not be encouraged or required to supplement DoD appropriations by bearing a portion of defense contract costs, whether through use of their IR&D funds or profit dollars. I have asked my staff to carefully examine the acquisition strategy and execution for ACAT I programs to ensure that contractor cost sharing is not included, and to revise the DoD 5000 series directives to more completely incorporate this policy.

I believe this is a particularly important issue, and I expect the full support of the Military Departments and Defense Agencies to ensure that contractor investment is curtailed.

A handwritten signature in cursive script, appearing to read "E. C. Aldridge, Jr.", written in dark ink.

E. C. Aldridge, Jr.

Defense News
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Pg. 6

Pentagon To Relieve Contractors Of R&D Costs

Acquisition Czar's Edict Marks Large Shift in DoD Practices

By Jason Sherman, Washington

The U.S. Defense Department will end its widespread practice of forcing or encouraging defense contractors to pay part of the research and development costs for major weapon programs.

Edward C. "Pete" Aldridge, the Defense Department's new undersecretary of defense for acquisition, technology and logistics, has directed the Pentagon's research directors and procurement chiefs to stop the practice of requiring or asking defense companies "to supplement [Defense Department] appropriations by bearing a portion of defense contract costs."

Aldridge's edict is contained in a May 16 memo to the Pentagon's service secretaries and other officials sent during his fourth day on the job. Before coming to the Pentagon, Aldridge was chief executive officer of The Aerospace Corp., Los Angeles, and has held many jobs in industry and government, including heading McDonnell Douglas Electronic Systems and serving as secretary of the Air Force.

His directive calls for a major shift in DoD procurement practices of recent years.

"This has been a concern to us," Terry Marlow, vice president of the Aerospace Industries Association's government division here, said May 25. "This practice was beginning to subvert dollars from the independent part of the research and development. And therefore, we were basically eating our seed corn."

Pentagon and industry officials said no figures are available to illustrate how the Defense Department cost-sharing practice has harmed industry, because of the proprietary nature of the data.

The front-end investments by contractors are "a creeping reverse subsidy," Gordon Adams, a professor at George Washington University here, said in a May 25 interview. "That's bad for the contractor," because industry has less money to invest in basic research and product innovations, "and it's bad for the government, because it means the contractors are buying less innovation."

In his May 16 memo, Aldridge said the practice is banned regardless of whether contractors would be expected to use "their [independent research and development] funds or profit dollars."

There are a number of ways the Defense Department encourages private industry to invest its own funds in military programs. Most of these methods are built into contracts, and Aldridge wants this practice to end. In particular, the new Pentagon acquisition executive wants to see an end to clauses that:

- *Unreasonably cap annual funding increments on research and development contracts.
- *Include cost ceilings that in essence convert cost-type contracts into fixed-price contracts.
- *Award development contracts at prices known to be less than contracts' probable performance cost.

