



DFARS Case 2017-D019: “Performance-Based Payments and Progress Payments”

Mr. Steve Trautwein
Aerospace Industries Association



Overarching Theme: This proposed rule undermines the *National Defense Strategy*

- The proposed rule will limit investment in more lethal and technologically-superior capabilities
 - Industry will not have the cash flow required for investments in research and development (R&D), facilities, or critical workforce skills
 - The proposed rule will result in higher costs for ‘back office’ functions over the long-term that will crowd out resources for modernization (for DoD and industry)
- The proposed rule undermines Secretary Mattis’s vision of “performance” and will make defense products more expensive
 - The proposal erroneously equates fulfillment of bureaucratic processes with performance, and additional workload associated with these processes will not allow DoD to realize performance “at the speed of relevance”
 - The proposal will undermine an “enterprise-wide” view of performance as it impacts various contractors, industries, and types of end items differently
 - The proposal will increase the costs of American defense products, making it more difficult to strengthen alliances and interoperability, and attract new partners

Overarching Theme: Proposed changes to financing rates need more careful study

- The manner in which proposed changes were pursued conflicts with Secretary Mattis’s call in *NDS* to provide the defense industry “with sufficient predictability to inform their long-term investments in critical skills, infrastructure, and R&D”
- If DoD had solely fulfilled Congressional intent, it could have completed implementation of Section 831 by the statutory deadline of April 22, 2017, and been able to leverage performance-based payments to attract nontraditional and commercial companies to the DoD market for the last 16 months
- Cutting contract financing rates will not result in any ‘efficiency’ savings for DoD – according to GAO/CBO analysis of Grace Commission study, which recommended 10% cut in progress payment rate, **“One should note, however, that this simply delays expenditures and that future expenditures must rise by an offsetting amount.”**
- Critical implementation details are lacking or incomplete



Overview of AIA Comments and Questions

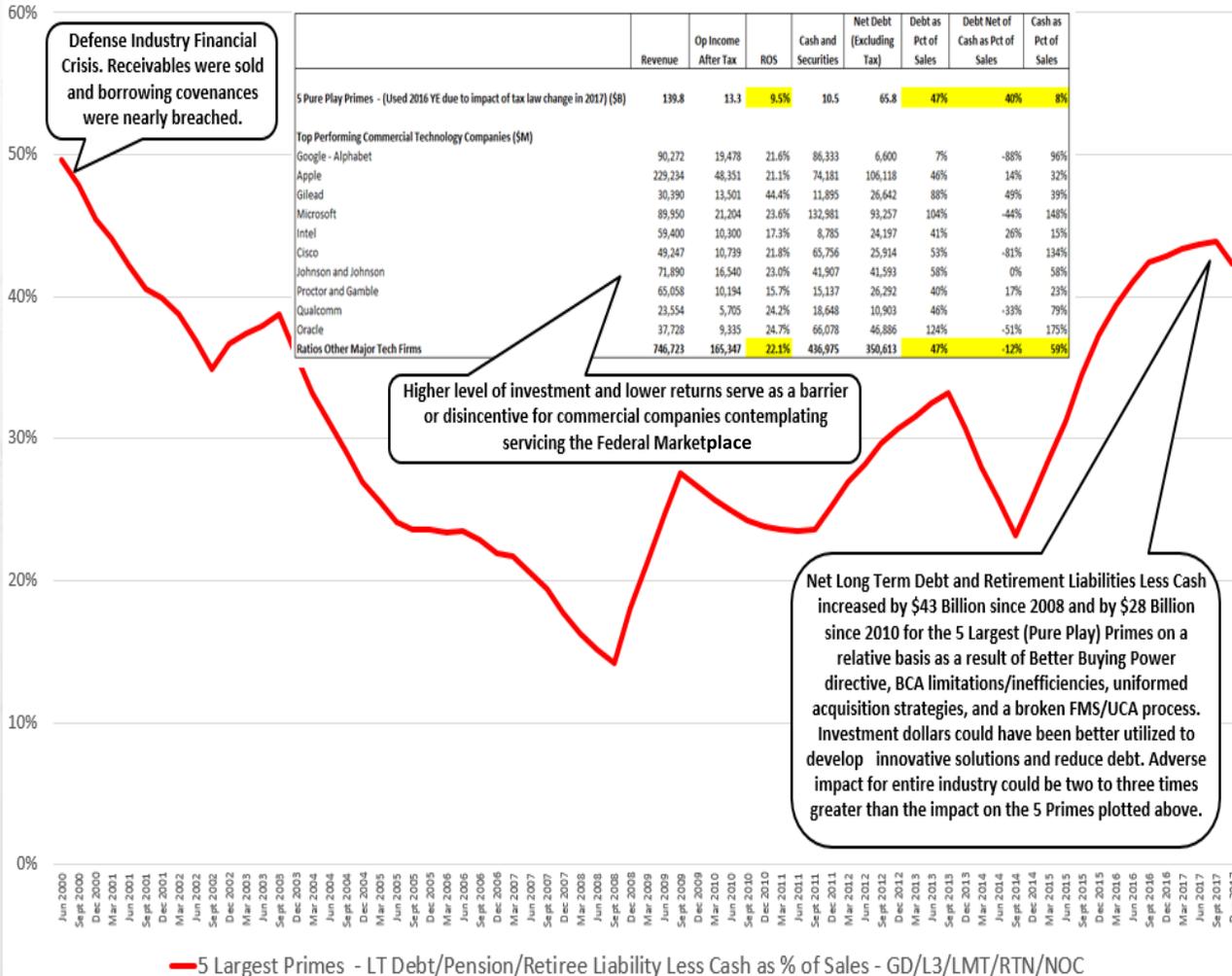
- The proposed rule:
 - Omits critical contextual details and factors related to the underlying rationale of the proposed rule
 - Relies on narrowly-drawn financial perspectives of industry
 - Future dialogue with DoD is needed to increase our mutual understanding of these complex issues
 - Conflicts with leading priorities of the Administration and DoD, as well as Congressional intent
 - Does not offer due consideration of business implications for the industrial base
 - Does not reflect nor discuss the implementation challenges and costs DoD and contractors will face

Considerations Omitted from DoD's Underlying Rationale/Assumptions

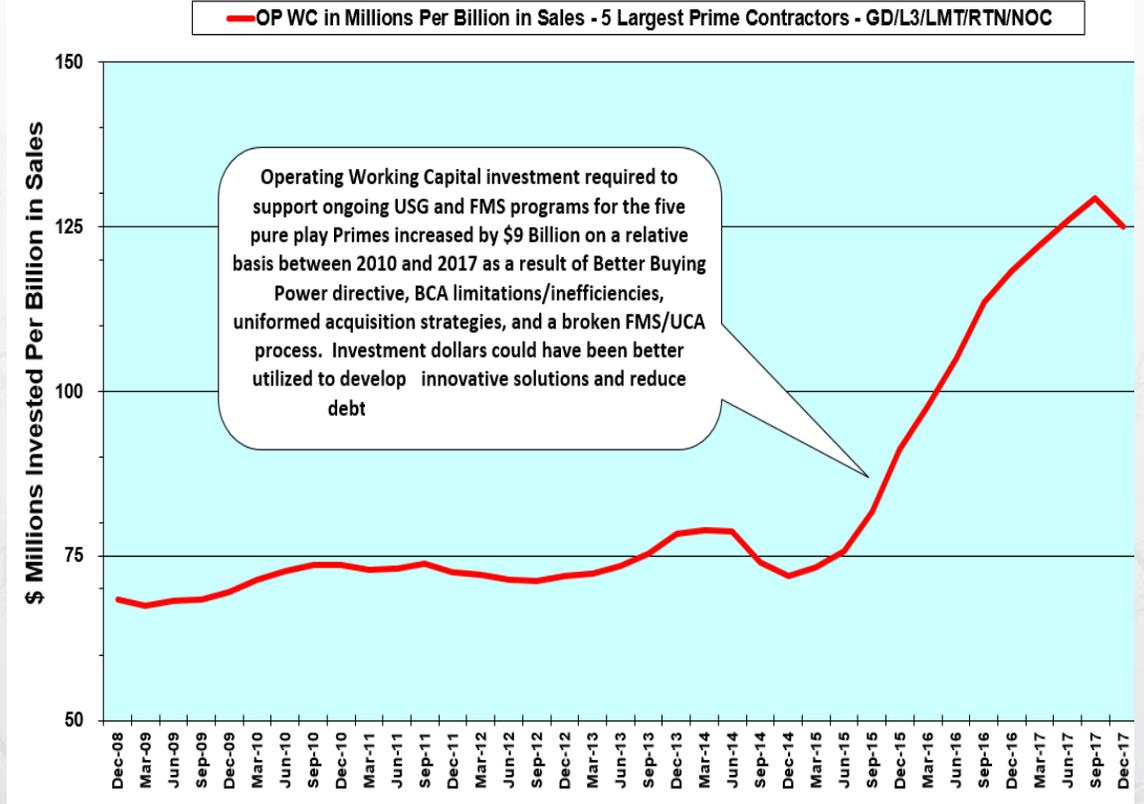
- Elimination of the flexible progress payment rate in 1992 that allowed contractors to recover up to 99% of incurred costs
- Barriers to full utilization of performance-based payments (e.g., 2014 final DFARS rule requiring use of PBP analysis tool)
- Use of fixed-price contracts (with financing limited to 80% of costs incurred) for long duration EMD and LRIP programs that were historically awarded on cost-type contracts (reimbursed at 100% of incurred costs)
- Increased use and value of Undefined Contract Actions (reimbursement limited to 80% of incurred costs)
- Lack of timely United States Government funding due to budget/appropriations process (contractors already are using their own funds to keep major programs on target)

Impact of Omitted Considerations*

5 Largest Primes - LT Debt/Pension/Retiree Liability Less Cash as % of Sales - GD/L3/LMT/RTN/NOG



Operating Working Capital Investment per \$1B Sales
(Operating Working Capital / Rolling 4 Qtr Basis)



*The intent of these charts is not to highlight the impact of the trends noted on the previous slide for just the five largest 'pure play' defense contractors, but rather, to illustrate the economic impact of acquisition policies on all contractors supporting DoD.

Conflicts with Administration Priorities and Congressional Intent

- Section 831 Report Language states: “While the Federal Acquisition Regulation in FAR 32.1001 establishes performance-based payments as the preferred Government financing mechanism, the Department has become even more focused on measuring cost as an output rather than focusing on measuring outcomes for the taxpayer and rewarding contractors for meeting those performance objectives. This provision re-establishes the policy objective.”
 - Decisions on financing made by subjective determinations of OSD officials, inserting them into execution of programs (not in line with USD Lord vision of A&S as “corporate office”)
 - Congress will not be able to hold SAEs/Service Chiefs accountable for performance of their programs under this arrangement
 - Congress intended for Section 831 to focus on performance criteria for individual contracts and remove constraints on cost; this proposal is retrospective, not forward-looking, and disassociates performance payments from performance on the specific contract
- This will hurt the health and resiliency of the manufacturing and defense industrial base
 - Squanders the top advantages the USG has in doing business and attracting new entrants – USG ability to borrow at the lowest rates of any entity in the world and its potential to provide strong cash flow
 - Shift costs of financing the supply chain to prime contractors – they will not be able to afford the same levels of financing for subcontractors and suppliers



Conflicts with Administration Priorities and Congressional Intent (con't)

- The proposed rule "will inhibit job creation," "imposes costs that exceed benefits" and "creates a serious inconsistency with regulatory reform initiatives and priorities"
 - Congress's clear intention for implementation of Section 831 was for DoD to rescind their final rule under DFARS Case 2011-D045 (hence 120-day implementation requirement)
 - Besides being required by law, this action (rescinding DFARS Case 2011-D045 final rule) should have been recommended by the DoD Regulatory Reform Task Force as DoD's existing policy is needlessly inconsistent with the FAR
 - The portions of this proposed rule that are not directly required by Section 831 were not included in the Spring 2018 Unified Agenda, and appear to conflict with Executive Order 13771 as no DoD request, nor OIRA waiver exist

Business Implications for Industrial Base

- Contract financing needs to be considered in concert with profit policy and the weighted guidelines (WGL)
- Potential for adequate cash flow from USG work offsets comparatively low profit margins received from USG work
 - Proposal undercuts this strength
 - Investors will look less favorably on industry – potential adverse impacts to credit ratings/borrowing rates, which will impact future prices/investments
 - Increased levels of debt that industry will need to incur represents an opportunity cost for investment in future products



Significant Implementation Challenges for DoD, Contractors and Congress

- Annual representation criteria and processing – e.g., how will these subjective determinations be measured, and what recourse will contractors have to contest determinations?
- Invoice processing – e.g., will rate changes be retroactive?
- Ability of DoD and contractor systems to accommodate variable financing rates – e.g., what impact will this have on DFAS’s existing backlog?
- Initial and recurring costs associated with policy changes and execution for DoD and contractors – e.g., what will be the cost to support new requirements and processes, and the impact on acquisition lead times?
- More funds “at risk” – e.g., how will the USD (Comptroller) manage the increased likelihood of replacement funds required for those that cancel?

Concluding Remarks and Recommendations

- This proposed rule should be rescinded
 - A separate class deviation should be issued immediately to implement the true intent of Section 831 of the FY17 NDAA (i.e. rescind policy/clauses established in 2014 DFARS rule)
 - Any further changes to the customary progress payment rate and maximum PBP rate should only be pursued after the results of GAO's study are available, and more thorough and transparent engagement with industry
- If DoD does not rescind this rule, the follow actions should be taken:
 1. Extend the public comment period by at least 120 days
 2. Provide written answers to the questions contained in the "Supplemental Materials" comprised in this submission not later than 60 days prior to the end of the comment period
 3. Hold a second public meeting at least 30 days after the public release of the written answers contained in "2"



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Supplemental Materials

About AIA

The Aerospace Industries Association of America (AIA), founded in 1919, only a few years after the birth of flight, is the most authoritative and influential trade association representing the U.S. aerospace and defense industry on Capitol Hill, within the administration and internationally. As the voice of American aerospace and defense, AIA's strong advocacy is essential to protecting the interests of our nation and our industry.

Today, more than 340 major aerospace and defense companies and their suppliers are members of the association, embodying every high-technology manufacturing segment of the U.S. aerospace and defense industry including commercial aviation and avionics, manned and unmanned defense systems, and space technologies and satellite communications.

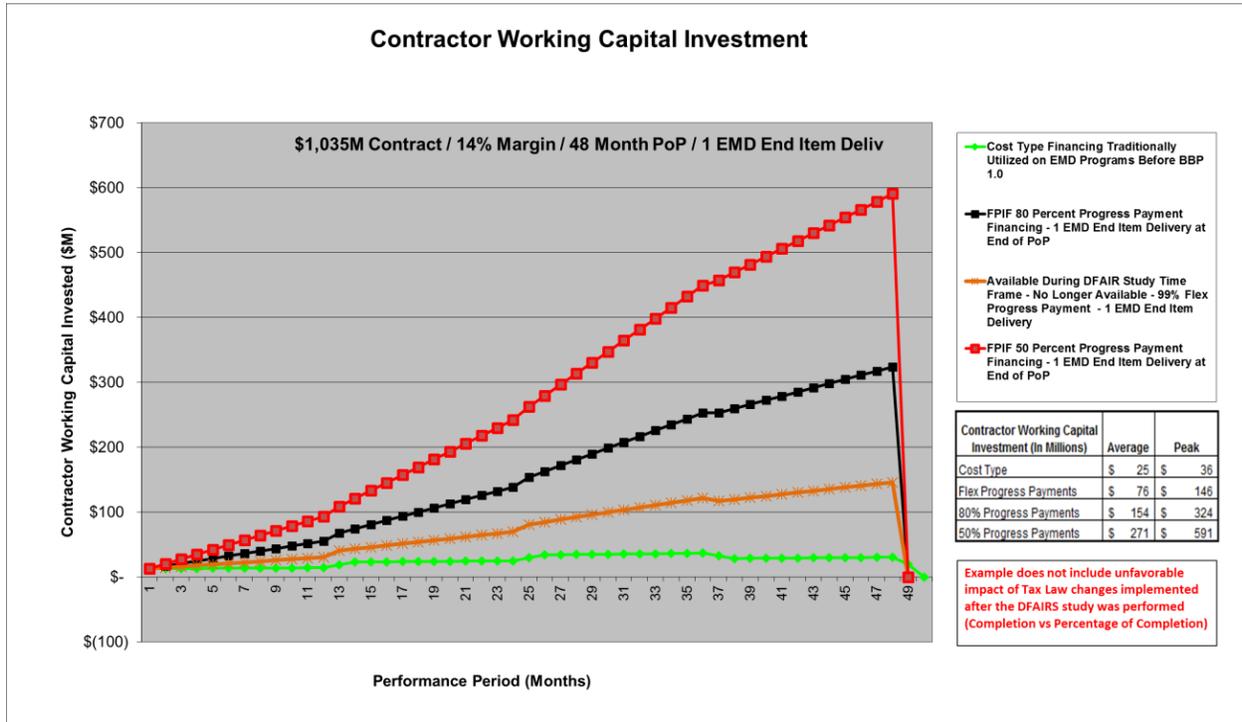
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Contents

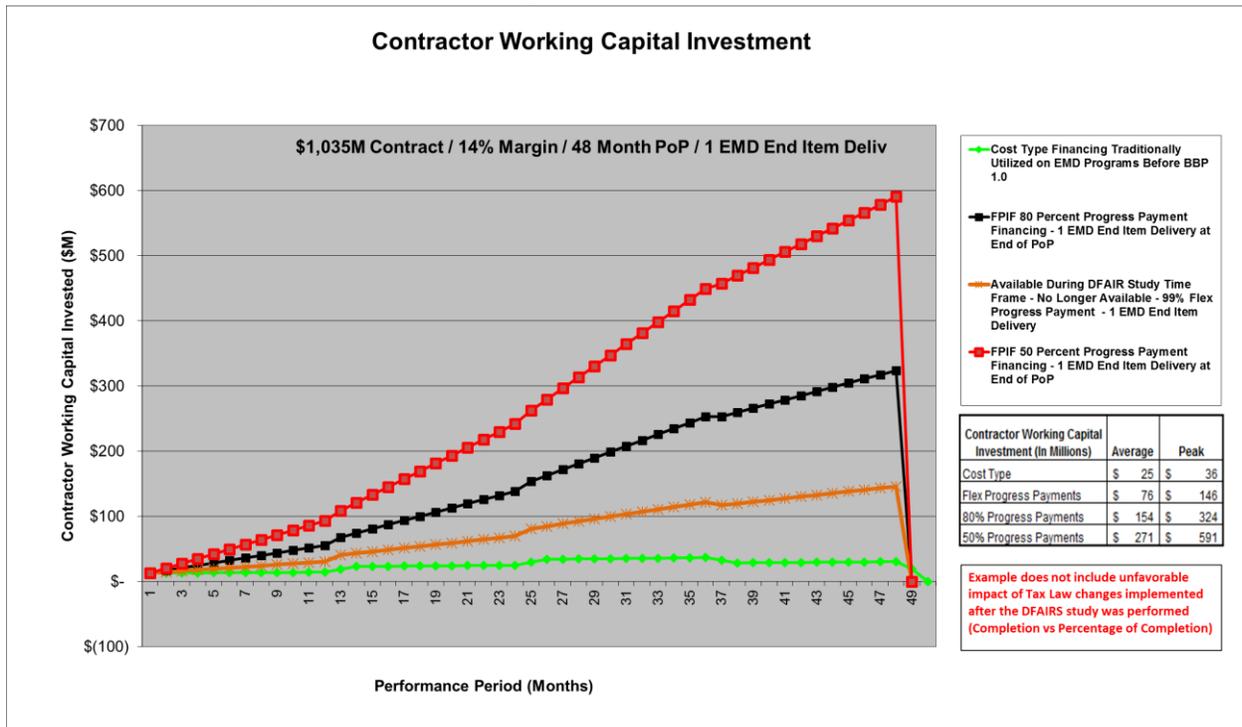
Impact of Omitted Considerations on Working Capital Investment	2
This Proposed Rule Undermines Congressional Oversight.....	3
This Proposed Rule is Inconsistent with Executive Order 13771.....	5
Questions on Criteria and Processing of Annual Representations	6

Impact of Omitted Considerations on Working Capital Investment

On a Notional Long Duration EMD Program



On a Notional Long Duration LRIP Program



This Proposed Rule Undermines Congressional Oversight

Inappropriately combining Section 831 with changes to contract financing rates is a ‘poison pill’ that undermines the ability of Congress to exercise oversight of “economically-significant” regulations. Congressional action to reject this rulemaking (as it pertains to customary progress payment rates/maximum PBP rate) under the Congressional Review Act would further delay the implementation of established law.

The public still awaits congressionally-mandated study of key topics germane to this proposed rule

- Section 890 of FY18 NDAA requires GAO study to, among other things, “analyze the extent to which implementation of such programs has affected, if at all, covered contractor performance or the management and oversight of covered contracts of DoD.”
- House-passed version of FY19 NDAA contained Directive Report Language to require USD(A&S) briefing “of the feasibility of providing contract incentives, such as more favorable contract terms and conditions, which had been considered in relation to the DON’s Superior Supplier Incentive Program that preceded the DoD’s program.”
- FY19 NDAA Conference Report requires a GAO report “on the results of an analysis of the effect of current financing levels of DoD contracts on contractors of the Department and the budgets of the Department to include an analysis and assessment of the impact to government and business on the relationship between financing amounts and contractor profit and the willingness of contractors to pursue contracts with the Department. The assessment should take into consideration past changes to progress payment rates and conditions as well as progress payment rates and limitations on progression for UCAs.”
- Section 851 of FY19 NDAA requires a small business strategy to align small business programs with the purpose of the defense acquisition system as defined in Section 801 of the FY18 NDAA.
- FY19 NDAA Conference Agreement rejected a contract goal of 1.5% for the AbilityOne Program contained in the House-passed version, and states: “The conferees note that the AbilityOne program must have policies and procedures in place to ensure that funding is used in a way that maximizes the benefits to the people it is intended to serve and that taxpayer funds are not wasted. Recognizing this, in 2015 the Congress directed the establishment of an AbilityOne Inspector General, and in 2016 Congress directed the establishment of a Panel on Department of Defense, and AbilityOne Contracting, Oversight, Accountability, and Integrity. The conferees note that both the Inspector General and the Panel are generating findings and recommendations for needed reforms and expect the AbilityOne Commission to take appropriate steps in the future to increase transparency and effectiveness of the program.”

The timeline of this rulemaking precluded congressional oversight

February-March 2018: DoD begins in-depth four-to-five-month review of progress payment rates (based on public comments by Director of Defense Pricing and Contracting, Shay Assad, on August 27th)

May 9, 2018: Spring 2018 Unified Agenda issued (entry under name of “Performance-Based Payments”)

May 24, 2018: FY19 NDAA passed in House (containing Report Language on SSIP)

June 18, 2018: FY19 NDAA passed in Senate (requiring GAO study on contract financing)

June 28, 2018: FY19 Defense Appropriations Act passed in House

FY19 Defense Appropriations Act approved by Senate Appropriations Committee

July 2, 2018: Proposed DFARS Rule submitted to OIRA (now under name of “Performance-Based Payments and Progress Payments)

July 25, 2018: FY19 NDAA Conference Agreement reached (requiring GAO study on contract financing)

August 13, 2018: FY19 NDAA signed into law

August 20, 2018: OIRA clears DFARS rule (just 32 days to review/approve DARS’s first “economically-significant” and “regulatory” action under current Administration)

August 23, 2018: FY19 Defense Appropriations Act passed by Senate

Confirmation hearings held by SASC for DUSD(A&S) and ASD(Sustainment) nominees (these are the last nominees awaiting confirmation hearings in the OUSD(A&S) organization)

August 24, 2018: Proposed DFARS Rule issued and public meeting announced

September 10, 2018: Deadline for submission of presentations for public meeting (11 business days from notice)

September 14, 2018: Public Meeting held at Mark Center with no audio/visual recording or official transcript to be taken

Both chambers of Congress in session (5th to last day in session prior to FY19 for House, 10th to last day in session prior to FY19 for Senate)

October 23, 2018: Public Comments due

December 1, 2018: Certifications for ‘performance’ criteria due for CY19

Deadline for issuance of “economically-significant” rule to be in effect by January 1, 2018 (House in session 8 days, and Senate in session 10 days to pass a CRA resolution before effective date)

USD(A&S) briefing on SSIP due

December 12, 2018: GAO Report on Business Systems Due (Section 890 of FY18 NDAA)

Mid-February, 2019: GAO Report on contract financing due

This Proposed Rule is Inconsistent with Executive Order 13771

- Speaking at an NDIA event on August 27th, Director, Defense Pricing and Contracting, Shay Assad, stated that proposed changes to contract financing rates took place after a four-to-five-month review.
- However, the Spring 2018 Unified Agenda entry for DFARS Case 2017-D019 (dated May 9th) is titled, “Performance-Based Payments” and solely describes a statutorily-based rule to implement the contents of Section 831 of the FY17 NDAA.
- The proposed rule issued on August 24th contained changes in title, scope, legal authority, “EO 13771 Designation” and economic significance, making it an entirely different rule than what is in the Spring 2018 Unified Agenda entry for DFARS Case 2017-D019.
- Since DoD knew it was considering changes to contract financing rates to be pursued under this rulemaking, it should have been disclosed on the Spring 2018 Unified Agenda.
- In accordance with Section 3(c) of Executive Order 13771
“Unless otherwise required by law, no regulation shall be issued by an agency if it was not included on the most recent version or update of the published Unified Regulatory Agenda as required under Executive Order 12866, as amended, or any successor order, unless the issuance of such regulation was approved in advance in writing by the [OIRA] Director.”
- Changes in contract financing rates were not required by law.
- OIRA Guidance issued on February 22 2018, “Compliance with Section 3(c) of Executive Order 13771, *Reducing Regulation and Controlling Regulatory Cost*,” states that effective with the Winter 2017 Unified Agenda:
“For all potential proposed or final regulatory actions that were not included as Active Actions in the latest version of the Unified Agenda, agencies should provide a brief explanation, endorsed by a senior policy official of the agency, why the Director should waive the requirement under Section 3(c), which should generally include why the rulemaking is a priority and needs to proceed. This explanation should include whether the rulemaking is required by a specific date established by law or court order.”
- Neither a request nor waiver from the OIRA Director exist.

Questions on Criteria and Processing of Annual Representations

Data for Annual Certifications

- Supporting data is not required with submissions. What objective data will be utilized by the Director of Defense Pricing and Contracting to determine the appropriate customary rate?
- What is the appeal process for contractors should the Director of Defense Pricing and Contracting determine that the rate should be less than the representation request submitted?
- Can a contractor submit more than one representation in a year if factors used in their December submission change (i.e. a level III CAR was closed)?
- What is the feasibility of one person at DoD performing reviews of annual certifications of all contractors within one month?

Application of Approved Rates

- Is it applied only to contracts with an initial award in that year?
- Does it apply to all subsequent delivery orders (DO) under a contract regardless of the year the DO is awarded?
- Will contract modifications, which add funding, invoke the new rate?

Definition of Organizational Entity

- At what level is the “contractor or higher level owner” defined (business unit, cage code, etc.)? Can a contractor submit requests for each individual CAGE code?

Certification Criteria

Small business subcontracting

Small business plans are at a contract level and are developed during the proposal process. Factors during execution often change, impacting the ability at contract-level to achieve each contract’s goal. This criterion is not stated as a percentage.

- How does a contractor account for deviations from their plans that are based on sound business decisions?
- Will there be ‘safe harbors’ in the event a contractor misses their goals due to cybersecurity-related concerns with a supplier (i.e., exclusion of a source under enhanced Section 806 procedures)?
- How will liquidated damages interact with the financing restriction for failure to meet small business plans?

AbilityOne

- No details exist for the AbilityOne requirement. How will opportunities be defined?

Corrective Action Requests

- DCAA generally does not perform out-of-cycle reviews and requires approximately 6-12 months to assess actions taken in response to Corrective Acquisition Reports. Does DoD intend to install more stringent requirements for DCAA to perform reviews in a timely manner?

Submission of certified cost or pricing data

- What metrics should be utilized to determine timeliness of certified cost or pricing data? What dispute process is available when disagreements arise regarding the adequacy of data provided?

End Items Deliveries and CDRLs

- Contractor records for on time delivery and MOCAS records generally disagree. What data should be used to support 95% on time delivery? When deliveries are late due to Government delinquencies, how is this reflected in the representation?
- Has DoD considered the disincentive created to pursue aggressive delivery schedules due to the serious consequences on not meeting goals that exceed what is expected or required?

Invoice Processing

- If rates can change throughout the life of a contract, is the change retroactive?
- If it is not intended to be retroactive, how will the progress payment process be adjusted to eliminate the retroactive adjustment?
- If the progress payment process doesn't change and rates go down, is a contractor expected to submit payment back to DFAS or delay billing until the situation resolves?
- If financing rates change, will liquidations on previously submitted deliverables be retroactively adjusted?
- If a contractor currently has business system withholds and then loses 10% of their financing in a given year, can they recover all of their withholds on previous contracts? Has the increased complexity of the withhold process been considered?
- Prime contractors with 50% financing on a contract with significant small business content financed at 95% will receive less than 50% as a result of work in progress (WIP) limitations in the DoD payment system. How will this situation be addressed?

Ability of DFAS to Fulfill New Requirements

- DFAS currently has a backlog in contract input of 20,000 modifications. Will contract modifications be required to modify all contracts with financing as rates change? How will this increased processing be managed?
- Has the impact to both DoD and Contractor systems cost to manage variable financing rates been considered?

Initial and Recurring Implementation and Execution Costs

- How have the consequences of increased direct costs, training requirements, and updates to existing systems in support of representation criteria and processing been considered as part of this proposal? Did DoD incorporate these considerations into their FY19 budget request?
- Has the cost of potential increases in erroneous payments been considered?
- This proposal will make it more difficult to offer quantity discounts for FMS sales, pushing foreign customers to increasingly pursue the purchase of defense articles through Direct Commercial Sales. What has DoD assessed as the costs associated with reduced FMS administration fees and elimination of savings in contracts leveraging combined domestic/FMS requirements?
- How will alternate liquidation rates be impacted?
- What type of training will be provided to DCMA, DCAA, DFAS and industry to ensure effective and efficient implementation? Has the cost of this training been considered in the cost impact? Has the timing of this training been considered in the implementation date?
- What is the impact of this change on profit policy/weighted guidelines?
- What does DoD anticipate the impact of this proposed rule to be on Procurement Administrative Lead Time (PALT)?
- Interest rates are on the rise since historic lows established in response to the Great Recession. How often does DoD plan to reevaluate progress payment rates as interest rates rise?

- What is DoD's assessment of the impact of this proposed rule on its ability to meet requirements for the legally-mandated DoD Headquarters reduction?
- Sections 921, 923 and 925-926 of the FY19 NDAA contain several new requirements for the DoD Chief Management Officer that will be affected by this proposed rule. To what extent has DoD studied the impact of the proposed rule on the implementation of these provisions? Will the additional costs and activities required by this proposed rule be incorporated into the baseline from which the CMO is required to generate savings?

Unliquidated Funds and Funds "At Risk"

This proposed rule will place increasing levels of appropriations "at risk" for certain categories of end items, especially long duration EMD and LRIP programs (e.g., satellites)

- Does DoD plan to make legislative proposals to extend the life of appropriations before they cancel?
- How will the USD (Comptroller) manage the increased complexity surrounding unliquidated funds, and the increased likelihood of needing replacement funds in future years for funds that cancel?
- How has this likelihood been incorporated into the FY20 budget request and FYDP based on the assumptions made in the Regulatory Cost Analysis accompanying the proposed rule?