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Defense Acquisition Regulations System
Attn: Mr. Mark Gomersall
OUSD (AT&L) DPAP/DARS
Room 3B941, 3030 Defense Pentagon
Washington, D.C. 20301-3060

Re: DFARS Case 2016-D017; Advanced Notice of Proposed Rulemaking, Independent Research and Development Expenses, 81 Fed. Reg. 6488 (February 8, 2016)

Dear Mr. Gomersall:

On behalf of the American Bar Association (“ABA”) Section of Public Contract Law (“Section”), I am submitting comments on the referenced Advanced Notice of Proposed Rulemaking (“ANPR”).¹ The Section consists of attorneys and associated professionals in private practice, industry, and government service. The Section’s governing Council and substantive committees include members representing these three segments to ensure that all points of view are considered. By presenting their consensus view, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the ABA’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the ABA and, therefore, should not be construed as representing the policy of the ABA.²

¹ Mary Ellen Coster Williams, Section Delegate to the ABA House of Delegates, and Heather K. Weiner, member of the Section’s Council, did not participate in the Section’s consideration of these comments and abstained from the voting to approve and send this letter.

² This letter is available in pdf format at http://www.americanbar.org/groups/public_contract_law/resources/prior_section_comments.html under the topic “Acquisition Reform and Emerging Issues.”
I. INTRODUCTION

The ANPR sets forth a proposed approach for evaluating future independent research and development ("IR&D") expenses in competitive procurements. In a subsequent public meeting, the Department of Defense ("DoD") also invited suggested alternative solutions. The Section commends DoD for its use of the ANPR as a device to solicit input from stakeholders before fashioning a proposed rule and encourages DoD to make continued use of that device in the future. Nevertheless, we believe that the rulemaking objective of this particular ANPR is not sufficiently defined to permit the ANPR to serve its intended purpose. Consequently, the Section respectfully recommends that DoD withdraw the ANPR. The Section encourages DoD to complete its fact-finding regarding the underlying concern, make policy decisions based on this information, and promulgate regulations, to the extent necessary, consistent with those policy decisions.

The Section respectfully submits that DoD has not clearly or consistently articulated the problem(s) it seeks to address with this proposed rulemaking, which makes it difficult to offer alternatives that would not discourage contractors from investing IR&D. The proposed approach appears to conflict with the existing statutes, regulations, and policy considerations that frame current IR&D practices. Indeed, the proposed approach outlined in the ANPR may be inconsistent with DoD’s stated goal to focus IR&D spending on programs that best benefit DoD.

Moreover, the contemplated rulemaking presumes that contractors gain an unfair competitive advantage by leveraging IR&D-funded technology in fixed-price contracts and to propose the imposition of an evaluation penalty on such proposals. The Section has two principal concerns with this presumption. First, it is not clear that leveraging IR&D-funded technology represents an unfair advantage to a contractor bidding on a fixed-price contract. Second, the proposed approach goes too far and, instead of incentivizing contractors to use IR&D to pursue lines of research that would promote immediate needs and goals of DoD, would discourage contractors from investing IR&D funds in such projects. Specifically, to avoid being penalized for use of IR&D, contractors may choose not to pursue any IR&D prior to the procurement envisioned or to pursue IR&D that is not of immediate interest to DoD. This would run counter to DoD’s recently stated goals and DoD’s announced priorities under its Better Buying Power initiatives.

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3 DoD summarized the ANPR as “DoD is seeking information that will assist in the development of a revision to the DFARS to ensure that substantial future independent research and development (IR&D) expenses as a means to reduce evaluated bid prices in competitive source selections are evaluated in a uniform way during competitive source selections. In addition to the request for written comments on this proposed rulemaking, DoD will hold a public meeting to hear the views of interested parties.” 81 Fed. Reg. 6488 (Feb. 8, 2016).

4 The ANPR states “DoD is considering a proposed approach whereby solicitations would require offerors to describe in detail the nature and value of prospective IR&D projects on which the offeror would rely to perform the resultant contract. Then, as a standard approach, DoD would evaluate proposals in a manner that would take into account that reliance by adjusting the total evaluated price to the Government, for evaluation purposes only, to include the value of related future IR&D projects.” Id.
Through the ANPR, DoD requested comments on this proposed approach and whether it “would achieve the objective of treating the proposed use of substantial future IR&D expenses as a means to reduce evaluated bid prices in competitive source selections in a uniform manner that is consistent with the objective of making IR&D an allowable cost.” The Section recommends that DoD provide the procurement community with additional information identifying those DoD concerns that the proposed approach to price evaluation is intended to address, as well as the facts and circumstances causing DoD to have these concerns.

II. COMMENTS

The Section recommends that the ANPR be withdrawn. Since originating it in the 1930s, the Government has consistently treated IR&D as an indirect cost to be spread proportionately among a contractor’s pursuits and as a valuable means of spurring technological innovation in the defense industry. In the 1990s, Congress codified its intent, directing DoD to encourage contractors to invest in IR&D broadly and independently.

DoD has not clearly and consistently identified what problem(s) the ANPR is meant to solve. Without a clear sense of the problem the ANPR is meant to address, the Section is concerned that the ANPR will (1) deter the Government from procuring innovative technology generated via IR&D (by making such offerings artificially more expensive), while contractors are deterred from making IR&D investments that would place them at a competitive disadvantage in multiple procurements; (2) be inconsistent with Congressional intent by discouraging IR&D investment; and (3) create administrative complications that are not acknowledged in the ANPR.

The ANPR’s proposed approach risks discouraging contractor investment in IR&D. For those contractors choosing to invest in IR&D, DoD’s proposed approach would increase the risk of lost procurement awards by (1) artificially increasing the evaluated price of proposals; and (2) increasing the likelihood of losing an award due to a protest. Contractors perform IR&D work at their own expense initially and then may indirectly recover some of the costs for that work through their government and commercial contracts. Contractors are unlikely to accept additional risk from IR&D projects if doing so will impair their ability to compete for and win government contracts, particularly because IR&D projects already serve to increase contractor indirect costs.

Consequently, the ANPR’s proposed approach inhibits DoD’s ability to harness innovation and maintain battlefield superiority. If IR&D expenses, which by definition benefit multiple programs, are added to the evaluated price of every program to which the IR&D results apply, innovation is put at a competitive disadvantage relative to reliance on legacy technology. Just as the U.S. Court of Appeals for the Federal Circuit in ATK Thiokol, Inc. v. United States was concerned that IR&D costs not be assigned arbitrarily to the first contract/project awarded among the many to which the technology might apply, so too should DoD be concerned that the

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5 Id. at 6488-89.
6 See Appendix for a history of IR&D.
proposed proposal-evaluation approach will exacerbate that potential problem by resting on the presumption that IR&D costs are attributed in full and repetitively to every program to which they relate. See 598 F.3d 1329, 1335-36 (Fed. Cir. 2010). Procurement decisions will be distorted by treating IR&D costs as direct, perhaps in multiple evaluations, although contractors will still incur the costs only one time and will allocate these costs indirectly.

A. DoD Has Not Clearly and Consistently Identified The Problem(s) That The ANPR Is Meant To Solve.

The IR&D rules have evolved to balance competing interests, namely: (a) contractor incentives to develop new DoD-specific technology; and (b) government benefits from the R&D programs for which it pays. The current rules already strike that balance in favor of the Government, as contractors work on IR&D primarily at their own risk. See FAR 31.205-18. Because DoD has not yet clearly articulated why altering this balance is appropriate, rulemaking on this issue is premature.

The Federal Register notice states:

As expressed in the “Implementation Directive for Better Buying Power 3.0—Achieving Dominant Capabilities Through Technical Excellence and Innovation,” dated April 9, 2015, the Under Secretary of Defense for Acquisition, Technology and Logistics noted a concern when “promised future IR&D [Independent Research and Development] expenditures are used to substantially reduce the bid price on competitive procurements. In these cases, development price proposals are reduced by using a separate source of government funding (allowable IR&D overhead expenses spread across the total business) to gain a price advantage in a specific competitive bid. This is not the intended purpose of making IR&D an allowable cost.”

This notice does not explain why DoD seeks to treat IR&D differently from other indirect costs when performing competitive source selections.

During the public meeting on March 3, multiple parties asked DoD to clarify its position on this issue, and the responses from DoD representatives focused on fairness, an increased attention to long-term solutions, and a concern for companies without IR&D programs. Given that Congress encourages contractors to pursue IR&D for the benefit the Government, we believe DoD should explain why a contractor that pursues IR&D should be considered to have an unfair competitive advantage relative to firms that choose not to do so. Moreover, as noted, IR&D is meant to benefit both near- and long-term technologies. On any of these purported issues, there may be multiple solutions that better address DoD’s concern(s) without upsetting the current IR&D balance or creating additional evaluation challenges.

Although DoD suggested that it may consider alternative approaches, it is difficult to offer such approaches without some articulation of the specific problems that DoD seeks to

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7 81 Fed. Reg. at 6488.
solve. Accordingly, the lack of clarity in defining the problem may impair interested parties’ abilities to identify appropriate remedies for DoD’s identified problem or to offer insight into alternative solutions through this particular rulemaking.

The ANPR states that using allowable IR&D costs to gain a price advantage in competition is not the intended purpose of IR&D. The Section does not believe that the legislative history and standard commercial business practice support this statement. Obtaining a price advantage—via reduced costs—is at least an ancillary purpose of the current IR&D statute. The statute states that regulations should encourage contractors to engage in IR&D activities of potential interest to DoD, including activities intended to reduce acquisition costs and life-cycle costs of military systems. 10 U.S.C. § 2372(g)(2). The very concept of IR&D is that it yields results from costs that are spread across multiple contracts (including commercial contracts), rather than burdening a single contract, which reduces the costs to the individual contracts for which those IR&D results are beneficially employed. Further, it is not uncommon for commercial and government contractors to invest in IR&D to obtain a competitive edge through technological advances and cost reductions.

Moreover, if DoD’s concern is that large contractors with advanced IR&D programs have an unfair competitive advantage, the Section recommends that DoD provide additional insight into its determination that an IR&D competitive-evaluation solution is the best solution to this concern. Importantly, as explained above, innovative contractors with IR&D programs put their competitive pricing position at risk by increasing their indirect costs allocable to productive programs and further risk that the additional IR&D costs will not be recovered in competitive prices offered to government and commercial customers. Thus, large or small contractors willing to risk their competitive position in the pursuit of advanced technologies for their customers should not be subject to further competitive disadvantage that would be created by the ANPR’s proposed approach.

In addition, it appears that the proposed approach is at odds with established government contract authority on the treatment of IR&D as an indirect cost. Indirect costs, like IR&D, are allocated to multiple cost objectives—both government and commercial. Relevant government-contract cost-accounting authority establishes that IR&D costs are for independent contractor development effort, the cost of which is allocable to contracts as an indirect cost. By adding the cost supporting IR&D projects to the total estimated cost of the contract during evaluation, the Government treats such costs as direct contract costs for purposes of determining offers’ costs. This addition will result in a proposal evaluation process that treats IR&D costs differently from the manner in which such costs are treated for estimating and cost-accumulation purposes under current regulations. The proposed approach may result in an unintentional distortion of the offerors’ expected costs of the contract. Thus, the ANPR may result in deviation or

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8 For example, DoD employs other methods to protect small businesses that may not have significant IR&D budgets through the operation of various set-aside procurements and subcontracting requirements that ensure small business participation in government contracts. See, e.g., FAR 52.219-9.

9 See FAR § 31.205-18(b)(2); 48 C.F.R. § 9904.420 (“CAS 420”); see also ATK Thiokol, Inc. v. United States, 598 F.3d at 1335; Boeing Co. v. United States, 862 F.2d 290 (Fed. Cir. 1988).
circumvention of the treatment of IR&D as an indirect cost. Accordingly, because the ANPR’s approach creates uncertainty and inconsistency in the evaluation of IR&D costs and DoD has not provided sufficient factual support for its proposed approach, DoD should withdraw the ANPR and republish it only with sufficient data to support a revised approach.\footnote{10 See Frank Kendall, Better Buying Power Principles, Defense AT&L Magazine at 3 (Jan. – Feb. 2016) (“Data should drive policy.”).}

Finally, and perhaps most significantly, from a practical perspective, there may be no one adversely impacted that actually wants such a change. If a contractor uses IR&D investment to lower its price, then there are two possible outcomes. First, the contractor’s proposal could be rejected. In that case, any advantage of the lower price associated with IR&D is of no moment. Second, that contractor’s proposal could be accepted for award. In that case, the Government is not harmed because it will realize the benefit of its IR&D investment. Indeed, because that IR&D investment is spread over multiple contracts, the Government will receive a multiplier on its IR&D investment. In the end, it appears that the only parties adversely affected are the disappointed offerors who do not have the price decrease associated with prior IR&D investment to include in their proposal and therefore propose an incrementally higher price. To date, however, the Section is aware of no complaints from the contractor community regarding the current approach to the use of IR&D savings in competitive procurements. This is likely because the disappointed offerors who cannot take advantage of IR&D discounts in one procurement may want to do the same thing in another procurement for which they have targeted their IR&D investment. As such, as discussed above, this may be an answer looking for a problem, rather than an actual problem.

B. The ANPR’s Proposed Approach Appears to Conflict With the Existing Statutory and Regulatory IR&D Framework and Policies.

1. IR&D Investments Are Contractor Determinations.

A basic policy issue underlies the ANPR: the degree to which DoD should be able to manage contractors’ choice of IR&D projects. As discussed further below, a long history supports the current IR&D rules, and the Section believes those rules strike an appropriate balance between the Government’s interests in IR&D and contractors’ ability to engage in and make productive use of IR&D projects.

DoD currently exercises oversight over IR&D pursuant to DFARS 231.205-18, which includes, as allowability criteria for major contractors, a requirement that IR&D projects be of potential interest to DoD. DFARS 231.205-18 further limits major contractors’ allowable IR&D costs under DoD contracts to the lesser of the “contracts’ allocable share of total incurred IR&D/B&P costs” or “[t]he amount of incurred IR&D/B&P costs for projects having potential interest to DoD.”
DFARS 231.205-18 is based on 10 U.S.C. § 2372, “Independent research and development and bid and proposal costs: payments to contractors,” which states at Section 2372(c)(1) that regulations may include “[a] limitation on the allowability of [IR&D] . . . to work which is of potential interest to the [DoD].” But Section 2372(f) also states that “[r]egulations prescribed pursuant to subsection (c) may not include provisions that would infringe on the independence of contractors to choose which technologies to pursue in its [IR&D] program.”

The Section believes the current statute and regulations strike the appropriate balance concerning DoD’s management of contractor IR&D costs, and thus the ANPR is not necessary.

2. IR&D Projects Are Intended to Yield Broadly Applicable Benefits, Including Competitive Advantage and Reduced Costs.

In the ANPR, the DoD identified its concern about the current use of IR&D expenses in competitive procurements:

[P]romised future [IR&D]…expenditures are used to substantially reduce the bid price on competitive procurements. In these cases, development price proposals are reduced by using a separate source of government funding (allowable [IR&D] overhead expenses spread across the total business) to gain a price advantage in a specific competitive bid. This is not the intended purpose of making [IR&D] an allowable cost.

Based on this concern, DoD is considering including in the total evaluated price of a competing contractor’s offer the “value of prospective IR&D projects on which the offeror would rely to perform the resultant contract.” Id.

The Section is concerned that the foundational premises for this proposed approach are not accurate. First, the ANPR references a concern that indirect IR&D expenses will be used to “gain a price advantage in a specific competitive bid.” This misconstrues the fundamental nature of IR&D. By definition, allowable IR&D expenditures support pursuits that will potentially benefit multiple programs, not only a specific competitive bid. Consequently, the

11 In a recent proposed rule concerning IR&D costs, DoD stated: “In accordance with 10 U.S.C. § 2372(f), contractor IR&D investments are not directed by the Government—they are identified by individual companies and are intended to advance a particular company’s ability to develop and deliver superior and more competitive products to the warfighter.” 81 Fed. Reg. 7721, 7722 (Feb. 16, 2016 (DFARS Case 2016-D002))


13 Id. at 6488.

14 IR&D costs are allowable as indirect expenses. FAR 31.205-18(c). Indirect costs, in turn, are “not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.” 48 CFR Part 9904.402-30(a)(5) (CAS 402-30). Independent research and development is defined as the contractor’s IR&D cost that consists of projects falling within the following areas: (1) basic research, (2) applied research, (3) development, and (4) systems and other concept formulation studies. The term does not include the costs of effort sponsored by a grant or required in the performance of a contract. IR&D effort shall not include technical effort expended in developing and preparing technical data specifically to support submitting a bid or proposal.
existing regulations preclude a contractor from including in its IR&D costs the expense of development work that is uniquely associated with a specific competitive bid. If a contractor intends to pursue IR&D projects that will potentially benefit multiple contracts—including the contract on which it intends to bid—then it can propose to use the results of that IR&D on the contract it is bidding for, as well as on other contract pursuits and existing projects, and account for those expenses as indirect IR&D.

Second, use of IR&D that has yielded positive results should be afforded a competitive price advantage, as well as a competitive technical advantage. IR&D includes efforts to improve existing products and systems and harness the potential of scientific discoveries. Thus, in addition to providing improved performance characteristics, a firm’s IR&D pursuits may allow it to propose a more efficient or otherwise less-expensive solution. And an offeror may rely on multiple innovative technologies developed with IR&D funding as various components of a proposed system. The creativity, foresight, and innovative thinking that led one firm to pursue IR&D efforts yielding such benefits may distinguish it from a competitor, but this is no different from any other competitive differentiation. Both Government and industry gain when IR&D results can be used to address the Government’s immediate and longer-terms needs.

Third, there is no self-evident reason to eliminate a competitive price advantage gained through legitimate IR&D efforts by adding the value of IR&D results to a competitor’s evaluated price, merely because the allowable IR&D costs were appropriately included in the cost pools used to develop the contractor’s indirect rates. Following the same logic, costs incurred to

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FAR 31.205-18.

Development is defined as:

the systematic use, under whatever name, of scientific and technical knowledge in the design, development, test, or evaluation of a potential new product or service (or of an improvement in an existing product or service) for the purpose of meeting specific performance requirements or objectives. Development includes the functions of design engineering, prototyping, and engineering testing.

**Id.**

15 In addition to the ANPR, DoD has published a proposed rule that would amend the DFARS “to require that proposed new IR&D efforts be communicated to appropriate DoD personnel prior to the initiation of these investments, and that results from these investments should also be shared with appropriate DoD personnel.” 81 Fed. Reg. 7721, 7722 (Feb. 16, 2016) (DFARS Case 2016-D002). In discussing that proposed rule, DoD stated:

IR&D investments need to meet the complementary goals of providing defense companies an opportunity to exercise independent judgment on investments in promising technologies that will provide a competitive advantage, including the creation of intellectual property, while at the same time pursuing technologies that may improve the military capability of the United States.

**Id.** (emphasis added). The ANPR and proposed rule appear at odds because the proposed rule recognizes that one goal of IR&D is contractor investment in technology that will provide a competitive advantage.

16 In addition, the ANPR includes an overly broad reference to a “separate source of government funding.” 81 Fed. at 6488. This does not appear to take into consideration that IR&D costs are not allocated entirely to DoD contracts, but are allocated across the contractor’s final cost objectives, including unallowable cost objectives and commercial contracts. See FAR 31.205-18(b)(2); CAS 420. Further, as a matter of law, the Section disagrees with the characterization of IR&D funding as a “separate source of government funding.” IR&D costs are deemed to
develop older, existing technologies that were directly reimbursed under prior government contracts should also be added to the evaluated price where a proposal relies on such legacy technology. New and innovative technology developed with IR&D expenditures and benefitting multiple programs should not be competitively burdened to a greater extent than reused older technology.

Attributing IR&D value or costs to a specific contract is antithetical to the concept of IR&D. As set forth in the appendix to these comments, the history of IR&D shows that the Government once before considered, and rejected, mounting restrictions on allowable IR&D. That history demonstrates recognition that these expenditures benefit the Government. It also evidences a movement towards greater contractor independence and flexibility and less government constraint regarding contractor decisions about what innovative programs contractors should pursue consistent with treatment of IR&D as allowable indirect costs.

3. The ANPR’s Proposed Approach Appears Inconsistent with Congressional Guidance.

As explained above, Congress began expressing its intent that defense contractors be encouraged to administer broad IR&D programs independently in the early 1990s. In 1996, congressional intent was codified at 10 U.S.C. § 2372. The relevant statutory provisions have not materially changed since being enacted. To the extent the proposed approach may discourage IR&D investment, the ANPR seems at odds with established law.

Section 2372, in relevant part, states that (1) regulations may not include provisions that would infringe on the independence of a contractor to choose which technologies to pursue in its IR&D program, and (2) regulations should encourage contractors to engage in IR&D activities of potential interest to DoD, including activities intended to reduce acquisition costs and life-cycle costs of military systems:

(f) Limitations on regulations.--Regulations prescribed pursuant to subsection (c) may not include provisions that would infringe on the independence of a contractor to choose which technologies to pursue in its independent research and development program.

(g) Encouragement of certain contractor activities.--The regulations under subsection (a) shall encourage contractors to engage in research and development activities of potential interest to the Department of Defense, including activities intended to accomplish any of the following:


   (2) Reducing acquisition costs and life-cycle costs of military systems.

constitute funding at purely private expense. See e.g., 10 U.S.C. § 2320(a)(3); KSD, Inc. v. U.S., 72 Fed. Cl. 236, 260 (2006); Bell Helicopter Textron, ASBCA No. 21,192, 85-3 BCA ¶ 18,415.
(3) Strengthening the defense industrial base and the technology base of the United States.

(4) Enhancing the industrial competitiveness of the United States.

(5) Promoting the development of technologies identified as critical under section 2506 of this title.

(6) Increasing the development and promotion of efficient and effective applications of dual-use technologies.

(7) Providing efficient and effective technologies for achieving such environmental benefits as improved environmental data gathering, environmental cleanup and restoration, pollution reduction in manufacturing, environmental conservation, and environmentally safe management of facilities.

10 U.S.C. 2372(f)-(g).

The legislative history for these provisions further illuminates Congress’s intent to encourage IR&D investment:

The committee believes that the defense acquisition reforms now underway must encourage defense executives in government and industry to take a long-term view of the national defense, particularly the defense technology base. These reforms should include steps to encourage defense industry to make investments in research and development that benefit both near- and long-term technology. It should encourage breaking down the barriers between civilian and military production and thereby stimulate research and development that benefits both sectors. Independent research and development (IRAD) programs, undertaken by industry under joint funding agreements with the Department of Defense, offer great promise for diffusing new technology into dual-use applications. The committee understands that, as presently structured under statute and regulation, the defense industry primarily undertakes IRAD projects that are predominately of a military nature. The committee believes that, in today’s climate of decreasing defense budgets, increasing international technological competition, and an urgent need to efficiently adjust the Nation’s defense industrial base, defense contractors should be encouraged to use IRAD projects to support Defense Department objectives in the broadest sense. Section 805 amends chapter 139 of title 10, United States Code, to direct the Secretary of Defense to prescribe new regulations for payment of independent research and development and bid and proposal costs. Payment for such costs is authorized for any work that is of potential interest to the Department, including IRAD projects that strengthen the defense industrial and technology base, that enhance the Nation's industrial competitiveness, that promote development of critical technologies as identified in the Department's Critical Technologies Plan, that support

Thus, the plain language of the statute and its legislative history encourage contractors to invest in IR&D and provide for DoD to reimburse an allocable share of that investment.

C. The Proposed Approach Would Discourage Investment in IR&D and May Result In Increased Bid Protests.

By proposing to increase the evaluation price for proposals relying on IR&D, the ANPR’s proposed approach is likely to discourage investment in IR&D and may increase bid protests.

First, because IR&D costs are typically included in a contractor’s overhead rates, there is a significant risk that this proposal will result in DoD’s unfairly factoring IR&D costs into evaluations at least twice, resulting in the distortion of anticipated costs of proposed contract performance. Again, IR&D costs are indirect costs allocated across a contractor’s final cost objectives, including unallowable cost objectives and commercial contracts. See FAR 31.205-18(b)(2); CAS 420. Allocable IR&D costs are already included in an offeror’s proposed forward pricing rates and estimated indirect costs; thus, if DoD further increases evaluated costs by the value of relevant IR&D projects, the offeror’s IR&D expenditures will be double counted in the offeror’s evaluated prices.

In fact, the ANPR’s proposed approach risks duplicative counting of IR&D costs against an offeror’s proposals. For example, in cases in which an offeror participates in multiple procurements that may benefit from the same IR&D efforts, it is unclear how evaluation criteria would be structured across procurements to ensure that the entire IR&D value is not unfairly and repetitively considered in each proposal evaluation. This result appears unwarranted and unnecessary because, as previously noted, an allocable amount of the IR&D effort is already appropriately priced into the indirect costs of the offeror’s proposal. Calculating how to apply an additional share of IR&D costs as an evaluation factor appears to risk counting such costs against an offeror multiple times for the same IR&D effort.

Second, the ANPR’s proposed approach will almost certainly increase the number of bid protests. The uncertainties surrounding how IR&D costs should be considered during evaluations present many opportunities for protest. Different contractors build up their indirect rates using various approaches, and often, contractors competing for a DoD program employ differing pricing strategies that take into account their particular risk appetite and profit goals. Moreover, contractors may include in their IR&D costs the costs associated with performing research and development effort under cooperative agreements and other transactions. It will be challenging for DoD to develop any standard approach to adjust total evaluated prices to include the value of related future IR&D projects given the complex variables involved. Hence, this approach likely will add time and complexity to the procurement cycle due to the need to
develop procurement-specific evaluation factors in certain instances. As in a cost or price realism challenge, a protester will have the ability to argue that the agency over- or under-counted the cost of its IR&D efforts or those of a competitor, as well as other potential protest grounds. These protests will increase the time and cost of procurements and consume resources that would be better spent on innovation.

With these risks in mind, contractors would be less likely to proactively anticipate and engage in IR&D of the kind of technological advances that DoD may be interested in the future, because the more IR&D they invest in, the less competitive their proposed prices would be. This outcome directly contravenes Congress’ goals in enacting 10 U.S.C. § 2372 and violates the statutory direction that DoD regulations should encourage IR&D.

The ANPR’s approach will also likely impair DoD’s ability to drive innovation of technologies with defense applications. Without robust industry investment in IR&D, DoD may be required to procure innovations directly and bear the entire development expense of the new technology as a direct contract cost under the initial DoD contract for the product. This would increase the cost of innovation to DoD because DoD would have to bear the entire cost of the innovative product, rather than share that burden with commercial business.

Alternatively, DoD may be required to delay development or adoption of new technology into defense products because, absent DoD funding of the innovation, DoD may be left to rely upon purely commercial technology development, rather than benefit from the current IR&D regime that encourages contractors to develop dual-use and military technology innovation. See ATK Thiokol, 598 F.3d at 1335 (“[P]roviding financial support for IR&D serves several Departmental goals, including creating an environment that encourages DoD contractors to expand knowledge in mathematics and science, improve technology in areas of interest to the Department of Defense, and enrich and broaden the spectrum of technology available to the Department of Defense.”) (internal quotation omitted).

D. The ANPR Would Create Administrative Challenges.

The proposed approach set forth in the ANPR may create administrative problems for DoD and its contractors. Accordingly, the Section recommends that additional analysis be undertaken in the following areas, among others, before the rulemaking process proceeds further:

**How will the value of an IR&D program be allocated to proposals?** It is unclear whether each proposal will bear the full burden of a contractor’s IR&D program, or whether the value of an IR&D program will be divided among a contractor’s proposal and other benefited contracts and programs. DoD should determine with input from industry what impacts and challenges will be presented in making this assessment. For example, how will an evaluation factor take into account each contractor’s non-government contracts that benefit from their IR&D program and what data will the procuring office need to effectively make such an assessment? This calculation and division will be even more complicated to the extent that current contracts benefit from an IR&D program, which is likely to be the case more often than not.
How will DoD account for the value of subcontractor IR&D programs? If a prime contractor proposes to incorporate technology developed in a subcontractor’s IR&D program, must the prime contractor roll up the total value of a subcontractor’s IR&D program into its proposal price? If not, may a prime contractor avoid having its proposed price increased by relying on a subcontractor’s IR&D program? For example, it seems that if the evaluation factor does not adjust the proposed price for subcontractor IR&D, a contractor team could identify as the prime contractor that team member with the smallest IR&D program to ensure that the proposed price has little to no adjustment as a result of the IR&D evaluation factor.

How is the “value” of an IR&D program calculated? To add any part of the value of an IR&D program to a contractor’s total evaluated price (“TEP”), the agency must first calculate the value of the IR&D program. It appears that this will be a fundamental step of every procurement to which the ANPR’s proposed approach would apply. It could perhaps be determined by the dollar value of the IR&D investment, or the value of the IR&D results as measured by some other metric, or a function of how much those results offset direct costs that would otherwise be incurred on the contract being competed. Any approach chosen seems to create a difficult calculation to reflect the “value” of an IR&D program accurately, and a calculation that may prove more complex and onerous, and more prone to dispute or protest, than other elements of the price evaluation.

Which IR&D Expenses Will Be Added To the TEP? The ANPR refers to concerns about “substantial future” IR&D. First, it is not clear what is meant by “substantial.” Second, a future IR&D effort expected to benefit a contractual activity that is being competed may involve a long-term undertaking, or an already existing but continuing activity. Where these efforts involve continuing technology evolution and development, only partial or intermediate results may have application for the competitive opportunity. The contract may benefit from both past and future (and perhaps still incomplete) IR&D results. Presumably, the TEP addition must be limited to that portion of the IR&D results to be used in connection with the contract that are anticipated to become available as a consequence of the “substantial future” IR&D effort and that will transpire during the period of contract performance should be added to the TEP. DoD will face extreme difficulty calculating fair “substantial future” IR&D costs.

III. CONCLUSION

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

David G. Ehrhart
Chair, Section of Public Contract Law

cc:
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Appendix: The History Of IR&D Reveals The Policy Evolution Underlying The Current Framework

1. Origins of IR&D

Treatment of IR&D in procurement law traces back to the 1934 Vinson-Trammell Act, Pub. L. No. 73-135, § 3(b), 484 Stat. 503, 505 (1934), which placed a profit cap on contractors building naval vessels and aircraft at 10% of “total contract price.” Having established a profit limit based on percentage of total contract price, the Government promulgated rules explaining which costs counted toward “total contract price.” The 1940 Treasury Decision 5000 identified “experimental and development costs” as a type of “other manufacturing cost” that are properly included in “total contract price” in a “proper portion . . . determined by a ratable allocation which is reasonable.” T.D. 5000, 5 Fed. Reg. 2788 (Aug. 9, 1940). Thus, from the very beginning, the Government intended to pay a pro rata share of profit to contractors for indirect R&D (i.e., an indirect expense). See generally Mark J. Nackman, Implicit verses Explicit Requirements and Independent Research & Development Costs Under ATK Thiokol: Securing the Future of U.S. Technology Investment, 44 Pub. Cont. L.J. 297 (2012).

Implementing the Treasury Decision, the 1942 Green Book also described early IR&D costs as allowable indirect costs. It distinguished between “engineering services related immediately to manufacturing operations (i.e. shop engineering expense) and research, experimental, and development costs not related to current manufacture but devoted to future improvement in and application of products.”

The cost of the latter research and experimental development work may be absorbed in manufacturing costs on a regular basis by means of absorption rates, on the principle that these activities are usually maintained under a consistent program independently and apart from current manufacturing operations, and that their benefit relates to products on a uniform scale over a period of years more properly than according to actual expenditures in a given year.


Following World War II (“WWII”), the Government rewrote the Armed Services Procurement Regulation (“ASPR”) cost principles. In the 1949 version, “general research expense” (a predecessor to IR&D) was unallowable unless specifically provided for in the contract. ASPR 15-204(s), 15-205(j) (1948). It was, however, common practice for contractors to negotiate pre-determined rates for IR&D costs prior to performance, which would then be provided for in the contract. The Air Force responded to this by requiring contractors to submit an annual IR&D plan so that the projects and costs could be reviewed and recovery amounts negotiated. Alexander et al., The RAND Corp., R-3649-ACQ, The Defense Department’s Support of Industry’s Independent Research and Development (IR&D): Analysis and Evaluation 7 (1989).
Following the launch of Sputnik in 1957, there was a general feeling that DoD support for R&D should increase, but this would need to be coupled with increased oversight. \textit{Id.} The 1959 ASPR created an explicit IR&D cost principle at 15-205.35(c). Independent research costs were allowable, but only the portions that could be expected to benefit future defense capabilities. The costs of independent development were generally allowable to the extent the development was related either to product lines for which the Government had contracts, or if the contractor did not have any product lines, to a field of effort in which the Government had contracts. To control these expenditures, the Government would limit the amount of IR&D allowed in the overhead rate of procurement contracts. The amount of IR&D recovered would not be determined solely by contractors, but through negotiations that would determine a reasonable amount stated in terms of an allowable ceiling. An allocable share of IR&D costs up to that ceiling could be charged as overhead to DoD. Contractors were required to submit technical brochures describing their IR&D projects, which were to be evaluated by technical specialists and provided to the DoD’s IR&D negotiator.

In 1968, the Government revised the ASPR 15-205.35(c) IR&D definition. The original, 1959 IR&D definition was “research and development which is not sponsored by a contract, grant, or other arrangement.” The 1968 version defined IR&D as “technical effort which is not sponsored by, or required in the performance of a contract or grant.” The ASPR Committee explained that the intent of the change was to “convey the concept that any work which must be accomplished in order to fulfill contractual requirements is a contract cost.”

The 1970 Military Procurement Authorization Act established that IR&D and bid and proposal costs were only to be paid if:

a) they had a potential relationship to a military function or operation, and

b) if advanced agreements were negotiated for contractors that received significant payments for IR&D and B&P in prior years.

Thereafter, DOD revised both the IR&D and B&P cost principles to place ceilings on the allowability of IR&D and B&P costs and to require that a contractor receiving DOD payments, as either a prime contractor or subcontractor, in excess of $2 million for IR&D and B&P in a fiscal year negotiate an advance agreement for allowability of IR&D and B&P costs for the following fiscal year. For contractors not required to negotiate an advance agreement, the IR&D and B&P cost principles prescribed a formula to determine the ceiling amount.

2. \textit{The Modern View of IR&D}

In Defense Authorization Acts during the early 1990’s, Congress expressed its recognition that IR&D activities are beneficial to the Government and should be encouraged. Thus, the 1991 NDAA eliminated the need for IR&D to have potential military relevance and broadened the categories of effort that could qualify as IR&D. National Defense Authorization Act for Fiscal Year 1991, Publ. L. No. 101-510, § 824, 104 Stat. 1485, 1603 (1990). In the 1992-93 NDAA, Congress eliminated the mandatory requirement for advance agreements defining IR&D and removed the annual cap on total allowable IR&D. National Defense
Authorization Act for Fiscal Years 1992 and 1993, Pub. L. No. 102-190, § 802, 105 Stat. 1290, 1412 (1991). The same NDAA required DoD to establish IR&D regulations that would “encourage contractors to engage in R&D activities of potential interest to the DoD … not infringe on the independence of contractors to choose which technologies to pursue in their IR&D activities, and . . . provide that IR&D . . . costs are allowable as indirect expenses on covered contracts.” Id. § 1413 (emphasis added).

The Under Secretary of Defense expressed the recognition, in a 1993 memorandum, that, consistent with the congressional intent expressed in the recent NDAAs, “we must change . . . DoD’s fundamental approach to acquisition and research and development in order to keep pace with reduced defense budgets and other challenges of the Post-Cold War era.” Manos, Government Contracts Cost & Pricing § 25:3 (quoting Memorandum from John M. Deutch, Under Secretary of Defense, “Broadened Use of Funds for Independent Research and Development,” at 1 (April 22, 1993); Letter from John M. Deutch, Under Secretary of Defense to C. Stanley Dees, Chairman, CODSIA at 1 (April 22, 1993)). He explained that the point of the 1990-93 NDAA’s changes to the treatment of IR&D was to provide an incentive to contractors to invest in dual-use technologies and expand their businesses beyond traditional military procurement. Thus, the IR&D regulations were expanded to “increase the development and promote efficient and effective applications of dual-use technologies, those that promote critical technologies, and those that enhance the industrial competitiveness of the United States.

Implementing these statutory directives, the regulatory history of FAR 31.205-18 reveals that amendments were made to reflect the “significant changes in the treatment of IR&D/B&P costs and eliminate[] most of the detailed administrative procedures that are currently in place to control the amount of IR&D/B&P reimbursement to contractors.” Federal Acquisition Regulation; Independent Research and Development and Bid and Proposal Costs, 57 Fed. Reg. 44264-01, 44264 (Sept. 24, 1992).

The DFARS IR&D provisions were revised “to include DoD policy of encouraging defense contractors to engage in IR&D/B&P activities of potential interest to DoD” and “prohibit[] departments and agencies from issuing supplemental regulations to limit IR&D/B&P cost allowability.” Department of Defense Acquisition Regulations; Miscellaneous Amendments, 57 Fed. Reg. 53596-01, 53968 (Nov. 12, 1992).

The Defense Department’s interest in encouraging contractor pursuit of technology innovation was also expressed in 1995 when DoD modified data rights regulations to eliminate expectations that the Government would secure rights in technical data, even for technology developed at private expense with IR&D funding, if the technology development was during or necessary for the performance of a Government contract. When it eliminated the “during” and “necessary” constraints, DoD explained the change as follows:

DOD believes [the “during” and “necessary”] criteria should be eliminated to protect private expense development, encourage developers of new technologies or products, many of whom are small businesses, to offer their products to the
Government, encourage dual use development, and balance the interests of data users and data developers.


DoD’s encouragement of IR&D endured throughout the 1990s. In 1999, it was express DoD policy that: “contractors shall be encouraged to undertake IR&D activities that may further national security in a broad sense, may lead to a superior military capability, or may lower the cost and time required for providing that capability. Dept. of Def., Directive No. 2304.1, Independent Research and Development (IR&D) and Bid and Proposal (B&P) Program 2 (May 10, 1999) (emphasis added). DoD recognized the necessity of treating industry’s IR&D expenses as allowable, indirect costs:

The costs incurred by DoD contractors for IR&D and B&P activities are recognized by the Department of Defense as necessary costs of doing business, particularly in a high-technology environment. IR&D and B&P costs incurred in performing activities of potential DoD interest shall be reimbursable as “indirect expenses” on covered contracts to the extent that they are allocable, reasonable, and not otherwise unallowable by law.

Id. at 3. The policy directive continued to explain the purpose of supporting such costs. This includes goals such as “creating an environment that encourages DoD contractors to expand knowledge in mathematics and science, improve technology in areas of interest to the Department of Defense, and enrich and broaden the spectrum of technology available to the Department of Defense.” Id. DoD also explained that it sought to support IR&D in order to create “conditions that allow DoD contractors the freedom to determine the focus of their IR&D programs and especially the freedom to exploit fruitful avenues of research that, in their judgments, may provide the greatest benefits.” Id. at 4 (emphasis added).

Following the relaxation of procedural burdens on IR&D throughout the 1990’s, the next major issue in the history of IR&D was determining exactly which costs constituted IR&D. This turned on determining when costs are “required in the performance of a contract” and thus excluded from the definition of IR&D. In a 2003 False Claims Act case, the E.D. Va. ruled that R&D implicitly required during performance of a contract should be treated as “required in the performance of a contract” and thus must be charged to the contract directly, not indirectly as IR&D. United States v. Newport News Shipbuilding, Inc., 276 F. Supp. 2d 539, 541 (E.D. Va. 2003). This remained the controlling view until 2010, when the Federal Circuit resolved the issue in the context of a contract dispute and decided that “required in the performance of a contract” meant that R&D expenses could not be treated as indirect IR&D costs, but only for activities necessary to fulfill an express contract requirement. ATK Thiokol, Inc. v. United States, 598 F.3d 1329 (Fed. Cir. 2010). Therefore, R&D that was not expressly required during contract performance could be treated as an indirect cost if it otherwise satisfied the definition of IR&D. Id. at 1335. In reaching this result, the court acknowledged DoD’s policy in favor of promoting IR&D. Id.
In ruling as it did in ATK Thiokol, the court sought to avoid an interpretation of the definition of IR&D that would result in a paradigm where the first purchaser of a new technology (whether government or commercial) would be forced to bear all of the R&D costs invested to develop a new technology that could be used not only for the benefit of that contract, but also to benefit many other contracts and customers – this is fundamental to the concept of an indirect cost. Id. To hold otherwise would risk loss of the benefits of sharing with a contractor’s commercial customers the costs to develop new technologies that have both government and commercial application. As the court observed, “[f]or research that, by hypothesis, benefits multiple potential contracts, both commercial and government, allocating general research and development costs [to the first contract awarded that uses the technology] … is not sensible as a policy matter.” 598 F.3d at 1335-36. The court also recognized that “[s]preading IR&D costs across multiple contracts encourages general research that enables the contractor to innovate, to maintain a high level of technological sophistication, and ultimately to improve the products it offers the government.” Id. at 1335.