

Audit



Report

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**ADDENDUM TO FINAL AUDIT REPORT ON CONTRACTING
PRACTICES FOR THE USE AND OPERATIONS OF DOD-
SPONSORED FEDERALLY FUNDED RESEARCH AND
DEVELOPMENT CENTERS**

Report No. 95-048A

April 19, 1995

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Acronyms

ARPA	Advanced Research Projects Agency
ASD(C ³ I)	Assistant Secretary of Defense (Command, Control, Communications, and Intelligence)
CNA	Center for Naval Analyses
DCAA	Defense Contract Audit Agency
DDR&E	Director, Defense Research and Engineering
DFARS	Defense Federal Acquisition Regulation Supplement
DSS-W	Defense Supply Service-Washington
FAR	Federal Acquisition Regulation
FFRDC	Federally Funded Research and Development Center
IDA	Institute for Defense Analyses
IPA	Intergovernmental Personnel Act
OFPP	Office of Federal Procurement Policy

Accession Number: 3892

Publication Date: Apr 19, 1995

Title: Addendum to Final Audit Report on Contracting Practices for the Use and Operations of DoD-Sponsored Federally Funded Research and Development Centers

Corporate Author Or Publisher: DoD, Office of the Inspector General, 400 Army Navy Dr., Arlington, VA Report Number: 95-048A

Descriptors, Keywords: Audit Report Inspector General DoD Contracting Practice Research Development Center

Pages: 00136

Cataloged Date: May 18, 1995

Document Type: HC

Number of Copies In Library: 000001

Record ID: 30017



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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April 19, 1995

MEMORANDUM FOR DIRECTOR, DEFENSE RESEARCH AND ENGINEERING
ASSISTANT SECRETARY OF DEFENSE (COMMAND,
CONTROL, COMMUNICATIONS, AND INTELLIGENCE)
DEPUTY UNDER SECRETARY OF DEFENSE (LOGISTICS)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL
MANAGEMENT AND COMPTROLLER)
DIRECTOR, ADVANCED RESEARCH PROJECTS AGENCY
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Addendum to Final Audit Report on Contracting Practices for the Use and
Operations of DoD-Sponsored Federally Funded Research and Development
Centers (Report No. 95-048A)

The enclosed addendum provides the management comments to the draft report and our evaluation of those comments. The Director, Defense Research and Engineering, comments include the Deputy Under Secretary of Defense (Logistics) comments. The comments were not incorporated in final Report No. 95-048 dated December 2, 1994, because the management comments were not received in time to be considered in preparing the final report. On December 12, 1994, we requested that the report addressees not provide any comments on the final report until this addendum was issued.

Based on our evaluation of the management comments, we revised a recommendation and deleted a recommendation in the final report. DoD Directive 7650.3 requires that all audit recommendations and potential monetary benefits be resolved promptly. Therefore, all addressees are requested to provide comments on unresolved recommendations and potential monetary benefits by June 19, 1995. See the table following the discussion of management comments for each finding in Part II (pages 21, 28 and 36) for the unresolved recommendations and the specific requirements for your comments.

We appreciate the courtesies extended to the audit staff. If you have any questions on the audit or this addendum, please contact Mr. Garold E. Stephenson, Audit Program Director, at (703) 604-9332 (DSN 664-9332) or Mr. John M. Gregor, Audit Project Manager, at (703) 604-9321 (DSN 664-9321). Copies of the addendum will be distributed to the offices that received the December 2, 1994, final report.

David K. Steensma

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for Auditing

Office of the Inspector General, DoD

Report No. 95-048A
(Project No. 1CH-5012)

April 19, 1995

ADDENDUM TO FINAL REPORT ON CONTRACTING PRACTICES FOR THE USE AND OPERATIONS OF DOD-SPONSORED FEDERALLY FUNDED RESEARCH AND DEVELOPMENT CENTERS

EXECUTIVE SUMMARY

Introduction. Inspector General, DoD, Report No. 95-048, "Contracting Practices for the Use and Operations of DoD-Sponsored Federally Funded Research and Development Centers," December 2, 1994, was published without management comments. The management comments were not received in time to be considered in preparing the final report. This addendum provides the management comments and our evaluation of those comments.

Summary of Audit Report. The audit report contained the following findings and recommendations.

Audit Findings. The work performed by DoD FFRDCs was generally consistent with their broad mission statements. However, DoD sponsors did not provide sufficient justification for using FFRDCs to perform 223 of the 229 projects reviewed. As a result, DoD sponsors could not demonstrate that the noncompetitive assignment of work to the FFRDCs kept DoD sponsor costs down and resulted in the best performance (Finding A).

DoD FFRDCs generally developed overhead rates that were in accordance with Government standards. However, the accounting for \$43 million of the \$46.9 million in management fees paid to DoD FFRDCs was not correct. About \$11.6 million of management fees should not have been paid, and \$31.4 million should have been charged to overhead. Also, a Navy approved increase in management fee payments to the Center for Naval Analyses increased contract costs by about \$2.7 million annually but does not provide any measurable benefits to the Navy (Finding B).

DoD FFRDCs had various conflict of interest policies that indicated a general awareness of their responsibility to avoid conflict of interest situations. However, contracting officers did not thoroughly consider potential conflicts of interest involving work assigned to DoD FFRDCs. Also, one FFRDC employee, who was on an Intergovernmental Personnel Act appointment with the Advanced Research Projects Agency, was responsible for directing the activities of another FFRDC. Further, in four instances, FFRDCs appeared to hire employees only to qualify the employees for Intergovernmental Personnel Act appointments requested by DoD. Overall, contracting officers needed better procedures to ensure that potential conflicts of interest were avoided or identified (Finding C).

Summary of Recommendations. We recommended that DoD strengthen controls over the screening and assignment of work to FFRDCs, to include ensuring the performance of market surveys. We recommended that DoD improve controls over the award of management fees. We recommended additional contracting officer oversight and use of appropriate contract clauses to ensure that conflicts of interest for FFRDCs are prevented. Also, we recommended excluding assignment, under Intergovernmental Personnel Act agreements, of FFRDC personnel to DoD positions that involve oversight of another FFRDC.

Management Comments. The Director, Defense Research and Engineering, comments include the Deputy Under Secretary of Defense (Logistics) comments. The Director, Defense Research and Engineering, generally agreed that improved controls over the noncompetitive assignment of work to federally funded research and development centers (FFRDCs) were needed, but did not identify specific actions to improve controls. The Director, Defense Research and Engineering, did not agree to conduct cost comparisons between use of FFRDC and DoD personnel or to use competitive solicitations to evaluate alternatives to use of FFRDCs.

The Director, Defense Research and Engineering, stated there was a need to document FFRDC fee needs in sponsoring agreements and there was an on-going congressionally mandated study of management fees that may develop appropriate actions needed. The Army and the Air Force concurred, and the Navy nonconcurred, with using operating cycle analysis to evaluate FFRDC fee needs. All DoD FFRDC sponsors agreed alternatives to fees should be evaluated. The Navy disagreed that reimbursement of incorporation fees should be obtained from the Center for Naval Analyses.

The Army, the Air Force, and the Advanced Research Projects Agency did not agree that sponsor certifications were needed for conflict of interest reviews or that FFRDC contract clauses for conflicts of interest should be improved. The Navy agreed improvements were needed. The Army, the Navy, the Air Force, and the Advanced Research Projects Agency, disagreed that contracting officers for FFRDCs should review Intergovernmental Personnel Act assignments of FFRDC personnel for potential conflicts of interest. The Director, Defense Research and Engineering, disagreed that FFRDC personnel on Intergovernmental Personnel Act assignments should be excluded from oversight or management of other FFRDCs.

See Part I for a synopsis of each finding and discussion of the management comments on each finding, Part II for a discussion of the responsiveness of management comments to the recommendations, and Part III for the complete text of the management comments.

Audit Response. Based on the management comments, we revised the recommendation on the Navy payment of incorporation fees, deleted the recommendation on including Intergovernmental Personnel Act assignees under congressional funding ceilings and were able to better clarify the need for the remaining recommendations. Although many positive actions were initiated, additional comments are warranted. We request that the Director, Defense Research and Engineering; the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence); the Deputy Under Secretary of Defense (Logistics); the Army; the Navy; the Air Force; and the Advanced Research Projects Agency provide final comments on the report by June 19, 1995.

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This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD.

**Part I - Summary of Management
Comments on the Findings and Audit
Response**

Introduction

This section summarizes the three findings in Inspector General, DoD, Report No. 95-048, "Contracting Practices for the Use and Operations of DoD-Sponsored Federally Funded Research and Development Centers," December 2, 1995. Management comments on each finding are summarized in the order in which the summarized issues appear in the final report. The section also gives our responses to the comments. Management comments are included in their entirety in Part III of this report.

Summary of Finding A

Finding A. Use of Federally Funded Research and Development Centers

DoD sponsors did not sufficiently justify the noncompetitive use of FFRDCs to perform 223 of the 229 projects reviewed. This condition occurred because FFRDC mission statements did not identify unique FFRDC capabilities and expertise, and the justifications for noncompetitively assigning the projects did not identify:

- o what unique FFRDC capabilities were needed to perform the research work, or

- o why or how FFRDCs could perform the work more effectively even though potential alternatives were considered and identified for 193 projects.

Sponsors also had not performed cost comparisons to show that utilizing the FFRDCs to provide the needed support was less costly than utilizing DoD civilian personnel. As a result, sponsors could not demonstrate that the noncompetitive assignment of work to the FFRDCs kept DoD sponsor costs down and resulted in the best performance.

Management Comments and Audit Response on Finding A

Director, Defense Research and Engineering, Comments. The Director, Defense Research and Engineering (DDR&E), stated the audit methodology was flawed because the audit relied on the rationale of individual task sponsors for using federally funded research and development centers (FFRDCs) to perform work instead of reviewing the process in effect at the time to approve and assign work to an FFRDC. The individual task sponsor reasons only provided an input to the determination process, whereas the primary sponsors as defined by

Summary of Management Comments on the Findings and Audit Response

Office of Federal Procurement Policy (OFPP) Letter 84-1 and Federal Acquisition Regulation (FAR) 35.017 were responsible for ensuring the appropriateness of work assignments to the FFRDCs.

Audit Response. The audit examined the review and approval processes for the projects reviewed for each FFRDC. We contacted task sponsors because they were most knowledgeable of the details regarding individual tasks and FFRDC performance on the tasks. We analyzed all information provided to us by individual task sponsors, by primary sponsors, by contracting officials, and by the FFRDCs. The primary sponsors were requested on two occasions prior to issuance of the draft report to review our analysis of the work assignments to the FFRDCs and to provide any additional information related to the work assignments. All additional information provided by the primary sponsors was considered in the preparation of the audit report.

Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) Comments. The Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) (ASD[C³I]) stated the audit relied on an informal questionnaire rather than a review of the formal documentary record.

Audit Response. We formally requested the sponsors for the tasks reviewed to provide written responses to questions regarding the justification for assigning the work to the FFRDC, alternative sources that could have performed the work, and oversight of the work. We requested written responses because much of the information had not been documented.

Air Force Comments. The Air Force stated that the audit approach of looking at individual projects did not apply to RAND Project AIR FORCE because the work was reviewed and approved as a complete research program.

Audit Response. We considered the Air Force process of including projects in annual research programs for assignment to RAND Project AIR FORCE during the audit. The research program areas were broadly defined and covered almost every conceivable mission of the Air Force. We evaluated all information provided by project and program sponsors and by RAND Project AIR FORCE. We also considered the requirements of Air Force Regulation 20-9, "Air Force Policy for Conducting Project AIR FORCE," October 28, 1991, which provides Air Force policies and responsibilities for the initiation, review, and approval of projects in the research program. None of the information provided to us supports a conclusion that the individual projects making up a research program area were dependent on one another and could not be evaluated separately.

DDR&E, Navy, and Air Force Comments. The DDR&E, the Navy, and the Air Force disagreed with the audit rationale on why the sponsor's reasons did not sufficiently support using FFRDCs for 223 of 229 of the projects reviewed. They stated the audit applied an absolute standard of uniqueness of FFRDC capability and expertise that exceeded the requirements of FAR 35.017. The DDR&E stated that the reasons given could individually or together be valid justifications for using an FFRDC. The Navy stated that the audit rationale on why justifications were not sufficient were based on having to perform actions, such as market surveys or requests for additional in-house staff, that are not

Summary of Management Comments on the Findings and Audit Response

required by regulation, law, or policy. The Air Force stated that corporate knowledge of FFRDC staff and FFRDC independence and objectivity are legitimate reasons for using FFRDCs.

Audit Response. We evaluated the noncompetitive work assignments to the FFRDCs based on the criteria in OFPP Letter 84-1 and FAR 35.017. This guidance provides that a FFRDC should only be used when the sponsor can show that non-FFRDC sources can not effectively perform the required work. We specifically requested the DoD sponsors to identify the specialized FFRDC capabilities that were needed to perform the projects reviewed and to explain why non-FFRDC sources could not do the work. If the sponsor had not performed a market survey or was aware of alternative non-FFRDC sources that could have performed the task, we concluded that assignment of the tasking to the FFRDC was not justified. Market surveys would provide a basis for establishing whether non-FFRDC sources could perform required work effectively. Where there is a continuing need for services, sponsors should determine whether the work could be performed effectively with DoD personnel. We agree that corporate knowledge and independence and objectivity are factors that may weigh in favor of assigning a task to an FFRDC; however, for the projects included in the audit we concluded those factors were not sufficient reasons for excluding non-FFRDC alternative sources.

Navy Comments. The Navy stated the audit did not recognize the revised work assignment procedures implemented in January 1993 through modification P00028 to the Navy contract with the Center for Naval Analyses (CNA). The CNA revised procedures list 14 major program mission areas for CNA work and require that the scope and focus of each research project be documented in an annual research plan and made a part of the contract. The Navy stated the revised procedures require additional levels of documentation and review to support work assignment to CNA and include cost estimates as part of the project proposal data. The Navy also stated that the revised CNA mission statement adequately differentiates between work that is and is not appropriate for CNA.

Audit Response. We considered the revised Navy procedures during the audit, and we agree that the additional documentation of review processes and preparation of project cost estimates are improved controls. However, we do not agree that CNA's mission statement sufficiently differentiates work appropriate for CNA from work that should be done by others. The 14 CNA program areas identified in the revised mission statement are broad enough to cover every mission area of the Navy and the Marine Corps. The revised Navy procedures do not specify how assignment criteria will be applied for studies and analyses within the program areas.

Air Force Comments. The Air Force disagreed that there was not sufficient justification to support that RAND Project AIR FORCE was more cost effective than non-FFRDC alternatives. The Air Force stated that the report's statement to that effect was in direct conflict with the Final Acquisition Approval for RAND Project AIR FORCE, dated August 11, 1990.

Summary of Management Comments on the Findings and Audit Response

Audit Response. The Final Acquisition Approval for RAND Project AIR FORCE, dated August 11, 1990, was supported by Acquisition Plan No. AFOSR 91-1 (90-AP-050), dated April 26, 1990, and Justification and Approval No. AFOSR 91-1 (90-J&A-077), dated July 5, 1990. Those documents formed the basis for the renewal of a 5-year, sole-source contract with the RAND Corporation for Project AIR FORCE. As reported in Inspector General, DoD, Report No. 94-012, "Sole-Source Justifications for DoD-Sponsored Federally Funded Research and Development Centers," November 4, 1993, none of the documents adequately supported that RAND Project AIR FORCE was more cost effective than non-FFRDC alternatives.

Air Force Comments. The Air Force stated thorough review and justification procedures were in place for each Air Force-sponsored FFRDC.

Audit Response. The Air Force review and justification procedures for task assignments to FFRDCs addressed criteria that should be considered in determining whether work was appropriate for assignment to the FFRDCs. However, no explanation of how the criteria should be applied was given, and the guidance made only broad references that the work should be appropriate or should be within the FFRDC mission statement and meet the requirements of OFPP Letter 84-1 and FAR 35.017.

Navy and Air Force Comments. The Navy disagreed that FFRDC work should be competed and stated that FAR 35.017 strictly prohibited FFRDCs from competing with any non-FFRDC for work other than operation of an FFRDC. The Air Force stated the RAND Project AIR FORCE contract was awarded under FAR 6.302-3, "Industrial Mobilization; or Engineering, Development, or Research Capability," and FAR 5.202(a)(10), "Exceptions," and did not require competitive solicitations.

Audit Response. Publicizing research and study requirements through agency announcements and permitting FFRDCs to compete would ensure the FFRDCs are performing tasks that private sector sources cannot perform as effectively. The FFRDCs should not compete with non-FFRDC contractors without the approval of their sponsors.

Navy Comments. The Navy stated that the audit relied on abbreviated mission statements that appeared in the DoD FFRDC Management Plan instead of considering the complete mission statement that appeared in the contract.

Audit Response. We reviewed complete mission statements, sponsoring agreements, and policy and regulatory guidance for each DoD FFRDC during the audit. The abbreviated mission statements for the FFRDCs were included in the audit to provide readers of the report with a general understanding of the mission of each FFRDC.

Navy and Air Force Comments. The Navy and the Air Force disagreed that adequate market surveys should be conducted to identify the extent of alternative sources that can effectively meet DoD sponsor needs. The Navy said such market surveys are not required, would unduly delay needed critical analyses, and would result in increased costs to the Government. The Navy also stated that comparison of costs is not the crucial factor in determining

Summary of Management Comments on the Findings and Audit Response

whether to assign work to an FFRDC. The Navy also disagreed that contracting officers should establish the existence and potential effectiveness of alternatives to FFRDCs before assigning work to FFRDC contracts.

Audit Response. The OFPP guidance and the FAR specifically provide that the FFRDCs should not be performing taskings that can be more cost-effectively accomplished either by in-house personnel or non-FFRDC contractors. Market surveys performed and documented by the sponsors would provide a basis for the noncompetitive assignment of tasks to the FFRDCs. The administrative burden of conducting a market survey is not an unreasonable requirement for justifying the noncompetitive assignment of taskings to an FFRDC. Cost is a factor that cannot be ignored in any work assignment and should be basic to determinations of effectiveness for the FFRDCs. Contracting officers are responsible for ensuring performance of all necessary actions for effective contracting and for safeguarding the interest of the Government in its contractual relationships, and should ensure that the existence and potential effectiveness of alternatives to FFRDCs are considered before assigning work to the FFRDCs.

Navy Comments. The Navy stated that cost comparisons of FFRDC and in-house personnel are not an adequate basis for determining whether in-house personnel can effectively perform the special research needs of the sponsor. Hiring of additional in-house resources is not consistent with current budget realities.

Audit Response. Cost is a factor, where personnel available in-house or through contractor resources have the skills and capabilities to perform required work. OFPP Letter 84-1, "Federally Funded Research and Development Centers," states that Federal agencies should rely to the extent practicable on existing in-house and contractor sources for satisfying their special research or development needs. OFPP Policy 93-1, "Management Oversight of Service Contracting," November 19, 1993, states that when contracting for services, the services must be obtained in the most cost-effective manner without barriers to full and open competition. Studies and analyses FFRDC services are contracted advisory and assistance services and are reported as such. DoD Directive 4205.2, "Acquiring and Managing Contracted Advisory and Assistance Services," states that for long-term or continuing requirements, DoD activities should perform an analysis to determine whether performing the services in-house or contracting out is the most efficient means of performance. Directive 4205.2 further requires certification by the requiring activity that such services have been reviewed for the most cost-effective or efficient means of accomplishment. Directive 4205.2 also requires that if the requirement is long-term and is being contracted out, but could be more cost-effective if performed by in-house resources, the purchase request package shall include a statement citing action being taken to hire additional in-house resources or an explanation citing why contracting out is necessary. We are not aware of any budget guidance that directs an agency to contract out for services when it does not make economic or operational sense.

Summary of Finding B

Finding B. Justification and Analyses of Management Fee Requirements

DoD did not properly determine the management fees to pay to the six nonprofit corporations that operated eight DoD FFRDCs. This condition occurred because program sponsors did not document FFRDC fee needs in sponsoring agreements. Further, contracting officers did not follow established procedures to review annual fee requests and did not perform working capital or other analyses to limit fee requirements to expenses that were ordinary and necessary to FFRDC operations. Also, contracting officers did not consider other alternatives for expenses that could be met through more effective funding arrangements. As a result, DoD FFRDCs received about \$43 million of the \$46.9 million of management fees for discretionary purposes during FY 1992. Of the \$43 million:

- o \$11.6 million was used for unallowable costs and future needs that were not necessary for the operation of the FFRDCs and should not have been paid; and

- o \$31.4 million was used for allowable costs and should have been charged against overhead.

Also, the Navy approved an increase in management fee payments to the Center for Naval Analyses during FY 1993 that increased contract costs by about \$2.7 million annually but provided no measurable benefits to the Navy.

Management Comments and Audit Response on Finding B

DDR&E Comments. The DDR&E recommended the "Executive Summary" be revised to state that \$43 million of the \$46.9 million in management fees paid to DoD FFRDCs was either inappropriate or charged to the incorrect cost category.

Audit Response. The change suggested by DDR&E was implemented in the final report.

Air Force Comments. The Air Force stated the audit did not address recent use of an award fee for need system to reduce management fee payments to the Air Force FFRDCs.

Audit Response. The Air Force implemented the award fee system after the period covered by our audit. The revised system, if properly administered, should result in improved management of the fee.

Navy Comments. The Navy disagreed with the statement, "If a fee is considered appropriate, the contracting officer computes a fee objective using the weighted guidelines method in Defense Federal Acquisition Regulation Supplement (DFARS) 215.971, 'Weighted Guidelines Method,' to establish limits on the amounts that can be awarded under the fee for use during

Summary of Management Comments on the Findings and Audit Response

negotiations. The Navy stated that the weighted guidelines approach is not an absolute computation of fee, but is a guideline that results in an objective for negotiation and not a limit.

Audit Response. We agree that the weighted guidelines approach should not be considered an absolute computation of fee by contracting officers.

Navy Comments. The Navy did not agree that the reasons for fees should be documented in sponsoring agreements. The Navy stated that FAR 35.017-1(d) provides "The sponsoring agreement . . . may also contain . . . other provisions, such as identification of . . . (2) Considerations which will affect negotiation of fees where payment of fees is determined by the sponsor(s) to be appropriate." The Navy further stated that DFARS 215.972(b) provides DoD policy for determining the appropriateness of management fee payments and that compliance with the policy meets the requirements of FAR 35.017-1(d).

Audit Response. DFARS 215.972(b) states that the contracting officer should consider whether any fee to a nonprofit organization that is an FFRDC is appropriate and identifies five factors the contracting officer should consider. We continue to believe that if the factors will be used by the contracting officer, they should be stated or referenced in the sponsoring agreement.

Navy Comments. The Navy did not agree with the report statement "Contracting officers did not properly establish FFRDC fee needs based on modified weighted guidelines contained in DFARS 215.972." The Navy stated the analysis was based on a CNA fee proposal that listed each appropriate fee element and that each element was independently assessed and the results stated in the price negotiation memorandum.

Audit Response. We reviewed the price negotiation memorandum during the audit. It states that the contracting officer determined a fee objective for CNA of 4.5 percent of proposal costs. It also states that CNA proposed to use fees for normally unallowable business expenses and other expenses, including the CNA dependent tuition scholarship program. The contracting officer did not question any part of CNA's proposed fee and accepted the proposed amount as "fair and reasonable."

Navy Comments. The Navy disagreed that contracting officers did not review and authorize payment of individual fee expense elements or categories. The Navy stated that use of a 5-year contract precludes the annual negotiation of fee amounts. The Navy further stated that there are no requirements that restrict fee use or that require the annual review and approval of fee use. The Navy added that while CNA provides an annual disclosure of previous fee use and a list of planned future expenditures, no legal mechanism exists under the contract for adjustment of the actual or proposed amounts.

Audit Response. FAR 35.017 and DFARS 215.972 require both program sponsors and contracting officers to consider whether management fees are appropriate for payment to FFRDCs. Considering the appropriateness of management fees entails justifying the need of the FFRDCs for and subsequent use of fees. As discussed in the report, including a fee clause in each

Summary of Management Comments on the Findings and Audit Response

FFRDC contract would provide the mechanism needed to enforce FFRDCs actual use of fees. Except for the cost-plus-a-percentage-of-cost system of contracting, DoD has the authority to enter into any kind of contract that will promote the best interests of the United States.

Navy and Air Force Comments. The Navy and the Air Force disagreed that a contract fee clause requiring annual FFRDC fee requests and annual FFRDC reports on fee use were appropriate.

Audit Response. The use of a contract fee clause would ensure that fees paid are for unallowable expenses necessary for the operation of the FFRDCs and purposes consistent with DFARS 215.972.

Air Force Comments. The Air Force stated that Air Force contracting officers already perform adequate reviews and analyses of fee justifications and monitor fee expenditures on a regular basis.

Audit Response. We agree that the Air Force contracting officers reviewed FFRDC fee justifications and monitored fee expenditures. However, we disagree that a valid justification existed for the total management fees paid to Air Force-sponsored FFRDCs during FY 1992.

Navy and Air Force Comments. The Navy and the Air Force disagreed that contracting officers did not use working capital analyses to assess annual fee requests. The Navy stated that a working capital analysis was used to establish an advanced payment pool for the CNA and also to determine the working capital necessary to eliminate the advance payment pool. The Navy stated that both working capital analyses were performed in accordance with applicable, generally accepted accounting practices. The Air Force stated that the contracting officer requested DCAA to conduct a working capital analysis for RAND Project AIR FORCE and that RAND Project AIR FORCE did not have excess working capital.

Audit Response. As stated in the discussion of the finding, we did not examine the working capital needs of CNA because the Navy primarily funded CNA under an advance funding pool arrangement instead of through management fees during FY 1992. The finding also stated that RAND Corporation did not have excess working capital.

Navy Comments. The Navy disagreed that employee leave liability not expected to be paid during the year should be excluded from current liabilities for purposes of computing working capital needs. The Navy stated that accrual of leave is a generally accepted accounting practice and it would be inappropriate for a contractor not to report in its working capital analysis the actual or projected accumulation of leave expense. The Navy stated the report seems to advocate a different method of accumulating costs for working capital analysis than is allowed in the contractor's accounting system.

Audit Response. By definition, working capital is the excess of current assets over current liabilities. Current liabilities are obligations whose liquidation is reasonably expected to occur within the current operating cycle or one year.

Summary of Management Comments on the Findings and Audit Response

The proper identification of current liabilities for working capital determinations requires the classification of accrued liabilities into the periods (short-term or long-term) in which they are expected to be liquidated or paid. The classification does not change the method under which costs or liabilities were originally recorded or are disclosed in a contractor's balance sheet.

Navy Comments. The Navy disagreed that fee needs of FFRDCs could be met through contractual guarantees that did not require the immediate disbursement of funds or through advance funding pool arrangements. The Navy stated that contractual guarantees or advanced funding could not be used in certain situations involving capital equipment purchases, unabsorbed overhead, unreimbursable expenses, and interest costs during termination proceedings and that existing FAR provisions do not cover all legitimate termination costs. Such factors necessitate maintaining reserves.

Audit Response. During the audit, we were not provided evidence that the Navy had specifically documented and analyzed the most cost-effective means of providing for CNA fee needs. FAR 35.017-1 provides that sponsoring agreements include provisions for the orderly termination or nonrenewal of the agreement, disposal of assets, and settlement of liabilities. If termination costs are a legitimate concern, then the sponsoring agreement should also address the payment of management fees to accumulate a reserve for potential termination costs.

Air Force Comments. The Air Force stated contracting officers reviewed fee requests and performed analyses that included considerations of alternatives to the use of management fees for Air Force FFRDCs that received management fees.

Audit Response. Contract negotiation memoranda did not document that the Air Force contracting officers considered the use of Government-furnished equipment and facilities or the use of advance funding arrangements or that the contracting officer ever questioned the use of management fees for expenses that were allowable under the FAR.

Navy Comments. The Navy stated that the following report statements were contradictory.

The use of advance funding arrangements could avoid Government payment of unnecessary interest costs by making funds available to FFRDCs only in amounts needed to fund anticipated expenses. . . Maintaining excess funds at FFRDCs also results in the Government incurring additional interest costs.

The Navy stated that if FFRDCs maintain their own reserves, the only interest expense (fee requirement) would be due to unplanned shortfalls in working capital. However, if an advance payment pool is used, the Government incurs the interest expense for maintaining the entire pool.

Audit Response. Management fees amounting to \$397,400 were used by the FFRDCs for short-term interest expense during FY 1992. Those fees might have been avoided if advanced funding arrangements were used. The FFRDCs had also accumulated about \$14.9 million in excess of working capital needs.

Summary of Management Comments on the Findings and Audit Response

Based on our audit, we concluded that the sponsors should more thoroughly evaluate the need for paying fees to FFRDCs. We disagree that interest expense should be the only factor considered by the Navy in evaluating the use of an advance payment pool.

Navy Comments. The Navy disagreed that management fees were used for discretionary purposes. The Navy stated the costs classified as unallowable were based on criteria contained in DFARS 215.972 and that the costs were all ordinary and necessary to CNA operations. The Navy stated that dependent scholarships were needed to offer competitive benefits similar to the benefits offered by other nonprofit organizations in order to retain and recruit employees. Community program expenses were appropriate because there was no legal mechanism to prevent CNA from incurring the cost. The Navy stated that costs for the Center for Naval Analyses symposia were not approved in advance and CNA had to charge the costs to management fee. The Navy stated that the miscellaneous unallowable costs not allowed by Office of Management and Budget Circular No. A-122 or the FAR are considered and accepted as normal costs of doing business. The Navy further stated that allowable costs that should have been charged to overhead such as corporate-sponsored research/independent research and development were also not approved in advance and had to be charged to fee. The Navy also stated that details of independent research and development can not be predicted in advance.

Audit Response. The contract negotiation memorandum did not state that the contracting officer found all of the items that CNA proposed to cover with management fees to be ordinary and necessary to CNA operations. No other DoD FFRDC requested management fees to pay dependent scholarship costs, and there is no evidence to support that the program was necessary to competitively recruit personnel. Community program expenses included contributions and donations of CNA employee services and are expressly unallowable under OMB Circular No. A-122. Also, the House of Representatives Conference Report 103-701, "National Defense Authorization Act For Fiscal Year 1995," August 12, 1994, requires FFRDCs to enter into agreements with DoD not to make any charitable donations. Management fee should not be authorized and paid unless the need can be documented in advance as required by OFPP Letter 84-1 and FAR 35.017. The Navy could seek to modify its contract with CNA to require that contracting officer approval be obtained for independent research and development projects or other expenses that cannot be predicted in advance.

Air Force Comments. The Air Force stated that the DCAA performed audits of the RAND Project AIR FORCE fee requests and that the Air Force contracting officer used information provided by DCAA to establish RAND Project AIR FORCE's need for fee.

Audit Response. During the audit, we considered DCAA Audit Report No. 4101-92F28000007, "Audit of Revised Need for Fee Proposal for Fiscal Year 1992, Contract No. F49620-91-C-0003, The RAND Corporation," dated March 13, 1992. The report was requested by the contracting officer and stated:

Summary of Management Comments on the Findings and Audit Response

our evaluation was limited to the application of agreed-upon procedures for the review of information relating to the revised need for fee proposal. We did not perform the customary auditing procedures necessary to constitute an examination made in accordance with generally accepted government auditing standards.

The DCAA audit did not include an evaluation of justifications required by FAR 35.017 and DFARS 215.272 of the appropriateness of paying management fees.

Navy Comments. The Navy stated the value of eliminating advance payments to and use of Government facilities by the Center for Naval Analyses was plain and required no enumeration. The Navy also stated that the finding was contrary to Government policy as stated in FAR subpart 32, "Contract Financing" and FAR subpart 45, "Government Property" that the Government prefers to pay for completed work and have the contractor provide the facilities and equipment necessary for contract performance. The Navy also stated that the audit did not consider the benefits identified by the contracting officer during the fee negotiations.

Audit Response. We considered the benefits identified by the contracting officer. The primary benefit identified by the contracting officer for eliminating advance payment and increasing management fees was to broaden the capabilities of CNA for work requested by Navy sponsors and possible non-DoD sponsors. We believe that the benefit goes beyond the policy statements regarding limitations on the use of FFRDCs and on actions encouraged to reduce the DoD cost of purchasing services under the contract. The contracting officer did not document any performance problems that required withholding payment from CNA, or that use of Government facilities and equipment was not economical.

Summary of Finding C

Finding C. Conflicts of Interest Issues

Contracting officers did not sufficiently inquire into FFRDC activities to ensure that conflicts of interest did not exist.

- o Contracting officers did not include required certifications in contracts and were not aware of FFRDC financial affiliations.

- o The DSS-W [Defense Supply Service-Washington] contracting officer did not include a conflict of interest clause in four FFRDC contracts.

- o The Navy's payment of incorporation fees to CNA, Incorporated was incorrect.

- o The Advanced Research Projects Agency used an IDA [Institute for Defense Analyses] employee, under an Intergovernmental Personnel Act (IPA) appointment, to provide the oversight of the Software Engineering Institute.

Summary of Management Comments on the Findings and Audit Response

o IDA, the MITRE C³I Division, and the Lincoln Laboratory FFRDCs may have hired four individuals only to qualify them for IPA appointments requested by DoD organizations.

These conditions were caused by insufficient guidance regarding the areas that contracting officers for the FFRDCs should review for conflicts of interest, by an assumption that FFRDCs operated by universities and nonprofit corporations reduced the potential for conflicts of interest, and by the belief that project sponsors would identify potential conflicts of interest. Also, the Navy did not adequately support its reasons for not competing for a new management agent. Further, contracting officers were not involved in monitoring or approving IPA appointments. As a result, DoD has inadequate assurance that conflicts of interest are avoided or identified.

Management Comments and Audit Response on Finding C

Air Force Comments. The Air Force stated that the contract with RAND Project AIR FORCE included an organizational conflict of interest clause and that certification was made annually at the program level.

Audit Response. The conflict of interest clause included in contract F49620-91-C-0003 awarded by the Air Force Office of Scientific Research to the RAND Corporation (Project AIR FORCE) on November 19, 1990, was not adequate. As stated in the report, we believe that each FFRDC contract should include conflict of interest provisions similar to those in the Navy contract for CNA and as provided in Recommendation C.1.b. of the audit report. Also, the RAND Corporation Project AIR FORCE made one organizational conflict of interest certification on September 19, 1990, prior to the November 19, 1990, contract. We were not provided evidence of the filing of annual certifications as stated by the Air Force.

Navy Comments. The Navy disagreed with the draft report statement, "The Navy's payment of incorporation fees for CNA, Incorporated, may have limited the independence of CNA." The Navy stated that the payment of organization costs such as incorporation fees are permitted under Office of Management and Budget Circular No. A-122 when approved in advance.

Audit Response. We revised the final report to state that payment of the incorporation fees was not correct. There were no documents or input from the Navy Office of General Counsel that the Navy had evaluated and approved the payment of CNA organizational costs prior to CNA's incorporation on September 12, 1990. The only documented evidence of the Navy's agreement to pay CNA organizational costs was in the September 28, 1990, contract with CNA.

Navy Comments. The Navy disagreed that the award of a non-competitive contract to CNA, Incorporated, was inappropriate and also disagreed that the reasons for the award were not adequately documented. The Navy stated that a new management agent for CNA was not necessary because CNA, Incorporated, already existed. The Navy stated the reasons for the

Summary of Management Comments on the Findings and Audit Response

noncompetitive award to CNA, Incorporated, were adequately and accurately set forth in the justification and approval for other than full and open competition. The Navy also stated that noncompetitive award was authorized by statute, and has resulted in lower costs and effective management of CNA.

Audit Response. Inspector General, DoD, Report No. 94-012, "Sole-Source Justifications for DoD-Sponsored Federally Funded Research and Development Centers," November 4, 1993, stated that the Navy did not justify why CNA, Incorporated, a new management agent, was awarded a contract noncompetitively. The report also stated that the Navy did not adequately document its future requirements or address why CNA services could not be provided by a combination of additional Navy personnel and private contractors. The report concluded that neither the comprehensive review nor the justification and approval adequately supported the award of the sole-source contract with an estimated value of \$240 million. Additional information was not provided by the Navy that the use of CNA, Incorporated, was justified beneficial or that its use has resulted in cost savings.

Navy Comments. The Navy disagreed with the overall conclusions in the finding and stated the Navy took conflict of interest issues seriously. Inclusion of an organizational conflict of interest clause in the contract with CNA illustrates that point. Also, the Navy required FFRDC trustees and employees to disclose their financial affiliations to help avoid conflict of interest violations.

Audit Response. We agree that the organizational conflict of interest clause in the Navy contract with CNA was the best clause in contracts for the DoD FFRDCs. Further actions by DoD program and contract officials for other FFRDCs were needed to ensure that potential conflicts of interest were being identified and controlled.

**Part II - Management Comments
and Audit Response on the
Recommendations, Potential Monetary
Benefits, and Internal Controls**

Introduction

This section restates the recommendations in Inspector General, DoD, Report No. 95-048, "Contracting Practices for the Use and Operations of DoD-Sponsored Federally Funded Research and Development Centers," December 2, 1995. The section also summarizes management comments on the recommendations. Our evaluation of the responsiveness of the management comments to the recommendations follows each summary.

Recommendations, Management Comments, and Audit Response on Finding A. Use of Federally Funded Research and Development Centers

We recommend that the Director, Defense Research and Engineering, establish procedures for the primary federally funded research and development center sponsors to:

A.1. Revise mission statements for the federally funded research and development centers to identify specific research areas for which the federally funded research and development centers have unique capabilities and expertise.

DDR&E Comments. The DDR&E partially concurred with the recommendation and stated the revised DoD FFRDC Management Plan effective October 1, 1994, requires each FFRDC sponsor to document criteria that specifically discriminates work that is within the scope of effort for which the FFRDC was established from work that should be performed by non-FFRDCs. Sponsors have been directed to ensure their sponsoring agreements comply with this revised DoD FFRDC Management Plan requirement by February 1, 1995.

Audit Response. We accept the DDR&E comments to the recommendation and request that the DDR&E provide the revised mission statements for each DoD FFRDC in response to the final report.

Additional Management Comments. Comments to the recommendation were also received from the ASD(C³I), the Army, the Navy, and the Air Force. The comments and our responses follow.

ASD(C³I) Comments. The ASD(C³I) disagreed and stated the recommendation was not based on the role and purpose of an FFRDC, as expressed in OFPP Letter 84-1, FAR 35.017, and the DoD FFRDC Management Plan. The ASD(C³I) stated that the FFRDCs possess unique

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

capabilities and expertise that reside not only in certain definable "specific research areas," but also in technical depth and breadth. Those capabilities and expertise allow FFRDCs to integrate across multiple research areas in a distinctive structure and relationship to the Government that allows the FFRDC to perform functions closely related to inherently Governmental functions that could not be entrusted to a non-FFRDC contractor. The ASD(C³I) also stated that the report is silent on whether the specific criteria in Air Force Regulation 80-1 and Army Communications-Electronics Command Regulation 70-64 that are used to determine the appropriateness of tasks assigned to the MITRE C³I (Command, Control, Communications, and Intelligence) Division FFRDC were considered during the audit.

Audit Response. We based our recommendation on criteria in OFPP Letter 84-1 and FAR 35.017. We believe that all special capabilities and expertise for which the FFRDC is maintained should be clearly specified to allow a clear differentiation between work appropriate for FFRDCs and work appropriate for non-FFRDCs. The audit evaluated Air Force Electronics Systems Center Regulation 80-1, "Utilization of MITRE Support," February 21, 1991, and Army Communications-Electronics Command Regulation 70-64, "Utilization of MITRE Support," October 1, 1990, and identified those regulations in Appendix B of the report. The regulations provided criteria for assigning work to the FFRDC that could be interpreted to justify almost any engineering and technical support involving the development and acquisition of command, control, communications, and electronics systems.

Army Comments. The Army agreed and stated that a revised mission statement that identifies specific research areas for which the Arroyo Center has unique capabilities and expertise will be included in the Arroyo Center sponsoring agreement by December 1994.

Navy Comments. The Navy partially agreed and stated that the mission statements need improvement and should not be limited solely to the "unique" capabilities and expertise of the FFRDCs, but should also document the "special" capabilities and expertise of the FFRDCs.

Audit Response. We agree that sponsors should document the unique or special capabilities and expertise of FFRDCs that are needed to meet a sponsor's special technical needs or mission requirements.

Air Force Comments. The Air Force disagreed and stated that Aerospace Corporation and MITRE C³I Division are chartered specifically in their sponsoring agreements to provide independent and objective systems engineering technical assistance to program offices. The Air Force also stated that FFRDCs already have clear and specific charters and that, therefore, the recommendation is unnecessary and duplicative of existing documents.

Audit Response. We agree that Aerospace Corporation and MITRE C³I Division are engaged in performing general systems engineering and integration support and related technical support to DoD sponsors. During the audit, we determined that the Air Force sponsors for FFRDCs also contracted with non-FFRDC contractors to provide engineering and technical support. The

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non-FFRDC contractors were required to work side-by-side with FFRDC personnel on programs and also to be independent and objective in providing support and performing analysis for program offices. The sponsoring agreements for the two FFRDCs did not clearly differentiate FFRDC work from non-FFRDC work.

A.2. Prepare justifications for the noncompetitive assignment of projects to the federally funded research and development centers that document:

a. The unique federally funded research and development center capabilities needed to perform the work.

b. The alternatives considered to perform the work and why the alternatives are unable to effectively do the work.

c. The specific characteristics of effectiveness (that is, quantity, timeliness, quality, and customer satisfaction) that justify assignment of work to the federally funded research and development center and that must be met when performing the project under consideration.

DDR&E Comments. The DDR&E partially concurred with the recommendation and stated that the revised DoD FFRDC Management Plan requires each sponsor to have adequate procedures to determine whether the proposed work should be assigned to its FFRDC. To ensure that each sponsor is in compliance with the requirements of the revised management plan, the DDR&E will request that each sponsor provide a description of its process and procedures to determine the appropriateness of work assigned to the FFRDC. The DDR&E stated that corrective action will be taken as necessary.

Audit Response. The DDR&E comments are partially responsive. Although the DDR&E agrees that adequate procedures are necessary to justify the noncompetitive assignment of work to FFRDCs, the comments do not state that sponsors will be required to document the criteria cited in the recommendation to support the work assignments to FFRDCs. We believe that the criteria should be stated in the DoD FFRDC Management Plan. We request that the DDR&E provide additional comments in response to the final report.

Additional Management Comments. Comments to the recommendation were also received from the ASD(C³I), the Army, the Navy, the Air Force, and the Advanced Research Projects Agency (ARPA). The comments and our responses follow.

ASD(C³I), Army, and Air Force Comments. The ASD(C³I), the Army, and the Air Force disagreed and stated that existing procedures and processes adequately identified capabilities, considered alternatives, and evaluated effectiveness of work to the FFRDCs.

Audit Response. We made the recommendation because adequate justification was lacking for many of the projects reviewed. The rationale for using FFRDCs often did not clearly describe the unique capabilities needed to

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do work, document why non-FFRDCs could not effectively do the work, or document what alternatives were considered to use of the FFRDC. Documenting justifications that address the three factors in the recommendation would ensure project assignments or taskings to the FFRDCs meet requirements of OFPP Letter 84-1 and FAR 35.017.

ASD(C³I) Comments. The ASD(C³I) also stated in its disagreement on Recommendation A.2.b. that considering alternatives for each project would be a change in policy and that alternatives to the use of FFRDCs should be assessed during the comprehensive reviews.

Audit Response. OFPP Letter 84-1 and FAR 35.017 provide that FFRDCs should be used only when it can be shown that existing in-house and non-FFRDC contractor sources can not effectively satisfy the special research or development needs of the sponsor. We agree that comprehensive reviews consider alternatives for determining whether a contract for an FFRDC is appropriate. Sponsors should also consider alternatives for individual projects to ensure the work requirement is appropriate for an FFRDC to perform.

ASD(C³I) and Navy Comments. On Recommendation A.2.c., the ASD(C³I) stated that effectiveness could also involve characteristics such as freedom from conflict of interest, access to proprietary data, or technical innovation. The Navy stated the sponsor should determine the effectiveness characteristics to be met when performing projects and that overly burdensome conditions should not be imposed or applied.

Audit Response. The justifications for assigning work should identify and document the rationale for why the FFRDC is the best suited to do assigned work. The intent of the recommendation is to establish a process to improve compliance with OFPP Letter 84-1 and FAR 35.017. Documentation of justifications should not impose a major administrative burden on the sponsor. The characteristics cited by the ASD(C³I) are valid reasons that can help document why noncompetitive work should be assigned to an FFRDC.

Navy Comments. The Navy stated that special FFRDC capabilities such as independence and objectivity or quick response capability adequately justified using an FFRDC.

Audit Response. Sponsors cited independence and objectivity and quick-response capability in justifications for using the FFRDCs. However, we do not consider such factors unique to the FFRDCs and believe the justifications should have documented that no in-house activity or non-FFRDC contractor could provide those capabilities as effectively.

ARPA Comments. ARPA agreed with the recommendation and stated that although an alternative source might be found for an individual task, the assignment of the individual project to the alternative source might not provide the same overall benefit to the DoD. Also, justifications need to be based on both characteristics of an individual task and on the benefit obtained by having a group of related tasks performed by the same organization.

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Audit Response. We accept the ARPA comments as positive actions.

A.3. Perform cost-comparison studies of federally funded research and development centers and DoD in house personnel costs as part of the comprehensive reviews.

Management Comments. The DDR&E nonconcurred and stated that the recommendation could not be implemented due to recent budget cuts and downsizing efforts required under the Federal Workforce Restructuring Act of 1994. The DDR&E also stated that decisions to establish and use FFRDCs are based not only on the comparative costs of FFRDC and in-house personnel, but on qualitative factors such as, independence, objectivity, and quick-response capability. The Army, the Navy, and the Air Force disagreed for reasons similar to those stated by the DDR&E.

Audit Response. The comments are partially responsive. We agree opportunities to retain or increase in-house capabilities when shown to be more efficient and cost effective are limited because of the civilian workforce constraints. However, we disagree that cost comparison studies should not be performed as part of the comprehensive reviews, which are only performed (about every 5 years) prior to awarding or renewing a contract for an FFRDC. The Federal Workforce Restructuring Act states that civilian workforce ceilings may be waived if it can be shown the efficiency of the agency or the performance of a critical mission function so requires. We made the recommendation because cost comparisons were not performed and independence, objectivity, and quick-response capability are not characteristics possessed only by the FFRDCs. We believe that sponsors should determine the cost effectiveness of the services provided by the FFRDCs. Also, the Federal Workforce Restructuring Act expires in 1999. We request that the DDR&E reconsider the stated position and provide comments in response to the final report.

ASD(C³I) Comments. The ASD(C³I) agreed and stated that cost comparisons of FFRDC and in-house personnel would be done during the next comprehensive review for the MITRE C³I Division FFRDC.

Audit Response. We accept the ASD(C³I) comments as positive actions.

A.4. Use broad agency announcements and competitive solicitations to assess the potential for non-federally funded research and development center contractors to perform research projects.

Management Comments. The DDR&E, the ASD(C³I), the Army, the Navy, and the Air Force disagreed with the recommendation. The DDR&E, the ASD(C³I), the Army, the Navy, and the Air Force stated that the use of such competitive processes were not required by or would violate existing FAR procedures. Also, they stated the use of these processes would duplicate existing assessment and review procedures for the assignment of work to FFRDCs.

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The DDR&E further stated in its nonconcurrency that open competition would drive down costs; however, cost was not the only factor used in assigning work to an FFRDC. The DDR&E also stated that the Defense Science Board task force was reviewing the "Role of FFRDCs in the DoD Mission" and will be considering the appropriateness of work assigned to FFRDCs. The DDR&E recommended waiting for the results of the Board's report.

Audit Response. The FAR does not prohibit the use of competitive solicitations for the evaluation of potential alternatives to FFRDCs. Congress has established full and open competition as the guiding principle for all Government acquisitions and has not prohibited FFRDCs from competitive processes. The audit determined that DoD sponsors did not adequately document the reasons that alternative sources could not effectively accomplish individual projects noncompetitively assigned to the FFRDCs. The intent of the recommendation is to supplement, not duplicate, existing assessment and review processes for assigning work to the FFRDCs and not to use formal competitive processes for every tasking to the FFRDCs. We believe the DDR&E should include in the DoD FFRDC Management Plan a statement that sponsors may use competitive processes to ascertain the best sources for certain research and studies. We request that the DDR&E reconsider the described position in providing additional comments to the final report.

We agree obtaining best value, not lowest cost, should be a prime consideration in deciding whether to assign work to an FFRDC. The DoD should consider the recommendations of the Defense Science Board along with those of the audit to improve their management of DoD FFRDCs.

Management Comments Required

Management is requested to comment on the items indicated with an "X" in the following table.

Number	Addressee	Response Should Cover			
		Concur/ Nonconcur	Proposed Action	Completion Date	Related Issue*
A.1.	DDR&E		X	X	IC
A.2.	DDR&E	X	X	X	IC
A.3.	DDR&E	X	X	X	IC
A.4.	DDR&E	X	X	X	

*IC = material internal control weakness.

Recommendations, Management Comments, and Audit Response on Finding B. Justification and Analyses of Management Fee Requirements

B.1. We recommend that the Director, Defense Research and Engineering; the Deputy Under Secretary of Defense (Logistics); the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence); the Army; the Navy; and the Air Force document in the federally funded research and development center sponsoring agreements why the federally funded research and development centers need management fees.*

DDR&E Comments. The DDR&E concurred. The DDR&E, who also commented for the Deputy Under Secretary of Defense (Logistics), agreed that FFRDC management fee needs should be documented and stated that the DoD FFRDC Management Plan dated September 13, 1994, requires each sponsor to document in its sponsoring agreements or operating instructions why FFRDCs need fees.

Audit Response. We consider the comments as responsive. The DDR&E did not identify an estimated date the sponsors would complete actions in response to the DoD FFRDC Management Plan. In comments on the final report, we request that the DDR&E and the Deputy Under Secretary of Defense (Logistics) provide copies of appropriate sections of sponsoring agreements that satisfy the DoD FFRDC Management Plan and an estimated completion date for the remainder of the sponsoring agreements.

ASD(C³I) Comments. The ASD(C³I) concurred and stated that the sponsoring agreement and the Air Force and Army contracts with the MITRE C³I Division FFRDC already include adequate documentation on why a fee is needed.

Audit Response. Although the comments are positive, the comments do not identify actions taken or planned in response to the recommendation. During the audit, we determined that the DoD sponsoring agreement for the MITRE C³I Division FFRDC dated February 11, 1991, referred to DFARS 215.972, but did not document rationale why management fees were appropriate for the FFRDC. In response to the final report, we request that the ASD(C³I) identify the actions taken or planned to document the rationale for payment of management fees to the FFRDC and actual or estimated completion dates.

Army Comments. The Army concurred and stated it will document why management fees are needed in accordance with the DoD FFRDC Management Plan and a revised sponsoring agreement would be completed by December 1994.

Audit Response. The Army comments are responsive to the recommendation.

*In the draft and final reports, the recommendation was also directed to the Director, Advanced Research Projects Agency. We omitted that office here because it does not sponsor an FFRDC that is paid management fees.

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Navy and Air Force Comments. The Navy and the Air Force nonconcurred and stated the DFARS clearly details the factors to consider in determining whether a fee should be paid. The Navy also stated that DFARS 215.972(b)(1) already requires contracting officers to document their reasons for payment of management fee and their decision is included in the price negotiation memorandum required by FAR 15.808. The Navy further stated the contracting officer's analysis includes business-sensitive information that should not be released to the public and could not be included in the sponsoring agreement. The Air Force stated incorporating the need for management fee in the sponsoring agreement would likely amount to statements that are of little value.

Audit Response. The September 1994 DoD FFRDC Management Plan required sponsors to document in sponsoring agreements or operating instructions why the FFRDCs need fees. The Navy and the Air Force should comply with this guidance. We request that the Navy and the Air Force reconsider their positions and provide additional comments on the final report on actions taken or planned and completion dates.

B.2. We recommend that the Service Acquisition Executives and the Director, Advanced Research Projects Agency, establish procedures for contracting officers to:

a. Include a management fee clause in each federally funded research and development center contract that requires federally funded research and development centers to justify management fee needs in accordance with criteria contained in Defense Federal Acquisition Regulation Supplement 215.972, "Modified Weighted Guidelines Method for Nonprofit Organizations." Management fees should be justified on all contract actions requiring cost analysis and in no case less than annually. The annual fee request should include:

- (1) A description of each fee expense.
- (2) A statement why the fee is not chargeable under existing cost guidelines.
- (3) An explanation of the benefits of incurring each fee expense to both the federally funded research and development center and the sponsor.
- (4) An annual report on the actual use of prior fee awards.

DDR&E Comments. The DDR&E agreed with the recommendation and stated that reviewing fee requirements and fee usage was appropriate and guidelines for such reviews existed in the DFARS and the DoD FFRDC Management Plan. The DDR&E suggested that no additional guidance be implemented until completion of the congressionally-directed study on management fees in April 1995.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Audit Response. We agree that it is appropriate to delay implementing revised fee guidance until completion of the congressionally-mandated fee study.

Army Comments. The Army concurred and stated the Arroyo Center was required to justify its management fee through an annual need for fee justification that was reviewed by the Defense Supply Services-Washington (DSS-W) and the Defense Contract Audit Agency.

Audit Response. The Army comments are partially responsive. The Army did not address actions taken or planned for all FFRDCs for which it contracts. In addition to the Arroyo Center, DSS-W is the procuring contracting office for the Institute for Defense Analyses (IDA), the Logistics Management Institute, and the National Defense Research Institute. The Army Communications-Electronics Command is the procuring contracting office for MITRE Washington C³I Division FFRDC. Also, the Army's comments are not clear as to whether the specific actions detailed in the recommendation were implemented for the Arroyo Center. We request that the Army identify the actions taken or planned and provide completion dates for all FFRDCs for which it contracts in additional comments on the final report.

Navy Comments. The Navy nonconcurred and stated the requirement to prepare annual fee requests would violate FAR 15.903(e), "Contracting Officer Responsibilities," which provides, "The contracting officer shall not require any prospective contractor to submit details of its profit or fee objective but shall consider them if they are submitted voluntarily." The Navy also stated preparing fee requests would only be meaningful if fees were negotiated annually. The Navy further stated that requiring annual fee requests would prevent the use of long-term agreements which is a basic part of the FAR policy for establishing FFRDCs.

Audit Response. DFARS 215.972 states that the contracting officer should consider whether any fee is appropriate for nonprofit organizations that are FFRDCs and lists five basic factors that should be included in the considerations. The five factors deal with the FFRDCs retained earnings, acquisition plans, working capital funding needs, contingency funding needs, and unreimbursed cost funding needs. Contracting officers must obtain detailed information from the FFRDC to determine the appropriateness of any fee for the FFRDC. In addition, FAR 35.017 states that FFRDCs have access to Government facilities and information that is beyond that which is common to a normal contractual relationship and that FFRDCs should conduct their business in a manner befitting its special relationship with the Government, to include the full disclosure of its affairs to the sponsoring agency. The provisions of DFARS 215.972 and FAR 35.017 support that the financial affairs of FFRDCs should be closely monitored and fully disclosed. The Navy should also note that the Air Force has annual fee negotiations with its FFRDCs. We request that the Navy reconsider its position and provide additional comments on the recommendation.

Air Force Comments. The Air Force partially concurred with the recommendation but did not agree that the benefits of incurring a fee expense that accrued to the sponsor should be explained. The Air Force stated that

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would be a change in OFPP policy implemented in DFARS 215.972(b)(1)(v) on the funding of unreimbursed costs deemed ordinary and necessary to the FFRDC.

Audit Response. The Air Force comments are partially responsive to the recommendation. If the FFRDCs and their sponsors cannot agree on the benefits of incurring a fee expense, the Air Force should consider denying the need for the fee expense. The guidelines in DFARS 215.972 do not grant blanket approval for unreimbursed costs considered ordinary and necessary to the FFRDC or for any other category of fee expense. We request that the Air Force reconsider its position on the need to explain the benefits of incurring fee expenses and provide additional comments on the final report.

Additional Management Comments. Comments to the recommendation were also received from the ASD(C³I). The comments and our response follow.

ASD(C³I) Comments. The ASD(C³I) partially agreed with the recommendation and stated that detailed descriptions of expenses and detailed explanations of benefits would not always be possible. The ASD(C³I) stated that some fee needs and fee benefits could only be described and estimated by expense category.

Audit Response. We agree that specific details of each fee expense may not always be possible in advance. In such instances, an estimate by expense category may be an acceptable alternative. The ASD(C³I) should inform the Army and Air Force contracting officials of its desires to contractually require adequate fee justifications.

b. Determine whether prior year fees were used in accordance with approved fee requests and reduce authorized fees for expended balances.

DDR&E and Air Force Comments. The DDR&E and the Air Force concurred with determining whether prior years fees were used unless the intent of "approved fee requests" is to require Government approval of detailed fee elements. The DDR&E and the Air Force stated that contractors should have some latitude in the use of fees. The DDR&E and the Air Force also stated that unexpended fee balances should not be reduced until current fee needs are analyzed.

Audit Response. The intent of the recommendation is to reduce the amount of latitude that the FFRDCs have in this area and to ensure that FFRDCs use fees for the purposes acceptable to the contracting officer. DFARS 215.972 provides that fees should only be authorized if they are considered appropriate based on FFRDC need. The FFRDCs should not be allowed to use fees for purposes that were not authorized by the contracting officer. If FFRDC fee needs change during the year, the FFRDC should request contracting officer approval before the costs for the unanticipated purpose are incurred. Fees not earned in prior years should be used to help satisfy current FFRDC funding needs in support of DoD missions. We request that the Air Force provide additional comments on when the planned procedures implementing the recommendation will occur.

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Army Comments. The Army concurred but did not provide comments specific to this part of the recommendation.

Audit Response. We request that the Army identify the actions taken or planned and the completion dates for the planned actions in response to the final report.

Navy Comments. The Navy nonconcurred and stated that determining whether prior year fees were used in accordance with approved fee requests did not offer any remedy and did not mean that a current year request for the same expense would be inappropriate. The Navy also stated fee objectives are determined in accordance with DFARS 215.972.

Audit Response. The intent of the recommendation is for FFRDC sponsors to followup to ensure fees were used for agreed-upon purposes necessary for FFRDC operations and to minimize the unjustified accumulation of unexpended fees. As stated previously, the Navy contracting officer accepted CNA's fee proposal as "fair and reasonable." We request that the Navy reconsider its position and provide additional comments in response to the final report.

c. Perform an annual operating cycle analysis to determine federally funded research and development center management fee needs.

DDR&E and Air Force Comments. The DDR&E and the Air Force agreed that an annual operating cycle analysis of FFRDC fee needs should be performed.

Audit Response. The comments are responsive to the recommendation. We request that the Air Force provide additional comments on when procedures implementing the recommendation will be issued.

Army Comments. The Army concurred but did not specifically address whether an annual operating cycle analysis would be performed to determine FFRDC fee needs.

Audit Response. In response to the final report, we request that the Army provide comments on whether an operating cycle analysis will be performed to determine FFRDC fee needs for each FFRDC for which it is the procuring contracting office.

Navy Comments. The Navy nonconcurred with the recommendation and stated that an operating analysis is only useful if fees are negotiated annually. The Navy also stated that use of an annual contract does not comply with provisions of FAR 35.017(a)(4) that encourage maintenance of long-term relationships with FFRDCs.

Audit Response. As discussed in the audit response to the Navy comments to Recommendation B.2.a., we believe that fee needs should be assessed annually and that requirements for such annual assessments can be incorporated in

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

long-term contracts similar to those the Air Force has with its FFRDCs that receive fees. We request that the Navy reconsider its position and provide additional comments on the final report.

Additional Management Comments. Comments to the recommendation were also received from the ASD(C³I). The comments and our response follow.

ASD(C³I) Comments. The ASD(C³I) disagreed with the recommendation and stated that operating cycle analysis should exclude long term vacation liabilities from the operating cycle analysis. The ASD(C³I) stated the report appears to suggest that income should be accounted for on an accrual basis while unused vacation was accounted for on a cash basis.

Audit Response. The operating cycle analysis for the MITRE C³I Division FFRDC incorrectly classified all employee vacation liabilities as current. However, only the cost of that portion of accrued vacation time expected to be used during the current year should have been included in the operating cycle analysis. The classification of liabilities as current or long-term for the operating cycle analysis should not be interpreted as suggesting a change to a cash-based accounting system.

d. Assess alternatives to the award of fees, such as advance funding arrangements, contractual guarantees for contingencies, providing Government facilities or equipment, or others, and use alternatives when more economical.

DDR&E and Army Comments. The DDR&E and the Army concurred. They agreed that alternatives to management fees should be assessed. The DDR&E stated that improved guidelines and procedures will be addressed in a study on FFRDC management fee needs and uses that was required by the Defense Appropriations Act for FY 1995 and was due to Congress by April 1, 1995. The Army stated that it would like to be part of any DoD group established to review alternatives to management fees.

Audit Response. The comments are responsive. We agree that improved guidelines and procedures should result from the congressionally-mandated fee study and they should be included in the DoD FFRDC Management Plan.

Navy Comments. The Navy nonconcurred with the recommendation and stated that advanced funding arrangements do not save money, that contingent liabilities are not fully covered by standard contract termination clauses so special contract clauses would require funding to cover any contingent liabilities, and that using Government facilities and equipment is more costly and puts greater liability on the Government.

Audit Response. The Navy comments are partially responsive. The Navy did not provide support for its conclusion that the payment of management fees is the most economical alternative either during the audit or in response to the audit report. In comments on the final report, we ask that the Navy provide additional comments that support the conclusion that payment of management fees to CNA is the most economical alternative for the Navy.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Air Force Comments. The Air Force did not provide comments on the recommendation.

Audit Response. We request the Air Force provide comments on the recommendation in response to the final report.

Management Comments Required

Management is requested to comment on the items indicated with an "X" in the following table.

<u>Number</u>	<u>Addressee</u>	<u>Response Should Cover</u>			
		<u>Concur/ Nonconcur</u>	<u>Proposed Action</u>	<u>Completion Date</u>	<u>Related Issues¹</u>
B.1.	DDR&E		X	X	IC
	DUSD(LOG) ²		X	X	IC
	ASD(C ³ I)		X	X	IC
	Navy	X	X	X	IC
	Air Force	X	X	X	IC
B.2.a.	Army		X	X	IC, M
	Navy	X	X	X	IC, M
	Air Force	X	X	X	IC, M ³
B.2.b.	Army		X	X	IC
	Navy	X	X	X	IC
	Air Force		X	X	IC
B.2.c.	Army		X	X	
	Navy	X	X	X	
	Air Force			X	
B.2.d.	Navy		X	X	M
	Air Force	X	X	X	M

¹IC = material internal control weakness

M = monetary benefits

²Deputy Under Secretary of Defense (Logistics)

³Applies to Recommendation B.2.a.(3).

Recommendations, Management Comments, and Audit Response on Finding C. Conflicts of Interest Issues

Revised, Deleted and Renumbered Recommendations. As a result of management comments, we revised final report Recommendation C.2. to recommend the Navy either obtain reimbursement or provide supporting documentation for incorporation fees paid to CNA, Incorporated. We also deleted final report Recommendation C.3.b. to include all payments to federally funded research and development center employees on Intergovernmental Personnel Act assignments to DoD under the funding ceilings imposed by Congress. Final report Recommendation C.3.a. is renumbered as Recommendation C.3.

C.1. We recommend the Service Acquisition Executives and the Director, Advanced Research Projects Agency, require contracting officers to:

a. Obtain certifications from the sponsor of each project that the statement of work has been reviewed for potential and actual conflicts of interest. Issue instructions for sponsoring program officials to assist in such evaluations and require sponsoring program officials to notify the contracting officer immediately of any conflict identified.

Management Comments. The DDR&E, the ASD(C³I), the Army, the Air Force, and ARPA nonconcurred. They stated that adequate safeguards already existed in OFPP Letter 84-1, the FAR, the FFRDC sponsoring agreements, and the contracts and that those safeguards assured conflicts of interest could not occur. Further, additional requirements would be burdensome and of little value.

Audit Response. The existing guidelines and restrictions in OFPP Letter 84-1, the FAR, FFRDC sponsoring agreements, and contracts were not sufficient to cause the contracting officers for the FFRDCs to question sponsors of work requirements regarding potential conflicts of interest. The intent of the recommendation is to promote compliance with the existing guidelines for Government officials to monitor FFRDC work for conflicts of interest and for contracting officers to be informed of the existence of conflicts of interest. Contracting officials primarily relied on project sponsors to monitor FFRDCs for conflicts of interest. However, of the 229 project sponsors questioned during the audit, 108 stated they did not review work for conflicts of interest and 27 thought that contracting officers and FFRDC oversight committees were monitoring for conflicts of interest. Twenty-four project sponsors stated that additional guidance on conflicts of interest would be useful. We request that the Army, the Air Force, and ARPA reconsider their positions and provide additional comments in response to the final report.

Navy Comments. The Navy concurred and said that a statement on conflict of interest review will be included in the task documentation for implementation in the Navy's planned new FFRDC contract.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Audit Response. The Navy comments are fully responsive to the recommendation and no further response is necessary.

b. Include in all federally funded research and development center contracts conflicts of interest clauses that:

(1) Require federally funded research and development centers to file marketing consultant or advisory and assistance services certificates required by Federal Acquisition Regulation 9.507 for each project assigned to the contracts.

(2) Require federally funded research and development centers to warrant that no conflicts of interest existed before contract award and that the contracting officer will be immediately notified if any conflicts of interest arise after contract award.

(3) Provide for remedies that include possible contract termination if the federally funded research and development center fails to inform the contracting officer of any conflicts of interest.

(4) Require federally funded research and development centers to establish procedures for employees in executive and research positions to file annual disclosures of personal financial interests.

(5) Require federally funded research and development centers to report their investments in and contributions from non-Government organizations.

Army Comments. The Army nonconcurred and stated the report was inaccurate in stating that the RAND Arroyo Center does not have a conflict of interest clause as part of the contract and recommended the statement be deleted from the report. The Army stated RAND has a DoD-approved conflict of interest policy dated March 2, 1993, that is maintained as part of the basic contract file at DSS-W. The Army further stated it would review current conflict of interest policies for the Arroyo Center during the upcoming contract renewal process.

Audit Response. Contract MDA903-91-C-0006 awarded by DSS-W to the RAND Corporation (Arroyo Center) on January 18, 1991, did not contain a conflict of interest clause. The referenced March 2, 1993, conflict of interest policy was prepared in response to Section 8107 of Public Law 102-172, and as noted in the report applies to conflicts involving trustees or board members who simultaneously serve on the boards of profit and nonprofit companies. We believe the policies over board of trustee members should also be incorporated in the contracts with each FFRDC. We agree the Army needs to further study the potential for conflicts of interest and that such study should include a consideration of incorporating the requirements of the recommendation into the contract. We request that the Army reconsider its position and provide additional comments in response to the final report.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Navy Comments. The Navy concurred in principle with Recommendation C.1.b.(1), but stated it was not needed because CNA is already required by its existing conflicts of interest clause to identify all potential conflicts of interest. The Navy concurred with Recommendations C.1.b.(2) through C.1 b.(5).

Audit Response. Except for its position on Recommendation C.1.b.(1), we consider the Navy comments to be responsive. Obtaining the certifications required by FAR 9.507 should not create a significant administrative burden to CNA if it must already identify potential conflicts of interest. In response to the final report, we request that the Navy reconsider its position on Recommendation C.1.b.(1) and provide additional comments.

Air Force Comments. The Air Force nonconcurred and stated there was no possibility for conflicts of interest in the Aerospace, MITRE, and Lincoln Laboratory FFRDCs because of existing regulatory and contractual provisions. The Air Force stated filing of FFRDC employee financial disclosures would not be useful unless work assignments were provided. The Air Force also stated the financial holdings of employees are not examined by company management or by the Government in non-FFRDC contractors.

Audit Response. The audit determined that regulatory and contractual provisions were not always sufficiently enforced to ensure actual and potential conflicts of interest were reported to the contracting officers for the FFRDCs. We agree that FFRDC employees' work assignments should be considered along with their disclosed financial interests. We believe that the special relationships FFRDCs have with their sponsors that involve access to Government and contractor information and facilities not afforded in a normal contractual relationship warrants the need for improved oversight. We request that the Air Force reconsider its position and identify the actions it intends to take on each element of the recommendation in response to the final report.

ARPA Comments. The ARPA disagreed with Recommendation C.1.b.(1) and stated it appeared excessive since Recommendation C.1.a. requires each statement of work to be reviewed by the sponsor for conflicts of interest. ARPA stated the certification requirements should apply to each contract instead of each project.

Audit Response. We believe that the certifications should be obtained for individual projects because FFRDC work requirements are not well defined in sufficient detail prior to the award of a 5-year contract. The potential for conflicts of interest is more appropriately considered at the time the project is assigned to an FFRDC, when the specific circumstances surrounding the project are better known. Also, consultants are usually employed by the FFRDCs for specific taskings rather than for the duration of the FFRDC contracts. We request that ARPA reconsider its position and provide comments in response to the final report.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Additional Management Comments. The DDR&E and the ASD(C³I) also provided comments to the recommendation. The comments and our response follow.

DDR&E Comments. The DDR&E partially agreed with the recommendation, but stated that Recommendation C.1.b.(1) was not needed because FFRDCs were prohibited from competition and, therefore, did not hire marketing consultants. The DDR&E also stated advisory and assistance certificates were not needed because the purpose of the certificates was to identify potential conflicts of interest involving for-profit activities seeking business with the Government. The DDR&E stated Recommendations C.1.b.(2) through C.1.b.(5) may have merit and will be considered.

Audit Response. Provisions of FAR subpart 9.5, "Organizational and Consultant Conflicts of Interest," apply to contracts with profit or nonprofit organizations, including nonprofit organizations created largely or wholly with Government funds. As stated in the report, FAR 9.502 recognizes that organizational conflicts of interest are likely to occur in organizations performing types of work that are similar to the work done by the DoD FFRDCs. We continue to believe that the FFRDCs should be requested to complete both certifications required by FAR 9.507. Completion of the certifications on use of marketing consultants should impose no significant administrative burden on the FFRDC if none were employed.

ASD(C³I) Comments. The ASD(C³I) disagreed with Recommendation C.1.b.(1) and stated FFRDCs do not compete and have no need for marketing consultants. Also, all the work of the MITRE C³I Division FFRDC is systems engineering rather than advisory and assistance services. The ASD(C³I) partially agreed with Recommendation C.1.b.(4) to require FFRDC executives and research personnel to file financial disclosures and stated the requirements already existed at the MITRE C³I Division FFRDC. The ASD(C³I) further stated all FFRDC employees earning a salary at or above Senior Executive Service level 4 should also file disclosures. The ASD(C³I) agreed with Recommendations C.1.b.(2), C.1.b.(3), and C.1.b.(5).

Audit Response. Our response to Recommendation C.1.b.(1) is the same as that made to the DDR&E comments. United States Code, title 31, section 1105(g), defines advisory and assistance services to include engineering and technical services when provided by non-government sources. The statute does not exempt systems engineering provided by FFRDCs from the definition. We believe that all FFRDC executives and research personnel involved in sensitive positions should be required to file financial disclosures.

c. Review Intergovernmental Personnel Act appointments for all DoD federally funded research and development center personnel for potential conflicts of interest.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Army Comments. The Army stated that the recommendation did not apply to the Army.

Audit Response. The recommendation applies to the Army because the Army sponsors one FFRDC, the Arroyo Center, and contracts through DSS-W and the U.S. Army Communications-Electronics Command for five FFRDCs that are sponsored by either the Army or the Office of the Secretary of Defense. Accordingly, we request that the Army provide comments in response to the final report.

Navy Comments. The Navy did not concur with the recommendation as written and stated that any recommendation to amend or revise regulations related to IPA appointments should be addressed to the Assistant Secretary of the Navy (Manpower and Reserve Affairs). The Navy stated that personnel regulations could be amended to require notification of the FFRDC contracting officer of a pending IPA appointment to ensure there were no potential conflicts of interest.

Audit Response. The comments are partially responsive to the intent of the recommendation. Contracting officers are responsible for identifying and mitigating potential conflicts of interest. Accordingly, contracting officers should be aware of IPA appointments involving FFRDC employees to avoid conflicts of interest. The Assistant Secretary of the Navy (Research, Development, and Acquisition) should provide input to and request the Assistant Secretary of the Navy (Manpower and Reserve Affairs) to make any required changes to Navy personnel regulations needed to implement the recommendation. We request that the Assistant Secretary of the Navy (Research, Development, and Acquisition) provide additional comments on the recommendation in response to the final report.

Air Force Comments. The Air Force did not comment on the recommendation.

Audit Response. We request that the Air Force provide comments on the recommendation in response to the final report.

ARPA Comments. ARPA stated it was reasonable to require review of IPA appointments for conflicts of interest, but that the examples provided in the findings and recommendation imply a definition of conflicts of interest that would be damaging to DoD programs.

Audit Response. The intent of the recommendation was to make contracting officers for the FFRDCs aware of IPA appointments of FFRDC employees that might result in conflicts of interest. We request that ARPA provide comments on how it intends to implement the recommendation in comments on the final report.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

DDR&E and ASD(C³I) Comments. The DDR&E and ASD(C³I) disagreed and stated that procedures used during the IPA selection and assignment process to avoid potential conflicts of interest were adequate.

Audit Response. We made the recommendation because during the audit we reviewed only the procedures at Washington Headquarters Services that deal with FFRDC personnel assigned to the Office of the Secretary of Defense. We did not examine the procedures for reviewing IPA assignments within the Military Departments or Defense agencies that did not obtain personnel support from the Washington Headquarters Services. We determined that contracting officers for the FFRDCs were not aware of FFRDC personnel who were on IPA assignments.

C.2. We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) either direct the Office of Naval Research contracting officer to obtain reimbursement from the Center for Naval Analyses for incorporation fees paid by the Navy or provide documentation of prior approval of the incorporation fees.

Management Comments. The DDR&E and the Navy nonconcurred with the recommendation and stated that since the organizational costs were approved in advance, as required by Office of Management and Budget Circular No. A-122, the contracting officer had no basis to require CNA to return the incorporation fees.

Audit Response. No documented evidence existed of an advance agreement in the contract files or in the sponsoring program office files on the payment of the organizational costs of CNA. The CNA was incorporated on September 12, 1990. The only documentation addressing the Navy's intention was the September 28, 1990, contract with CNA, which authorized the payment of organization costs retroactive to September 1, 1990. Without documentation supporting the action, we had no recourse other than to request reimbursement. Based on Navy comments, we revised the recommendation. We request that the Navy provide comments on the revised recommendation.

C.3. We recommend that the Director, Defense, Research and Engineering, revise the DoD federally funded research and development center management plan to exclude federally funded research and development center personnel from assignment to DoD positions under Intergovernmental Personnel Act appointments that involve oversight or management responsibilities over a federally funded research and development center.

DDR&E and ASD(C³I) Comments. The DDR&E and ASD(C³I) stated IPA appointees should not exercise oversight or management responsibilities over the organization from which they came. The DDR&E also stated that existing IPA assignment and selection procedures ensure this will not occur.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Audit Response. The comments are partially responsive. FAR 35.017-2(c) requires FFRDC sponsors to ensure sufficient Government expertise is available to adequately and objectively evaluate work to be performed by an FFRDC. The intent of the provision is best served by using only full-time Government employees to oversee FFRDC affairs. FFRDCs are granted access to Government information beyond that afforded normal contractors, and the close relationships of the FFRDCs with their sponsors increase rather than reduce the potential for conflicts of interest. The use of an employee of an FFRDC to monitor and make decisions regarding the affairs of another FFRDC only increases the potential for a conflict of interest. We request the DDR&E to reconsider the position on the recommendation and provide additional comments in response to the final report.

Additional Management Comments. Comments to the recommendation were also received from the Army, the Navy, and ARPA.

Army and Navy Comments. The Army and the Navy concurred with the recommendation.

ARPA Comments. ARPA partially disagreed with the recommendation and stated that the assignment of an FFRDC employee on an IPA to oversee another FFRDC seemed similar to having a university employee on an IPA oversee work at another university. ARPA also stated that the fact that the Software Engineering Institute was established based on a report that was prepared by a group that included IDA participants is not grounds for disqualifying the IDA IPA.

Audit Response. The DoD FFRDCs are primarily dependent on their DoD sponsors for the majority of their funding through noncompetitive contract awards. The same dependence does not exist for most universities. As stated in the audit, the assignment of the IDA employee to the ARPA position gives the appearance of a conflict of interest. We continue to believe that implementation of the recommendation would help avoid such situations in the future.

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

Management Comments Required

Management is requested to comment on the items indicated with an "X" in the table below.

Number	Addressee	Response Should Cover			
		Concur/ Nonconcur	Proposed Action	Completion Date	Related Issue ¹
C.1.a.	Army	X	X	X	IC
	Air Force	X	X	X	IC
	ARPA	X	X	X	IC
C.1.b.	Army	X	X	X	IC ²
	Navy		X	X	IC ³
	Air Force	X	X	X	IC ²
	ARPA	X	X	X	IC ²
C.1.c.	Army	X	X	X	
	Navy	X	X	X	
	Air Force	X	X	X	
	ARPA	X	X	X	
C.2.	Navy	X	X	X	
C.3.	DDR&E	X	X	X	IC

¹IC = material internal control weakness.

²Applies to Recommendations C.1.b.(1) through (5).

³Applies to Recommendation C1.b.(1).

Management Comments and Audit Response on Potential Monetary Benefits

Management Comments. The Navy nonconcurred with the reported monetary benefits. The Navy stated that the \$11.6 million savings are necessary costs of doing business and that the elimination of those funds would jeopardize the existence of the FFRDCs. The Navy stated there was no contractual authority to eliminate fees or to specify how FFRDCs can use fees, and that savings could not be realized unless the FFRDCs agree and new contracts are negotiated without fees. The Navy further stated that monetary and other benefits far outweigh the \$2.9 million increase in CNA management fees. The Navy also

Management Comments and Audit Response on the Recommendations, Potential Monetary Benefits, and Internal Controls

stated there was no way to rescind the increased fee payment and that the increased fee payment was for a specific purpose and will not extend beyond the September 30, 1995, termination date of the existing contract with CNA.

The DDR&E, the ASD(C³I), the Army, and the Air Force did not indicate concurrence or nonconcurrence with the stated monetary benefits of the report.

Audit Response. The Navy's stated intention to reduce fee payments to CNA upon expiration of the current contract in September 1995 is responsive. However, we believe that the Navy can impose additional controls over fees or specify how CNA uses its fees. The fee payments to CNA include funding for programs that are not necessary operating expenses for CNA. We believe the Navy could cease fee payments to CNA for expenses that do not meet the described criteria. In response to the final report, we request that the Navy reconsider its position on the potential monetary benefits and provide additional comments.

We also request that the DDR&E, the ASD(C³I), the Army, and the Air Force state their concurrence or nonconcurrence with the monetary benefits of the report in response to the final report.

Management Comments and Audit Response on Internal Controls

Navy Comments. The Navy disagreed with the audit conclusion on internal controls. The Navy stated current controls for assigning work to CNA, which include reviews by the project sponsor, the contracting officer, and a high-level CNA Policy Council, provide appropriate assessment of the need for CNA services as well as adequate internal controls. The Navy stated that the FAR and DFARS provide policies and procedures needed to establish fee objectives and make determinations on whether fees should be paid and the contracting officer complied with all requirements for CNA fees.

Audit Response. As discussed in the audit report and in our response to the management comments, internal controls over the work assignments to FFRDCs needed improvement. The Navy did not have sufficient documented criteria for assessing proposed CNA work assignments, to include a mission statement that clearly differentiated work appropriate for CNA from work that should be done by non-FFRDCs. Regarding management fees, the report states that the Navy did not follow the established FAR and DFARS provisions in establishing CNA fee needs or establish effective control over CNAs use of fees.

Part III - Management Comments

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Defense Research and Engineering Comments



DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING

WASHINGTON, DC 20301-3010

December 2, 1994

EAG Dec 7, 94

MEMORANDUM FOR THE INSPECTOR GENERAL

SUBJECT: Review of Draft Audit Report on "Contracting Practices for the Use and Operation of DoD-Sponsored Federally Funded Research and Development Centers (FFRDC) (Project No. 1CH-5012)

I have provided at the attachment my comments to subject report findings and recommendations. In addition, the comments provided to me by each of the FFRDC sponsoring activities are also attached. These responses comment in more detail on findings and recommendations that directly impact the management and operation of a specific FFRDC.

For most recommendations, I have identified the action I intend to take or have explained why I do not concur. For others, we will have to await the results of ongoing reviews, audits and studies of pertinent FFRDC issues to ensure that we have adequate information to make an informed determination.

Overall, the audit tended to emphasize events that occurred during the FY 1988 to FY 1992 time frame. Since that time, there have been a number of changed or improved management practices initiated by either DDR&E or FFRDC sponsoring activities. Also, the audit ignores the intentionally unique relationship the Department has with its FFRDCs and recommends changes that would alter this relationship. Many of these changes treat FFRDCs as if they had the same characteristics as a for-profit company. That is not the case as evidenced by the designation of FFRDC status.

I believe that the DoD is in compliance with Office of Federal Procurement Policy letter No. 84.1, the Federal Acquisition Regulation and the Competition in Contracting Act. I agree, however, that there are areas that can or should be improved and that will result in a stronger and more effective DoD FFRDC capability. As you are aware, many of these areas are already undergoing thorough review and will be the subject of Congressional activity this coming summer.

Anita K. Jones
Anita K. Jones

Attachments

**Comments on Draft DoDIG Audit Report on
"Contracting Practices for the Use and Operation of DoD
Sponsored Federally Funded Research and Development Centers"
(Project Number 1CH-5012)**

Finding A.

Work performed by DoD FFRDCs was generally consistent with their broad mission statements. However, DoD sponsors did not provide sufficient justification for using FFRDCs to perform 223 of the 229 projects reviewed. As a result, DoD sponsors could not demonstrate that the noncompetitive assignment of work to the FFRDCs kept DoD sponsor costs down and resulted in the best performance.

Comment: The auditors surveyed individual task sponsors for their rationale for using FFRDCs to perform the work, rather than reviewing the process that was in effect at that time to approve work for assignment to an FFRDC. Specific task sponsors have never been responsible for determining the appropriateness of work assigned the FFRDC. When these projects were initiated, each of the FFRDC Management Offices had some kind of process to review proposed work. Policy guidance in both the Office of Federal Procurement Policy (OFFPP), Policy Letter No. 84-1, and the Federal Acquisition Regulation (FAR) designate the "sponsor of the FFRDC" as responsible to ensure that all work it places with its FFRDC is within the purpose, mission, and scope of effort of the FFRDC. Individual task sponsor reasons for using an FFRDC is only an input to the determination process. Because of the flawed methodology used by the audit, it is inappropriate to claim that sponsors cannot demonstrate reasonable costs and best performance.

The auditor also applies an extreme standard of uniqueness of FFRDC capability and expertise that is neither reasonable nor required. The justifications based on unique knowledge, special models, familiarity with sponsor requirements, independence, access to proprietary information, and quick response capability could individually or together be valid justification for assigning work to an FFRDC. Moreover, the audit objects to justifications that are the core of the rationale for the existence of the FFRDCs.

Recommendation A.1. We recommend that the Director, Defense Research and Engineering establish procedures for the primary FFRDC sponsors to revise mission statements for the FFRDCs to identify specific research areas for which the FFRDCs have unique capabilities and expertise.

Partially Concur. The DDR&E issued a revised DoD FFRDC Management Plan effective October 1, 1994. The plan requires each FFRDC sponsor to ensure that either their sponsoring agreement or operating policies/procedures contain "a statement of purpose for establishing the FFRDC, along with a description of its mission, general scope of effort, and the role the FFRDC has in accomplishing sponsoring agency's mission. This statement must be specific enough to permit a discrimination between work that is within the scope of effort for which the FFRDC was established and work that should be performed by a non-FFRDC." Sponsors have been told to ensure that their sponsoring agreement or operating policies/procedures comply with this requirement by February 1, 1995.

Recommendation A.2. We recommend that the Director, Defense Research and Engineering establish procedures for the primary FFRDC sponsors to prepare justifications for the noncompetitive assignment of projects to the FFRDCs that document:

- a. The unique FFRDC capabilities needed to perform the work.
- b. The alternatives considered to perform the work and why alternatives are unable to effectively perform the work.
- c. The specific characteristics of effectiveness (that is, quantity, timeliness, quality, and customer satisfaction) that justify assignment of the work to the FFRDC and that must be met when performing the project under consideration.

Partially Concur. The DDR&E believes that it is necessary to establish processes and or procedures to assist the sponsor determine if the proposed work should be assigned to its FFRDC. The revised management plan requires each sponsor to have adequate procedures. As part of the effort to ensure that each sponsor is in compliance with the requirements of the revised management plan, the DDR&E will request that sponsors provide a description of their process/procedures to determine the appropriateness of work assigned to the FFRDC. Corrective action will be taken as necessary.

Recommendation A.3. Perform cost-comparison studies of FFRDC and DoD in-house personnel costs as part of the comprehensive review.

Nonconcur. Performing cost comparison studies of DoD personnel and FFRDC costs are not meaningful without the prospect of hiring additional personnel to accomplish the work. In the current downsizing environment and in light of the 1994 Federal Workforce Restructuring Act, this recommendation cannot be implemented. In addition, the recommendation provides little if any apparent

value. An FFRDC is established and justified when work is required that cannot be done as effectively by alternative sources. This determination is not based solely on cost. The desired outcome is that the work be independent, objective and of high quality. Costs need only be reasonable. It would be impossible to establish and maintain over time and under current personnel policies, an in-house capability with the same characteristics and proven ability to produce the required high quality work now being done by our FFRDCs.

Recommendation A.4. Use broad agency announcements and competitive solicitations to assess the potential for non-FFRDC contractors to perform research projects.

Nonconcur. The basis of the recommendation appears to be cost driven and we certainly agree that open competition tends to drive down cost. However, as pointed out in our response to Recommendation A.3., cost is not the only factor used when assigning work to an FFRDC. If the FFRDC sponsor complies with the policies and procedures prescribed for the management and use of the FFRDC, adequate review and screening is done before work is assigned. The Congressionally directed Defense Science Board task force that is reviewing the "Role of FFRDCs in the DoD Mission" will be considering the appropriateness of work that is assigned our FFRDCs. Suggest that we await the results of the DSB report.

Finding B.

DoD FFRDCs generally developed overhead rates that were in accordance with Government standards. However, \$43 million of the \$46.9 million paid in management fees to DoD FFRDCs was inappropriate. About \$11.6 million should not have been paid, and \$31.4 million should have been charged to overhead. Also, the Navy increased management fee payments to the Center for Naval Analyses by about \$2.9 million annually but does not receive any measurable benefits from the increase.

Comment: The management fee issue is clearly contentious. The audit report provides useful information contributing to a better understanding of the issues involved. In the short term, the Congress has imposed limitations and guidelines on the use of fee. To implement a more permanent solution, the Congress has asked that the DoD perform a study of FFRDC management fees and to provide a report with recommendations. This report is due to the Congress in April 1995. Recommend that we adhere to current guidelines until the study is completed and a course of action defined. Request that the last paragraph, second sentence on page (i) of the "Executive Summary" be changed to read, "However, \$43 million of the \$46.9 million in management fees paid to DoD

Revised in
final report
to say
"accounting
for \$43.0
million ...
was not
correct."

FFRDC was considered either inappropriate or charged to the incorrect cost category." The sentence in the report implies that all \$43 million was inappropriate and as indicated in the body of the report, a major portion of that amount was a cost accounting error. The final costs to the Government would not change in either case.

Recommendation B.1. Document in FFRDC sponsoring agreements why FFRDCs need fees.

Concur. The DoD FFRDC Management Plan dated September 13, 1994 requires each sponsor to ensure that its sponsoring agreement and/or operating instructions complies with the following guidance:

"Where fees are determined by the sponsor(s) to be appropriate, considerations affecting their negotiations should be identified. In establishing fee objectives, evaluation should be made of the sources of capital reserves (e.g., fees, depreciation, facilities capital cost of money, borrowing, etc.) and the application of funds (e.g., capital acquisitions, non-reimbursable costs ordinary and necessary for the operation of the FFRDC, etc.). Working capital needs should be evaluated to assure that balances are sufficient, but not excessive, for the operation of the FFRDC."

Recommendation B.2.a. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency establish procedures for contracting officers to include a management fee clause in each FFRDC contract that requires FFRDCs to justify fees in accordance with the criteria contained in DFARS 215.972, "Modified Weighted Guidelines Method for Nonprofit Organizations. Management fees should be justified on all contract actions requiring cost analysis and in no case less than annually. The annual fee requests should include:

- (1) A description of each fee expense.
- (2) A statement why the fee is not chargeable under existing cost guidelines.
- (3) An explanation of the benefits of incurring each fee expense to both the FFRDC and the sponsor.
- (4) An Annual Report on the actual use of prior year fee awards.

Partially Concur. Reviewing fee requirements and usage is appropriate and we currently have guidelines in both the DFARS and the DoD Management Plan. However, before implementing revised or additional guidance, we should wait until the

Congressionally directed study on management fees is completed and appropriate action determined.

Recommendation B.2.b. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency establish procedures for contracting officers to determine whether prior year fees were used in accordance with approved fee requests and reduce annual fees for unexpended balances.

Partially Concur. Concur with determining whether prior years fees were used in accordance with approved fee requests unless the intent of "approved fee requests" is to require government approval of detailed fee elements. We believe that the contractor should have some reasonable latitude in this area. Do not concur with automatically reducing authorized fees for unexpended balances without an analysis to include the need and requirement for working capital. The emphasis on reducing fees as to "unexpended balances" would likely motivate contractors to expend all funds.

Recommendation B.2.c. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency establish procedures for contracting officers to perform an annual operating cycle analysis to determine FFRDC management fee needs.

Concur. An outcome of the management fee study should be improved guidelines and procedures for fee determination to include performance of an annual operating cycle analysis.

Recommendation B.2.d. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency establish procedures for contracting officers to assess alternatives to the award of fees, such as advance funding arrangements, contractual guarantees for contingencies, providing Government facilities or equipment, or others, and use alternatives when more economical.

Partially Concur. Again, the Congressionally directed fee study should result in improved guidelines and procedures for fee determination.

Finding C.

Contracting officers did not thoroughly consider potential conflicts of interest involving work assigned to DoD FFRDCs. The Navy's payment of incorporation fees appeared to limit the independence of the Center for Naval Analyses. Also, one FFRDC employee who was on an Intergovernmental Personnel Act appointment with the Advanced Research Projects Agency, was

Defense Research and Engineering Comments

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Revised in
final report
to say
"payment
... was
incorrect."

responsible for directing the activities of another FFRDC. In four instances, FFRDCs appeared to hire employees only to qualify the employees for Intergovernmental Personnel Act appointments requested by DoD. Overall, DoD had inadequate assurance that conflicts of interest were avoided or identified.

Comment: Per OFPP policy letter 84-1 and FAR 35.017-1(c)(4), FFRDCs are isolated from competitive pressures and commercial interests of profit-making concerns. FFRDCs are not allowed to manufacture products or compete in the commercial marketplace, except for the operation of an FFRDC. Provisions to avoid potential conflicts of interest are included in the FFRDC sponsoring agreements which are referenced in the FFRDC contracts. No further clauses or certifications are necessary.

The Navy's payment of CNA's incorporation fees was approved prior to payment and was therefore allowable. No rationale is offered to explain why this payment would limit CNA's independence any more than reimbursement of any allowable cost.

As for the FFRDC employee who was on an Intergovernmental Personnel Act (IPA) appointment with ARPA and responsible for overseeing certain activities at the Software Engineering Institute, we could not find any potential conflict of interest situation based on the facts presented in the audit.

Lacking an in-depth investigation into all details regarding the alleged hiring of four individuals by FFRDCs only to qualify them for an IPA appointment, it is inappropriate to comment on the propriety of each action. However, we agree that changes to current policy and procedures should be addressed in order to ensure against abuse of IPA provisions.

Recommendation C.1.a. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency require contracting officers to obtain certifications from each project sponsor that the SOW has been reviewed for potential and actual COI. Issue instructions to sponsoring program officials to assist in such evaluations and require sponsoring program officials to notify the contracting officer immediately of any conflict identified.

Nonconcur. The recommended certification is unnecessary and is not required by the FAR or any other regulatory requirement. The special restrictions placed on FFRDCs specifically to avoid potential conflict situations are adequate. Additional requirements would be both burdensome and of little value.

Recommendation C.1.b. We recommend that the Service Acquisition Executives and the Director, Advanced Research Project Agency require contracting officers to contracting officers to include in all FFRDC contracts COI clauses that:

- (1) Require all FFRDCs to file marketing consultant or advisory and assistance certificates required by FAR 98.507 for each contract and for each project assigned to the contracts.
- (2) Require FFRDCs to warrant that no COI existed before contract award and that the contracting officer will be immediately notified if any COIs arise after contract award.
- (3) Provide for remedies that include possible contract termination if the FFRDC fails to inform the contracting officer of any COI.
- (4) Require FFRDCs to establish procedures for employees in executive and research positions to file annual disclosures of personal financial interest.
- (5) Require FFRDCs to report their investments in and contributions from non-Government organizations.

Partially Concur. Recommendation C.1.b.(1) is unnecessary since FFRDCs are restricted from competing for work and would have no requirement to hire a "marketing consultant." Filing of an advisory and assistance certificate is also unnecessary. The primary purpose of these certificates is to assist in identifying potential conflict of interest situations when for-profit activities are seeking to do business with the government. This would be a burdensome an unnecessary requirement. The other four recommendations may have merit and will be considered for implementation.

Recommendation C.1.c. We recommend that the Service Acquisition Executives and the Director, Advanced Research Projects Agency require contracting officers to review Intergovernmental Personnel Act appointments for all DoD FFRDC personnel for Conflict of Interest.

Nonconcur. While we believe there should be a process in place to advise sponsors and contracting officers of pending IPA assignments, there already exists adequate procedures during the IPA selection and assignment process to avoid potential conflict situations.

Recommendation C.2. We recommend that ASN(RD&A) direct ONR to obtain reimbursement from CNA for incorporation fees paid by the Navy.

Nonconcur. We support the Navy's position that OMB Circular A-122 allows agencies to approve organizational costs in advance. The Department of the Navy did approve the questioned expenditure in advance. Since the costs were an allowable cost that had been

Revised

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approved in advance there is no basis for the contracting officer to require their return.

Revised
Recommendation C.3.

Recommendation C.3.a. We recommend that the DDR&E revise the FFRDC Management Plan to exclude FFRDC personnel from IPA appointments that involve management or oversight of FFRDCs.

Partially Concur. No IPA appointee should exercise oversight or management responsibilities over the organization from which they came. IPA selection and assignment procedures already ensure this from occurring. It is unnecessary to include additional assignment policies for IPA's in the DoD FFRDC Management Plan or to subject FFRDC employees to more rigorous rules regarding assignment possibilities.

Deleted

Recommendation C.3.b. We recommend that the DDR&E revise the FFRDC Management Plan to include all payments to FFRDC employees on IPA assignments to DoD under the funding ceilings imposed by Congress.

Nonconcur. The functions performed by an FFRDC employee under an IPA appointment are totally different than when that employee is functioning as a member of the FFRDC staff in support of a user. It is the latter that concerns the Congress and is the subject of ceilings.

Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) Comments



COMMAND, CONTROL,
COMMUNICATIONS
AND
INTELLIGENCE

ASSISTANT SECRETARY OF DEFENSE

WASHINGTON, D.C. 20301-3040

November 10, 1994

MEMORANDUM FOR THE DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING

SUBJECT: OASD(C3I) Comments: DoD Inspector General Draft Audit Report on Contracting Practices for the Use and Operation of DoD-Sponsored Federally Funded Research and Development Centers (Project Number 1CH-5012)

As requested, we have reviewed the subject DoD Inspector General audit report. Our comments are included in the attachment.

In summary, we believe that the methodology discussed in the draft report on why FFRDCs were used was unreasonable. An informal questionnaire was used rather than a review of the formal documentary record. The report then criticized the responses to the questionnaire on the grounds that they were insufficiently documented. In addition, this report goes astray because of a misconception regarding the following FFRDC purposes:

1. A special research and technical capability not available inside the Government or from non-FFRDC contractors, and
2. An organization that has a continuing, long-term relationship with its Government Sponsor.

The special relationship between an FFRDC and its Sponsor is in many cases the principle reason why non-FFRDC contractor cannot perform the work "as effectively as" the FFRDC. Section 35.017 of the Federal Acquisition Regulations (FAR) cites the need for such a continuing relationship as a primary reason for establishing an FFRDC. Further, restrictions placed on FFRDCs and their parent organizations (for example, "no competing") are imposed in order to make the special relationship with the Sponsor possible without conflicts of interest or unfairness. Because of these restrictions, the apparatus of certifications and warranties are unnecessary for parent companies of FFRDCs as long as they do not compete with or work for "for-profit" organizations. In contrast, to protect the Government against possible conflict of interest, certifications and warranties are necessary with non-FFRDC contractors, "for profit" organizations, and parent companies of FFRDCs that do not include anti-competition restrictions in their DoD contracts.


Emmett Paige, Jr.

Attachment

Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) Comments

OASD(C3I) COMMENTS

**DOD INSPECTOR GENERAL AUDIT REPORT ON CONTRACTING PRACTICES
FOR THE USE AND OPERATION OF DOD-SPONSORED
FEDERALLY FUNDED RESEARCH AND DEVELOPMENT CENTERS
(Project Number 1CH-5012)**

FINDING A: USE OF FEDERALLY FUNDED RESEARCH AND DEVELOPMENT CENTERS

A.1. RECOMMENDATION: Revise mission statements for the FFRDCs to identify specific research areas for which the FFRDCs have unique capabilities and expertise.

OASD(C3I) Position: Nonconcur

This recommendation is not based on the role and purpose of an FFRDC, as expressed in OMB's OFPP Policy Letter 84-1, Section 35.017 of the Federal Acquisition Regulations (FAR), and the DoD FFRDC Management Plan. It is true that FFRDCs possess unique capabilities and expertise, which are major reasons why they can perform certain tasks more effectively than in-house resources or non-FFRDC contractors. However, these unique capabilities and expertise reside not only in certain definable "specific research areas," but also in (a) technical breadth and depth which enable FFRDCs to integrate across multiple research areas, and (b) a distinctive structure and relationship to the Government, which makes it appropriate for FFRDCs to carry out tasks which, although not inherently Governmental functions, are so closely related to such that they could not to be entrusted to a non-FFRDC contractor.

In the case of the MITRE C3I FFRDC, Air Force Regulation 80-1 and CECOM Regulation 70-64 lay out specific criteria that are to be applied in determining whether a particular task is appropriate for that FFRDC. The draft audit report does not mention whether these regulations were examined to determine if they are adequate for their purpose. In the absence of such an examination, there does not appear to be any basis for modifying them.

A.2. RECOMMENDATION: Prepare justifications for the noncompetitive assignment of projects to the FFRDCs that document:

- a. The unique FFRDC capabilities needed to perform the work.
- b. The alternatives considered to perform the work and why the alternatives are unable to effectively do the work.
- c. The specific characteristics of effectiveness (that is, quantity, timeliness, quality, and customer satisfaction) that

**Assistant Secretary of Defense (Command, Control, Communications, and
Intelligence) Comments**

justify assignment of the work to the FFRDC and that must be met when performing the project under consideration.

OASD(C3I) Position: Nonconcur

The recommendation calls for establishing procedures which already exist in the case of the MITRE C3I FFRDC. Specifically:

Recommendation A.2.a. Air Force Regulation 80-1 and CECOM Regulation 70-64 require documentation by project that documents the FFRDC's unique capabilities and/or expertise enabling it to perform the work more effectively than available in-house resources or non-FFRDC contractors. It should not be necessary to document that the FFRDC has unique capabilities that are "needed" to perform the work; the criteria is that the FFRDC has unique capabilities and characteristics that enable it to perform the work "more effectively."

Recommendation A.2.b. This recommendation would be a change in current policy. Alternatives considered to perform FFRDC-work should be assessed when preparing the Comprehensive Review.

Recommendation A.2.c. These justifications address specific reasons that justify assignment of the work to FFRDCs. However, this recommendation appears to be assuming that "effectiveness" is limited to quantity, quality, timeliness, or customer satisfaction. Often effectiveness is a question of the special characteristics of an FFRDC (freedom from conflict of interest, access to proprietary data, etc.) or the synergy that results when multiple projects that interact with each other are performed by the same organization. Effectiveness may also be measured in technical innovation (i.e., Government money saved by re-use of existing hardware, software, or concepts). Contract documents other than the justification for using the FFRDC specify schedules, budgets, and details of required deliverables.

A.3. RECOMMENDATION: Perform cost-comparison studies of FFRDC and DoD in-house personnel costs as part of the comprehensive reviews.

OASD(C3I) Position: Partially Concur

The next comprehensive review for the MITRE C3I FFRDC will compare the costs of the FFRDC with costs of using in-house personnel. Such a comparison will address Government personnel who have the technical skills necessary to perform the work typically carried out by the FFRDC, and will include an assessment of the practicability of recruiting such personnel if they are not now available. It will also attempt to compare the full cost of using MITRE with the full cost of using Government personnel, including costs such as depreciation of Government-owned buildings in which in-house personnel work.

A.4. RECOMMENDATION: Use broad agency announcements and competitive solicitations to assess the potential for non-FFRDC contractors to perform research projects.

OASD(C3I) Position: Nonconcur

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The fundamental characteristic of an FFRDC, as laid down in OMB's OFPP Policy Letter 84-1, the FAR, the DoD FFRDC Management Plan, and the Sponsoring Agreements, is its "special relationship" with its Government Sponsor. This long-term relationship, based on a Government determination that a continuing need exists, means that "fair competition" between FFRDCs and non-FFRDC contractors is impossible. Even if a non-FFRDC contractor were capable of performing the particular task at issue, the non-FFRDC contractor could not match the added effectiveness derived from the continuity and breadth of the FFRDC involvement with the Sponsor and the mission. This is why the FAR prohibits such competition. The Primary Sponsor has interpreted this FAR provision to mean that the entire MITRE Corporation should refrain from responding to broad agency announcements as well as to competitive solicitations if profit seeking firms will also respond. Therefore, Government Sponsors can use such announcements only after they have determined that the use of the FFRDC is not appropriate. Because good faith competition between an FFRDC and a non-FFRDC is impossible, other procedures have been put in place, including the requirement for justification of each use of the FFRDC and the imposition of an annual ceiling on the work done by the FFRDC, to ensure that the FFRDC is not used on tasks where in-house resources or non-FFRDC contractors would be equally effective or more effective.

FINDING B: JUSTIFICATION AND ANALYSIS OF MANAGEMENT FEE REQUIREMENTS

B.1. RECOMMENDATION: We recommend that the DDR&E, DUSD(Logistics), ASD(C3I), the Army, the Navy, the Air Force, and the Director of ARPA document in the federally funded research and development centers needed management fees.

OASD(C3I) Position: Concur

The MITRE C3I FFRDC Sponsoring Agreement and DoD (Air Force and Army) contracts with the MITRE Corporation already include adequate documentation on why a fee is needed. Note that the DoD FFRDCs in general, and the MITRE C3I FFRDC in particular, do not receive "management fees" analogous to those paid to operators of the Department of Energy "GOCO" (Government-owned, contractor operated) FFRDCs; instead they receive a "fee-for-need" intended to provide resources that are necessary for the FFRDC to perform its mission.

B.2. RECOMMENDATION: We recommend that the Service Acquisition Executives and the Director of ARPA establish procedures for contracting officers to:

B.2.a. Include a management fee clause in each FFRDC contract

OASD(C3I) Position: Concur

B.2.a.(1) A description of each fee expense

Assistant Secretary of Defense (Command, Control, Communications, and
Intelligence) Comments

OASD(C3I) Position: Partially concur

A description by category of expenses is appropriate. A description of each expense would not be practicable. For example, there can be an estimate of the amount of excess relocation costs, but not a list (a year in advance) of each employee who will be relocated during the year.

B.2.a.(2) A statement why the fee is not chargeable under existing cost guidelines.

OASD(C3I) Position: Concur

B.2.a.(3) An explanation of the benefits of incurring each fee expense to both the FFRDC and the sponsor.

OASD(C3I) Position: Partially concur

As in B.2.a(1), above, these should be by categories of expense.

B.2.a.(4) An annual report on the actual use of prior year fee awards.

OASD(C3I) Position: Concur

B.2.b. Determine whether prior year fees were used in accordance with approved fee requests and reduce authorized fees for unexpended balances.

OASD(C3I) Position: Concur

B.2.c. Perform an annual operating cycle analysis to determine FFRDC management fee needs

OASD(C3I) Position: Partially concur

Such an analysis is already performed for the MITRE C3I FFRDC. However, the text of the report appears to suggest that such an analysis should account for income on an accrual basis, while accounting for certain liabilities (e.g. unused vacation) on a cash basis. This would violate Federal cost accounting regulations. Shifting the entire analysis to a cash basis might be possible, but we doubt its wisdom, given that a small number of accounts remain open for years.

B.2.d. Assess alternatives to the award of fees

OASD(C3I) Position: Partially Concur

The Defense Appropriations Act for FY95 requires that the Secretary of Defense conduct a study and submit a report to Congress on fees granting procedures, use of fees, and why some FFRDCs do not require fees.

FINDING C: CONFLICT OF INTEREST ISSUES

C.1.a. RECOMMENDATION: We recommend that the Service Acquisition Executives and the Director of ARPA require contracting officers to obtain certifications from the sponsor of each project that the statement of work has been reviewed for potential and actual conflict of interest. Issue instructions for sponsoring program officials to assist in such evaluations and require sponsoring officials to notify the contracting officer immediately of any conflict identified.

OASD(C3I) Position: Nonconcur

The special restrictions placed on FFRDCs by OMB's OFPP Policy Letter 84-1, the FAR, the DoD FFRDC Management Plan, Sponsoring Agreements, and contracts all serve to ensure that FFRDCs are far less vulnerable to conflict of interest than non-FFRDC contractors. We believe that no amount of certifications can make non-FFRDC contractors as free of potential conflicts of interest as FFRDCs are without such certifications. Accordingly, special reviews of each project, and special Sponsor certifications are unnecessary.

C.1.b. RECOMMENDATION: We recommend that the Service Acquisition Executives and the Director of ARPA require contracting officers to include in all FFRDC contracts conflicts of interest clause that:

C.1.b.(1) Require FFRDCs to file marketing consultant or advisory and assistance services certificates required by FAR 9.507 for each contract and project assigned to the contracts.

OASD(C3I) Position: Nonconcur

Because FFRDCs do not compete for work, they have no need for marketing consultants and should not be allowed to use them. In the case of the MITRE C3I FFRDC, all of its work is systems engineering rather than "advisory and assistance services."

B.1 b.(2) Require FFRDCs to warrant that no conflicts of interest existed before contract award and that the contracting officer will be immediately notified if any conflicts of interest arise after contract award.

OASD(C3I) Position: Concur

C.1 b.(3) Provide for remedies that include possible contract termination if the FFRDC fails to inform the contracting officer of any conflicts of interest

OASD(C3I) Position: Concur

C.1 b.(4) Require FFRDCs to establish procedures for employees in executive and research positions to file annual disclosures of personal financial interests.

OASD(C3I) Position: Partially concur

Assistant Secretary of Defense (Command, Control, Communications, and
Intelligence) Comments

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These requirements already exist at the MITRE C3I FFRDC for personnel involved in technical support to source selection. We believe that all FFRDC executives/employees earning a salary at/above Senior Executive Service (SES) Level 4 should also file annual disclosures of personal financial interests. Disclosure requirements for all research personnel are unnecessary and would go beyond the current requirements imposed on Government workers.

C.1 b.(5) Require FFRDCs to report their investments in and contributions from non-Government organizations.

OASD(C3I) Position: Concur

C.1.c. RECOMMENDATION: We recommend that the Service Acquisition Executives and Director of ARPA require contracting officers to review Intergovernmental Personnel Act (IPA) appointments for all DoD FFRDC personnel for potential conflicts of interest.

OASD(C3I) Position: Nonconcur

A process regarding IPA appointments is already in place. Additional restrictions on FFRDC personnel are not required.

C.2. RECOMMENDATION: We recommend that the Assistant Secretary of the Navy (Research, Development, and Acquisition) direct the Office of Naval Research contracting officer to obtain reimbursement from the Center for Naval Analyses for incorporation fees paid by the Navy.

OASD(C3I) Position: none (does not pertain to OASD(C3I))

C.3.a. RECOMMENDATION: We recommend that DDR&E revise the DoD FFRDC Management Plan to exclude FFRDC personnel from assignment to DoD positions under IPA appointments that involve oversight or management responsibilities over a FFRDC.

CASD(C3I) Position: Partially concur

Employees of an FFRDC on an IPA assignment should not exercise oversight or management responsibilities over the FFRDC which is their permanent employer.

C.3.b. RECOMMENDATION: We recommend that DDR&E revise the DoD FFRDC Management Plan to include all payments to FFRDC employees on IPA assignments to DoD under the funding ceilings imposed by Congress.

OASD(C3I) Position: Nonconcur

This recommendation misconstrues the purpose of IPA assignments, which are intended to be quite distinct from the work done by the individual for his/her permanent employer. The ceiling imposed by Congress, like the ceilings previously imposed by internal DoD action, are intended to be ceilings on the work done by the FFRDCs, not on the number of individuals who appear on the FFRDC staff rosters.

Revised
Recommendation C.3.

Deleted

Department of the Army Comments



REPLY TO
ATTENTION OF

DEPARTMENT OF THE ARMY
OFFICE OF THE CHIEF OF STAFF
WASHINGTON, DC 20310-0200



November 9, 1994

MEMORANDUM FOR DIRECTOR, DEFENSE RESEARCH AND ENGINEERING

SUBJECT: Draft Audit Report 1CH-5012, (Contracting Practices for
Federally Funded Research and Development Centers)

This memorandum provides the Army's response to draft DOD IG
Report 1CH-5012 dated September 15, 1994. The Army has commented on
all findings and recommendations except C.1c and C.2 which do not
apply to the Army.

David K. Heebner
Brigadier General, U. S. Army
Director, Program Analysis
and Evaluation



OFFICE OF THE DIRECTOR OF
DEFENSE RESEARCH AND ENGINEERING

WASHINGTON, DC 20301-3030

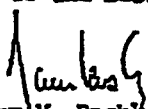
NOV 2 1994

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (COMMAND, CONTROL,
COMMUNICATIONS, AND INTELLIGENCE)
DIRECTOR, OPERATIONAL TEST AND EVALUATION
ASSISTANT SECRETARY OF THE NAVY (RESEARCH,
DEVELOPMENT, AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITION)
DIRECTOR, ADVANCED RESEARCH PROJECTS AGENCY
DIRECTOR, NATIONAL SECURITY AGENCY
DEPUTY UNDER SECRETARY OF DEFENSE (LOGISTICS)
DIRECTOR, ACQUISITION PROGRAM INTEGRATION
DIRECTOR, PROGRAM ANALYSIS AND EVALUATION, ARMY
STAFF

SUBJECT: Audit Report on Contracting Practices for the Use and
Operations of DoD-Sponsored Federally Funded Research
and Development Centers (Project No. 1CH-5012)

The DDRE intends to respond to each of the findings and recommendations contained in the subject audit. At recent meetings with the FRDC points of contact, it was suggested that a DoD consolidated response would be more appropriate than each sponsor responding separately. The DDRE agrees with that course of action. However, to ensure that your position on any specific finding/recommendation is fully considered by both the DDRE and the DoDIG, request that you submit your separate response directly to DDRE. It will be included as an attachment to the consolidated response.

Bob Nemetz, (703) 756-2096 is the point of contact for this effort. He will work with your staff to ensure that all the necessary information is provided to the DoDIG.


John M. Bachkosky
Deputy Director

DEPARTMENT OF THE ARMY RESPONSE
TO DODIG DRAFT AUDIT REPORT ICH-5012

"CONTRACTING PRACTICES FOR FEDERALLY FUNDED RESEARCH
AND DEVELOPMENT CENTERS"

Finding A - Conclusions and Recommendations for
the Use of FFRDC's.

"Work performed by DoD FFRDCs was generally consistent with their broad mission statements. However, DoD sponsors did not provide sufficient justification for using FFRDCs to perform 223 of 229 projects reviewed. As a result, DoD sponsors could not demonstrate that the noncompetitive assignment of work to FFRDCs kept DoD sponsor costs down and resulted in the best performance."

Recommendation 1 "Revise mission statements for the FFRDCs to identify specific research areas for which the FFRDCs have unique capabilities and expertise."

Army Response: CONCUR - The mission statement for the Arroyo Center, the Army's only sponsored Federally Funded Research and Development Center (FFRDC), is currently being revised as part of FY96 contract renewal process. The Army will include a revised mission statement in the Arroyo Center Sponsoring Agreement which will identify specific research areas for which the Arroyo Center has unique capabilities and expertise. Estimated completion is December 1994.

Recommendation 2 "Prepare justifications for the noncompetitive assignment of projects to the FFRDCs that document unique FFRDC capabilities; alternatives considered to perform the work; and specific characteristics of effectiveness that justify assignment of work to an FFRDC."

Army Response: NON CONCUR - A detailed process already exists for review and approval of both core research projects and customer reimbursable efforts. In the case of the core research agenda, the Arroyo Center Policy Committee (ACPC) review process is specifically designed to ensure that the Arroyo Center is conducting studies and analyses requiring unique expertise, of mid-to-long term importance to the Army, involving independent and objective research, and serving a need for quick response within a specialized area. This process is an evolving six month effort beginning in the spring with the identification of major Army issues, request for research topics that support the issues, senior leadership review of the

topics, formulation of topics into projects, consideration of alternative sources for research by the Study Program Coordination Committee (SPCC), and formal approval of the research agenda by the ACPC in the fall. In the case of customer reimbursable projects, they must fall within the DOD imposed funding ceiling and meet the criteria established in AR 5-21, Arroyo Center Policies and Responsibilities. Approval authority for these efforts is the Army Executive Agent.

Recommendation 3 "Perform cost-comparison studies of FFRDC and DoD in-house personnel costs as part of the comprehensive review."

Army Response: NON CONCUR - The basis for establishing study and analysis FFRDCs was predicated on the governments need to develop a significant independent, objective, analytical capability that is not available in-house. The comprehensive review currently being conducted by the Army validates the continued need for the study and analysis FFRDC and confirms that the criteria for establishing the Arroyo Center as the Army's Study and Analysis FFRDC still exists. Since this in-house capability is not available, nor is it likely to be established within the currently constrained fiscal environment, the Army non concurs with this recommendation.

Recommendation 4 "Use broad agency announcements and competitive solicitations to assess the potential for non-FFRDC contractors to perform research projects."

Army Response: NON CONCUR - The recommendation to use broad agency announcements and competitive solicitations prior to assignment of a task to an FFRDC is not supported by existing policy or regulation. In the case of the Arroyo Center, this represents a duplication of effort. The previously noted ACPC review process is designed to determine which research work is appropriate for the Arroyo Center FFRDC. Announcements and solicitations, as recommended in the report, would add another unneeded layer of evaluation to this detailed, existing process.

Finding B - Management Fees

"DoD FFRDCs generally developed overhead rates that were in accordance with Government standards. However, \$43M of the \$46.9M paid in management fees to DoD FFRDCs was inappropriate. About \$11.6M should have been charged to overhead. Also, the Navy increased management fee payments to the Center of Naval Analyses by about \$2.9M annually but does not receive any measurable benefits from the increase."

Recommendation 1 "Document in FFRDC sponsoring agreements why FFRDCs need fees."

Army Response: CONCUR - The DOD FFRDC Management Plan dated September 13, 1994 directs "current sponsoring agreements must cover

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such items as authorization of management fees". The Army will include this provision in the revised sponsoring agreement that will be completed in December 1994.

Recommendation 2 "Establish procedures for contracting officers to include a management fee clause in each FFRDC contract that requires FFRDCs to justify fee IAW DFARS 215.972. Additionally, determine whether fee has been used IAW fee requests; perform annual operating cost analysis on management fee; and assess alternatives to award fee."

Army Response: CONCUR - The Army requires the Arroyo Center to justify their use of management fee through the annual Need for Fee Justification. This is submitted as part of the annual contract proposal. The Need for Fee Justification is reviewed by Defense Services Supply-Washington (DSS-W) and audited by the Defense Contract Audit Agency (DCAA). The last audit was dated December 20, 1993. The Army also supports assessing alternatives to award fee, and would like to participate in any OSD lead group that reviews these alternatives.

Finding C - Conflict of Interest

"Contracting officers did not thoroughly consider potential conflicts of interest involving work assigned to DoD FFRDCs."

Recommendation 1a "Require contracting officers to obtain certifications for each project sponsor that the Statement of Work (SOW) has been reviewed for potential Conflict of Interest (COI)"

Army Response: NON CONCUR - The requirement for the contracting officer to obtain a certification from the sponsor for each tasking is unnecessary. The Army already has an established process for review of proposed projects. This process does not require a certification from the sponsor but serves as a safeguard to preclude conflict of interest violations. All proposed projects are reviewed by the individual sponsors, the FFRDC management office, the Arroyo Center, and the ACPC. In order for a project to be approved by the ACPC, a general officer or Senior Executive Service (SES) must approve the project description (Statement of Work). These safeguards are more than adequate to avoid conflict of interest violations, however in the event a violation occurs, the contracting officer would be notified.

Recommendation 1b "Require contracting officers to include in all FFRDC contracts COI clauses."

Army Response: NON CONCUR - The report states the RAND Arroyo Center does not have a conflict of interest clause as part of the contract. This is inaccurate. RAND has a DOD approved conflict of interest policy dated March 2, 1992. It is maintained as part of the basic contract file at DSS-W. This statement should be deleted from the final report. In the upcoming five year contract renewal process, the Army, in coordination with DSS-W will review the current

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Reference

conflict of interest policy for the Arroyo Center. This review will be completed by late summer 1995.

Recommendation 1c "Review all DoD Intergovernmental Personnel Act appointments for potential COI."

Army Response: This recommendation does not apply to the Army.

Recommendation 2 "Recommend that ASN(RDA) direct ONR to obtain reimbursement from CNA for incorporation fees paid by the Navy."

Army Response: This recommendation does not apply to the Army.

Recommendation 3a "Revise FFRDC Management Plan to exclude FFRDC personnel from IPA appointments that involve the management or oversight of FFRDCs."

Army Response: CONCUR.

Recommendation 3b "Revise the FFRDC Management Plan to include all payments to FFRDC employees in IPA assignments to DoD under the funding ceilings imposed by Congress."

Army Response: NON CONCUR - The Army currently does not assign FFRDC employees to Intergovernmental Personnel Act appointments, however if the Army chose to initiate this process, including the IPA salary in the Congressionally imposed ceiling is to restrictive. Over the past two years Congressional funding ceilings have significantly limited the FFRDC's ability to meet stable level of effort requirements established by the Army. An additional requirement will further limit an already constrained environment.

Revised
Recommendation C.3.

Deleted

Department of the Navy Comments



DEPARTMENT OF THE NAVY
CHIEF OF NAVAL OPERATIONS
2000 NAVY PENTAGON
WASHINGTON, DC 20350-2000

IN REPLY REFER TO
5041
Ser N81/4U643903
17 November 1994

MEMORANDUM FOR DIRECTOR, DEFENSE RESEARCH AND ENGINEERING

Subj: CONTRACTING PRACTICES FOR THE USE AND OPERATIONS OF
DOD-SPONSORED FEDERALLY FUNDED RESEARCH AND DEVELOPMENT
CENTERS (PROJECT NO. 1CN-5012)

Ref: (a) DODIG memo of 15 Sep 94
(b) DDR&E memo of 2 Nov 94

Encl: (1) Department of the Navy Response to DODIG draft audit
report of 15 Sep 94

1. The Department of the Navy has reviewed the subject draft report, contained in reference (a), and assessed each finding and recommendation impacting the Department of the Navy. As requested in reference (b), enclosure (1) is forwarded for inclusion in the Department of Defense response.

2. Our concerns center on those findings and recommendations which appear to be based on disagreement with or inappropriate interpretation of existing policy guidelines. Some recommendations introduce standards which are not currently required or add work to an already cumbersome process, with little or no supporting evidence that such changes will result in measurable benefits. Our specific concerns are addressed below.

3. With respect to the Inspector General's findings and recommendations concerning the use of Federally Funded Research and Development Centers, we have concerns in three specific areas. First, procedures employed for assigning work to the Center for Naval Analyses during the period reviewed (FY 1990 - FY 1991) are now obsolete. Reference (a) did not consider the impact of changed management practices by the Director, Defense Research and Engineering or the Department of the Navy which have substantially improved oversight of the Center for Naval Analyses. Second, in assessing the adequacy of the rationale for assigning tasks to Federally Funded Research and Development Centers, the Inspector General has introduced standards which are not required by statute, regulation, or official policy. Third, we believe that implementing the additional requirements for documentation and review recommended by reference (a) would cause serious delays in the assignment of appropriate work to the Center for Naval Analyses and would seriously degrade the Department of the Navy's capability to utilize the independent, objective and high quality studies and analyses provided by the Center for Naval Analyses.

Subj: CONTRACTING PRACTICES FOR THE USE AND OPERATIONS OF
DOD-SPONSORED FEDERALLY FUNDED RESEARCH AND DEVELOPMENT
CENTERS (PROJECT NO. 1CH-5012)

4. With respect to the findings and recommendations related to management fee requirements, at least in the case of the Center for Naval Analyses, the Department of the Navy does not agree with the Inspector General's conclusions that fees were excessive or that excessive fees were caused by the Contracting Officer's failure to perform proper fee analysis. Excess costs attributed to the Center for Naval Analyses were based on the Inspector General's erroneous application and interpretation of appropriate cost principles. A fee analysis consistent with Department of Defense policy was conducted both at the time of initial fee negotiation and during negotiation of the last contract modification. In both cases, the price negotiation memorandum documented the factors considered in determining that a fee was appropriate and how the weighted guidelines and the needs analysis supported the fee ultimately negotiated. The Navy did the required fee analysis and, while the conclusions drawn may differ, the fact that an analysis was properly conducted cannot be disputed.

5. In addition, the Department of the Navy believes that measurable benefits have been realized as a result of the increased fee paid to the Center for Naval Analyses. The rationale for the fee increase was in accordance with clear Government policy, as stated in Federal Acquisition Regulation 32 and 45, that the Government prefers to pay for completed work and have the contractor provide the facilities and equipment necessary for contract performance. A discussion of the benefits which have accrued to the Navy since the implementation of the higher fee is contained in enclosure (1).

6. With respect to concerns raised on conflict of interest issues in reference (a), the Department of the Navy concurs, at least in principle, that Organizational Conflict of Interest clauses could be strengthened. However, within the Department of the Navy, the Contracting Officers did take seriously the potential for conflicts of interest, as evidenced by the inclusion of an Organizational Conflict of Interest clause in the Navy's contract with the Center for Naval Analyses. While we relied primarily on project sponsors and Federally Funded Research and Development Centers to identify and avoid conflicts, there was existing guidance in the form of the Department of the Navy-approved conflict of interest policies and procedures and the Organizational Conflict of Interest contract provision. Further, Federally Funded Research and Development Center trustees and employees are required to disclose their financial affiliations to help avoid conflict of interest violations. Therefore, we believe we have adequate assurance that conflicts of interest are being identified and avoided.

Department of the Navy Comments

Subj: CONTRACTING PRACTICES FOR THE USE AND OPERATIONS OF
DOD-SPONSORED FEDERALLY FUNDED RESEARCH AND DEVELOPMENT
CENTERS (PROJECT NO. 1CH-5012)

7. Finally, the Department of the Navy sees no basis for the Inspector General's conclusion that the Navy's payment of incorporation fees to CNA, Incorporated may have limited the independence of the Center for Naval Analyses. Office of Management and Budget Circular A-122, which provides the cost principles for nonprofit organizations, permits agencies to approve organization costs such as incorporation fees. The Department of the Navy approved the questioned expenditure in accordance with Circular A-122, and there is no authority for the Contracting Officer to require its return unilaterally.

8. The Department of the Navy remains fully committed to executing its oversight responsibilities for the Center for Naval Analyses in full accordance with the spirit, intent, and letter of statutes and guidelines related to Federally Funded Research and Development Centers. Significant steps have already been taken to address concerns raised in reference (a), and we will look closely for possible additional improvements during the next comprehensive review cycle.



D. T. OLIVER
Center for Naval Analyses
Contracting Officer's Technical
Representative (CNA COTR)

Copy to:
ASN (RD&A, M&RA)
CNO (N8)
CG, MCCDC
CNR
NAVCOMPT (NCB 53)
Dir, OCPM

Department of the Navy Response

to

Assistant Inspector General for Auditing
Draft Report of 15 September 1994

on

Contracting Practices for the Use and Operations
of Department of Defense-Sponsored
Federally Funded Research and Development Centers
(Project No. 1CH-5012)

Executive Summary

Page i. Paragraph 3: Objectives.

"We also determined whether management fees were properly justified, and we evaluated applicable internal controls."

Department of the Navy Position. To our knowledge, the Inspector General was not requested to look at management fees; this appears to be a self-initiated objective. It must be pointed out that there is no specific "justification" required in determining the need for or amount of fees. The contracting officer is required to consider whether or not there is a need for fee and if, in his/her judgement, fee is considered necessary, to calculate the objective amount for fee in accordance with applicable guidelines. The Contracting officer is then responsible for negotiating fee and documenting those negotiations and the rationale which led to the negotiated amount in the price negotiation memorandum. In attempting to review the "justification" for fee, the Inspector General is substituting its judgement for that of the contracting officer, without the benefit of the contracting officer's intimate knowledge and expertise with respect to the Federally Funded Research and Development Center and its operations. In addition, the Inspector General is assessing actions taken and the judgement of the contracting officers, based on information that resulted from those actions, not on information that was available to contracting officers at the time their judgements were made.

Page i. Paragraph 4: Audit Results.

"We concluded that work performed by DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] was generally consistent with their broad mission statements. However, DoD [Department of Defense] sponsors did not provide sufficient justification for using FFRDCs [Federally Funded Research and Development Centers] to perform 223 of the 229 projects reviewed. As a result, DoD [Department of Defense] sponsors could not demonstrate that the noncompetitive assignment

Department of the Navy Comments

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of work to the FFRDCs [Federally Funded Research and Development Centers] kept DoD [Department of Defense] sponsor costs down and resulted in the best performance (Finding A)."

Department of the Navy Position. Nonconcur. There is no policy or regulatory requirement for this level of documentation in assigning work to a Federally Funded Research and Development Center. Nonetheless, based on our own concerns regarding proper use of the Center for Naval Analyses, contract modification P00028 introduced additional levels of review and documentation to support the assignment of work to the Center for Naval Analyses. This modification was signed in January 1993 and was made applicable to all work which followed. By limiting their review to Federally Funded Research and Development Center projects for Fiscal Years 1990 and 1991, the Inspector General did not recognize these important oversight changes. Had the Inspector General considered the results of this contract modification, most of their concerns relative to assignment of work to the Center for Naval Analyses would have been answered. Additional comments are included under Finding A.

Page 1, Paragraph 5: Audit Results.

"DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] generally developed overhead rates that were in accordance with Government standards. However, \$43 million of the \$46.9 million in management fees paid to the FFRDCs [Federally Funded Research and Development Centers] was inappropriate. About \$11.6 million should not have been paid, and \$31.4 million should have been charged to overhead. Also, the Navy increased management fee payments to the Center for Naval Analyses by about \$2.9 million annually but does not receive any measurable benefits from the increase."

Department of the Navy Position. Nonconcur. The classification of \$43 million of the \$46.9 million of fee payments as inappropriate is incorrect. The rationale for determining the amounts paid as inappropriate was based on application of inappropriate cost principles and misinterpretation of existing policies and procedures governing fee payments to Federally Funded Research and Development Centers. Further, the inclusion of amounts that would have been paid to Federally Funded Research and Development Centers, in the form of overhead, artificially inflates the monetary findings of the report. Finally, the increase in fees paid to the Center for Naval Analyses was justified by the Contracting Officer prior to their authorization, and the benefits received from those payments were not adequately considered by the Inspector General. Additional comments are included under Finding B.

Revised in
final report
to say
"accounting
for \$43.0
million . . .
was not
correct."

Revised in
final report
to say "The
Navy's
payment
... was
incorrect."

Page ii, Paragraph 1: Audit Results.

"The Navy's payment of incorporation fees appeared to limit the independence of the Center for Naval Analyses."

Department of the Navy Position. Nonconcur. The Inspector General provides no explanation of or rationale for the conclusion that payment of the Center for Naval Analyses' incorporation fees limits their independence. Reimbursing that particular allowable cost should no more limit the Center for Naval Analyses' independence than reimbursing any other allowable cost. Additional comments are included under Finding C.

Page ii, Paragraph 2: Internal Controls.

"Internal management controls were inadequate to ensure the noncompetitive assignment of work and to limit payment of management fees to FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position. Nonconcur. We believe that the Department of the Navy's current process for assigning work to the Center for Naval Analyses, which includes project evaluation and management review by the Contracting Officers Technical Representative and the Procurement Contracting Officer, coupled with high-level review by the Center for Naval Analyses Policy Council, provides an appropriate assessment of the need for the services of the Center for Naval Analyses, as well as adequate internal management controls. Defense Federal Acquisition Regulation Supplement 215.972 and 215.971 provide the policies and procedures (internal management controls) for establishing fee objectives and determining whether or not to pay fees to Federally Funded Research and Development Centers. The Contracting Officer responsible for the negotiation of fee with the Center for Naval Analyses followed these policies and procedures in negotiating fee amounts with the Center for Naval Analyses. The Contracting Officer complied with the requirements of Federal Acquisition Regulation 35.017-1(c)(3) in requiring and reviewing statements of retained earnings and plans for their use prior to award/renewal of the Center for Naval Analyses contract. The proper implementation of these requirements allowed the Contracting Officer to comply with all established Government policy and legal requirements concerning the payment of fees. Therefore, we believe that existing internal controls are sufficient to ensure appropriate payment of fees at Federally Funded Research and Development Centers.

Page ii, Paragraph 3: Potential Benefits of Audit.

"Benefits should derive from better assurances that work is appropriately assigned to the Federally Funded Research and Development Centers, that management fee awards are properly

justified, and that potential conflicts of interest are properly controlled and mitigated. We could not quantify those benefits. Management fees could be reduced by about \$58 million over the next five years by not paying unallowable costs and by not funding contingencies. Another \$2.9 million could be avoided annually by rescinding the Navy's unsupported FY 1993 management fee increase to the Center for Naval Analyses."

Department of the Navy Response. Nonconcur. Although the Department of the Navy concurs that improvements in areas addressed in this audit will be a continuous process, we do not agree that measurable benefits, monetary or nonmonetary, will result from the recommendations provided by the Inspector General. Our specific reasons are contained in the responses to Findings A, B, and C and their associated recommendations.

With respect to projected monetary benefits in the area of management fees, the fee authorized by the current Center for Naval Analyses contract was properly justified and the amount properly determined by the Contracting Officer. Most of the unallowable expenses included in the \$58 million savings cited are necessary costs of doing business for Federally Funded Research and Development Centers, and their reimbursement could not be eliminated without jeopardizing the continued existence of the Federally Funded Research and Development Centers. The Government has no inherent or legal (contractual) authority to unilaterally reduce fees or to specify how fees earned by the Federally Funded Research and Development Center can be used (absent non-profit entity limitations). Therefore, no savings could be realized, without Federally Funded Research and Development Center concurrence, until such time as new contracts are issued which eliminated fee payments. Finally, regarding the increase in the Center for Naval Analyses fee, the benefits received from the increase in fee, both monetary benefits and benefits resulting from reduced cost and performance risk to the Government, outweigh the savings perceived by the Inspector General. Additionally, since the Government has executed a legally binding contractual modification to pay the increased fee, there is no mechanism for the Government to rescind the authorized increase. Further, the Inspector General's statement that "\$2.9 million could be avoided annually" seems to indicate an assumption that the savings attributed to the increased fee will continue. The increase was included for a specific purpose and is not scheduled to be duplicated beyond the current contract period (1 October 1990 - 30 September 1995).

Page ii, Paragraph 4: Summary of Recommendations.

"We recommend that DoD [Department of Defense] strengthen controls over the screening and assignment of work to FFRDCs [Federally Funded Research and Development Centers], to include ensuring the performance of market surveys. We recommend that

DoD [Department of Defense] improve controls over the award of management fees. We recommend improved contracting officer reviews of FFRDC [Federally Funded Research and Development Center] operations and use of appropriate contract clauses to ensure that conflicts of interest are controlled."

Department of the Navy Position: Nonconcur. The Department of the Navy is committed to executing our oversight responsibilities according to all statutes, regulations, and policies related to Federally Funded Research and Development Centers. We also believe that improvement must be a continuous process, therefore, we are continuing to seek out improvements in the process for assigning work to the Center for Naval Analyses. However, we do believe the current management controls within Department of Defense for reviewing and assigning work, as well as determining management fees, are adequate. The additional burdens which would be imposed in implementing the documentation and review requirements recommended by the Inspector General would result in tremendous delays in acquisition processing, require additional effort (cost) on the part of both the Government and the Federally Funded Research and Development Centers, and provide no benefits as a result. We believe they would seriously hamper the Navy's ability to effectively utilize a valued and vital resource, the Center for Naval Analyses. With respect to fees, the additional management controls recommended by the Inspector General are unreasonable and impractical in an environment in which contract costs and fees are negotiated and are not set by law. No statutory, policy or regulatory requirement exists for imposing the recommended documentation and review requirements.

Part I - Introduction

Page 6, Paragraph 5: Adequacy of Implementation of the DoD [Department of Defense] Internal Management Control Program

"The Military departments implementation of the DoD [Department of Defense] Internal Management Control Program was not effective because management did not adequately assess the need for FFRDC [Federally Funded Research and Development Center] services or controls over conflicts of interest. Therefore, the program did not identify material control weaknesses in assigning projects..."

Department of the Navy Position: Nonconcur. We believe the Department of the Navy does in fact have adequate controls in place to assure effective oversight of, and assignment of work to, the Department of the Navy-sponsored Federally Funded Research and Development Center, the Center for Naval Analyses. The Department of the Navy's current contract with the Center for Naval Analyses provides for a process of project evaluation and management review, including the Contracting Officer's Technical

Representative and the Procurement Contracting Officer, to determine if assignment of the project to the Center for Naval Analyses is appropriate.

This process is itself subject to review by the Center for Naval Analyses Policy Council (membership comprised of senior civilian and uniformed leaders of the Department of the Navy). The Policy Council is charged with responsibility to review Center for Naval Analyses performance, annually review and approve the Center for Naval Analyses research program, determine Department of the Navy appropriated fund support for the Center for Naval Analyses, establish policy regarding the Government's relationship with the Center for Naval Analyses, and review and approve procedures and processes for accomplishing oversight of the Center for Naval Analyses. The Department of the Navy's current process for assigning work to the Center for Naval Analyses, coupled with the high level review provided by the Center for Naval Analyses Policy Council, combine to effectively assess the need for the services of the Center for Naval Analyses as well as assure the adequacy of internal management controls.

Page 6, Paragraph 6: Adequacy of Internal Controls.

"Internal controls were not effective to ensure that FFRDCs' [Federally Funded Research and Development Centers] resources, including management fees, were properly utilized and that the costs charged to DoD [Department of Defense] by the FFRDCs [Federally Funded Research and Development Centers] were fair and reasonable."

Department of the Navy Position. Nonconcur. As discussed previously, we believe the current process for evaluating, reviewing, and approving work for assignment to the Center for Naval Analyses is sufficient to ensure proper utilization of the Center for Naval Analyses. With respect to adequacy of internal controls for management fees, we believe Defense Federal Acquisition Regulation Supplement 215.972 and 215.971 provide the necessary policies and procedures for establishing management fee objectives and determining whether or not to pay management fees.

FINDING A. USE OF FEDERALLY FUNDED RESEARCH AND DEVELOPMENT CENTERS (PAGE 10)

Page 10, Paragraph 1: Finding Summary

"DoD [Department of Defense] sponsors did not sufficiently justify the noncompetitive use of FFRDCs [Federally Funded Research and Development Centers] to perform 223 of the 229 projects reviewed. This condition occurred because FFRDC [Federally Funded Research and Development Center] mission statements did not identify unique FFRDC [Federally Funded Research and Development Center] capabilities and expertise, and

the justifications for noncompetitively assigning projects did not identify:

- o what unique FFRDC [Federally Funded Research and Development Center] capabilities were needed to perform the research work, or
- o why or how FFRDCs [Federally Funded Research and Development Centers] could perform the work more effectively even though potential alternatives were considered and identified for 193 projects.

Sponsors also had not performed cost comparisons to show that utilizing the FFRDCs [Federally Funded Research and Development Centers] to provide the needed support was less costly than utilizing DoD [Department of Defense] civilian personnel. As a result, sponsors could not demonstrate that the noncompetitive assignment of work to the FFRDCs [Federally Funded Research and Development Centers] kept DoD [Department of Defense] sponsors costs down and resulted in the best performance."

Department of the Navy Position: Nonconcur. The Department of the Navy has previously indicated its intention to continue to implement initiatives to improve the procedures for assignment of work to the Center for Naval Analyses, yet we must express our general disagreement with the findings, conclusions, and resulting recommendations regarding the use of Federally Funded Research and Development Centers found in this section of the draft report. Our concerns can be characterized by three main points:

- (1) The period of performance of Federally Funded Research and Development Center work reviewed by the auditors was FY 1990 - FY 1991 (10 of 22 Center for Naval Analyses projects reviewed by the Inspector General were worked on in 1990); procedures employed for assigning work to the Center for Naval Analyses at that time are now obsolete. The report does not take into consideration the impact of changed management practices by the Director, Defense Research and Engineering or the Department of the Navy that have improved oversight of the Center for Naval Analyses (particularly relevant is the Center for Naval Analyses contract modification P00028, which substantially revised procedures for controlling assignment of work to the Center for Naval Analyses);
- (2) In assessing the adequacy of the bases of assigning projects to Federally Funded Research and Development Centers, the report holds sponsors to standards and criteria (e.g., absolute uniqueness of Federally Funded Research and Development Center capabilities,

performance of market surveys) that are not required by statute, regulation, or official policy, and, that in at least one instance, i.e., Federally Funded Research and Development Centers' competing for work, are specifically prohibited in conjunction with the use of Federally Funded Research and Development Centers; and

- (3) Implementing the additional requirements for documentation and review recommended by the report would strain existing resources (manpower and funds) to the breaking point with no foreseeable relief, cause unacceptable delays in the assignment of appropriate work to the Center for Naval Analyses, and would seriously degrade the Department of the Navy's capability to make available to its decision makers the independent, objective and high quality studies and analyses that the Center for Naval Analyses provides.

Page 11, Paragraph 2: Sufficiency of Justifications for Use of FFRDCs [Federally Funded Research and Development Centers]

"DoD [Department of Defense] sponsors did not provide adequate justifications for the use of the FFRDCs [Federally Funded Research and Development Centers] for 223 of 229 projects reviewed. Assignment of the remaining six projects to two FFRDCs [Federally Funded Research and Development Centers] was based on competition. Although OFPP [Office of Federal Procurement Policy] Policy Letter 84-1 and the FAR [Federal Acquisition Regulation] specifically prohibit FFRDCs [Federally Funded Research and Development Centers] from competing for work, we believe that competition provided better evidence that the FFRDCs [Federally Funded Research and Development Centers] could more effectively perform the work on the six projects than the reasons provided for the other projects."

Department of the Navy Position: Nonconcur. The Inspector General concluded that for the 22 Center for Naval Analyses projects that were reviewed, justifications were not sufficient for the assignment of work to the Center for Naval Analyses. Rationale provided by the report for reaching this opinion is based solely on the fact that project sponsors did not perform additional steps, e.g., market surveys, formal requests for additional in-house staffing, etc., prior to deciding to assign a project to the Center for Naval Analyses. However, these steps are not required by regulation, law, or policy. Further, the Inspector General did not consider, in reaching the findings regarding use, the improvements to the review process that resulted from adoption of modification P00028 to the Department of the Navy's contract with the Center for Naval Analyses. Effective as of January 1993, the modification responded to the Department of the Navy's concerns that procedures for assigning work to the Center for Naval Analyses should be improved. The

modification introduced additional levels of documentation and review to further articulate and support assignment of work to the Center for Naval Analyses. By limiting its review to work that predates this modification, the report addresses processes and procedures that have already been superseded and thus make this finding incorrect.

Page 12, Paragraph 1: FFRDCs [Federally Funded Research and Development Centers] Had Unique Expertise or Knowledge

"None of the sponsors identified specific skills or knowledge that supported their assertions that the specialized expertise was unique to the FFRDC [Federally Funded Research and Development Center] or that the level of expertise applied was necessary to the project's success. Sponsors for 181 projects stated that FFRDCs [Federally Funded Research and Development Centers] were selected because they possessed unique expertise that was essential to the success of the projects. This specialized expertise included prior experience of the FFRDC [Federally Funded Research and Development Center] staff, maintenance of special models or databases, and maintenance of 'corporate knowledge.'"

Department of the Navy Position: Nonconcur. The finding states that sponsors did not document unique skills or knowledges possessed by the Federally Funded Research and Development Center when they determined that the project was appropriate for a Federally Funded Research and Development Center. The implication is that, when work is assigned to a Federally Funded Research and Development Center, it must be because the Federally Funded Research and Development Center possesses some absolutely unique area of expertise that is not to be found at any level anywhere in Government or the private sector. This is an incorrect standard that far exceeds the requirements of the Federal Acquisition Regulation. Federal Acquisition Regulation 35.017 states that "An FFRDC [Federally Funded Research and Development Center] meets some special long-term research or development need which cannot be met as effectively by existing in-house or contractor resources." It does not require that an arbitrary, extreme standard of absolute uniqueness be applied in order to assign work to a Federally Funded Research and Development Center. Under the provisions of Federal Acquisition Regulation 35.017, the specialized areas of expertise cited by the finding, i.e., prior experience of the Federally Funded Research and Development Center staff, maintenance of special models, etc., are all valid and appropriate reasons for determining that the Federally Funded Research and Development Center would indeed meet the need more effectively than other resources.

Page 12, Paragraph 3: FFRDC [Federally Funded Research and Development Center] Development of Specialized Models or Databases

"Examples of projects for which the sponsors cited the maintenance of specialized models or databases as a factor included the Marine Corps Enlisted Retention study performed by the Center for Naval Analyses (CNA)... The sponsor for the CNA [Center for Naval Analyses] study stated that CNA [Center for Naval Analyses] had the data on enlistments and reenlistments that were needed for the study. ...The justifications did not explain why another contractor or an in-house organization that performs program evaluations could not have performed the studies as effectively."

Department of the Navy Position: Nonconcur. We believe that the fact that the Center for Naval Analyses possessed the data necessary to perform the study is an obvious justification for determining that the Center for Naval Analyses could perform the study more effectively and more timely than in-house organizations or other contractors. This justification, clearly not accepted by the Inspector General, recognizes the need for responsiveness in obtaining results from such studies and does not presume that the Department of the Navy has infinite resources (money and manpower) to spend and can wait, if necessary, an inordinate amount of time for study results.

Page 13, Paragraph 1: FFRDC [Federally Funded Research and Development Center] Was Easier and Quicker to Use

"Sponsors for 70 projects stated that the primary reason for assigning the work to the FFRDCs [Federally Funded Research and Development Centers] was because obtaining support services from FFRDCs [Federally Funded Research and Development Centers] was easier and quicker than using normal competitive procedures and that these factors influenced their decisions to use FFRDCs [Federally Funded Research and Development Centers]. Work assignments to FFRDCs [Federally Funded Research and Development Centers] should be based on the need for unique expertise or capabilities and not on the convenience of using an FFRDC [Federally Funded Research and Development Center]. Sponsors believed that the FFRDCs [Federally Funded Research and Development Centers] were easier and quicker to use because of the prior involvement of the FFRDCs [Federally Funded Research and Development Centers] with sponsor requirements. While ease and speed did not influence their decisions to use the FFRDCs [Federally Funded Research and Development Centers], sponsors for another 93 projects also stated that the FFRDCs [Federally Funded Research and Development Centers] were easier and quicker to use."

Department of the Navy Position: Nonconcur. We believe the finding misrepresents the rationale of sponsors for deciding to assign work to the Federally Funded Research and Development Centers. The finding itself states that sponsors utilized Federally Funded Research and Development Centers because of the prior involvement of Federally Funded Research and Development Centers with sponsor requirements. This prior involvement, or prior knowledge and expertise, is, in actuality, the rationale for using the Federally Funded Research and Development Center, not, as the finding tries to suggest, convenience. Contrary to the finding's characterization of the sponsors' rationale, ease of use of the Federally Funded Research and Development Center arose out of the Federally Funded Research and Development Center's ability to employ a quick response capability to issues as a result of prior knowledge. Work was assigned to Federally Funded Research and Development Centers, not as a matter of convenience, but because the Federally Funded Research and Development Centers possessed a depth and breadth of knowledge and expertise that had been obtained through their long-term special relationship with their sponsoring agencies. Such a relationship and such prior knowledge and expertise is authorized and encouraged by Federal Acquisition Regulation 35.017.

Additionally, the fact that sponsors of another 93 projects indicated they received an added benefit of ease and quickness of use in relation to the projects is not relevant. As the finding states, ease and speed were not the factors these sponsors considered in determining whether to assign the projects to Federally Funded Research and Development Centers. Thus, inclusion of this last sentence in the finding serves no useful purpose.

Page 13, Paragraph 2: FFRDC [Federally Funded Research and Development Center] Was Independent and Objective

"The sponsors for 53 projects cited independence and objectivity as reasons for assigning the work to the FFRDCs [Federally Funded Research and Development Centers]. ...Sponsors of projects to the studies and analysis FFRDCs [Federally Funded Research and Development Centers] stated that these FFRDCs [Federally Funded Research and Development Centers] were independent of the existing views or preferences of in-house managers or operations and other service contractors. We concluded that in each of the 53 instances cited, other for-profit or non-profit contractors could have performed the work if contractual restrictions were placed on the contractor. Contractors are advised of such restrictions by notices in solicitations and by clauses in resulting contracts..."

Department of the Navy Position: Nonconcur. Again, this finding applies a standard that far exceeds that required by the Federal Acquisition Regulation. Objectivity and independence are

the very foundation for the existence of Federally Funded Research and Development Centers, particularly in the case of studies and analysis Federally Funded Research and Development Centers. To assert that contractual restrictions alone would assure independence and objectivity and vitiate the innate biases of non-Federally Funded Research and Development Center contractors and in-house personnel is unwise and ignores the real-world concerns on the part of decision makers that commercial or internal organizational interests could influence the results of analyses they, the decision-makers, require.

Page 13, Paragraph 3: FFRDC [Federally Funded Research and Development Center] Was More Cost- or Operationally Effective

"Sponsors cited cost or operational effectiveness as reasons for using the FFRDCs [Federally Funded Research and Development Centers] on 50 projects. ... Also, the sponsors for another 30 projects stated that the FFRDCs [Federally Funded Research and Development Centers] could do the work at less cost because they were familiar with the area and could avoid start-up costs that less-experienced contractors would have to incur, but the project sponsors provided no other evidence to support their belief that the FFRDCs [Federally Funded Research and Development Centers] were cost-effective."

Department of the Navy Position: Partially concur. We assert that consideration of cost-avoidance as one of the factors for determining the appropriateness of assigning work to a Federally Funded Research and Development Center is perfectly acceptable. However, in the case of the Center for Naval Analyses, the projects reviewed by the Inspector General did not include cost estimates as part of the project proposal data. A lack of such data would obviously hamper the efforts of project sponsors and reviewers to assess the reasonableness of costs. With respect to the Center for Naval Analyses contract, this lack of data has been remedied through contract modification P00028, which the Inspector General did not consider in its evaluation of Department of the Navy Federally Funded Research and Development Center use procedures.

Page 13, Paragraph 4: FFRDCs [Federally Funded Research and Development Centers] Had Access to Sensitive or Proprietary Data

"Sponsors stated that 45 projects either were sensitive or required access to proprietary information. ... We concluded that this factor could also be resolved through contractual restrictions on contractors or through hiring additional in-house personnel to perform the work."

Department of the Navy Position: Nonconcur. We reiterate our previous statement that to rely upon contractual restrictions to avoid the innate commercial and competitive predispositions of

non-Federally Funded Research and Development Center contractors is unwise and ignores the real-world environment from which sponsors must select resources to conduct research. The Inspector General's suggestion that sponsors hire additional in-house personnel to do the work makes no sense. Such a suggestion, in an era of downsizing and budget reductions and cutbacks, is impractical. Further, Federal Acquisition Regulation 35.017 does not require that additional in-house personnel be sought before work can be assigned to a Federally Funded Research and Development Center. All that is required by regulation is that a determination be made that existing in-house resources cannot meet the need as effectively as the Federally Funded Research and Development Center.

Page 14, Paragraph 1: In-House Staff Was Fully Employed or Not Available

"The sponsors for 41 projects stated that proposed projects were assigned to FFRDCs [Federally Funded Research and Development Centers] because the existing in-house staff with the necessary skills were fully employed and because personnel ceilings restricted further hiring. All 10 DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] were represented by the 41 projects. However, none of the sponsors stated that they had taken action to obtain authorization for additional in-house staffing or to recruit persons with the needed skills and knowledge."

Department of the Navy Position: Nonconcur. Refer to our position regarding the issue immediately preceding.

Page 14, Paragraph 2: Projects Needed a Quick Response

"The need for a quick or timely response was cited by sponsors on 22 projects. However, none of the sponsors explained why the needed work could not have been procured by justifying an exception to competition authorized under FAR [Federal Acquisition Regulation] 6.302-2, "Unusual and Compelling Urgency," to obtain the required services from non-FFRDC [Federally Funded Research and Development Center] contractors."

Department of the Navy Position: Nonconcur. This finding states that sponsors utilized Federally Funded Research and Development Centers in 22 cases because of the need for a quick response. Such a need is recognized by Federal Acquisition Regulation 35.017 as one of the principal reasons for the existence of Federally Funded Research and Development Centers. In fact, Federal Acquisition Regulation 35.017 requires that, in performing comprehensive reviews, sponsoring agencies must include the Federally Funded Research and Development Centers' ability to maintain its quick-response capability as a measure of the efficiency and effectiveness of the Federally Funded Research

and Development Center. Such a requirement for the comprehensive review serves as evidence of the importance of the capacity of a Federally Funded Research and Development Center to meet the quick response research needs of the Government and also serves to validate that it represents an appropriate justification for assigning a project to a Federally Funded Research and Development Center. To imply that other non-Federally Funded Research and Development Center contractors could routinely meet this vital Department of Defense research need disregards the fact that in such situations there is no time for a non-Federally Funded Research and Development Center contractor to acquire the extensive knowledge base and expertise that would be required to execute the work. For studies and analysis Federally Funded Research and Development Centers, quick response often equates to immediate response--a Commander in Chief cannot wait for the contractor to "get up to speed" before obtaining an analysis of options for contingency operations in a fast-breaking crisis.

Page 14, Paragraph 4: Project Was FFRDC [Federally Funded Research and Development Center] Initiated

"Sponsors for eight projects stated that the work was self-initiated by the FFRDCs [Federally Funded Research and Development Centers]. ... CNA [Center for Naval Analyses] performed one project that involved the role of Naval forces in the Middle East. ... Each FFRDC [Federally Funded Research and Development Center] contract allowed FFRDCs [Federally Funded Research and Development Centers] to perform exploratory research to develop enhanced skills in support of their sponsors. While the work was subject to sponsor approval, none of the sponsors identified any unique FFRDC [Federally Funded Research and Development Center] skills that were applied to the project or that were developed from the work."

Department of the Navy Position: Nonconcur. It is part of the mission of a Federally Funded Research and Development Center to "...maintain currency in its field(s) of expertise, maintain its objectivity and independence, preserve its familiarity with the needs of its sponsor(s), and provide a quick response capability" (Federal Acquisition Regulation 35.017(a)(4)). To ensure compliance, Federally Funded Research and Development Centers are authorized to perform independent research and development in all of the areas cited in the Federal Acquisition Regulation. In the case of the Center for Naval Analyses, that means they are authorized to self-initiate a limited number of studies per year. The finding attempts to limit the justification for independent research and development to only one criterion, thereby suggesting wrongdoing on the part of the Federally Funded Research and Development Centers. As we have shown, application of such a narrow standard for independent research and development is in direct contradiction with the intention of Federal Acquisition Regulation 35.017.

Page 15, Paragraph 1: FFRDCs [Federally Funded Research and Development Centers] Prohibited From Competing For Work

"OFFP [Office of Federal Procurement Policy] Letter 84-1 and FAR [Federal Acquisition Regulation] 35.017-1, "Sponsoring Agreements," specifically prohibit FFRDCs [Federally Funded Research and Development Centers] from competing with universities and contractors in response to a Federal agency request for proposal for other than operation of an FFRDC [Federally Funded Research and Development Center]. Considering our review of the justifications for the work assigned to the FFRDCs [Federally Funded Research and Development Centers], we believe that more competition should be injected into the assignment of work to the FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position: Nonconcur. Federal Acquisition Regulation 35.017 strictly prohibits Federally Funded Research and Development Centers from competing with any non-Federally Funded Research and Development Center for work other than for the operation of a Federally Funded Research and Development Center. We agree that work that is found not to be appropriate for a Federally Funded Research and Development Center should be competed to the greatest extent possible. Although the law recently changed to permit limited competition, this Department cannot institute practices that are in direct violation of Federal Acquisition Regulation provisions.

Page 15, Paragraph 2: Differentiating Work Unique to FFRDCs [Federally Funded Research and Development Centers] in Mission Statements

"The DoD [Department of Defense] FFRDC [Federally Funded Research and Development Center] mission statements do not differentiate work appropriate for an FFRDC [Federally Funded Research and Development Center] from work that should be done by DoD [Department of Defense] personnel or non-FFRDC [Federally Funded Research and Development Center] contractors. The mission statements provide broad definitions of the types of work that the FFRDCs [Federally Funded Research and Development Centers] will perform. DoD [Department of Defense] sponsors have not prepared detailed mission statements that differentiate FFRDC [Federally Funded Research and Development Center] efforts from work to be performed by a non-FFRDC [Federally Funded Research and Development Center] because the sponsors did not conduct adequate comprehensive reviews to identify unique capabilities that the FFRDCs [Federally Funded Research and Development Centers] should possess..."

Department of the Navy Position: Nonconcur. In evaluating Federally Funded Research and Development Center mission statements, the report relies upon those that appear in the

Department of Defense Federally Funded Research and Development Center Management Plan and does not consider improvements made by the Center for Naval Analyses contract modification of January 1993. The Management Plan mission statement for the Center for Naval Analyses is an abbreviated one and is not the mission statement by which the Department of the Navy differentiates work appropriate for the Center for Naval Analyses. The complete mission statement is contained in the Center for Naval Analyses' contract, and it was completely revised by modification P00028 in order to rectify what the Department of the Navy ascertained was a contract deficiency. Modification P00028 not only delineates the major elements of the Center for Naval Analyses' research program, it requires that the scope and focus of each product area be delineated in each year's annual research plan and that the plan (once approved by the Center for Naval Analyses Policy Council) be incorporated into the contract. We believe that if the revised Center for Naval Analyses mission statement had been considered, the Inspector General would not have found that the mission statement is too broad to differentiate between work that is, and is not, appropriate for the Center for Naval Analyses.

Page 15, Paragraph 3: Conducting Thorough Comprehensive Reviews to Identify Unique FFRDC [Federally Funded Research and Development Center] Capabilities

"Inspector General, DoD [Department of Defense], Report No. 94-012, "Sole-Source Justifications for DoD [Department of Defense]-Sponsored Federally Funded Research and Development Centers," November 4, 1993, states that DoD [Department of Defense] sponsors did not conduct thorough comprehensive reviews of the continued need for FFRDCs [Federally Funded Research and Development Centers]. The DoD [Department of Defense] sponsors did not adequately document their specific research needs or document their bases for stating that no other resources could effectively meet required research needs. Formal market surveys were not conducted and determination of the FFRDCs' [Federally Funded Research and Development Centers] efficiency and effectiveness was based on sponsors' personal opinions. The sponsors based the comprehensive reviews and the justifications for 5-year sole-source contracts for the FFRDCs [Federally Funded Research and Development Centers] on the continuing long-term need for the services provided by the FFRDCs [Federally Funded Research and Development Centers...]"

Department of the Navy Position: Nonconcur. The Department of the Navy's reasons for nonconcurrence with the Inspector General report cited in this finding is contained in our previous comments of 9 August 1993, so we will not reiterate them here. However, it is still our contention that formal market surveys are not required by law or regulation, and the fact that the Department of the Navy did not conduct such surveys during its 1990 comprehensive review is not adequate evidence for inferring

a deficiency on the part of the Department of the Navy. Nevertheless, the Department of the Navy is committed to improving its comprehensive review process, to include further refinement and articulation of the Center for Naval Analyses' mission as well as its special capabilities, knowledges, and expertise.

Page 16, Paragraph 2: Identifying Unique Project Requirements

"In justifications for noncompetitively assigning projects, DoD [Department of Defense] sponsors did not identify unique FFRDC [Federally Funded Research and Development Center] capabilities that were needed to successfully perform required research work. Identifying unique FFRDC [Federally Funded Research and Development Center] capabilities in project descriptions would better ensure the appropriateness of noncompetitive work assignments to the FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position: Partially concur. We do not concur that a project description must be written in such detail that it proves beyond an absolute doubt that a given Federally Funded Research and Development Center is the one and only organization in the Nation that can perform the needed research. The provisions of Federal Acquisition Regulation 35.017 hold to the reasonable-man standard for determining if the Federally Funded Research and Development Center meets the research need more effectively than existing in-house or other contractor resources. It is to this standard that project descriptions should be written. Nonetheless, the Department of the Navy is continuing to seek out and implement improvements to project descriptions to ensure the appropriateness of noncompetitive work assignment to Federally Funded Research and Development Centers.

Page 16, Paragraph 3: Considering Potential Alternatives to FFRDCs [Federally Funded Research and Development Centers]

"The sourcing decisions for the 223 projects reviewed that were noncompetitively assigned to the FFRDCs [Federally Funded Research and Development Centers] were not supported by convincing rationale that potential alternatives could not accomplish the work. The justifications for assigning projects to the FFRDCs [Federally Funded Research and Development Centers] should document the analysis of other servicing options in reaching the conclusion that the FFRDCs [Federally Funded Research and Development Centers] are best suited to perform the work."

Department of the Navy Position: Partially concur. For the reasons stated above, we do not concur with the judgement of the report that the rationale for assignment of work to Federally

Funded Research and Development Centers was inadequate; however, we do concur that the justifications for assigning projects to Federally Funded Research and Development Centers should document the reasons why alternative resources could not perform the proposed work as effectively.

Page 16, Paragraph 4: Consideration of Non-FFRDC (Federally Funded Research and Development Center) Contractors

"The DoD [Department of Defense] sponsors had not conducted adequate market surveys to identify the extent of alternative sources to meet their needs or to support assertions that the alternatives could not do the work as efficiently and effectively as the FFRDCs [Federally Funded Research and Development Centers]. DoD [Department of Defense] sponsors indicated that they identified and considered either non-FFRDC [Federally Funded Research and Development Center] contractors, in-house personnel, or both, for 193 of the projects reviewed. However, the DoD [Department of Defense] sponsors did not define effectiveness characteristics for work assigned to the FFRDCs [Federally Funded Research and Development Centers] in terms of quantity, timeliness, quality, and customer satisfaction. The work performed by the studies and analyses and systems engineering FFRDCs [Federally Funded Research and Development Centers] is closely related to the plans, programs, and operations of their sponsors. The sponsors did not support:

- o that the level of skills and knowledge that the FFRDCs [Federally Funded Research and Development Centers] used to perform the work were required or

- o that the skills and knowledge were unique to the FFRDCs [Federally Funded Research and Development Centers].

Some contractors, such as Analytic Services, Incorporated; Johns Hopkins University Applied Physics Laboratory; and the Pennsylvania State University Applied Research Laboratory, were formerly DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers]. These nonprofit and for-profit contractors compete for work in the same areas as the studies and analyses and systems engineering FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position: Nonconcur. As previously discussed, such market surveys are NOT required, and to require them would place an intolerable administrative burden upon project sponsors and oversight management officials. Further, we believe the inordinate and unnecessary level of detailed justification documentation would only serve to unduly delay and severely hamper the Department of the Navy's capacity to obtain critical analyses. Additionally, such administrative burdens would result in an increased cost to the Government.

Page 17. Paragraph 1: Comparison With Private Contractors

"The sponsors also had not compared FFRDC [Federally Funded Research and Development Center] costs with the costs of non-FFRDC [Federally Funded Research and Development Center] contractors performing similar types of work. Several DoD [Department of Defense] officials stated that the nonprofit corporations operating DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] were less costly than regular contractors. They cited lower fees as the basis for their opinion. We agree that fees may be lower; however, direct labor and overhead costs account for the majority of the costs of FFRDCs [Federally Funded Research and Development Centers] and contractor performance. DoD [Department of Defense] contracting officers should be reviewing all individual projects [assigned] to the FFRDCs [Federally Funded Research and Development Centers], and should be validating that adequate market surveys were performed to justify the noncompetitive assignment to the FFRDC [Federally Funded Research and Development Center]. If the work can be performed by non-FFRDC [Federally Funded Research and Development Center] contractors, competition and price analysis by the contracting officers should determine the price reasonableness of contract costs."

Department of the Navy Position: Partially concur. We agree that for the period of performance that was reviewed, Department of the Navy sponsors were unable to accurately assess cost reasonableness because cost related data was not available to sponsors or reviewers. Modification P00028 to the Center for Naval Analyses' contract has remedied this deficiency. However, it should be noted that cost comparison is not the crucial factor in determining whether to assign work to a Federally Funded Research and Development Center. The overriding consideration is, and must remain, the ability of the Federally Funded Research and Development Center to more effectively perform the work required.

Page 17. Paragraph 2: Contracting Officer Considerations of Alternative Sources

"Contracting officers did not attempt to establish the existence and effectiveness of potential alternatives to the FFRDCs [Federally Funded Research and Development Centers] before assigning individual projects against the contracts. Contracting officers issued modifications to the contracts to fund FFRDC [Federally Funded Research and Development Center] taskings. In assigning work to the FFRDC [Federally Funded Research and Development Center] contracts, contracting officers certified under FAR [Federal Acquisition Regulation] 6.303, "Justifications," paragraph 6.303-1(c), "Requirements," that individual contract actions (tasking or modifications) were within the scope of the justification and approval. Contracting

officers routinely accepted the assertions made by sponsoring program officials and users that the FFRDCs [Federally Funded Research and Development Centers] were the only sources that could effectively provide needed support."

Department of the Navy Position: Nonconcur. The Department of the Navy maintains the position that it is entirely appropriate for contracting officers to rely upon those with knowledge and expertise in the area of research, i.e., project sponsors and flag level reviewers, in obtaining a determination as to whether or not alternative resources can as effectively meet the needs of the sponsors. This finding places an additional, unnecessary layer of administrative review, which we believe adds no value to the process.

Page 17, Paragraph 3: Conducting Costs Analyses

"Except for the Air Force Materiel Command, none of the DoD [Department of Defense] sponsors had performed cost comparisons to determine whether support provided by the FFRDCs [Federally Funded Research and Development Centers] was more economical than performing the work using DoD [Department of Defense] civilian personnel. DoD [Department of Defense] Directive 4205.2, "Acquiring and Managing Contracted Advisory and Assistance Services," requires cost analyses before contracting for advisory and assistance services. ...Procedures should be established to require sponsors to perform cost comparison studies of FFRDC [Federally Funded Research and Development Center] and DoD [Department of Defense] in-house personnel costs as part of the comprehensive review."

Department of the Navy Position: Nonconcur. We do not believe that comparison of Federally Funded Research and Development Center labor costs with the cost of Department of Defense personnel is an adequate basis for determining whether in-house resources could effectively meet the special research needs of the sponsor. We contend that the essential considerations are qualitative, not quantitative, and include such things as depth and breadth of expertise across a broad spectrum of defense issues, objectivity and independence, quick response capability, and familiarity with the special research needs of the sponsor.

Page 17, Paragraph 4: Obtaining Additional In-House Staff

"Except for the Air Force Materiel Command, none of the DoD [Department of Defense] sponsors assessed the effectiveness of performing work in-house versus contracting the work out, even though much of the work done by the FFRDCs [Federally Funded Research and Development Centers] was continuing and long-term in nature. DoD [Department of Defense] Directive 4205.2 requires program and contracting officials to cite actions being taken to

hire additional in-house resources or to provide an explanation of why contracting out is necessary. The Air Force Materiel Command initiated action in 1990 to reduce its use of contractor and FFRDC [Federally Funded Research and Development Center] support at the Air Force Electronic Systems Center and the Air Force Space and Missile Systems Center. ...On September 10, 1993, the Deputy Assistant Secretary of the Air Force (Acquisition) suspended the conversion [of 100 FFRDC [Federally Funded Research and Development Center] positions to in-house positions]...because of the conclusion of the National Performance Review that the government should be reduced by 252,000 personnel."

Department of the Navy Position: Nonconcur. This finding, which suggests that sponsors must attempt to hire additional Department of Defense civilian personnel before making a determination that in-house resources cannot meet the sponsor's research needs as effectively as a Federally Funded Research and Development Center, is inconsistent with current Department of Defense fiscal realities. Additionally, as previously stated, Federal Acquisition Regulation 35.017 requires only that Federally Funded Research and Development Centers use determinations be made only in the context of existing in-house resources, not an unrealistic and unattainable future level of in-house staffing.

Page 18, Paragraph 3: Exploring the Potential for Competition

"Existing internal control procedures do not ensure that the FFRDCs [Federally Funded Research and Development Centers] are the most effective source for performing required work. General Accounting Office Report No. GAO/NSIAD-88-22 (OSD Case No. 7751), "Competition: Issues on Establishing and Using Federally Funded Research and Development Centers," March 7, 1988, states that the lack of competition surrounding the use of FFRDCs [Federally Funded Research and Development Centers] limited DoD [Department of Defense] ability to know whether non-FFRDCs [Federally Funded Research and Development Centers] could do work better or at less cost. The report recommended a program to test the use of broad agency announcements to assess the potential for non-FFRDC [Federally Funded Research and Development Center] contractors to accomplish DoD [Department of Defense] research and to improve DoD [Department of Defense] assurance that FFRDC [Federally Funded Research and Development Center] work was the most effective. DoD [Department of Defense] disagreed with the recommendation, stating that the needs for uses of the FFRDCs [Federally Funded Research and Development Centers] were thoroughly assessed under existing procedures. As shown from our review of the 229 projects, we believe that existing procedures have not ensured that FFRDCs [Federally Funded Research and Development Centers] can perform all of the work noncompetitively assigned to the FFRDCs [Federally Funded Research and Development

Centers] better and at less cost than non-FFRDC [Federally Funded Research and Development Center] contractors.

DoD [Department of Defense] sponsors should use broad agency announcements and competitive solicitations and should permit FFRDCs [Federally Funded Research and Development Centers] and non-FFRDC [Federally Funded Research and Development Center] contractors to compete for research requirements to assess the potential for non-FFRDC [Federally Funded Research and Development Center] contractors to perform the work. Numerous studies have confirmed that when service providers are required to compete, they keep their costs down, respond quickly to changing demands, and strive to be responsive to their customers."

Department of the Navy Position: Nonconcur. The actions suggested in the finding are specifically prohibited by Federal Acquisition Regulation 35.017. Until such time as the Federal Acquisition Regulation is revised, the Department of the Navy cannot engage in such suggested practices.

Page 19, Paragraph 2: Conclusion

"The FFRDC [Federally Funded Research and Development Center] mission statements do not identify specific niches in which the FFRDCs [Federally Funded Research and Development Centers] have special expertise not possessed in-house or by private sector contractors. DoD [Department of Defense] sponsors also had not compared the costs of operating the FFRDCs [Federally Funded Research and Development Centers] with performing the work using DoD [Department of Defense] personnel. The lack of competition for most work assigned to the FFRDCs [Federally Funded Research and Development Centers] limits DoD['s] [Department of Defense] ability to know whether other contractors could do the work better or at less cost."

Department of the Navy Position: Nonconcur. Refer to our specific comments regarding the individual findings in this section of the draft report.

Page 19: Recommendations for Corrective Action

"We recommend that the Director, Defense Research and Engineering, establish procedures for the primary sponsors to:

1. Revise mission statements for the FFRDCs [Federally Funded Research and Development Centers] to identify specific research areas for which the FFRDCs [Federally Funded Research and Development Centers] have unique capabilities and expertise."

Department of the Navy Position: Partially concur. As we have previously stated, we would agree with a recommendation that Federally Funded Research and Development Center mission statements be improved. However, we do not concur that mission statements be limited solely to the unique capabilities and expertise of Federally Funded Research and Development Centers. In accordance with Federal Acquisition Regulation 35.017, mission statements should also document the special capabilities and expertise of Federally Funded Research and Development Centers.

"2. Prepare justifications for the noncompetitive assignment of projects to the FFRDCs [Federally Funded Research and Development Centers] that document:

- a. The unique FFRDC [Federally Funded Research and Development Center] capabilities needed to perform the work.
- b. The alternatives considered to perform the work and why the alternatives are unable to effectively do the work.
- c. The specific characteristics of effectiveness (that is, quantity, timeliness, quality, and customer satisfaction) that justify assignment of the work to the FFRDC [Federally Funded Research and Development Center] and that must be met when performing the project under consideration."

Department of the Navy Position: Partially concur. Documentation of any unique Federally Funded Research and Development Center capabilities should be included in the justification of noncompetitive assignment of work if unique capabilities exist and are applicable to the proposed project. However, we maintain that it is appropriate and adequate (as required by Federal Acquisition Regulation 35.017) for justifications to include only the special capabilities of the Federally Funded Research and Development Center (including independence and objectivity, and quick response capability) that are necessary to perform the work more effectively than in-house or other contractor resources. We concur that justification should document the alternatives to Federally Funded Research and Development Centers that were considered and why the alternatives were not able to do the work as effectively as the Federally Funded Research and Development Center. The Department of the Navy concurs with the spirit of Recommendation 2.c., but believes it is the sponsoring agencies that must determine the project proposal content, and that overly burdensome conditions which are not applicable to Federally Funded Research and Development Centers should not be imposed or applied.

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"3. Perform cost-comparison studies of FFRDC [Federally Funded Research and Development Center] and DoD [Department of Defense] in-house personnel costs as part of the comprehensive reviews."

Department of the Navy Position: Nonconcur. Please refer to our comments above pertaining to comparisons with Department of Defense civilian personnel.

"4. Use broad agency announcements and competitive solicitations to assess the potential for non-FFRDC [Federally Funded Research and Development Center] contractors to perform research projects."

Department of the Navy Position: Nonconcur. Although the law was recently changed to permit limited competition, implementation of this recommendation would currently constitute a violation of Federal Acquisition Regulations. The Department of the Navy would, of course, comply with any changes to the Federal Acquisition Regulation.

FINDING B. JUSTIFICATION AND ANALYSES OF MANAGEMENT FEE REQUIREMENTS (PAGE 21)

Page 21. Paragraph 1: Finding Summary

"DoD [Department of Defense] paid inappropriate management fees to the six nonprofit corporations that operated eight DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers]. This condition occurred because program sponsors did not document FFRDC [Federally Funded Research and Development Center] fee needs in sponsoring agreements. Further, contracting officers did not follow established procedures to review annual fee requests and did not perform working capital or other analyses to limit fee requirements to expenses that were ordinary and necessary to FFRDC [Federally Funded Research and Development Center] operations. Also, contracting officers did not consider other alternatives for expenses that could be met through more effective funding arrangements. As a result, about \$43 million of the \$46.9 million of management fees received by the DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] during FY 1992 were for discretionary purposes. Of the \$43 million:

- o \$11.6 million was used for unallowable costs and future needs that were not necessary for the operation of the FFRDCs [Federally Funded Research and Development Centers] and should not have been paid; and

- o \$31.4 million was used for unallowable costs and should have been charged against overhead.

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Revised in final report to say "DoD did not . . . properly determine management fees."

Also, the Navy approved an increase in management fee payments to the Center for Naval Analyses during FY 1993 that increased contract costs by about \$2.9 million annually but provided no measurable benefits to the Navy."

\$2.7 million
in final
report.

Department of the Navy Position: Nonconcur. The three issues raised in this finding, with regards to the Center for Naval Analyses, are that fees paid to the Center for Naval Analyses were excessive, that the excessive fees were caused by the contracting officer's failure to perform a proper fee analysis, and that the Navy received no benefits from an increase in the fee rate authorized in FY 1993. All of these findings are without merit and are based on conclusions which have no basis in fact. A detailed response to each area supporting this position follows.

Page 21, Paragraph 3: Background

"...The reason for paying profit or fee to contractors that are nonprofit differs from the reason for paying fees to for-profit contractors. Fees paid to nonprofit contractors are considered necessary to provide required operating capital and to cover nonreimbursable expenses that are considered ordinary and necessary to the successful operation of the organization. Fees paid to for-profit contractors are contributions to their profits."

Department of the Navy Position: As clarification, the report should acknowledge that for-profit contractors use the profit or fees received to cover the same items listed for non-profits and that payment of returns on investment (contributions to the profit of stock or share holders) is in addition to these expenditures.

Page 22, Paragraph 4: DFARS [Defense Federal Acquisition Regulation Supplement] Guidelines Governing Appropriateness of Management Fees

"If a fee is considered appropriate, the contracting officer computes a fee objective using the weighted guidelines method in DFARS [Defense Federal Acquisition Regulation Supplement] 215.971, 'Weighted Guidelines Method', to establish limits on the amounts that can be awarded under the fee for use during negotiations."

Department of the Navy Position: Nonconcur. Defense Federal Acquisition Regulation Supplement 215.902 states that the weighted guidelines method is one of three approaches "... for developing a prenegotiation profit or fee objective...". The weighted guidelines approach is not an absolute computation of profit or fee, rather it is a guideline, which results in an objective for negotiation, not a limit as stated. In fact,

Federal Acquisition Regulation 15.901(c) specifically prohibits such limits by stating "With the exception of statutory ceilings in 15.903(d) on profit and fee, agencies shall not (1) establish administrative ceilings or (2) create administrative procedures that could be represented to contractors as de facto ceilings."

Page 23, Paragraph 2: Documenting FFRDC [Federally Funded Research and Development Center] Fee Needs in Sponsoring Agreements

"Program sponsors did not adequately document FFRDC [Federally Funded Research and Development Center] fee needs in sponsoring agreements...The sponsoring agreement for CNA [Center for Naval Analyses] ... stated these nonprofit corporations were authorized to receive management fees but did not explain why the specific fee elements were necessary. Sponsors should document in sponsoring agreements why management fee payments to FFRDCs [Federally Funded Research and Development Centers] are considered necessary."

Department of the Navy Position: Nonconcur. The only regulations that identify any need for identification of the considerations used to determine whether or not a fee is paid are Federal Acquisition Regulation 35.017-1(d) and Defense Federal Acquisition Regulation Supplement 215.972(b). Federal Acquisition Regulation 35.017-1(d) states "The sponsoring agreement or sponsoring agencies' policies and procedures may also contain, as appropriate, other provisions, such as identification of ... (2) Considerations which will affect negotiation of fees where payment of fees is determined by the sponsor(s) to be appropriate." Defense Federal Acquisition Regulation Supplement 215.972(b) provides Department of Defense policy for determining whether or not any fee is appropriate and the procedures to be followed (and ultimately the factors to be considered) in determining a fee objective. The existence of the Defense Federal Acquisition Regulation Supplement provisions meets the Federal Acquisition Regulation language for delineation of considerations which will affect fee negotiations. Further, the results of the required analysis used to determine the need for payment of a fee (i.e., identification of retained earnings, facilities acquisition plans, working capital analyses, contingent funding requirements, and amounts and types of unreimbursed expenses) cannot be included in the sponsoring agreement due to the business sensitive nature of the information.

Page 23, Paragraph 4: Reviewing Annual Fee Requests

"Contracting Officers did not properly establish FFRDC [Federally Funded Research and Development Center] fee needs based on the modified guidelines contained in DFARS [Defense Federal Acquisition Regulation Supplement] 215.972."

Department of the Navy Position: Nonconcur. As stated previously, in the case of the Center for Naval Analyses, the fee analysis was based upon a fee proposal from the Center for Naval Analyses which stated, as appropriate, their retained earnings (undistributed fees), their facilities acquisition plans, their working capital requirements, contingency requirements, and estimates for ordinary and necessary costs that are unreimbursable. Each of these elements was independently assessed by the Navy and the results stated in the price negotiation memorandum. Further, the weighted guidelines method was utilized in computing the fee objective, as required by Defense Federal Acquisition Regulation Supplement 215.972.

Page 23. Paragraph 5: Reviewing and Approving Fee Requirements.

"Contracting officers did not review and authorize payment of individual management fee expense elements or categories. ...Once payment of the fee was authorized by the contracting officer, the FFRDCs [Federally Funded Research and Development Centers] believed the fees could be used for any purpose involving DoD [Department of Defense] work."

Department of the Navy Position: Nonconcur. The contract negotiated with the Center for Naval Analyses was a cost-plus-fixed-fee type contract with a single estimated cost and fixed fee for the completion of study and analysis projects over a five year period. The use of a five year contract precludes the annual negotiation of fee amounts. Additionally, there are no requirements for restricting fee use or annual review and approval of fee uses. Federal Acquisition Regulation 35.017-1(c)(3) requires the identification of retained earnings (reserves) and the development of a plan for their use and disposition; however, it does not require their submission on an annual basis. In regards to actual use of fees, there is no provision in the contract or agreement (nor is one required) which would require that usage be restricted to Government-approved purposes. Certainly the planned use of fee should be (and in the case of the Center for Naval Analyses was) a consideration of the Contracting Officer in negotiating the fee. As discussed in the report, the Center for Naval Analyses does provide annually a disclosure of previous fee usage and a list of planned fee expenditures; however, there is no legal mechanism under the contract for adjustments to fee amounts based on such information. Typically, in contracts with nonprofit organizations which are paid fee, there are no restrictions on fee usage other than those statutory limits imposed on organizations in order to maintain their status as a "nonprofit" entity. Thus, the assumption by the Center for Naval Analyses that actual expenditure of fee was under their control was and is appropriate.

Page 24, Paragraph 3: Including Contract Fee Clause to Require Annual Fee Requests.

"Contracting Officers did not include a contract fee clause that required annual FFRDC [Federally Funded Research and Development Center] fee requests and annual FFRDC [Federally Funded Research and Development Center] reports on actual fee use in any of the FFRDC [Federally Funded Research and Development Center] contracts. Including such a special clause under section H, "Special Contract Requirements," of the contract would better ensure that management fees were properly justified and only used for approved purposes."

Department of the Navy Position: Nonconcur. There is no requirement to include the suggested clause, and we believe that inclusion of such a clause is inappropriate. Currently all Federally Funded Research and Development Center contracts are negotiated for a five year term. There is no mechanism to negotiate a contract for five years and leave the fee to be negotiated in one-year increments. Essentially the requirement of such a provision would necessitate the conversion to one-year contracts and sponsoring agreements. The use of one-year contracts does not meet the Federal Acquisition Regulation requirement at 35.017(a)(4) for establishment and maintenance of long-term relationships between Federally Funded Research and Development Centers and the Government. Further, there is no mechanism for the Government to unilaterally determine the fee provided on a cost-plus-fixed-fee contract.

Page 24, Paragraph 4: Conducting Working Capital Analyses.

"Contracting Officers did not adequately perform working capital analyses to assist in assessing annual FFRDC [Federally Funded Research and Development Center] fee needs. Working capital is the amount by which current assets exceed current liabilities."

Department of the Navy Position: Nonconcur. A working capital analysis was performed at the Center for Naval Analyses as part of the mechanism used to establish the Advance Payment pool requirement for the Center for Naval Analyses. A second working capital analysis was performed prior to the issuance of modification P00028 to determine the working capital necessary to eliminate advance payment requirements. Both working capital analyses were performed in accordance with applicable, generally accepted accounting practices. The definition of working capital in the report does not distinguish between reserves held to meet cash-flow needs and other reserves. Under the definition assigned in the report, there is no allowance for reserves for facilities capital, contingent liabilities or unreimbursable expenses, even though these factors, in addition to working

capital, are recognized as a basis for determining the need for a fee.

Page 25, Paragraph 1: Operating-Cycle Analysis of Working Capital Needs.

"Operating-cycle analysis of working capital needs is a useful tool for identifying excess management fee requests by FFRDCs [Federally Funded Research and Development Centers]. We computed working capital requirements using the operating-cycle approach for five of the six nonprofit corporations that received management fees during FY 1992. We did not examine the working capital needs of CNA [Center for Naval Analyses] because it was funded under an advance funding pool arrangement instead of through management fees during FY 1992."

Department of the Navy Position: As clarification, the fact that advanced payments were used does not obviate the fact that management fees were paid to the Center for Naval Analyses. Further, a working capital analysis is the basic method used to establish the amount of an advance payment pool.

Page 25, Paragraph 2: Current Liabilities Overstated in Operating-Cycle Analysis.

"We believe that the excess working capital at MITRE C3I Division and Aerospace Corporation was not questioned by Air Force contracting officers because current liabilities included employee leave that would not be paid during the operating cycle. The overstatement of current liabilities reduces the amounts of working capital available to meet routine operating requirements. However, the FFRDCs [Federally Funded Research and Development Centers] invoiced and were paid for employee leave costs as earned. The FFRDCs [Federally Funded Research and Development Centers] pay employees for leave earned when the leave is taken. Significant amounts of employee leave liabilities were carried over from year to year at the FFRDCs [Federally Funded Research and Development Centers]. At the end of FY 1992, the employee leave liability for the seven FFRDCs [Federally Funded Research and Development Centers] was \$52.3 million. Employee leave liability not expected to be paid in the year should be excluded from current liabilities for purposes of computing working capital needs under the operating-cycle approach. Overall, working capital funding was not a material factor in justifying FFRDC [Federally Funded Research and Development Center] fee requirements."

Department of the Navy Position: Nonconcur. Applicable accounting standards require that contractors accumulate and report costs consistently. The allocation of leave costs as they are accrued is a generally accepted accounting practice. Therefore, it would be inappropriate for a contractor not to

report in its working capital analysis the actual or projected accumulation of leave expense. While these expenses may not occur in the accounting period, use of the accrual method ensures that all contracts pay for the benefits accrued as a result of performance of that contract. Under the method advocated by the Inspector General, a current contract could be charged for all of the leave taken by employees who worked on another contract, and the contract on which the employees previously worked charged nothing. The report appears to advocate a different method of accumulating costs for purposes of working capital analysis than is actually allowed in the contractor's accounting system.

The conclusion drawn, that working capital analysis was not a material factor in determining fee requirements, is inconsistent with current policy for establishing fee. Working capital analysis is one of the criteria to be used in determining whether or not a fee (any fee) should be paid. If working capital needs exceed available retained earnings or any of the other criteria for establishing a need for fee are met, then the fee objective is determined by using the weighted guidelines method. In the case of the Center for Naval Analyses, a working capital analysis was performed and the need for accumulation of working capital sufficient to allow the elimination of advance payments was a major consideration in the decision to pay/increase the Center for Naval Analyses' fee.

Page 25, Paragraph 3: Considering Fee Alternatives.

"The stated fee needs of FFRDCs [Federally Funded Research and Development Centers] could have been met through contractual guarantees that did not require the immediate disbursement of funds and through the use of advance funding pool arrangements."

Department of the Navy Position: Nonconcur. This statement is incorrect. While some of the uses of fee could be covered through contractual guarantees and use of advance payments, all could not. For example, capital equipment purchases made to support contract performance are depreciated in accordance with a schedule and are reimbursed based upon that schedule. If the contract were terminated, since the Federally Funded Research and Development Center may be able to use the equipment on their other, non-Federally Funded Research and Development Center work, the contractor would not be assured of full reimbursement of the cost of that equipment. The settlement also cannot include amounts for unabsorbed overhead; therefore, any increase in indirect (overhead) expenses on any other work, including any accepted on a fixed-price basis, as a result of the termination cannot be covered. Additionally, advance payments and contract guarantees cannot cover expenses related to unreimbursable costs which are ordinary and necessary for Federally Funded Research and Development Center operation. Further, termination settlements would not include any interest incurred for working

capital funding during the period of settlement negotiations (vouchering of costs can only be continued for six months following termination).

Page 25, Paragraph 4: Using Contingent Liability Clauses in FFRDC [Federally Funded Research and Development Center] Contracts to Eliminate Need for Reserves.

"...Each FFRDC [Federally Funded Research and Development Center] contract includes the clause at FAR [Federal Acquisition Regulation] 52.249-5, "Termination for Convenience of the Government (Educational and Other Nonprofit Institutions)" or at FAR [Federal Acquisition Regulation] 52.249-6, "Termination (Cost Reimbursement)." These clauses provide for the Government's payment of all legitimate liabilities arising out of the Government's desire to terminate a contract and would negate any need for an FFRDC [Federally Funded Research and Development Center] to accumulate capital reserves for contingent liabilities that may arise."

Department of the Navy Position: Nonconcur. All Federally Funded Research and Development Centers are given cost-reimbursement contracts with fee which makes the clause at Federal Acquisition Regulation 52.249-6 the only applicable clause. Federal Acquisition Regulation 52.249-5 is only applicable when a cost-reimbursement contract which provides for no fee is used.

As stated in the previous response, and as pointed out by IDA and RAND, all legitimate costs of termination are not provided for in the termination provisions of the Federal Acquisition Regulation. This is probably because it was not anticipated that termination of any single contract would result in the dissolution of the contractor. In the case of Federally Funded Research and Development Centers, who are very restricted in the work they can do for entities other than their sponsor, the sponsoring agreement and resulting contract are their primary source of income. This results in the Federally Funded Research and Development Centers' inability to absorb any costs not covered by the termination, necessitating a need for reserves.

Page 26, Paragraph 2: Advance Funding Arrangements Could Reduce Fee Needs

"The use of advance funding arrangements could avoid Government payment of unnecessary interest costs by making funds available to the FFRDCs [Federally Funded Research and Development Centers] only in amounts needed to fund anticipated expenses. ...Maintaining excess funds at FFRDCs [Federally Funded Research and Development Centers] also results in the Government incurring additional interest costs."

Department of the Navy Position: Nonconcur. We find these two statements contradictory. If advance payments are used, then the Government incurs an interest expense associated with the maintenance of the advance payment pool (which was calculated by the Inspector General in this report to be \$240,000 per year for the Center for Naval Analyses). If the Federally Funded Research and Development Centers maintain their own reserves, then the only interest expense (fee requirement) is that caused by unplanned shortfalls in working capital reserves. By definition, it would be impossible for the interest expense paid to cover shortfalls in working capital to exceed the amount paid (lost) for financing (maintaining) 100% of the working capital.

Page 26, Paragraph 4: Use of Fees for Discretionary Purposes and Pages 100 and 103, Tables Q-1 and Q-2.

"During FY 1992, FFRDCs [Federally Funded Research and Development Centers] used \$43 million of \$46.9 million of management fees received for discretionary purposes. ...Of the \$43 million:

- \$5 million was for unallowable costs considered not necessary to operations; and
- \$6.6 million was undistributed or not necessary for current year expenses, for a total of \$11.6 million that should not have been paid; and
- \$31.4 million was for allowable expenses that should have been charged to overhead.

The FFRDCs [Federally Funded Research and Development Centers] used the remaining \$3.9 million of fees for facility and equipment costs."

Department of the Navy Position: Nonconcur. The report classifies excessive fees into three categories: (1) unallowable costs, (2) allowable costs which were not charged to appropriate indirect cost pools (overhead), and (3) amounts which were used for facility and equipment costs. Tables Q-1 and Q-2, pages 100 and 103 respectively, provide a breakdown by Federally Funded Research and Development Center of the excessive fee costs. Excess costs attributed to the Center for Naval Analyses fell into two categories, unallowables and allowables that should have been charged to overhead. The costs classified as unallowables include those specifically defined by the Defense Federal Regulation Supplement 215.972 as being a reason to pay fees to Federally Funded Research and Development Centers. Most of the other costs classified as unallowable are based upon the Inspector General's erroneous application and interpretation of appropriate cost principles. The amount classified as allowables that should have been charged to overhead was based on the application of cost principles which do not apply to the Center for Naval Analyses. In addition, the total premise that fee

requirements can be predicted with 100% accuracy during negotiations, and their use controlled after negotiations, is unrealistic.

Page 27, Paragraph 1: Unallowable Costs Not Necessary to FFRDC [Federally Funded Research and Development Center] Operations and Page 100, Table Q-1.

"About \$5 million was spent for unallowable items such as interest, dependant scholarships, contributions, relocation and travel, and miscellaneous unspecified expenses. ...No justifications or analyses supported benefits derived from paying these costs or supported negative impacts if the costs were not incurred by the FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position: The costs identified as unallowables in this subsection include interest expense incurred to finance shortcomings in working capital, dependent scholarships, contributions, relocation and travel, and miscellaneous unspecified expenses. All of these expenses are typical expenses incurred by both profit and nonprofit companies in their normal operating environment. The Defense Federal Acquisition Regulation Supplement 215.972(b)(1) requires that the contracting officer consider certain contractor requirements in determining whether any fee is appropriate. There is no prescribed format nor a requirement for the analyses advocated by the Inspector General. The Contracting Officer, in the case of the Center for Naval Analyses, obtained a detailed proposal for fee requirements from the contractor. This proposal was compared against the contracting officer's extensive knowledge of the history and operation of the Federally Funded Research and Development Center as well as reviews made of the working capital analysis, facilities acquisition plan, contingency funding claims (lease for office space), and Defense Contract Audit Agency reports of final incurred costs. This review allowed the Contracting Officer to make the judgement that there was sufficient justification (need) to warrant payment of a fee to the Center for Naval Analyses. In accordance with the Defense Federal Acquisition Regulation Supplement 215.972 (b)(2), once a fee is determined appropriate, the fee objective is calculated using the weighted guidelines method.

The Center for Naval Analyses is reported to have received excessive fees amounting to \$232.7 thousand (Appendix Q, Table Q-1, page 100) for expenses classified as Dependent Scholarship, Community Program, Center for Naval Analyses Sponsored Symposia, and Miscellaneous Unallowables. Department of Defense policy found in the Defense Federal Acquisition Regulation Supplement 215.972 states the factors to be considered when determining whether or not any fee should be paid to a Federally Funded Research and Development Center. Among these considerations is a

"provision for funding unreimbursed costs deemed ordinary and necessary to the FFRDC." Since the need for funding to cover unreimbursed costs (unallowables) is a consideration for determining the need to pay a fee to Federally Funded Research and Development Centers, it would reasonably follow that any fees paid could be used for that purpose. The Inspector General's blanket classification of fees used to cover unallowable costs as excessive is unreasonable in light of the stated Department of Defense policy. The only measure by which these costs could be classified as excessive, in light of the stated policy, is if they were determined not to be ordinary and necessary expenses for the Federally Funded Research and Development Center. A closer examination of each item of unallowable costs ascribed to the Center for Naval Analyses to determine their nature in terms of ordinary and necessary expenses is as follows:

Dependent Scholarships: The report states that these items are unallowable costs since they are not specifically listed as an allowable cost in Office of Management and Budget Circular A-122, the applicable cost principles, and in the Federal Acquisition Regulation cost principles (Federal Acquisition Regulation 31.205-44). In the case of A-122, the cost principles are completely silent on the question of dependent scholarship costs. In fact A-122 states in the introduction to the selected items of cost discussion that "Failure to mention a particular item of cost is not intended to imply that it is unallowable; ...". Furthermore, these costs are specifically allowable under the fringe benefits portion of contracts with other types of nonprofit institutions (i.e., educational institutions which are governed by Office of Management and Budget Circular A-21) and had been an allowable cost under all previous Center for Naval Analyses contracts. In addition, the Federal Acquisition Regulation cost principle cited (Federal Acquisition Regulation 31.205-44) applies only to commercial companies. A justification for inclusion of these costs in fee was included in the fee request prepared by the Center for Naval Analyses as part of their contract proposal. Among the reasons cited was their need to offer "competitive" benefits similar to those offered by other nonprofits in order to retain and recruit employees.

Community Program: The costs in this area include those associated with tutoring, career counseling, and other programs at local high schools. The report cites a Cost Accounting Standard which is not applicable to the Center for Naval Analyses. This expenditure could, however, be construed as a cost that is unallowable under the standards of the applicable cost principles. The question then becomes whether it is an ordinary and necessary cost of operating Federally Funded Research and Development Centers. Since it is not specifically intended to support future

recruitment efforts or retention of any current employees, it is unlikely that these particular expenses could be used to justify the need for fees. The fact that the fee was used in this manner is, however, irrelevant to the amount of fees actually paid the Center for Naval Analyses. The fee objective is determined in accordance with the criteria set forth in the weighted guidelines method as required by Defense Federal Acquisition Regulation Supplement 215.972(b)(2). The actual use of fee is only considered in determining whether or not payment of any fee is necessary. While negotiations may include considerations of anticipated fee needs in actually determining the final negotiated fee amount, once a fee amount is established, the Federally Funded Research and Development Center need only comply with the provisions of Defense Federal Acquisition Regulation Supplement 215.972(a), which stipulates the conditions upon which determination of nonprofit status is evaluated. Just as in for-profit companies, there is no legal mechanism by which we can control the expenditure of profit or fee.

Center for Naval Analyses Sponsored Symposia: These costs were related to meetings held to exchange views and were not directly attributable to any specific contract tasks. The cost principle cited in the report to classify these costs as unallowables was Federal Acquisition Regulation 31.205-1 "Public Relations and Advertising Costs". The cost principle cited applies only to commercial firms, which the Center for Naval Analyses is not. A-122 (Attachment B, Selected Items of Cost, 29 Participant Support Costs) specifically does allow the costs for attending symposia, meetings and conferences with prior agency approval. Since the meetings in question were conducted to exchange views with peers in similar fields, this could reasonably be considered an ordinary expense of the Federally Funded Research and Development Center and unallowable only because they were hosted by the Center for Naval Analyses and did not have prior agency approval. Had these meetings been proposed as an allowable cost in the form of an advance agreement, these costs probably would have been allowed; however, since there was no advance approval, the Center for Naval Analyses had to charge them to fee.

Miscellaneous Unallowables: The description provided for these costs in the report is "... costs not allowed by OMB [Office of Management and Budget] Circular A-122, or FAR [Federal Acquisition Regulation] 31, but which are generally considered and accepted as normal cost of doing business." These costs are the very definition of those to be considered when determining fee to be paid to Federally Funded Research and Development Centers. No rationale is presented as to how these costs could be classified as excessive.

In terms of the costs not necessary for current year needs, the Center for Naval Analyses was cited as having \$33.7 thousand of costs in this category. These "undistributed fees" were disclosed to the Navy as part of the Center for Naval Analyses' annual report on fee expenditures. It was determined by the Contracting Officer that these fees would not be recouped but would be held as a reserve pending determination of final incurred costs by the Defense Contract Audit Agency. A memorandum to the contract file, documenting the Contracting Officer's decision, accompanied the annual fee report made available to the Inspector General. It was a conscious decision of the Contracting Officer to allow these "retained earnings". Defense Federal Acquisition Regulation Supplement 215.972 specifically states that retained earnings is a consideration in the need for fee; it can, therefore, be assumed that some amount of retained earnings is reasonable.

The report states that the payment of excessive fees was a result of the failure of contracting officers to conduct proper fee analysis. In the case of the Center for Naval Analyses, a fee analysis consistent with Department of Defense policy was conducted both at the time of initial fee negotiation and during negotiation of modification P00028 which provided for the increased fee. In both instances, the price negotiation memorandum documented the factors considered in determining that a fee was appropriate and how weighted guidelines and the needs analysis supported the fee ultimately negotiated. The Inspector General was provided copies of the price negotiation memoranda which covered both instances. While, as noted in our discussion of the "excessive fee", the Inspector General may not agree with the rationale and interpretation of the applicable policy and regulatory standards, it is incorrect for them to state that failure to conduct a proper fee analysis was the cause. The Navy did the required analysis and, while the conclusions drawn may differ, the fact that an analysis was properly conducted cannot be disputed.

The fee analysis was based upon the provision by the Center for Naval Analyses of a fee proposal which stated, as appropriate, their retained earnings (undistributed fees), their facilities acquisition plans, their working capital requirements, contingency requirements, and estimates for ordinary and necessary costs that are unallowable. Each of these elements was independently assessed by the Navy and the results stated in the price negotiation memorandum. In addition, as required by Defense Federal Acquisition Regulation Supplement 215.972, the weighted guidelines method was utilized in computing the fee objective. The weighted guidelines initially completed supported the rate ultimately provided by modification P00028; however, since the Center for Naval Analyses did not propose the higher fee, it was not initially authorized. The original fee amount negotiated is a reflection, in part, of the inexperience of the

Center for Naval Analyses in assessing fee requirements and a result of using advance funding arrangements which eliminate the need for working capital.

Page 28, Paragraph 5: Allowable Costs That Should Have Been Charged to Overhead.

"The \$31.4 million of allowable costs that should have been charged to overhead (Table Q-2) included \$4.7 million that the FFRDCs [Federally Funded Research and Development Centers] claimed as ordinary and necessary expenses to their operations and \$26.7 million for corporate-sponsored research."

Department of the Navy Position. Nonconcur. In the area of costs which should have been charged to overhead, the Center for Naval Analyses was reported to have received \$371.6 thousand (Appendix Q, Table Q-2), all of which was classified as Corporate Sponsored Research. These costs are for research intended to broaden and enhance the expertise available to the Department of Defense by performing research in areas which, while not specifically necessary to the Navy, could provide benefit through the experience gained by Federally Funded Research and Development Center researchers. Office of Management and Budget Circular A-122 lists this category of costs, Independent Research and Development, as "Reserved". Since there was no advance agreement which specifically allows these costs, they could be determined as unallowables. In fact, this research may be tasks proposed to the Navy which the Navy declined to fund directly as a part of their cost, either due to a limit in the available funds or due to the intangible nature of the benefits to be provided. As such, it is unreasonable to assume that they would have been determined allowable as an indirect cost.

Page 32, Paragraph 1: Analysis of Center for Naval Analyses Fee Increase.

"The Navy realized no measurable benefits associated with the increased management fee paid to the CNA [Center for Naval Analyses]. Inspector General, DoD [Department of Defense], Report No. 94-012, "Sole-Source Justifications for DoD-[Department of Defense] sponsored Federally Funded Research and Development Centers," November 4, 1993, stated that the Navy did not adequately support the need for the sole-source contract awarded to the CNA [Center for Naval Analyses] in September 1990. The Office of Naval Research justification for the increased management fee, effective with the January 1993 modification to the CNA [Center for Naval Analyses] sole-source contract, did not provide any evidence supporting a Navy need for a "financially stronger more independent FFRDC [Federally Funded Research and Development Center]" or accurately document the financial impact of the fee restructuring. CNA [Center for Naval Analyses] will use the increased management fee to diversify its consulting work

to non-Navy and non-DoD [Department of Defense] organizations.

The cost to the Government to maintain a \$4.8 million advance payment pool is about \$20,000 per month, or \$240,000 per year (based on an annual interest rate of 5 percent), and is the savings directly achievable from discontinuing the \$4.8 million advance payment pool. The Navy did not estimate or document any reduction in administrative costs. Thus, the administrative savings would be negligible. Against this annual cost of \$240,000, the Navy will pay an additional \$2.9 million, or a net annual cost increase to the Government of about \$2.7 million."

Department of the Navy Position. Nonconcur. The Contracting Officer believed that the value of eliminating advance payments and Government facilitization of the Center for Naval Analyses was plain and required no enumeration. The Inspector General's advocacy that money can be saved by utilizing advance payments and Government facilitization is contrary to clear Government policy, as stated in Federal Acquisition Regulation 32 and 45, that the Government prefers to pay for completed work and have the Contractor provide the facilities and equipment necessary for contract performance.

The following is a brief discussion of the benefits that have accrued to the Navy (as of August 1994) since implementation of the higher fee:

- The calculated savings of \$240,000 per year, as stated in the report, is considered an adequate representation of the benefits derived from the elimination of the advanced payment pool. There are, however, more benefits derived in the areas of facilities, financial stability and associated performance risk, independence, and diversification.
- The use of retained earnings for facilities capitalization results in several monetary benefits. The first of these benefits is the use of a long term depreciation schedule to cover the costs of facilities versus the immediate costs of Government purchase of facilities. Since the increased fee was put in place, the Center for Naval Analyses has invested \$1,546,200 in the purchase of facilities. The spread of some depreciation expenses over Department of Defense and non-Department of Defense customers will also serve to reduce the cost of facilities ultimately reimbursed by the Department of Defense. In addition, the risk of loss, damage and repair of these items is shifted from the Government to the Center for Naval Analyses. Added to these savings is the reduction in administrative costs associated with approving the purchase of facilities, maintaining Government property records and

controls of the property, and disposing of the property when no longer required.

- The improved financial stability of the Center for Naval Analyses greatly reduces the risk of non-performance, provides for a more stable work force, and helps to ensure the continued existence of a nationally important source of scientific expertise. Absent working capital and some retained earnings, any disruption in the flow of Department of Defense work, funding and/or long term dispute over reimbursable costs would seriously jeopardize performance by the Center for Naval Analyses. Without the establishment of a moderate amount of retained earnings, the Center for Naval Analyses would have no ability to cover any fluctuations in workload, receipt of payments, or reimbursement of incurred costs. Periods necessary to resolve disputes related to appropriateness of costs are often lengthy and, without retained earnings, absorption of these costs could not be made either temporarily or permanently without affecting operations. The financial stability and the associated risk to performance cannot be described in monetary terms; however, they do represent a benefit to the Department of Defense.
- The increased fees promote the independence of the Center for Naval Analyses. This independence can be translated through the diversification and Independent Research and Development efforts funded through the increased fee. Diversification allows the Center for Naval Analyses to improve its ability to broaden its expertise and to gain perspective on how non-Department of Defense activities view and solve problems or questions. The Independent Research and Development efforts also allows the Center for Naval Analyses the latitude to address issues that may not be viewed as necessary or desirable by the Department of Defense sponsor. For example, the Center for Naval Analyses self-initiated a study concerning the Navy's role in the Persian Gulf. This study may never have been funded by the Department of Defense if the report could be anticipated to lead to unfavorable evaluations or unfavorable changes in either Navy force structure or the overall distribution of air, land, and sea assets necessary to respond to such conflicts in the future. However, if the Center for Naval Analyses is prohibited (albeit monetarily) from addressing concerns that may result in criticism of the sponsor, then their independence cannot be assured. While this goal of increased independence does not suggest any lack of

independence previously, it does serve as a benefit to the Navy.

- Diversification of the Center for Naval Analyses, allowed through capitalization and Independent Research and Development efforts, allows the sharing of general overhead expenses with non-Department of Defense entities, thereby reducing the amount paid by the Department of Defense. The increased fee allows the Center for Naval Analyses the necessary resources to fully establish the Institute for Public Research division and to increase the Center for Naval Analyses' marketability to non-Department of Defense customers. This directly resulted in the charging of \$580,934 in Research Overhead and General Administrative expenses to non-Department of Defense entities through the Institute for Public Research and the Center for Naval Analyses' contract with the Federal Aviation Administration. These costs, had they not been absorbed through the Institute for Public Research and by the Federal Aviation Administration, would have been charged to the Department of Defense. These represent significant monetary benefits to the Navy.
- The increase in fee also allows a broadening of available expertise through Institute for Public Research and Independent Research and Development activities. In the past, only that expertise was maintained which could be fully utilized by the Center for Naval Analyses in support of the Navy. As a result, any areas of expertise which were necessary but did not represent full employment potential were either obtained through consultants, not utilized or included in the study efforts, or were inefficiently used. The development of the Institute for Public Research means that expertise not previously cost-beneficial to maintain or efficiently employed can now be realized by sharing their costs over the Institute for Public Research and the Center for Naval Analyses work. This expands the expertise available for work and thus provides a benefit to the Navy.

These elements represent benefits realized by the Navy as a result of the increased fee provided. These benefits, as identified by the Contracting Officer in the rationale supporting the increased fee negotiations, were not considered by the Inspector General in concluding that there are no measurable benefits accrued as a result of the increased fee.

Page 32: Recommendations for Corrective Action.

"1. We recommend that the Director, Defense Research and Engineering; the Deputy Under Secretary of Defense (Logistics); the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence); the Army; the Navy; the Air Force; and the Director Advanced Research Projects Agency document in federally funded research and development center sponsoring agreements why the federally funded research and development centers need management fees."

Department of the Navy Position. Nonconcur. The requirement to document the contracting officer's decision as to whether or not payment of any fee is appropriate already exists within Defense Federal Acquisition Regulation Supplement 215.972(b)(1). This documentation is made a part of the price negotiation memorandum required by Federal Acquisition Regulation 15.808. The information required to determine the need for a fee, and the resulting analysis, would necessarily include business sensitive information which should not be released to the public. Inclusion of such information in the sponsoring agreement, as recommended, would violate the restrictions placed on such information and would serve no purpose. The factors which are considered in determining whether a fee should be paid are clearly established in Defense Federal Acquisition Regulation Supplement, and the documentation of the decision is already required to be included in the price negotiation memorandum.

"2. We recommend that the Service Acquisition Executives and the Director, Advanced Research Projects Agency, establish procedures for contracting officers to:

a. Include a management fee clause in each federally funded research and development center contract that requires federally funded research and development centers to justify management fee needs in accordance with criteria contained in Defense Federal Acquisition Regulation Supplement 215.972, "Modified Weighted Guidelines Method for Nonprofit Organizations". Management fees should be justified on all contract actions requiring cost analysis and in no case less than annually. The annual fee requests should include:

- (1) A description of each fee expense.
- (2) A statement why the fee is not chargeable under existing cost guidelines.
- (3) An explanation of the benefits of incurring each fee expense to both the federally funded research and development center and the sponsor.
- (4) An annual report on the actual use of prior year fee awards.

b. Determine whether prior year fees were used in accordance with approved fee requests and reduce authorized fees for unexpended balances.

c. Perform an annual operating cycle analysis to determine federally funded research and development center management fee needs.

d. Assess alternatives to the award of fees, such as advance funding arrangements, contractual guarantees for contingencies, providing Government facilities or equipment, or others and use alternatives where more economical."

Department of the Navy Position.

Recommendation 2.a. Nonconcur. It would serve no purpose to include in a contract the requirement to submit fee justification because fee is negotiated prior to award of the contract. Additionally, Federal Acquisition Regulation 15.903(e) specifically states "The contracting officer shall not require any prospective contractor to submit details of its profit or fee objective but shall consider them if they are submitted voluntarily." Federal Acquisition Regulation 15.903(b) already requires that the contracting officer comply with agency guidelines in developing prenegotiation objectives for fee whenever a contract action is based on cost analysis. The requirement to prepare annual fee requests would not only violate Federal Acquisition Regulation 15.903(e), it would only be meaningful if fees were negotiated annually. This annual requirement for negotiation of fees would prevent the use of long-term agreements, which is a basic part of the policy for establishing Federally Funded Research and Development Centers stated in Federal Acquisition Regulation 35.017(a)(4). The long term contractual relationship is intended to provide stability and continuity necessary to attract high quality personnel to the Federally Funded Research and Development Center. The use of annual contracts would abandon this policy and create an environment that would hamper the conduct of major research projects which could not be completed in one year. It also introduces the instability associated with any delays in providing funds and authorizing work associated with the contract renewal cycle.

Recommendation 2.b. Nonconcur. This recommendation to determine whether prior year fees were used in accordance with approved fee requests does not offer any remedy. If a prior year's fee was used for some expense considered inappropriate, then it does not mean the current fee request is inappropriate. Each fee request must stand on its own merits, whether it is done annually or every five years. Information on past year's fee expenditures is useful in predicting the amount of costs that are repetitive (ordinary) expenses, but this information is readily

available in audits of incurred costs and the retained earnings plan, required by Federal Acquisition Regulation 35.017-1(c)(3). Once again, this all hinges on the assumption that a fee request is submitted. Further, the method for determining fee objectives is set forth in Defense Federal Acquisition Regulation Supplement 215.971, as prescribed by Defense Federal Acquisition Regulation Supplement 215.972(b)(2) and Federal Acquisition Regulation 15.903(b).

Recommendation 2.c. Nonconcur. This recommendation is only useful if fees are negotiated annually. As discussed in the response to Recommendation 2.a., the use of an annual contract does not comply with the stated policy for Federally Funded Research and Development Centers set forth in Federal Acquisition Regulation 35.017(a)(4).

Recommendation 2.d. Nonconcur. As discussed in the response to "Considering Fee Alternatives" (page 25, paragraph 3 of the report), advance funding arrangements do not save money, contingent liability is not fully covered by standard termination clauses and development of special clauses would require budgeting and funding to cover the contingent liabilities, and the provision of facilities and equipment by the Government is more expensive and places greater liability on the Government.

Advance funding requires that 100% of the working capital needs be paid out up front. This means the Government incurs interest on the debt of establishing the pool from the first day of the contract. Under normal cost-reimbursement payment methods, the contractor finances his working capital from retained earnings (which already exist) and finances any temporary shortfall in working capital. This results in something less than 100% of the working capital being financed for something less than the full performance period, therefore, less interest expense is incurred. In addition, Government disbursement of funds takes place after, not before, performance, thereby reducing interest expense on Government borrowing.

Contingent liabilities due to cancellation of sponsorship are not completely covered by the cancellation of the contract. For example, interest on financing of working capital expenses during the settlement negotiations are not covered and cannot be made a part of any settlement agreement amount. If there were special clauses negotiated to cover contingencies, they would have to be funded as a part of the termination liability of the contract.

The provision of facilities and equipment by the Government necessitates the immediate expenditure of funds to cover acquisition cost versus the charging of acquisition cost as a part of depreciation expense in the overhead account. Further, if the Government provides the facilities and equipment, then the

Government is responsible for maintaining administrative records; maintaining the equipment; any performance delays resulting from equipment non-availability, risk of loss or damage, and disposal costs. While most of these costs are allowable expenses, they must be charged to overhead, which means the cost is spread over the entire cost base and acquisition cost must be amortized over the useful life of the equipment or facility (as required). This results in lower interest charges and the potential sharing of costs with non-government sponsors of work.

FINDING C. CONFLICTS OF INTEREST ISSUES (PAGE 34)

Page 36, Paragraph 3: Contracting Officer Oversight.

"Conflict of interest provisions similar to those in the contract for CNA [Center for Naval Analyses], but also requiring the reporting of any use of marketing consultants, should be included in all FFRDC [Federally Funded Research and Development Center] contracts."

Department of the Navy Position: Concur in principle. The Organizational Conflict of Interest clause currently contained in the Navy's contract with the Center for Naval Analyses requires reporting of any potential conflicts of interest. The requirement for reporting use of marketing consultants is unnecessary since any potential conflict of interest posed by their use (i.e., marketing consultants) must be identified in accordance with existing Organizational Conflict of Interest clause requirements.

Page 36, Paragraph 4: Awareness of FFRDC [Federally Funded Research and Development Center] Financial Affiliations.

"Contracting officers were not aware of the financial affiliations of the FFRDCs [Federally Funded Research and Development Centers], the FFRDC [Federally Funded Research and Development Center] trustees, or the FFRDC [Federally Funded Research and Development Center] employees."

Department of the Navy Position: To clarify, the Center for Naval Analyses is required to collect financial disclosure information in accordance with their Department of the Navy-approved Conflict of Interest policy. Although this information is not currently provided to the Contracting Officer, the information is available if needed. Financial disclosure information will be provided on an annual basis as a requirement of the Navy's new Federally Funded Research and Development Center contract.

Page 37, Paragraph 3: Trustee Affiliations and Conflicts of Interest Policies.

"Contracting officers for 9 of 10 FFRDCs [Federally Funded Research and Development Centers] agreed that individuals simultaneously serving on the board of an FFRDC [Federally Funded Research and Development Center] and the board of a major defense contractor could pose a conflict of interest, but were personally not aware of the affiliations of the FFRDC [Federally Funded Research and Development Center] trustees. Our review of meetings of Boards of Trustees and discussions with FFRDC [Federally Funded Research and Development Center] officials showed that, in at least six instances, individual trustees recused themselves from meetings because of possible conflicts. Our review of trustee affiliations disclosed 28 instances of individuals who were simultaneously serving on the Boards of FFRDCs [Federally Funded Research and Development Centers] and major defense contractors. Trustees also had significant affiliations with other nonprofit organizations, including other FFRDCs [Federally Funded Research and Development Centers], which had major contracts with the DoD [Department of Defense]. Procuring contracting officers should be aware of trustee affiliations for their respective FFRDCs [Federally Funded Research and Development Centers]."

Department of the Navy Position: Concur. The Navy's contract with the Center for Naval Analyses requires disclosure of any potential conflicts of interest.

Page 38, Paragraph 2: FFRDC [Federally Funded Research and Development Center] Susceptibility to Conflict of Interest Situations.

"...DOD [Department of Defense] sponsors should require contractually that all FFRDCs [Federally Funded Research and Development Centers] establish procedures for employees in executive and research positions to file annual disclosures of personal financial interests."

Department of the Navy Position: Concur. This provision is a part of the Center for Naval Analyses' Department of the Navy-approved Conflict of Interest Policy.

Page 38, Paragraph 4: Disclosing Investments or Contributions.

"We believe that the DoD [Department of Defense] sponsors should include a provision in the FFRDC [Federally Funded Research and Development Center] contracts that requires the FFRDCs [Federally Funded Research and Development Centers] to report their investments in and contributions from non-Government organizations."

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Department of the Navy Position: Concur. The Department of the Navy will include this requirement in the Organizational Conflict of Interest clause in the Navy's new Federally Funded Research and Development Center contract.

Page 39, Paragraph 3: Contracting Officer Views of Potential Conflicts of Interest.

"All FFRDCs [Federally Funded Research and Development Centers] should be required to communicate to the contracting officer any use of marketing consultants and actual or potential conflicts of interest involving their operations."

Department of the Navy Position: Concur. Under the Navy's current Federally Funded Research and Development Center contract, the Center for Naval Analyses is required to report all potential conflicts of interest to the Contracting Officer.

Page 39, Paragraph 5: Project Sponsor Review for Conflicts of Interest.

"Contracting officers should require sponsoring program officials to review all FFRDC [Federally Funded Research and Development Center] procurement actions in accordance with FAR [Federal Acquisition Regulation] subpart 9.5 and to notify the contracting officer immediately of any potential conflicts identified."

Department of the Navy Position: Concur. We agree that sponsoring program officials should review assignment of tasks to Federally Funded Research and Development Centers for potential conflicts of interest. This requirement will be part of the sponsor documentation in the Navy's new Federally Funded Research and Development Center contract.

Page 40, Paragraph 2: Incorporation of CNA, Incorporated.

"The Navy's payment of incorporation fees for CNA, Incorporated may have limited the independence of CNA [Center for Naval Analyses]."

Department of the Navy Position: Nonconcur. The Inspector General has provided no explanation of or rationale for the conclusion that the payment of CNA, Incorporated's incorporation fees limits the Center for Naval Analyses' independence. Incorporation fees are an item of cost that may be reimbursable under certain conditions. Reimbursing that particular cost should no more limit the Center for Naval Analyses' independence than reimbursing any other allowable cost. As the draft audit report indicates, Office of Management and Budget Circular A-122, which provides cost principles for nonprofit organizations, permits agencies to approve organization costs such as

Revised in
final report
to say "The
Navy's
payment
... was
incorrect."

incorporation fees. The amendment to A-122 quoted by the draft audit report ("Expenditures, such as incorporation fees. . . .in connection with the establishment of an organization, are unallowable except with prior approval of the awarding agency.") became effective on 8 July 1980. The Office of Management and Budget explained in the Federal Register notice that its coverage of organization costs was amended "to provide that organization costs may be allowable when approved in writing by the awarding agency." There was no indication or concern expressed that, by allowing agencies to reimburse organization fees, the nonprofit organization would somehow lose its independence. The draft Inspector General report also cites Federal Acquisition Regulation 31.205-27 which states that the costs of organizing or reorganizing a corporate structure are unallowable. Federal Acquisition Regulation 31.205-27, however, (as the rest of Federal Acquisition Regulation Subpart 31.2) applies to contracts with commercial organizations. Federal Acquisition Regulation Subpart 31.7 applies to contracts with nonprofit organizations, and Federal Acquisition Regulation 31.702 specifically provides that Office of Management and Budget Circular A-122 sets the principles for determining costs applicable to nonprofit organizations. Office of Management and Budget Circular A-122, as explained above, allows agencies to approve organization costs in advance.

Page 40. Paragraph 3: Incorporation of CNA, Incorporated.

"In a May 22, 1990 letter to the Chief of Naval Operations, the Hudson Institute notified the Navy of its intention to terminate its management of CNA [Center for Naval Analyses]. The Navy, instead of competing for a new management agent, proceeded to award a noncompetitive contract to CNA, Incorporated, a new nonprofit corporation formed to operate CNA [Center for Naval Analyses]."

Department of the Navy Position: Nonconcur. As stated in the Department of the Navy's prior response of 9 August 1993 to the Inspector General's draft audit report of 23 March 1993 (Project No. 1CH-5012.02), Federal Acquisition Regulation 35.017-2(h) provides for management of Federally Funded Research and Development Centers by private corporations. When the Hudson Institute relinquished management of the Center for Naval Analyses in 1990, there was no need for the Navy to seek a new management agent. A new management agent already existed, namely, The CNA Corporation. It would have been neither necessary nor reasonable for the Navy to pursue, and arbitrarily attempt to impose, some other outside source of management for the Center for Naval Analyses. Such attempts would have served only in inserting an unnecessary layer of administration and cost. Further, it is questionable if such an attempt could have even been feasible; once the Center for Naval Analyses had incorporated as an autonomous organization, it was under no

obligation to accept outside management. Management of a Federally Funded Research and Development Center by a private corporation (even if that corporation equates to the Federally Funded Research and Development Center itself) is neither improper nor illegal. In fact, private corporations are the structure of the vast majority of business entities in America.

Page 41. Paragraph 1: Justification for Paying CNA Incorporation Fees.

"The Navy never adequately documented its reasons for not pursuing competition for a new management agent."

Department of the Navy Position. Nonconcur. Even if true, there is no requirement in Office of Management and Budget Circular A-122 that there be any competition or documentation of lack of competition before approving the expenditure of organization fees. It should also be noted that contracts to establish or maintain the services provided by the Center for Naval Analyses are permitted to be awarded without full and open competition in accordance with 10 U.S.C. Section 2304(c)(3).

The reasons for noncompetitive award of the contract to The CNA Corporation were adequately and accurately set forth in the Justification and Approval for other than full and open competition and approved in accordance with appropriate statutory requirements. It was determined, prior to approval of the Justification and Approval, by both the sponsor and the prior Center for Naval Analyses management contractor, that the Center for Naval Analyses possessed the capability to manage its own Federally Funded Research and Development operations without outside control. The Inspector General has not disclosed any area where the Center for Naval Analyses' self-management has resulted in increased costs or a reduction in quality. The Center for Naval Analyses can be reimbursed for allowable costs related to maintenance of their corporate structure. Therefore, the introduction of an outside management organization, whether through competition or non-competitive procedures, would result in increased costs and bureaucracy in an already cumbersome and complex process. It is unclear what benefits, if any, would be realized from the award of a management contract. Since the non-competitive award to the Center for Naval Analyses is authorized by statute and has resulted in lower costs and effective management of the Federally Funded Research and Development Center, there is no reason to take actions beyond those already taken by the Navy.

Page 43, Paragraph 3: Approval of Intergovernmental Personnel Act Appointments.

"We asked DoD [Department of Defense] contracting officers for the DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] whether they were aware that employees from their FFRDCs [Federally Funded Research and Development Centers] were brought into the Government under IPA [Intergovernmental Personnel Act] appointments and whether they reviewed and approved appointment requests. All of the contracting officers stated that they had not been involved in approval of the requests. ...Contracting officers should be informed of IPA appointments of DoD [Department of Defense] FFRDC [Federally Funded Research and Development Center] personnel and their positions upon return to the FFRDC [Federally Funded Research and Development Center]."

Department of the Navy Position: Concur. Contracting officers for Federally Funded Research and Development Center contracts should be informed of proposed Intergovernmental Personnel Act assignments (whether by appointment or detail) of employees of Federally Funded Research and Development Centers.

Page 44, Paragraph 2: Including IPA [Intergovernmental Personnel Act] Salary Payments Under FFRDC [Federally Funded Research and Development Center] Funding Ceilings.

"Reimbursements of salary and benefits of FFRDC [Federally Funded Research and Development Center] personnel on IPA [Intergovernmental Personnel Act] assignments with DoD [Department of Defense] organizations should be included under the funding ceilings imposed by Congress on the FFRDCs [Federally Funded Research and Development Centers]. The terms of the IPA [Intergovernmental Personnel Act] agreements between the FFRDCs [Federally Funded Research and Development Centers] and DoD [Department of Defense] provided that the FFRDCs [Federally Funded Research and Development Centers] would continue to pay the salaries and benefits of FFRDC [Federally Funded Research and Development Center] employees on IPA [Intergovernmental Personnel Act] assignments to DoD [Department of Defense]. ... The Director, Defense Research and Engineering, who is responsible for establishing the funding ceiling for each DoD [Department of Defense] FFRDC [Federally Funded Research and Development Center] and monitoring execution by each FFRDC [Federally Funded Research and Development Center] sponsor, had not issued guidance in the DoD [Department of Defense] FFRDC [Federally Funded Research and Development Center] Management Plan for the FFRDC [Federally Funded Research and Development Center] sponsors to include the IPA [Intergovernmental Personnel Act] salary reimbursements under the funding ceilings."

Department of the Navy Position: Nonconcur. The purpose of the Intergovernmental Personnel Act is to facilitate the temporary assignment of personnel between the Federal Government and state and local governments, institutions of higher education, and other certified eligible organizations. Assignments under the Act are to be made for work of mutual concern to the parties involved that will be beneficial to both and serve a sound public purpose. When an individual is assigned to the Department of Defense on an Intergovernmental Personnel Act assignment, that individual is acting as a Government employee, and is subject to certain Federal laws and regulations, such as those governing conflict of interest, submission of financial statement, political activity, and disclosure of confidential information. While on assignment to the Department of Defense, the employee of the Federally Funded Research and Development Center would be performing work on behalf of the Government, rather than the Federally Funded Research and Development Center. Therefore, the salary reimbursement to the individual's employer pays for work performed for the Government that would not be appropriate for assignment to the Federally Funded Research and Development Center. We believe it would be inappropriate to include the salary reimbursement under the Federally Funded Research and Development Center funding ceiling. In addition, to do so would unnecessarily restrict the support which could be funded for tasks appropriate for performance by the Federally Funded Research and Development Center.

Page 44, Paragraph 3: Conclusion.

"DoD [Department of Defense] contracting officers believed that the potential for conflicts of interest at DoD [Department of Defense] FFRDCs [Federally Funded Research and Development Centers] was minimal and, therefore, did not place emphasis on the identification of conflicts of interest. The contracting officers primarily relied on project sponsors and the FFRDCs [Federally Funded Research and Development Centers] to identify and report or avoid potential conflicts of interest even though existing guidance and contract provisions did not require the project sponsors or the FFRDCs [Federally Funded Research and Development Centers] to do so. FFRDC [Federally Funded Research and Development Center] trustees and employees were involved in financial affiliations and personnel arrangements under IPA [Intergovernmental Personnel Act] assignments that could result in conflicts of interest violations. Unless contracting officers or their designated representatives maintain awareness of potential conflicts of interest situations at the FFRDCs [Federally Funded Research and Development Centers] and review and monitor potential occurrences, DoD [Department of Defense] will have no adequate assurance that conflicts of interest are being avoided or identified."

Department of the Navy Position: Nonconcur. In Department of the Navy, the Contracting Officers did take seriously the potential for conflicts of interest as evidenced by the inclusion of the Organizational Conflict of Interest clause in the Navy's contract with the Center for Naval Analyses. While it is true that we did rely on project sponsors and Federally Funded Research and Development Centers to identify and avoid conflicts, there was existing guidance in the form of the Department of the Navy-approved conflict of interest policies and procedures and the Organizational Conflict of Interest contract provision. Federally Funded Research and Development Center trustees and employees are required to disclose their financial affiliations to help avoid conflict of interest violations. Therefore, we believe we have adequate assurance that conflicts of interest are being identified and avoided.

Page 45: Recommendations for Corrective Action.

"1. We recommend that the Service Acquisition Executives and the Director, Advanced Research Projects Agency, require contracting officers to:

a. Obtain certifications from the sponsor of each project that the statement of work has been reviewed for potential and actual conflicts of interest. Issue instructions for sponsoring program officials to assist in such evaluations and require sponsoring program officials to notify the contracting officer immediately of any conflict identified.

b. Include in all federally funded research and development center contracts conflicts of interest clauses that:

(1) Require federally funded research and development centers to file marketing consultant or advisory and assistance services certificates required by Federal Acquisition Regulation 9.507 for each contract and each project assigned to the contracts.

(2) Require federally funded research and development centers to warrant that no conflicts of interest existed before contract award and that the contracting officer will be immediately notified if any conflicts of interest arise after contract award.

(3) Provide for remedies that include possible contract termination if the federally funded research and development center fails to inform the contracting officer of any conflicts of interest.

(4) Require federally funded research and development centers to establish procedures for employees in executive and research positions to file annual disclosures of personal financial interest.

(5) Require federally funded research and development centers to report their investments in and contributions from non-Government organizations.

c. Review Intergovernmental Personnel Act appointments for all DoD [Department of Defense] federally funded research and development center personnel for potential conflicts of interest."

Department of the Navy Position:

Recommendation 1.a. Concur. A statement to this effect is included in the task documentation for implementation in the Navy's planned new Federally Funded Research and Development Center contract.

Recommendation 1.b.(1). Concur in principle. Contracting Officers should be required to include an Organizational Conflict of Interest clause in all Federally Funded Research and Development Center contracts. The included clause should require the Federally Funded Research and Development Center to report any potential conflicts of interest and actions taken to avoid such conflicts; require the Federally Funded Research and Development Center to report any potential or actual violations of the conflict of interest provisions; and contain language which provides that the Contracting Officer may take actions, up to and including contract termination, for violation of any of the conflict of interest provisions of the contract. Such a clause is already in place in the current contract with the Center for Naval Analyses. However, this recommendation as written is not practical. It would require a clause in contracts requiring Federally Funded Research and Development Centers to comply with the certification requirements of Federal Acquisition Regulation 9.507. Federal Acquisition Regulation 9.507 requires the inclusion of provisions in affected solicitations notifying each offeror that marketing consultant certifications and advisory and assistance services certifications will have to be submitted if it is notified that it is the apparent successful offeror. All of this occurs, of course, before contract award. The certificates are intended to identify potential conflicts of interest relating to use of marketing consultants and advisory and assistance services. Since the Center for Naval Analyses is required by its existing Organizational Conflict of Interest clause to identify all potential conflicts of interest, this is duplicative effort and not necessary. We believe that the intent of this recommendation has already been met.

Recommendation 1.b.(2). Concur. Refer to response to Recommendation 1.b.(1). This provision is already contained in the Organizational Conflict of Interest clause in the Navy's contract with the Center for Naval Analyses.

Recommendation 1.b.(3). Concur. Refer to response to Recommendation 1.b.(1). This provision is already contained in the Organizational Conflict of Interest clause in the Navy's contract with the Center for Naval Analyses.

Recommendation 1.b.(4). Concur. The Center for Naval Analyses currently has such procedures in place.

Recommendation 1.b.(5). Concur. This provision will be included in the Organizational Conflict of Interest clause in the Navy's planned new contract.

NOTE ON DEPARTMENT OF THE NAVY POSITION ON RECOMMENDATIONS 1.a. and 1.b.1 While the Department of the Navy concurs in principle, implementation of these recommendations may require the prior approval of the Under Secretary of Defense (Acquisition and Technology), Director of Defense Procurement, in accordance with Defense Federal Acquisition Regulation Supplement 201.304.

Recommendation 1.c. Nonconcur with recommendation as written. Regulations related to Intergovernmental Personnel Act assignments are implemented in the Department of the Navy by the Office of Civilian Personnel Management. Any recommendation to amend or revise those regulations should be addressed to the Assistant Secretary of the Navy (Manpower and Reserve Affairs). Further, Intergovernmental Personnel Act assignments (whether by appointment or detail) are not made under the Federally Funded Research and Development Center contract. Personnel regulations could be revised to require that "Prior to approval of an Intergovernmental Personnel Act assignment of an employee of a Federally Funded Research and Development Center, the Contracting Officer of the sponsoring agency must be notified to ensure that the duties to be performed under the Intergovernmental Personnel Act assignment pose no organizational conflict of interest with the Federally Funded Research and Development Center." The Government is responsible for approving both the assignment of individuals under the Intergovernmental Personnel Act and for assigning work to those employees. Financial disclosure statements of prospective assignees are reviewed by agency ethics officials prior to assignment. Once an individual is assigned under the Intergovernmental Personnel Act, the Federally Funded Research and Development Center has no control over that individual in terms of work performance. Therefore, it is unreasonable to attempt to relate work performed by an Intergovernmental Personnel Act assignee to performance under the Federally Funded Research and Development Center

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contract. To the extent that the Federally Funded Research and Development Center might be aware of work to be or being performed by an Intergovernmental Personnel Act assignee which would pose a potential conflict of interest with its own operations, the Federally Funded Research and Development Center is already bound by the Organizational Conflict of Interest clause to report it (refer to response to Recommendation 1.b.).

"2. We recommend that the Assistant Secretary of the Navy (Research, Development and Acquisition) direct the Office of Naval Research contracting officer to obtain reimbursement from the Center for Naval Analyses for incorporation fees paid by the Navy."

Department of the Navy Position: Nonconcur. As discussed above, Office of Management and Budget Circular A-122 allows agencies to approve organization costs in advance. The Department of the Navy did approve the questioned expenditure. Since the costs were an allowable cost that had been approved and paid, there is no authority for the contracting officer to require their return unilaterally.

"3. We recommend that the Director, Defense Research and Engineering revise the DoD [Department of Defense] Federally Funded Research and Development Center Management Plan to:

a. Exclude federally funded research and development center personnel from assignment to DoD [Department of Defense] positions under Intergovernmental Personnel Act appointments that involve oversight or management responsibilities over a federally funded research and development center.

b. Include all payments to federally funded research and development center employees on Intergovernmental Personnel Act assignments to DoD [Department of Defense] under the funding ceilings imposed by Congress."

Department of the Navy Position:

Recommendation 3.a. Concur.

Recommendation 3.b. Nonconcur. Work being performed on Intergovernmental Personnel Act assignments is being performed on behalf of the Government, not the Federally Funded Research and Development Center, and is not work which should be assigned to a Federally Funded Research and Development Center. Therefore, the recommendation to include these funds in the Federally Funded Research and Development Center ceiling unreasonably restricts the support which can be funded for tasks appropriate for performance by a Federally Funded Research and Development Center.

Revised
Recommendation C.3.

Deleted

**Appendix B. Criteria For Using DoD [Department of Defense]
Federally Funded Research and Development Centers**

**Management of FFRDC [Federally Funded Research and Development
Center] Work**

Page 54: Task Order Processing

"Sponsors and FFRDC [Federally Funded Research and Development Center] management informally discussed and agreed on the taskings assigned to the FFRDCs [Federally Funded Research and Development Centers], the statements of work, and the estimated cost to perform the work. Sponsors also determined that taskings were consistent with the broad mission statement, and that in-house personnel and non-FFRDC [Federally Funded Research and Development Center] contractors were not available or could not perform the work effectively."

Department of the Navy Position: Nonconcur. This finding states that the process for assigning work to Federally Funded Research and Development Centers was an informal one and therefore inadequate. We contend that this was not so for the Center for Naval Analyses during the period reviewed. Since that timeframe, the Department of the Navy has added improvements to the formal process of evaluation and review to ensure that adequate procedures for assigning work to the Center for Naval Analyses now exist. Further, we restate our commitment to continuing to improve these procedures through the next Center for Naval Analyses comprehensive review (to be completed by the end of the third quarter of the fiscal year), Center for Naval Analyses Policy Council direction, and initiatives that arise from day-to-day oversight operations.

Appendix D. Summary Evaluation of Projects Reviewed

Page 57: Rationale

Department of the Navy Position: Nonconcur. See our specific comments in the response to Finding A regarding the issues raised by the listed rationale in this appendix.

Appendix I. Center for Naval Analyses Project Details

Page 72: Rationale

Department of the Navy Position: Nonconcur. See our specific comments in the response to Finding A regarding the issues raised by the listed rationale in this appendix.

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Page 108, Appendix B: Summary of Potential Benefits Resulting from Audit.

Recommendations A.1, A.2, and A.3 - Nonmonetary benefit results from improved compliance with the OFPP [Office of Federal Procurement Policy] and FAR [Federal Acquisition Regulation] policy on proper and effective use of FFRDCs [Federally Funded Research and Development Centers].

Department of the Navy Position: Partially concur. The Department of the Navy agrees, as a matter of general principle, that improvements to Federally Funded Research and Development Center mission statements and proposed project documentation could result in some nonmonetary benefits. However, we do not concur that imposing a requirement to perform market surveys would be beneficial. As we have previously stated, we do not believe performing the cost comparisons described in the recommendation is an adequate basis for determining whether in-house resources could more effectively meet the special research needs of a sponsor on a given project. We contend that the essential considerations are qualitative, not quantitative, and include such things as depth and breadth of expertise across a broad spectrum of defense issues, objectivity and independence, quick response capability, and familiarity with the special research needs of the sponsor. We believe that this recommendation would not result in a nonmonetary benefit, but would serve to add delays and administrative burdens to an already cumbersome process.

Recommendation B.1. - Nonmonetary benefit results from improved justification for FFRDC [Federally Funded Research and Development Center] management fees.

Department of the Navy Position: Nonconcur. The existing policies and procedures used to determine fees are sufficient to adequately justify need for and determine the amount of fees to be paid to Federally Funded Research and Development Centers. Consequently, the increased documentation and review requirements recommended by the Inspector General add no qualitative benefits and result in increased expenses to perform the efforts.

Recommendation B.2. - \$11.6 million of funds and an additional \$2.9 million of Navy funds annually could be put to better use.

Department of the Navy Position: Nonconcur. Most of the costs included in the \$11.6 million savings cited are necessary costs of doing business for Federally Funded Research and Development Centers, and their reimbursement could not be eliminated without jeopardizing the continued existence of the Federally Funded Research and Development Centers. The

\$2.7 million
in final
report.

Government has no inherent or legal (contractual) authority to unilaterally reduce fees or to specify how fees earned by the Federally Funded Research and Development Center can be used (absent nonprofit entity limitations). Therefore, no savings could be realized, without Federally Funded Research and Development Center concurrence, until such time as new contracts are issued which eliminated fee payments. Finally, in regards to the \$2.9 million associated with the Navy for the increase in the Center for Naval Analyses fee, the benefits received from the increase in fee, both monetary and benefits due to reduced cost and performance risk to the Government, outweigh the perceived savings. Additionally, since the Government has executed a legally binding contractual modification to pay the increased fee, there is no mechanism for the Government to rescind unilaterally the authorized increase. Further, the Inspector General's statement that "\$2.9 million could be avoided annually" seems to indicate an assumption that the savings attributed to the increased fee will continue. The increase was included for a specific purpose and is not scheduled to be duplicated beyond the current contract period (1 October 1990 - 30 September 1995).

Recommendation C.1.a. - Nonmonetary benefits result from prevention of organizational conflicts by requiring timely evaluation of all procurement actions by program and contracting officials.

Department of the Navy Position: Concur. Refer to discussion under Finding C, Recommendation 1.a.

Recommendation C.1.b. - Nonmonetary benefits result from prevention of organizational conflicts of interest by requiring FFRDC [Federally Funded Research and Development Center] compliance with FAR [Federal Acquisition Regulation] and contract requirements.

Department of the Navy Position: Concur in part. Refer to discussion under Finding C, Recommendation 1.b.

Recommendation C.2. - Nonmonetary benefits result from promoting FFRDC [Federally Funded Research and Development Center] independence.

Department of the Navy Position: Nonconcur. The Inspector General has provided no explanation for the claim that payment of Center for Naval Analyses' incorporation fees by the Navy limits the independence of the Center for Naval Analyses. Incorporation fees, if approved in advance, represent an allowable cost. Reimbursing that cost should no more limit independence than reimbursing any other allowable cost.

Revised in final report to say "Provides for collection of incorporation fees incorrectly paid."

Recommendation C.3. - Nonmonetary benefits result from prevention of organizational conflicts of interest by excluding assignment of Federally Funded Research and Development Center personnel to oversight of Federally Funded Research and Development Centers and promotes compliance with Congressional funding limitations on Federally Funded Research and Development Centers.

Department of the Navy Position: Nonconcur. As discussed under Finding C, work performed under an Intergovernmental Personnel Act assignment would be performed on behalf of the Government, not the Federally Funded Research and Development Center. To include these funds in the Federally Funded Research and Development Center ceiling unreasonably restricts the support which can be funded for tasks appropriate for performance by a Federally Funded Research and Development Center.

Department of the Air Force Comments



OFFICE OF THE ASSISTANT SECRETARY

DEPARTMENT OF THE AIR FORCE
WASHINGTON DC



NOV 22 1994

MEMORANDUM FOR DIRECTOR, DEFENSE RESEARCH AND ENGINEERING

FROM: SAF/AQX
1060 Air Force Pentagon
Washington DC 20330-1060

SUBJECT: Draft Proposed Audit Report on Contracting Practices for the Use and Operations of DoD-Sponsored FFRDCs (Project No. 1CH-5012)

Thank you for the opportunity to contribute to a consolidated response to the subject audit report. After careful review of the complete draft proposed audit report, we non-concur with all three findings of the DoDIG. The report ignores the intentionally unique relationship the Services have with Federally Funded Research and Development Centers (FFRDCs) which is well established in regulation and recommends changes that would alter this relationship. The Air Force has always managed the use of the unique technical capabilities provided by the FFRDCs according to well established and documented procedures. These procedures are continuously reviewed and improved, most recently as noted in attachment one. We do not believe that any additional changes are necessary. The HQ AFMC/ENR letter at attachment one and the HQ USAF/XOXP letter at attachment two provide specific comments on the report.

Any proposal to change the Service's relationship with FFRDCs--as suggested by the entire audit report at hand--would be a dramatic change in the way the U. S. Government intends to conduct its technological business activities. Such an action would require changes to the Federal Acquisition Regulation and other DoD policy. Until such direction is indicated I intend to make no changes to the way the US Air Force conducts business with its FFRDCs. Your staff may address questions to Capt Chris Kinne at (703) 697-8110.

CHARLES C. DURANTE
Deputy Assistant Secretary
(Management Policy & Program Integration)
Assistant Secretary (Acquisition)

- 2 Attachments:
1. HQ AFMC/ENR Ltr
2. HQ USAF/XOXP Ltr

Department of the Air Force Comments



DEPARTMENT OF THE AIR FORCE

HEADQUARTERS AIR FORCE MATERIEL COMMAND
WRIGHT-PATTERSON AIR FORCE BASE, OHIO

MEMORANDUM FOR SAF/AQXA (Lt Col Harrington)

16 NOV 1994

FROM: HQ AFMC/ENR
4375 Chidlaw Road, Suite 6
Wright-Patterson AFB OH 45433-5006

SUBJECT: Response to DOD IG Draft Audit, Contracting Practices
for the Use and Operations of DOD-Sponsored FFRDCs,
Project No. 1CH-5012

1. The following is our response to the subject draft audit report.

Finding A: Non-concur. This appears to demonstrate a flawed understanding of why FFRDCs were created and the legal basis in FAR 35.017 for why they still exist. The auditors cite several reasons which they consider inadequate justification for the use of FFRDCs. "Corporate Knowledge of FFRDC Staff" and "FFRDC Was Independent and Objective" are legitimate reasons to use FFRDCs.

FAR 35.017 states "The FFRDC is required to conduct its business in a manner befitting its special relationship with the Government, to operate in the public interest with objectivity and independence, to be free from organizational conflicts of interest, and to have full disclosure of its affairs to the sponsoring agency." In addition, it states "This relationship should be of a type to encourage the FFRDC to maintain currency in its field(s) of expertise, maintain its objectivity and independence, preserve its familiarity with the needs of its sponsor(s), and provide quick response capability." These passages of the FAR directly support our justifications for using the FFRDCs.

"Corporate Knowledge of FFRDC Staff," a reason used in 181 of the 229 projects the IG reviewed, is sufficient justification for SMC use of Aerospace Corporation because they are uniquely skilled to provide necessary systems engineering and integration services. If organic or SETA capability existed, or were appropriate, there would be no need for Aerospace to perform the role. Retention of corporate memory is a prerequisite to reduce risk in satellite and launch systems. No other source of corporate memory can provide Aerospace Corporation's role.

"FFRDC Was Independent and Objective" was used in 53 of the 229 projects the IG reviewed, and is the primary reason MITRE C3I FFRDC is essential to ESC acquisition programs. C3I systems have historically been technically complicated and difficult to acquire. MITRE C3I keeps the independent

viewpoint necessary for successful systems engineering and integration of these systems. The existing workload assignment process mandates the work be assigned to existing organic or other contractors, if possible and appropriate, rather than to MITRE C3I DIVISION.

Thorough procedures for review and justification of FFRDC tasks, including approval at the General Officer or civilian-equivalent level, are in place for each Air Force FFRDC. The review process includes annual reviews by HQ AFMC and SAF/AQ of the planned total FFRDC workload, and comprehensive reviews under FAR 35.017. The total review process assures that FFRDC tasks are appropriate, are not circumventing government hiring limitations, and are not possible with organic or other contractor support. In addition, Air Force FFRDCs do not perform inherently governmental functions, but merely provide technical advice and recommendations to government program managers who make program decisions. Sponsoring agreements and local instructions clearly define the roles of FFRDCs and the criteria for assigning noncompetitive FFRDC work, and provide procedures for assessing the effectiveness of FFRDC services.

The sponsors are required to justify they require unique FFRDC capabilities and not that they are the least costly source. FAR 35.017 states "An FFRDC meets some special long-term research or development need which cannot be met as effectively by existing in-house or contractor resources." Evaluating a cost comparison is illogical if the FFRDC is the only source available to accomplish the work.

RECOMMENDATIONS of Finding A: We do not concur with the recommendations following finding A. Specifically, system engineering FFRDCs Aerospace Corporation and MITRE C3I DIVISION are not primarily engaged in research. These FFRDCs are chartered specifically in the sponsoring agreements to provide independent and objective systems engineering technical assistance to program offices. They do conduct limited research in the course of their work, however, it is a consequence, not an objective. Air Force FFRDCs already have clear and specific charters, therefore, it is unnecessary and duplicative of existing documents.

The current workload assignment process ensures that FFRDCs are given tasks which require their unique capabilities. Alternative sources are reviewed and if organic or competitive contractors can do the work, it must not be assigned to the FFRDCs. In addition, tasks assigned to FFRDCs are reviewed for effectiveness and used in their rating.

Performing cost comparison studies of DOD personnel and FFRDC costs are not meaningful without the prospect of hiring additional personnel to accomplish the work. In the wake of the 1994 Federal Workforce Restructuring Act, this recommendation cannot be implemented.

Current FFRDC workload assessment and assignment process make broad agency announcements and competitive solicitations unnecessary and needlessly burden the contracting process. Sponsoring and using FFRDCs are already a time consuming and highly detailed process that is taxing the diminishing resources at ESC and SMC. Adding additional and unnecessary steps merely further strain the already overburdened FFRDC oversight process. This increased workload has partially contributed to the perceived problems associated with using FFRDCs, such as a lack of organic resources.

Finding B: Non-concur. The audit implies Air Force management of FFRDC fees is almost nonexistent. This is not the case. Air Force FFRDCs may receive fee-for-need to cover ordinary and necessary costs to meet their customers' needs. Such costs cover facilities and equipment, working capital, internal research, and other areas necessary for the operation of the FFRDCs. Air Force FFRDCs receiving a fee provide requirements as part of their annual planned workload reviews. Contracting officers review the fee requests and perform analyses of cash flow and working capital, as required by DFARS 215.972. Included in this review are an assessment of fee alternatives such as advance funding arrangements, providing government facilities and equipment, etc. Contracting officers may also request DCAA review as part of the annual fee negotiation process. During the course of FFRDC operations, contracting officers also monitor fee expenditures on a regular basis.

Sponsoring agreements may document a need for fee as outlined in OFFP Policy Letter 84-1 and FAR 35.017-1(d). No further documentation is necessary. In addition, contract clauses are not necessary because Air Force contracting officers already perform the reviews and analyses of fee justifications and monitor fee expenditures on a regular basis.

The report did not mention two recent developments at ESC and SMC that improve management of the FFRDC award fee. First, an example of improved management is the "award fee for need" system directed by SAF/AQ in FY93 FFRDC Spring Review for MITRE C3I. ESC management has developed an innovative incentive system for MITRE C3I to reduce cost and get the best possible value. ESC controls the amount of MITRE Sponsored Research with an incentive to improve their cost performance. This new approach led to unprecedented levels of cooperation

and is being transitioned to SMC management of Aerospace Corporation. Secondly, ESC's and SMC's cooperation with the DCAA identified areas for management improvements with Air Force FFRDC contracts. The rigorous reviews of the contracts have caused reductions in fees with Aerospace and MITRE C3I contracts.

RECOMMENDATIONS of Finding 3: Additional documentation regarding fees in the Sponsoring Agreement is unnecessary. Rationals to support the need for fee is already included in the sponsoring agreements through the guidelines set out in DFARS 215.972 and product center Operating Instructions. FAR 35.017(d) list two items for discretionary inclusion in the Sponsoring Agreement or other agency policy and procedures. The second item identifies "the considerations" that will affect fee negotiation "where payment of fees is determined by the sponsor(s) to be appropriate." The origin of this matter is OFFP Policy Letter No. 84-1, para 6(c)(2)(b), which was essentially the same except that it listed considerations to be used "...as determined appropriate by the sponsor." If the need for management fee gets incorporated into sponsoring agreements, it will likely amount to statements that are of little value. A sponsoring agreement is a long-term, fundamental document. Although it is considered for revisions in the annual review, it does not lend itself to short-term or volatile topics.

A common "fee for need" clause for all FFRDC contracts could standardize the approach and serve to clarify the procedure to be used for evaluating and documenting the fee need. Although most of the elements in the recommended clause are currently being requested of, and provided by, the Contractor, incorporation of the elements into the clause would make them a contractual requirement. If all elements to this recommendation were incorporated, however, they would require several changes in FAR 35.017 and possibly many other current regulatory and/or historical requirements. The clause is inadequate unless the text is also carried as a solicitation provision so that it covers the negotiation of new contracts. In terms of the subparagraph terms, they are acceptable with the exception of the requirement to explain benefits to "the sponsor." This is a significant change in the OFFP policy that now rests in the DFARS. DFARS 215.972(b)(v) refers to "unreimbursed costs deemed ordinary and necessary to the FFRDC."

Concur with determining whether prior year fees were used in accordance with approved fee requests unless the intent of "approve fee requests" is to mandate Government approval of detailed fee elements. We believe the contractor should have some reasonable latitude in this area. Currently, the annual

fee briefing by the contractor includes the use of prior year fee as well as working capital position. Do not concur with automatically reducing authorized fees for unexpended balances. The reduction should not be made without an analysis including the need and requirements for working capital. The emphasis on reducing fees as to "unexpended balances" would likely motivate contractors to expend all funds.

Concur with the need of performing an annual operating cycle analysis to assist in determining federally funded research and development center management fee needs. As a part of the fee for need analyses, the DCAA and the PCO performed a cash flow/operating cycle analysis. Using the results of the analysis and the justifications provided by the FFRDC, they established a fee amount. The approach used to perform this analysis has been consistently used and acceptable. If the FFRDCs retained earnings, like a for-profit corporation, there would not be a need to borrow funds and therefore no need to pay interest expenses with the fee.

The overall thrust of Finding B points to a fundamental overhaul of FFRDC fees. We think it appropriate to reexamine the fee process, but the approach should be comprehensive and well-thought out. Air Force FFRDCs have submitted Comprehensive Reviews when their five-year contract renewal cycles came due. The implication that all sponsors still have not conducted adequate reviews is inaccurate and misleading.

Finding C: Non-concur. By law, FFRDCs are isolated from the competitive pressures and commercial interests of profit-making concerns. They are not allowed to manufacture products or compete in the commercial marketplace, except for the operation of an FFRDC. Sponsoring agreements recognize that it is in the best interests of the government to ensure the independence and objectivity of FFRDCs. As a result, strict conflict of interest provisions are included in each FFRDC contract. No further clauses or certifications are necessary.

RECOMMENDATIONS of Finding C: There is no possibility of organizational conflicts of interest in the Aerospace, MITRE, or Lincoln Laboratory. The sponsoring agreements, product center regulations, and provisions in the contracts remove conflicts of interest.

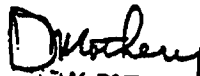
Members of Board of Trustees are already covered by the statutory requirements because of recent DOD Appropriations Acts. Having a file of FFRDC employees' disclosure statements available for CO review would not be useful unless the employees' work assignments were provided. This situation will likely escalate into an administrative morass and tend toward

Government supervision which is prohibited as "personal services". In non-PFRDC contractors the financial holdings of employees are not examined by company management or the Government. Prime contractors are fully aware that PFRDC employees are not Government employees.

2. In addition to the above comments on the report findings, the report is incomplete by not mentioning recent initiatives to further improve management of PFRDCs underway at ESC, SMC, HQ AFMC, and SAF/AQ. The report implies that PFRDCs are subject to widespread abuse, faulty contracting practices, and a lack of adequate oversight. AFMC product centers have recently undergone comprehensive reviews of Aerospace, MITRE, and Lincoln Laboratory which have thoroughly and rigorously analyzed PFRDC management. We believe the DOD IG report is factually incomplete because it ignores these management improvements.

3. If you have any questions regarding this, please contact Mr. Andrew Lynch, HQ AFMC/ENRM, DSN 787-5575.

FOR THE COMMANDER



DONALD R. BOTTERY, CM-15, DA
Major General
Air Force Materiel Command
Engineering and
Technology Division

Department of the Air Force Comments



DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON DC

NOV 10 1994

MEMORANDUM FOR SAF/AQXA

FROM: AF/XOXP

SUBJECT: Response to the DoD IG Working Draft, *Contracting Practices For the Use and Operations of DoD-Sponsored Federally Funded Research and Development Centers* (Project No. ICH-5012)

The following is our response to the subject audit from the RAND Project AIR FORCE (PAF) perspective:

a. **Finding A: Non-concur.** This finding appears to fault us for using the FFRDC for the explicit purpose for which it was created — as defined in FAR 35.017.

(1) The approach used to perform the audit was not applicable to PAF. The audit looked at a group of individual projects and indicated that each of these items must be reviewed and justified prior to the "non-competitive assignment of work to the FFRDC." Note that PAF research is approved as a complete research program via the Annual Research Plan. Annual research plan development involves continuous involvement among the Air Force and PAF IAW Air Force Advisory Group (AFAG) direction and guidance. The AFAG, is a board of Air Force general officers and senior civilian officials composed of the Vice Chief (AFAG Chairman), the deputy and assistant chiefs of staff, and senior executives from the Secretariat. Specifically, the process requires review and approval at the overall program level consistent with the PAF purpose, mission, and general scope. Additional constraints, as detailed in the PAF Sponsoring Agreement, also require all research to be sponsored (i.e., approved) by a general officer or SES equivalent. Then, a final corporate Air Force level (i.e., AFAG) control mechanism provides monitoring and oversight. The final proposal is submitted for AFAG consideration and approval each fall. The research agenda while jointly developed (i.e., Air Force and PAF) is approved solely by the AFAG.

(2) Page 13. Non-concur. The audit indicates that "the Air Force did not provide sufficient justification to support this assertion [PAF was more effective than in-house or other contractor resources] relative to the overall contractor or for the individual projects reviewed." This statement is in direct conflict with the *Final Acquisition Approval for Project AIR FORCE* dated 11 Aug 90. Further, citing cost or operational effectiveness as reasons for using PAF are based on a summary of other reasons. PAF represents an organization that has unique expertise/knowledge, special models/data bases, corporate knowledge, and a history of sustained superior performance, and is therefore more effective. The PAF contract has been priced, and cost has been determined to be fair and reasonable, and therefore effective.

(3) Page 15. The audit indicates "Formal market surveys were not conducted." This comment is not applicable to PAF since the PAF FFRDC contract action is made under conditions described in FAR 6.302-3, and FAR 5.202(a)(10) which gives the authority to not synopsise (or conduct a market survey).

(4) Page 17, Contracting Officer Considerations of Alternative Sources. Not applicable for PAF. As described previously, PAF research is approved via an annual research plan. The PAF contract is not a task letter contract; specifically, the PAF Contracting Officer did not issue modifications to the contract for individual taskings outside of the Annual Research Plan. Further, the Contracting Officer thoroughly reviews the Annual Research Plan and is available for advice and assistance whenever needed.

(5) Page 19, Conclusion. Non-concur. PAF is a distinctive, highly tailored effort; its mission requires an Air Force-wide perspective, an ability to deal with cross-cutting, multi-disciplinary problems, a responsibility to follow problems wherever they lead regardless of organizational boundaries, a focus on future Air Force needs and effectiveness, an institutional memory, and access to senior Air Force personnel and planning data. Further, while competition is important, it is specifically prohibited by FAR 35.017 for a FFRDC to compete with non-FFRDC entities. The in-place systems (i.e., government oversight, auditors, administrators, etc.) are reliable and are there to ensure the government receives the best value for the price.

(6) Pages 19-20, Recommendations. #1 & 2 not applicable, and #4 non-concur.

b. Finding B: Non-concur.

(1) Page 24, Need for Fee. Not applicable for PAF. The PAF contract includes a fee clause requiring an annual fee request. In addition, while the contract does not require an actual fee use report, since 1991 each fee request has included a report on actual fee use and projections for need for fee for the next contract year.

(2) Pages 24-5, Working capital analysis. Non-concur. The Contracting Officer has requested and received from DCAA at least since 1991, a working capital analysis for PAF. PAF does not have excess working capital.

Pages 26-30. Non-concur. DCAA performed audits on PAF fee requests and takes exception when applicable. The Contracting Officer relies on the information provided by DCAA, and uses that information to reach a fair and reasonable agreement on PAF's need for fee.

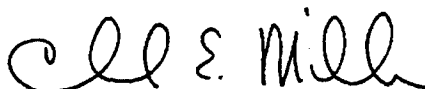
c. Finding C: Non-concur.

(1) The PAF contract contains the applicable Organizational Conflict of Interest (OCI) Clause. OCI certification is made annually at the aggregate level. Just as PAF research is approved at the program level, it is applicable to perform the OCI certification at the all encompassing program level.

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(2) Pages 45-6, Recommendations. **Non-concur.** In addition to the contract, the Sponsoring Agreement also prohibits OCI; accordingly, no additional clauses or certifications are necessary.

Please contact Lt Col Daryl Tomczyk at 73717 if you require additional information.

A handwritten signature in cursive script, reading "C. E. Miller".

CHARLES E. MILLER, Colonel, USAF
Chief, Strategic Planning Division
Directorate of Plans, DCS/P&O

Advanced Research Projects Agency Comments



ADVANCED RESEARCH PROJECTS AGENCY
3701 NORTH FAIRFAX DRIVE
ARLINGTON, VA 22203-1714



NOV 15

MEMORANDUM FOR DIRECTOR, DEFENSE RESEARCH AND ENGINEERING

SUBJECT: Audit Report on Contracting Practices for the Use and
Operations of DoD-Sponsored Federally Funded Research
and Development Centers (Project No. 1CH-5012)

In response to the DoD Office of Inspector General's
memorandum of September 15, 1994, the Advanced Research Projects
Agency's (ARPA) comments are provided in the attachment.

The ARPA point of contact on this matter is Dr. John Salasin
at (703) 696-2318.


Ron H. Register
Deputy Director for Management

Attachment

Contracting Practices for the Use and Operations of DoD Sponsored Federally Funded Research and Development Centers

Finding A: Use of FFRDCs

Recommendation 2 recommends that procedures be established for the primary FFRDC sponsor (ARPA for the SEI) to prepare justifications for the noncompetitive assignment of projects to the FFRDC that document:

Unique capabilities

Alternatives considered

Specific characteristics of effectiveness that justify assignment.

Concur: There is no objection to this recommendation, depending upon its implementation.

The SEI has a policy that it will accept reimbursable tasks that are consistent with its core-funded mission and tasks planned in support of that mission -- to improve the software technology in DoD programs. While an alternative source might be found for an individual task (or project), the assignment of the individual project to the alternative source might not provide the same overall benefit to the DoD or Service. It might not, for example, allow the methodology being employed to be evaluated and the results of this evaluation to be made public.

The use of the term "projects" suggests the requirement for a (full blown) Sole Source Justification (and, as implied by recommendations in Finding C, Conflicts of interest determination) for each task added to the contract. The implication of the findings and recommendations is that each task to be added to an FFRDC contract must be judged in isolation -- making it impossible for these (or other) organizations to develop the critical mass necessary to support their mission. The justifications need to be based on both characteristics of an individual task and on the benefits obtained by having a group of related tasks performed by the same organization.

Recommendation 4 requires that DDR&E establish procedures to "Use broad area announcements and competitive solicitations to assess the potential for non-FFRDC contractors to perform research projects."

Partially Concur: As discussed with regard to Recommendation 2, the selection of a performer based on specific task requirements and capabilities may be sub-optimal with respect to overall Service or DoD needs; however, this consideration may be unique to the SEI, since it has a DoD-wide mission that transcends individual tasks.

Finding B: Justification and Analyses of Management Fee Requirements

Non Concur: The SEI does not collect a management fee.

Finding C: Conflicts of Interest Issues

The Draft Report recommends (Recommendation 1.1, page 45) that the sponsor of each project certify that the statement of work has been reviewed for potential and actual conflicts of interest.

Non Concur: There are adequate safeguards for conflicts of interest since the SEI contract includes a conflict of interest clause.

In addition, SEI has a policy (Policy P200-01, Conflicts of Interest/Commitment, dated April 30, 1992) to address individual employee's activities that might be interpreted as actual and apparent conflicts of interest situations. This is in addition to the policy on conflicts of interest of its parent organization (Carnegie Mellon University).

Requiring all project sponsors to provide the recommended certification does not seem warranted if the FFRDC and contracting office for the FFRDC have established appropriate policies.

Recommendation 1.b.1 requiring "FFRDCs to file marketing consultant ... certificates...for each contract and each project assigned to the contracts" appears excessive and burdensome given that recommendation 1.a requires that each SOW be reviewed by the sponsor for potential and actual conflicts of interest. Recommendation 1.b.1 might be reasonable if applied to each contract, rather than to each task in the contract. (However, see comments with respect to Recommendation 1.1, above.)

Recommendation 1.c requires that IPA appointments for all FFRDC personnel be reviewed for potential conflicts of interest. While this is reasonable (all temporary appointments should be reviewed for conflicts of interest), the examples provided in the Findings and Recommendation 3.a (page 46) imply a definition of conflicts of interest that will be damaging to DoD programs

Recommendation 3.a suggests that the DoD FFRDC Management Plan be revised to "exclude FFRDC personnel [DoD and non-DoD] from assignment to DoD positions under the Intergovernmental Personnel Act that involve oversight or management responsibilities over a FFRDC."

Advanced Research Projects Agency Comments

Partially Concur: This recommendation is an improvement over words in the previous draft that sought to prohibit any IPA appointments to DoD from FFRDCs. However:

1) The single example cited to justify this recommendation, that of an IDA IPA overseeing the SEI, is not relevant to the recommendation. The assignment of an FFRDC employee to oversee another FFRDC seems similar to having a University employee (on an IPA appointment) oversee work at another University -- a common occurrence. The fact that the SEI was established based on a report that was prepared by a broad group that included the IDA participants is, similarly, not grounds for disqualifying the IDA IPA. Should nuclear physicists who participate (as university members) in developing a research agenda be prohibited from providing their expertise to the Government in managing that program? Should a nuclear physicist who merely works at the same institution as the physicist who participated in developing the recommendations also be prohibited?

2) The findings paragraph entitled "Performing Inherently Governmental Functions" (Page 43) states that: "The FFRDC employee was performing an inherently governmental function..." The ARPA General Counsel has previously provided information documenting that this is the intent of the IPA statute (?).

3) It is unclear whether "oversight or management responsibilities" refer to the individual with primary responsibility (the COR), those with significant involvement with providing direction and review (the COTR), and/or all individuals in the management chain for the COR and/or COTR?