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SUPPLEMENTARY INFORMATION: See the information provided in the Direct Final action of the same title which is located in the Rules and Regulations section of this **Federal Register**.

Authority: 42 U.S.C. 7401 *et seq.*

Dated: September 5, 2001.

Jack W. McGraw,

Acting Regional Administrator, Region VIII.

[FR Doc. 01-23597 Filed 9-20-01; 8:45 am]

BILLING CODE 6560-50-P

DEPARTMENT OF DEFENSE

48 CFR Part 215

[DFARS Case 2000-D018]

Defense Federal Acquisition Regulation Supplement; Changes to Profit Policy

AGENCY: Department of Defense (DoD).

ACTION: Proposed rule with request for comments.

SUMMARY: DoD is proposing to amend the Defense Federal Acquisition Regulation Supplement (DFARS) to make changes to DoD profit policy that would reduce the emphasis on facilities investment, add general and administrative expense to the cost base used in determining profit objectives, increase emphasis on performance risk, and encourage contractor cost efficiency.

DATES: Comments on the proposed rule should be submitted to the address shown below on or before November 20, 2001, to be considered in the formation of the final rule.

ADDRESSES: Respondents may submit comments directly on the World Wide Web at <http://emissary.acq.osd.mil/dar/dfars.nsf/pubcomm>. As an alternative, respondents may e-mail comments to: dfars@acq.osd.mil. Please cite DFARS Case 2000-D018 in the subject line of e-mailed comments.

Respondents that cannot submit comments using either of the above methods may submit comments to: Defense Acquisition Regulations Council, Attn: Ms. Sandra Haberlin, OUSD (AT&L) DP (DAR), IMD 3C132, 3062 Defense Pentagon, Washington, DC

20301-3062; facsimile (703) 602-0350. Please cite DFARS Case 2000-D018.

At the end of the comment period, interested parties may view public comments on the World Wide Web at <http://emissary.acq.osd.mil/dar/dfars.nsf>.

FOR FURTHER INFORMATION CONTACT: Ms. Sandra Haberlin, (703) 602-0289.

SUPPLEMENTARY INFORMATION:

A. Background

This rule proposes amendments to the profit policy in DFARS Subpart 215.4. DoD published a proposed rule at 65 FR 45574 on July 24, 2000. That rule proposed to—

- Add general and administrative expense to the cost base used to establish profit objectives;
- Reduce the values assigned to facilities capital employed by 50 percent, with the objective, over time, to eliminate completely facilities investment as a factor in establishing profit objectives on sole-source, negotiated contracts;
- Offset these changes by increasing the values for performance risk by 1 percentage point and decreasing the values for contract type risk by 0.5 percentage point; and
- Add a special factor for cost efficiency to encourage cost reduction efforts.

Twelve sources submitted comments in response to the proposed rule. Due to the complexity of the issues raised in the comments received, DoD published a notice of public meeting at 65 FR 69895 on November 21, 2000. The public meeting was held on December 12, 2000. After considering written comments received in response to the proposed rule, and verbal comments provided during the public meeting, DoD is publishing a revised proposed rule. The major differences between the initial proposed rule and the revised proposed rule are—

- Facilities capital employed. Over a 4-year period, the initial rule eliminated facilities capital employed as a factor in developing profit objectives. The revised rule retains 50 percent of the current values for equipment as an incentive for modernization of equipment.
- Contract type and performance risks. The intention of the proposed profit policy changes is to revise the incentive structure of the policy and not to increase or decrease average profit objectives. Changes to contract type and performance risks in the initial proposed rule were made to offset the addition of general and administrative expense to the cost base and the

elimination of facilities capital employed. Since the revised proposed rule restores a portion of facilities capital employed, offsets to performance risk contained in the initial rule have been reduced. Likewise, the revised rule restores the current values for contract type risk, that had been reduced by 0.5 percent in the initial rule.

This rule was not subject to Office of Management and Budget review under Executive Order 12866, dated September 30, 1993.

B. Regulatory Flexibility Act

The proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*, because most contracts awarded to small entities are below \$500,000, are based on adequate price competition, or are for commercial items, and do not require submission of cost or pricing data. Therefore, an initial regulatory flexibility analysis has not been performed. Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected DFARS subpart also will be considered in accordance with 5 U.S.C. 610. Such comments should be submitted separately and should cite DFARS Case 2000-D018.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the rule does not impose any information collection requirements that require the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

List of Subjects in 48 CFR Part 215

Government procurement.

Michele P. Peterson,

Executive Editor, Defense Acquisition Regulations Council.

Therefore, DoD proposes to amend 48 CFR part 215 as follows:

1. The authority citation for 48 CFR part 215 continues to read as follows:

Authority: 41 U.S.C. 421 and 48 CFR Chapter 1.

PART 215—CONTRACTING BY NEGOTIATION

215.404-4 [Amended]

2. Section 215.404-4 is amended by removing paragraph (c)(2)(C)(1)(i) and redesignating paragraphs (c)(2)(C)(1)(ii) through (iv) as paragraphs (c)(2)(C)(1)(i) through (iii), respectively.

3. Sections 215.404-71-1 and 215.404-71-2 are revised to read as follows:

215.404-71-1 General.

(a) The weighted guidelines method focuses on four profit factors—

- (1) Performance risk;
- (2) Contract type risk;
- (3) Facilities capital employed; and
- (4) Cost efficiency.

(b) The contracting officer assigns values to each profit factor; the value multiplied by the base results in the profit objective for that factor. Except for the cost efficiency special factor, each profit factor has a normal value and a designated range of values. The normal value is representative of average conditions on the prospective contract

when compared to all goods and services acquired by DoD. The designated range provides values based on above normal or below normal conditions. In the price negotiation documentation, the contracting officer need not explain assignment of the normal value, but should address conditions that justify assignment of other than the normal value. The cost efficiency special factor has no normal value. The contracting officer must exercise sound business judgment in selecting a value when this special factor is used (see 215.404-71-5).

215.404-71-2 Performance risk.

(a) *Description.* This profit factor addresses the contractor's degree of risk in fulfilling the contract requirements. The factor consists of two parts:

- (1) Technical—the technical uncertainties of performance.
- (2) Management/cost control—the degree of management effort necessary—

- (i) To ensure that contract requirements are met; and
- (ii) To reduce and control costs.

(b) *Determination.* The following extract from the DD Form 1547 is annotated to describe the process.

Item	Contractor risk factors	Assigned weighting	Assigned value	Base (Item 20)	Profit objective
21.	Technical	(1)	(2)	N/A	N/A
22.	Management/Cost Control	(1)	(2)	N/A	N/A
23.	Reserved				
24.	Performance Risk (Composite)	N/A	(3)	(4)	(5)

(1) Assign a weight (percentage) to each element according to its input to the total performance risk. The total of the two weights equals 100 percent.

(2) Select a value for each element from the list in paragraph (c) of this subsection using the evaluation criteria

in paragraphs (d) and (e) of this subsection.
(3) Compute the composite as shown in the following example:

	Assigned weighting percent	Assigned value percent	Weighted value percent
Technical	60	5.0	3.0
Management/Cost Control	40	4.0	1.6
Composite Value	100		4.6

(4) Insert the amount from Block 20 of the DD Form 1547. Block 20 is total contract costs, excluding facilities capital cost of money.

(5) Multiply (3) by (4).
(c) *Values: Normal and designated ranges.*

	Normal value percent	Designated range percent
Standard	5	3 to 7
Technology Incentive	9	7 to 11

(1) *Standard.* The standard designated range should apply to most contracts.
(2) *Technology incentive.* For the technical factor only, contracting officers may use the technology incentive range for acquisitions that include development, production, or application of innovative new technologies. The technology incentive range does not apply to efforts restricted to studies, analyses, or demonstrations that have a technical report as their primary deliverable.
(d) *Evaluation criteria for technical.*

(1) Review the contract requirements and focus on the critical performance elements in the statement of work or specifications. Factors to consider include—

- (i) Technology being applied or developed by the contractor;
- (ii) Technical complexity;
- (iii) Program maturity;
- (iv) Performance specifications and tolerances;
- (v) Delivery schedule; and
- (vi) Extent of a warranty or guarantee.

(2) *Above normal conditions.*

- (i) The contracting officer may assign a higher than normal value in those cases where there is a substantial technical risk. Indicators are—

- (A) Items are being manufactured using specifications with stringent tolerance limits;
- (B) The efforts require highly skilled personnel or require the use of state-of-the-art machinery;
- (C) The services and analytical efforts are extremely important to the Government and must be performed to exacting standards;

(D) The contractor's independent development and investment has reduced the Government's risk or cost;
(E) The contractor has accepted an accelerated delivery schedule to meet DoD requirements; or
(F) The contractor has assumed additional risk through warranty provisions.

- (ii) Extremely complex, vital efforts to overcome difficult technical obstacles that require personnel with exceptional abilities, experience, and professional credentials may justify a value significantly above normal.
- (iii) The following may justify a maximum value—

- (A) Development or initial production of a new item, particularly if performance or quality specifications are tight; or
- (B) A high degree of development or production concurrency.

(3) *Below normal conditions.*

- (i) The contracting officer may assign a lower than normal value in those cases where the technical risk is low. Indicators are—

- (A) Requirements are relatively simple;

(B) Technology is not complex;
(C) Efforts do not require highly skilled personnel;
(D) Efforts are routine;
(E) Programs are mature; or
(F) Acquisition is a follow-on effort or a repetitive type acquisition.

(ii) The contracting officer may assign a value significantly below normal for—

(A) Routine services;
(B) Production of simple items;
(C) Rote entry or routine integration of Government-furnished information; or
(D) Simple operations with Government-furnished property.

(4) *Technology incentive range.*

(i) The contracting officer may assign values within the technology incentive range when contract performance includes the introduction of new, significant technological innovation. Use the technology incentive range only for the most innovative contract efforts. Innovation may be in the form of—

(A) Development or application of new technology that fundamentally changes the characteristics of an existing product or system and that results in increased technical performance, improved reliability, or reduced costs; or

(B) New products or systems that contain significant technological advances over the products or systems they are replacing.

(ii) When selecting a value within the technology incentive range, the contracting officer should consider the relative value of the proposed innovation to the acquisition as a whole. When the innovation represents a minor benefit, the contracting officer should consider using values less than the norm. For innovative efforts that will have a major positive impact on the product or program, the contracting officer may use values above the norm.

(e) *Evaluation criteria for management/cost control.*

(1) The contracting officer should evaluate—

(i) The contractor's management and internal control systems using contracting office information and reviews made by field contract administration offices or other DoD field offices;

(ii) The management involvement expected on the prospective contract action;

(iii) The degree of cost mix as an indication of the types of resources applied and value added by the contractor;

(iv) The contractor's support of Federal socioeconomic programs;
(v) The expected reliability of the contractor's cost estimates (including the contractor's cost estimating system);
(vi) The adequacy of the contractor's management approach to controlling cost and schedule; and

(vii) Any other factors that affect the contractor's ability to meet the cost targets (e.g., foreign currency exchange rates and inflation rates).

(2) *Above normal conditions.*

(i) The contracting officer may assign a higher than normal value when there is a high degree of management effort. Indicators of this are—

(A) The contractor's value added is both considerable and reasonably difficult;

(B) The effort involves a high degree of integration or coordination;

(C) The contractor has a good record of past performance;

(D) The contractor has a substantial record of active participation in Federal socioeconomic programs;

(E) The contractor provides fully documented and reliable cost estimates;

(F) The contractor makes appropriate make-or-buy decisions; or

(G) The contractor has a proven record of cost tracking and control.

(ii) The contracting officer may justify a maximum value when the effort—

(A) Requires large scale integration of the most complex nature;

(B) Involves major international activities with significant management coordination (e.g., offsets with foreign vendors); or

(C) Has critically important milestones.

(3) *Below normal conditions.*

(i) The contracting officer may assign a lower than normal value when the management effort is minimal. Indicators of this are—

(A) The program is mature and many end item deliveries have been made;

(B) The contractor adds minimal value to an item;

(C) The efforts are routine and require minimal supervision;

(D) The contractor provides poor quality, untimely proposals;

(E) The contractor fails to provide an adequate analysis of subcontractor costs;

(F) The contractor does not cooperate in the evaluation and negotiation of the proposal;

(G) The contractor's cost estimating system is marginal;

(H) The contractor has made minimal effort to initiate cost reduction programs;

(I) The contractor's cost proposal is inadequate;

(J) The contractor has a record of cost overruns or another indication of unreliable cost estimates and lack of cost control; or

(K) The contractor has a poor record of past performance.

(ii) The following may justify a value significantly below normal—

(A) Reviews performed by the field contract administration offices disclose unsatisfactory management and internal control systems (e.g., quality assurance, property control, safety, security); or

(B) The effort requires an unusually low degree of management involvement.

4. Section 215.404-71-3 is amended as follows:

a. In paragraph (b), in the table, by removing the heading "Base (Item 18)" and adding in its place "Base (Item 20)"; and

b. By revising paragraph (b)(2) and the introductory text of paragraph (e)(2) to read as follows:

215.404-71-3 Contract type risk and working capital adjustment.

* * * * *

(b) * * *

(2) Insert the amount from Block 20, i.e., the total allowable costs excluding facilities capital cost of money.

* * * * *

(e) * * *

(2) Total costs equal Block 20 (i.e., all allowable costs excluding facilities capital cost of money), reduced as appropriate when—

* * * * *

5. Section 215.404-71-4 is amended as follows:

a. In paragraph (a), in the first sentence, by removing the word "aggressive";

b. In paragraph (b)(2)(ii), in the first and last sentences, by removing "Block 18" and adding in its place "Block 20"; and

c. By revising paragraphs (c) and (d) to read as follows:

215.404-71-4 Facilities capital employed.

* * * * *

(c) *Values: Normal and designated ranges.* These are the normal values and ranges. They apply to all situations.

Asset type	Normal value percent	Designated range
Land	0	N/A
Buildings	0	N/A

Asset type	Normal value percent	Designated range
Equipment	17.5	10% to 25%

(d) *Evaluation criteria.*

(1) In evaluating facilities capital employed, the contracting officer—

(i) Should relate the usefulness of the facilities capital to the goods or services being acquired under the prospective contract;

(ii) Should analyze the productivity improvements and other anticipated industrial base enhancing benefits resulting from the facilities capital investment, including—

(A) The economic value of the facilities capital, such as physical age, undepreciated value, idleness, and expected contribution to future defense needs; and

(B) The contractor's level of investment in defense related facilities as compared with the portion of the contractor's total business that is derived from DoD; and

(iii) Should consider any contractual provisions that reduce the contractor's risk of investment recovery, such as termination protection clauses and capital investment indemnification.

(2) *Above normal conditions.*

(i) The contracting officer may assign a higher than normal value if the facilities capital investment has direct, identifiable, and exceptional benefits. Indicators are—

(A) New investments in state-of-the-art technology that reduce acquisition cost or yield other tangible benefits such as improved product quality or accelerated deliveries; or

(B) Investments in new equipment for research and development applications.

(ii) The contracting officer may assign a value significantly above normal when there are direct and measurable benefits in efficiency and significantly reduced acquisition costs on the effort being priced. Maximum values apply only to those cases where the benefits of the facilities capital investment are substantially above normal.

(3) *Below normal conditions.*

(i) The contracting officer may assign a lower than normal value if the facilities capital investment has little benefit to DoD. Indicators are—

(A) Allocations of capital apply predominantly to commercial item lines;

(B) Investments are for such things as furniture and fixtures, home or group level administrative offices, corporate aircraft and hangars, gymnasiums; or

(C) Facilities are old or extensively idle.

(ii) The contracting officer may assign a value significantly below normal when a significant portion of defense manufacturing is done in an environment characterized by outdated, inefficient, and labor-intensive capital equipment.

6. Section 215.404–71–5 is added to read as follows:

215.404–71–5 Cost efficiency factor.

(a) This special factor provides an incentive for contractors to reduce costs. To the extent that the contractor can demonstrate cost reduction efforts that benefit the pending contract, the contracting officer may increase the prenegotiation profit objective by an amount not to exceed 4 percent of total objective cost (Block 20 of the DD Form 1547) to recognize these efforts.

(b) To determine if using this factor is appropriate, the contracting officer must consider criteria, such as the following, to evaluate the benefit the contractor's cost reduction efforts will have on the pending contract:

(1) The contractor's participation in Single Process Initiative improvements;

(2) Actual cost reductions achieved on prior contracts;

(3) Reduction or elimination of excess or idle facilities;

(4) The contractor's cost reduction initiatives (e.g., competition advocacy programs, technical insertion programs, obsolete parts control programs, spare parts pricing reform, value engineering, the use of metrics to drive down key costs);

(5) The contractor's adoption of process improvements to reduce costs;

(6) Subcontractor cost reduction efforts; or

(7) The contractor's effective incorporation of commercial items and processes.

(c) When selecting the percentage to use for this special factor, the contracting officer has maximum flexibility in determining the best way to evaluate the benefit the contractor's cost reduction efforts will have on the pending contract. However, the contracting officer must consider the impact that quantity differences, learning, changes in scope, and economic factors such as inflation and deflation will have on cost reduction.

215.404–72 [Amended]

7. Section 215.404–72 is amended as follows:

a. In paragraph (b)(1)(i), in the first sentence, by removing “Block 18” and adding in its place “Block 20”;

b. By removing paragraph (b)(1)(ii); and

c. By redesignating paragraph (b)(1)(iii) as paragraph (b)(1)(ii).

8. Section 215.404–73 is amended by revising paragraph (b) introductory text and the first sentence of paragraph (b)(2)(i) to read as follows:

215.404–73 Alternate structured approaches.

* * * * *

(b) The contracting officer may design the structure of the alternate, but it must include—

* * * * *

(2) * * *

(i) The contracting officer must reduce the overall prenegotiation profit objective by the amount of facilities capital cost of money. * * *

* * * * *

9. Section 215.404–74 is amended by revising the introductory text and paragraph (c) to read as follows:

215.404–74 Fee requirements for cost-plus-award-fee contracts.

In developing a fee objective for cost-plus-award-fee contracts, the contracting officer must—

* * * * *

(c) Apply the offset policy in 215.404–73(b)(2) for facilities capital cost of money, i.e., reduce the base fee by the amount of facilities capital cost of money; and

* * * * *

[FR Doc. 01–23690 Filed 9–20–01; 8:45 am]
BILLING CODE 5000–04–U

DEPARTMENT OF DEFENSE

48 CFR Part 252

[DFARS Case 2000–D027]

Defense Federal Acquisition Regulation Supplement; Tax Exemptions (Italy)

AGENCY: Department of Defense (DoD).

ACTION: Proposed rule with request for comments.

SUMMARY: DoD is proposing to amend the Defense Federal Acquisition Regulation Supplement (DFARS) to update requirements pertaining to tax