

Commercial Item Definition Facilitates Affordable Military Products

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A number of recent acquisition reform initiatives have helped facilitate the use of commercial items in meeting defense requirements. While the new laws recognize that commercial items can and should be acquired at all tiers, the majority of the attention has been directed at the scenario where the government buys commercial products directly from commercial firms. In the case of weapon system acquisitions, however, this is unlikely. The real opportunity for both streamlining and savings is to be found at the Department of Defense (DOD) prime/subcontractor interface.

The defense prime on the military products from commercial lines (MPCL) pilot program was able to demonstrate the purchase of electronic modules for the Air Force F-22 Raptor fighter and the Army RAH-66 Comanche helicopter as commercial items. The subcontractor on this project was a purely commercial firm that had never done defense work. By "going commercial," the number of terms and conditions (flow-downs) was reduced from 30 *Federal Acquisition Regulation (FAR)/Defense FAR Supplement (DFARS)* clauses to three. The implications of this event for defense manufacturing are significant. It has the potential to both simplify the acquisition process and make defense work more attractive to the commercial sector. Further, lower-cost defense products will be available from a wider selection of suppliers.

MPCL PROGRAM BACKGROUND

The MPCL is an Air Force industrial base pilot program administered by the Manufacturing Technology Division of the Air Force Research Laboratory. The primary goal of the program is to demonstrate the production of military components on a commercial line at lower cost and comparable quality to those produced on a dedicated military line. A commercial automotive manufacturing line is producing demonstration electronic boards matching the requirements of the F-22 and RAH-66.

A secondary objective of the program is to share lessons learned with the acquisition community. The MPCL program has been documenting the policies, regulations, and situations that hinder or complicate access to the commercial sector and the adoption of commercial practices (see endnotes 1-9). One of the most trying issues has been dealing with the issue of commerciality and the commercial item definition.

The advertised benefits from commercial acquisitions (lower costs, shorter lead times, and relief from statutory reporting and compliance requirements) are realized only if the procurement falls under the definition of a commercial item. A procurement that does not meet the criteria for a commercial item acquisition will have numerous government-unique terms and conditions. This in turn leads to extensive reporting, compliance, and

oversight requirements that deter many commercial firms from seeking defense work. This was the situation faced by the MPCL program in its early stages.

After two and a half years, MPCL was able to overcome the real and perceived barriers surrounding commercial item acquisition. Success can be attributed collectively to three factors. The first is the perseverance of the pilot program team members. The second stems from a change in the law with the passage of the Federal Acquisition Streamlining Act (FASA) and the Federal Acquisition Reform Act (FARA). The implementing regulations from FASA and FARA allow a broad interpretation of what constitutes a commercial item acquisition. Third, the acquisition reform environment is facilitating a change from risk-averse procurement practices to those best described as risk-management ones. This last factor helped the MPCL team overcome the cultural resistance that still exists within both the government and defense industry.

The implications from this achievement are far reaching. Defense primes now have the ability (if they choose to exercise it) to more easily and affordably take advantage of the capabilities, technologies, and products of purely commercial firms as subcontractors. For world-class commercial firms, defense work is more inviting. Defense work no longer means changing internal accounting and management practices to accommodate a single customer. More important, this change will help expand the defense industrial base into a national industrial base. It is hoped that the success of MPCL will encourage other programs to actively pursue purely commercial sources in meeting defense requirements. The MPCL team's experiences and lessons learned in commercial acquisition follow.

SELECTING THE CONTRACTOR

The announcement for a pilot program to promote commercial-military integration was published in the *Commerce Business Daily (CBD)* on February 2, 1993. The CBD announcement resulted in eight offerors. Of these, only TRW's Avionics Systems Division (ASD) proposed subcontracting to a commercial firm as a way to demonstrate dual-use production. ASD, a division with extensive military experience, would redesign the F-22 avionics modules so that they could be manufactured by ASD's purely commercial TRW sister division, the Automotive Electronics Group--North America (AEN).

The AEN production facility was chosen because some of its primary products, such as airbag sensor modules and diesel engine control modules, have technology similarities to the avionics modules of the pilot program. AEN manufactures automotive electronic products for commercial customers such as Chrysler and Caterpillar.

OBJECTIONS TO GOVERNMENT TERMS AND CONDITIONS

Before contract award, AEN expressed serious objections to the many terms and conditions that would be flowed down to them from ASD. Figure 1 provides a list of the *FAR* and *DFARS* clauses that AEN would have to deal with.

The list alone is intimidating to a company that has never done defense business. AEN took exception to the extensive reporting, compliance, and oversight requirements that were part of this government effort. There were four major areas that caused problems for AEN. These same issues may help explain why many other commercial firms are reluctant (or refuse) to pursue defense work. The following addresses some of the major problem areas and gives the reasons for AEN's objections.

Data Rights/intellectual Property

In commercial contracts, it is standard practice for the supplier to retain data rights. AEN usually does design and development with its own funds and therefore retains all rights. AEN was concerned that by providing such information, its competitors would gain access to designs and technical data, thus jeopardizing its competitive position.

Certifications

AEN found many of the certification requirements to be duplications of existing state and federal law. Since it was already obligated to comply, it did not see the need for a redundant requirement. As a market-driven firm, it was unwilling to establish and maintain a nonvalue-added reporting system for just one (and, in this case, minor) customer.

Socioeconomic Provisions

As with certifications, many of these requirements already were imposed on companies through public law and executive order. AEN felt that government socioeconomic programs should not be added to its contract. It objected to the added cost of ensuring that it remain compliant. It also objected to the audit rights that these clauses give the government to verify compliance.

The Biggest Barrier: Cost and Pricing Data

The most contentious issue, however, dealt with the numerous cost and pricing data requirements of the Truth in Negotiations Act (TINA) and the cost accounting standards (CAS). Because AEN is a commercial production firm, it has not had a previous business relationship with the government. Consequently, unlike a typical defense contractor, AEN has never generated cost data that is compliant with CAS.

As a commercial entity, AEN instead maintains an accounting system that is compliant with generally accepted accounting principles. AEN's prices are driven more by existing market conditions and less by the costs they incur. Unlike CAS, AEN's accounting data is collected at a generalized level. Costs are not differentiated between allowable and unallowable. AEN's source documents are maintained in accordance with the federal tax code and with the practices of its industry.

FIGURE 1: Clauses Applicable to the Subcontract Before Commercial Item Status

Clause	Title & Date
52.203-7	Anti-Kickback Procedures (October 1988)
52.212-8	Defense Priority and Allocation Requirements
	Examination of Records by Comptroller General (February 1993)-Note: Buyer will assume costs associated with Seller's providing records to auditors in support of any audit under this requirement.
52.215-2	Audit-Negotiation (February 1993)-Note: Buyer will assume costs associated with Seller's providing records to auditors in support of any audit under this requirement.
52.215-24	Subcontractor Cost or Pricing Data (December 1991)
52.215-37	Termination of Defined Benefit Pension Plan (September 1989)
52.215-39	Revision or Adjustment of Plans for Post-retirement Benefits Other than Pensions (July 1991)
52.220-3	Utilization of Labor Surplus Area Concerns (April 1984)
52.220-4	Labor Surplus Area Subcontracting Program (April 1984)
52.222-1	Notice to the Government of Labor Disputes (April 1984)
52.222-20	Walsh-Healey Public Contracts Act (April 1984)
52.222-26	Equal Opportunity (April 1984)
52.222-35	Affirmative Action for Special Disabled and Vietnam Era Veterans (April 1984)
52.222-36	Affirmative Action for Handicapped Workers (April 1984)
52.222-37	Employment Reports on Special Disabled Veterans and Veterans of the Vietnam Era (January 1988)
52.223-2	Clean Air and Water (April 1984)
52.225-11	Restrictions on Certain Foreign Purchases (May 1992)
52.227-1	Authorization and Consent (April 1984) - Alternate I (April 1984)
52.227-2	Notice and Assistance Regarding Patent and Copyright Infringement (April 1984)
52.243-1	Changes-Fixed Price
52.246-23	Limitation of Liability (April 1984)
252.203-7001	Special Prohibition on Employment (April 1993)
252.209-7000	Acquisition from Subcontractors Subject to On-site Inspection Under the Intermediate-Range Nuclear Treaty (December 1991)
252.225-7009	Duty Free Entry - Qualifying Country End Products and Supplies (December 1991)
252.225-7014	Preference for Domestic Specialty Metals (December 1991), Alt 1, (December 1991)
252.225-7025	Foreign Source Restrictions (April 1993)
252.227-7013	Rights in Technical Data and Computer Software (October 1988)
252.227-7018	Restrictive Markings on Technical Data (October 1988)-Note: Buyer will provide training to the Seller at the Seller's facility.
252.203-7029	Identification of Technical Data (April 1988)
252.203-7000	Statutory Prohibition on Compensation to Former Department of Defense Employees (December 1991)

To become CAS compliant, AEN would have to incur substantial initial and continuing costs. This in turn would lead to significantly higher prices for its products. Ironically, this increase could reduce the attractiveness of AEN as a low-cost source of military electronic boards. AEN found those clauses that permit the government to audit books, records, documents, and other data totally unacceptable. It believes that detailed financial data is confidential and disclosing this information might jeopardize its competitive advantage.

A STOPGAP SOLUTION

It took more than three months of negotiations to come up with a set of terms and conditions acceptable to AEN. The lion's share of the problem was resolved when the contracting officer (CO) sought an individual exemption for the requirement to submit certified cost and pricing data. In February 1994, in accordance with (then) *FAR* 15.804-3 (g), the head of the contracting office approved a determination and finding that granted AEN relief from the requirement to report its labor costs. Even with this exemption, however, AEN was informed that it was still subject to audits under *FAR* 52.215-2 and to an examination of its records by the comptroller general under *FAR* 52.215-1.

Because the exemption was only for the labor portion of the effort, another workaround for materials was necessary to keep the program on schedule and viable. To remedy this second problem, ASD agreed to purchase the necessary materials and provide them to AEN. As a defense contractor, ASD had the necessary accounting infrastructure to accommodate the requirements of TINA and CAS. This work-around would eliminate many of the government reporting and compliance clauses that AEN found objectionable. It also would reduce the requirement for government oversight of AEN by the Defense Contract Management Command (DCMC).

Though necessary to keep the program on schedule, this compromise was suboptimal. It would be a far more convincing pilot demonstration of dual-use manufacturing if the commercial supplier that was making the military product could also buy the parts.

PURSUING OTHER OPTIONS

In January 1995, both the government and TRW members of the pilot program team met to assess other options. The dilemma: how do you take advantage of a purely commercial firm like AEN without imposing objectionable government-unique terms and conditions? The team came up with three possible courses of action. The first sought to use the commercial item acquisition procedures of *DFARS* 211. Although the existing commercial item definition was restrictive, the team generated a justification for a commercial item determination.

On May 10, 1995, the CO requested a legal opinion on the commercial status of the MPCL modules under the proposed new FASA definition of commercial items. On May 18, 1995, the team received a negative legal opinion stating that the MPCL modules cannot be construed as commercial items under either *DFARS* 211 or the proposed Commercial Item Acquisition section of FASA. The MPCL team considered this decision a disappointing setback.

The second option was to seek individual waivers for each of the clauses that AEN found objectionable. This would be a Herculean effort with little promise of success. The team would be forced to provide lengthy documentation to justify each waiver. To complicate the process, the ultimate approving authority varied from a service command to a service secretary at the DOD level. The team debated whether it would be better to request all of the waivers as a block or send them out individually. Sending them individually would probably result in a number of individual waivers, but how beneficial would a partial exemption be? Would AEN be more willing to accept defense work with half as many government-unique terms and conditions? The team finally concluded that seeking waivers to more than 30 terms and conditions was neither feasible nor practical.

THE FINAL OPTION: FASA

The third option was to take advantage of forthcoming legislation. In fall 1994, Congress passed FASA. This new legislation was advertised as a major breakthrough in acquisition reform. It would streamline the process, minimize government-unique requirements, and modify a number of areas identified as major barriers to acquisition reform. The most significant of these was a change to TINA. FASA would waive the requirement for certified cost and pricing data and exempt commercial item acquisitions from a number of government-unique statutes to facilitate access to commercial firms.

One of FASA's most important provisions addresses the acquisition of commercial items. It established a first-tier preference for commercial products. FASA also expanded the definition of commercial item to include products customarily purchased by the general public. Items not yet available in the commercial marketplace would be considered commercial items if they evolved out of commercial items, as would products not yet available in the commercial marketplace but available in time to meet government requirements.

On March 1, 1995, the interim FASA rules on the acquisition of commercial items were published in the *Federal Register* for public comment. Members of the MPCL team felt that the proposed rules did not adequately address their situation. The team felt that the proposed definition needed to be expanded or clarified to better accommodate integrated manufacturing. Two approaches to address the problem were pursued in parallel. The first sought to expand the definition, or at least get clarification relative to the MPCL situation. The second approach took steps to use the new definition as is.

PUBLIC COMMENTS TO FAR SECRETARIAT

During the public comment period, the MPCL team provided written comments addressing FAR Case 94-790, Acquisition of Commercial Items, to the FAR secretariat on May 1, 1995. The team recommended an expansion of, or clarification in, the commercial item definition. No formal response or acknowledgement of the team's recommendation was received. The final rules for the acquisition of commercial items were published in the *Federal Register* on September 18, 1995, and had an effective date of October 1, 1995.

The Legislative Initiative Program

There were two distinct reform issues that the MPCL team believed needed to be addressed if the DOD was to fully benefit from the technologies and capabilities of the commercial sector. The first issue is facilitating DOD's ability to go to the private sector for commercial-off-the-shelf type items. The second issue is encouraging purely commercial firms to seek DOD work for military-unique items. FASA provided substantial inroads in the first issue, but the MPCL team felt that insufficient attention had been given to the second issue. A purely commercial firm with no previous DOD experience still would encounter numerous restrictive government terms and conditions if it decided to seek new business providing military-unique products to the DOD.

Each year, the Staff Judge Advocate office of Air Force Materiel Command (AFMC) solicits recommendations from field units for changes in federal law as part of its legislative initiatives program. The MPCL team saw this as an opportunity to eliminate much of the confusion and conflicting interpretations surrounding dual-use firms and commercial items. The team proposed the following additional commercial item definition modeled after the one recommended by the Section 800 Panel in 1993:

An item may be considered to meet the definition of a commercial item even though it is produced in response to government performance requirements provided that the item is purchased from a company or business unit which ordinarily uses customer drawings or specifications to produce similar items for the general public using the same workforce, plant, or equipment.

While many of the Section 800 Panel recommendations were adopted in FASA, this expanded definition was not. One possible reason for its exclusion is the use of the phrase "government drawing or specification." Since military specifications were being eliminated as a result of the Perry Memo of June 1994, this wording became outdated. The objectionable portion of the Section 800 Panel definition was replaced with the phrase "government performance requirements" in the preceding definition.

On August 29, 1995, the commander of Wright Laboratory approved the MPCL team's recommendation. This in turn was forwarded to the Staff Judge Advocate office at AFMC. The recommendation was not forwarded by AFMC and no acknowledgment was received.

ARMY INTEREST

Although AFMC elected not to pursue an expanded definition, the Army expressed interest. The Comanche Helicopter Program Office was experiencing an identical definition problem. It had been closely following the efforts of Wright Laboratory's MPCL team. Following the AFMC decision to not pursue an expanded definition, the Comanche Program Office asked for copies of the Wright Laboratory legislative initiative package with all of its supporting documentation. On February 15, 1996, Brig Gen James Snider, the Comanche program manager, wrote to Gilbert Decker, assistant secretary of the Army (research, development and acquisition), recommending that the Wright Laboratory definition be adopted. He believed that the expanded definition would provide "significant savings across all services."

AIR STAFF SUPPORT

It became apparent to the team that there was a pronounced reluctance to expand the definition of a commercial item beyond the final FASA rules. Many thought that the new FASA definition was infinitely better than the pre-FASA one. Others felt the new definition was broad enough to allow the CO to include products like those found on the MPCL program as commercial items. On April 17, 1996, the MPCL program manager briefed Darleen Druyun of secretary of the Air Force (acquisition) on both the program and the definition problem. It was Druyun's opinion that the revised FASA definition of a commercial acquisition applied to the MPCL pilot modules with no additional expansion.

As it turned out the implementing regulations of FASA provide significant latitude in the commercial item designation. The CO can subjectively call the procured item commercial by determining that the necessary modifications to the item are (1) of a type customarily available in the commercial marketplace or (2) not of a type customarily available in the commercial marketplace, but the modifications are minor. Perhaps it was possible to approach the issue again using the new definition as is. Realizing the risk of asking the same legal office the same question twice, the team decided to pursue the "of a type" strategy and attempt to establish the commercial nature of the MPCL modules once again.

REVISITING THE LEGAL OPINION

ASD, the MPCL prime contractor, also is the supplier for CNI modules for both the Air Force F-22 fighter and Army RAH-66 helicopter. The MPCL subcontractor, AFN, is a purely commercial division of TRW. Before this contract, AEN performed work only for non-government customers, and its production items were of a type customarily used for non-governmental purposes. Therefore, since the military electronic modules for the MPCL demonstration would be manufactured using the same processes, the same equipment and the same work force, they met the criteria that the items be *of a type* customarily used for non-governmental purposes and sold to the general public.

The new definition allows for minor modifications that do not alter a commercial item's function or essential physical characteristics. The MPCL electronic components do not share all the traits of those manufactured for AEN's commercial customers, either functionally or in physical characteristics. However, allowance was made in the definition for modifications *of a type* customarily available in the commercial marketplace. As it turns out, AEN routinely tailors its products to specific customers. Using this information, ASD prepared a determination that its subcontract was one supplying commercial items.

On August 12, 1996, a meeting was held with the program, contracting, and judge advocate general (JAG) offices to discuss ASD's position paper stating that the MPCL modules were commercial items. After intense discussions, the group concurred with ASD's determination. As a result the buyer and CO generated an endorsement letter to accompany ASD's position paper. The endorsement was routed to the JAG office, which found it to be legally sufficient on August 26, 1996.

TAKING ADVANTAGE OF CHANGE

This commercial item determination was a significant event for the program. It was a breakthrough in accomplishing the objective of streamlining the AEN subcontract. The number of flow-down clauses was reduced from 30 to three (see Figure 2), which AEN did not object to. This event has potential long-term implications for defense acquisition programs. A precedent has been set that facilitates the ability of a defense prime contractor to go to a purely commercial subcontractor. This also has the advantage of making defense work more attractive to world-class commercial manufacturers, expanding the industrial base and having a major and positive impact on the affordability of weapon systems. The acquisition cost savings for the MPCL modules are greater than 50 percent when compared to modules previously produced on a dedicated military line. The commercial item determination was a key enabler for MPCL.

FIGURE 2: CLAUSES APPLICABLE TO THE SUBCONTRACT AFTER COMMERCIAL ITEM STATUS

Clause	Title and Date
52.222-26	Equal Opportunity (April 1984)
52.222-35	Affirmative Action for Special disabled and Vietnam Era Veterans (April 1984)
52.222-36	Affirmative Action for Handicapped Workers (April 1984)

Other Benefits

The commercial item determination also can benefit those subcontractors that have both military and commercial work. Since it is no longer economically feasible to maintain separate production facilities, many subcontractors now produce commercial and military

orders in a single facility. Unfortunately, to accommodate both types of orders, the overall operation often is driven by the flow-down requirements of the most restrictive customer--the DOD. In the case of one sub-contractor, defense work makes up only 11 percent of its business, yet this work drives the internal processes and procedures of the remaining 89 percent. This situation could be improved if the prime would designate its subcontractor's products as commercial; then the subcontractor could gear all of its operations to its commercial business. This would help the subcontractor be more competitive in the commercial market and make its products more affordable to the DOD.

A case in point is B.F. Goodrich. Goodrich sells aircraft wheels and brakes to both commercial and military customers, but the majority of its work is commercial. It sells F-16 wheel and brake spares directly to the Ogden Air Logistics Center at Hill Air Force Base, Utah. Goodrich took its commerciality case directly to the CO and technical staff at Ogden. Goodrich emphasized that all of its products were made in the same facility using the same work force. The F-16 spares were of a type sufficiently similar to its other commercial products to be designated as commercial under the new definition. The Air Force accepted its justification. Now all of B.E Goodrich's wheel and brake products are commercial.

BARRIERS TO IMPLEMENTATION

While commercial item determination seems to be a clear win/win situation, many of the defense primes are not taking advantage of the opportunity. Their reluctance appears to stem from poorly defined financial incentives, cultural resistance, and fear that such a move will adversely impact their next contractor purchasing system review (CPSR). To allay the CPSR concern, the prime contractor can work this issue through a joint government/contractor integrated product team. The team should include the administrative CO and representatives from the Defense Contract Audit Agency and DCMC. This approach will help ensure that there is government buy-in and that the contractor's purchasing system approval is maintained.¹⁰ Cultural resistance will abate over time. This process can be facilitated through training. While it appears intuitive that gearing one's operations entirely to the commercial sector should provide a financial incentive, this case has yet to be clearly established.

LEARNING FROM MPCL'S JOURNEY

A major theme of acquisition reform is to use commercial products at all tiers to the maximum extent possible in meeting military requirements. The MPCL program has shown that DOD can leverage the commercial sector. The benefits include affordability, shorter lead times, and access to a larger industrial base. Although the journey to commercial item status was difficult for the MPCL program, it is hoped that other military programs can benefit from the lessons learned and experiences of this unique commercial acquisition.

ENDNOTES

1. Michael E. Heberling and Tracy J. Houpt “What Is and What Is Not a Commercial Item,” *Contract Management*, August 1995, at 10.
2. “The Missing Definition of a Commercial Item,” *Federal Acquisition Report*, October 1995, at 4.
3. “DOD Skirts Commercial Path,” *Defense News*, November 20-26, 1995, at 26.
4. “Acquisition Panacea Keyed to Commercial Base Access,” *National Defense*, March 1996, at 36.
5. Michael E. Heberling, “Open Issues in Acquisition Reform,” *National Contract Management Journal*, volume 27, issue 2 (1996), at 43.
6. Mary E. Kinsella and Michael E. Heberling, “Applying Commercial Processes to Defense Acquisition,” *National Contract Management Journal*, volume 28, issue 1 (1997), at 11.
7. “Army, Air Force Seek Commercial Solutions to Cut Acquisition Costs,” *National Defense*, February 1998, at 36.
8. Michael E. Heberling and Mary E. Kinsella, “Remaining Issues in Adopting Commercial Practices in Defense Acquisition,” *Contract Management*, February 1998, at 13.
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10. Leising, Laura A., “Changing Purchase Thresholds to Achieve Savings,” *Contract Management*, March 1998, at 4.

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