"Five percent of the value of the inventory of production equipment in current use will be considered as a valid level for programming annual replacement of the active industrial equipment. * * *"

The fiscal year 1966 modernization program for another contractor included four gear-making machines amounting to $232,100. The justification for replacement was based on data showing that the investment would be repaid within 3 to 4 years through reduced operating costs. We noted that, to achieve this objective, the initial-year use would have had to exceed current use by about eight times but that, as of September 1966, the contractor still had no active requisitions for additional gear machine operators. Moreover, one of the replaced machines had been used exclusively for commercial work for at least a year. Military officials informed us that the contractor had not been encouraged to invest its own capital in these machines.

DOD officials informed us that existing and experimental incentives have met with limited success in encouraging private investment in IPE. Department officials directed our attention to the following factors.

1. The weighted guidelines which provide additional profit to contractors providing equipment required for DOD contracts were generally considered insufficient by contractors to warrant purchase of the IPE.

2. The facilities amortization plan which guarantees contractors a minimum depreciation recovery had been tested at some contractor plants and was unsuccessful. Under this plan, if a contract were terminated before 50 percent of the investment had been written off for tax purposes, the Government would underwrite the difference. Contractors felt that this procedure offered no greater incentive than that currently existing under tax regulations which allows accelerated depreciation charges.

3. The short duration of Government contracts, as a practical matter, reduced the incentive for contractor investment.

4. In allocating funds under modernization programs, the Department gave consideration to the contractor's record of investing its capital in equipment. The needs of the overall military programs were the underlying consideration; however, the estimated savings shown on the application for the IPE was a primary factor in providing funds.

One contractor informed us that its policy was to invest in IPE one half of its after-tax earnings, plus the amount of depreciation for the period. The remaining IPE needed would then be requested from modernization funds and the DIPEC inventory. The stated policy appears to be in consonance with present DOD objectives in the modernization program.

Conclusions

While the Department's policy is very restrictive as to the conditions under which new Government facilities will be furnished to contractors, the modernization and replacement program appears to provide a means for contractors to acquire new machines for old ones under different and less restrictive criteria. The program as presently administered will, in our opinion, perpetuate the large Government investment in general purpose machine tools in possession of contractors and thus defer indefinitely the time when contractors must furnish all facilities, in accordance with the Department's basic policy, required for performance of a Government contract.

We proposed that, in consonance with the foregoing conclusions, the Department place concentrated effort on the revision and administration of the following aspects of its industrial facility modernization and replacement program.

1. Inclusion in procedures of a requirement for the specific consideration of, and a statement as to, the contractor's ability or willingness to privately finance modernization proposals.

2. Consideration of a revision of guidelines to make the provision of Government-furnished plant equipment more directly related to new, major defense programs.

3. Improvement in the validity and review of justification and actual experience data, with particular attention to the commercial use of Government-furnished equipment.

4. A reexamination of the principle of recovery of savings through repricing of incentive-type contracts and subcontracts.

Agency comments

The Deputy Assistant Secretary agreed with our proposals and stated that it was DOD's policy that the contractor be encouraged to replace old, inefficient Government tools with more modern, efficient, privately owned tools. He indi-

87-847—68——29