August 9, 2016

The Honorable Thad Cochran
Chairman
Committee on Appropriations
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Section 702(e) of the Bipartisan Budget Act of 2013 ("BBA") (Public Law 113-67) directed the Director of the Office of Management and Budget (OMB) and the Secretary of Defense to report to Congress on alternative benchmarks and industry standards for government reimbursement of contractor employee compensation to the benchmark established by section 702. This report responds to this requirement. In addition, this report also contains the Fiscal Years (FYs) 2014 and 2015 data required in section 702(d) on agencies' use of exemptions to the compensation cap.

Section 702 of the BBA established a cap of $487,000 per year on the amount the Federal Government will reimburse contractors for contractor-paid employee compensation on contracts with defense and civilian agencies. By law, this amount must be adjusted annually to reflect the change in the Employment Cost Index for all workers, as calculated by the Department of Labor's Bureau of Labor Statistics (BLS).

Pursuant to section 702(c), the new cap applies to costs of compensation incurred under contracts entered into on or after June 24, 2014.[1] On this date, the Federal Acquisition Regulatory Council published an interim rule in the *Federal Register* (79 Fed. Reg. 35865) to implement section 702 that became effective upon publication. The rule amends the cost principle that implements the cap on contractor employee compensation at section 31.205-6(p) of the Federal Acquisition Regulation (FAR). Cost principles are used to determine the allowability, reasonableness, and allocability of costs under Federal contracts. The new rule applies to cost-reimbursement contracts and any contract awarded without competition on a sole source basis, including fixed-price contracts, as well as to other situations where the contracting

[1] Contracts awarded prior to June 24, 2014, are not subject to the new $487,000 cap. Instead, they are subject to the cap calculated per 41 U.S.C. 1127, the statutory formula cap. Section 803 of the FY 2012 National Defense Authorization Act expanded the application of the statutory formula cap from the five senior executives to all contractor employees on contracts awarded by and for the title 10 agencies, DOD, the National Aeronautics and Space Administration, and the United States Coast Guard. DOD has submitted proposed legislation for the FY 2017 National Defense Authorization Act cycle to repeal the retroactive application of section 803 to contracts entered into before December 31, 2011.

officer cannot rely on competition to determine that prices are fair and reasonable. This may occur, for example, when the agency conducts a competition but receives only one bid and must perform cost analysis (i.e., where the contractor submits projected cost information for the agency to analyze) or negotiates with the contractor to determine if the offered price is fair and reasonable.

Consistent with section 702, the interim FAR rule allows an agency head to establish one or more narrowly targeted exceptions for scientists, engineers, or other specialists upon a determination that such exceptions are needed to ensure that the executive agency has continued access to needed skills and capabilities. The interim rule requires that decisions be made on a case-by-case basis so that the agency must consider, at a minimum, for each affected contractor employee: (i) the amount of taxpayer-funded compensation to be reimbursed to the contractor for each employee (i.e., allocability), (ii) the duties and services performed by each employee, and (iii) the allowability and reasonableness of the compensation.

Section 702(d) requires OMB to report annually on use of the exception authority, including the total number of contractor employees in narrowly targeted exception positions, the taxpayer-funded compensation amounts received by the contractor for each contractor employee, and the duties and services performed by these employees. OMB reports that no exceptions to the cap were made by agencies in FY 2014 since the law took effect on June 24, 2014, or in FY 2015. OMB's Office of Federal Procurement Policy surveyed the major departments and agencies to verify this information.

Section 702(e) directs OMB and the Department of Defense (DOD) to report to Congress on alternative benchmarks and industry standards for compensation, including whether any such benchmarks or standards would provide a more appropriate measure of allowable compensation than the current $487,000 cap established by section 702 on contractor employee compensation that may be reimbursed by the Government. To inform this review, OMB and DOD sought public comment on alternative benchmarks and appropriate inflators. See 79 Fed. Reg. 55507 (September 16, 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-09-16/pdf/2014-22005.pdf. For a copy of the responses, go to http://www.whitehouse.gov/omb/procurement/ccp_reports. In addition, OMB and DOD reviewed relevant reports, including the study conducted by the Government Accountability Office (GAO), *Defense Contractors: Information on the Impact of Reducing the Cap on Employee Compensation Costs* (GAO-13-566, June 2013), available at http://www.gao.gov/assets/660/655319.pdf, and consulted with the Defense Contract Audit Agency, the Defense Contract Management Agency, and the Chief Acquisition Officers Council.

Based on this feedback and review, OMB and DOD considered the following four alternatives: (1) creation of multiple caps, (2) use of "say-on-pay" principle established in the Dodd-Frank Act to establish the cap, (3) use of alternative inflators to adjust the cap, and (4) creation of an alternative definition of compensation to address the scope of the cap. OMB and DOD considered the extent to which each of these proposals furthers key purposes of the cap, namely: (1) to provide a reasonable level of contractor reimbursement of compensation costs for high value Federal contractor employees and (2) to ensure taxpayers are not saddled with paying excessive compensation costs. OMB and DOD do not believe any of these alternatives offer an improvement over section 702. As explained below, each alternative would either add complexity, increase the likelihood of requiring excessive payments, or both.

1. *Creation of multiple benchmarks.* One respondent recommended use of multiple benchmarks that take into consideration a company's size and revenue. The respondent explained that the current one-size-fits all approach fails to consider the various market factors that influence compensation in the private sector. As an example, the respondent stated that executive managers of large companies with significant revenue tend to receive significantly higher salaries than those that manage smaller companies. OMB and DOD believe use of multiple benchmarks based on company size and revenue would significantly increase the complexity of establishing and applying the caps, and still could draw criticism for ignoring other market forces, such as those related to industry, job type, or geographic location. The complexity of the process increases exponentially as more factors are considered in developing multiple benchmarks that are more targeted to specific populations of companies with defined characteristics. Equally important, section 702 already gives agencies the ability to consider narrowly tailored exceptions to gain access to needed specialized skills and capabilities. The FAR cost principles provide the factors to consider when determining whether use of an exception would be appropriate in a given instance. For example, an agency that is unable to find a contractor that could support its needs within the cap with the requisite skills and quality may be able to build support for paying a higher amount by considering the consistency of the contractor employee's compensation with the compensation for employees with the same skill set at other companies that are similar in size, industry, geographic area, and other factors. Agency discretion to exercise an exception for specialized work would not extend to such skilled employees performing managerial functions. OMB and DOD believe this result is consistent with ensuring taxpayers are not burdened by paying compensation costs that are excessive, unaffordable, and have little bearing on the value agencies receive under their government contracts.

2. *Use of "say-on-pay" policy.* One respondent noted that the Dodd-Frank Act allows for a "say-on-pay" for all public companies in the United States, which allows stockholders to periodically approve the compensation for certain executives. The respondent noted that a study of companies worldwide with "say-on-pay" requirements have found lower levels of overall CEO compensation. However, use of such benchmarks approved by stockholders would not be easy to administer nor likely to avoid the potential for payment of excessive compensation costs. Not all government contractors are subject to the Security and Exchange Commission's rules on "say-on-pay." Only the compensation for certain executives are subject to vote by stockholders and results are not necessarily binding. In addition, corporate stockholders' interests in the compensation of their executives may be driven by interests (e.g., success in maximizing profits for stockholders) that are not necessarily aligned with the interests of taxpayers and may result in payment of excessive compensation costs.

3. *Use of different benchmark inflators.* The law requires that the new benchmark be adjusted annually based on the Employment Cost Index (ECI) for all workers. The ECI, which is determined by BLS, measures the growth of employee compensation (wages and benefits) at all levels of a company. BLS also maintains an index focused just on private sector employee compensation. OMB and DOD considered whether the narrower index would provide a more suitable adjustment mechanism, but concluded that the broader index, which

takes into account both private and public sector employees, is more appropriate, since government contractors compete for labor in a market that includes both private industry and government.[2] OMB and DOD also considered the well-known Consumer Price Index as an inflator, but do not believe it makes sense to use an index based on the costs of spending on a weighted basket of consumer goods and services rather than the costs of labor.

4. *Revision to definition of compensation subject to the cap.* The interim FAR rule defines compensation subject to the cap as "wages, salary, bonuses, deferred compensation, and employer contributions to defined contribution pension plans for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the employer's cost accounting records for the fiscal year." This definition mirrors the statutory definition of compensation that was used in connection with the prior statutory benchmark formula. In creating the new benchmark, however, Congress repealed the statutory definition of compensation. The definition of compensation could be narrowed to focus only on wages and salary both as a way to simplify application of the cap and reduce the potential to prevent the Government from gaining access to the talent it needs to meet its missions. Limiting the elements of the compensation definition could arguably simplify administration of the cap for contractors. However, narrowing the elements of the cap to exclude, for example, bonuses and deferred compensation would significantly erode the purpose of the cap in limiting the reimbursement of excessive compensation costs because bonuses and deferred compensation are significant dollar components of compensation, especially executive compensation. Employers would simply reduce the amount of the allocation of overall compensation to the compensation elements subject to the compensation cap (i.e., wages and salaries), and increase the amount of overall compensation paid as elements of compensation that are not subject to the cap (i.e., bonuses and deferred compensation).[3]

Finally, OMB and DOD note that one respondent to the public notice recommended elimination of the cap and associated benchmarking. The commenter stated that the interests of the taxpayer are adequately protected by rules requiring the payment of "reasonable" contractor compensation and associated processes that result in "review [of] contractor business systems, [approval of] invoices and audit [of] submitted costs on a regular basis." OMB and DOD believe that a cap plays a critical role—in addition to consideration of cost reasonableness—by ensuring compensation costs are affordable and not excessive. Continued application of a cap that defines the maximum compensation that is allowable for reimbursement to the contractor enables agencies to make determinations of affordability in a consistent manner.

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[2] The Federal Government also uses the ECI for all workers to establish and adjust the pay for Federal employees, as well as executives in the Senior Executive Service and Executive Schedule. See 5 U.S.C. 5308, 5318, 5376, and 5382.

[3] In a study of the impact of the $1 million cap on the tax deductibility of top management compensation (26 U.S.C. 162(m)), researchers found little evidence that the tax deductibility cap had significant effects on overall executive compensation levels as corporate employers restructured their executive compensation packages to mitigate the effect of the tax deductibility limits. (Rose, Nancy L. and Catherine Wolfram. "Regulating Executive Pay: Using the Tax Code to Influence Chief Executive Officer Compensation," *Journal of Labor Economics*, 2002, Part 2, S138-S175; also available as NBER Working Paper 7842 at http://www.nber.org/papers/w7842.)

For the reasons discussed above, OMB and DOD have concluded that the alternatives identified to date would not be more effective than the benchmark established by section 702. OMB and DOD also believe that section 702 represents a substantial improvement over the statutory formula that it replaced, which set the cap at the median (50th percentile) amount of compensation provided to the top senior executive officers at publicly-owned U.S. companies with annual sales over $50 million. Based on this formula, the cap rose more than 300 percent from 1995-2013, an increase that bore no relationship to either the type of work that contractor employees are actually performing under applicable Federal contracts or general trends in the U.S. economy with respect to increases in prices and wages. By contrast, section 702 put in place a more affordable and fiscally responsible cap along with an appropriate limited exception for specialized skills that should ensure agencies and their government contractors may continue to attract and retain the best and highest performing employees. Accordingly, OMB and DOD do not recommend changes to section 702 at this time.

OMB and DOD look forward to working with Congress on the implementation of these and other steps to ensure our acquisition decisions result in actions that are affordable and fiscally responsible.

Sincerely,

Frank Kendall
Under Secretary of Defense
Acquisition, Technology, and Logistics

Shaun Donovan
Director
Office of Management and Budget

Identical Letter Sent to:

The Honorable William M. "Mac" Thornberry
The Honorable Adam Smith
The Honorable John McCain
The Honorable Jack Reed
The Honorable Thad Cochran
The Honorable Barbara A. Mikulski
The Honorable Hal Rogers
The Honorable Nita M. Lowey
The Honorable Ron Johnson
The Honorable Thomas R. Carper
The Honorable Jason Chaffetz
The Honorable Elijah E. Cummings