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# Best Practices for Longer-Term Service Contracts

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## Abstract

This project summarizes best practices identified by commercial companies, foreign governments, and State governments in using service contracts for periods longer than 5 years. The project also covers service contracts longer than 5 years used by the Federal Government. The findings indicate that relational management approaches are best suited for longer-term service contracts. This research better informs the Department of Defense on possibly increasing the number of service contracts longer than 5 years to obtain cost and performance benefits.

## Background: Department of Defense (DoD) and Longer-Term Service Contracts

### DoD and Service Contracts

This paper articulates best practices for using longer-term service contracts, as experienced and described by various practitioners. *Longer-term contract* is defined as an agreement in excess of 5 years.<sup>1</sup> Although this paper also summarizes instances or situations in which longer-term service contracts are desirable, its focus remains on best practices associated with implementing and managing longer-term service contracts. Starting with the premise that the decision has been made to enter into a longer-term service contract, we delve into how that decision can best be executed.

Every individual interviewed stated that longer-term service contracts were most applicable to highly technical or complex services with sustained demand. Such agreements often necessitate investments in human and physical capital by contractors, which require sufficient time to recoup such investments.

In fiscal year (FY) 2016, Department of Defense (DoD) contracting obligations were around \$300 billion for products and services. Services accounted for \$149.5 billion, or 50.2% of total DoD contracting obligations. It is expected this trend will continue.

The Federal Acquisition Regulation (FAR) states a service contract:

means a contract that directly engages the time and effort of a contractor whose primary purpose is to perform an identifiable task rather than to furnish an end item of supply. A service contract may be either a nonpersonal or personal contract. It can also cover services performed by

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<sup>1</sup> As discussed in Chapter II, Congress provided the definition of a longer-term service contract in Section 854 of the FY 2018 National Defense Authorization Act (NDAA).



either professional or nonprofessional personnel whether on an individual or organizational basis. (FAR 37.101, Definitions, 2023)

The definition offers an array of possible examples, such as maintenance of equipment, base maintenance, professional services, etc. (FAR 37.101).

Pursuant to policy initiated in the 1980s and continuing to this day, many functions once performed by military or U.S. government civilian personnel are now outsourced to contractors.<sup>2</sup>

### **“Service” Is an Expanding Concept**

As technology progresses and business operations evolve, the scope of services is expanding. The end result will most likely be greater consumption of services vs. products (or supply)<sup>3</sup> by the DoD (FAR 2.101). Typical examples are cloud-based software, analytical software, and data storage capabilities.<sup>4</sup> Another example is the evolution of a more traditional function: procurement of hospital and medical supplies. Contractors integrate themselves into the inventory process of medical facilities and maintain stocks of materials at the customer site.

### **DoD’s Legal Authority to Enter into Longer-Term Service Contracts**

This paper does not delve into the minutiae of the policies and laws as expressed in the FAR and Defense Federal Acquisition Regulation Supplement (DFARS).

There is a common misconception that government contracts are limited to a duration of 5 years on the combined basic and option periods. Both the FAR and DFARS allow contracts for service and supplies to endure for much longer periods. The FAR allows agencies to waive the 5-year limit in accordance with their own procedures:

*Unless otherwise approved in accordance with agency procedures, the total of basic and option periods shall not exceed 5 years in the case of services, and the total of the basic and option quantities shall not exceed the requirement for 5 years in the case of supplies. (FAR 17.204(e), emphasis added)*

DFARS authorizes the ability of agencies to contract for longer periods (DFARS 217.204, 2023).<sup>5</sup>

For DoD, the two general means to purchase the type of services contemplated in this paper are multiple year and multi-year.<sup>6</sup> The close homonymy of these two phrases often leads to much confusion. The most succinct explanation of the differences is found in the FAR:

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<sup>2</sup> An example is contractor logistics support for United States Air Force aircraft.

<sup>3</sup> FAR 2.101 defines product the same as supplies: All property except land or interest in land. It includes (but is not limited to) public works, buildings, and facilities; ships, floating equipment, and vessels of every character type and description, together with parts and accessories; aircraft and aircraft parts, accessories, and equipment; machine tools; and the alteration or installation of any of the foregoing.

<sup>4</sup> The Defense Information Systems Agency (DISA), for example, offers cloud service support. See *Cloud Service Support*, DISA, <https://storefront.disa.mil/kinetic/disa/service-catalog#/forms/cloud-service-support> for details.

<sup>5</sup> DFARS 217.204 indicates periods of 10 years or longer are possible if the head of agency approves.

<sup>6</sup> Indefinite delivery, indefinite quantity contracts are another means for the U.S. government to purchase supplies or services (FAR 16.504).



The key distinguishing difference between multiyear contract and multiple year contracts is that multi-year contracts defined in the statutes cited at 17.101, buy more than 1 year's requirement (of a product or service) without establishing and having to exercise an option for each program year after the first.<sup>7</sup>

A multi-year procurement of services commits DoD to buy more than one year's worth of requirements, but not more than five program years, in a single contract award (FAR 17.103).<sup>8</sup> Thus, the DoD is committed to buying services required in more than one fiscal year.<sup>9</sup> More specifically, a multi-year procurement of services obligates the DoD in advance of the availability of appropriated funds.<sup>10</sup>

We do not discuss multi-year procurements but instead focus on multiple year contracts.

### **DoD Practice and Longer-Term Service Contracts**

We explored the typical length of service contracts in the FPDS data but were unable to affirmatively quantify the number of longer-term service contracts (Kaye et al., 2014). Our interviews provided two general rationales as to why the DoD is reluctant to intentionally engage in longer-term service contracts: one was budgetary, and the other was operational.

There are two budgetary reasons. First, multiple year contracts provide the flexibility to reallocate budget dollars as military needs change. Second, annual congressional appropriations are uncertain; even if the DoD executes a multi-year contract with notifications to Congress, subsequent Congresses may decrease overall DoD funding. This situation then puts the DoD in the position of decreasing funding for other programs, attempting to renegotiate contracts, or paying lump-sum cancellation charges to contractors with multi-year contracts.

With regard to day-to-day operations, although longer-term service contracts are permitted by the FAR/DFARS, our research indicates an institutional or cultural bias against such arrangements (in other words, it appears that there is a preference for 5 years as the maximum duration for service contracts).

Several primary reasons or explanations for the apparent institutional bias exist:

- Regular churn of contractors is positive, as it produces the best price.
- Churn keeps contractors on their toes.
- Industrial base—if the U.S. government does not share the wealth with a rotating set of firms or limit the number of longer-term service contracts, the number of future qualified bidders may shrink over time.
- Fear that contracts longer than 5 years may leave the DoD locked in with undesirable or underperforming contractors.

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<sup>7</sup> FAR 17.103 is the multi-year definition. FAR 22.1001 defines multiple year contracts as contracts having a term of more than 1 year regardless of fiscal year funding. The term includes multi-year contracts.

<sup>8</sup> DFARS 217.171 provides for purchase of supplies relating to the service provided.

<sup>9</sup> Congress is not bound to appropriate funds for future years. If this occurs, the DoD must cancel the contract and pay a cancellation charge (FAR 17.106-1(c)). Cancellation charges are standard clauses in multi-year contracts.

<sup>10</sup> Multi-year contracting provides an exception to the Antideficiency Act (Pub. L. 97-258, 96 Stat. 923).



- A statement of work (SOW) can become stale over time on contracts of longer duration than 5 years.
- Past history of attempting longer-term service contracts has turned out less than optimal.
- Habitual behavior—it is easier to recycle shorter-term contracts than to try new approaches.
- Bureaucratic inertia—time and effort are required to seek exceptions to a standard 5-year contract.
- Lack of knowledge among contracting officers and program managers with regard to what is possible; thus it is easier to fall back on what has been done in the past.
- Turnover on the government side—military personnel often change jobs every 3 years, and civilian employees frequently change jobs as they move up the ranks.

### Longer-Term Service Contracts

Although the general DoD mindset is averse to longer-term service contracts, our discussions with a variety of non-U.S. government entities clearly indicates they believe use of longer-term service contracts provides lasting value to the buyer. The term we heard repeatedly from these entities to describe their approach is *relational*; that is, they treat their service providers as strategic partners or critical suppliers. They view the purchase of key services as having the same importance as major capital investments in plant or equipment. The relationship between buyer and seller is much more than a purchase order.

A textbook definition of *relational contract* is one that involves a written agreement, interface protocols, and managerial interaction norms among the parties that seek continuous efficient and effective communication—all leading to the goal of minimizing friction in order to achieve commercial goals (Keith et al., 2016).

## Congress and the FY 2018 National Defense Authorization Act

### Pilots for Longer-Term Multi-Year Contracts

In Section 854 of the FY 2018 National Defense Authorization Act (FY 2018 NDAA), Congress seems to signal its opinion that the DoD may not be leveraging the benefits of longer-term service contracts.<sup>11</sup> In Subsection (a), it granted the DoD the authority to enter into five multi-year service contracts with duration of up to 15 years if options clauses were included and executed.<sup>12</sup> Section 854(b)(1) instructed the DoD to carry out a study on this matter and to include best practices from commercial companies, foreign governments, state governments, and civilian federal agencies.

### When to Use and Not Use Longer-Term Service Contracts

There are many reasons for entities to use longer-term service contracts. This list is not exhaustive but illuminates major motivators brought forth by this research that are focused on best practices for longer-term contracts.

<sup>11</sup> The formal title of Section 854 is *Pilot Program for Longer Term Multiyear Service Contracts*.

<sup>12</sup> Section 854(a) cited Section 2306c of title 10 U.S. Code. Section 2306c concerns multi-year contracts and acquisition of services; Section 2306b concerns the acquisition of property (supplies or products).



## **Need for Contractor Investments in Equipment, Facilities, and Technology**

One of the prime drivers for longer-term service contracts is to provide contractors with the incentive to improve productivity through their own investment in facilities, equipment, and technology.<sup>13</sup>

## **Complex or Technically Challenging Services Requiring Specialized Knowledge and Abilities (Human Capital)**

Economic theory and practitioner experience (especially emphasized by DoD personnel) indicated that services involving special skills, abilities, or talent were strong motivators to have longer-term service contracts.

## **Attracting More Qualified Bidders**

A number of non-DoD practitioners highlighted that one driver for longer-term service contracts (coupled with other factors) is to attract more qualified bidders.

## **Obtaining Greater Value and Efficiencies**

All of the foreign governments stated that cooperation between the parties added value to the work by solving problems more easily and efficiently.

## **Avoiding Workflow Disruption and Solicitation Costs**

All the non-DoD interviewees considered the disruptions resulting from change of contractors as significantly negative.

## **Flexibility**

Many of the interviewees stated longer-term contracts facilitate greater operational flexibility. This flexibility was particularly true with foreign governments and commercial firms.

## **Harmony in Working Relationships**

A surprising finding is the desire for and recognition of value of harmony in buyer–vendor relations. Many of the interviewees believe that longer-term relationships lead to familiarity with each other’s abilities and awareness of work rhythms.

## **Industrial Base Considerations**

The commercial firms and foreign governments all stressed the need to maintain an industrial base.

## **Managing Risk**

A number of the interviewees—including the foreign governments—believe that if a national policy is to transfer risk to the contractor subject matter experts (SMEs), longer-term contracts will promote this practice.

## **Supported by Literature**

The economic literature also supports the above-mentioned themes. Crocker and Masten (1988) note that the optimal contract length depends on a trade-off between negotiating costs and the costs of being bound to an inflexible agreement for additional time. Cohen and Agrawal (1999) view long-term contracts as offering price certainty, reduced transaction costs (by reducing the frequency of rebidding the project), more effective monitoring, and opportunities for investment, in return for reduced flexibility. The “short-term equals flexible” meme also appears in Vásquez (2007), where the need

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<sup>13</sup> As an example, FAR 17.105-2 provides the rationale for using multi-year contracts (supplies and services).



for flexibility leads to shorter contracts. This view is balanced by the long-term contracts, creating an incentive for specific investment. That investment may take the form of capital equipment or an investment in knowledge and skills.

## **Approach and Methodology**

### **Practitioner Approach**

The interviews we conducted with selected top-level practitioners in the public and private sectors were general in nature and focused on key facets of implementing and managing longer-term contracts, regardless of the mechanism.

### **Selection of Interviewees and Interview Approach**

In alignment with Section 854(b), we interviewed individuals representing 37 entities from the following categories:

- Commercial companies
- Foreign allied government defense officials (foreign governments)
- U.S. States
- Non-DoD federal agencies
- DoD personnel, including senior procurement executives

The interviewees consisted of 11 commercial firms, four foreign governments, nine non-DoD governmental (federal, state, and local) organizations, and 13 DoD entities.

### **Interviews and Categorization of Comments and Statements**

All interviews were conducted on a non-attribution basis in order to solicit candid statements.

## **Best Practices for Longer-Term Service Contracts**

### **Background: How to Move Beyond Transactional Contracts to Relational Contracts**

We identified six critical best practice areas through our interviews. What stood out among all our discussions with many non-U.S. government interviewees was an overarching emphasis on having long-term relational contracts with service contractors.

The underlying premise of successfully enacting the best practices enumerated below is a relationship approach based on the buyer and seller discussing and resolving differences in operations, services, and all aspects of the relationship. This relational approach stands in stark contrast to a traditional U.S. government “arm’s-length approach” business contract that involves contracting officers and lawyers acting as enforcers of contract terms and conditions.<sup>14</sup>

The six best practices discussed in the remainder of this chapter are as follows:

1. Create a strategic and management approach (environment) within the DoD that will enable longer-term service contracts.
2. Nurture and maintain a cadre of governmental personnel. The DoD requires SMEs to create and manage longer-term service contracts.

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<sup>14</sup> It was noted by IDA personnel with DoD contracting experience that it was not uncommon to have a U.S. government contracts attorney, contracting officer, and acquisition manager participate in a contracts discussion with a contractor.





3. Develop and update business cases, which is key to the DoD's ability to maximize value.
4. Communicate desired outcomes to industry. The DoD should describe and regularly communicate outcomes and not dictate statements of work.
5. Emphasize critical contract elements. Share data and clearly articulate goals and metrics.
6. Manage the relationship and not the contract. Be responsive to new information and situations.

### **Create a Strategic and Management Approach: Set the Stage**

The foundational insight that we heard from practitioners is that the organizational ecosystem must be geared toward having longer-term contracts, and leadership must be more than acquiescent.

#### ***View Services as Strategic***

Our interviews with many commercial firms and foreign governments indicated that they view procured services as strategic to their missions. They perceive all services suitable for longer-term contracts to be just as important as capital equipment investments.

#### ***Industry Is a Friend, not an Enemy***

We found a significant sentiment among DoD officials of suspicion or lack of trust in their dealings with contractors. The preference is for an arm's-length relationship—that at times can become combative or litigious. In a striking contrast, foreign governments stated they view relationships with service contractors as an important foundation for their defense structures. We heard a similar theme from the commercial sector, which views firms engaged as long-term service contractors as strategic providers.

#### ***Organizational Culture Focused on Enduring Long-Term Relationships***

The overarching theme among many non-U.S. government interviewees was an organizational culture geared toward relational contracts for high-value services.

#### ***Senior Leadership Encourages Innovation and Experimentation***

The interviewees emphasized that senior leadership must push and encourage contracting officers and program managers to use new contracting methods and processes or leverage existing ones.

#### ***Pragmatic***

This insight is philosophical in that it combines realistic/open-minded interpretation of regulations and practical business acumen. This insight is summarized in the salient point put forth by one foreign government: What is the worst that can happen? Does someone die, or does cost go up by a minuscule amount because of market conditions?

#### ***Trust Governmental Personnel***

We heard from state officials that empowerment of frontline managers is important. The consensus among all interviewees—including the DoD—is that senior leaders need to trust their personnel and not micromanage or second-guess them.



### ***Fiscal and Budgetary***

While the issue of congressional funding cannot be controlled by DoD officials, the uncertainty of annual appropriations arose multiple times in our interviews. DoD personnel regularly noted that the nature of annual appropriations complicates their contracting strategies.

### ***Nurture and Maintain a Cadre of Governmental Personnel***

Although the DoD outsources many services, the clear statement from the DoD and all other interviewees is that one of the most important best practices for using or managing longer-term service contracts is to have a robust and well-trained cadre of governmental personnel. This recommendation pertains to operations and to contracting and financial functions.

### ***Business Case: Bedrock of Success***

The need for business planning and analysis was strongly advocated by most interviewees. Furthermore, the need for business case development reinforces the best practice to have a robust governmental cadre of personnel to direct such analyses prior to issuing a request for proposal.

### ***Market-Facing Research***

The commercial firms were particularly adamant on the need to understand comprehensively the market for the services to be procured under long-term contracts.

### ***Benchmarking***

In line with market research, the commercial firms said they would benchmark service providers in terms of quality, price, and reputation as part of the contractor selection process.

### ***Not Static***

Market research does not cease once a service contractor is selected. Regular evaluation of the market for innovations in service and price are routine.

### ***Risk Analysis***

The commercial firms were the primary proponents of risk analysis. Some of the considerations were:

- Price: How predictable? Could inputs increase?
- Team: Guarantees on team to be deployed—A or B team?
- Market changes: Will availability of talent or key inputs change over time?
- Confidence in contractor
- Cost to switch service contractors

### ***Communicate Desired Outcomes to Industry***

The approach is to tell industry the outcomes that are desired—and then hear what industry suggests in terms of approaches.

### ***Emphasize Critical Contract Elements***

All of the interviewees highlighted a number of contract elements they believed to be of importance.

### ***Share Cost and Benchmarking Data***

Almost all the interviewees and their contractors share cost and other benchmarking data.



### ***Contract Form***

Observations from many interviewees familiar with government contracts maintained that contracts suited for short time periods and transactional work should not be relabeled or retrofitted for longer-term services contracts.

### ***Duration and Rewards***

All of the participants emphasized that the market should dictate the optimal contract duration and that the contract duration should be appropriate for the type of work.

### ***Learning Period for the Contractor***

A majority of the foreign governments pointed out that on any new longer-term service contract, the first 2–3 years are a learning period for both sides.

### ***Off-Ramps and Doors to Modifications***

All of the foreign governments emphasized that they include off-ramps in their longer-term service contracts.

### ***On-ramps***

In line with the “rolling wave” contract renewals on the annual reviews, it might be appropriate to increase the renewal term if the contractor’s performance is exceptional.

### ***Annual Cost Reviews***

These reviews are not necessarily an attempt to audit or manage profit margins; rather, they represent an opportunity to exchange data and seek to ensure that the best market price is obtained for the buyer.

### ***Measures/Metrics***

The overwhelming message from all the interviewees is to use metrics that are easy to measure reliably and are fully controlled by the contractor.

### ***Cost Escalation Clauses***

The consensus regarding cost is that reviewing and sharing cost data are essential.

### ***Contract Administration Plan***

It is used to establish internal management protocols and help manage risk.

### ***Government Gains Intellectual Property (IP) and Knowledge***

Acquire knowledge and IP from the contractor. This goal is part of a strategy to keep the customer SMEs versed in latest techniques and technologies so the government can exercise appropriate oversight and due diligence.

### ***Relationship Management: Manage the Relationship, not the Contract***

The best practice that stood out in terms of innovation is relationship management. This method is a management and attitudinal method of managing contractors—in contrast to regulation-driven management.

## **Summary**

This paper summarizes from a high-level perspective the best practices developed from using service agreements with durations in excess of 5 years. The best practices were identified through interviews with executives and senior leaders from a diverse array of entities—including commercial firms, foreign governments, U.S. states,



and other federal agencies. Congress directed this research, and we understand the intent is to encourage the DoD to explore and pilot a greater number of longer-term service contracts. We believe doing so might bring significant benefits to the DoD.

The insights from most interviewees indicated that longer-term contracts are best suited for highly complex or technical services. These services necessitate highly skilled labor and expert management and typically involve capital investments in equipment and facilities, investment training, and education of workers.

We found that the DoD has the legal and regulatory authority to enter into longer-term service contracts. However, due to a variety of reasons—including business culture and beliefs, habitual practices, and possible complications presented by the idiosyncratic U.S. fiscal and budget systems—it has largely declined to do so. Nonetheless, we identified instances in which the DoD does engage in long-term service contracts, but they seem to be relatively few and infrequent.

The clear message from a diverse array of practitioners is that to succeed at longer-term service contracts, the mindset and management approach must move from “transactional” to “relational”—that is, to treat service providers as strategic partners and manage the relationship in a collaborative manner that will endure for many years. The six high-level best practices we identified rest upon the foundation of this relational approach.

We believe the DoD can reap significant cost and performance benefits from successfully implementing these best practices. The experiences from our diverse group of interviewees—in particular the foreign governments—strongly suggest pilots and experimentation are well worth the effort.

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