FIRM FIXED PRICE CONTRACTING FOR DEVELOPMENT-A GOVERNMENT VIEWPOINT

MR. LeROY J. HAUGH
Deputy Director, Procurement OASN (I & L), Department of the Navy

Twenty years ago the accepted method of acquiring a weapon system was to let a cost type contract for Research and Development, then a cost type contract for pilot production and a fixed price type contract for production. Costs often greatly exceeded the original estimates then as now. So about ten years ago, Defense attempted to control cost overruns by imposing ceilings on cost contracts and emphasis was placed on using fixed price type contracts for the lesser risk programs. One result was a dramatic reduction in the use of CPFF contracts, and an expanded use of FFP contracts for development. Perhaps the pendulum swung too far. It does appear now to be swinging back again and more emphasis is being placed on use of cost type contracts.

It was not the intent of DoD in the ASPR rewrite of types of contracts to preclude the use of cost type contracts, or to require fixed price types for R&D. The change in emphasis was designed to ensure that we don't automatically equate R&D with cost type contracts. Its purpose was to make people think. There may be situations in which R&D work can very well be accomplished under a fixed price type. The problem has been that too often the statistics took precedence over the facts of a particular procurement.

It has never been the policy of DoD to use Fixed Price contracting without adequate justification, or to state it another way, it has never been the policy to preclude the use of cost type contracting if there was adequate justification. But as with any statement of general policy, there is much misinterpretation and communication breakdown between the enunciation of policy at top levels and the implementation of that policy at operating levels. We are, after all, dealing with people, and human judgments and values differ. Experience shows that fixed-price contracts were often used when they should not have been. Why? Two basic reasons--a failure to adequately consider all the factors involved in the particular procurement, and too much emphasis on a statistical record of fixed-price transactions. The shoe was made to fit many times when it shouldn't have been worn.

Our goal in procurement is to acquire suitable hardware, on time, and at reasonable prices. We live in a fishbowl, with Congress and the public rightfully "looking over our shoulder" to ensure that the monies Congress appropriates are spent wisely. One means of minimizing potential waste or unnecessary spending is to transfer to contractors some share of the cost risk in performing under a contract. This is only really effective, however, when the other parts of the equation are reasonably firm. Otherwise, we may be militating against our objective of acquiring suitable hardware, by motivating the contractor to stay within certain cost limits.

Let's take a brief look at the basic objective of RDT&E. If we simply look at the various stages of R&D effort--beginning with basic research, feasibility studies, exploratory development, and so on--it is quite obvious that in many if not most cases, we do not have at the outset any clear parameters, any yardsticks, by which to establish a fixed price which is reasonable to both parties and which will ensure the desired performance.

The goal or output of the RDT&E process is broader than just the development of hardware. It is the development of an operational capability, of which weapons hardware is only one part. Other elements of the operational capability include:

- Trained maintenance and operating personnel,
- Facilities logistics,
- Material logistics,
- Personnel support system for replacement personnel,
- Tactics for optimal employment of the system.

The function of RDT&E in the development of operational capabilities is the production of knowledge required to achieve such capabilities. It is a multistage process of integration and conversion of knowledge within the stages, and flow of information coupling the various stages. The process is a way of progressively reducing uncertainty by buying knowledge. In the earliest stages of the process, uncertainty is usually very high concerning the probable results of effort and the value of the results. Judicious decisions must be made on how much to pay for knowledge to reduce uncertainties before making particular RDT&E investment decisions. Fortunately, costs and uncertainty seem to be inversely related in the RDT&E process. At the research end, uncertainty is high, but the cost per project is relatively low. At the systems development end, cost per project is extremely high, but uncertainty is relatively low.

The RDT&E manager, like every manager, is obligated to attempt to get the maximum productive use out of the resources at his disposal. Thus, the contracting officer is alert to opportunities to reduce cost-type contracts. It is only natural that both would look for and take advantage of opportunities to bind a contractor to perform at a fixed price.

One of Mr. McNamara's last issuances on procurement before he left office was the 24 February 1968 letter, published in DPC 60, which addressed itself among other things to the misuse of firm-fixed-price contracts. He recognized that the pendulum had perhaps swung too far and that one of his earlier goals of passing a share of cost risks to contractors was being mis-

applied to the detriment of good procurement practice. The means had become an end for some overzealous managers and contracting officers and the result was inimical to the real goal of R&D. In his 24 February letter, Mr. McNamara reiterated that "Good judgment must be exercised in the choice of type of contract for each situation. Our emphasis on using the higher risk type contracts should not be construed as a mandate for their use in inappropriate situations."

Sometime before Secretary McNamara's 24 February letter, the Defense Science Board made several recommendations with respect to the regulatory coverage of R&D. The ASPR Committee appointed a subcommittee to study the Board's recommendations and the results of that subcommittee's efforts were published in revision 30 to the 1963 edition of ASPR in September 1968. I won't go into the details of that revision because I am sure you are all familiar with it, but I would like to touch on the intent behind some of the changes. Most of the changes were in the emphasis on fixed price contracts, in a conscious effort to turn back some of the over-reaction that had occurred over the years since 1961. ASPR 3-402 was changed to read - "The firm fixed price contract is the most preferred type for harnessing the profit motive....." Other language was added to emphasize that there are situations, "particularly in the early stages for research and development, in which the profit motive may be secondary." DoD's primary concern at this stage is the achievement of technical objectives, and attempting to harness the profit motive could very well be inimical to those objectives.

One significant addition introduced in revision 30 was the expanded discussion of selection of the proper type of contract for R&D —"to fit the work required"— and the admonition to discuss the type of contract with prospective contractors. The contracting officer's motivation at this point may be to minimize contract administration and to tie down the price, while the prospective contractor might be inclined to overemphasize the technical problems and the need for complete freedom in a cost-type invironment. Neither one is probably 100% right, but somewhere in between these two extremes there is room to negotiate a proper contract type. No one knows better than the contractor what technical problems he may encounter, and a prospective contractor should not hesitate to make these known to the contracting officer. He can't assume that the contracting officer has adequately considered all the ramifications in making his choice of a contract type.

The coverage of type of contract for advanced development states that "no restriction exists as to the type of contract that may be used for work in this R&D category. The nature of the work often necessitates the use of CPFF...."

Finally, revision 30 added CPAF contracts to the list of contract types available for use. Under CPAF, we can to a certain extent "harness the profit motive," by rewarding better than minimal performances, and at the same time retain the flexibility of a cost type environment.

Shortly before revision 30 was published, the military departments were directed to undertake a study of Firm Fixed Price Contracts for Development, to determine whether they had been misused and to make recommendations for any changes in ASPR. The studies did conclude that fixed price contracts had been inappropriately used in a number of cases. The Navy made several specific recommendations for changes in ASPR but the consensus of the ASPR Committee was ultimately that the then recent revision 30 should solve the problem. Everyone agrees that revision 30 has helped, but after more than a year of working with it, there is some feeling that perhaps it didn't go far enough, so the issue is not completely closed yet.

One other ASPR subcommittee effort which is currently underway as a result of a GAO report has to do with fixed price level of effort contracts. GAO criticized the use of such contracts and suggested the need for clarification of ASPR to provide better guidance in the selection of the appropriate contract type for procurement of R&D investigations and studies. While some "better guidance" may be necessary for other reasons, I think that the misuse of level of effort contracts stemmed from a lack of understanding of what a level of effort is and how it should be administered. In other words, it is a "people problem" and not a regulation problem. A level of effort is essentially no different than a labor hour contract. The rates are fixed for different categories of labor. The end objective of the contract may or may not be achieved, whether it be a feasibility report or what have you. The performance of the contract consists of expending an agreed level of effort towards achieving some objective. The Government is relieved of having to audit costs, but it cannot ensure that it has received full performance without auditing or otherwise checking the effort expended by the contractor. The contractor who fails to perform an agreed level of effort may be guilty of breach of contract or fraud. I don't see any real need for expanded guidance in this area, and I don't view it as a significant part of the problem we are addressing today.

To summarize, and to repeat what I said at the outset. DoD's goal is to procure hardware to do a particular job, at reasonable prices. The goal is not to play games with statistics. The goal is not to look for the "easy way out" insofar as contract administration is concerned. The goal is not to force contractors into losses. We all deal through people, and people's interpretations and judgments differ. What we have tried to provide in the regulatory coverage is a sense of balance between cost, risk, time, hardware capability, and other factors which affect the decision as to type of contract. We invite the prospective contractor's input to the equation. The additional time required to explore and discuss the type of contract will be well spent.