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Fixed-Price Contracts

Far from saving taxpayer funds, the improvident use of fixed-price contracts in hyper-competitive procurements inevitably gives birth to underfunded contractor performance, leading, in turn, to unhappy customers and proliferation of disputes. And under current economic conditions, contract disputes, once easily avoided with a handshake, now degenerate into protracted, bitter wars fought years after the fact by combatants struggling with poor, sketchy facts and data, attempting to deal with problems often bequeathed to them by long-gone predecessors.

Free Lunch Often Tastes Terrible: Dealing With Inappropriate Use of Firm Fixed-Price Contracts

By Richard B. O'Keeffe Jr.

Federal procurement exists within a postmodern civilization that swirls with fads and fashions generated by instant global telecommunication, volatile market trends, ever-changing politics and, above all, the cold, imperious reality of scarce resources. Within this system, agency procurement officials, their legislative overlords and supplicant contractors circle each other warily, seeking advantage wherever it may be found, adapting to change when required, limiting damage when it befalls. Agency choice of contract type — a fundamental determinant driving all aspects of any procurement (formation, administration, performance and termination) — is not immune to these forces.

Richard B. O'Keeffe Jr. is of counsel at Wiley Rein LLP in Washington with more than 21 years of experience in federal procurement matters.

Fixed-price contracts, for many decades, were predominant in a simpler federal market when agency purchases centered on stable, well-defined requirements for commodities and services in a resource-constrained environment of limited government. The fixed-price contract type gave way in the late 20th century, during a time of relatively plentiful resources, coinciding with enormous technological change and more complex government needs, to a profusion of flexibly priced contract types limited only, so it seemed, by human ingenuity.

As we approach the end of the second decade of the 21st century, agency needs have become dramatically

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more challenging as the number, complexity and urgency of many missions spiral up. But at the same time, total available resources have shrunk in relative terms. In response to these clashing imperatives, agencies have increasingly sought to shift from flexibly priced contracts — riskier for the government — back to fixed-price vehicles under which contractors bear the burden of proposal estimation, fine competitive judgments under intense time pressure, razor-thin margins and exacting budget execution in contract performance. This is ''free lunch'' for agency programs — the contractor takes all the risk and competition drives companies in a race to the bottom as they chase opportunities in a crowded field.

That works well when the procurement is for commercial off-the-shelf items, for low-tech services in well-established settings based on fixed labor rates, or for routine job-order construction projects. However, when fixed-price contracts are used to fulfill vast, highly complex requirements for which price estimation — to make business sense — must be based on well-established requirements and adequate, actionable historical data, serious difficulties can arise when these necessities are wanting.

Often the problems first manifest during contract formation when there is an imbalance of information as between an incumbent contractor (which may know more about the requirement than the agency) and its competitors seeking the follow-on work. Surprisingly, this data disproportion does not necessarily benefit the incumbent, which is burdened with superior knowledge that drives a price that is both more realistic and less competitive than its blissfully ignorant competitors who, during the procurement, are free to propose lower prices to win the work, betting that it will all work out somehow in the long run. Agency program and contracting officials sit by, cheering on the players, counting their savings, applauding a system that generates the ''best value'' for the American taxpayer. And because a fixed-price contract will be awarded, there is not even a requirement to conduct a cost realism analysis so as to gain some measure of confidence that the proposed price is what actual performance will cost — it's all on the contractor.

But at this point, it's the integrity of the procurement that loses because the competition may appear to have been compromised. And then there is the inevitable protest, which may enforce more rigor and realism in source selection, leading to a more defensible outcome. Or it may not. And if not, for the time being, everyone is happy except, of course, for the former incumbent. If unseated, even by a low-ball competitor, the former incumbent is out of work just the same. If it hangs on by proposing a price lower than (it well knows) is required, the company faces dreary years of contentious performance challenges to make the distorted budget work.

This leads to the second, more enduring part of the problem: After pursuing the quarry for months or even years, the business development team hands off the new contract to operations for execution. Following the kickoff meeting with the agency, the afterglow of victory may rapidly dissolve as the successful contractor's project manager learns (or is reminded) what is really required to get the job done, what condition the government facilities and equipment are really in, and what the agency's actual, unstated requirements — the hidden specifications that, as a practical matter, must be fulfilled — really are.

In past times of relative plenty, there was far greater flexibility in such situations: Agencies had more money to resolve disputes — to keep the machine running smoothly and the relationship harmonious. And on the contractor side, companies often had more leeway in their budgets to absorb higher costs of performance.

That's not the case now. Agencies are more strapped for resources, and contractors' margins have been pounded lower to remain competitive in procurements driven by the fixed-price reality. Disputes once easily avoided with a handshake now degenerate into protracted, bitter wars fought years after the fact by combatants struggling with poor, sketchy facts and data, attempting to deal with problems often bequeathed by long-gone predecessors.

Much of this is fair. Business is hard and not for the faint of heart. The government is allowed to drive a hard bargain, and contractors should not be in business if they do not have the skills, experience and nerve to compete. It's the American way.

But again, the problem stems from and is wrongly exacerbated by the use of fixed-price contracts in situations not suited for that contract type. Here are the Federal Acquisition Regulation criteria for use of fixed-price contracts:

(a) There is adequate price competition;

(b) There are reasonable price comparisons with prior purchases of the same or similar supplies or services made on a competitive basis or supported by valid certified cost or pricing data;

(c) Available cost or pricing information permits realistic estimates of the probable costs of performance; or

(d) Performance uncertainties can be identified and reasonable estimates of their cost impact can be made, and the contractor is willing to accept a firm fixed price representing assumption of the risks involved. [1]

Mismatches of fixed-price contracts to procurements do not often result from lack of competition or the absence of reasonable price comparisons with former purchases. Rather, the breakdown most commonly stems from a lack of information for competitors to price their proposals, or from contractors, in the heat of competition, that improvidently bid for a fixed-price contract, despite inadequately defined performance requirements, with an aggressive price that is doomed to budget-execution failure.

However one views the situation — as a deplorable state that demands radical change, or as the harsh but acceptable cost of doing business — these conditions are real, and they appear to be enduring.

As such, what should contractors do to protect themselves from the unwarranted, unfair loss of opportunities and from contract performance risks from fixed prices that have been set too low? There are three business practices by which contractors can mitigate the worst risks.

1. *Engage with the agency to influence contract type selection*. Whenever possible, contractors should take

[1] FAR 16.202-2.

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advantage of the opportunity to talk to agency customers about their needs and the company's capabilities, and such engagement — even one-on-one conversations — are encouraged by FAR Part 15 for negotiated procurements. FAR 15.201(c)(4).

The Office of Federal Procurement Policy is attempting to open up such lines of communication even more broadly (as discussed in a Wiley Rein client alert published Nov. 29) but there is no problem even now with including, in any such interactions, a discussion of which contract type is the best fit for the agency's needs.

Such exchanges could profitably focus on questions such as the existence and availability of data needed for reliable price estimation; on ambiguities or internal conflict in relation to the statement of the requirements for use in bidding; and on contractual provisions that impose undue risk on the contractor.

At the extreme end of such engagement, when an opportunity has been improperly framed by such provisions in the context of an unsuitable contract type, and the agency will not retreat from unreasonable positions, a bid protest should be considered.

2. *Demand discipline in proposal preparation*. After deciding to pursue a fixed-price opportunity that entails elevated risks of these kinds, it is even more important to continue engagement with the agency — through the contracting officer — to minimize any ambiguities or agency overreach, and with due care for good customer relations. Beyond this — in high-risk, fixed-price competitions — it is critical to create and preserve the most robust set of contemporaneous work papers to establish the basis of estimate. Such papers, clearly documenting how the contract was priced and why critical decisions were made, will be vital, in the context of a fixed-price contract, to establishing the reasonableness of the proposal as a baseline against which to compare the actual costs of performance, in the event of a dispute relating to actual or constructive changes.

3. *Enforce discipline in contract performance*. In high-risk projects, greater rigor is needed to manage that risk while the job is underway. The techniques to do that:

- A high level of vigilance regarding efforts demanded beyond the statement of work;
- Continual engagement to document issues as they arise;
- Timely assertion of requests for adjustment where appropriate. These can be corrosive of good customer relations, and the benefits from such efforts could be outweighed by the costs if they are ineptly applied.

Nevertheless, sound performance planning for fixed-price contracts should include even greater thought to design a means to balance risk management against customer care.

Contractors compete in a tough, highly regulated marketplace administered by hard-pressed, budget-driven bureaucrats striving in good faith to advance their careers while achieving agency goals at the lowest possible cost. Where the effect of agency business mistakes, such as the selection of an improper contract type, can potentially be avoided through prudent engagement and rigorous prosecution of competition-focused and project execution efforts, those efforts should be undertaken to the greatest, most cost-effective extent.

A fixed-price contract may seem like free lunch to the agency program manager, but the risk is never really all on the contractor. Loss of faith in the integrity of the procurement system, and ceaseless post-award wrangling and disputes, impose a tax on all parties to the contract, and ultimately on the system as a whole.

A badly awarded and administered contract will leave a bad taste in everyone's mouth. The best contractors plan for these risks, minimize them and succeed in the long run.