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More Restrictions on Cost-Reimbursable Contracts: DOD Issues Interim Rule Prohibiting Cost-Type Contracts for the Production of Major Defense Acquisition Programs

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On January 29, 2014, the U.S. Department of Defense (DOD), issued an interim rule to amend the Department of Defense Federal Acquisition Regulation Supplement (DFARS) to prohibit DOD from entering into cost-type contracts for the production of major defense acquisition programs absent a certification to Congress by the Under Secretary of Defense for Acquisition, Technology and Logistics. *See* 79 Fed. Reg. 4631 (Jan. 29, 2013). The rule is effective October 1, 2014.

The rule implements Section 811 to the National Defense Authorization Act for Fiscal Year 2013, which dictated the prohibition and established an October 1, 2014 implementation deadline. DOD promulgated the change as an interim final rule because it is eager to ensure that acquisition professionals are aware of the ban ahead of the October 1 deadline, noting that any delays in implementation could jeopardize the ability of contracting officers and program managers to "perform appropriate acquisition planning to select a contract type that complies with the law." DOD has also asserted that timely implementation of the rule is necessary to avoid harm to the Government posed by award of a cost-type contract for production of a major defense acquisition program, which the Federal Register notice states "would inappropriately shift the responsibility for performance cost risk from the contractor to the Government."

The statute and rule are limited to contracts for production rather than development or other earlier phases of programs. Theoretically, at the production stage, contractors should be able to develop a

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fixed price at least for some portion of the effort. Nonetheless, both the statute and interim rule provide for an exception if the Under Secretary of Defense for Acquisition, Technology, and Logistics provides a written certification to Congress that includes (1) a statement that a cost-type contract is needed to secure the work in a timely, cost-effective manner; and (2) an explanation of the steps taken to ensure the use of cost-type pricing is limited to only the portions of the contract necessary to do so.

Cost-type contracting, in which the contractor is reimbursed for all allowable costs incurred in the performance of the contract, is traditionally used when performance requirements cannot be sufficiently defined, costs of performance cannot be accurately estimated, or the requirements are complex and unique to the Government. *See generally* FAR 16.301-2. Fixed-price contracting, by contrast, is deemed appropriate for commercial items and when acquiring products or services based on reasonably definite specifications. *See generally* FAR 16.202-2. Because cost-type contracts allocate the risk of increased costs of performance to the Government, they have been a popular target for procurement reform.

Congress's effort through legislation to restrict discretion to choose contract type is nonetheless arguably inconsistent with DOD's separate initiatives to reform its acquisition processes, known as "Better Buying Power" (BBP). The first iteration of BBP, issued in 2010, advised using fixed-price incentive vehicles whenever possible, but BBP 2.0, released in 2012, pulled back on that guidance and, instead, emphasizes use of professional judgment in selecting contract type: "The contract type employed must be tailored to each particular product or service acquisition. The guidance included in BBP 1.0 suggested to some that Fixed Price Incentive contract types should be used much more broadly and to the exclusion of other contract types. . . This guidance modifies BBP 1.0 to encourage acquisition officials to consider the full range of contract types before deciding on an acquisition approach." *See* Implementation Directive for Better Buying Power 2.0 - Achieving Greater Efficiency and Productivity in Defense Spending.

Moreover, despite Congress's continuing disfavor of cost-type contracts, DOD's first annual report on the performance of the defense acquisition system, which was focused on major defense acquisition programs, concluded that "fixed price contracts did not exhibit a significantly different cost growth than cost-reimbursable contracts." In an interview about the report, Under Secretary of Defense for Acquisition, Technology and Logistics Frank Kendall called attention to the report's finding and noted that fixed-price contracts are not a "panacea" to solve all of the Government's contracting woes. *See* Karen Parrish, Pentagon Releases First Annual Acquisition Report (July 8, 2013); *see also* Dietrich Knauth, DOD Issues Interim Rule Restricting Cost-Type Contracting, *Law360*, Jan. 30, 2014.

Finally, although production phases of programs typically have more well-defined requirements than development efforts, the U.S. Government Accountability Office's (GAO) latest report on DOD's 2012 portfolio of 86 major defense acquisition programs found that the vast majority of programs conduct developmental testing and production concurrently: "[n]early 80 percent of the programs we surveyed that were in production, reported that 30 percent or more of their developmental testing had been or was going to be done during production despite the increased risk that design changes and costly retrofits will need to be made." Thus, it is not a given that fixed-price contracting is appropriate for the production phase in all instances or will yield

cost savings.

Regardless of the final form of the interim rule, it is clear that there will be continued pressure on the defense industry to assume more cost risk in the performance of contracts. To remain competitive for award, contractors at all levels of the supply chain must adapt to this trend, starting with a clear understanding of the assumption of risk in fixed price contracting. In addition, contractors must be prepared for the possibility that equitable adjustments may be warranted based on formal or constructive changes during contract performance and thus ensure that as performance is underway, they are vigilant to such potential changes.

Comments on the interim rule (DFARS Case 2013-D016) are due March 31, 2014. Wiley Rein's Governments Contracts Practice will continue to monitor the interim rule and other developments in acquisition reform.