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From Our Readers

Making the Contract Type Fit the Program

Republican Sen. John McCain of Arizona, the vice chairman of the Senate Armed Services Committee, recently proposed limiting the Pentagon to fixed-price contracts for weapon programs. In considering this proposal, it is worth reviewing available contract types and past policy in applying contract types.

First, the two main contract types are fixed-price and cost-plus. Fixed-price contracts place greater risk on defense contractors to deliver a weapon system at a quoted cost. If uncertainty exists, contractor proposals can be expected to have higher prices to compensate for any added risk. Cost-plus contracts allow the government and contractor to share risk by giving the government the option to continue funding a weapon program above a contractor's initial estimate.

Second, past reform initiatives appear to follow the swings of a pendulum. In the mid-1960s, for example, the objective of "Total Procurement" was to transfer more risk to defense contractors by competitively bidding fixed-price contracts over both development and production phases of a weapon system. The expected advantages included avoiding "low-ball" bidding of development contracts, and obtaining production price commitments from contractors. The focus on awarding more fixed-price contracts resulted in cost-plus contracts going from the most common contract type to less than 5 percent of Air Force procurement dollars by 1966, according to G. Brunner and G. Hall in a 1968 publication "Air Force Procurement Practices 1964-1966." Problems with Total Procurement resulted in a July 1969 memorandum by then Deputy Secretary of Defense David Packard advocating cost-plus contracts for development and fixed-price contracts for production of weapon systems. This guidance appears to have remained consistent until 1980, when the emphasis shifted again toward fixed-price contracts for all phases of a weapon program. The use of a fixed-price contract proved to be a mistake on the now successful Advanced Medium Range Air-to-Air Missile development contract. Awarded in 1981, the AMRAAM contract experienced significant cost growth and schedule delays that led to a complete restructuring of the program by 1985.

Current practice is consistent with then Deputy Secretary of Defense Frank Carlucci's reform initiative from 1981 that advocated the use of appropriate contract types.

In general, fixed-price contracts are more appropriate for production contracts where costs are either known or easily predicted, and cost-plus contracts are more appropriate in situations—such as development—where costs are uncertain. Over time, safeguards have also been established to avoid defense contractor misuse of cost-plus contracts. For example, government personnel with the Defense Contract Management Agency provide on-site inspections of defense contractor facilities and work, and Defense Contract Audit Agency personnel perform audits of contract costs to ensure they are appropriate.

In light of available safeguards, a review of past reform efforts suggests that mandating a single contract type is not better than matching the unique circumstances of a weapon program with an appropriate contract type.

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