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Two New Contract Types for Operation of Government-Owned Facilities

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TWO NEW CONTRACT TYPES FOR OPERATION
OF GOVERNMENT-OWNED FACILITIES

BY

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ABSTRACT

With the ongoing emphasis or thrust, if you will, within the Government being placed on contracting out, under OMB Circular A-76, the types of contractual instruments employed become more of a focus for our attention than ever before. Consequently, the contracting structure used by the Government in the management of Government-owned, Contractor-operated facilities (GOCO) needs to be re-examined in this light. Objectives to be considered are lowering costs, increasing flexibility, and maintaining ease of transition between the various phases of the contracting process. New contract types must be designed and utilized to meet changing conditions and requirements. Federal Acquisition Regulations need to be revised to accommodate new contracting techniques. The use of the Cost Plus Award Fee contracts with subjective evaluation at GOCO-type facilities needs to be reviewed. The use of Fixed Price contracts will be discussed, and the pros and cons of their use in this environment will be discussed by the author in depth. Two new contract types which the author has devised will then be presented. Future contract types will evolve as needs arise.

The first contract type proposed is the Cost Plus Award Fee (Objective) contract. This contract provides for development of objective criteria that are definitive and not subjective in nature.

The second type of contract is the Fixed Price Award Incentive contract which lends itself well for application as a management contract in GOCO operations. This contract type provides wider latitude in the management of the operations of a GOCO or maintenance-type operation when the volume and type of work cannot be definitively specified during the initial phases of the process. This type of contract precludes the Government from active involvement in many adjustments to the cost/profit/fee base during a contract performance period.

This paper will describe in complete detail the workings of these contract types, the individual merits of each, and the problems which have been encountered in utilizing traditional contract types in the management of Government-owned, Contractor-operated facilities.

DISCLAIMER

The views expressed in this paper are those of the author and do not necessarily reflect the official policy or the position of the Department of the Army, Department of Defense, or any Federal agency.

BACKGROUND

It is the policy of the Government to make periodic reviews of its operations to determine if the Government should continue to operate a commercial-type activity or if the Government's needs would be better served by contracting out that operation. The policy

covering this process is promulgated by the Office of Management and Budget in OMB Circular A-76. When it has been determined by the Government that a facility will undergo a "cost comparison," a group of designated employees of that activity will develop a scope of work (Statement of Work) that identifies what each of the parties must do to operate, maintain, and in some cases, determine what product must be produced. The Government then issues a solicitation to industry, and at the same time, the Government employees develop an "in-house proposal" to perform the work complying with the scope of work set forth in the solicitation.

Contractors exhibiting an interest in competing for the operation of the commercial activity assemble their proposals for the work and submit those proposals to the Government in the form of a sealed bid or proposal. The results of the submissions by private industry are reviewed and compared, and the apparent low evaluated price is determined. At a prespecified, exact date and time, the Government's proposal is formally opened, and a comparison is made with the apparent low proposal submitted by the prospective contractor. In the event the Government is determined to be the most cost effective operator, no contract award is made, and the Government assumes or continues operation of the facility as a Government-owned, Government-operated (GOGO) facility. In nearly all cases, the Government operation is scaled down and streamlined by the scope of work. If, after all factors are considered, the contractor's price is considered the lowest, most economical price, a contract is awarded, and the operation then becomes a Government-owned, Contractor-operated (GOCO) facility.

The preferential type of contract resulting from these commercial activity reviews is usually a Fixed Price contract. To be most equitable to all the parties, a Fixed Price contract is almost mandatory. However, the scopes of work that are developed in consideration of the nature of the work at these facilities occasionally do not support a Fixed Price contract. Because there is often some uncertainty in the amount and type of work that will be performed during the course of the performance of the contract, there are often a considerable number of changes required to the scope of work. The variety and the nature of these changes make Fixed Price contracts difficult, if not impossible, to administer. These deviations from the scope are what necessitate the renegotiation of the scope and cause a dollar impact to the contractor. During this renegotiation phase, the contract becomes a Cost Plus type of contractual arrangement until the negotiations are complete and an equitable adjustment consummated.

SAMPLE PROBLEM

For example, the Government may have a need to negotiate a contract to operate a Government facility. A proposed contractor is provided the scope of work which identifies the work or services to be performed. In this hypothetical case, trucks, trailers, and wheel barrows are to be manufactured. The Government has provided the contractor the facilities, and it is the contractor's responsibility to hire and compensate the workers. The contractor is contractually obligated to purchase only the raw materials that are required to manufacture the specific components that the facility is designed to make or otherwise specified by the contractual agreement. In our example, the rubber tires, motors, transmissions, drive shafts, axles, and the electrical wiring items are all supplied as Government-furnished property (GFP) to be incorporated into the trucks, trailers, and wheel barrows. Suppose that one of the contractors who is manufacturing some of the items which are being furnished as GFP is late in delivery of his product. This delay has an impact upon the delivery and production schedule of the GOCO Operator. The GOCO operator delivery must slip, and he has to reschedule his work, causing cost impact to the contract. Depending upon which stage in the production effort the GOCO operator has reached, the exact magnitude of the cost change would have to be determined. Let us examine the provisions of the contract clauses covering changes as they currently exist in the Federal Acquisition Regulations (FAR).

FIXED PRICE CLAUSE

The Fixed Price clause that is included in the Fixed Price contracts is the "Changes" clause (FAR 52.243-1, Changes--Fixed Price, Apr 84). That clause provides that: "(b) If any such changes cause an increase or decrease in the cost, or the time required for, performance of any part of the work under this contract, whether or not changed by the order, the Contracting Officer shall make an equitable adjustment in the contract price, the delivery schedule, or both, and shall modify the contract." What happens when the change is made to the delivery schedule? It affects when the contractor performs the work and impacts the various manufacturing overhead costs, general and administrative costs, and even the direct labor rates of the employees. This change has impact upon the price of the effort as originally planned and proposed by the contractor to perform the work under the contract. It may require that the contractor work overtime or a second shift to offset the delay caused by the nonreceipt of the Government-furnished property. It affects the learning curve of the employees on the production line, thereby increasing the costs that the contractor proposed. In the Fixed Price contract situation, the contractor has a right to be made whole again. The problem is that the contractor usually makes up for "Buy-in" by the changes made after contract production begins and is made more than whole.

INCENTIVE CONTRACT CLAUSE

Some contracts are awarded on an "Incentive Fee" basis. The clause that is applicable to the "Incentive Fee" contracts is FAR 52.216-10, Incentive Fee (Apr 84). This clause stipulates: "(d) Equitable adjustments. When the work under this contract is increased or decreased by a modification to this contract or when any equitable adjustment in the target cost, target fee, minimum fee and maximum fee, as appropriate, shall be stated in a supplemental agreement to this contract."

It would appear from this contract provision that we are talking about revisions to the various targets when there is an increase or decrease in the amount of work to be performed on the contract. However, we cannot overlook changes that would delay performance periods or changes that affect the contractor's profitability. If there is a late receipt of GFP, the contractor who is operating under an incentive-type contract where the target cost is affected must be treated fairly. The targets must be adjusted to reflect the cost impact of the delay. The stage of the contractor's performance has a substantial impact on the adjustment required to the targets.

COST REIMBURSEMENT CLAUSE

FAR 52.243.2, Changes - Cost Reimbursement (Apr 84) clause provides that: "(b) If any such change causes an increase or decrease in the estimated cost of, or the time required for, performance of any part of the work under this contract, whether or not changed by the order, or otherwise affects any other terms and conditions of this contract, the contracting officer shall make an equitable adjustment in the (1) estimated cost, delivery or completion schedule or both, (2) amount of any fixed fee, and (3) other affected terms and conditions shall modify the contract accordingly"

The same examples as stated before would require that this contract be adjusted. Adjustments require an expense for Government evaluation of the changes, contractor preparation of a proposal, and the evaluation of the contractor's proposal. They also require negotiation and the reaching of a settlement. These are very costly procedures which can be avoided as will be discussed later.

WHAT IS NEEDED?

The question of what kind of contract is ideal for the operation of a GOCO is a difficult one to answer in a few words. A contract that has the flexibility to meet the demands of constant changes and yet provide an incentive for the contractor to perform well is that ideal contract type. Some contractors, like those Department of Energy contractors who operate laboratories, often are not paid a profit or a fee. Their corporate benefit is from the research that can support advances in their consumer product lines or advance the "state of the art" which will indirectly aid their corporate product lines or add new products to their commercial business. Most contractors, however, want to make a profit to add to the corporate income statement. Thus, the current contract types with the FAR clauses that exist do not provide this needed flexibility because they require constant adjustment to both target cost and fee or, in the case of fixed price contract, to the total price of the contract. What is needed is a contract that is flexible, allows for work changes and delivery revisions, increase in quantities to be produced or changes to the scope of work within predetermined guidelines without a corresponding change in the profit or fee structure that is applied. The current contract types that are used in the GOCO Operations do not facilitate the latitude of flexibility that is desired and, in most cases, needed by the Government.

The question that immediately comes to most peoples' minds is "What about the need to increase the rate of production of a product that might be the mission of the Government-owned, Contractor-operated facility?" For instance, the Government requires the contractor to produce 2,000 pounds of TNT a month instead of 1,500 pounds that were originally forecasted at the beginning of the year. The process requires that the batch sizes be increased and, in most cases, the only additional effort that is required is the increase in the quantities of raw materials that are purchased and possibly some additional packaging and shipping effort. Additional people and management would be minimal, if at all. Under the operation of the current contract clauses that would apply, the Government and the contractor would have to negotiate a change to the contract. This would require a proposal, evaluation, audit, and the effort to negotiate a supplemental agreement to the contract for the additional costs. What is needed is a contract which by its operation and the agreement of the parties, in the beginning of the contract, provides for changes which, for example, will not require the addition of more than 25 to 50 people to the work force without adjustment of the fee/profit of the contract. The only change would be an increase in the Government's limitation of cost to cover the new or additional work. The cost base increase would be established based upon historical data that is available to the Government in most situations or from a budget estimate that the contractor would provide upon request by the Government.

COST PLUS AWARD FEE CONTRACTS

Under the current provision of the FAR, we can negotiate Cost Plus Award Fee contracts to provide a contractor an incentive to perform against established incentive criteria. The intended results are improved performance in areas where the Government believes that improvement is needed or in areas where emphasis by the contractor is needed to preclude problems (e.g. safety, security, and quality). The evaluation process for these contracts permits the contractor to provide the Government with an evaluation of the contractor's performance. This evaluation is, in many cases, a detailed synopsis of the contractor's perceived great performance and comprises hundreds of pages of good stories and examples. The Contracting Officer's Representative, a person who heads a staff of Government employees who review the day-to-day operations and performance of the contractor at the work site, also prepares a detailed evaluation of the contractor's work against the established criteria. This is a subjective evaluation open to judgment calls by this staff.

These two evaluations are normally reviewed by a Cost Plus Award Fee Board which meets and reviews the evaluation and then arrives at some percentage to apply to the performance. This is translated into dollars from the fee pool by the Fee Determination Authority. In 99

out of 100 cases, the Board's determination becomes the percentage of the fee pool that is awarded the contractor. The author has sat upon many of these boards and has discovered that an overall rating of between 85 to 95 percent of the total fee pool is awarded to the contractor for the evaluation period. Further, there is a tendency, over time, for the evaluations to creep higher. Thus, in the first year if the contractor is awarded 86 percent of the fee pool, the next year it will be 88 or 89 percent and eventually will creep into the 90-percent range.

Notwithstanding this creep, there is a reluctance on the part of many contractors to accept the subjective nature of the Cost Plus Award Fee contracts in use today. The reason for this reluctance is the fact that the evaluation is subjective and not open for challenge. The contractors fear that contracting officers or other people in the Government will unjustly evaluate them low and thereby deprive them of a just reward for their performance. The author cannot validate that there is a basis for this concern in factual situations based upon his years of board reviews in actual situations. Nonetheless, this concern has been expressed by many companies. What the contractors want are definitive goals or objectives and the right to appeal the fee assessment based on questions of fact.

The author, after considerable evaluation of the efforts of contractors and the desires of the Government, has reached the conclusion that an "objective" award fee contract could be developed. Since the Government is dealing with services and general contractor performance as opposed to the performance of the end products, the Cost Plus Incentive Fee contracts with multiple incentives is not practical.

What are the usual desires of the Government for the contractor to operate any Government facility? The contractor should manage costs, produce a quality product, or perform the service outlined, perform the work safely, and maintain the Government equipment without causing excessive wear of that equipment.

Objective criteria are called for, such as the contractor's being required to produce acceptable lots of product 98 percent of the time, thereby providing a reduction in the fee pool in the event that the contractor had rejection rates of 97 percent or more. The same type of consideration could be applied to equipment maintenance or safety. The key in any of these contracts is that the areas to be incentivized must not be excessive and the criteria clearly written. Only in areas where poor performance has been a problem should incentives be considered. To have ten areas with three and four sub-elements only dilutes the incentive pool to a point where there is no longer any incentive. The objective criteria and the applicable ratings would not require the convening of an Award Fee Board. The statistics that are generated during the performance of the contract would be applied against the standards, and a numerical rating calculated. The contracting office would only have to compute the figures and modify the contract for contractor payment based on these results. This feature would save the Government substantial dollars in the cost of preparing the evaluation data for subjective evaluations. If we equate a page of data to be worth \$25.00, multiplied by hundreds of pages developed by both parties, the savings resulting during the evaluation period could conceivably amount to thousands if not tens of thousands of dollars. In a Cost-type contract, the contractor's costs are passed on to the Government as an allowable element of cost. This can also be true in Fixed Price contracts in GOCO operations.

FIXED PRICE AWARD INCENTIVE

In a recent copy of the "National Contract Management Magazine," there was an article on Fixed Price Award Incentive contracts. The concept that the author of the article set forth provided that the Government and contractor would agree to a fixed-price contract. Within the framework of that contract, there would be established a pool of money that would be at risk based upon the contractor's quality of performance, such as is normally the case in the Cost Plus Award Fee contracts. The normal cost plus award fee arrangement allows change to the fee pool as work increases or decreases, as changes to rate and time of delivery occur,

etc. A better method is needed to manage the Department of Energy and Department of Defense GOCO contracts.

The author proposes a Fixed Price Award Incentive contract to run concurrently with a cost-reimbursement production effort. The Fixed Price Award Incentive contract would not be adjusted when the effort under the cost reimbursement production effort increases. The Fixed Price Award Incentive would be the dollars that the contractor wanted to manage the facility or operation for the period of production covered by the contract. The scope would be general in nature and reflect the mission of the facility and, within that mission, the contractor would manage the operation. The Fixed Price Award Incentive would be the fee/profit that is normally applied to any contract. The difference would be that there would be no adjustments to this contract unless a pre-established trigger was reached. The trigger would be to change the mission of the facility to add new work. This new work would be similar to the "new start" work considered under OMB Circular A-76. At that time, the increased effort would be evaluated, and the contractor's Fixed Price Award Incentive contract would be amended. A good example of this would be the facility that the contractor operated which produced tanks being converted to produce cannon or other items which were not generic to the operations of that facility. The new effort would then require additional skills or technology not currently available at the facility and thus require more intensive managerial efforts or risks. The mere increase of effort or addition of quantity would not increase the Fixed Price Award Incentive contract. The Fixed Price Award Incentive contract would not be tied directly to the dollar effort of the Cost Reimbursement production/maintenance effort of the facility. Excluding the Fixed Price Award Incentive contract's relationship to cost would preclude the escalation of costs by the contractor to achieve a higher profit. This escalation occurs in many contracts from year to year.

One of the key elements of the Fixed Price Award Incentive is that objective criteria would be established not unlike those of the Cost Plus Award Fee contract indicated above, but in this contract type operation, there would be no negotiation of the cost base or cost-type contract. The Government, based upon historical operation data, would determine the limitation of cost ceiling that would be established for the contractor's performance of the cost-reimbursement contract. If the Government did not have exact data available and could not develop an estimated cost, a budget estimate would be obtained from the operating contractor for this differing work. The Government would perform a limited evaluation of that proposal and would establish the limitation of liability based upon the evaluated amount. The detail and extent of the evaluation would be based upon the nature of the proposal. By not going through a detailed cost proposal evaluation and negotiations, substantial dollars would be saved on the part of the Government and the contractor. The cost of both efforts could reduce the cost that the Government (public) must experience. Since the Fixed Price Award Fee contract would not have its base in the dollars of the cost-reimbursement effort, the exact amount is not as important. The determination of the reasonable cost for the purpose of establishing a reasonable fee is not a problem for the Fixed Price Award Incentive contract. What we are looking at is the quality of the management effort for which the Government is obligating itself. The Fixed Price Award Incentive contract will place most of the dollars at risk. There could be an agreement made that 90 percent of the contract amount would be at risk under the incentive arrangement that is negotiated by the parties. These areas would be objective in nature. Cost management must be a large and key element. This element serves to preclude the contractor from failing to halt runaway costs in production, maintenance, etc. The other elements such as safety, security, production quality, timely delivery, timely service, quality of service, etc., can be evaluated against objective criteria. Statistical guidelines can be developed, and a ranking against these criteria can be made by the contracting officer in order that the contractor be paid. In the event there is a disagreement, the contractor could dispute the question of fact that was causing the difference of opinion, and some judicial remedy could apply.

RECOMMENDATION

One of the military services, in cooperation with the Department of Energy, should take hold of this concept and develop the necessary implementation provisions to test the concept at one or more of the Government-owned, Contractor-operated facilities. Such a test could be accomplished over a 3-year period of time. At the end of that period or at some point in the interim, the Federal Acquisition Regulations (FAR) could be amended to include the use of these contract types when the circumstances dictate. The use of the Cost Plus Award Fee (objective) contract should be the easier of the two to implement since the departure from the norm is only miniscule, in that the criteria become objective, as opposed to the current subjective nature of the criteria presently being used. The cost base of the contract is still negotiated and yet does not drastically change the manner in which business is conducted. The Fixed Price Award Incentive contract and the Cost-Reimbursement combined contract should be reviewed in more detail to confirm the conclusions of the author. This contract type could save many dollars in pre-contractual costs on the part of both the Government and the contractor. One estimate is that there might be as much as \$500,000 savings per contract on the large, hundred-million-dollar contracts. These figures mandate that serious consideration be given the matter. It is recommended that efforts be undertaken to test the Fixed Price Award Incentive contracting method and that a FAR deviation be granted for a period of 3 years in order to undergo testing by the military and the Department of Energy in current, active production operations.