



FEDERAL CONTRACTS



REPORT

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Contractor Accountability

Fixed-Price Development Contracting: When Politics Trump Basic Contracting Principles

By SCOTT F. LANE

Veterans of Government contracting know that despite a myriad of technological advances and the increasing oversight of defense contractors, basic rules of thumb continue to underlie successful contract performance. Failure to fully implement these rules leads to problems, and there is no better recurring example of this than selecting the contract type.

Under a typical fixed-price contract, the contractor commits to completing the entire job at established (fixed) prices. Sometimes this includes pre-defined economic price adjustments, based on certain anticipated events or issues. Basic principles dictate that fixed-price contracts are reserved for situations where specifications are reasonably definite and problems can be specifically anticipated by the contractor up-front. Federal Acquisition Regulation 16.103(b) says, "A firm-fixed price contract, which best utilizes the basic profit motive of business enterprise, shall be used when the risk involved is minimal or can be predicted with an acceptable degree of certainty." By comparison, under a cost-reimbursement contract, the work is less defined, and

the contractor and the Government effectively become a team: the Government reimburses costs up to an established ceiling; if the job is not complete when that ceiling is reached, the Government may continue to pay for the costs, but typically does not pay any fee on an overrun. A variety of cost-reimbursement arrangements are available to fit the program in question.

Because of the flexibility they provide to the parties, cost-reimbursement contracts are normally used for research and development work, while fixed-price contracts are reserved for production work. In spite of all of the new tools and ideas about how to monitor and manage contractor performance, the different contract types exist for a reason. Despite these long-honored rules of thumb, the Obama Administration and the Department of Defense are strongly embracing fixed-price contracts, even for research and development work, as a political solution to the inherently expensive cost of new defense programs.¹ In submitting to this political pressure, agencies are struggling to force a square peg into a round hole.

The poster child that has been used to justify DOD's policy on fixed-price development contracting was the F-35 Joint Strike Fighter (JSF). The JSF is unquestionably intended to incorporate technology and systems that will secure its status as the most advanced tactical aircraft in the world for decades. Furthermore, to en-

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¹ 91 FCR 170, March 10, 2009.

sure functionality across U.S. military services and across the services of multiple allied nations that are contributing to the development costs, Lockheed Martin is simultaneously developing three variants of the JSF. When the initial cost-reimbursement development contract was awarded in October 2001, the total program was anticipated to cost about \$200 billion to develop and procure 2,852 aircraft.² Recent estimates now put the total program at \$382 billion for 2,457 aircraft. The political backlash has been loud and angry.

In spite of how outraged politicians are at what happened with the JSF, there is no reason to believe that a fixed-price contract would have made the development of this multi-role stealth aircraft any easier, any more predictable, any faster, or any less expensive. Nevertheless, there has been significant political pressure placed on Lockheed Martin and the Air Force over the past year to begin shifting the continuing development or the concurrent production of the JSF onto fixed-price contract vehicles. Last month, DOD finally pressured Lockheed Martin into accepting a contract that separates one section, valued at around \$5 billion, onto a fixed-price contract.

Mixing Fixed-Price and Development Work is a Bad Idea.

The floodgates allowing fixed-price development contracts have only recently opened, but the concept is far from new for DOD. The Air Force rolled out the idea of large-scale fixed-price development on the C-5A Galaxy in the 1960s through the "Total Package Procurement Concept." In essence, the Air Force held a competition for a contract that included the design, development, production, and support of 58 enormous aircraft (with priced options for 57 more) using a fixed-price incentive contract. As intended, this forced contractors to aggressively price everything up-front under the pressure of a competition.³

Since prudent acquisition policy reserves fixed-price contracting for situations where the specifications are reasonably definite, the Air Force justified the fixed-price approach for the Galaxy by explaining that the designs could be extrapolated from the much smaller C-130 that already was flying. Lockheed "won" the competition and the real work began. Before long, the enormous size created weight issues (a frequent problem in aircraft development), which in turn created cost pressures. Because Lockheed did not have unlimited resources to commit, the program was forced to make compromises that led to structural weaknesses. With cost overruns alone estimated to reach \$2 billion, Lockheed and its major subcontractors threatened litigation and bankruptcy. This created pressure on the Government because of the jobs at risk, and, perhaps more importantly, as a practical matter, the Government still desperately needed the airplane. Eventually, the Gov-

² See Joint Strike Fighter Acquisition: Mature Critical Technologies Needed to Reduce Risks, U.S. Government Accountability Office, GAO-02-39, October 2001 (recommending that the Secretary of Defense delay the start of development until critical technologies were matured).

³ For a contemporaneous discussion of the elements and ideas behind the procurement of the C-5A Galaxy see, Gravallase, Albert, "An Evaluation of the Total Package Procurement Concept as Exemplified by Three Air Force Weapon System Contracts," *Massachusetts Institute of Technology: Research Program on the Management of Science and Technology*, #330-68, Appendix B, June 1968.

ernment cut its losses and restructured the entire program, temporarily killing the Total Package Procurement Concept (and giving unintended meaning to the "Womb to Tomb" slogan).⁴

The lessons from the Galaxy were soon addressed in DOD regulations; however, they were effectively forgotten by the 1980s. This made way for the most disastrous attempt at fixed-price development: the A-12 Avenger II. The A-12 was to be an all-weather, carrier-based stealth bomber, similar in revolutionary stature to the JSF. The Navy was well aware of the rules about reducing risks and uncertainties in development programs prior to utilizing fixed-priced contracts, but the Navy leveraged the pressure of a competition to impose a fixed-price incentive contract encompassing the design, development, production, testing and support of eight prototypes and options for four production lots. Of course, with a \$5 billion contract at stake, the contracting community simply fell in line, and the award was made to a team composed of McDonnell Douglas and General Dynamics. Unfortunately, like its predecessors, the A-12 program faced severe technical issues, and, as with its predecessors, a restructuring negotiation was attempted. McDonnell Douglas and General Dynamics offered to accept a \$1.5 billion loss if the Navy would convert the contract to cost-reimbursement, but the Navy refused (wanting \$2.1 billion) and terminated the contract for default at the direction of then-Secretary of Defense Dick Cheney. That termination has been the subject of litigation ever since and is now headed for the Supreme Court some 20 years after the termination.⁵

As a direct result of these issues and similar experiences on other programs, the 1988 National Defense Authorization Act placed a direct prohibition on fixed-price development contracts for systems over \$10 million. This is where the law remained for nearly 20 years.⁶

Politics Collide With Common Sense. Every year, the Senate Armed Services Committee analyzes various defense acquisition changes. During the course of debating the 2007 changes, DOD acquisition officials testified that Congress's prohibition on fixed-price development had contributed to widespread cost growth. The officials said that although history had proven a fixed-price approach was not practical in all contexts, it could be used effectively if contracts were issued in low-risk stages, where each stage would add a new increment of capability.⁷ Congress welcomed this opportunity and

⁴ For more information on the settlement of the C-5A Galaxy Program see, Knaack, Marcelle, "Military Airlift and Aircraft Procurement: The Case of the C-5A," *Air Force History & Museums Program*, Washington D.C., 1998, Ch. IV.

⁵ *McDonnell Douglas Corp. v. U.S.*, 567 F.3d 1340 (Fed. Cir. 2009).

⁶ There were still isolated incidents where agencies and contractors overlooked or disregarded the prohibition. Shortly after the prohibition was passed, the Navy awarded a fixed-price development contract for the design and development of ship systems on the Reduced Diameter Array program for \$19 million, which ultimately cost the contractors \$91 million and went through years of litigation. *AT&T Co. v. U.S.*, 177 F.3d 1368 (Fed. Cir. 1999).

⁷ Senate Armed Services Committee Report 109-254, Sec. 807, quoting Mr. Terry Little, then-Acquisition Advisor to the Director, Missile Defense Agency.

reversed the nearly 20-year prohibition against fixed-price development contracts.⁸ Fixed-price contracts are now the new standard, unless the agency can thoroughly justify why ongoing technical challenges increase program risk so much that only a cost-reimbursement contract is appropriate. Of course, agencies brave enough to pursue that justification will risk not receiving approval to move the program into the next phase, *i.e.*, from the Technology Development phase into the Engineering and Manufacturing Development phase, and agencies are not going to follow that path willingly.

The tide clearly has turned. DOD 5000.02 Instruction, “Operation of the Defense Acquisition System,” the guide for major system acquisitions, was revised in December 2008 to express a preference for fixed-price development, and a revision to the Defense Federal Acquisition Regulation Supplement followed shortly thereafter. When these regulations were finalized, the concept of low-risk stages was brushed aside, as evidenced by the pending 18-year KC-X Tanker Modernization Program.

The KC-X Program is a current example of a situation where the Government is trying to implement fixed-price contracting under circumstances that do not make good business sense. This \$35 billion contract will include the design, development, production and support of 172 tankers, with deliveries stretching 18 years into the future. In other words, Boeing and its competitors have offered commitments to firm prices covering the entire KC-X Program before testing the product. Notwithstanding the risks posed by such a task, and ap-

parently bowing to political pressure, the Air Force is abandoning basic principles of Government contracting and is pursuing a fixed-price development contract.

Basic Principles: No R&D Work on a Fixed-Price Basis.

Fixed-price contracting has a sensible role when the Army is buying boots or even when the Navy is buying a proven aircraft, but it simply makes no business sense when the Government is contracting for development programs, *i.e.*, when buying an armored flying gas station that has not been redesigned since the 1950s. However, the Government uses this contract type as a way to force all of the risk that is inherent in any new program onto the contractor and to mollify Congress in the process. Moreover, if the contract’s period of performance is long enough, the Government will feel assured that it will not face large “get well” pricing during production. But therein lies the rub: in taking this path, the Government sacrifices the most important component of any successful development effort: cooperation. History has shown that using a fixed-price contract for a development program fosters adversarial relationships, eliminates the incentives to communicate concerns in advance and encourages shortcuts, all of which delay performance and snowball into procurements (and litigation) like the A-12.

The easy and popular response to cost overruns is to point the finger at contractors and criticize cost-type development. For that reason, we can expect to see an upward trend in fixed-price development contracts in the coming years—at least until another contracting disaster comes along. We should expect nothing less when political considerations trump common sense and good business judgment.

⁸ Section 818 of P.L. 109-364.