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FEDERAL CONTRACTING

Application of OMB Guidance Can Improve Use of Award Fee Contracts

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GAO-09-839T

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our recent work for this subcommittee on the use of award fee contracts. An award fee is an amount of money that a contractor may earn in whole or in part by meeting or exceeding subjective criteria stated in an award fee plan. Typically the criteria are related to quality, technical ingenuity, cost-effective management, program management, and other unquantifiable areas. From fiscal year 2004 through fiscal year 2008, agencies spent over $300 billion on contracts which include award fees. While many agencies use award fee contracts, over 95 percent of the government's spending using this contract type in fiscal year 2008 occurred at five: the departments of Defense (DOD), Energy (DOE), Health and Human Services (HHS), and Homeland Security (DHS) and the National Aeronautics and Space Administration (NASA). In December 2007, the Office of Management and Budget's (OMB) Office of Federal Procurement Policy issued guidance to chief acquisition officers and procurement executives across the government that echoed several recommendations we made in 2005 on the use of award fees and emphasized positive practices to be implemented by all agencies.[1]

My statement today is based on our May 29, 2009, report, *Federal Contracting: Guidance on Award Fees Has Led to Better Practices But is Not Consistently Applied* (GAO-09-630). Like the report, this statement addresses how agencies are implementing OMB's guidance. Specifically, we (1) identified the actions agencies have taken to revise or develop policies and guidance to reflect OMB guidance on using award fees, (2) determined the extent to which current practices for using award fee contracts are consistent with the new guidance, and (3) identified the extent to which agencies collect and analyze information on award fees to evaluate their use and share that information within their agencies.

To identify the actions that these five agencies have taken to revise or develop guidance on the use of award fees, we assessed procurement policies and discussed planned and implemented policy changes with procurement officials at each agency. To determine the extent to which current practices for using award fee contracts are consistent with OMB guidance, we reviewed data from 645 evaluation periods for 100 contracts

[1]GAO, *Defense Acquisitions: DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes*, GAO-06-66 (Washington, D.C.: 2005).

at the five agencies. For DOD and NASA, our scope included contracts examined in prior GAO work and DOD contracts awarded after policies were changed that had held at least one award fee period. Where applicable, we identified the programmatic and monetary effect of implementing policy changes. For DOE, HHS, and DHS, we selected all award fee contracts with over $50 million obligated against them from fiscal year 2004 through fiscal year 2008 as identified in the Federal Procurement Data System (FPDS). We collected data on the amount of the award fee available compared to the amount awarded as well as the criteria used to evaluate contractor performance. We reviewed contract documents including award fee plans to determine the extent to which the contracts reflected positive award fee practices identified in our prior work and OMB guidance. We also interviewed procurement officials at each agency on efforts to collect data on award fees, evaluate their effectiveness, and share information on successful strategies.

Our work for our May 29, 2009, report was conducted from August 2008 through May 2009 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. More detailed information on our scope and methodology appears in our 2009 report.

OMB's Guidance Is Not Consistently Addressed at All Agencies

In December 2007, the OMB Office of Federal Procurement Policy issued guidance to chief acquisition officers and senior procurement executives to review and update their acquisition policies on the appropriate use of incentive fee contracts, which include award fee contracts. The guidance highlighted preferred practices including: (1) linking award fees to acquisition outcomes, such as cost, schedule, and performance results; (2) limiting the use of rollover[2] to exceptional circumstances defined by agency policies; (3) designing evaluation factors that motivate excellent contractor performance by making clear distinctions between satisfactory and excellent performance; and (4) prohibiting payments for contractor performance that is judged to be unsatisfactory or does not meet the basic

[2] Rollover is a practice in which unearned award fee is moved from one evaluation period to a subsequent evaluation period or periods, thus providing the contractor an additional opportunity to earn previously unearned fee.

requirements of the contract.[3] Further, OMB asked agencies to obtain and share practices in using award fees through an existing Web-based resource. The OMB guidance was developed based on award fee problems that had been identified by GAO and which DOD and NASA had begun to address. The following shows how OMB's guidance is reflected in guidance provided by each agency:

- In response to GAO recommendations in 2005[4] and subsequent legislation,[5] DOD issued guidance in 2006 and 2007 that states it is imperative that award fees are linked to desired outcomes, that the practice of rolling over unearned award fees should be limited to exceptional circumstances, that award fees must be commensurate with contractor performance, and that performance that is unsatisfactory is not entitled to any award fee. It also states that satisfactory performance should earn considerably less than excellent performance; otherwise, the motivation to achieve excellence is negated.
- While NASA's Award Fee Guide already addressed the four issues, our previous work found that NASA did not consistently implement key aspects of its guidance on major award fee contracts.[6] In response to our findings, a June 2007 NASA policy update reemphasized these policies to contracting staff and added a requirement that contracting officers include documented cost-benefit analysis when using an award fee contract.
- DOE has supplemental guidance to the Federal Acquisition Regulation (FAR) that outlines how award fees should be considered and in September 2008 created implementing guidance specific to management and operations contracts that links award fees to acquisition outcomes and limits the use of rollover. However, DOE's departmental guidance does not clearly define the standards of performance for each rating category or prevent payment of fees for unsatisfactory performance. Divisions of DOE have developed their own standards and methods of evaluation which vary in their consistency with the OMB guidance.

[3] Other guidance in OMB's guidance memo included performing a cost-benefit analysis before using incentive fees and ensuring that plans had clear definitions on how contractors would be evaluated, the levels of performance used to judge them, and specific criteria on how to achieve those levels.

[4] GAO-06-66.

[5] The John Warner National Defense Authorization Act for Fiscal Year 2007. Pub. L. No. 109-364, § 814 (2006).

[6] GAO-07-58, *NASA Procurement: Use of Award Fees for Achieving Program Outcomes Should Be Improved*, GAO-07-58 (Washington, D.C.: 2007).

- DHS provides guidance on award fees in its acquisition manual, but does not fully address the issues in the OMB guidance. The DHS guidance requires award fee plans to include criteria related (at a minimum) to cost, schedule, and performance and establishes that award fees are to be earned for successful outcomes and that no award fee may be earned against criteria that are ranked below "successful" or "satisfactory." However, the manual does not describe standards or definitions for determining various levels of performance or include any limitation on the use of rollover.
- HHS officials did not have guidance specific to the use of award fees and were not aware of any such guidance at their operational divisions. Officials told us that they relied on the FAR for guidance on using award fees. However, contracting officials at HHS operational divisions noted a need for better guidance and told us that the FAR did not provide the level of detail needed to execute an award fee contract. As a result, contracting officers at these operational divisions have developed approaches to award fee contracts which vary in their degree of consistency with OMB's guidance.

The National Defense Authorization Act for Fiscal Year 2009[7] directed that the FAR be amended by the middle of October 2009 to expand the requirements placed on DOD in 2007 to all executive agencies.[8] A working group including representatives from these agencies is reviewing and updating the FAR. DOD officials also told us that they are developing supplemental guidance on award fees, but will wait until the FAR working group completes its work before finalizing the guidance.

Agency Practices Are Not Always Consistent with OMB Guidance

By implementing the revised guidance, some DOD components reduced costs and improved management of award fee contracts. Potential changes at NASA —such as documented cost-benefit analyses—are too recent for their full effects to be judged. At DOE, DHS, and HHS, individual contracting offices have developed their own approaches to executing award fee contracts which are not always consistent with the principles in the OMB guidance or between offices within these departments.

- **Use of Rollover**: Guidance from DOD, DOE, and OMB states that allowing contractors a second chance at unearned fees should be limited

[7] The Duncan Hunter National Defense Authorization for Fiscal Year 2009, Pub. L. No. 110-417 §. 867 (2008).

[8] Pub. L. No. 109-364, § 814 (2006).

to exceptional circumstances and should require high-level approval. NASA guidance does not allow rollover. Allowing contractors an opportunity to obtain previously unearned fees reduces the motivation of the incentive in the original award fee period. In almost all of the 50 DOD contracts we reviewed, rollover is now the exception and not the rule. While in 2005 we found that 52 percent of all DOD programs rolled over fee, only 4 percent of the programs in our sample continue this practice. We reviewed active contracts from our 2005 sample and found that eliminating rollover will save DOD more than an estimated $450 million on 8 programs from April 2006 through October 2010. However, with the exception of NASA where rollover is not allowed, we found instances at each agency, where rollover was allowed, at times, for 100 percent of the unearned fee.

- **Linking Fees to Outcomes**: OMB's guidance indicates that award fees should be used to achieve specific performance objectives established prior to contract award, such as delivering products and services on time, within cost, and with promised performance; and must be tied to demonstrated results, as opposed to effort. Contracting officers and program managers across all five agencies said award fee contracts could benefit from objective targets that equate to a specific amount of the fee. While the combination of award fee contracts which evaluate subjective criteria and incentive contracts which evaluate objective targets was the preferred approach of several officials, there is no guidance on how to balance or combine these contract types. The effective use of subjective criteria requires that they be accompanied by definitions and measurements of their own to ensure they are linked to outcomes rather than processes or efforts. DOD's Joint Strike Fighter is one program that has incorporated more discrete criteria. In comparing periods before and after the application of these criteria, the contractor has consistently scored lower in the performance areas than in previous periods where less defined criteria were applied. We estimate that the more accurate assessment of contractor performance has saved almost $29 million in less than 2 years of the policy change. However, contracts do not always use criteria that are linked to outcomes. For example, an HHS contract for call center services awarded a portion of the fees based on results, such as response times, but also included criteria based more on efforts, such as requiring the contractor to ensure that staffing levels were appropriate for forecasted volumes during hours of operation, rather than measuring results.
- **Using Evaluation Factors to Motivate Excellent Performance**: The amount of the fee established for satisfactory performance or meeting contract requirements generally awards the contractor for providing the minimum effort acceptable to the government. Programs used a broad range in setting the amount of the fee available for satisfactory

performance, but many left little to motivate excellent performance. For example, DOE's Office of Science uses a model that sets the amount of the fee able to be earned for meeting expectations at 91 percent, thus leaving 9 percent to motivate performance that exceeds expectations. In contrast, in an HHS contract for management, operation, professional, technical, and support services, the contractor earns 35 percent of the award fee for satisfactory performance, leaving 65 percent of the fee to motivate excellent performance. DOD and NASA are the only agencies we reviewed that provide guidance on the amount of the fee to be paid for satisfactory performance, up to 50 percent and 70 percent respectively. However, not all DOD programs have followed this guidance. For example, a DOD Missile Defense Agency (MDA) contract signed in December 2007 awards the contractor up to 84 percent of the award fee pool for satisfactory performance, which the agency defines as meeting most of the requirements of the contract. This leaves only 16 percent of the award fee pool to motivate performance that fully meets contract requirements or is considered above satisfactory.

- **Payments for Unsatisfactory Performance**: DOD, NASA, and OMB have stated that performance not meeting contract requirements or judged to be unsatisfactory merits no award fee. However, while the median award fee scores indicate satisfaction with the results of the contract, programs we reviewed continue to use evaluation tools that could allow for contractors to earn award fees without performing at a level that is acceptable to the government under the terms of the contract. For example, an HHS contract for Medicare claims processing rates contractor performance on a point scale, from 0 to 100, where the contractor can receive up to 49 percent of the fee for unsatisfactory performance and up to 79 percent for satisfactory performance (defined as meeting contract requirements). The National Nuclear Safety Administration, a separate agency within DOE, uses a tool that prohibits payments for unsatisfactory performance while the evaluation method used by DOE's Office of Science allows a contractor to earn up to 84 percent of the award fee for performance that is defined as not meeting expectations. Further, current award fee plans for some programs using the Office of Science lab appraisal process allow for an award fee to be earned at the "C" level, which guidance defines as performance in which "a number of expectations ... are not met and/or a number of other deficiencies are identified" with potentially negative impacts to the lab and mission. According to Office of Science guidance, as much as 38 percent of the fee can be earned for objectives that fall in this category.

Agencies Do Not Have Methods for Evaluating Award Fee Effectiveness in Improving Contractor Performance

While programs have paid more than $6 billion in award fees for the 100 contracts we reviewed, none of the five agencies has developed methods for evaluating the effectiveness of an award fee as a tool for improving contractor performance. Instead, program officials noted that the effectiveness of a contract is evident in the contractor's ability to meet the overall goals of the program and respond to the priorities established for a particular award fee period. However, officials were not able to identify the extent to which successful outcomes were attributable to incentives provided by award fees versus external factors such as a contractor's interest in maintaining a good reputation. When asked how they would respond to a requirement to evaluate the effectiveness of an award fee, officials told us that they would have difficulty developing performance measures that would be comparable across programs.

Of the five agencies we reviewed, only DOD collects data on award fee contracts. In 2006, legislation required DOD to develop guidance on the use of award fees that included ensuring that the department collects relevant data on award and incentive fees paid to contractors and that it has mechanisms in place to evaluate such data on a regular basis.[9] DOD has collected and analyzed data and provided that analysis to Congress and the Senior Procurement Executives of the military services and other DOD agencies. However, DOD does not have performance measures to evaluate the effectiveness of award fees as a tool for improving contractor performance and achieving desired program outcomes. DOD's data collected on objective efficiencies include cost and schedule measures but do not reflect any consideration of the circumstances that affected performance, a critical element in determining award fees.

While DOD has established an award fee community of practice through its Defense Acquisition University, most information regarding successful strategies for using award fees is shared through informal networks. Contracting officers at DOD, DOE, DHS, and HHS were unaware of any formal networks or resources for sharing best practices, lessons learned, or other strategies for using award fee contracts, and said they rely on informal networks or existing guidance from other agencies. However, within agencies, procurement executives are beginning to review award fee criteria across programs for consistency and successful strategies.

[9] Pub. L. No. 109-364, § 814 (2006).

Concluding Observations and Prior Recommendations for Executive Action

Award fee contracts can motivate contractor performance when certain principles are applied. Linking fees to acquisition outcomes ensures that the fee being paid is directly related to the quality, timeliness, and cost of what the government is receiving. Limiting the opportunity for contractors to have a second chance at earning a previously unearned fee maximizes the incentive during an award fee period. Additionally, the amount of the fee earned should be commensurate with contractor performance based on evaluation factors designed to motivate excellent performance. Further, no fee should be paid for performance that is judged to be unsatisfactory or does not meet contract requirements. While DOD has realized benefits from applying these principles to some contracts, these principles have not been established fully in guidance at DOE, DHS, and HHS. Having guidance is not enough, however, unless it is consistently implemented. Further, the lack of methods to evaluate effectiveness and promote information sharing among and within agencies has created an atmosphere in which agencies are unaware of whether these contracts are being used effectively and one in which poor practices can go unnoticed and positive practices can be isolated.

In our report, we recommended that DOE, HHS, and DHS update or develop implementing guidance on using award fees. This guidance should provide instructions and definitions on developing criteria to link award fees to acquisition outcomes, using an award fee in combination with incentive fees, rolling over unearned fees, establishing evaluation factors to motivate contractors toward excellent performance, and prohibiting payments of award fees for unsatisfactory performance. To expand upon improvements made, we recommended that DOD promote consistent application of existing guidance, including reviewing contracts awarded before the guidance was in effect for opportunities to apply it, and provide guidance on using an award fee in combination with incentive fees to maximize the effectiveness of subjective and objective criteria. We also recommended that the five agencies establish an interagency working group to (1) identify how best to evaluate the effectiveness of award fees as a tool for improving contractor performance and achieving desired program outcomes and (2) develop methods for sharing information on successful strategies. The agencies concurred with our recommendations and noted that both the FAR working group and an interagency working group could be potential mechanisms for implementing our recommendations.

Mr. Chairman, this concludes my statement. I would be pleased to respond to any questions you or other Members of the Subcommittee may have.

For questions regarding this statement, please contact John P. Hutton at (202) 512-4841 or at huttonj@gao.gov. Individuals making contributions to this testimony include Thomas Denomme, Assistant Director, Kevin Heinz, John Krump, and Robert Swierczek.

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