COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS
1000 Wilson Boulevard
Suite 1800
Arlington,VA 22209
www.codsia.org
703 243-2020

November 9, 2004
CODSIA CASE 07-04

Director, Defense Procurement and Acquisition Policy (DPAP)
Policy Directorate Office
ATTN: Mr. David Capitano
3000 Defense Pentagon, Room 3C838
Washington, DC 20301-3000

Subject: Performance Based Payments as a Method
Of financing DoD contracts

Dear Mr. Capitano:

The Council of Defense and Space Industry Associations (CODSIA) is pleased to provide comments in response to your September 9, 2004 request for public input regarding actions DoD should undertake to increase the use of performance-based payments financing on DoD contracts, and to improve the efficiency of systems and processes to award and administer contracts utilizing the performance-based payment (PBP) mechanism.

Founded in 1964 by industry associations with common interests in the defense and space fields, CODSIA is currently composed of six associations representing over 4,000 member companies across the nation. Participation in CODSIA is strictly voluntary. Therefore, a decision by a member association to abstain from participating in a particular CODSIA case is not necessarily an indication of dissent.

The introduction of performance based payments in the late 1990s was a key improvement by DoD in responding to the concerns raised by the Defense Science Board and detailed in its report on “Preserving a Healthy and Competitive U.S. Defense Industry to Ensure Our Future National Security.” Their increased use over the last several years has provided industry with a significant opportunity to improve working capital investments in support of Department of Defense programs.

DoD contractors have gained significant insight into the requirements, processes, and administration of performance based payments since their introduction. Our collective experience using performance-based payments has identified a number of areas where the current systems and processes for their use can be improved. Our recommendations for improvements are enumerated below. Detailed responses to the questions posed in the September 9th Federal Register notice on the use of performance based payments are in Attachment A.

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS
1000 Wilson Boulevard
Suite 1800
Arlington,VA 22209
www.codsia.org
703 243-2020

Recommendations

1. Verifying incurred costs should not be a part of PBP. The most important advantage of using PBP from an administrative perspective is the elimination of government auditing of incurred costs. Further, it is not clear what the government intends to do with incurred cost information. It would appear that, regardless of the costs incurred to achieve a performance milestone, the payment terms of the contract must prevail. Therefore, the incurred costs should have no impact on the payments. We recommend prohibiting the verification of incurred costs paid to date against PBPs in all cases.

We are concerned that the language in FAR 32.1004 (a) (3) (ii) may be causing contracting officers to request incurred cost data at each milestone, even though the language appears to apply only to the pre-award phase of the contract. The second sentence in (ii) states that the contracting officer may request expenditure profile information to confirm that the contractor's investment is sufficient. It is our understanding that some contracting officers are citing this language as support for their requests for incurred cost information. We recommend that either the FAR language be modified to make it clear that expenditure profiles may only be requested during the contract pre-award stage to assure the Government that the contractor's investment is sufficient, or guidance clarifying the FAR language be issued by both DPAP and DCMA.

2. Establish one financing and liquidation rate (see Recommendation #3 below) for all lines, lots, and options of a contract until the DFAS and other DoD payment systems are capable of systematically handling multiple financing rates. The utilization of one rate will make it much simpler for DoD and the contractor to administer, pay, and closeout contracts. Contracts with multiple rates require both the contractor and payment offices to maintain manual spreadsheets of financing balances, in some cases down to the line item level, throughout the life of the contract. The use of one rate reduces the potential for overpayments and permits Government payment offices to utilize automated features of their payment systems. Recognizing the fact that existing contracts are of mixed types and have multiple rates, we recommend that DFAS (and other paying offices) promptly initiate a system change to provide the capability within the payment system to handle multiple financing rates and contract types in the same contract on an automated basis.

3. Ensure PBP financing rates offer true financing incentives above that which could be achieved with the no-risk, administratively burdensome, 80% progress payment option. To become the preferred method of financing the rates must be favorable and reflect the performance risk that contractors assume. The FAR currently states that performance based payment financing must be prudent and not exceed 90% of the contract price. There have been numerous situations where rates significantly lower than 90% have been awarded and this trend is a disincentive for contractors to accept the risks associated with meeting performance based financing events. There have even been situations where actual PBP rates awarded provided lower effective financing than the 80% progress

payment option. Therefore, we urge DPAP to issue guidance to the field advising PCOs to issue PBP rates that offer a true financial incentive. The situation could be greatly improved if the DPAP guidance recommended the use of 90% on an ordinary basis, and lower rates only when significant justification exists.

4. As part of the acquisition planning and contract formation process, make each PBP event as objective, quantifiable and easy to measure as possible. For example, tying PBP events to already defined program reviews, test or manufacturing plan milestones or other events on the integrated program schedule for manufacturing activities is often the best course. For services, tying PBP events to program reviews, key performance milestones or other suitable events is good business practice. However, defining the PBP event as "100% completion" of tasks should be avoided since there are frequently minor action items left open even when a major milestone is otherwise considered accomplished. Resolution of this problem does not require a regulatory change to FAR Part 31, but could be addressed through clarifications in Part 7 (relating to acquisition planning) and DPAP guidance, and addressed through Government training. Also clarify that PBPs are financing payments for which events indicate contract progress. Some administrative contracting officers (ACO) believe monthly payments should reflect only the cost of the performance event, rather than financing payments.

5. For mature programs with very reliable production processes, permit PBP based on production lead times rather than performance events. This is a common commercial practice and is appropriate in situations when the lead times and production processes are well known. The end result would be a PBP payment contract that is simple to award and administer because the effort to validate and approve events would be eliminated.

6. Simplify the contract administration and payment process by eliminating the requirement for contractors to bill, and for DFAS (or other pay office) to pay, PBP financing requests by contract line and ACRN. Financing is not payment for goods and services accepted and therefore should not be subject to the strict billing requirements mandated by the Anti-Deficiency Act. PBP financing should be treated the same as progress payment financing by having the DoD payment system allocate the billing amount to all the appropriate ACRNS on the contract. Adoption of this recommendation would eliminate the need for preparation of complex billings and the maintenance of manual spreadsheets by contractor and DoD, respectively, and is consistent with the DPAP guidance on minimizing the use of multiple ACRNS. It would also permit the use of existing automated features of the payment system. Currently, 80% of progress payments pay on an automated basis while the rate for PBPs is only 8%. The automated features and process controls built into the payment system for progress payments also diminish the risk of overpayment and make the need for reconciliations less likely. We are told that PBP requests go to audit 2.5 times more often than progress payment billings.

7. Permit billings to be segregated into multiple invoices in situations where a problem with a funding source, accounting station, or FMS customer is expected to delay payment. One contractor had payment of a $100 million PBP billing held up on an Air Force contract because there was a problem at a Navy accounting station related to a $5 million stand-alone event that was part of the total invoice request. The multiple invoices option is important because the DoD payment system lacks controls to permit financing requests to be "short-paid" in situations where payment delays are expected. The option also provides contractors with the ability to receive payment on time for a portion of the billing when problems like those described above are anticipated or arise, and minimizes reconciliation and the risk of expiring funds.

8. Issue guidance to clarify that a corrected or delayed billing from a prior month does not preclude a contractor from issuing a new billing for PBP events achieved in a subsequent month.

PBPs are a valuable tool for reducing administrative effort for contracts with lengthy periods of performance. Although additional efforts are frequently required by both government and contracting officials to establish the appropriate and measurable payable events, the mutual benefits of reduced administrative effort over cost-based progress payments, together with the potential for reduced financing burdens on the contractor, almost always offset the additional efforts.

We would welcome the opportunity to have further discussions regarding our comments and recommendations. Please contact Ms. Bettie McCarthy, CODSIA Administrative Officer, on 703 243-2020. Ms. McCarthy can be reached by email at codsia@csa-dc.org.

Sincerely,

CODSIA Signatories

Robert T. Marlow
Vice President
Procurement and Policy
Aerospace Industries Association

Alan Chvotkin
Senior Vice President and
Counsel
Professional Services Council

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS
1000 Wilson Boulevard
Suite 1800
Arlington,VA 22209
www.codsia.org
703 243-2020

Chris Jahn
President
Contract Services Association

Attachment

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS
1000 Wilson Boulevard
Suite 1800
Arlington,VA 22209
www.codsia.org
703 243-2020

Attachment A

Responses to Questions Posed in the September 9, 2004 Federal Register

1) What actions should be taken by DPAP to increase the use of performance-based payments as the method of contract financing on DoD contracts (e.g., what should be done to increase the number of contracts that utilize performance-based payments)?

In addition to considering our recommendations in our cover letter, DPAP should ensure that all of the military departments and defense agencies exert maximum efforts to make performance based payments (PBP) the preferred methodology for payment of their contracts. It should be noted that at least one major buying command is not using performance based payments for interim financing on negotiated fixed price contracts but we are not aware of their reasons for preferring to use progress payments. In addition, there has been a general resistance to using performance-based payments on those programs that have been criticized in recent GAO reports.

A policy letter from DPAP reminding the services that FAR 32.1001 states that performance based payments is the preferred method of financing on negotiated fixed price contracts when the contractor concurs, could be helpful in increasing their use. Such a letter would also give contractors another basis for requesting contract payments tied to performance events when the buying command prefers the use of progress payments without adequate support for its position.

2) What actions should be taken to improve the efficiency of performance-based payments when used on DoD contracts (e.g., what should be done to improve the use of performance-based payments on those contracts that provide for such contract financing)?

In addition to our recommendations in the cover letter, one of the biggest inefficiencies from a billing/collection perspective is the misuse of ACRNs and the proliferation of the use of multiple ACRNS spread against multiple CLINs. DPAP has previously issued policy guidance to address the “multiple ACRN” issue. Contractors should be allowed to submit invoices by performance event, and the payment office should be required to distribute costs to appropriate CLINs and ACRNs based on contract terms.

In our view, certain PBP events included in contracts have violated FAR 31.1001. PBP events have been defined as the delivery of line items, e.g., events with references to DD250's as evidence that the event was completed. This is inconsistent with the provisions of the FAR Clause that provides: "Performance based payments are contract financing payments that are not payments for accepted items." Language dealing with the structuring of performance events should be consistent with the FAR and be included both in solicitations and in resulting contracts. Where mixed contract types exist in the same contract (e.g. fixed price line items and cost-type line items), the contract must provide clear guidance to both the contractor and the payment office on how the effort should be billed and paid. If a contract contains mixed types of effort (e.g. PBPs, milestones, cost effort, and deliveries), the contract should stipulate how each effort is to be billed, paid, and liquidated (if applicable). This issue could be addressed in guidance from DPAP or in DoD training courses. The payment system should also be modified to ensure contracts with mixed types can be accurately paid on a fully automated basis.

Contracts with performance-based payments do not always clearly state if the PBPs apply at the entire contract level or the deliverable item level, and this omission causes contractor and Government administrative/pay office personnel problems in determining whether a financing payment request should be invoiced or paid. We recommend that FAR 32.1004 be revised to require the contracting officer to clearly indicate whether the PBP events apply to the whole contract or only to a deliverable item(s).

Maximizing the use of Wide-Area-Workflow (WAWF) to present and approve PBPs has been a significant benefit to DFAS and to contractors. However, additional effort should be expended to ensure all ACOs and contract administrators are fully trained, and have appropriate backup for absences to ensure the success of this critical transaction in WAWF. From a systems perspective, the WAWF system could be enhanced by permitting contractors utilizing the web input mode to upload Excel spreadsheets containing EVENT/CLIN/ACRN detail rather than inputting dozens and in some cases hundreds of lines into the system. The spreadsheet upload option would permit contractors to incorporate additional controls to improve the accuracy of the information; it would also eliminate a frustrating "timeout" problem that has been experienced when contractors try to input complex contracts with hundreds on lines.

Finally, the FAR should affirmatively sanction the use of progress payments and performance based billings on the same contract.

Disadvantages of Performance Based Payments

The Government sometimes imposes complex billing terms and establishes inaccurate contract funding structures, which result in long billing preparation cycles and major government and contractor analysis, accounting and reconciliation efforts.

Payment instructions provided by the ACOs for approved amounts by CLIN and ACRN are occasionally at variance with the information in the payment system or are misinterpreted or not understood by DFAS (or another payment office), causing further payment confusion and delays.

Regulations require that PBP invoices be paid in fourteen days. We believe paying offices should make every effort to pay these invoices in the same seven-day time frame as required for progress payment invoices. This will facilitate prompt contract administration, facilitate the Department's payment recordings and enhance the Department's financial reporting systems and funds management.

Finally, some PBPs require pre-approval by both the buying command and the ACO that further delays submission of the invoice to the paying office by up to an additional two weeks. Guidance should be provided to the buying commands to minimize contractual requirements for pre-approvals, and the situations where such pre-approvals are appropriate should be clearly described.