



# CONTRACT LAW DIVISION

Office of Assistant General Counsel for Finance and Litigation



## A Lawyer's View of Performance Based Service Contracting

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### Performance-Based Service Contracting

By

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#### I. Purpose

The purpose of this Lawyer's View Article is to examine Performance-Based Service Contracting (PBSC) by discussing the principal elements and benefits of PBSC, and related case law. Also, a list of helpful resources for information on PBSC is included in this article. We hope that this Lawyer's View Article will not only provide an informative overview of PBSC to both the Government and contractor communities, but also encourage the increased use of PBSC within the Department of Commerce.

#### II. Performance-Based Contracting Explained

Performance-Based Service Contracting is the preferred method for procuring services from the private sector. FAR §37.101 explains that "Performance-based contracting means structuring all aspects of an acquisition around the purpose of the work to be performed as opposed to either the manner by which the work is to be performed or broad and imprecise statements of work." According to The Office of Federal Procurement Policy (OFPP), a performance-based service contract should include: (1) a statement of work, referred to as a Performance Work Statement (PWS); (2) a Quality Assurance Plan (QAP) or allowable error rate; and (3) appropriate incentives for the contractor which encourage good performance and discourage unsatisfactory

performance.<sup>3</sup> OFPP has stated that these elements are "interdependent" and that they must be "compatible in form, style, and substance, and should be cross-referenced."<sup>4</sup>

#### III. Background

PBSC is not a new approach to service contracting. Indeed, nearly 20 years ago, in October, 1980, OFPP issued OFPP Pamphlet Number 4, A Guide for Writing and Administering Performance Statements of Work for Service Contracts (hereinafter, "Pamphlet No. 4"). Subsequently, on April 9, 1991, OFPP issued Policy Letter 91-2, which states that it "is the policy of the Federal Government that . . . agencies use performance-based contracting methods to the maximum extent practicable when acquiring services."<sup>5</sup> FAR Subpart 37.6, "Performance-Based Contracting", implements OFPP Policy Letter 91-2. In October, 1998, OFPP published "Information on Best Practices for Performance-Based Service Contracting" (hereinafter, "Best Practices Guide").

#### IV. Principal Elements of a PBSC

As noted above, OFPP has indicated that a true performance-based service contract should include a Performance Work Statement (PWS), a Quality Assurance Plan (QAP), and appropriate incentives.

##### A. The PBSC Statement of Work: The Performance Work Statement (PWS)

FAR §37.602-1 sets forth general guidance on drafting PBSC statements of work (SOW) and provides that the SOW must be "tailored to consider the period of performance, deliverable items, if any, and the desired degree of performance flexibility." FAR §37.602-1(a) also provides additional guidance

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<sup>3</sup> See Information on Best Practices for Performance-Based Service Contracting, Office of Federal Procurement Policy, October 1998, at 7.

<sup>4</sup> *Id.* at 7.

<sup>5</sup> Office of Federal Procurement Policy Letter 91-2, ¶ 5.



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for task order contracts. FAR §37.602-1(b)(1)-(4) provides that when preparing a SOW agencies shall, to the maximum extent practicable, describe the work in terms of required output instead of how the work is to be accomplished, and use both measurable performance standards as well as financial incentives.

OFPP has published considerable guidance on drafting a PBSC SOW (also referred to as a PWS), in its Best Practices Guide and in Pamphlet No. 4. As a preliminary matter, OFPP encourages agencies to conduct a Job Analysis before writing a PWS. A Job Analysis is a process which enables the “analyst to pull together all of the essential information needed to write a performance-oriented Statement of Work.”<sup>6</sup> At its core, a Job Analysis determines what the agency needs, and what services and outputs the contractor will provide. This is “of particular importance because the services or outputs identified form the basis for establishing performance requirements, developing performance standards and indicators, writing the PWS and producing the QAP.”<sup>7</sup>

Once a Job Analysis has been conducted, an agency will be well-poised to write the PWS. OFPP has described the PWS as the “foundation”<sup>8</sup> of performance-based services; the PWS should establish: (1) a statement of required services in terms of output, referred to as Performance Requirements; (2) a measurable Performance Standard for output; and (3) an Acceptable Quality Level (AQL) or allowable error rate. Each will be discussed in turn.

First, in establishing Performance Requirements in the PWS, an agency should describe the required services in terms of output and should “identify only

those outputs that are essential.”<sup>9</sup> The Performance Requirements should be written clearly and succinctly, yet with sufficient flexibility for the contractor to determine the best manner in which to perform the work. Second, the agency should set forth in the PWS a measurable Performance Standard for output which establishes the performance level required by the Government. The Performance Standards are the criteria used to assess whether the contractor has satisfied the Performance Requirements. The Performance Standards should establish “what, when, where, how many, and how well the work is to be performed.”<sup>10</sup> Care should be given to ensure that the standard is not only clearly established but also is necessary, not unduly burdensome, and carefully chosen.<sup>11</sup> Third, in the PWS the agency should establish an AQL or a maximum allowable error rate which establishes what variation from the Performance Standard is allowed. Agencies should proceed cautiously in establishing an AQL. OFPP advises that the “minimum acceptable performance standard should rarely be 100 percent, since the standard directly affects the cost of the service. Conversely, if the quality level is too low, it may act as a disincentive to good contract performance.”<sup>12</sup>

In its Best Practices Guide, OFPP demonstrates the interplay between the Performance Standard and the AQL with the following example: “In a requirement for taxi services, the performance standard might be ‘pickup within five minutes of an agreed upon time.’ The AQL then might be five percent, i.e., the taxi could be more than five minutes late no more than

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<sup>6</sup> Office of Federal Procurement Policy Pamphlet Number 4, A Guide for Writing and Administering Performance Statements of Work for Service Contracts, October 1980, at 17.

<sup>7</sup> Note 1, *supra*, at 10.

<sup>8</sup> *Id.* at 17.

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<sup>9</sup> *Id.* at 17.

<sup>10</sup> *Id.* at 7.

<sup>11</sup> *See, id.*, at 11.

<sup>12</sup> *Id.* at 10.



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five percent of the time. Failure to perform within the AQL would result in a contract price reduction.”<sup>13</sup>

### B. Quality Assurance Plan (QAP)

A QAP establishes what the “government must do to ensure that the contractor has performed in accordance with the Performance Standards set forth in the PWS. . . It is needed to ensure the Government receives the quality of services called for under the contract, and pays only for the acceptable level of services received.”<sup>14</sup> A QAP forms the basis for establishing appropriate performance incentives. It bears repeating that since the PWS, QAP, and incentives are “interdependent,” they should be “compatible in form, style, and substance, and be cross-referenced.”<sup>15</sup> In sum, these elements should make sense when read together, and be well-referenced throughout the contract.

FAR §37.602-2 requires agencies to develop a quality assurance surveillance plan and refers to FAR §46.103 and FAR §46.401(a) for more specific requirements in developing the QAP. Also, FAR §37.602-2 requires that a QAP “recognize the responsibility of the contractor (see 46.105) to carry out its quality control obligations” and “contain measurable inspection and acceptance criteria corresponding to the performance standards in the PWS.”

A QAP should clearly articulate the surveillance methods the Government intends to use. Agencies should take care to use appropriate surveillance methods taking into consideration task criticality, task lot size, the surveillance period, Performance Requirements, Performance Standards, availability of quality assurance evaluators, surveillance value in relation to task cost/criticality, and available

resources.<sup>16</sup> A QAP should also establish a surveillance schedule. Establishing a schedule and surveillance methods up front provides a mechanism not only for the Government to get what it is contracting for, but also to determine what resources are needed to administer the contract.

### C. Incentives

An important aspect of PBSC is the use of incentives. The use of incentives in PBSC is somewhat comparable to the use of an award fee. Under PBSC, payment is made for services that meet required or minimum performance levels. However, in many procurements, the Government is willing to pay more than a minimum contract price for performance that exceeds the AQL. In those cases, a performance-based contract can provide for monetary incentives for superior performance.

Incentive payments should be selectively applied. Remember that in a PBSC situation, the Government has already built in an incentive for successful performance by basing contract payments on achieving an acceptable or minimum level of quality. Incentives should be used to encourage superior performance in areas of particular importance or to motivate contractor efforts that might not otherwise be emphasized.<sup>17</sup> As with other aspects of PBSC, payment of incentives is determined by the quality level desired and measurement of the contractor’s performance to determine if the level was achieved.

PBSC can also include negative incentives. Negative incentives are deductions for failure to perform a required task up to required quality levels. Negative incentives generally represent a percentage price reduction tied to the magnitude that performance fails to meet the AQL. For instance, the AQL may require the contractor to perform a task correctly 95% of the time. Rather than withhold contract payment

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<sup>13</sup> *Id.* at 11.

<sup>14</sup> *Id.* at 21.

<sup>15</sup> *Id.* 7.

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<sup>16</sup> *See, id.*, at 21.

<sup>17</sup> *Id.* at 14.



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for anything less than 95% performance, the contract could provide that for every percent that performance falls below 95%, payment for the task will be reduced by 20%.

Incentives, both positive and negative, can be a powerful tool to ensure that superior contract performance results. Nevertheless, contracting officers need to monitor the effectiveness of incentives throughout the course of the contract to ensure that they really are resulting in enhanced performance or discouraging unsatisfactory performance.

### V. Case Law

Although PBSC has been the policy of the federal Government since the issuance of OFPP Policy Letter 91-2 in April, 1991, it has been the subject of remarkably few protest decisions.

An early decision, *Logistical Support, Inc.*, 91-2 Comp. Gen. 267 (9/23/91), was issued soon after the policy letter took effect and before PBSC requirements were incorporated into the FAR. In that case, the protestor asserted that the Navy was required by the policy letter to use PBSC in obtaining attendant services, and the RFP's specification of minimum staffing levels was inconsistent with PBSC, which requires that the offerors determine how they would perform the contract and what staffing levels would be appropriate. GAO denied that it had jurisdiction over this protest, however, because it only reviews violations of statutes or regulations, not policy directives. This case does leave open the issue whether an agency's failure to follow the FAR's requirements to use PBSC when appropriate is protestable; no case has yet addressed this issue.

Other cases show that the Comptroller General will allow agencies wide latitude in applying PBSC. For instance, when an agency shifts from a specification-based procurement to performance-based contracting, this change represents such a significant difference in approach that the agency does not have to give significant weight to an incumbent's prior experience. *Suncoast Associates, Inc.*, 95-2 Comp. Gen. 268 (12/7/95). In general, when using PBSC, an agency

has wide discretion to determine the contract type, pricing structure and degree of risk that will be placed on the contractor. *Diversified Technology & Services of Virginia*, 99-2 Comp. Gen. 16 (7/19/99). Under PBSC, offerors may propose a range of staffing options and technical solutions, and it is the agency's job to determine which proposal will produce the best results; this determination, if reasonable and in accord with the solicitation, will not be overturned by the Comptroller General. *Ogden Government Services*, 93-2 Comp. Gen. 339 (12/27/93).

### VI. Benefits of PBSC

Performance-based contracting is now the preferred method when the federal Government procures services. As agencies begin to apply this requirement across their services contracts, they can expect tangible benefits. In the conclusion to the Best Practices Guide, OFPP notes that the use of PBSC methods "should lead to more cost-effective acquisitions, better value, and greater competition."<sup>18</sup> OFPP notes, in addition, that PBSC shifts the performance risk from the Government to contractors, while giving contractors more latitude for determining the methods of performance and more responsibility for the quality of performance. The net result may very well be lower costs, as well as fewer delays and performance deficiencies.

Agencies that shift to PBSC should find that many areas of contract dispute may be eliminated. Because the contractor is responsible for results and methods, disputes over ambiguities in specifications and who is to blame for performance failures should be minimized. While some contracting officers have found that developing a PWS and QAP is more time-consuming than writing a specification-based RFP, letting the contractor determine how the work will be done may significantly reduce the need for agency oversight of contractor performance.

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<sup>18</sup> *Id.* at 32.



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PBSC ties in very closely with the current emphasis on the federal Government relying upon the expertise found in the commercial marketplace. By letting contractors determine how they will achieve the results desired, the Government is taking advantage of the efficiencies that are inherent in the commercial sector and providing incentives for lower cost performance. As OFPP concludes, a properly focused PBSC program creates a “win/win situation”<sup>19</sup> for both the Government and private sector.

### VII. Resources

Helpful resources for information on PBSC include:

**1. FAR Subpart 37.6, Performance-Based Contracting**

**2. Information on Best Practices for Performance-Based Service Contracting, published by OFPP in October 1998, available at:**

<http://www.far.npr.gov/BestP/PPBSC/BestPPBSC.html>

**3. OFPP Policy Letter 91-2, issued April 9, 1991, available at:**

[http://www.arnet.gov/Library/OFPP/PolicyLetters/Letters/PL91-2\\_4-9-91.html](http://www.arnet.gov/Library/OFPP/PolicyLetters/Letters/PL91-2_4-9-91.html)

**4. OFPP Acquisition Reform Network web site:**

<http://www.arnet.gov>

(Note: Conduct a search using the term “performance-based” which produces 24 results with helpful links.)

**5. National Aeronautics and Space Administration web site:**

<http://ec.msfc.nasa.gov/hq/library/perfba.htm>

Note: Select Services Administration web site:

<http://www.itpolicy.gsa.gov/mkm/pathways/pb-contr.htm>

**7. U. S. Department of Transportation web site:**

<http://www.dot.gov/ost/m60/pb-sc/>

**8. A training slide show is available at the U.S. Navy web site:**

<http://www.ace.navy.mil/public/events/pb-sc/navyworkshop/index.htm>

**9. U. S. Army Materiel Command web site:**

<http://www.amc.army.mil/amc/rda/rda-ac/pb-sc/pb-sc-amc.htm>

10. Study Papers available at Department of Defense web site:

<http://www.acq.osd.mil/ar/initiati.htm#pb-sc>

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<sup>19</sup> *Id.* at 32.