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Rewarding Contractor

Structuring an appropriate and defensible fee is challenging for both the government and contractors.

By Nicholas Monahan, Olga Wall, and Krista Pages

"Both the government and contractors should be concerned with profit as a motivator of efficient and effective contract performance. Negotiations aimed merely at reducing prices by reducing profit, without proper recognition of the function of profit, are not in the government's interest. Negotiation of extremely low profits, use of historical averages, or automatic application of predetermined percentages to total estimated costs do not provide proper motivation for optimum contract performance." – FAR 15.404-4(a)(3)

Negotiating and setting defensible profit and fees under cost reimbursable contracts is challenging for the government and contractors alike.

Contractors bear most of the risk in fixed-price contracts with the government. A recent example is the renegotiated Air Force One contract for a pair of Boeing 747 airliners in 2018. Based on White House reports, Boeing's initial Air Force One cost-plus proposal was valued at $5.3 billion.

The final renegotiated agreement established a fixed-price development contract worth $3.9 billion, placing all the risk of cost overruns on Boeing. As of April 2022, Boeing's cost overrun is valued at $660 million with an additional two years of schedule delay.

"Air Force One, I'm just going to call a very unique moment, a very unique negotiation, a very unique set of risks that Boeing probably shouldn't have taken," said Boeing CEO David Calhoun during an April 27, 2022, earnings call.[1]

Conversely, the general perception is that the government assumes the lion's share of the risk of cost-reimbursable contracts, so negotiated fee should reflect reduced risk to the contractor.

In fact, both contractors and the government face real risks under cost-plus-fixed-fee (CPFF) contracts. They should be entered into with care and their incentives and rewards carefully factored when establishing a pre-negotiation target profit or fee.

Risky Business

A review of the *Federal Acquisition Regulation (FAR)* definition of CPFF contracts sets the stage for a discussion of handling risk within them.

"A cost-plus-fixed-fee contract is a cost-reimbursement contract that provides for payment to the contractor of a negotiated fee that is fixed at the inception of the contract. The fixed fee does not vary with actual cost but may be adjusted as a result of changes in the work to be performed under the contract.

This contract type permits contracting for efforts that might otherwise present too great a risk to contractors, but it provides the contractor only a minimum incentive to control costs." – FAR 16.306

The profit on this contract type is addressed in FAR 15.404-4, which describes six common profit-analysis factors to consider in a structured approach[2] to develop profit/fee objectives:

1. Contractor effort.
2. Cost risk.
3. Socioeconomic programs.
4. Capital investment.
5. Cost control and other positive past performance.
6. Independent development.[3]

The risks can be further divided into four categories: financial, performance, reputational, and regulatory/compliance:[4]

- Financial risks may include costs that are unrecoverable because they are not allowable under contract terms or regulations, fraud, waste, or abuse. In incrementally funded contracts, which CPFF contracts almost always are, financial risks also include not receiving the total amount of funding originally promised by the government, or a slow commitment of such funding.
- Performance risks include complexity and location of the work, ability to obtain appropriate

human and other resources required to complete performance, duty to cooperate and not hinder performance by the government or a related third party, abuse of discretion or improper contract administration by the government, lack of appropriate systems and diligence by the contractor, as well as impracticability of performance, force majeure, and stop work orders and changes.

- Reputational risks and potential loss of future business opportunities include poor Contractor Performance Assessment Reporting System (CPARS) evaluations, public disclosure of audit findings, personnel misconduct (especially in overseas environments), and so on.
- Regulatory/compliance risks are mainly self-explanatory. Under cost-type contracts, the government's visibility into every aspect of a contractor's systems – accounting, human resources, compliance – can mean unplanned administrative and legal costs.

Factoring risks when determining the price of the work and appropriate fee percentage is essential for both the government and the contractor. The financial loss and potential criminal penalties for non-compliance can be severe, so the contractor must have the opportunity to set its price to mitigate this risk while ensuring it can successfully execute the contract.

To establish a negotiation objective during cost-type contract acquisition planning, the government must also review and understand these factors.

In addition to risk, the government must consider a contractor's prioritization of federal socioeconomic programs, according to the *FAR*. These programs cover small businesses, small disadvantaged businesses, HUBZone and women- and service-disabled veteran-owned small businesses, sheltered workshops for workers with disabilities, energy conservation, and more. Contractors in these programs that have a record of delivery and unusual initiative should be eligible for greater profit opportunity.

Finally, the government is required to consider additional profit opportunities for a prospective contractor that has demonstrated its ability to perform similar tasks effectively (past performance) and economically (cost control), has independently invested in research and development to enhance intellectual property (IP) in the field and assisted with application of innovative technologies, or has performed other actions relevant to contract performance.

Rewards for past performance and cost control in future procurements often are overlooked in establishing an appropriate fee objective or negotiating a fair fee. The ability to earn more fee in future contracts because of efficient and successful past performance not only provides additional contractor incentives but can mitigate some government cost risk under cost-type contracts.

Cost-reimbursement contracts generally are lucrative. Vendors on cost-type contracts can earn a negotiated fee plus reimbursement of the allowable costs. Their labor and materials are covered without unknown potential costs. They also build past performance history.

These companies also can improve their EBITDA (earnings before interest, taxes, depreciation, and amortization). This rewards owners or shareholders and in turn improves companies' competitive ability to compensate and retain highly qualified staff.

In the heavily regulated federal contracting world, the Competition in Contracting Act (CICA),[5] is the gold standard for establishing fair and reasonable pricing. CICA requires agencies to obtain full-and-open competition to the maximum extent practicable (with a few exceptions) as a default, and dictates employing a competition advocate to challenge procurements that limit competition.

Since its inception, CICA has guided competitive pricing through three levels of competition: FAR 6.1 Full and Open Competition, FAR 6.2 Full and Open Competition After Exclusion of Sources, and FAR 6.3 Other Than Full and Open Competition.

CICA is an effective competition tool, however, it cannot aid in determining fair and reasonable prices on sole-source procurements where competition does not exist. Government contracting officers are responsible for evaluating the reasonableness of proposed prices to ensure that final negotiated prices are fair and reasonable prior to award.

FAR 15.404-4 outlines policies for establishing negotiation cost and pricing objectives on noncompetitive sole-source contract procurements over $100,000 totaling $50 million or more a year that require cost and pricing data, which are subject to 15.404-4(c)(4)(i)[6] statutory limitations:

"(A) For experimental, developmental, or research work performed under a cost-plus-fixed-fee contract, the fee shall not exceed 15% of the contract's estimated cost, excluding fee.

(B) For architect-engineer services for public works or utilities, the contract price or the estimated cost and fee for production and delivery of designs, plans, drawings, and specifications shall not exceed 6% of the estimated cost of construction of the public work or utility, excluding fees.

(C) For other cost-plus-fixed-fee contracts, the fee shall not exceed 10% of the contract's estimated cost, excluding fee."

Structuring an appropriate and defensible fee is challenging for both the government and contractors. The Department of Defense (DoD) led the charge to develop a fee-setting methodology after the 1962 McClellan Hearings.[7]

Congress had become incensed at the high profits earned by some contractors, particularly "profit-pyramiding" that occurred when prime contractors earned a profit on fully subcontracted work.

DoD responded by conducting an analysis of the profits that defense contractors expected to earn while performing cost-type contracts. The result was the Weighted Guidelines System (WGLS) launched in 1963 to establish percentage ranges to be applied to target costs to determine a target fee. With updates, this general approach is still used by government agencies.[8]

In 1983, the deputy secretary of defense initiated a major study of defense contract pricing, financing and profit policies.[9] With subsequent DoD updates, it is the basis for Office of Federal Procurement Policy (OFPP) 1980 Policy Letter 80-7 on which FAR Part 15.404-4 is grounded.[10]

This provision requires a structured approach in analyzing a contractor's proposed profit with the objective of providing a higher potential for profit to reward greater risk or stimulate more efficient and/or timely performance. Risk factors are quantified and weighted with a formula calculating a justified amount of profit in proportion to the total cost of the contract.

For DoD contracts, the DD 1547[11] is used for determining the structured approach for negotiation objectives. Other agencies developed their own approaches based on DoD guidance.

"Weighted Guidelines" Methodology Fee Objective Ranges: DD Form 1547

In a commercial setting, prices are normally determined by the market. A buyer conducts price analysis and approaches negotiations based on market research and offers.

For many defense contractors, there is no commercial market. Prices are negotiated directly with the only buyer, the government. Contractors voluntarily report their profits on various types of engagements, and DoD uses this information to determine the profit necessary in various situations.

FAR 15.404-4 directs federal agencies to use a structured approach in negotiating a fee in cost-type contracts when the price negotiation is based on cost analysis.[12] The DoD FAR supplement (DFARS) Subpart 215.404-71 Weighted Guidelines describes profit factors and procedures contracting officers use to assign values to each profit factor – the value multiplied by the base results in the profit objective for that factor.

Except for the cost-efficiency special factor, each has a normal value and a designated range of values. The normal value represents average conditions on the prospective contract when compared to all goods and services acquired by DoD.

The designated range provides values based on above normal or below normal conditions. In the price negotiation documentation, the contracting officer need not explain assignment of the normal value but should address conditions that justify assignment of other than the normal value.

Although not perfect, this structured procedure, summarized in DoD DD Form 1547, provides a roadmap for contracting officers in establishing profit targets and negotiating an acceptable fixed fee in CPFF contracts.

DoD practice is well established and is based on the survey of many DoD contractors and their profit tolerance levels. Because of their origin in DoD contractor surveys, however, the current profit ranges in DFAR 215.404-71 are not necessarily suitable or relevant to other industries or contractors serving civilian agencies.

The following section attempts to review this methodology as it might apply to a civilian agency, using the U.S. Agency for International Development (USAID) as an example.

FIGURE 1. USAID Base Ranges for Structured Profit Approach

Type of Risk	Designated Range	Normal Value	Above Normal	Significantly Above Normal	Agile Below Normal
Technical	2 – 10%*	5%	5.1 – 7.5%	7.6 – 10%	2 – 5%
Management/ Cost Control	2 – 10%*	5%	5.1 – 7.5%	7.6 – 10%	2 – 5%
Contract Type CPFF**	0 – 1%	0.50%	0.75%	1%	0%
Grants under Contract	0 – 3%	1%	2%	3%	0 – 0.5%

**Adjusted from the DoD standard range for the specific risks of U.S. foreign aid*

***CPAF/CPIF do not normally use the weighted approach but it can be used as a reference point with adding higher percentage (above 10% max) to the Above Normal+ range to motivate contractor performance. The 10% statutory limitation on proposed fixed fee only applies to CPFF contracts, which are not R&D (FAR 35.0002); 15% applies to R&D CPFF contracts (FAR 15.404-4 (4)(i)(A) & (C)). CPAF and CPIF contracts do not have a statutory limitation on the percentage of the profit.*

Applying Weighted Guidelines to Negotiated Fee Objectives in Civilian Agency CPFF Contracts

Cost-reimbursable contracts often are the only type USAID can use when acquiring services under international development projects. USAID often buys technical assistance services on a cost-reimbursable basis. The contractor earns a fixed fee for completion of desired objectives/targets (CPFF completion type contract[13]) or for delivering a certain number of labor hours/days (CPFF term type contract[14]).

USAID must use cost realism analysis to determine the probable cost of performance for each offeror. USAID also must evaluate the proposed fixed fee against its negotiated fee objectives.

Determining a normal baseline for USAID CPFF contracts, permits evaluation of the factors that drive the percentage needle up or down. We reviewed more than 200 USAID CPFF contracts for work performed in more than 30 countries over the last 10 years.

We determined 5% of the total estimated cost is the average fee proposed to, or accepted by, USAID in the reviewed contracts. We also reviewed contracts that used fees over or under 5%, and we have analyzed factors that may have contributed to fee-setting in those instances.

Based on our analysis, Figure 1 represents the current minimum, normal, and maximum profit percentages appropriate for USAID contracts. (This analysis is not scientific and is based on historical precedents rather than on actual industry surveys.)

Determining the Profit Objective Within the Base Ranges

Step 1 - Weighting Technical Risk vs. Management/Cost Control Risk

Weighting compares the technical uncertainties of performance against the degree of management effort necessary to meet contract requirements and control and reduce costs. USAID usually determines its contract requirements to be highly complex. Usually, understanding of the problem is a key evaluation criterion.

Contractors also face substantial uncertainties during performance. The ability to pivot and course correct are key capabilities.

Accordingly, out of a total weight of 100%, here are some examples of how to assign weight to technical risk vs. management/cost control risk, considering a starting weight of 50/50:[15]

Contracts with a performance work statement (PWS) proposed by the contractor: 75% technical – 25% management.

Contracts with USAID-designed statement of work or PWS: 65% technical – 35% management.

The weight of the risks in each of the components above is influenced by the non-inclusive factors shown in Table 1 and can be adjusted from the equal weight of 50/50.

TABLE 1. Weighting Technical Risk vs. Management/Cost Control Risk

Technical	Management/Cost Control
• Technically complex solution/program design • Likelihood of changes • Complex stakeholder engagement (multifaceted coordination, fluid local politics, lack of stakeholder motivation to cooperate) • Program maturity (new vs. ongoing) • Performance specifications and tolerances • Delivery schedule	• Degree of subcontracting • Authorization to issue grants under contract (especially in large volumes) • Extensive reporting • Multiple teams in various areas • Multiple funding streams • Unpredictable incremental funding • Country cost risks: banking/cash operations/high crime/fraud • Contractor's management and internal control systems and their maturity • Degree of management involvement expected under the contract • Small business subcontracting

TABLE 2. Assigning Fee Percentage to Technical Risks

Above Normal Technical Risk (5.1% - 7.5%)	Below Normal Technical Risk (2% - 5%)
• Aggressive delivery schedule • Unusual or scarce professional talent required • Extremely important to USAID and must be performed to exacting standards (high visibility, political pressures, etc.) • State-of-the-art technology is needed	• Relatively simple requirements • Personnel not difficult to find • Technology not complex • Mature program • Routine effort • Follow-on efforts

Significantly Above Normal Technical Risk (7.6% - 10%)
• Extremely complex effort to overcome difficult technical obstacles • Vital efforts (lifesaving, responding to emergencies, crisis modifiers, post-kinetic) • Requires personnel with exceptional abilities, experience, and professional credentials

Step 2 – Assigning Fee Percentage to Technical Risks

The technical risk factor assigns a fee percentage for normal, below, above, or significantly above normal program complexity. From a normal value of 5%, we can evaluate up or down based on the considerations shown in Table 2.

Step 3 – Assigning Fee Percentage to Management Component

This component evaluates how challenging management efforts are to meet contract requirements and to control and reduce costs. It also considers the contractor's proposed and past experience in contributing to socio-economic goals and past performance under similar efforts. From a normal value of 5%, we can evaluate up or down based on the considerations shown in Table 3.

Step 4 – Assigning Fee Percentage for Contract Type Risk

This factor assesses the degree of cost risk accepted by the contractor under varying contract types. This is almost always low for USAID contracts. USAID predominantly uses cost reimbursement mechanisms providing contractors substantial protection against uncertainty. A normal value for USAID CPFF contracts is 0.5% (on a 0 to 1% scale). See Table 4 for more details on this.

Step 5 – Assigning Fee Percentage for Grants Under Contract

Grants Under Contract are an outsourced grant-making facility: USAID pays contractors to issue very small grants that the government lacks the

TABLE 3. Assigning Fee Percentage to Management Component

Above Normal Management/Cost Control Risk (5.1% - 7.5%)	Below Normal Management/Cost Control Risk (2% - 5%)
• Contractor's value add is considerable and reasonably difficult • High degree of integration with other efforts (e.g., other contractors) • Major international activities (e.g., across multiple countries) • Contractor has substantial record of economical and successful past performance • Contractor has significant record of small business subcontracting and is proposing to support socioeconomic programs • Indirect cost ceilings	• Program is mature • Contractor adds minimal value • Efforts are routine and require little supervision • Contractor fails to provide reliable estimates or analysis of subcontractor costs • Contractor does not cooperate in the evaluation and negotiation of the proposal • The contractor has a record of cost overruns or lack of cost control • The contractor has a poor record of past performance
Significantly Above Normal Management/Cost Control Risk (7.6% - 10%)	**Significantly Below Normal Management/Cost Control Risk (0% to 1.9%)**
• Subcontracting and/or grants under contract in large volumes requiring hands-on management • Participant training components • Performance in high risk/kinetic environments	• Contract is for a relatively short term • Contractual provisions substantially reduce the contractor's risk • Incentive provisions place a low degree of risk on the contractor • A performance-based payment schedule that is routine or simple with minimal risk

TABLE 4. Assigning Fee Percentage for Contract Type Risk

Above Normal Contract Type Risk (0.75-1.00%)	Below Normal Contract Type Risk (0.00-0.25%)
• Minimal cost history for the program design, place of performance, etc. • Long-term contracts lacking provisions that protect the contractor, especially in areas with considerable economic uncertainty • Incentive provisions (e.g., cost and performance incentives) place a high degree of risk on the contractor • An aggressive performance-based payment schedule	• Contract is for a relatively short term • Contractual provisions substantially reduce the contractor's risk • Incentive provisions place a low degree of risk on the contractor • A performance-based payment schedule that is routine or simple with minimal risk

staffing resources to handle or require a presence in countries where security limitations curtail the agency's ability to interact with and monitor recipients. USAID must be substantially involved in the decision to award each grant, so the risk accepted by the contractor is low.

Because grants under contract are low risk to the contractor, fees range from 1% to 3%. One percent to 2% is an appropriate fee range when USAID finances them through a letter of credit. Two percent to 3% is appropriate when the contractor finances grants under contract through its own resources and seeks reimbursement from USAID.

Final Analysis

Once completed, the final analysis might look like Figure 2 on the next page (adapted/extracted from the DD 1547). In this example, the overall profit proposal (or objective, if compiled by the government) is 6.8%, based on the following assigned values:

- Technical effort is deemed more substantial at 70% of the weight.
- Management effort is deemed less substantial at 30%.
- The overall profit assigned to technical is at a higher-than-normal value of 7%.
- The overall profit assigned to management is at a normal value of 5%.
- The composite for technical and management risks/incentives based on weight is 6.4% applied to the total proposed cost (less grants under contract).
- Grants under contract risk are valued at 2%, above normal, applied to grants under contract

FIGURE 2. Final Analysis of Determining the Profit Objective Within the Base Ranges

		ITEM	COST ELEMENTS	PROPOSED		
PROJECT:						
TYPE OF SUBCONTRACT:						
PRIME CONTRACT:		1.	DIRECT LABOR	$ 11,602,802.48		
BIDDER:		2.	OTHER DIRECT COSTS	$ 10,589,359.02		
SOLICITATION NO.:		3.	GRANTS UNDER CONTRACT	$ 1,000,000.00		
NEW AWARD OR	☐ New Award	4.	INDIRECT COSTS	$ 9,253,183.27		
MODIFICATION?	✓ New Award	5.	SUBCONTRACTS	$ 1,200,000.00		
DATE:		6.	TOTAL COSTS	**$ 33,645,344.77**		

WEIGHTED GUIDELINES PROFIT FACTORS

ITEM	CONTRACTOR RISK FACTORS	ASSIGNED WEIGHTING	ASSIGNED VALUE	OBJECTIVE BASE *(6.)*	PROFIT OBJECTIVE
7.	TECHNICAL	70.00%	7.00%		
8.	MANAGEMENT/COST CONTROL	**30.00%**	5.00%		
9.	PERFORMANCE RISK (COMPOSITE) - Weighted Technical & Management		**6.40%**	$ 32,645,344.77	$ 2,089,302.07
10.	GRANTS UNDER CONTRACT RISK		**2.00%**	**$ 1,000,000.00**	**$ 20,000.00**
11.	CONTRACT TYPE RISK		0.50%	$ 33,645,344.77	$ 168,226.72
12.				**TOTAL PROFIT OBJECTIVE**	**$ 2,277,528.79**

NEGOTIATED SUMMARY

ITEM		TOTAL CPFF
13.	TOTAL COSTS	$ 33,645,344.77
14.	PROFIT	$ 2,277,528.79
15.	TOTAL PRICE *(Line 12+13)*	**$ 35,922,873.56**
16.	MARKUP RATE *(Line 14 divided by 13)*	**6.77%**

amount only.

- Contract type risk for CPFF completion contract is valued at a normal 0.5% applied to total cost.
- The final profit percentage composite is 6.8%.

Why Does It Matter?

Government cost-reimbursable contracts are relatively lucrative for the contractors with covered incurred costs and fee and relatively low risk. The government, on the other hand, incurs more risk and can test innovative approaches through flexible cost type contracting mechanisms. However, the government is limited in its ability to control costs, efficiency, and accountability due to the best-effort nature of cost-type contracts.

By properly and meaningfully following the structured approach laid out in FAR 15.404, DFARS 215.404-71, as well as related agency regulations, the parties can mitigate risk, reward past efficiency, and drive cost control. **CM**

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ENDNOTES

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2 FAR 15.404-4(b)(1).
3 Contract Management Standard, Second Edition, CMS Competency 2.0 Pre-Award, 3.0 Award. NCMA.
4 Contract Management Standard, Second Edition, CMS Competency 1.0 Guiding Principles, 1.4 Regulatory Compliance. NCMA.
5 41 U.S.C. 253.
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