

PBPs? Stick a Fork in 'Em: They're Done

Written by Nick Sanders
Monday, 31 March 2014 00:00



It was nearly three years ago when the Hon. Shay Assad left his role as the Director of Defense Procurement and Acquisition Policy (DPAP) to assume a new job as Director, Defense Pricing. As we [told our readers](#) at the time, "Mr. Assad's lateral move to his new position-a position apparently created for him-portends something new in the Pentagon's approach to establishing contract prices." In that article, we speculated wildly about where that move might lead to in terms of DCMA's relationship with DCAA.

Three years later, we're confident in telling you that we nailed it. As the new DPAP Director (Mr. Richard Ginman) recently noted in official correspondence that Mr. Assad's mission was to be "responsible for overseeing the complete renovation of DoD's pricing capability." In other words, we hit the mark when we speculated that the new DOD Pricing Center of Excellence was a key move to upgrade the Pentagon's ability to evaluate and negotiate contractor prices without reliance on a DCAA audit report.

Self-congratulatory pats on the back aside, most reasonable observers would agree that Mr. Assad's effort to renovate DOD's cost monitoring and price analysis capabilities was sorely needed. We are thinking about the November, 2011, [GAO report](#) that asserted DCMA had been mismanaged for more than a decade and, as a result, the agency "had experienced an atrophy of some key skill sets." One of the specific functions identified by GAO was DCMA's cost/price analysis function, the degradation of which increased cost risk on DOD programs. GAO said "Loss of this skill set ... meant that many of [DCMA's] pricing-related contract administration responsibilities, such as negotiating forward pricing rate agreements and establishing final indirect cost rates and billing rates, were no longer performed to the same level of discipline and consistency as in prior years."

Accordingly, Mr. Assad is on a mission to address the shortfall in DOD's ability to perform cost and price analysis, and we think that mission should be supported by both government civil servant and government contractor.

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But we have not always agreed with Mr. Assad's approach to that mission. When he spearheaded the initiative to make contractor's health care costs associated with ineligible dependents expressly unallowable, we believed (and still believe) that was a distraction from what Pentagon leaders told the public he was supposed to be doing. Frankly, it appeared to have been more of a personal crusade than anything else.

And when Mr. Assad spearheaded the initiative to make Performance-Based Payments (PBPs) harder and more costly to contractors to obtain, we disagreed that his initiative was commensurate to the risk he had publicly identified. Indeed, we opined (rather stridently) that the policy change he drove, where the Pentagon's acquisition force stopped treating PBPs as if they were the "preferred" form of contract financing (which they were, and still are, according to the FAR) and, instead, returned to a preference for cost-based "customary" progress payments, was going to lead to future fiascos such as had been experienced in the A-12 "train wreck".

Despite our opinion of the matter, in point of fact the Defense Department has just issued a [final DFARS rule](#) that ends PBPs as we know them. We here at Apogee Consulting, Inc., were approached by the press for a comment/quote regarding the final rule, no doubt because our previous blog articles on the topic have been so strident and quote-worthy. We declined the request, because we hadn't yet had a chance to read through the final rule and digest the responses to public comment. Now we have and we want to share our thoughts with the readership of this blog.

The official reason for issuing the rule is "to provide detailed guidance and instructions on the use of the performance-based payments analysis tool." That's not, in fact, the reason for issuing the rule. If that were the reason for issuing the rule then the DOD already had its Procedures, Guidance, and Instruction (PGI) companion to the DFARS to make that happen. If that were the reason for the rule, the Pentagon would not need a DFARS Case or the need to solicit public input. So right off the bat, we are presented with a rationale that simply does not make sense.

Instead, we assert the final rule redefines PBPs into a new contract financing tool not originally contemplated by Congress when it passed the Federal Acquisition Streamlining Act of 1994 (FASA) and created PBPs. Now it is neither fish nor fowl: It is neither cost-based progress payment nor is it the performance-based payment contemplated by FAR subpart 32.10. We don't know what it is, but we do know some of the attributes of the new contract financing

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tool.

First, use of the new "PBP" requires that a contractor has an adequate accounting system in the eyes of the awarding Contracting Officer. A new DFARS rule at 232.1003-70 states "The contracting officer will consider the adequacy of an offeror's or contractor's accounting system prior to agreeing to use performance-based payments." The adequacy of a contractor's accounting system is defined at DFARS 252.242-7006. While it is possible that a Contracting Officer might use other, less rigorous, criteria with respect to firm, fixed-price contracts that use PBPs, it's rather doubtful.

This is a dramatic shift from historical PBPs, where the adequacy of a contractor's accounting system was irrelevant, since PBP event values were never linked to incurred costs. Back in the late 1990's, the reason for decoupling cost accounting information from PBP events was to encourage non-traditional defense contractors to submit proposals to DOD, and to eliminate "non value-added" oversight such as lengthy and expensive audits.

The reason for the shift is that now contractors that use PBPs will have to report the cumulative incurred costs on the contracts for which they are submitting PBPs. The DOD has to be sure that contractors have the capability to report that information accurately before they consent to provide PBP contract financing. The reason contractors will now have to report cumulative incurred costs is that a new PBP contract clause will prohibit payment of accomplished PBP events, if by doing so the cumulative amount of contract financing provided would exceed cumulative incurred costs. Even if a contract makes technical progress ahead of plan, it cannot submit PBP requests for that progress; it must delay submission until it spends more money.

Of course, now that contractors will be reporting incurred costs, it only makes sense that the auditors have the ability to verify that the incurred costs were reported accurately. Accordingly, "the final rule includes the requirement for the contractor to provide access, upon request of the contracting officer, to the contractor's books and records, as necessary, for the administration of the clause."

In addition, the new rule will tell Contracting Officers contemplating usage to go visit [a special website](#) in order to learn about the new PBPs, and to download a DOD Tool to be used to determine how much consideration a contractor must provide to the government in order to use PBPs

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instead of cost-based progress payments. Much public input was received regarding the DOD Cash Flow tool, especially regarding the interest rate assumptions it used. In response to some comments, the rule-makers responded as follows-

The cost of raising money is not the same for industry and the Government and therefore the time-value of money is not the same for each. The model will be revised as follows: The discount rate for contractor cash flows will be reflective of the short term borrowing rate as represented by the published Prime Rate adjusted for the corporate income tax rate of 35%. At the current Prime Rate of 3.25%, the discount rate for contractor cash flows would be 2.11% $[3.25\% \times (1 - .35)]$.

Other commenters pointed out that rules associated with the new PBPs conflicted with the DOD's "Users' Guide to Performance-Based Payments." That comment was disposed of quickly, by announcing publication of a [new Users' Guide](#) that covered all the new guidance and procedures. However, despite the new Users' Guide, at least one commenter expressed concern that the Cash Flow Tool, in particular was counter-intuitive and would lead to potential errors in calculation of consideration. Another commenter asked why all the new guidance and procedures was expected to address long-standing concerns about the ability to DOD Contracting Officers to effectively administrate PBPs. The rule-makers replied to those concerns by stating "The cash flow model will be used by trained contracting officers who will be able to walk the contractor through the process"

To other commenters who stated that the new PBP guidance conflicts with the regulatory preference for use of PBPs, the rule-makers stated "This rule does not change the FAR stated preference for PBPs when Government financing is determined to be appropriate." In our view, that statement was true only because what the Pentagon now calls Performance-Based Payments is no longer the same PBPs as was contemplated by the FAR. The new PBPs are now a bastardized hybrid, a Frankenstein's Monster cobbled together from pieces of cost-based progress payments and milestone billings.

Whatever you want to call it, we don't think it should be called Performance-Based Payments. The PBP events are no longer solely tied to program execution, to technical milestones that are "Yes/No" achievements that lay outside the province of cost accountants and auditors. Now contractors wishing to use PBP financing will need much the same accounting system as those who use cost-based progress payments. Now the PBP requests will be subject to auditor scrutiny, much the same as would be the case for cost-based progress payments.

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Much of the rationale for the "win/win" associated with the use of PBPs has gone by the wayside. We don't expect many contractors will be eager to enter into the burdensome business of PBPs when there are now so many disincentives for their use. Instead, we expect most if not all contractors will go back to the tried-and-true contract financing method of cost-based progress payments.

You know, the kind of financing that doesn't care about technical progress, and reimburses contractors for how much they spend and not what they actually accomplish for the money.

So stick a fork in the old PBPs. They lasted from 1996 until 2014. It was a good run, but now it's over.

And when DCAA shows up to audit your accounting system for adequacy, or when the auditors show up to audit your cost-based progress payments, then raise a glass in memory of the quaint notion that contractors and their government customers had more to worry about than contract financing payments on firm, fixed-priced contracts.