

# A proposal for a new approach to Performance-Based Services Acquisition.

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Performance-Based Services Acquisition (PBSA) is the government's preferred approach for service contracting, but despite great efforts and training, PBSA remains difficult to implement. An analysis of services acquisition suggests that while PBSA may be useful for routine, common, and relatively simple services, it is not as applicable for services that are too long-term and complex to permit complete specification of results and competitive pricing at the outset of contracting. A new approach for contracting these kinds of services is recommended.

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Since the publication of the Office of Federal Procurement Policy's (OFPP) policy letter 91-2, Service Contracting, on April 15, 1991, Performance-Based Services Acquisition (PBSA, formerly called "Performance-Based Contracting") has been the government's preferred approach to service contracting. It requires specification of the results that contractors must produce instead of the processes that they must use.

Agency acquisition managers and working-level agency acquisition personnel have devoted a lot of energy to PBSA since 1991. But despite goal-setting, the publication of numerous guidebooks, the development of an informational Web site, and significant investments in training and in the services of consultants, PBSA has not been as successful as hoped, and agencies still struggle to apply it. Even when agencies claim to have adopted PBSA, close examination of their contracts often shows that those documents do not entirely satisfy the criteria in the Federal Acquisition Regulation (FAR) (GAO, 2002). Moreover, despite occasional agency "success stories," the policy has not produced verified quality improvements or cost savings. (1)

This article proposes that there are two categories of services, and that PBSA as it is known at the beginning of 2007 works for one, but not the other. The first category includes many common, routine, and relatively simple services that can be acquired through PBSA as it is currently defined, including many housekeeping services, simple equipment maintenance and repair services, and the like. The second category includes services that are too long-term and complex to permit complete specification of results and competitive pricing at the outset of contracting. These include many long-term information technology services, services to operate government-owned facilities, and long-term and multifunction or multitask professional, administrative, and management support services. These are the services for which the government spends the most money. This article proposes a new approach to contracting for this second category of services.

## DESCRIPTION AND HISTORY OF PBSA

The FAR provides that when using PBSA, agencies must specify the service results (outputs, outcomes) they want in "clear, specific, and objective terms with measurable outcomes." They must prepare performance work statements and quality assurance surveillance plans, use performance incentives when appropriate, and inspect and compensate contractors on the basis of their work

products rather than their work processes.

The PBSA, in various manifestations, has a long history. During 1969--1971, the Office of Economic Opportunity (OEO) in the Department of Health, Education, and Welfare experimented with an outcomes-based approach to contracting for educational services. The results were mixed and the program was dropped. (2) In September 1979, the U.S. Air Force adopted a comprehensive performance-based approach to contracting for base support services, which OFPP adopted for government-wide use in October 1980. The efforts of the Air Force and OFPP produced few, if any positive results. (3)

The 1991 OFPP policy letter was a response to growing concerns about the amounts that agencies were spending to buy services and the quality of the services they were receiving. (4) However, agencies were slow to respond to the policy letter, and although the letter called for FAR implementation before the end of 1991, it was not until 1997 that the FAR was amended to include rules for PBSA. (5) Since then, agencies have tried to use the technique, but with disappointing results. Implementation goals were established, but not achieved. Government acquisition officials and industry representatives have expressed doubts about the success of PBSA, independent reviews have not validated predictions and anecdotal claims of improvements in quality and reductions in cost, and people at the working level are frustrated. In 2001 and 2002, the Honorable Angela Styles, then-Administrator of OFPP told Congress that Performance-Based Services Acquisition had not been more successful because the concept had not been adequately defined. (6) In July 2003, an interagency team assembled by OFPP recommended minor changes to the FAR, which were published in December 2005. (7)

## WHY HAS PBSA NOT BEEN MORE SUCCESSFUL?

The main reason that PBSA has not been more successful is that it is not a practical approach to buying long-term and complex services. Agencies have been unable to implement PBSA as hoped because it requires them to do something that is too often impracticable.

It is unrealistic to ask agencies to specify services at the time of contract award in clear, specific, objective, and measurable terms when future needs are not fully known or understood, requirements and priorities are expected to change during performance, and the circumstances and conditions of performance are not reliably foreseeable. Yet those are the difficulties faced by agencies and their contractors when they negotiate long-term and complex service contracts.

In real life, parties to long-term and complex service contracts do not specify all requirements at the time of contract award in clear, specific, objective, and measurable terms. Instead, they engage in ad hoc decision making in response to emerging and changing requirements, shifting priorities, and unexpected circumstances. They make it up as they go along, developing and adjusting expectations and agreements accordingly. Reality is never the same as expectations and projections, and plans and agreements go awry. No matter how long and hard future needs are considered, contracts will include things that will not be needed and leave out things that will be. Specifications and expectations must be adjusted over the course of time. (8)

Thus, in requiring that agencies fully specify results at the outset of contracting, PBSA often requires them to do something that is too hard to do and sets them up to fail. More training will not make PBSA appropriate for long-term and complex service acquisitions.

## THE CHALLENGES OF SERVICE CONTRACTING

When contracting for services, agencies must follow regulations and use practices that were developed for the procurement of supplies. Supplies are always specified based on known design or performance requirements. The PBSA is an attempt to buy services like we buy supplies. But this attempt ignores

key differences between supplies and services.

## SERVICE QUALITY

Unlike most supply purchases, long-term service contracts entail close human relationships that enable the parties to deal with dynamic complexity and respond to emerging and changing needs and circumstances. Relationships are crucial, and it is well established in service marketing literature that subjective customer satisfaction is as important, and sometimes more important, than technical success. (9) The importance of subjective factors in government service contracting is confirmed by the fact that subjective incentives--award fee and award term--are the most popular of all incentives used in performance-based contracts. (10)

Services confront agencies with quality specification problems, unlike those associated with contracts for supplies. Services are always rendered in response to actual circumstances and conditions. It is often impossible and even unwise to try to fix specifications of service quality at the outset of contract performance, because quality often "depends." What is good service in one set of circumstances might be poor service in another, and the standard contract modification process is not nimble enough for the realities and demands of a high-speed, electronic world.

The PBSA requirement for beforehand specification and objective and measurable standards ignores the nature of long-term and complex service relationships. (11)

## CONTRACTOR SELECTION AND CONTRACT PRICING

A lynchpin of PBSA is competitive contractor selection based on price and other factors in compliance with the Competition in Contracting Act (CICA) and FAR Part 15. In theory, PBSA allows competing firms to devise their own ways to produce the results sought by the government, which supposedly lets the government enjoy the benefits of vigorous price competition. But when an agency cannot describe its requirements and the circumstances and conditions of performance, competing firms cannot do so either. So when an agency evaluates a proposal for a service contract, it evaluates the product of the marketing imagination, which describes something that does not yet exist and cannot be examined or tested before purchase.

An agency proposal evaluation team cannot be sure whether the firm selected for contract award will truly be the best value or that it just produced the best proposal document. In the absence of specific knowledge about future needs, firms cannot propose specific solutions, and strict enforcement of vague commitments is an unlikely prospect. In the absence of clear and binding promises, prices or estimated costs are not very meaningful. Comparative evaluation of competing proposals of service quality and prices is thus a dubious undertaking, because an agency cannot be sure about what it will actually get or be entitled to get from a contractor for its price.

Contractor selection under FAR Part 15 procedures does not readily permit a full and frank airing of issues and resolution of concerns between the government and its contractor before contract award. Industry responses to draft solicitations and participation in preproposal conferences are constrained by competitive strategy and tactics and government reticence. After proposal submission, agencies either award contracts without discussions or conduct discussions that are constrained by issues of fairness and procedure and fear of protests. The result is that the parties to a new contract are often virtual strangers to one another, who learn of gaps and disconnects in their understanding of the work and their expectations only after contract award.

The CICA price competition and FAR Part 15 source selection are ill-fitted to the procurement of long-term and complex services.

## CONTRACT ENFORCEMENT: PRICE REDUCTIONS, DAMAGES, AND TERMINATIONS

The FAR tells contracting officers to inspect service results and make price or fee reductions when services are not acceptable. However, long-term and complex services confront agencies with unique quality assurance problems. Inspection can be difficult because many service results are intangible, and many tangible results are ephemeral. One hundred percent inspection is usually impracticable, but acceptance sampling is not always appropriate. The quality of some results, like the results of observational or analytical work, may depend on the quality of unobservable mental processes. It is easy enough to verify that a floor is "clean" in the morning, that wastebaskets have been emptied, that grass has been cut to a prescribed length, and that an item of equipment has been repaired. But the results produced by security guards who must check the identities and possessions of the hundreds of persons seeking entry to a federal office building on a daily basis are not easily inspected or verified.

Reviews of decisions by boards of contract appeals and by courts about price reductions under long-term and complex performance-based contracts show that price reductions generally are not a satisfactory remedy for poor performance. Under long-term and complex contracts, such reductions are administrative nuisances to both the agency and to its contractor, and reductions for minor technical flaws in performance sour a business relationship. Moreover, price reductions and money damages cannot adequately compensate the government for poor performance of critical operations.

Termination is truly a last resort when a contract is for long-term and complex services because it takes a lot of time and effort to award a replacement contract, and award might be delayed by a protest. So an agency might choose to live with marginal performance, or be forced to exercise an option to extend a contractor that is performing marginally so it can buy time to find a replacement. In sum, contract law and court enforcement cannot ensure satisfactory service and cannot remedy poor performance. The only way for the government to get the service results it needs is by choosing good contractors and by establishing and maintaining effective working relationships with them. Relationship management, not contract administration, is the key to success.

Contract law and court enforcement cannot guarantee satisfactory service or adequate remedies for poor performance.

## HOW THE GOVERNMENT SHOULD BUY LONG-TERM AND COMPLEX SERVICES: AN EMPHASIS ON RELATIONSHIPS

While the government should usually focus on service results instead of processes, the realities of long-term and complex service contracting require a new approach to PBSA. The following paragraphs describe a relational approach to PBSA, an approach that emphasizes the need to establish a solid working relationship between the government and its contractor that will allow the two of them to engage in ad hoc specification and adjustment of expectations throughout the life of the contract.

This proposed approach to PBSA is called Relational Contracting or Relational PBSA. The key features of this approach are:

- \* competency-based contractor selection;
- \* in-depth, one-on-one negotiations with the contractor selectee before contract award to jointly develop a contract work statement;
- \* joint management to budget instead of to a fixed-price or estimated costs;
- \* advanced agreement on specified direct and indirect cost limitations;
- \* ad hoc specification of results and adjustment of expectations during performance;

\* fair and reasonable fee arrangements; and

\* mandatory use of alternative dispute resolution procedures.

An agency would use the relational approach to PBSA only when:

1. the contract will be of at least two years duration, including options;
2. the contract will have a total value of at least \$10 million, including options;
3. the agency cannot fully specify key requirements or describe key performance circumstances at the time of contract award;
4. the head of the contracting activity approves its use; and
5. the head of the contracting activity makes provision for periodic independent review of the management of the contract by neutral officials.

This article will now address each of the elements of relational PBSA in greater detail.

#### COMPETENCY-BASED CONTRACTOR SELECTION

The approach to contractor selection would be similar to the architect-engineer selection approach described in FAR Subpart 36.6. Price would not be a factor in contractor selection. The main factors would be experience, past performance, and key personnel qualifications. An evaluation board would consider candidate firms and recommend two or three highly qualified firms to the selection official, who would then select one for contract negotiations.

The contracting officer would solicit an offer from the selectee, disclosing the agency's budget and objectives and providing for joint fact-finding about known and anticipated requirements and anticipated performance circumstances and conditions. The parties would then conduct in-depth negotiations to jointly develop a work statement, an advance agreement on small business subcontracting, an advance agreement on cost limitations, and a fee agreement. The contracting officer would award a contract following approval of the negotiations in accordance with agency procedures.

This approach to contractor selection and contract pricing will permit a fuller and franker airing of issues and cooperative problem solving before contract award. It will enable the parties to reach a common understanding of what they can and cannot specify at the outset and what they must set aside for ad hoc resolution during performance. This approach will lay a better foundation for a successful working relationship than source selection under CICA and FAR Part 15.

#### ADVANCED COST LIMITATION AGREEMENTS/JOINT MANAGEMENT TO BUDGET

The resultant contract would be a modified cost-reimbursement type, with government risk mitigated by advance cost limitation agreements. The contract would provide for the parties to jointly manage performance within the government's operation or project budget, but with the government having the final say on all requirements. The parties would work together to prioritize and schedule activities, set standards, establish work package budgets, and monitor performance. They would use earned value management techniques when appropriate.

#### AD HOC SPECIFICATION OF REQUIREMENTS DURING PERFORMANCE

A key feature of relational PBSA would be ad hoc specification of service requirements as they emerge or become more fully understood in the course of performance. The parties would specify requirements

in terms of results whenever possible, unless they agree that specification of process would be better. In order to remain within budget, the parties would make tradeoffs, adjusting expectations, reordering priorities, and modifying performance standards as necessary. If requirements change, the parties would bargain to make adjustments to stay within the budget.

Adjustments within budget would not require formal contract modifications and equitable adjustments and would be within the authority of the government's program manager as long as they do not require fund obligations or de-obligations. But all transactions would be documented to reflect the agreement and expectations of the parties.

## FAIR AND REASONABLE FEE ARRANGEMENTS

The contract would provide for payment of fee in accordance with the agreement negotiated prior to contract award. The maximum available fee would be fixed and would not change during the course of performance unless the government increases or decreases its budget due to the addition or deletion of requirements. Changes in budget due to cost overruns would not entitle the contractor to additional fees. The contractor would be guaranteed a fair and reasonable fee for acceptable performance within budget and could earn additional fees for excellent performance, based on objective and subjective considerations to which the parties agreed in advance.

## MANDATORY USE OF ALTERNATIVE DISPUTE RESOLUTION

The contract would require the parties to engage in alternative dispute resolution before resorting to the FAR disputes procedures. Each party would name one senior official outside the immediate program organization as its principal, and they would jointly hear the dispute and work to resolve it with the assistance of a neutral. Only if the two principals cannot agree on a resolution within a reasonable period of time would the parties be permitted to resort to the dispute procedures described in FAR Subpart 33.2.

## PREREQUISITES TO USE

Because relational PBSA would permit the award of contracts without price competition, and because it would grant very broad discretion to government program managers and contractor personnel, it is essential that it be used only when appropriate and only as approved by higher level agency officials. It is also essential that relational contracts be subjected to periodic independent review in order to maintain the integrity of the acquisition system and public confidence. Relational PBSA should be approved for use only for complex contracts of two years duration or longer and with a total value of \$10 million or more, including options. It is also recommended that the use of relational PBSA require approval of the head of the contracting activity, subject to arrangements for periodic independent review of each relational contract by neutral agency officials.

## CONCLUSION

The time has come to try something new. We propose that OFPP obtain statutory approval for a pilot program to conduct a number of controlled experiments in relational contracting by selected agencies. The OFPP should set criteria for evaluating the effectiveness of relational contracting, establish a preparatory training program for participants, and appoint a panel which includes executive branch officials; representatives of the Government Accountability Office; working-level acquisition personnel; members of academia; members of the Bar; industry representatives; and a support staff to monitor, evaluate and report the results, and make recommendations for further action.

## REFERENCES

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General Accounting Office. (2002). Contract management: Guidance needed for using performance-based service contracting (GAO-02-1049). Washington, DC: Author.

Office of Federal Procurement Policy. (1991, April 15). Policy letter on service contracting (56 FR 15110). Washington, DC: Author.

## END NOTES

(1.) "There is little current data to support monetary savings, and if such data did exist, it would be extremely difficult to isolate the exact reasons the savings occurred." In Interagency Task Force On Performance-Based Service Acquisition. (2003, July). Performance-based service acquisition: Contracting for the future. Washington, DC: Office of Federal Procurement Policy, p. 10. "The effect of PBSA practices on contract prices is hard to assess for the contracts we studied because (a) the work scopes relevant to the contracts we examined changed with the new contracts, and (b) the Air Force has no simple way to adjust costs for the changes observed in work scopes. In most cases, we could not clearly attribute price changes to a move toward PBSA." In Ausink, J., Carom, E, & Cannon, C. (2001). Performance-based contracting in the Air Force: A report on experiences in the field. Santa Monica, CA: Rand, p. 34.

(2.) See Levine, D. M., ed. (1971). Performance contracting in education--An appraisal. Englewood Cliffs, N J: Educational Technology Publications: and Stucker, J. R & Hall, G. R. (1971). The performance contracting concept in education (R-699/1-HEW). Santa Monica, CA: Rand. Performance contracting in education was controversial. Some state and foreign governments still use the technique in secondary and higher education and, although the results are unclear, the technique still has supporters. Performance contracting in education should not be confused with energy performance contracting.

(3.) The approach was described in Air Force Regulation (AFR) 400-28, Base Level Service Contracts, a detailed, multi-volume guide to the preparation of performance work statements and quality assurance surveillance plans. Supplementary Air Force publications, such as AFR 70-9, Base Level Service Contract Administration, provided instructions to quality assurance evaluators (inspectors). OFPP adopted the first volume of that regulation for government-wide use in October 1980, dubbing it OFPP Pamphlet No. 4, A Guide for Writing and Administering Performance Statements of Work for Service Contracts. The Air Force withdrew AFR 400-28 in 1994, replacing it and other guidance with Air Force Manual (AFMAN) 64-108, Service Contracts, a 63-page document which still included fairly detailed guidance for the preparation of performance work statements and quality assurance surveillance plans. But in 1999, the Air Force replaced AFMAN 64-108 with Air Force Instruction 63-124, Performance-Based Service Contracts (PBSC), an 11-page document that contains a statement of policy but virtually no practical guidance, and it remains in effect today. OFPP withdrew Pamphlet No. 4 in the mid-1990s, but in October 1998, it issued "A Guide To Best Practices" For Performance-Based Service Contracting, a severely edited version of Pamphlet No. 4, containing less detailed guidance. In December 2000, the Department of Defense issued its current Guidebook for Performance-Based Services Acquisition (PBSA) in the Department of Defense, a 54-page document that contains sparse practical guidance. Several other agencies have issued similar guidance of their own. Much of this guidance can be accessed through the Web site, Seven Steps to Performance-Based Services Acquisition, available at <http://www.arnet.gov/Library/OFPP/BestPractices/pbsc/home.html>. For a fascinating first-hand account of an attempt to develop a performance work statement in accordance with OFPP Pamphlet No. 4, see Paddock, C. D. (1987, June). Performance work statements: Significant problems in the preparation process. (Master's thesis) Defense Technical Information Center (DTIC No. ADA 184 897).

(4.) "Each year the Government contracts for a significant amount of services. Such services range

from the routine maintenance of facilities or equipment to highly sophisticated technical and management assistance such as the design, development and furnishing of systems, or expert assistance for management and program activities. Attempts to apply contracting methods which are inappropriate to the services being acquired have often resulted in unsatisfactory performance and contract administration problems, as reflected in several internal agency investigations and evaluations, General Accounting Office Reports, and OFPP studies. These reports criticized unnecessarily vague statements of work, insufficient use of firmer pricing arrangements, the lack of quantifiable performance standards, and the inadequacy of quality assurance surveillance. In addition, there is concern that the Government underemphasizes quality versus price in the acquisition of services." In Office of Federal Procurement Policy. (1991, April 15). Policy letter on service contracting (56 FR 15110, 15113). Washington, DC: Author.

(5.) Federal Acquisition Circular 97-01, 62 FR 44802, August 27, 1997.

(6.) "In part, I believe the problem centers on a lack of clarity regarding the definition of what constitutes a performance-based service contract. Based on my experience, there is considerable disagreement among agencies regarding the requirements to qualify a contract as performance-based. Previous attempts by OFPP to clarify the definition, including a 'checklist' of minimum required elements for an acquisition to be considered performance-based, have been unsuccessful." Styles, A. B. (2001, November 1). Statement of Angela B. Styles, Administrator for Federal Procurement Policy, before the Subcommittee on Technology and Procurement Policy, Committee on Government Reform, United States House of Representatives. Retrieved from <http://www.acqnet.gov/Notes/sarafinal.doc>, p. 11. See also Styles, A. B. (2002, March 7). Statement of Angela B. Styles, Administrator for Federal Procurement Policy, before the Subcommittee on Technology and Procurement Policy, Committee on Government Reform, United States House of Representatives, retrieved from <http://www.acqnet.gov/Notes/saratestimony37.doc>

(7.) Published results can be seen in: Interagency Task Force On Performance-Based Service Acquisition. (2003, July). Performance-based service acquisition: Contracting for the future. Washington, DC: Office of Federal Procurement Policy; and Federal Acquisition Circular (2005-07, 71 FR 198, 211), published January 3, 2006.

(8.) This has long been recognized in economic and legal scholarship. See Coase, R. H. (1988). The nature of the firm. In *The Firm, the Market, and the Law*. Chicago: The University of Chicago Press, pp. 33-56; Knight, E (1971). Risk, uncertainty and profit. Chicago: University of Chicago Press; MacNeil, I. R. (1978). Contracts: Adjustment of long-term economic relations under classical, neoclassical, and relational contract law. *Northwestern University Law Review* 72(6), p. 854; and Williamson, O. E. (1988). *The economic institutions of capitalism*. New York: The Free Press.

(9.) "Of course, it is possible to measure service quality with more objective criteria, such as in the technical approach to quality. Services could be compared to a checklist of quality indicators, such as whether calls are answered in three rings or whether employees remember to smile and say "thank you" to customers at least 99 percent of the time. However, setting specific goals for particular aspects of service might narrow the vision of employees so that they will achieve these goals by lowering quality in areas for which no goals have been set. For example, service representatives might start answering all customer calls within three rings by terminating other customer calls or placing people on hold. This situation would not be an overall improvement in service quality, even though the objective, technical approach to quality might indicate that it was. Thus a user-based approach, rather than an objective checklist approach, has been found to be superior for evaluation the quality of intangible services." In Schneider, B., & White, S.S. (2004). *Service quality: Research perspectives*. Thousand Oaks, CA: Sage Publications, p. 11. See, too, discussions of service quality in several articles in Rust, R. T., & Oliver, R. L., eds. (1994). *Service quality: New directions in theory and practice*. Thousand Oaks, CA: Sage Publications.

(10.) FAR 16.404(a) and 16.405-2(b) say that award fee incentives are to be used only when it is not possible to develop objective incentive criteria. Their use in performance-based contracts is inconsistent with the PBSA requirement for objective, measurable performance standards.

(11.) "The feasibility requirement in contracting for results is that the product must lend itself to clear definition. Whether he is contemplating a fixed (price) or a performance contract (a contract with incentives), the buyer must be able to specify the desired results in simple, straightforward terms to a prospective seller. These terms must also be meaningful to a knowledgeable third party so that, if a dispute arises, he can determine whether the contract terms have been fulfilled or not. In purchasing books or equipment or even buildings, the school is usually able to describe exactly the product it is after. Such procurements as the purchase of administrative services is not so easy." In Stucker, J., & Hall, G. (1971). *The performance contracting concept in education*. Santa Monica, CA: Rand, p. 6.

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