

# Defense Industrial Initiatives Current Issues: Cost-Plus Contracts

For the first time in the history of televised presidential debates, contracting has moved to the stage. During the first Presidential debate, one candidate stated that to get defense costs under control, “we have to do away with cost-plus contracts.”<sup>1</sup>

## What are cost-plus contracts?

Cost-plus, or cost-reimbursement, contracts pay a contractor for all of its allowed expenses, typically up to a set limit.<sup>2</sup> The ‘plus’ refers to an additional payment that allows a contractor to make a profit. Three key types of cost-plus contracts provide different incentives to contractors:

### Award-fee contracts (\$38B in FY’07)

Tie the contractor fee to the quality of the end product.

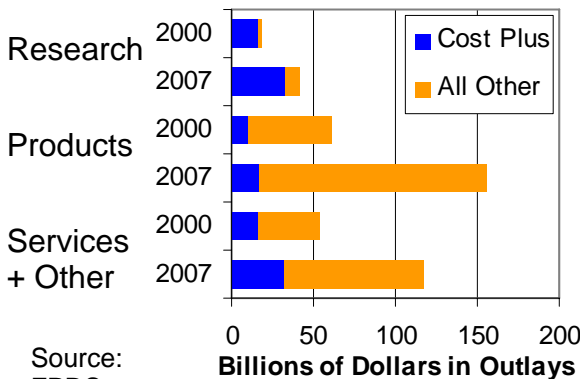
### Incentive fee contracts (\$8B in FY’07)

Provide a larger fee for contracts that meet or exceed performance targets such as cost savings.

### Fixed-fee contracts (\$32B in FY’07)

Entail a pre-negotiated fee for the contractor, providing no incentive for performance or cost savings.

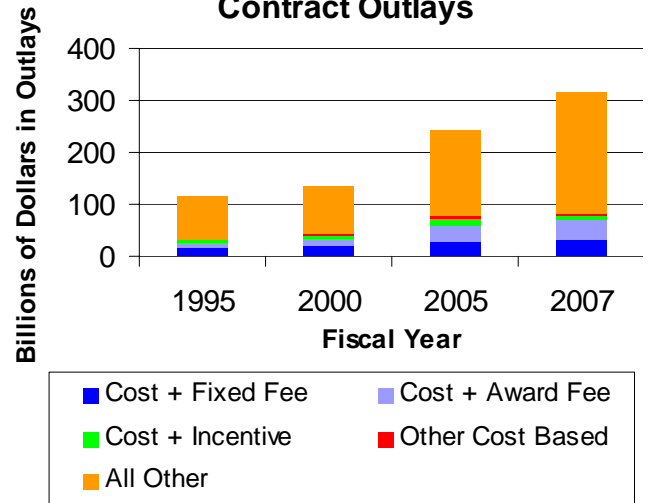
## Defense Contract Outlays by Category and Fiscal Year



<sup>1</sup> [The New York Times - First Presidential Debate – Transcript – Election Guide 2008](#)

<sup>2</sup> Other types of contracts are based in part on costs e.g. Time and Materials contracts. They are included in “All Other.”

## Defense Department Total Contract Outlays



Source: FPDS.gov

## Why are they controversial?

Concerns about cost overruns could lead to a preference for more predictable fixed price contracts. Some argue that cost-plus contracts, particularly those with fixed fees, may provide insufficient incentives to reduce costs.

## Why are they used?

The government often has difficulty predicting the cost of large scale projects. Michael Sullivan, GAO’s director of acquisition and sourcing management, argues that contractors would simply not bid on high-risk endeavors, such as R&D projects, if they were operated under fixed-priced contract structures. Broken down by product or service codes, the research sector is dominated by cost-plus contracts as expected for the less predictable task of research.<sup>3</sup>

<sup>3</sup> Product code definitions do not align with RDT&E vs. Procurement breakdown. Research code excludes research management and support.

# Defense Industrial Initiatives Current Issues: Cost-Plus Contracts

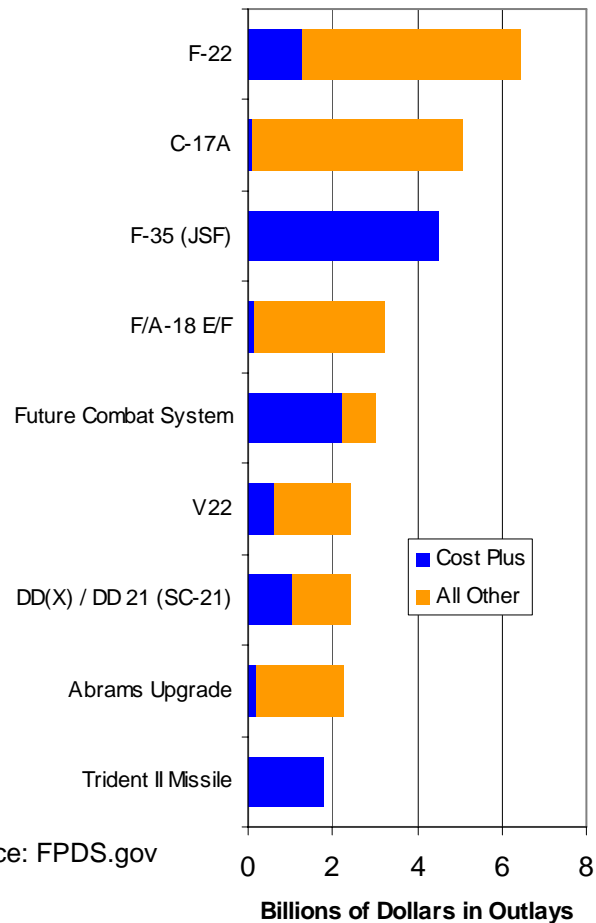
## What can be done to avoid cost overruns?

Cost-plus contracting is essential under the right conditions. As the GAO reports found, overruns often result from the government’s failure to understand and define requirements adequately up-front. Moreover, requirements that are still changing can lead to the expansion of cost-plus contracting beyond R&D into production. Finally funding programs at realistic baseline cost estimates also helps. Beyond requirements and cost realism, proper oversight and management and the application of reasonable incentive and award fee standards will contribute to controlling program costs.

GAO reports found that many of the shortcomings in cost-plus contracting are actually attributable to problems with requirement and management. FY2009 National Defense Authorization Act provisions to strengthen FAR regulations on tying award and incentive fees to objective and measurable contract performances will help in correcting these deficiencies. Another improvement would be to increase the number and quality of the contracting officers to administer cost-plus contracts in a more effective manner. Perhaps the most critical step is to restore the capability of the U.S. government acquisition workforce, both before award and in managing contracts.

- Joachim Hofbauer and Greg Sanders

**Top Ten Defense Programs  
Fiscal Year 2007 Outlays**



Source: FPDS.gov

## For More Information See:

[The Structure and Dynamics of the U.S. Federal Professional Services Industrial Base, 1995-2005](#) Update coming soon to [www.csis.org/isp/diig/](http://www.csis.org/isp/diig/)

The raw data on Federal Outlays is available at <https://www.FPDS.gov>

GAO: [Defense Acquisitions: Assessments of Selected Weapon Programs](#), 2008