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United States General Accounting Office
Washington, DC 20548

May 22, 2003

Congressional Committees

Subject: *Use of Legislative Incentive for Performance-Based Contracting Unknown*

The Department of Defense (DOD) spent about \$93 billion in fiscal year 2002 to acquire various types of services, such as base operations, logistical support, and information technology. To achieve greater cost savings and better outcomes when agencies acquire these and other services, Congress and the executive branch have encouraged greater use of performance-based contracting. Performance-based contracts specify the desired outcomes and allow the contractors to determine how best to achieve those outcomes, rather than prescribe the methods contractors should use.

In October 2000, Congress sought to provide an incentive for the use of performance-based contracts through legislation¹ giving DOD temporary authority to treat certain performance-based service contracts as contracts for commercial items.² Contracts for commercial items may be awarded using streamlined procedures under Part 12 of the Federal Acquisition Regulation (FAR). This authority is scheduled to expire in October 2003.

As required by the October 2000 legislation, we reviewed DOD's implementation of the temporary authority, including the interim and final implementing regulations, public comments on the interim regulation, and other DOD documents. We also discussed with DOD officials the extent to which the authority had been used. We conducted our review from September 2002 through February 2003 in accordance with generally accepted government auditing standards.

Results in Brief

DOD issued regulations to implement the legislative authority, but because there is no tracking mechanism, DOD does not know the extent to which the authority has been

¹ Section 821(b) of the Defense Authorization Act for Fiscal Year 2001, Pub. L. 106-398, Oct. 30, 2000.

² The term "commercial item" is defined as any item that is of a type customarily used for nongovernmental purposes that has been sold, leased, or licensed or offered for sale, lease, or license to the general public. 41 U.S.C. 403 (12). With respect to services, the statute includes "services offered and sold competitively, in substantial quantities, in the commercial marketplace based on established catalog or market prices for specific tasks performed and under standard commercial terms and conditions." *Id.*

used. DOD officials believe, however, that use of the authority has been limited, at best. Although a January 2002 DOD policy memorandum indicated that additional guidance on reporting use of the authority would be forthcoming, no additional guidance has been issued to date.

Background

In October 2000, Congress passed section 821(b) of the National Defense Authorization Act for Fiscal Year 2001, which allows DOD to treat performance-based service contracts or task orders as contracts for the procurement of commercial items under specified conditions. The conditions are that the contract or task order must: (1) be valued at \$5 million or less; (2) define the work in measurable, mission-related terms; (3) identify a specific end product or output; (4) contain a firm, fixed price; and (4) be awarded to a contractor that provides similar services to the general public under terms and conditions similar to those offered to the federal government.³

The use of performance-based contracts to acquire services offers a number of potential benefits. Performance-based contracts can encourage contractors to be innovative and to find cost-effective ways of delivering services. By shifting the focus from process to results, they hold the promise of better outcomes and reduced costs. In view of the potential benefits, Congress has been encouraging greater use of performance-based contracting, and the administration has set a general goal that 20 percent of eligible service contracts should be performance based.⁴ DOD has a goal that 50 percent of its service contracts will be performance based by 2005.

Congress and the administration also have been encouraging agencies to acquire commercial items to the maximum extent practicable to satisfy agency needs for goods and services. The objectives are to reduce the government's reliance on government specifications and to take advantage of technical innovations available in the commercial marketplace. Special rules designed to facilitate the acquisition of commercial items are contained in Part 12 of the FAR. These rules permit greater flexibility in negotiating contract terms and conditions. In addition, certain enumerated laws do not apply to commercial item acquisitions, such as the requirement that the contractor submit cost or pricing data. In general, to be acquired using the commercial item procedures of FAR Part 12, services must be of a type that are sold competitively in substantial quantities in the commercial marketplace based on established catalog or market prices for specific tasks performed. Under the authority of section 821(b), a service could be acquired as a commercial item even though it would not otherwise meet the commercial item definition.

³ In addition, the legislation provided that special simplified procedures previously authorized for acquiring commercial items valued up to \$5 million would not apply to acquisitions of services deemed to be commercial items under section 821(b).

⁴ For additional information, see *Contract Management: Guidance Needed for Using Performance-Based Service Contracting*, [GAO-02-1049](#) (Washington, D.C. Sept. 23, 2002).

DOD Issued Regulations to Implement Section 821

On December 6, 2001, DOD issued an interim rule amending the Defense Federal Acquisition Regulation Supplement to implement section 821(b). The rule listed the legislative conditions for use of the new authority, as well as additional conditions that apply generally to the use of performance-based contracts. For example, the rule required the use of quality assurance surveillance plans. Although there is no mention of these plans in section 821(b), other sections of the FAR require them whenever performance-based service contracting is used.

DOD also requested comments on the interim rule and received four sets of comments from various sources. In some cases DOD agreed with the points raised and revised the final rule. Other comments dealt with conditions imposed by the legislation. For example, one comment pointed out that the requirement that a contract under the section 821(b) authority be with an entity that provides similar services to the general public precludes use of the authority to contract with an entity whose only business activity consists of contracts with the government under section 8(a) of the Small Business Act or other federal preference programs. DOD agreed with this conclusion, but noted that the requirement was contained in the legislation and could not be changed through regulation. DOD published the final rule in the *Federal Register* on October 25, 2002.

DOD Does Not Know the Extent to Which Section 821(b) Has Been Used

Department of Defense officials are not aware of the extent to which the new authority contained in section 821(b) has been used to acquire services because DOD does not have a reporting system to track the use of this authority. At our request, however, DOD officials asked each of the military services to query some of their buying commands about possible instances of the use of section 821(b) authority. Officials from each of the services confirmed that data on the possible use of this authority are not collected. In addition, Air Force and Navy officials told us that they were unaware of instances in which contracting personnel used the authority. Army officials, however, said they believed a minimal number of contracting personnel in the Army had used the authority to treat certain services as commercial items, such as plumbing and electrical motor repair services. Army officials were unable to identify the specific contracts on which the authority had been used.

DOD officials suggested two possible explanations for why the authority provided by section 821(b) may have seen little, if any, use. First, the officials cited a perception among some contracting personnel that the section provided no new authority. In fact, in our discussions with some DOD personnel it was apparent that they believed section 821(b) could only be used to acquire services that already met the definition of commercial item. As indicated by DOD, however, the implementing regulation “provides additional authority for use of FAR Part 12 to acquire services that do not meet the definition of commercial item.”⁵ Second, numerous DOD officials cited the requirement for a firm, fixed-price contract as an impediment to use of the authority. In this regard, the existing regulatory definition of commercial item expressly excludes services sold in the commercial marketplace at hourly rates without an

⁵ 67 *Fed. Reg.* 65,512 at 65,513 (Oct. 25, 2002). (Emphasis in original.)

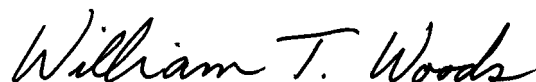
established catalog or market price for a specific service performed. Although services priced on an hourly basis--and thus by definition not considered to be commercial items--might be good candidates for use of the new authority, the requirement of section 821(b) for a fixed-price contract reportedly made the authority less attractive.

In January 2002, the Under Secretary of Defense, Acquisition and Technology issued a policy memorandum reemphasizing the department's commitment to performance-based contracting and highlighting the temporary authority provided in section 821(b). The memorandum said it was "important that we thoroughly test this authority during the pilot period to demonstrate its value." In addition, the memorandum said that DOD would provide additional direction on the reporting requirements applicable to the pilot authority. To date, DOD has not provided any additional direction. According to one DOD official, a reporting system would have been an unnecessary burden on contracting personnel because they anticipated only limited use of the temporary authority.

We requested comments from DOD on a draft of this report. On May 16, 2003, a representative of the Office of the Director of Defense Procurement and Acquisition Policy stated that the draft report was technically accurate and that no other comments were needed.

We are sending copies of this report to the Secretary of Defense; Director, Office of Management and Budget; and interested congressional committees. We will also make copies available to others on request. In addition, this report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If there are any questions concerning this report, please call me at (202)-512-8214. The major contributors to this report were Odi Cuero, Chris Galvin, Gary Middleton, and Ralph White.



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