I've told the story before about that one DOE contractor that kept winning contract after contract after contract. Its secret? The solicitation stated that the government intended to award a cost-reimbursement contract, but the contractor proposed to accept a firm, fixed-price contract for the same scope of work. The government was delighted to reduce its cost risk associated with an otherwise capable contractor, and gladly awarded that contractor a FFP contract.

The contractor knew it was going to take a loss on the work. It was willing to make an "investment"—knowing that, as its business base grew through new contract awards, that additional work was going to absorb fixed costs, reducing total costs on all contracts. The logic was: the investment was going to be reduced as the indirect cost rates came down.

Well, reality didn't correspond to the plan.

The fact was that the government knew that the proper contract type was cost-reimbursement, because the scope of work wasn't fully known. The government knew what it didn't know, and it guessed there might be quite a bit of scope creep. The contractor's "investment" didn't take the possibility of scope creep (without corresponding equitable adjustment to contract price) into its FFP philosophy. As a result of unforeseen cost overruns on its FFP contracts, that contractor become a former contractor.

But the key point here is that the government was pleased to accept the contractor's "investment" at the time. It seemed like a great decision from the government's perspective, even though we wonder if it still seemed like a great decision a few years later, when contracts were terminated and the work needed to be reprocured.

There is nothing inherently wrong with a proposing a price lower than the contractor believes it will take to do the job. In fact, so long as the contractor does not intend to "get well" downstream, there is nothing improper with the practice. FAR 3.501 prohibits the practice of "buying-in" but that practice is expressly defined as "submitting an offer below anticipated costs, expecting to—(1) Increase the contract amount after award (*e.g.,* through unnecessary or excessively priced change orders); or (2) Receive follow-on contracts at artificially high prices to recover losses incurred on the buy-in contract." So long as the contractor avoids either of those two practices, it is free to propose at whatever price it wants to.

Boeing is perhaps the contractor that most obviously practices the concept of investing to win. In fairness, many other contractors do it as well; though we suspect Boeing practices it more consistently (or is better at it).

Now before we get into this topic any deeper, a couple of caveats. First, I own Boeing stock! Not a lot of it, true. But some. It's been a good stock to own. Second, I work full-time for a company that recently lost out to Boeing in a major competition (MQ-25). Consequently, you may believe that I'm not entirely objective about this topic. So be it.

Frank Kendall, former USD (AT&L) kicked off the discussion in September, 2018, in his **article** at Forbes entitled "Boeing And The Navy Place A Big, Risky Bet On The MQ-25 Unmanned Air Vehicle." In that article, Mr. Kendall discussed risks that both Boeing and the Navy were accepting when the Navy let Boeing's bid—which was significantly below its two competitors' prices—sway it to awarding the contract to Boeing. Importantly, with respect to the risks that the Navy was taking on, Mr. Kendall wrote—

[The Navy] cannot transfer all the program risk to Boeing; if Boeing fails to execute the program, the Navy customer will not get the UAVs it wants. If Boeing can deliver the aircraft but runs over on costs, claims against the Navy can be expected. Under the fixed price incentive contact, the Navy will also share at least a fraction of the financial risk of development.

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There is no doubt that Boeing went into the competition for MQ-25 with its eyes open, but that doesn't eliminate the risk. Competitive pressures, as in the case of the MQ-25, also incentivize aggressive bids. In this case, because Boeing has not won a major new program for some time, the pressure on management to win can be assumed to have been very strong.

Indeed, recent reports state that Boeing has *already* recorded a $691 million charge against earnings related to its recent MQ-25 and T-X training jet contract awards. This means that for one or both of those contracts, Boeing has officially forecasted an at-completion overrun that burns through its FPIF cost share, the Navy's FPIP cost share, any profit it may have proposed—plus an additional $700 million on top of that. That's a *lot* of money.

But that has been Boeing's strategy, according to its CEO, Dennis Muilenburg. According to a US Naval Institute article (written by Ben Werner). The **USNI article** quoted Boeing's CFO as follows—

"Our T-X and MQ-25 investments are based on deliberate and intentional decisions to create long-term valuable products and services franchises," Smith said. "In selective key market opportunities such as these, we are taking into account the considerable market potential in our business cases, and not just the initial order quantity with the contracts."

That article also discussed the possible downside of Boeing's strategy. It stated—

Analysts, though, voiced some concerns over the expense of creating the bids and fears Boeing executives did not accurately measure the risk to the company's bottom line when developing bids lower than what competitors offered.

The article also noted that Boeing—a company that reportedly has a warchest of $8 billion in cash on hand—has the resources to make such investments. Not every government contractor has such resources, which is one reason that Boeing keeps winning new contracts.

In fact, Lockheed Martin's CEO, Marilyn Hewson, clearly stated that LockMart doesn't have those same resources and cannot compete if the competition is based on the size of the contractor investment. **Another USNI article** by Ben Werner discussed the situation and possible consequences for future competitions. He wrote—

Lockheed Martin officials say their loss to Boeing in three recent aircraft competitions indicates that Pentagon weapon buyers are valuing low price tags over high-tech capabilities, which may lead the company to question its participation in some future competitions. … "We believe our proposals represented outstanding technical offerings at our lowest possible pricing," Hewson said. “Had we matched the winning prices and been awarded the contracts, we estimate that we would have incurred cumulative losses across all three programs in excess of $5 billion; an outcome that we do not feel would have been in the best interest of our stockholders or customers.”

LockMart CFO Tanner had some further thoughts, according to the article, which quoted him as follows—

“Those [losses] were disappointing for a lot of reasons. But the fact they really decided, all three, on an LPTA (lowest price technically acceptable) basis, didn’t help the situation,” Tanner said. “It’s not getting the best capabilities for the warfighter in the hands of the warfighter.”

The Lockheed Martin executives’ comments frame the question as one of cost versus capability. When developing new weapon systems, should the Pentagon acquire the “technically acceptable” solution for the lowest price, or should it pay a premium to acquire more (and better) capability?

In addition, we would frame the question in terms cost versus innovation. When developing new weapon systems, should the Pentagon acquire a workable solution based (as much as possible) on nondevelopmental technology, or should it encourage contractors to propose the most innovation possible?

And what about big versus small contractors? If the Pentagon is going to award contracts based on the amount of investment that contractors are willing to make, then only the largest of contractors will win awards. The smaller contractors will be locked out of the “pay for play” competitions.

To sum up these thoughts, it seems that certain larger contractors are willing to pay to play in long-term Pentagon contracts, betting that they will earn back developmental losses over the lives of the programs. They may be right; but we remember the story of that DOE contractor, whose program investments turned out to be larger than it ever dreamed of.

In related news, Boeing announced on October 24, 2018, that it was taking another $179 million in charges related to its KC-46a FPIF tanker program.