Congress and many policy-makers in the Department of Defense would prefer that all government contracts be firm fixed-price (FFP) types. They are convinced that awarding FFP contracts reduces the risk of cost growth, because the contract price is “fixed.” And it’s not just the Federal government; many prime contractors will only award FFP subcontracts (typically via purchase orders that contain a standard set of boilerplate terms and conditions). If they award only FFP subcontracts then they don’t have to do a lot of reviews of accounting systems and they don’t have to do a lot of cost surveillance—or so they think.

They’re all wrong, of course.

If you award an FFP contract or subcontract, you should expect change orders—perhaps a lot of them. If you have changes to technical scope or schedule, you are very likely to see changes to the previously negotiated contract price. You may find that, ultimately, it’s more expensive and time-consuming to manage the change order activity than it would have been to have awarded a cost-type contract (or subcontract). If you counted on that FFP value in your at-completion estimates, then you may be blind-sided when that FFP value grows and grows and grows, because of changes to the program.

Government programs have changes. The bigger the program, the more the changes. The more technically challenging the program, the more the changes. If you think your government program will be the first program in history to have no changes, we bet you are wrong.

Our position is that a program change management strategy should be determined at program kick-off (or earlier). This is especially true for those deluded prime contractors who have a development or LRIP prime contract and have decided to “manage” costs by awarding only FFP subcontracts. We strongly suggest that those prime contractors have a change management plan, fully staffed and ready to go—because they are going to need it.

There was a time when everybody had learned the lessons from the A-12 program (and others), and we all pinky-sweared that development contracts would no longer be awarded (or accepted) on an FFP basis. When you don’t know what you’re going to design and produce, it’s very hard to provide a solid cost estimate as to how much it’s going to cost. We all knew that, and thus we all agreed that the appropriate contract type for development contracts was some form of cost-plus. The policy was enshrined in the FAR—

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“Complex requirements, particularly those unique to the Government, usually result in greater risk assumption by the Government. This is especially true for complex research and development contracts, when performance uncertainties or the likelihood of changes makes it difficult to estimate performance costs in advance.” (FAR 16.104(d).)

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“The contracting officer shall use cost-reimbursement contracts only when circumstances do not allow the agency to define its requirements sufficiently to allow for a fixed-price type contract [or] uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract.” (FAR 16.301-2(a).)

We all knew that and we pinky-sweared to follow the policy … but somewhere over the past decade or so we broke our oath. The government started awarding fixed-priced development contracts and contractors started accepting them.

Oh, they don’t call them fixed-price development. They call them “fixed-price-incentive fee” (FPIF) and they pretend to believe that the FPIF development contract is, somehow, different from the FFP development contract.

It’s not different. Not really. No substantively.

The FPIF contract creates the fiction that the customer is sharing in the cost-overrun (or underrun) risk. The FAR states “A fixed-price incentive (firm target) contract is appropriate when the parties can negotiate at the outset a firm target cost, target profit, and profit adjustment formula that will provide a fair and reasonable incentive and a ceiling that provides for the contractor to assume an appropriate share of the risk. When the contractor assumes a considerable or major share of the cost responsibility under the adjustment formula, the target profit should reflect this responsibility.”

But the conundrum is still there: how can you possibly negotiate a “firm target cost” or even determine a fair “profit adjustment formula” when you don’t have a design yet? It’s a complete gamble not fundamentally different from the gamble of an FFP development contract. It is almost certain that, for a pure development effort or even an LRIP situation, the contractor is going to overrun the firm target cost. It is very likely that the contractor will suck up all the government participation in the profit adjustment formula to cover its overrun.

And when the contractor has used up all the government’s participation in the profit adjustment formula, then the contract is no longer FPIF. Instead, going forward it’s a pure FFP contract. Every overrun dollar is to be covered by the contractor (absent change orders). Period.

Does this ever happen? Sure it does! Let’s revisit the most prominent example of FPIF development contracting: Boeing’s KC-46a Pegasus aerial refueler program.

We’ve reported on that program before. Over the years we have reported on how Boeing has recorded charge after charge against earnings. It’s become an annual refrain in the company’s quarterly earnings reports. In 2016, the company recorded a multi-million dollar charge. The same thing happened in 2017. A supplier (Cobham) even recorded a charge against earnings for its role in the program.

And now, here we are again. At the end of July, Boeing recorded another charge against earnings related to the KC-46a program. This time the company recorded another $426 million—*nearly a half billion dollars*—for “delays in the certification process as well as ‘higher estimated costs’ for incorporating needed modifications to six flight test and two early-build aircraft,” according to **this story** at DefenseNews, authored by Valerie Insinna. That same story reports that Boeing’s total charges against earnings is now *$3.4 billion*
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Let’s be very clear: Boeing was originally awarded a $4.8 billion FPIF development contract, a contract on which it has now used up all the government’s share of the overrun plus acknowledged another $3.4 billion in cost overruns. Had the contract been cost-type, the price would have roughly *doubled* from the original award value.

Thus the title of this blog article. Accept a FPIF development contract at your own peril. The investment you are prepared to make may not be the investment you end up making.