



Reducing Spending on Service Contracts in Order to Comply with Sequestration

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INTRODUCTION

In order to comply with budgetary cutbacks caused by sequestration, how can agencies reduce spending on service contracts? Specifically, what changes should agencies make to their service contract spending, and how may managers make these changes?

Most managers want to reduce spending on service contracts but don't know how because some aspects of the procurement process appear to be shrouded in mystery. Some managers may fear cutting back on service contracts for fear of legal consequences. However, all managers know that at least some of the savings required by sequestration must be derived from spending on service contracts. The Department of Defense alone spent almost \$200 billion on service contracts in FY2011,¹ with civilian agencies spending approximately another \$100 billion.

The Office of Management and Budget (OMB) recently issued guidance to help agencies plan for sequestration. Hiring freezes for federal employees, firing of temporary and term federal employees, incentives for federal employees to retire, and extensive furloughs of federal employees—all of these options constitute actual reductions in spending on federal employees. In contrast, agencies are merely directed by OMB to review “contracts to determine where cost savings may be achieved in a manner that is consistent with the applicable terms and conditions, remaining mindful of the manner in which individual contracts advance the core mission of the agency...”

This brief memorandum is intended to demystify the procurement process so that managers can look to their service contractors for savings as surely as they are already looking at their federal employees for

savings. In other words, I aim to provide managers with the guidance on cutting spending on service contracts that OMB did not adequately provide.

The good news is that managers have all of the tools they need to reduce spending on service contracts, often with the consent, albeit grudging, of service contractors. The bad news is that service contractors, like any other businesses, are not eager to voluntarily give up revenues, so strong leadership is required from the heads of agencies. They must establish thoughtful but ambitious goals to take savings from service contracts, support their managers when they encounter predictably fierce resistance from service contractors, and then hold their managers accountable for meeting those goals. As discussed below, agencies could generate sequestration savings predominantly from cutting spending on service contracts. Indeed, from 70% to 90% of the savings otherwise required by sequestration to be cut out of in-house personnel funding instead could come from reductions in service contract spending.

FOUR OPTIONS FOR CUTTING SPENDING ON SERVICE CONTRACTS

This memorandum recommends four established and completely legal options for reducing spending on service contracts. To some extent, these options overlap and complement one another, although they differ in the details. For overall coordination, it is imperative that heads of agencies develop plans that would establish savings requirements for various categories of service contracts in order to comply with sequestration.

¹ “Competition for Services and Recent Initiatives to Increase Competitive Procurements,” GAO -12-384 (Mar. 15, 2012).

For example, an agency's plan might anticipate that a category of deferrable maintenance contracts take a 50% reduction in spending, while a category of information technology service contracts for immediate problems might take just a 10% reduction, while a category of acquisition service contracts might take a 30% cut. These particular percentages are, of course, merely illustrative of the concept.

After receiving their agency's plan for achieving spending reductions in categories of service contracts, managers can then use four options to actually reduce that spending, either for specific service contracts or categories of service contracts:

1 Pauses of Task Orders

An increasing percentage of service contracts consist of indefinite delivery/indefinite quantity (ID/IQ) contracts against which services for a particular need are purchased by task orders. A task order constitutes a new requirement, except that typically only particular contractors may bid for it. An agency has complete discretion to decide not to award new task orders—provided that minimum order quantities have already been acquired—the same as whether to award new contracts. For example, agencies may buy minor construction services, such as facilities augmentation or repairs, through a new task order off of an ID/IQ construction services contract. Pursuant to the agency's sequestration plan, it could be determined that an agency should reduce spending on service contracts in the category of minor construction by 50%. That agency's managers could then implement this pause simply by placing fewer new task orders.

The government often buys its information technology (IT) services by task orders. During the development of the Administration's FY12 budget an industry survey found that "federal IT spending to commercial contractors is expected to grow about 5 percent annually, according to Input Inc. [a market research firm], which sizes the 2010 federal IT market at about \$86 billion. By 2015, that would rise to about \$110 billion in IT products and services contracted out to commercial suppliers."² Even a very limited reduction in the upward trend in the purchasing of IT task orders would produce significant savings.

It's no secret managers sometimes hold spending down during most of the fiscal year, and then in a last few frenzied weeks before the end indiscriminately spend the residual funding on ID/IQ task orders:

"Come July and August, the ID/IQs light up like Christmas trees," said Paul Strasser, senior vice president and general manager of Dynamics Research Corp., a federal group. "There are task orders going out like crazy because, with the continuing resolutions, agencies are trying to spend the money they have allocated. The ID/IQ has become the vehicle of choice. So you have to prepare."³

It would be perverse if agencies constrained by sequestration furloughed their federal employees in March and April, only to spend some or all of the savings on the usual last-minute, capricious, and nonessential task orders in July and August. Instead, agencies should plan right now to generate significant savings in their spending on service contracting through pausing or even eliminating task orders.

2 Partial Terminations for Convenience⁴

Agencies have complete discretion to reduce current contracts and task orders through partial terminations for convenience.⁵ A manager may determine that a particular contract should actually end earlier and with less work, or reduce its schedule for work, compared to what was originally anticipated. For example, an agency may have a contract for weekly janitorial services. A manager may partially terminate that contract for convenience so that services need be rendered only in two of every three weeks, effectively terminating one-third of that contract.

Often, agencies can ask service contractors to provide their own schemes for how partially terminated contracts will be performed. Pursuant to the agency's sequestration plan, managers can inform service contractors in a particular category that sequestration requires that their costs be reduced by a certain percentage and then invite those service contractors to provide schemes for how the savings will be achieved. Managers, of course, may ultimately reject service contractors' schemes in favor of their own arrangements. However, managers, who might find it difficult to unilaterally devise new contract terms, could find it easier to simply revise schemes supplied by service contractors. And while they may understandably regret seeing their contracts partially terminated, service contractors can at least try to mitigate adverse consequences by providing valuable input to managers for performance of the balance of their contracts.

3 Deductive Change Orders⁶

Pursuant to an agency's sequestration plan, all service contracts and task orders in a particular category might be subject to the same reductions through change orders, which would in turn make commensurate reductions in the work required of the affected service contractors as well as their payments.

There is some overlap between Partial Terminations for Convenience and Deductive Change Orders in this context.⁷ A leading analyst has said: "the case law suggests that deletions in excess of 20% of the work scope likely will be considered partial terminations for convenience and that deletions of less than 10% of the work scope likely will be considered to be deductive changes."⁸ This is a crude distinction, but also, "a court or board will assign a high level of deference to the designation made by the CO [Contracting Officer] or by agreement of the parties."⁹ Combining these points, an agency which uses change orders to reduce work in a particular category of contracts by 10% would likely find its characterization of its reduction as a deductive change would be largely immune to service contractors' litigation.

Although they cannot prevent agencies from undertaking terminations for convenience or deductive change orders, service contractors can litigate agencies' determinations—of how to price the reduction in their payments—before either boards of contract appeals or the Court of Federal Claims. For example, a service contract for maintenance and repair of agency vehicles might be assigned a deductive change order to reduce its locations of operation from ten to eight. The agency may estimate this deductive change as reducing work and cost by 15%, while the contractor may contend that it only reduces cost by 5%. Litigation over such questions is ultimately not to the benefit of agencies or service contractors. That is why it is so important for contractors to work with managers on realistic plans to realize the required savings.

4 Reduction by Bilateral Modifications¹⁰

Managers may reach agreement with some or even all service contractors in particular categories through bilateral modifications. Bilateral modifications constitute a complete agreement between the contractors and an agency. Although skeptics may doubt that this process occurs fully consensually, they do have, in the end, contractors' agreement, even if only grudging. Historically, many reductions in payments to service contractors have occurred through such modifications.

Contracting officers and program managers have far more power than they realize. Rather than be subjected to entirely involuntary partial terminations for convenience or deductive change orders, most service contractors would voluntarily consent to bilateral modifications for reductions, particularly if they can help to plan new arrangements for performance of their service contracts.

My work on the Commission on Wartime Contracting acquainted me with an excellent example of reduction by bilateral modification. In 2009, the Army began to reduce its footprint in Iraq. As troops were withdrawn, the Army also wanted to effect a "contractor drawdown" in order to sharply reduce the number of contractor employees—particularly in its biggest contract, KBR's omnibus logistics support contract. KBR, however, vigorously resisted, insisting on maintaining "faces without spaces" so that the Army would continue to provide reimbursement for KBR employees even after their bases had closed. Thanks to the leadership of General Ray Odierno, then the Army's commanding officer in Iraq and now the Army's Chief of Staff, and the Defense Contract Audit Agency, the manager of the contract successfully pressured KBR to agree to sharply reduce the number of its employees. Again, it can't be emphasized enough how important strong leadership will be in order to achieve the savings from service contracting costs that are required by sequestration.

² Paul McCloskey, "Federal IT Spending to Increase 5 Percent, Analyst Says," *Government Contract News*, April 20, 2011.

³ David Hubler, "6 Keys, and a Caveat, to Winning Bigger Contracts." *Wash. Technology*, July 1, 2011.

⁴ Joseph D. West, "Practical Advice Concerning the Federal Government's Termination for Convenience Clause," *Const. Law.*, Oct. 1997, at 26.

⁵ *Krygoski Const. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1990).

⁶ John C. Person, "Deductive Changes," *Briefing Papers*, July 2001.

⁷ *J.W. Bateson Co. v. United States*, 308 F.2d 510 (5th Cir. 1962).

⁸ John C. Person, "Deductive Changes," *Briefing Papers*, (July 2001), at 3.

⁹ *Id.* at 3.

¹⁰ Steven Tomanelli, "Types of Contract Modifications," 2 *Ann. Fed. Acquisition Reg. Desk Reference* sec. 43.103 (updated to March 2012).

CONCLUSION

Agencies can reduce their substantial spending on service contracts in order to comply with sequestration, often with minimal impact on services. Government contracting law provides agencies with ample tools to make such reductions.

In fact, the four options I have discussed, all well-established and perfectly legal, could, with strong leadership, be used to generate 70-90% of the savings otherwise required by sequestration to be cut out of in-house personnel funding instead to occur through reductions in spending on service contracts.

While several of these tools can be used with the absolute discretion of the agencies, service contractors still have plenty of opportunities to helpfully revise the terms of their service contracts.

The Budget Control Act (“BCA”), Pub. L. 112-25, provides for cuts in large pools of appropriations measured by budget accounts. The BCA does not require that cuts be taken out of the more limited subpools of “allocations” (known as Budget Object Classifications) within those accounts. An agency often has lump-sum appropriation accounts for its operations, including both service contracting and in-house personnel costs. The appropriation for that

agency’s operations (or “salaries and expenses”) might be, for example, \$1 billion. As a part of its discretionary budget execution, the agency could decide to reduce service contract spending, in-house personnel spending, or any other type of spending authorized by the particular appropriation.

In other words, the BCA permits agencies to make cuts predominantly in service contract spending, without having to make equivalent cuts in in-house personnel costs, so long as the agency achieves the requisite savings in the overall appropriation account. All that the BCA mandates is that savings be made by a set percentage at the individual account level calculated as a whole, and so the BCA makes it legal for the agency to make cuts in that appropriation account in service contracting costs, rather than in in-house personnel costs.¹¹

Some service contractors may be highly reluctant to reduce their costs, and they possess significant political influence. That is why it is so important that heads of agencies provide strong leadership to contracting officers and program officials—establishing thoughtful but ambitious goals for savings from reductions in service contract spending, backing up their staff to the hilt when they encounter resistance, while also holding their staff accountable for meeting those goals.

¹¹ There has been some discussion about whether the uniform sequestration percentage cut applies just at the level of the full appropriation account, or whether that uniform percentage applies more minutely and rigidly at the level of each program, project, and activity (“PPA”) within the account. There appear to be statutory indications that the uniform percentage applies at the level of each PPA despite the rigidity of this approach. Also, it would be somewhat unexpected to do away entirely with the traditional reprogramming procedures used for appropriations. In any event, this memo applies regardless of whether the sequestration percentage applies at the level of each PPA, because there is typically a choice even at the level of PPAs as to how an agency will comply with sequestration, as sequestration does not usually address agency expenditures at the Budget Object Classification level -- i.e., it will not specify whether furloughing federal government employees or pausing contracts is the appropriate way to comply with sequestration.

Charles Tiefer – Biography



Charles Tiefer is a professor of law at the University of Baltimore Law School where he teaches Government Contract Law and Contracts Law. He recently served for three years as one of eight Commissioners on the Congressionally authorized Commission on Wartime Contracting in Iraq and Afghanistan. He is the author of five books, including *Government Contract Law in the Twenty-First Century* and *Government Contract Law*, 2d. Edition, as well as numerous law review and other articles and papers. He regularly serves as an expert in complex government contract law matters.

Prior to joining the University of Baltimore Law School in 1995, Charles was Deputy Counsel to the U.S. House of Representatives for 11 years and assistant legal counsel to the U.S. Senate prior to that. Charles is a summa cum laude graduate of Columbia University and a magna cum laude graduate of Harvard Law School where he served on the Harvard Law Review.

