Audit of USAID/Philippines' Use of Award Fee Contracts

Report No. 5-492-98-002-P
February 28, 1998

Regional Inspector General
Bangkok

February 28, 1998

MEMORANDUM

TO: Director USAID/Philippines, Kenneth G. Schofield

FROM: RIG/Bangkok, Bruce M. Watts

SUBJECT: Audit of USAID/Philippines' Use of Award Fee Contracts, Report No. 5-492-98-002-P

This is the final report on the subject audit. We considered your comments on the draft report and have included them at Appendix II. The report contains three recommendations. Actions taken by management as described in the comments are responsive to Recommendation Nos. 1, 2, and 3 contained in the report. We therefore consider final management action on the three recommendations to be complete.

I appreciate the cooperation extended to my staff during the audit.

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EXECUTIVE SUMMARY

USAID/Philippines uses technical assistance contracts to support USAID-funded programs in the Philippines. For these contracts, USAID/Philippines is responsible for ensuring that the technical assistance is performed efficiently and effectively (page 1).

In April 1991, the Office of Management and Budget (OMB) issued Policy Letter 91-2 requiring federal agencies, to the maximum extent practicable, to use performance-based contracting methods when acquiring technical assistance services. The Policy Letter also requires that performance-based technical assistance contracts include incentive provisions to ensure that appropriate performance quality levels are achieved and that payments are made only for services which meet contract standards (page 1).

USAID/Philippines interpreted the Policy Letter requirements to mean that the Mission should use cost-plus-award-fee contracts (award fee contracts) and that these contracts should identify the results and standards expected to be achieved under the contracts. As of February 1997, USAID/Philippines was administering four active award fee contracts for technical assistance with estimated costs totaling $45.4 million, of which $35.1 million and $8.8 million had been obligated and spent, respectively (page 1).

Our review of three award fee contracts (with estimated costs totaling $43.6 million) found that USAID/Philippines did not comply with Federal policies and requirements concerning the use of award fee contracts. Although USAID/Philippines officials attempted to implement OMB and Federal Acquisition Regulation (FAR) requirements, their efforts were hampered by a lack of guidance from Washington (page 3).

The OMB Policy Letter also requires that performance-based contracting include formal and measurable performance standards and surveillance plans to facilitate assessment of contractor performance. Although surveillance plans were prepared, USAID/Philippines did not establish objective and measurable performance standards against which to evaluate contractor performance. Therefore, the Mission could not effectively rate and assess the quality of contractor performance. This report recommends that USAID/Philippines establish standards for assessing performance by contractors (pages 3-5).

According to FAR Section 16.401, incentive increases should be applied to performance targets rather than to minimum performance requirements. The three contracts reviewed tied incentive increases to adjectival ratings of the contractors overall performance. As a result, incentive payments could be made even though contractors met only minimum performance levels. The report recommends that the Mission establish performance targets as the basis for payment of award fees (page 6).

The three award fee contracts reviewed permit the USAID contracting officer to roll over unearned award fees allocated for one period to subsequent periods. This practice tends to increase cost and reduce the quality of contractor performance. If USAID/Philippines continues to roll over unearned award fees to subsequent periods, by the end of the three contracts the contractors will have received 99 percent or $1.9 million of the total available award fees. This report recommends that the Mission stop the practice of rolling over award fees to subsequent periods (pages 6-7).

In responding to the draft audit report, USAID/Philippines' management described actions taken to implement the three recommendations contained in the report. Management comments are discussed on pages 7 and 8 and included in their entirety as Appendix II.

Office of the Inspector General
February 28, 1998

INTRODUCTION

Background

USAID/Philippines uses technical assistance contracts to support USAID-funded programs in the Philippines. For these contracts, USAID/Philippines is responsible for ensuring that the technical assistance is performed efficiently and effectively.

In April 1991, the Office of Management and Budget (OMB) issued Policy Letter 91-2 requiring Federal agencies to use performance-based contracting methods to the maximum extent possible when acquiring technical assistance services. The Policy Letter also requires that performance-based technical assistance contracts include both incentive provisions (including award fee provisions) to ensure that contractors are rewarded for good performance and quality assurance schedules to discourage unsatisfactory performance. Although the Policy Letter encourages the use of award fee contracting, it restricts the use to situations where the contract amount, performance period and expected benefits justify the additional administrative effort and costs involved.

According to the Policy Letter, performance-based contracting focuses on the purpose of the work to be performed, as opposed to either the manner in which the work is performed or broad and imprecise statements of work. The Policy Letter also emphasizes the importance of proactive management support and direction from the highest levels to the success of performance-based contracting, including award fee contracting. In addition, Section 16.405(e) of the Federal Acquisition Regulations (FAR) requires that award fee contracts include an agency prescribed or approved award fee clause. However, USAID did not take action to prescribe an award fee clause to meet the FAR requirements until mid-1997.[1] Without such agency level guidance, USAID/Philippines interpreted the OMB Policy Letter to mean that the Mission should use cost-plus-award-fee contracts to acquire technical assistance services and that the contracts should identify the standards and results expected to be achieved under the contracts.

As of February 1997, USAID/Philippines was administering four active award fee contracts with estimated costs totaling $45.4 million, of which $35.1 million and $8.8 million had been obligated and spent, respectively.

[1] In May 1997, USAID's Office of Procurement issued Procurement Information Bulletin No. 97-12 containing guidance on the structure, organization, and administration of award fee contracts. The Office also prescribed a standard clause for award fee contracts.

Audit Objective

As part of the fiscal year 1997 audit plan, the Regional Inspector General/Bangkok audited USAID/Philippines' use of award fee contracts to answer the following question:

> **Did USAID/Philippines comply with Federal policies and requirements in the use of award fee contracts?**

Appendix I contains a discussion of the scope and methodology for this audit.

REPORT OF
AUDIT FINDINGS

Did USAID/Philippines comply with Federal policies and requirements in the use of award fee contracts?

USAID/Philippines did not comply with Federal policies and requirements in the use of award fee contracts. Although USAID/Philippines officials attempted to implement OMB and Federal Acquisition Regulation (FAR) requirements, their efforts were hampered by a lack of guidance from Washington concerning the use of award fee contracts. USAID/Philippines is to be commended for its efforts. However, the Mission did not establish objective and measurable performance standards against which to evaluate contractor performance. In addition, the Mission improperly tied award fee payments for contractors to overall performance rather than specific targets and routinely rolled over unearned award fees to subsequent rating periods without evidence of improved contractor performance. These issues are discussed below.

Standards For Assessing Contractor
<u>Performance Have Not Been Established</u>

OMB Policy Letter 91-2 indicates that performance-based contracting focuses on the purpose of the work to be performed as opposed to the manner in which it is performed or compliance with a broad and imprecise statement of work. The Policy Letter requires that performance-based contracting include formal and measurable in terms of quality, timeliness, and quantity performance standards and surveillance plans to facilitate the assessment of contractor performance.

In accordance with the OMB Policy Letter, USAID/Philippines developed contractor surveillance plans for determining the award fee payment based on the performance of contractors and cost-cutting measures they employ. However, USAID/Philippines did not establish appropriate standards for measuring contractor performance. Therefore, USAID/Philippines could not effectively assess the quality of contractor performance or the effectiveness of cost-saving measures they may have used. As a result, contractor performance ratings were unjustifiably high which could translate into excessive award fees.

USAID/Philippines' contractor performance surveillance plans for determining the amount of award fee that would be given to a contractor for each award fee period consisted of:

an evaluation resulting in a preliminary rating of the contractor's performance as it relates to the contract requirements. The evaluation, conducted by an Award Fee Evaluation Committee composed of representatives from the Government of the Philippines and USAID/Philippines, is based primarily on the contractor s semi-annual report, standard communications, and products defined in the contract and the contractor s work plans.

a review of the Evaluation Committee s report by the contracting officer to determine the award fee to be paid the contractor. The contracting officer s review should ensure that the evaluation was made consistent with the award fee evaluation criteria and reflects USAID's best objective assessment of the contractor's accomplishments and performance for the period.

USAID/Philippines generally followed the prescribed plans in determining award fee payments. However, due to the lack of objective and measurable standards for contractor performance as well as deficient performance reports prepared by the contractors, USAID/Philippines was not always able to objectively determine (1) if the contractors' performance was better or worse than satisfactory in achieving the anticipated results under the contract, and (2) that the award fee payments were made only for services which met contract requirements. For example:

The contractor's work plan for the rating period ended December 31, 1995, under the Governance and Local Democracy Project mostly identifies activities to be performed, including assisting organizations and conducting working groups, and documents to be prepared. However, standards needed to assess the quality for those activities and documents were not established.

The work plan called for the contractor to define and initiate 14 to 21 protocols. The protocols were to include performance benchmarks for assessing implementation progress and maintaining accountability of the contractor and the participating local government units. However, standards necessary to assess the overall quality of the protocols were not established. In addition the contractor s semi-annual report for the period ended December 31, 1995, did not report on progress toward the performance benchmarks or identify the number of protocols implemented during the period.

The contractor's 15-month work plan for the period ending June 30, 1997, under the Coastal Resources Management Project identified quantitative targets for some activities such as six coastal resource management plans developed and 34 municipalities assisted. However, quality standards were not established for these activities. In addition, the contractor's semi-annual progress report covering the award fee period that ended September 30,1996, did not identify progress made toward achieving the targets identified in the work plan.

The contractor under the Growth and Equity in Mindanao Project submitted a work plan for the year ending March 31, 1997. The work plan specified 70 targets, consisting of activities to be performed or documents to be prepared, for the contractor to achieve. The plan also identified the base fee and/or award fee that the contractor would be paid if the targets were met. However, standards for assessing the quality of the contractor s accomplishments were not established. Therefore, we could not determine whether the progress reported in the contractor s semi-annual report for the period ended September 30, 1996 was responsive to the contract intent.

In addition to the portion of award fees available for technical performance, each of the contracts set aside an available award fee amount for cost reduction measures implemented by the contractors. However, no standards were established to objectively determine whether the contractor achieved the anticipated performance. For example, the contracts under the Governance and Local Democracy Project and the Coastal Resources Management Project allocated 15 percent of the available award fee each rating period for cost control objectives such as "control of overhead," "purchasing effectiveness," and "economies in use of manpower, energy, materials, computer utilization". However, performance standards and targets were not established. Therefore, USAID/Philippines could not effectively assess the quality and effectiveness of cost savings methods employed by the contractors.

Two of the three contracts reviewed provided for adjectival ratings of contractor performance (i.e., superior, excellent, good, fair, poor, and unsatisfactory). Each adjectival rating corresponded to a numerical equivalent which was the basis for determining the percent of allowable award fee paid to the contractor. However, standards tying the quality of contractor performance to the adjectival ratings were not established. Without such standards, Award Fee Evaluation Committees could not determine appropriate adjectival ratings and the contracting officer could not determine appropriate award fee amounts. For the two contracts in question, the difference in award fees paid for performance rated as fair and performance rated excellent could be as much as $900,000 over the life of the two contracts.

Recommendation No. 1: We recommend that USAID/Philippines establish objective and measurable standards for assessing contractor performance under the Governance and Local Democracy Project, the Growth and Equity in Mindanao Project and the Coastal Resources Management Project.

Award Fee Payments Are Tied
<u>To Overall Performance Ratings</u>

OMB Policy Letter 91-2 indicates that performance-based contracts should, to the maximum extent practical, include incentive provisions to ensure that contractors are rewarded for good performance and quality assurance deduction schedules to discourage unsatisfactory performance. However, according to FAR Section 16.401, incentive increases should be applied to performance targets rather than to minimum performance requirements. The three contracts reviewed did not meet this FAR requirement.

The three contracts tied incentive increases to adjectival ratings of the contractors overall performance rather than to whether specific performance target were met. As a result, contractors could be paid a percentage of the award fees for performance rated from a high of superior to a low of poor. For example, under contracts for the Governance and Local Democracy Project and the Coastal Resources Management Project, the contractors could earn 20 percent of the available award fee for performance rated poor and 47.5 percent for performance rated fair. Thus, for poor performance the two contractors could receive award fees totaling $247,000. For fair performance the contractors could receive $586,000.

USAID/Philippines' officials believed that the above examples of paying award fees for "poor" and "fair" performance as well as the overall allocation of available award fees were misleading. They stated that the amounts established for base fees under the three contracts are not reasonable and should be higher, and that amounts allocated for award fees are probably excessive. USAID/Philippines officials said that they are taking action to modify current award fee contracts to increase base fees and decrease award fees by equal amounts.

> **<u>Recommendation No. 2</u>: We recommend that USAID/Philippines establish performance targets for contractors working under award fee contracts and base the payment of award fees on achievement of the targets.**

Award Fees
<u>Were Rolled Over</u>

The three award fee contracts reviewed permit the USAID contracting officer to roll over award fees. Under this practice award fee amounts unearned by contractors because they do not meet performance targets are carried over from one award fee period to subsequent periods. The carried over amounts then become available to the contractor during the subsequent periods. Roll-overs tend to increase cost and reduce the quality of contractor performance. Roll-over was approved for each of the award fees that had been granted to the three contractors at the time of our audit. If USAID/Philippines continues to roll over unearned available award fees to subsequent periods, at the end of the three contracts the contractors will have received 99 percent or $1.9 million of the total available award fees.

Some USAID/Philippines officials believed that the higher award fees available in subsequent award fee periods provide additional motivation for contractors to improve performance. However, evidence is to the contrary. For example, the contractor under the Growth and Equity in Mindanao Project, submitted a work plan in August 1996 stating that the plan includes several large outputs with significant award fees attached. The outputs included policies changed and projects implemented. However, the work plan further indicates that in many cases the policies would not be changed and the projects would not be implemented in the proposed rating period. However, this did not seem significant to the contractor because the award fees would be carried over to subsequent rating periods until the outputs were achieved.

The roll-over practice significantly increases USAID's costs. The amount of increase depends on the performance rating and related percentage of available award fee paid during prior periods. For example, if performance under the three contracts reviewed was rated "excellent" or "fair" over the life of the contracts, the roll-over practice would result in increased USAID costs totaling approximately $240,000 and $820,000, respectively.

Furthermore, if a contractor's performance was rated as "fair" throughout the contract period, the roll-over practice could result in payments equivalent to the award fee that would be paid had the performance been rated "excellent." For example, under the Governance and Local Democracy Project, if the contractors performance was rated fair over the nine rating periods of the contract he would be paid 35 percent of the available award fee or $255,360. However, rolling over the unearned award fees for the nine periods would result in additional payments to the contractor of $348,205. The contractor s total compensation would be $603,565, an amount that equates to 82.6 percent of the available award fee or an excellent performance rating.

USAID/Philippines officials concurred with the audit finding and stated that they would stop the practice of rolling over unearned award fees.

> **<u>Recommendation No. 3</u>: We recommend that USAID/Philippines modify the technical assistance contracts for the Governance and Local Democracy Project, the Growth and Equity in Mindanao Project and the Coastal Resources Management Project to prohibit the practice of rolling over unearned award fees to subsequent award fee periods.**

Management Comments and Our Evaluation

In response to Recommendation No. 1, USAID/Philippines' management modified the contract for the Growth and Equity in Mindanao Project (GEM), eliminating the use of adjectival ratings and deleting contractor performance in the area of "Contract Management/Administration" as one of the factors to be assessed in determining payment of incentive awards. Management believes that the other factors used to judge contractor performance under the contract are measurable and objective and proposes to continue to use them. With reference to the Governance and Local Democracy Project (GOLD) and the Coastal Resources Management Project (CRM), management converted the contracts for the projects from cost plus award fee to cost plus fixed fee, deleting all contract articles that refer to award fees and award fee procedures. In addition, the fee distribution structure for CRM has been revised. Management actions are responsive to Recommendation No. 1. We therefore consider final management action on Recommendation No. 1 to be complete.

In response to Recommendation No. 2, management modified the contract for GEM to reduce the number of performance targets, thus refocusing the award fee on fewer target elements and easing the management burden on both the contractor and the Mission. As discussed above, fee structures under GOLD and CRM have been changed from award fee to fixed fee. These actions are responsive to Recommendation No. 2, therefore we consider final management action on Recommendation No. 2 to be complete.

In response to Recommendation No. 3, management states that roll-overs may be appropriate in circumstances where events outside the control of the contractor, such as natural disasters or political unrest, make it impossible to achieve project objectives within a given time frame. Therefore, for the GEM contract the Mission believes that rolling over unearned award fees frequently may be necessary. The Mission will, however, scrupulously review all requests for roll-overs and allow them only in cases where roll-overs are in the interest of the program objectives. Management stated that roll-overs will not affect the GOLD and CRM contracts since they have been converted to fixed fee. Management actions are responsive to Recommendation No. 3. We therefore consider final management action on Recommendation No. 3 to be complete.

SCOPE AND METHODOLOGY

We audited the use of award fee contracts by USAID/Philippines. The audit was performed in accordance with generally accepted government auditing standards and was conducted at USAID/Philippines from January through May 1997.

To accomplish the audit objective we reviewed Federal Acquisition Regulations (FAR) and Office of Management and Budget policies and guidance for the use of performance-based contracts with award fee provisions. We also contacted USAID s Office of Procurement to identify USAID policies and procedures on the use of award fee contracts.

As of February 1997, USAID/Philippines was administering four award fee contracts. We selected, based on estimated costs, the three largest award fee contracts for review. Estimated costs for the three contracts totaled $43.6 million, representing 96 percent of the $45.4 million in estimated costs for the four active award fee contracts. The three contracts selected for review provided for award fees totaling $1.9 million. We reviewed work statements contained in the contracts and work plans and progress reports prepared by the contractors. The objective of the reviews was to determine whether standards for measuring contractor performance had been established and targets had been set for determining award fee payments. We also reviewed Award Fee Evaluation Reports which were to be used by the contracting officer in determining award fee amounts. Further, we interviewed USAID/Philippines officials.

We provided USAID/Philippines officials an initial draft of the audit findings for discussion purposes in March 1997 and again discussed the findings with the officials during an exit conference in May 1997.

MEMORANDUM

TO : Mr. Bruce Watts
RIG/A/Bangkok

FROM : Priscilla del Bosque
Acting Mission Director
USAID/Philippines

SUBJECT : Draft Report on the Audit of USAID/Philippines' Use of Award Fee Contracts
Report No. 5-492-98-00X-P

REF. : Watts/Redder e-mail dated October 23, 1997

USAID/Philippines (Mission) appreciates RIG/A's efforts and cooperation in completing the subject audit report and is pleased to have the opportunity to respond to it by presenting the following comments for incorporation into the final audit report.

Recommendation No. 1: We recommend that USAID/Philippines establish objective and measurable standards for assessing contractor performance under the Governance and Local Democracy Project (GOLD), the Growth with Equity In Mindanao Project (GEM) and the Coastal Resources Management Project (CRM).

Mission Response:

The Mission has taken the following actions in response to this recommendation:

1. Modified the award fee system of the GEM contract, eliminating the use of adjectival ratings and deleting contractor performance in the area of "Contract Management/
Administration" as one of the factors to be assessed in determining payment of incentive awards (Attachment A). The Mission, however, believes that the rest of the factors/standards it has been using to judge contractor performance in this contract are measurable and objective and proposes to continue to use them;

2. Converted the GOLD contract from cost-plus-award-fee to cost-plus fixed fee, deleting all contract articles that refer to award fees and award fee procedures (Attachment B); and,

3. Converted the CRM contract from award fee to cost-plus-fixed fee, deleting all contract articles that refer to award fees and award fee procedures, and revising the fee distribution structure (see draft, Attachment C).

On the basis of these actions, Mission requests that Recommendation No. 1 of the draft audit report be considered resolved and closed.

Recommendation No. 2: We recommend that USAID/Philippines establish performance targets for contractors working under award fee contracts and base the payment of award fees on achievement of the targets.

Mission Response:

1. While the GEM contract has employed performance targets all along, and has tied payment of award fees to attainment of these targets -- as a result of recommendations made by the auditors, the Mission has significantly reduced the number of performance targets under it, thus, refocusing the award fee on fewer target elements and reducing the management burden for both the contractor and the Mission (Attachment A);

2. The award fee was eliminated and converted to a fixed fee under the GOLD contract (Attachment B); and the fee structure under the CRM contract revised to a fixed fee (Attachment C). Therefore, the above recommendation would no longer be applicable to both contracts.

Based on these, Mission requests that Recommendation No. 2 of the draft audit report be considered resolved and closed.

Recommendation No.3: We recommend that USAID/Philippines modify the technical assistance contracts for the Governance and Local Democracy Project, the Growth with Equity in Mindanao Project and the Coastal Resources Management Project to prohibit the practice of rolling over unearned award fees to subsequent award fee periods.

Mission Response:

The Mission would like the report to note that in certain instances, there are events outside the control of the contractor that would make it impossible for the objectives to be achieved under a given timeframe. For example, if the contractor was unable to meet specified targets set for a one-year period, in terms of: investments generated, desirable government policies/ practices adopted and jobs created [GEM activity] -- due to political unrest, a natural disaster, or any other event outside of its control, but was able to meet these targets later, that is, after the occurrence of such situations, then a roll-over would be appropriate. Therefore, under the GEM contract, the Mission believes that the rolling over of unearned award fees may frequently make sense. The Mission will, however, scrupulously review all requests for roll-overs and allow these only in cases where it is determined that such are in the interest of the program's objectives.

Roll-overs will not affect the GOLD and the CRM contracts since these are now fixed fee contracts.

In this regard, Mission requests that Recommendation No. 3 of the draft audit report be considered resolved and closed.

The Mission Management's Representation letter is shown under Attachment D.

cc: PRM:RGold