Share-in-Savings Contracting: The Big Lie

By Angela B. Styles

In an obscure section of the E-Government Act of 2002, titled "share-in-savings initiatives," Congress authorized shady financing and accounting techniques for federal information technology (IT) purchases.[1] This provision effectively removed federal IT purchases from public and congressional scrutiny. More troubling, however, is recent legislation introduced by Congressman Tom Davis—H.R. 4228, the Acquisition System Improvement Act—to expand this financing mechanism to cover more than $240 billion a year in federal purchases. One can only hope, for the taxpayers' sake, that Congress and the administration stand firm against an expansion of federal accounting and financing practices that mirror the private sector practices that so recently shook the core of our economy.

To date, President George W. Bush has held firm against the implementation of these risky so-called "share-in-savings" (SIS) schemes. On December 17, 2002, the president sent a rare warning shot to Congress and executive branch agencies. While signing the E-Government Act into law, President Bush instructed agencies to ensure that "these contracts are operated according to sound fiscal policy and limit authorized waivers for funding of potential termination costs to appropriate circumstances, so as to minimize the financial risk to the Government" and ultimately the taxpayer. As a further indication of the president's reluctance, 23 months after passage, the administration has yet to issue final regulations implementing these SIS initiatives.

Unfortunately, a number of factors make the prospects for fending off the expansion of this financing scheme dim. The budget deficit looks a lot smaller with $240 billion in liability off-budget—great news for an election year. The executive branch will be reluctant to divest the power and financial flexibility that Congress appears to have ceded through these share-in-savings contracts—a power that the Supreme Court regards as the single most important constitutional curb on presidential power—that "no money can be paid out of the Treasury unless it has been appropriated by an Act of Congress."[2] And, finally, the proliferation of misinformation regarding the success of SIS initiatives makes rational decision making on both sides of Pennsylvania Avenue difficult.

This article examines the modern history of share-in-savings schemes, the validity of the key claims of proponents, the constitutional ramifications of these contracts, and the potential effect on the federal workforce.

The "Enronization" of the Federal Purchases

Congress has created two significant mechanisms for private sector financing of federal purchases. In 1986, Congress created "Energy Savings Performance Contracts," allowing for federal agencies to execute 25-year contracts to finance the installation of energy conservation measures in federal facilities. Under these financing packages, agencies pay contractors a predetermined share of cost savings that directly result from the installation of new energy efficient equipment. Recognizing the potential for abuse, Congress constrained the payments that could be made to contractors under this mechanism: "Aggregate annual payments by an agency to both utilities and energy savings performance contractors . . . may not exceed the amount that the agency would have paid for utilities without an energy savings performance contract."[3] Moreover, as an additional protection to the agency and taxpayers, contractors are required to "provide for a guarantee of savings to the agency."[4]

In 2002, after considerable maneuvering by the House Government Reform Committee, Congress authorized a less constrained mechanism for private sector financing of federal IT purchases. The provision, titled "share-in-savings contracting," in the E-Government Act of 2002, allows agencies to execute 10-year contracts for IT equipment and services without an up-front cost to the federal government. The E-Government Act provides: "the head of an agency may enter into share-in-savings contracts under this section in any given fiscal year even if funds are not made specifically available for the full costs of cancellation or termination of the contract if funds are available and sufficient to make payments with respect to the first fiscal year of the contract . . . ."[5] Assuming savings (a term left undefined in the Act) are achieved, agencies will pay the contractors a portion (or all) of the cost savings achieved from efficiencies created by new IT equipment and services. There are, however, two important and troubling differences between the IT financing authority in the E-Government Act and energy savings performance con-

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tracts. The E-Government Act does not limit the money that may be paid to the contractor as "savings" nor does the Act require a guarantee of savings by the contractor. Indeed, all that the Act requires is that SIS contracts to "the maximum extent practicable . . . contain performance measures that must be met before payment is made."[6]

The simplest use of this initiative, financing the purchase of energy conservation or IT equipment, is similar to the way a consumer finances the purchase of a car. A consumer can buy a car outright for $20,000 or pay $25,000 by financing the $20,000 cost of the car over five years. The consumer pays $20,000 for the car and $5,000 in interest to finance. Similarly, under the E-Government Act, an agency can execute a 10-year contract to purchase $20 million in IT equipment even though the agency only has $2 million to pay the contractor. The government could agree to pay a contractor a portion of savings achieved by the new IT equipment that would be equivalent to $18 million plus a percentage for financing over 10 years. The agency is happy because it got $20 million in equipment for $2 million in cash without having to seek congressional approval or an appropriation. The contractor is happy because it receives more than $20 million for $20 million worth of equipment. The only loser is the taxpayer. The taxpayer foots the bill for private sector financing that would not have been necessary if the agency received a direct appropriation to buy $20 million in IT equipment.

Somehow forgotten when Congress authorized these SIS initiatives is the fact that the federal government is different than the individual consumer in two important respects: (1) the federal government is spending someone else's money (the taxpayer's); and (2) the federal government has the means to finance its own purchases. Financing may be the only option available for an individual consumer to purchase a car because he or she may not have $20,000 on hand for the purchase. The consumer may also rationally decide that $5,000 in finance charges is worth the cost of having $20,000 available for other needs. For the federal government, however, it is impossible to conceive that private sector financing of federal purchases could ever, much less consistently, be less expensive to the taxpayer than a direct appropriation. No private sector company can finance capital purchases for less money than the federal government.

Although some people may honestly disagree over whether private sector financing of federal projects is worth the cost, the problems with the share-in-savings authority in the E-Government Act and the Acquisition System Improvement Act (H.R. 4228) are much more than just a debate about the merits or costs of private sector financing of federal projects. The E-Government Act and H.R. 4228 authorize much more than simple private sector financing for federal purchases. Virtually unlimited taxpayer dollars are at risk because the E-Government Act and H.R. 4228 have no limits on the undefined "savings" that can be shared with a private sector contractor. Savings are defined as "monetary savings" or "savings in time or other benefits realized by the agency, including enhanced revenues." In an infinitely circular fashion, "savings" are defined as "savings." There is no formula, no definition of savings, no guidance on how savings will be calculated, and no limit to the taxpayer dollars that can be shared with contractors by defining something as "savings."

Virtually unlimited taxpayer dollars are at risk because the E-Government Act and H.R. 4228 have no limits on the undefined "savings" that can be shared with a private sector contractor.

Using this same example, let's assume that the government agrees to pay the contractor 80 percent of the cost savings directly attributable to new IT equipment over 10 years. If the IT equipment saves the government $40 million over 10 years, the contractor could be paid $34 million ($32 million in savings plus the $2 million original payment) for $20 million worth of IT equipment. Not a bad return on investment for the contractor. The agency is happy because it got $20 million in equipment for $2 million in cash in the first year without having to seek congressional approval or an appropriation. Again, the only loser is the taxpayer. The taxpayer effectively foots a $34 million bill for $20 million of IT equipment. If Congress had directly appropriated the $20 million, the agency would have paid the contractor only what the technology was worth. The agency and the taxpayer would have retained the $14 million in savings created through new, more efficient IT equipment and spent the money on significant and higher priority agency missions like education or homeland security.

Without any constraints, the E-Government Act and H.R. 4228 allow agencies to mortgage billions of dollars in future spending. Federal agencies now, and for the next 10 years, will share the savings with contractors, not the taxpayers. While the SIS proponents will argue that skillful government managers can be trusted to safeguard hard-earned taxpayer dollars and effectively utilize this new-found financing flexibility, cash-strapped and historically underfunded agencies will have a hard time avoiding the temptation of private sector financing for all the gadgets, service, and new equipment that Congress and the president have long denied them. The allure of this type of financing will attract unsophisticated government buyers into bad deals for the agency and bad deals for the taxpayers—contracting arrangements that neither Congress nor the administration will be able to control.

Two recent comments from high-level government officials summarize the problems with SIS contracts. A career official at the Department of Education compared other

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types of contacting to SIS schemes: "We're savings billions of dollars and we don't have to share it with anybody."[7] Another high-level government official privately provided the following insight:

> One of the principal problems in Government procurement today is that agencies are unable to define their requirements with sufficient particularity. If agencies could define requirements better, they could seek economical firm, fixed-price contracts to meet their needs. Because agencies do such a poor job of definition, they have to hire many contractors under time-and-materials contracts, under which, in effect, the contractors define the agencies' requirements as they proceed with their work. If agencies need so much help in defining their requirements under the current regime, what possibilities for mischief would arise under a share-in-savings regime? It doesn't take much imagination to see agencies having to rely on contractors to establish baselines against which those same contractors' savings shares will be determined.

While contractors are entitled to a reasonable profit for government work, the Acquisition System Improvement Act effectively would allow contractors to determine their own profit margins for government work.

Examining the Share-in-Savings Myths

Proponents of these SIS schemes have cleverly cloaked this financing mechanism in good-government rhetoric, selling the initiative with three fictional claims: (1) share-in-savings will save the taxpayers billions of dollars; (2) share-in-savings contracts only pay the contractor for results; and (3) share-in-savings is a new and innovative contracting method. This intense lobbying campaign has consistently and effectively masked the true nature of the SIS initiative. Even the E-Government Act makes a half-hearted attempt to mask the true nature of SIS initiatives: "These contracts represent an innovative approach to encourage industry to share creative technology solutions with the Government. Through these contracts agencies can lower their costs and improve service delivery . . . . Share-in savings [sic] is an innovative contract vehicle that allows agencies to leverage their limited resources in order to achieve a greater return on investment."[8] Contrary to the sales pitch, there is nothing new or innovative about backdoor, off-budget spending, and the claims of "cost-savings" are patently false.

Myth #1: Share-in-Savings Initiatives Save the Government Money

The dishonest calculation. To make the case for monetary savings, the proponents of SIS calculate "savings" by comparing the cost to the federal government of performing a function using old equipment to the cost of performing it using new equipment under an SIS contract. It is not hard to find savings under this formula. No one will question the proposition that it is cheaper to buy a copy machine than have five people retype documents on a manual typewriter. However, it does not logically follow (as the SIS proponents would have you believe) that because it is cheaper to use a copy machine than to retype, the private sector should finance the purchase of copy machines and share the money the federal government saves by using the machines. To argue that the share-in-savings *contract vehicle* saves the federal government money, SIS proponents calculate "savings" by proving that new equipment is more efficient than old equipment. Contrary to the claims, the increased efficiency from new equipment and services (and resulting savings) occur whether the purchase is a fixed-priced federal purchase using appropriated money or a share-in-savings contract using private sector financing. The new equipment and services create the savings, not the contract or financing vehicle for the purchase. Indeed, interest charges included in the private financing component of an SIS contract means the SIS contract vehicle will always cost more than a purchase using another contract vehicle requiring a direct appropriation.

To return to our example, the government buys $20 million worth of IT equipment and agrees to pay the contractor $2 million in the first year and 80 percent of the cost savings directly attributable to the new IT equipment over the next 10 years. If the IT equipment saves the government $40 million over 10 years, the SIS proponents would argue that the government has saved $38 million ($40 million savings minus $2 million payment in the first year). The SIS proponents assert "savings" through a little smoke-and-mirrors accounting. In reality, the taxpayer has paid $34 million for $20 million worth of IT equipment, a loss of $14 million to the taxpayer.

Contrary to the sales pitch, there is nothing new or innovative about backdoor, off-budget spending, and the claims of "cost-savings" are patently false.

Perhaps more disturbing is the fact that savings are hard to find using the dishonest SIS formula. During my tenure at the Office of Management and Budget, I asked for evidence to document savings realized through this financing mechanism at any level of state, federal, or local government. In spite of repeated requests and significant research, my office never found or received evidence of any savings realized through these financing schemes, even using the SIS formula for calculating savings.

Continuing the fraud: The E-Government and Acquisition System Improvement Acts. The E-Government Act and the Acquisition System Improvement Act perpetuate the myth that share-in-savings contracting saves money. To qualify as an SIS contract, the contract must require that some amount of money be paid to the contractor from savings achieved by the improvements to the agency's mission. Savings are defined as "monetary savings" or "savings in time or other benefits realized by the agency, including enhanced revenues." Savings are calculated by

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comparing the cost to the federal government of performing a function using old equipment to the cost of using new equipment under an SIS contract. Again, it is not hard to find savings under this formula. No one will question the proposition that it is cheaper to buy a copy machine than have five people retype documents on a manual typewriter. Contrary to what the E-Government Act and the Acquisition System Improvement Act would have you believe, it is the new equipment that achieves the cost savings and not the fact that the new equipment is purchased with private sector financing under an SIS contract. The efficiency savings would be achieved without regard to whether the purchase was made with a direct appropriation or was financed by the private sector through an SIS contract.

With a disturbing new twist, however, the E-Government Act and the Acquisition System Improvement Act require that savings in "time or other benefits" achieved under an SIS contract be monetized and paid to the contractor. As long as money is saved (instead of saving time or other benefits), the statute is clear that the contractor must receive some payment from the monetary cost savings achieved. But the definition is problematic when the savings are "time or other benefits." The statutory definition requires that money be paid to the contractor when the savings are in "time or other benefits." This definition will require the federal government to monetize time or other benefits, resulting in the payment of money for these efficiencies where no money is available. This statutory requirement for paying for non-monetary efficiencies adds significantly to the off-budget, backdoor obligations created by these SIS schemes.

In spite of repeated requests and research, my office [OMB] never found evidence of any savings realized through these financing schemes.

Myth #2: The Government Won't Owe the Contractor Money if Cost Savings Aren't Achieved

During a complete break with reality, the SIS proponents invented the idea that "share-in-savings contracts pay only for success—contractor payment is based on the savings that a contract delivers." Someone in the SIS camp forgot to consult the law. At the bare minimum, the party that has breached a contract owes the nonbreaching party for the fair market price of the goods and services delivered and accepted before the contract was breached. In our example, the contractor invested $20 million in IT equipment in the first year of the contract. There is nothing in the statute that relieves the government of liability for the $20 million in equipment delivered and accepted. There is nothing uniquely created by the payment mechanism of the SIS contract that relieves federal government of the responsibility to pay for a product or service that has been delivered and accepted even if the contractor was not completely successful. Nowhere does the E-Government Act or H.R. 4228 create a "contingent fee" federal contract. All that either the Act or the proposed legislation require is that: "[t]he amount payable in the event of cancellation or termination of a share-in-savings contract shall be negotiated with the contractor at the time the contract is entered into." This provision only requires the government and the contractor to "negotiate"; the parties do not have to actually reach an agreement on the amount payable in the event of termination. Assuming no agreement is reached, the government is liable for goods and services delivered and accepted. If the contractor and the government reach an agreement on the amount payable in the event of termination or cancellation, only the most unsophisticated and desperate contractors would agree to an amount less than damages they would receive from the government under federal common law. Certainly, the last contracting vehicle that the federal government needs is one that attracts desperate and unsophisticated contractors into risky financing schemes.

Myth #3: Share-in-Savings Contracts Are a New Innovative Contracting Tool

A key SIS proponent stated on April 5, 2004: "A huge frustration to anybody interested in a procurement system that delivers better value for agency missions and taxpayers is how slowly the use of share-in-savings contracting is spreading. . . . This procurement method is a superb example of how one can structure a business relationship to promote successful contractor performance."[9] The messages are clear and completely bogus: share-in-savings contracting is all about good government—a *new* method of contracting that will save taxpayers money.

Contrary to the SIS claims, as far back as 1817, the executive branch has been using backdoor financing techniques to fund federal projects where congressional appropriations were not available. The permanent funding statutes in Title 31 of the United States Code were cobbled together over two centuries to combat what Congress saw as abuses and "backdoor spending" measures by the executive branch. One of the objectives of the Congressional Budget Act of 1974 was to provide increased control on "backdoor spending" through contractual obligations. By characterizing these initiatives as a "new form of innovative contracting," honest people are distracted from the fact that these contracts are just an old way of spending money without congressional oversight. There is nothing new or innovative about SIS contracts.

Indeed, the federal government already has a vast range of options to provide incentives to contractors and to allocate risk between the government and contractors. Under the Federal Acquisition Regulation (FAR), an incentive contract is appropriate when "the required supplies or services can be acquired at lower costs and . . . with improved

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delivery or technical performance, by relating the amount of profit or fee payable under the contract to the contractor's performance."[10] If SIS proponents were really seeking to improve contractor performance through performance incentives, they need not look further than the current FAR:

> **16.402-2 Performance Incentives**
> (a) Performance incentives may be considered in connection with specific product characteristics (e.g., a missile range, an aircraft speed, an engine thrust, or a vehicle maneuverability) or other specific elements of the contractor's performance. These incentives should be designed to relate profit or fee to results achieved by the contractor, compared with specific targets.
> (b) To the maximum extent practicable, positive and negative performance incentives shall be considered in connection with service contracts for performance of objectively measured tasks when quality of performance is critical and incentives are likely to motivate the contractor.
> (c) Technical performance incentives may be particularly appropriate in major systems contracts, both in development (when performance objectives are known and the fabrication of prototypes for test and evaluation is required) and in production (if improved performance is attainable and highly desirable to the Government).
> (d) Technical performance incentives may involve a variety of specific characteristics that contribute to the overall performance of the end item. Accordingly, the incentives on individual technical characteristics must be balanced so that no one of them is exaggerated to the detriment of the overall performance of the end item.

If SIS proponents were seeking to improve delivery through incentives, the current FAR provides: "[d]elivery incentives should be considered when improvement from a required delivery schedule is a significant Government objective."[11]

The FAR not only allows but encourages incentive contracting to motivate contractors. The contracting regulations provide tremendous flexibility to give incentives to contractors without putting billions of taxpayer dollars at risk and without "smoke and mirrors" accounting or expensive private sector financing. With such a vast range of incentive contracting, it becomes strikingly apparent that the only purpose of the SIS initiative is to provide private sector financing for cash-strapped agencies where spending has been constrained by Congress or the president.

Constitutional Background

In separating powers among the three branches of government, our Founding Fathers were explicit that the expenditure of public funds was proper only when authorized by Congress. The Constitution provides that "[n]o money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law . . . ."[12] Thus, a never-ending struggle between the executive and legislative branches has centered on control of the public fisc with the executive branch constantly pushing for flexibility and latitude in expenditures and the legislative branch exacting reporting and accountability appropriate for the public interest.

Often forgotten in the day-to-day functioning of government is the fact that executive branch agencies are creatures of law and can only function to the extent authorized by law: "The established rule is that the expenditure of public funds is proper only when authorized by Congress, not that public funds may be expended unless prohibited by Congress."[13] Payments promised under a contract by an executive agency may not be made from the United States Treasury unless Congress has made the funds available. Congress finances federal programs, including contracts with the private sector, by providing "budget authority" through annual appropriations. These appropriations provide the legal authority for agencies to enter into contracts that will result in the immediate or future payments of money out of the treasury.

With SIS contracting under the E-Government Act and H.R. 4228, Congress gives agencies legislative authorization to enter into contracts in advance of an appropriation. Because contracts entered into under this authority are legally binding on the government, Congress is left with little choice but to make the necessary subsequent appropriation. Even if Congress chooses not to appropriate the funds, the contractor may enforce the contract in the Court of Federal Claims. For example, in *New York Airways, Inc. v. U.S.*, 369 F.2d 743 (Fed. Cl. 1966), the Court found that despite the congressional intention to curtail and finally eliminate helicopter subsidies, Congress's deliberate failure to appropriate the necessary funds did not alter the government's obligation to pay subsidy compensation decreed by the Aeronautics Board to helicopter companies for carrying mail. Under the Federal Aviation Act, Congress gave the Aeronautics Board the contract authority to obligate the government to pay carriers subsidies in advance of an appropriation for such subsidies. The Court found that only an amendment to the Federal Aviation Act could eliminate the obligation to pay subsidies set by the Aeronautics Board. Likewise, once an agency executes an SIS contract, Congress will not be able to limit future appropriations. Congress will not be able to limit the federal government's obligations under these contracts. No matter how good or bad the contract, the taxpayers will be obligated to pay for all the goods and services delivered.

Ramifications for the Federal Workforce

The E-Government Act and the Acquisition System Improvement Act are particularly disturbing to federal employees in positions categorized as commercial in nature and subject to competition under the administration's competitive sourcing initiative. Nothing in Office of Management and Budget Circular A-76, governing public-private competitions for commercial positions, restricts the use of a share-in-savings contracting approach for public-private competition. When agencies start to use SIS contracts in public-private competitions, federal employees will be effectively prohibited from competing for their jobs. Unlike a private sector company, federal employees competing under A-76 cannot hold capital or provide financing for federal purchases. Moreover, the E-Government

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Act prohibits agencies from retaining any "savings that is attributable to a decrease in the number of civilian employees of the Federal Government performing the function." Effectively, this provision prohibits federal employees from decreasing the number of employees required to perform a particular function—a certain recipe for losing the competition and their jobs. By giving a significant edge to private sector companies, the E-Government Act creates a patently unfair playing field for competition between the public and private sectors.

When agencies use share-in-savings contracts in public-private competitions, federal employees cannot compete for their jobs.

The SIS schemes will also encourage historically underfunded agencies to bend the A-76 policies defining "new work" to utilize these SIS private sector financing schemes. Under OMB Circular A-76, agencies cannot outsource the work currently performed by federal employees to a contractor without a public-private competition. Only if work is not currently performed by federal employees (defined as "new work" in the Circular A-76), may agencies execute a contract with the private sector without allowing federal employees to compete. With an alluring private sector financing tool that allows cash-strapped agencies to buy new goods and services off-budget without having to ask Congress or the Office of Management and Budget for authority, agencies will attempt to characterize work as "new work" to avoid the constraints of public-private competition and utilize the private sector financing tool offered by SIS contracts.

Conclusion

Congress and the executive branch must look beyond the rhetoric of share-in-savings proponents. Not only should the federal government be prohibited from buying goods and services on credit, the federal government should not be trying to hide its real cost from the taxpayer with questionable accounting. The citizens of our country must have confidence that the government and the people who run it, at every level, have integrity. At a time when Congress should be concerned about building the public's confidence in our contracting system, we should not be looking for ways to eliminate one of the few remaining constraints and mechanisms for oversight—Congress's power over appropriations.

Endnotes

1. Pub. L. No. 107-347.
2. Cincinnati Soap Co. v. United States, 301 U.S. 308, 321 (1937).
3. 42 U.S.C. 8287(a)(2)(B).
4. *Id.*
5. Pub. L. No. 107-347.
6. *Id.*
7. Anitha Reddy, *Sharing Savings, and Risk Special Contracts Appeal to Cash-Strapped Agencies*, WASH. POST, Feb. 16, 2004, at E1.
8. H. REP. No. 107-787, pt. 1, at 74 (2002).
9. FED. COMPUTER WK. at 28 (April 5, 2004).
10. FAR 16.401(a).
11. FAR 16.402-3.
12. U.S. CONST. art. I, § 9, cl. 7.
13. United States v. MacCollom, 426 U.S. 317, 321 (1976).

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