

# Incentive Contracts: Driving Favorable Outcomes

*Robert L. Tremaine*

**I**n the past several years, major weapon system development programs have drawn significant attention. The reasons are varied. In some cases, costs have skyrocketed; schedules have experienced significant delays; and performance levels have failed to meet government expectations, despite the employment of management tools designed to control costs, preserve schedule, and influence performance outcomes. Some of these management tools—including contractual measures, as originally conceived and specified by the Federal Acquisition Regulation (FAR)—can give tremendous flexibility to the implementation of government contracts. However, the Government Accountability Office recently identified an apparent disconnect between the use of certain measures—like incentives—and expected outcomes in weapon system acquisitions. In short, it appeared that incentives were not driving performance outcomes as originally envisioned.

The GAO looked closely at the use of incentives in the Department of Defense. They conducted structured interviews with contracting and program officials representing 92 contracts from a study population of 597 DoD incentive-type contracts active between 1999 and 2003. In a December 2006 report (GAO-06-66), GAO asserted that “DoD has paid billions in Award and Incentive Fees without favorably influencing performance.” In essence, the GAO found few results that could be directly traced to the award of incentives. Not surprisingly, their findings set off a few alarms and raised questions about the efficacy of incentives in general.

Were these incentive strategies ill-conceived? Were they poorly applied? Did they work as advertised? Have they

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outlived their usefulness? What went wrong? These and many other questions immediately surfaced in the acquisition, technology, and logistics community. Consequently, the Defense Acquisition University assembled a small team of subject matter experts from its combined regional workforce to research the issues. Rather than search for even more examples of the failure of incentives, however, the research would focus on where incentives succeeded. More specifically, where have incentives actually worked, why were they effective, and what could be done to restore confidence in incentive contracts? Invariably, that confidence (which has frequently been challenged in the past) would have to be restored in order to garner continued support and calm the critics; otherwise, the usefulness of incentive strategies would be irrevocably damaged, and their days could be numbered.

## **Incentives Defined**

Contract incentives are various, and understanding and appropriately applying them is crucial. In its basic form, an incentive is really an extraordinary tool for certain applications. All incentives are designed to drive some kind of desired outcome through the use of monetary awards or the withholding of them. Incentives can be extremely useful, and when vigilantly and carefully applied in accordance with FAR16.401, they can drive specific acquisition objectives by establishing reasonable and attainable targets that are clearly communicated to the contractor, including appropriate incentive arrangements designed to motivate contractor efforts that might not otherwise be emphasized. They also discourage contractor inefficiency and waste.

By design, incentives are also tightly integrated into overall acquisition strategies for very specific purposes in DoD contracts. They can help reduce risk; they can help combat uncertainty; and they can also help drive favorable

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## Learning About Incentive Contracting

**W**hat near- and far-term adjustments should be made to DAU curricula as a result of the research team's findings? And how can DAU make both lessons learned and best practices widely available?

First, it seems reasonable that every functional area should contain an introductory lesson on incentive contracting that incorporates lessons learned and best business practices. But in the meantime, before the curriculum development teams make specific determinations, there are a number of learning assets already available for immediate review and possible revision. Aside from a couple of specialized incentive contract lessons embedded in a few DAWIA contracting and budgeting courses, DAU offers two 24/7 online Continuous Learning Modules (CLMs) that can help guide organizations with their incentive selection and subsequent development pathway. The first, Contractual Incentives (CLC018), focuses on understanding the balance between government and industry goals and objectives in crafting an effective incentive strategy. The second, Provisional Award Fees (CLC034), addresses the 2003 rule that permits award fee payments to be made anytime prior to the interim or final evaluation.

Both CLMs are useful but do not address the execution essentials. An Incentive Contracts CLM that is more comprehensive and readily available to the acquisition community would be indispensable and provide much more assistance on the mechanics and implementation of incentive contracts. Additionally, the exploitation of an increasingly popular collaborative medium called Communities of Practice on the DAU Acquisition Community Connection (ACC) at <<https://acc.dau.mil/communitybrowser.aspx>> can offer access to a wide array of current experiences and lessons learned regarding incentives ranging from the general to the specific.

DAU has already established a rich information site on the ACC: Award and Incentive Fee Contracts at <<https://acc.dau.mil/communitybrowser.aspx?id=105550>>. Access to these and other collaborative training aids is critical because once an incentive strategy is in place, its maximum value truly depends on its ability to implement techniques that drive favorable outcomes. There's no better source of experts to consult than those who face contract incentive challenges every day—the acquisition workforce members who are charged with appropriately implementing the techniques that drive outcomes.

behavior throughout a program's life cycle. By their nature, "incentives should result in expected outcomes," as Shay Assad, [director, defense procurement and acquisition policy, Office of the Deputy Under Secretary of Defense for Acquisition, Technology and Logistics] reinforced in November 2006 at the PEO/SYSCOM Conference held at Fort Belvoir, Va. Of course, understanding when and how to apply incentives is just as important, and that may be the tallest hurdle. Even though the concept of incentive-type contracts sounds straightforward, it is far from simple to execute, especially in an environment like DoD, where funding instability, technology barriers, leadership changes, and even cultural barriers frequently stand in the way. Each element alone can potentially handicap a program, as PMs would attest; the presence of all four factors can be truly threatening. Nonetheless, each type of incentive contract offers promise. If they are properly planned and integrated into an overall acquisition strategy and well executed, incentives create strong correlations to expected outcomes. They should be designed to meet specific goals from the outset.

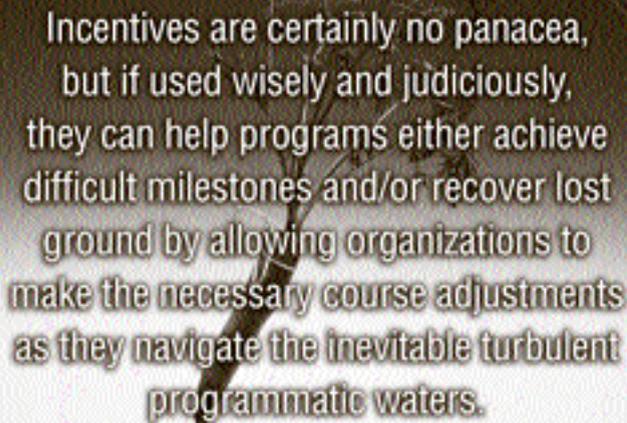
### The Research Approach

DAU interviewed 25 representative weapon system acquisition programs (listed in the sidebar on page 11). Ideally, data collected from these first 25 would also serve as the starting point for best practices. Programs were selected in various phases of the acquisition life cycle to confirm what particular award and/or incentive techniques (if any) indeed created strong correlations to performance outcomes. The interviewees included agency directors, program executive officers, PMs, principal contracting officers, and systems engineers in government program offices.

### The Findings

#### Strongly Communicated Expectations and Feedback

Frequent and unambiguous communication/feedback made a noticeable difference for incentive contracts. Even though incentive contracts entail some additional administrative burden, the outcome justified the increased workload of feedback for most programs. Continuous and open dialogue at both junior and senior levels led to early discovery and timely reconciliation of many known issues and helped keep a program on track. The introduction of specialized response teams enabled issues uncovered by monthly reports to be routinely tackled. The use of emphasis letters during award periods stressed the importance of certain outcomes or "events." Some organizations even used barometer reports during interim reviews to ensure that information from monitors was readily available to management at critical junctures. Informal monthly feedback sessions surfaced known issues or raised potential concerns early in the process. Government and contractor Friday meetings kept the lines of communication wide open. Small issues sometimes sur-

A quote in a stylized font with a dark, textured background. The text reads: "Incentives are certainly no panacea, but if used wisely and judiciously, they can help programs either achieve difficult milestones and/or recover lost ground by allowing organizations to make the necessary course adjustments as they navigate the inevitable turbulent programmatic waters."

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faced and could be reconciled almost immediately. Glossary tools improved communication during evaluation briefings when there were team member changes—as was frequently the case. Strongly prepared and focused review boards and upper management support provided consistent evaluations. Expectations known by all and a disciplined award fee board structure along with refined mechanics strengthened the viability of incentives.

### Metrics

The selection of key and enduring measures within an evaluation period, and measures that could be connected to subsequent evaluation periods, made a noticeable difference for incentive contracts. Key measures validated whether or not a program achieved certain necessary intermediate milestones along its critical glide path. They confirmed program momentum. They served as an early warning system—a bellwether—and answered the age-old question, “Are we on track?” They also filled a huge role as performance benchmarks. Key measures helped many programs better navigate their pathway, despite the unavoidable programmatic turbulence. Selecting between the most suitable measure types, objective and/or subjective, presented the biggest challenge.

The ability to hardwire them to achievable outcomes made objective measures like technical performance measures, cost performance indices, and schedule performance indices, invaluable gauges. They served as tremendous forecasting devices when they were carefully connected to outcomes. Objective measures were ideally suited for: (1) key performance events such as “ground contractor satellite operations facilities established, spacecraft available for space vehicle integration and test, and thermal vacuum test complete”; and (2) mission success criteria such as “capability and system delivered.” They were just as practical for cost controls (especially if the contractor could share in the savings) and delivery of critical subcomponents, since they were vital to the aggregate system. Subjective criteria—the more elastic of the two measure types and just as important—depended on certain factors such as judgment, beliefs, and the propensity to yield specific

outcomes, like highly effective and comprehensive systems engineering processes, management responsiveness and effective communication, resourcefulness, and timely solutions to known and unknown obstacles. Ironically, there has been an increased use of objective measures in award fee-type contracts in the form of more tangible measures. In fact, objective measures used as criterion variables in award fee contracts seem to fill an air gap by demonstrating the attainment of certain intermediate milestones and irrefutable performance outcomes. Subjective measures were still important, especially since they verified qualitative characteristics; but the combination of objective and subjective measures tended to create some of the strongest correlations to expected outcomes.

### Incorporation of Base Fee in Award Fee Contracts

The incorporation of base fee in award fee contracts made a noticeable difference. Many award fee contracts use some form of base fee on cost-plus award fee contracts. Numerous organizations employ cost-plus award fee value-base fees as a leverage tool. Even though the Defense Federal Acquisition Regulation Supplement (DFARS) 216.405-2(c)(iii) allows up to 3 percent of the estimated cost of the contract exclusive of fee, a contractor could provide “best efforts” for the award fee term and still, however, receive no award. As a result, there has been some pressure on the government to provide a portion of the award fee for best efforts. Some programs found themselves in such a predicament, since they originally planned to pay an award fee only for “excellence.” Some contractors expected consideration of a base fee if they met discrete contractual terms and conditions. Many program offices agreed and implemented up to a 3 percent base fee, giving the government ample flexibility to award the remaining balance for excellence. Base fees can be invaluable, since they provide certain intangibles, such as responsiveness and timeliness; they also separate excellence from best efforts.

### Trained and Experienced Personnel

Nothing seems to have a more dramatic impact in DoD than training and experience. Training draws its roots from practical experience, and practical experience, in turn, helps build better training programs. Organizations that had formalized instruction and/or had coached their personnel on the use of incentives indicated they more favorably influenced outcomes. Specifically, those organizations reviewed all assessments generated by performance monitors for accuracy and completeness prior to each Award Fee Review Board; encouraged all performance monitors to sit through the review of all other assessments to ensure consistency in terms of quality, format, scope, etc.; and provided lessons learned to others, resulting in faster, more comprehensive assessments and more effective review processes in current and succeeding periods.

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## Industry Reinforcement

Even though the research team did not meet individually with industry representatives, contractor perspectives were considered an important element of this research. The team found an expedient method to collect industry input on incentive contracts. During mid-summer 2006 and before the interview process started with government program offices, DAU hosted an Industry Day at Ft. Belvoir. With nonattribution safeguards in place, 18 senior-level defense industry representatives participated and spoke freely about their experiences with incentive contracts. Their views were enlightening. In many cases, industry confirmed the data the research team found through field interviews.

## The Verdict on Incentives

So what about incentives? Are they, in spite of the recent criticism and doubt, still a good tool to drive performance behaviors? Have organizations found a way to effectively apply incentives and demonstrate their usefulness? The answer to these questions is “yes.” There is no one-size-fits-all, but the incentive attributes that seemed to matter the most in influencing performance outcomes for the 25 programs examined in the context of this study generally afforded strong correlations between incentives and desired performance.

Ideally, an optimal incentive strategy features these and perhaps other attributes in the context of cost, schedule, and performance factors forged together as a unified accord. In practice, cost, schedule, and performance are interdependent and tend to interfere with each other's outcome. Influencing all three, and not at the expense of one another, becomes a delicate balancing act.

As he indicated in his response before the Subcommittee on Defense, Committee on Appropriations, House of Representatives (Dec. 21, 2006), David M. Walker, comptroller general of the United States, emphasized that we should not discontinue the use of award and incentive fees. Instead, he recommended that we look more closely at incentives in general and ask whether we have adequately defined and established appropriate criteria that enable us to measure outcomes, and how we will apply those criteria in determining the level of fee that can be justified.

Unlike simple commercial development efforts, DoD builds and sustains many one-of-a-kind systems that count on cutting-edge technologies and operate in unforgiving or threatening conditions, often under enemy fire. Considered a prevailing element that distinguishes DoD and other U.S. government agencies from general industry, motivational contracting tools like incentives can help organizations overcome numerous obstacles and reach very definitive outcomes. Incentives provide tremendous flexibility for the implementation of certain government con-

## Organizations Interviewed For the Study

Advanced Extremely High Frequency Satellite Communications System  
Air Force Satellite Control Network  
Air Mobility Command Contractor Tactical Terminal Operations  
AV-8 (Harrier)  
B-2 Aircraft-Radar Modernization Program -Frequency Change  
Biological Detection System  
C-17 Aircraft-Sustainment  
E2D (Major upgrade to E2C)  
F-15 Aircraft-Suite 6 Software Upgrade for A-D & E Models  
F-16 aircraft-Operational Flight Program Development  
Future Combat Systems  
Global Hawk Unmanned Aerial Vehicle  
Global Positioning System  
Global Transportation Network  
Marine Expeditionary Fighting Vehicle  
MH-60 Black Hawk Helicopter  
Missile Defense C2BMC  
Missile Defense Kinetic Weapons  
Missile Defense Sensors  
Missile Defense Targets & Countermeasures  
Multi-Mission Maritime Aircraft (MMA)  
Rapid Attack Identification Detection and Reporting System  
Space Based Infra-red System – High  
Space Tracking and Surveillance System  
Total Integrated Engine Revitalization Program

tracts. They are certainly no panacea, but if used wisely and judiciously, they can help programs either achieve difficult milestones and/or recover lost ground by allowing organizations to make the necessary course adjustments as they navigate the inevitable turbulent programmatic waters.

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