CONTRACT INCENTIVES AND DISINCENTIVES

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Fred Schlich
Fred.Schlich@DAU.mil
+1 334 728 2256
CONTRACT INCENTIVES AND DISINCENTIVES

Why
What
How
How Much
How Many
...and much more
WHY HAVE INCENTIVES AND DISINCENTIVES

Contract incentives are designed to obtain specific acquisition objectives by

- motivating contractor efforts that might not otherwise be emphasized
- discouraging contractor inefficiency and waste

Incentives are not only focused on financial performance
INCENTIVE

...something that incites or tends to incite to action or greater effort, as a reward offered for increased productivity

...stimulus, spur, incitement, impulse, encouragement

...similar to motivation
WHAT TO USE AS AN INCENTIVIZE

Financial
- Adjustment to Fee or Profit
- Cash flow (delivery payments, progress payments, performance based payments)
  - Hard to responsively tie to acquisition outcomes or efficiencies

Non-Financial
- Impact on future potential work (options, CPARS, etc.)
- Sharing of contract outcomes
  - Commercial use, intellectual property, data rights

All financial incentive usually have an impact to profit
Non-Financial incentives usually have a financial root value
WHAT TO USE AS AN INCENTIVIZE

The market will set an incentive’s comparable value to industry

Market research is key

• If the government is the only buyer, industry may be motivated by continued access to sell
  • Contract options, incumbency, continued customer familiarity

• If the government is one of many buyers, industry may have broader financial motivations
  • Less intrusion may be strong incentive for commercial seller

• Or is this an industry in which immediate profits will drive performance?
WHAT TO INCENTIVIZE

• **Cost Incentive**
  • Intended to motivate the contractor to effectively manage costs
  • Typically starts with a target cost and a target profit/fee, then is adjusted based on cost management during performance

• **Performance Incentives**
  • Connected to specific product characteristics or other specific elements of the contractor’s performance
  • Should be as specific as possible up front to motivate desired outcomes
  • Balanced with other incentives to emphasize overall acquisition results

• **Delivery Incentives**
  • Valuable when schedule improvement is of primary importance to the government
  • Impact by government caused delays should be considered and resolution preplanned

Performance or delivery incentives must be paired with cost incentives or cost constraints
WHAT TO INCENTIVIZE

- Stakeholder Objectives
- Warfighter Needs
- Key Performance Parameters
- Source Selection Criteria
- Performance Evaluation
- Basis for incentives
# Values Matrix

## Aligning Government with Contractor Value

<table>
<thead>
<tr>
<th>What’s important to the government</th>
<th>Profit/Fee</th>
<th>Future Business with Options</th>
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**Aligning government with contractor value**

**What’s important to contractors**

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### What’s important to contractors

- **Profit/fee**
- **Future Business with Options**
- **Past Performance Rating**
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## VALUES MATRIX

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Incentives reward outcomes beyond satisfactory. Contractors must expend additional resources to earn incentives.

Cost to pursue incentive

Value of improved outcomes

The government must value the above satisfactory performance to set aside resources to incentive the improved outcomes.
Incentives reward outcomes beyond satisfactory. Contractors must expend additional resources to earn incentives.

The incentive must be larger than the cost to pursue to attract the interest of the contractor.

The government must value the above satisfactory performance to set aside resources to incentive the improved outcomes.
Incentives reward outcomes beyond satisfactory. Contractors must expend additional resources to earn incentives.

Cost to pursue incentive

Incentive

Value of improved outcomes

The incentive must be smaller than the value to the government to make it worth its while.

The government must value the above satisfactory performance to set aside resources to incentive the improved outcomes.
Sizing the incentive is critical
- Estimating the “cost to pursue” is hard
- Establishing a value to the government is even harder
INCENTIVE CONTRACTS

Two Types of Incentives
- Subjective
  - Award Fee
- Predetermined, Formula-Type

Two Families of Contracts
- Cost reimbursement
  - Cost Plus Incentive Fee
- Fixed Price
  - Fixed Price Incentive
TWO FAMILIES OF CONTRACTS

Cost Reimbursement
• Reimburses contractor costs based on characteristics of the cost not acquisition outcomes - “Best Effort”
• Amount of fee can be contractually conditioned on outcomes (cost, performance, schedule, etc.)

Fixed Price
• Pays irrespective of actual costs - profit is derived based on cost relative to price
• Pay is conditioned on successful performance
• Amount of profit can be linked to outcomes

Award Fees can be a feature of cost reimbursement or fixed price contracts
SUBJECTIVE INCENTIVES

Award Fees

- Can be added to any contract type
  - Fixed price, including firm fixed price
  - Cost reimbursement, as long as cost efficiency is incentivize or costs are constrained
AWARD FEE

Suitable for use when--

• It is neither feasible nor effective to devise *predetermined objective incentive targets* applicable to cost, schedule, and technical performance

• The likelihood of meeting acquisition objectives will be enhanced by using a contract that effectively motivates the contractor toward exceptional performance and provides the Government with the flexibility to evaluate both actual performance and *the conditions under which it was achieved*
AWARD FEE PRINCIPLES

- Award fees are helpful to motivate contractor activity that cannot be objectively measured.

- Typically an “award fee pool” is set aside and explicitly tied to criteria evaluating intermediate activity or acquisition outcomes.

- Input is provided to a fee determining official who unilaterally decides what portion will go to reward the contractor.

- Award fee processes are administratively burdensome – benefits must outweigh the procedural costs.
AWARD FEE EXAMPLES

Contractors are given the opportunity to earn an award fee…

• A research contractor devises a superior approach to solve the research problem even though the outcome may be uncertain

• A food service contractor provides an innovative meal plan that delights patrons

• A contractor facilitates the performance of associate contractor beyond what is required

In each case, the desired behavior is described to the contractor in advance so that it can commit resources to earn the award
PRE-DETERMINE FORMULA INCENTIVES

Cost Incentive

- **Fixed price incentive (firm or successive targets)**
  - Retains the primary features of fixed price contracts
  - Contractors must deliver a contractually acceptable outcome to be compliant
  - Price is re-determined at the end of the contract

- **Cost plus incentive fee**
  - Retains the primary features of cost reimbursement contracts
  - Costs are reimbursed based on accounting and regulatory principles not satisfactory outcome
  - Fee is formulaically adjusted based on cost efficiency
FIRM FIXED PRICE CONTRACT

Actual Cost of Performance → Profit → Loss → Overrun Reduces Profit
Initial Cost Estimate → Cost

- Cost to government does not change based on actual cost
- Maximum cost incentive to contractor
  - Overrun and Underruns impact profit 100%
COST
Profit
Initial Cost Estimate → Overrun Reduces Profit
Actual Cost of Performance →
Cost to government changes based on actual cost, shared with contractor
• Substantial cost incentive to contractor
  • Overrun and Underruns impact profit as specified in the contract
• Ceiling price limits maximum expense to government

Ceiling →
Loss
Actual Cost of Performance →

Fixed Price Incentive

Initial Cost Estimate →
52.216-16 -- Incentive Price Revision -- Firm Target

(d) Price Revision

(2) The total final price shall be established by applying to the total final negotiated cost an adjustment for profit or loss, as follows:

(i) If the total final negotiated cost is equal to the total target cost, the adjustment is the total target profit.

(ii) If the total final negotiated cost is greater than the total target cost, the adjustment is the total target profit, \( \text{less } ____ \) percent of the amount by which the total final negotiated cost exceeds the total target cost.

(iii) If the final negotiated cost is less than the total target cost, the adjustment is the total target profit \( \text{plus } ____ \) percent of the amount by which the total final negotiated cost is less than the total target cost.

...in no event shall the total final price of these items exceed the ceiling price of $ ____).
COST PLUS FIXED FEE

Actual Cost of Performance → Fixed Fee

Initial Cost Estimate → COST

} Overrun Does NOT Impact Fee

• Cost to Government changes based on actual cost
  • Government financially responsible for 100% of cost overrun
• No direct cost incentive to contractor for cost efficiency
  • Overrun and Underruns do NOT impact fee
COST PLUS INCENTIVE FEE

Actual Cost of Performance → Fixed Fee → Overrun Cost Share Reduces Fee

Initial Cost Estimate → COST

Cost Plus Incentive Fee

• Cost to Government changes based on actual cost
  • Government financially responsible for a portion of cost overrun
• Cost incentive to contractor for cost efficiency
  • Overrun and Underruns impact fee to the extent of the contractor’s share
(e) **Fee payable.**

(1) The fee payable under this contract shall be the target fee increased by _____ cents for every dollar that the total allowable cost is less than the target cost

or

decreased by _____ cents for every dollar that the total allowable cost exceeds the target cost.

In no event shall the fee be greater than _____________ percent or less than ________________ percent of the target cost.
Performance or Schedule Incentive

- Can be added to any type of contract
- Essentially equates objective measures of superior performance to predetermined incentives
- Can only be used if cost efficiency is also incentivized or costs are contained by the contract
Airfield Runway Repair

- Project cost easily estimated
  - Firm fixed price contract
- Daily cost to government by closure calculable
- Daily incentive and disincentive (liquidated damages)
- Cost to contractor to accelerate performance or avoid delays
MULTIPLE INCENTIVES

Contracts can contain more than one incentive

Conventional wisdom – fewer incentives are better

• Unintended consequences
  • Competing incentives
  • Competing resources and contractor focus

Identify what is of primary importance and consider well targeted incentives
RESOURCES

- FAR Subpart 16.4 Incentive Contracts
- DoD Guide on Using Incentive and Other Contract Types
- CLC 137 Advanced Issues in Incentive Contracting
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