

A close-up, low-angle photograph of a man in a dark suit, white shirt, and dark tie. He is smiling broadly, showing his teeth, and looking upwards. He is holding a thick stack of US one hundred dollar bills in his hands. The background is a bright, slightly blurred sky.

Incentive and Award-Fee Contracting:

Lessons Learned
and Best Practices

About the Author

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Incentive and award-fee contracts provide the government with greater input or leverage to motivate contractors to achieve exceptional performance, when properly structured and intelligently implemented.

BY GREGORY A. GARRETT

IN DECEMBER 2005, THE GENERAL Accountability Office (GAO) issued report GAO-06-66, titled “Defense Acquisitions: DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes.” What GAO found in their study of 93 contracts, from a population of 597 Department of Defense (DOD) award-fee and incentive-fee contracts valued at more than \$10 million each, from fiscal year 1999 through 2003, was the power of monetary incentives to motivate superior contractor performance and improve acquisition outcomes was diluted by the way DOD structures and implements contract incentives. As a result, GAO concluded DOD has paid out an estimated \$8 billion in award fees and incentive fees regardless of outcomes.

As a result of the GAO-06-66 report, early in 2006 DOD issued a new policy on the use of contract incentives and award fees to ensure each of the U.S. military services acquisition organizations focused on superior performance outcomes, not just meeting basic contract requirements and achieving interim milestones on major system acquisitions.

Then, in January 2007, GAO issued their report GAO-07-58, titled “NASA Procurement: Use of Award Fees for Achieving Program Outcomes Should Be Improved.” While GAO’s report on NASA procurement was not nearly as critical as their report on DOD, it did reveal some significant concerns. GAO found in some cases there was a major disconnect between program results and fees paid to contractors. For example, NASA paid the contractor 97 percent of the available award fee for the Earth Observing System Data and Information System

Core System. From this, a reasonable person would assume the contractor did an excellent job (i.e., delivered on time, met or exceeded all performance requirements, and was on budget). However, this was not the case. In fact, the subject contractor on the NASA program delivered the program two years late and 50 percent over budget. Of course, there are always numerous unique aspects to each complex major system acquisition, in both the public and private business sectors, and often some fault lies on both sides of the business equation. However, it is still very troubling when program results and payouts do not seem to be properly aligned.

Fundamentally, most people understand contract incentives and award fees are designed to pay contractors more money if and when they deliver superior performance. However, historically contract incentives and award fees have met with mixed results—sometimes they have worked very successfully and other times they have failed to motivate the contractor to achieve excellent results. In a world of performance-based acquisition, the use of contract incentives and/or award fees tied to specific contract performance standards, measures, and metrics is increasingly used. Thus, it is important to share some valuable lessons learned and best practices of planning, structuring, and administering contract incentives and award fees to ensure mutual (buyer and seller) business success.

Classification of Contract Incentives

The fundamental purpose of contract incentives is to motivate desired performance in one or more specific areas.

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Actions to Improve Your Use of Contract Incentives

These best practices should be followed when using incentive contracts.

- 1 Think creatively. Creativity is a critical aspect in the success of performance-based incentive contracting.
- 2 Avoid rewarding sellers for simply meeting contract requirements.
- 3 Recognize that developing clear, concise, objectively measurable performance incentives will be a challenge, and plan accordingly.
- 4 Create a proper balance of objective incentives—cost, schedule, and quality performance.
- 5 Ensure that performance incentives focus the seller's efforts on the buyer's desired objectives.
- 6 Make all forms of performance incentives challenging yet attainable.
- 7 Ensure that incentives motivate quality control and that the results of the seller's quality control efforts can be measured.
- 8 Consider tying on-time delivery to cost and/or quality performance criteria.
- 9 Recognize that not everything can be measured objectively—consider using a combination of objectively measured standards and subjectively determined incentives.
- 10 Encourage open communication and ongoing involvement with potential sellers in developing the performance-based statement of work (SOW) and the incentive plan, both before and after issuing the formal request for proposals.
- 11 Consider including socioeconomic incentives (non-SOW-related) in the incentive plan.
- 12 Use clear, objective formulas for determining performance incentives.
- 13 Use a combination of positive and negative incentives.
- 14 Include incentives for discounts based on early payments.
- 15 Ensure that all incentives, both positive and negative, have limits.

Contract incentives are generally classified as either (1) objectively based and evaluated or (2) subjectively based and evaluated. Further, both classifications of contract incentives are typically categorized as either positive incentives (rewards—get more money) or negative incentives (penalties—get less money) or some combination thereof.

Those incentives that use predetermined formula-based methods to calculate

the amount of incentive, either positive or negative, in one or more designated areas are objectively based and evaluated. Facts and actual events are used as a basis for determination—individual judgment and opinions are not considered in an evaluation of performance. Objectively based and evaluated contract incentives commonly include the following designated performance areas:

- Cost performance,
- Schedule or delivery performance, and
- Quality performance.

Subjectively based and evaluated contract incentives are those incentives that use individual judgment, opinions, and informed impressions as the basis for determining the amount of incentive, either positive or negative, in one or more designated areas. These incentives can and often do contain some objective aspects or factors. However, subjective contract incentives are ultimately determined by one or more individuals making a decision based on their experience, knowledge, and the available information—a total judgment.

Subjectively based and evaluated contract incentives typically include the following:

- Award fees,
- Award term, and
- Other special incentives.

Figure 1 (on page 12) summarizes the link between rewards and penalties and contract incentives as described in the following paragraphs.

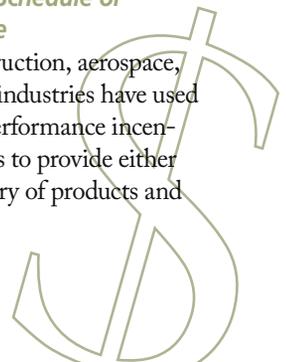
Objective Incentives

Incentives Based on Cost Performance

Cost is the most commonly chosen performance variable. For fixed-price (cost) incentive contracts, the parties negotiate a *target cost* and a *target profit* (which equals the *target price*), and the *sharing formula* for cost overruns and cost underruns. They also negotiate a *ceiling price*, which is the buyer's maximum dollar liability. When performance is complete, they determine the final actual costs and apply the sharing formula to any overrun or underrun. Applying the sharing formula determines the seller's final profit, if any.

Incentives Based on Schedule or Delivery Performance

For many years, construction, aerospace, and numerous service industries have used schedule or delivery performance incentives to motivate sellers to provide either early or on-time delivery of products and services.



Liquidated damages are a negative incentive (penalty) for late delivery. Typically, a liquidated damages clause in the contract terms and conditions designates how much money one party, usually the seller, must pay the other party, usually the buyer, for not meeting the contract schedule. Often the amount of liquidated damages payable is specified as an amount of money for a specific period of time (day, week, or month). A key aspect of liquidated damages is that the penalty is to be based on the amount of damages incurred or compensable in nature, not an excessive or punitive amount.

A proven best practice for buyers is to require negative incentives (or penalties) for late delivery and late schedule performance. Likewise, a proven best practice for sellers is to limit their liability on liquidated damages by agreeing to a cap or maximum amount, and seeking positive incentives (or rewards) for early delivery and early schedule performance.

Incentives Based on Quality Performance

Quality performance incentives are one of the most common topics in government and commercial contracting. Surveys in both government and industry have revealed widespread service contracting problems, including deficient statements of work, poor contract administration, performance delays, and quality shortcomings.

When a contract is based on performance, all aspects of the contract are structured around the purpose of the work to be performed rather than the manner in which it is to be done. The buyer seeks to elicit the best performance the seller has to offer, at a reasonable price or cost, by stating its objectives and giving sellers both latitude in determining how to achieve them and incentives to achieving them. In source selection, for example, the buyer might publish a draft solicitation for comment, sue quality-related evaluation factors, or both. The statement of work will provide performance standards rather than spelling out what the seller is to do. The contract normally contains a plan for quality assurance surveillance. And the contract typically includes positive and negative performance incentives.

Few people disagree with the concept that buyers, who collectively spend billions of dollars on services annually, should look to the performance-based approach, focusing more on results and less on detailed requirements. However, implementing performance-based contracting (using cost, schedule, and/or quality performance variables) is far easier said than done. The sound use of performance incentives is key to the success of the performance-based approach.

Problems with Applying Objective Incentives

The objective-incentive schemes described have some merit, but they also involve some serious practical problems. First, they assume a level of buyer and seller competence that may not exist. Second, they assume effects that may not occur. Third, they create serious challenges for contract administration. To negotiate objective incentives intelligently, the parties must have some knowledge of the range of possible costs for a project. They also must have some knowledge of the likely causes and probabilities of different cost outcomes. If both parties do not have sufficient information on these issues, they will not be able to structure an effective incentive formula.

It is important that the parties share their information. If one party has superior knowledge that it does not share with the other, it will be able to skew the formula in its favor during negotiation. If that happens, the whole point of the arrangement, which is to equitably balance the risks of performance, will be lost. The buyer is usually at a disadvantage with respect to the seller in this regard. An objective incentive assumes that the seller can affect a performance outcome along the entire range of the independent variable. However, such may not be true. For instance, the seller may actually exercise control along only a short sector of the range of possible costs. Some possible cost outcomes may be entirely outside the seller's control because of factors such as market performance. In reality, the seller's project manager may have little control over important factors that may determine the cost outcome, such as overhead costs. In addition, short-term companywide factors, especially

those involving overhead, may, on some contracts, make incurring additional cost rather than earning additional profit more advantageous for the seller.

In addition, objective cost incentives are complicated and costly to administer, with all the cost definition, measurement, allocation, and confirmation problems of cost-reimbursement contracts. The parties must be particularly careful to segregate the target cost effects of cost growth from those of cost overruns; otherwise, they may lose money for the wrong reasons. As a practical matter, segregating such costs is often quite difficult. When using other performance incentives, the parties may find themselves disputing the causes of various performance outcomes. The seller may argue that schedule delays are a result of actions of the buyer. Quality problems, such as poor reliability, may have been caused by improper buyer operation rather than seller performance. The causes of performance failures may be difficult to determine.

One reason for using such contracts is to reduce the deleterious effects of risk on the behavior of the parties. Thus, if a pricing arrangement increases the likelihood of trouble, it should not be used. The decision to apply objective incentives should be made only after careful analysis.

Subjective Incentives

Award-Fee Plans

In an award-fee plan, the parties negotiate an estimated cost, just as for cost-plus-fixed-fee (CPFF) contracts. Then they negotiate an agreement on the amount of money to be included in an *award-fee pool*. Finally, they agree on a set of criteria and procedures to be applied by the buyer in determining how well the seller has performed and how much fee the seller has earned. In some cases, the parties also negotiate a *base fee*, which is a fixed fee that the seller will earn no matter how its performance is evaluated.

The contract performance period is then divided into *award-fee periods*. A part of the award-fee pool is allocated to each period proportionate to the percentage of the work scheduled to be completed. All this information is included in the award-fee plan, which becomes a part of

the contract. In some cases, the contract allows the buyer to change the award-fee plan unilaterally before the start of a new award-fee period.

During each award-fee period, the buyer observes and documents the seller's performance achievements or failures. At the end of each period, the buyer evaluates the seller's performance according to the award-fee plan and decides how much fee to award from the portion allocated to that period. Under some contracts, the seller has an opportunity to present its own evaluation of its performance and a specific request for award fee. The buyer then informs the seller how much of the available award fee it has earned and how its performance could be improved during ensuing award-fee periods. This arrangement invariably involves subjectivity on the part of the buyer; precisely how much depends on how the award-fee plan is written.

Base Fees

As stated earlier, a base fee on a cost-plus-award-fee (CPAF) contract is a fixed fee established by the buying activity upon contract award. A base fee is incrementally paid to the contractor regardless of its performance on the contract, so long as the contract is not terminated. On government cost-reimbursement type contracts that actual payment of a base fee typi-

cally accompanies a contractor's monthly reimbursement (by the government) for "best efforts" of actual contractor expenses. Simply knowing what a base fee is and how it is paid is good, but knowing how to determine a base fee amount is better!

In the following discussion, I have identified three common concepts to determine an appropriate amount of base fee (which may be used) for CPAF contracts. These concepts have been used by various government buying activities to determine an appropriate amount of base fee for CPAF contracts.

1. **Marginal-Performance-Level (MPL) Concept**—Inherent in this concept is the idea that the base fee is established with a particular quality or level of performance in mind. Base fees are established by taking into consideration the various profit analysis factors, but in an amount commensurate with that level or quality of performance categorized as minimum acceptable. The MPL concept, to determine the amount of base fee, has been used by NASA and other government buying activities for nearly 30 years. This concept contains no present limits to the amounts of base fee.
2. **Unallowable Cost Off-set (UCO) Concept**—For many years the *Defense Federal Acquisition Regula-*

tion Supplement (DFARS) stated "The base fee shall not exceed three percent of the estimated cost of the contract exclusive of the fee." The *DFARS* did not provide the rationale for why this limit was required on DOD contracts; however, through research I have concluded that several financial aspects caused the development of this UCO concept. One of the most significant financial aspects, considered vital to the establishment of the UCO concept, was and is the business strategy of all contractors to offset unallowable costs that they incur on government cost-reimbursement types of contracts. Typically, aerospace contractors have had two to three percent of their contract costs deemed unallowable as a result of government cost accounting standards and audits. Thus, many contractors will not agree to enter into a cost-reimbursement type of contract unless they are assured a minimum fee of two to three percent of the estimated cost. The government under the UCO concept would provide contractors a minimum base fee guarantee up to three percent to offset contractor unallowable costs, thereby reducing the possibility of a contractor financial-loss situation.

3. **Zero-Base-Fee (ZBF) Concept**—Over the past 20 years, many gov-

TYPES OF INCENTIVES	POSITIVE (REWARDS)	NO REWARD OR PENALTY	NEGATIVE (PENALTIES)
Objective Incentives			
Cost Performance	Under Budget	On Budget	Over Budget
Schedule or Delivery Performance	Early Delivery	On-time Delivery	Late Delivery
Quality Performance	Exceed Requirements	Achieve Contract Requirements	Do Not Achieve Requirements
Subjective Incentives			
Award-Fee Plan/Award-Term Plan	Exceed Requirements	Achieve Award-Fee Plan/or Award-Term Plan	Do Not Achieve Requirements

Figure 1. Contract Incentives

ernment buying activities have established and used the ZBF concept or policy. The ZBF concept is based upon the assumption that eliminating a base fee, total fee pool, (consisting solely of an award fee), would provide a greater incentive for contractors to achieve superior performance. A ZBF policy was used for many years by the Air Force Systems Command (AFSC), now Air Force Material Command (AFMC), buying activities.

When examining these concepts to determine the amount of base fee, it is obvious that the MPL concept provides the contractor with the largest possible base fee, while the ZBF concept provides none. Therefore, the UCO concept is often considered to be a fair and reasonable compromise to determine a base-fee amount.

Award Fees

For years, major defense buying activities have instructed their buying offices to use objective methods to arrive at either the size of the award-fee pool or the amount of the award-fee determination on CPAF contracts. In many instances, this was manifested in the use of weighted guidelines or an alternate structured approach for these determinations. The use of weighted guidelines or an alternate structured approach to arrive at either the size of the award-fee pool or the amount of an award-fee determination on a CPAF contract is not appropriate because it is a misapplication of the DOD profit policy. Equally important, the use of totally objective methods to arrive at the award-fee pool or award-fee determination is a contradiction of the concepts that underlie and support the use of a CPAF contract. Flexibility is needed to arrive at both an award-fee pool and award-fee determination that suit the circumstances of a particular procurement.

While there is a need for flexibility in the determination of an award fee, there is also a need for consistency in the process. Consistency and flexibility are not exclusive of each other. Award-fee ratings must be clearly related to the available award-fee pool. Consistency does not mean using an unalterably structured approach. Rather, it means clearly defining the subjective/

objective elements of the flexible approach one is using. Defining your philosophy in the determination of award fee is beneficial to both the contractor and the government.

The description of how you will create and administer an award fee is the essence of communications. While there should be flexibility in the application of the philosophy, the philosophy itself should be consistently applied throughout a buying activity. The consistent application of an award-fee determination will improve communications and have an impact on the entire contracting cycle from the request for proposal to the completion of the contract effort.

Award Fee—Lessons Learned

1. **Use award fees on FFP contracts—**Seldom has an award fee been used on a multimillion-dollar contract in conjunction with a firm-fixed-price-type contract. In addition, when an award fee is combined with a type of contract other than CPAF, the profit or fee already part of the contract serves as the equivalent to the base fee. Thus, the FFP contracts do not contain a typical base fee, as commonly used on CPAF-type contracts.
2. **Select only a few highly skilled performance monitors—**Some successful organizations managing the government administration of the award-fee contracts have selected only a few highly skilled performance monitors in each functional area to provide input to the government's Award Review Board (ARB). Typically, large complex contracts have many people involved in evaluating the contractor's performance. Several organizations have found that sometimes *fewer highly skilled* performance monitors, who are well educated and trained in their functional area and their specific performance monitoring responsibilities, are *better!*
3. **Create a highly empowered ARB—**Creating highly empowered members of the Award Review Board (ARB) to evaluate, tailor, and summarize performance monitors' find-

ings has proven very successful. Even with the best performance monitors, it is possible (even likely) to have a variety of opinions when it comes to subjectively evaluating a contractor's performance, no matter how much you objectively structure the evaluation process. The fee determining official (FDO) needs a clear and concise recommendation from the ARB, concerning the contractor's performance versus the award-fee plan. Highly empowering the ARB allows the ARB members to segregate the chaff from the wheat, and provides the ARB with the flexibility to examine the whole effort from a system perspective, rather than merely reporting functional inputs.

Award Fee—Best Practices

1. **Update the award-fee plan (for example)—**Do not be caught with 50 percent of the award fee allocated in the award-fee plan to field performance when you have not fielded the equipment.
2. **Do not be afraid to vary the award fee by period—**Do not be trapped by your previous contractor's performance evaluations. Give the contractor the amount of award fee that the contractor deserves, whether they like it or not!
3. **Develop effective performance evaluation standards—**Award-fee evaluations should not vary dramatically based solely upon evaluator personalities. Performance standards must be established and clearly communicated to the contractor and to all government performance monitors.
4. **Award fees must communicate a message—**The FDO must use the award-fee process to clearly communicate to a contractor his view of their performance and where improvement is required.
5. **Use rollover of unearned award fees only when appropriate—**Do not allow contractors to be able to receive award fees, which were

unearned (i.e., not paid in previous award-fee periods) unless the contractor was able to in some appropriate way make up for their previous shortcomings in performance.

6. **Do not be afraid to revise award-fee evaluation criteria**—Many organizations have determined that their criteria needed to reflect a different emphasis, so they changed the criteria. They were not hesitant to change the criteria so that it better met their needs and their desired outcomes. Do not be afraid to change any aspect of the award-fee plan if it better motivates the contractor to achieve superior results.
7. **Use Defense Contract Management Agency (DCMA) contract administration support**—DCMA is organized to support their customers, government/military buying offices. Through the *FAR* delegation process, DCMA can serve as a valuable asset for evaluating contractor performance.
8. **Write it down!**—Sooner or later your memory will fail you. It is imperative to keep detailed written records. Be specific in your examples to include the impact of what you are documenting. Put your written records where you can find them.
9. **Communicate!**—Frequent and specific communication with the contractor and other government organizations is a must at all levels there should be no surprises when there is open communication. An award fee should be a part of daily management of the program.
10. **Only pay incentives and award fees for superior performance**—Do not pay contractors award fees as a means to increase their base fee for merely meeting minimal contract requirements.

Conclusion

This article has examined numerous aspects of incentive and award-fee contracting including

- Different kinds of contract incentives,
- Various concepts for establishing a base fee,
- Different philosophies and actual approaches for creating an award fee, and
- Numerous lessons learned and best practices for contract incentives and award fees.

These issues do not comprise an all-encompassing list of items concerning contracting with incentives or award fees. Rather, this article has focused on some of the key issues of creating and implementing contracts with incentives and award fees.

The use of contract incentives and award fees on government contracts are complex and often controversial. They require a significant amount of contractor performance evaluation by the government. But, simply stated, any contract is a communications vehicle to express an agreement between its parties. Contracts containing incentives and award fees provide contractors with numerous avenues to communicate openly with the government during contract performance. Moreover, incentive and award-fee contracts provide the government with greater input or leverage to motivate contractors to achieve exceptional performance, when properly structured and intelligently implemented!

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