Incentive Contracting And Pricing Issues In DoD Acquisitions

NCMA Boston Chapter March Workshop
Bentley College
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BAE Systems
Vice President, Contracts
Electronic Systems
Today’s Agenda

• The Recent DoD Buzz - Incentive Contracting

• A few Thoughts on “Better Buying Power 1.0 and 2.0”

• An Industry Perspective: How Do Incentive Arrangements Align With The Profit Motivation of Business?

• An Overview Tutorial On Incentive Contracting Arrangements
  – FPI
  – CPIF

• An Overview Tutorial On Award Fee Contracting Arrangements

• Questions and Wrap-up
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  • Questions and Wrap-up
Current Contracting Environment

- Commercial Market is different than the Defense Market

- US Defense Market as *Monopsony*
  - One Buyer, Multiple Suppliers
  - Buyer (USG) Regulates vs. Pure Market Forces
Current Contracting Environment

- Challenges of the Current Environment
  - Afghan/Iraq Wind-down
  - Challenging World & US economy
  - Budget pressures – SEQUESTRATION!
  - Fewer new program starts and opportunities
  - Aggressive competition
  - Highly regulated industry
  - Increased Government oversight, regulation, audit, investigation
  - Industry consolidation?
  - Public perception of the industry – Bad actors
  - Pressure on cost control and profits
  - Uncertain program health long term – constant review and scrutiny, threat of cancellation

(Partial Source: DAU on-line briefing)
Current Contracting Environment

• Congress and DoD (and the Public) Frustrated with Cost & Schedule Overruns
  – “Conspiracy of Hope” – optimistic initial budget estimates and Contractor’s accommodating proposal. (USAF Paper)

• GAO Reports Highlight Program Execution Failures
  – Not on time, Not on budget, Not meeting Spec
  – Compensation (rewards) not matching performance
  – “DoD Has Paid Billions in Award & Incentive Fees Regardless of Outcomes” (GAO Report to the Senate Armed Services Committee (SASC), December 2005)

• Section 814 of FY06 NDAA Required SECDEF to Issue Guidance on Award & Incentive Fees

The Point Is, It’s Not A New Discussion!
Where Are We Trying to Go?

• “... Consistently motivate excellent contract performance while ensuring cost, schedule, and technical performance control.”

• “... implement a contract fee structure tying incentive or award fee to realized program outcomes, while at the same time recognizing the Contractor’s need to earn fee throughout the contract performance period...”

• “... we should initially focus on incentives based wholly on objectively verifiable criteria (i.e.: FPIF, CPIF)”

Michael W. Wynne, SAF
04 April 2006
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Better Buying Power

• BPP 1.0 – Ashton Carter, USD AT&L, 28 June and 14 Sept 2010
  *Guidance for Obtaining Greater Efficiency & Productivity In Defense Spending*

• Introduced 23 Principal Actions In 5 Major Areas
  1. Target Affordability & Control Cost Growth
  2. **Incentivize Productivity & Innovation In Industry**
  3. Promote Real Competition
  4. Improve Tradecraft in Services Acquisitions
  5. Reduce Non-productive Process & Bureaucracy
Focus on #2 – Incentivize Productivity and Innovation In Industry

- Reward Contractors for Successful Supply Chain Management

- Instructed DPAP to Review Weighted Guidelines for Profit with the Aim of Emphasizing the Tie Between Profit and Performance
  - Reward and Incentive Strategy Behind the Profit Policy
  - Savings Expected to Be Realized in Cost, Not Profit

- Increase the Use of Fixed Price Incentive Contract Type, where appropriate
  - 50/50 Share Line
  - 120% Ceiling
  - FPI seen as appropriate in early production and single source production where year-on-year price improvement can be rewarded
Focus on Incentives

- Contract Incentives, by definition, shares the cost of overruns and rewards of under-runs between Government & Industry (Buyer and Seller).

- 50/50 Share Line suggests the Government and Contractor have a common view of likely execution costs.

- A Flat or Steep Share Line suggests that the Government and Contractor do NOT see the project the same way with respect to the cost execution risk.

- 120% Ceiling – sets a 20% limit on the Governments liability for over-runs of the contracts target cost.

  “Programs that over-run more than this amount in an era of flat defense budgets should face a review with an eye to cancellation.”  
  Ashton Carter
Focus on Incentives

- **Adjust Progress Payments to Incentivize Performance**
  - Use Progress Payments as the starting point for negotiations
  - After price agreement, determine the economic benefit to the Contractor of the payment terms or more favorable payment terms
  - Government should benefit through reduced price in exchange for better payment terms that yield cash flow benefits
4. Improve Tradecraft in Service Acquisitions

− DoD’s Practices for Buying Services Are Much Less Mature Than For Buying Weapons Systems and Equipment

− BPP 1.0: Limit the use of T&M and CPAF Contracts for Services
  • T&M least preferred contract type for understanding costs
  • CPAF contracts provide only limited motivation for cost discipline
  • Pre-disposition to CPFF or CPIF when cost history, buying experience, and competition is limited
  • FFP to be used when cost history and buying experience is sufficient, and competition exists.

− Incentive Arrangements Are Somewhere In the Middle (FPI)
Better Buying Power 2.0

• BBP 2.0 – Frank Kendall (USD AT&L) Memo 13 November 2012

• Stated objective: Ensure affordability and increase productivity in defense spending and deliver better value to the warfighter
  – Deliver better value to the taxpayer and the warfighter by improving the way the Department does business.

“DO MORE WITHOUT MORE”

– 36 Principal Actions in 7 Major Categories
BPP 1.0

1. Target Affordability & Control Costs
2. Incentivize Productivity & innovation in Industry
3. Promote Real Competition
4. Improve Tradecraft In Services Acquisitions
5. Reduce Non-productive Process & Bureaucracy

BPP 2.0

1. Achieve Affordable Programs
2. Control Costs Through Product Life Cycle
3. Incentivize Productivity & Innovation In Industry and Government
4. Eliminate Unproductive Process & Bureaucracy
5. Promote Effective Competition
6. Improve Tradecraft in the Acquisition of Services
7. Improve the Professionalism of the Total Acquisition Workforce
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Basic Contracting Considerations

Contract Selection – What Does The Government (Buyer) Want?

- Value for Money
- Contract Performance
  - Dependable, Predictable
- Budget Protection
  - What was bargained for, at the price it was bargained for
- Proper Stewards of Public Resources

In a word .... Results!
Basic Contracting Considerations

Contract Selection – What Does Industry (Seller) Want?

✓ Contract Performance
✓ Proper Allocation of Risks
✓ An Opportunity at Rewards (e.g.: Return)
  • Adequately Address the Profit Motivation of Business
  • Understanding of the true nature of “Fee” and “Profit”
  • No apologies for this basic motivator
✓ Appreciation of the Different Behaviors of Buyer and Seller As Driven by the Contracting Arrangement
The Business Pyramid

- Orders
- Sales
- Cash
- Profit
Striking the Critical Balance

Risk

Rewards
Why Incentives?

Motivation + Behavior = Performance Outcome

Incentives Arrangements – Any Type – Generally Offer Unique Means To Motivate Performance And Encourage Desired Outcomes
On Risk and Rewards ...

The Selection of Contract Type is the Primary factor in the Allocation of Risk and the Nature of the Profit Determination

Allocation of Risk – Who bears the financial risk of performance

Profit Determination – How earned and the variability of the margin potential
Incentives vs. Awards

Subjective Criteria

Objective Criteria
Definitions To Keep In Mind

PROFIT: The difference between the cost of a Product or Service and the price charged for that product or service. The Seller can impact his profit through positive or negative performance.

The Seller (Industry) Controls

FEE: A set sum certain to be paid by the Buyer to the Seller for providing a product or rendering a service. The fee as a real dollar amount is not impacted by fluctuations in performance.

No One Controls, It Just Is

INCENTIVES or AWARD FEES: An Additional monetary return based on performance against some pre-determined events or criteria.

Both Parties Have Some Control
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• 48 CFR Part 16 – Types of Contracts

• Subpart 16.4 – Incentive Contracts
  • Cost
  • Performance
  • Delivery
  • Multiple Incentives

• FAR 16.204/16.403 – Fixed Price Incentive

• FAR 16.304/6.405 – Cost Plus Incentive Fee

• FAR 16.305/16.405-2 – Cost Plus Award Fee

• FAR 16.404 – Fixed Price Contract with Award Fees
Fixed Price Incentive (FPI)
Fixed Price Incentive

Defined:
• Provides for adjusting profit and establishing the final contract price by a formula based on the relationship of final negotiated total cost to the target cost
• Final Price is subject to a price ceiling (negotiated up front)
• Two (2) Types
  – Fixed Price Incentive, Firm
  – Fixed Price Incentive, Successive Target

When Applied:
• When a straight FFP contract is not suitable
• Contractors assumption of a degree of cost responsibility will provide a positive profit incentive for cost control and performance
• When other incentives (technical performance or delivery) are being used.
Elements of a FPI Contract

- Involves a pre-negotiated formula for sharing cost over-runs and under-runs

- Target Cost
- Target Profit
- Ceiling Price
- Share Ratio
Elements of a FPI Contract Defined

Target Cost

- Represents a reasonable estimate that both parties are willing to accept of the anticipated total cost of performance
  - “Represents the most likely outcome to be attained through efficient performance of the work”
- Establish prior to performance

Target Profit

- A reasonable return on the anticipated cost of performance as agreed by the parties prior to performance
- Is not (necessarily) the final profit
Ceiling Price

- The maximum dollar value the buyer is willing and obligated to pay for the goods or services
- Unique to fixed price incentive contracts
- Most critical element of an FPI contract
- Represents the point at which financial responsibility is 100% on the contractor (Well, not really ... But bare with me ... It’s the PTA)
- Final price never exceeds ceiling (what the Buyer will pay)
• Share Ratio (Sometimes expressed simply as “Contractor’s Share”) -
  — Represents the percentage of sharing above and below the target cost to
determine the profit and price.

• When two percentages expressed, first percentage always refers to the
  Government (Buyer) and the second percentage to Contractor (Seller)

Example: 75% / 25% Share Ratio
  Government (75%)/Contractor (25%)
The Point of Total Cost Assumption

• Defined
  – Identifies the mathematical point at which the contractor’s risk changes from the negotiated incentive sharing to a fixed price risk - 100% responsibility for cost incurred.
  – PTA = The point at which for every dollar you spend, you lose a dollar of profit.
  – PTA is the mathematical point at which Government sharing has maximized, and Government sharing ends.
Expressed as a formula

\[ \text{PTA} = \frac{\text{Ceiling Price} - \text{Target Price}}{\text{Government Share}} + \text{Target Cost} \]
FPI Example - Negotiated Value

- Target Cost: $10,000,000
- Target Profit: 1,500,000
- Target Price: $11,500,000
- Ceiling Price (125%): 12,500,000
- Share Ratio: 75% / 25%

These elements are stated in the Contract

- Point of Total Cost Assumption (PTA)

\[
\frac{12,500,000 - 11,500,000}{.75} + 10,000,000 = 11,333,333
\]
Mechanics of the PTA  
(Illustrative Examples)

- Total Cost @ PTA  $11,333,333
- Overrun @PTA  $1,333,333
- Gov’t Share (75%)  $1,000,000
- Contractor Share (25%)  $333,333
- Contractor Target Profit  $1,500,000
- Less Contractor Share  $333,333
- Delta = Profit Remaining  $1,166,667
Mechanics of the PTA
(Illustrative Examples)

• Ceiling Price $12,500,000
• Total Cost @ PTA $11,333,333
• Delta to Ceiling $1,166,667
• Contractor Profit Remaining @ PTA $1,166,667

NOTE THE COINCIDENCE…?
<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ceiling</td>
<td>$12,500,000</td>
</tr>
<tr>
<td>Target Profit</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>PTA</td>
<td>$11,333,333</td>
</tr>
<tr>
<td>K’or Share (25%)</td>
<td>$333,333</td>
</tr>
<tr>
<td>Delta</td>
<td>$1,166,667</td>
</tr>
<tr>
<td>Delta (Profit Left)</td>
<td>$1,166,667</td>
</tr>
</tbody>
</table>

If Cost Goes to $11,333,334
Then Profit Drops to $1,166,666

$1 additional cost... equals... $1 less in Contractor Profit

Cost Increase of $116,667... means ...Further Profit Erosion of $116,667
### FPI Example -

<table>
<thead>
<tr>
<th>Negotiated</th>
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<tbody>
<tr>
<td>(Target) Cost</td>
</tr>
<tr>
<td>$ 10,000,000</td>
</tr>
<tr>
<td>(Target) Profit</td>
</tr>
<tr>
<td>1,500,000</td>
</tr>
<tr>
<td>(Target) Price</td>
</tr>
<tr>
<td>$ 11,500,000</td>
</tr>
<tr>
<td>Ceiling Price</td>
</tr>
<tr>
<td>$12,500,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Share Ratio</th>
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<tbody>
<tr>
<td>75/25</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Actual Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>TBD</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Final Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>TBD</td>
</tr>
</tbody>
</table>
### FPI Example - Actual Performance (Under-run)

<table>
<thead>
<tr>
<th></th>
<th>Negotiated</th>
<th>Scenario 1</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Target) Cost</td>
<td>$10,000,000</td>
<td>$9,000,000</td>
<td></td>
</tr>
<tr>
<td>(Target) Profit</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td>(Target) Price</td>
<td>$11,500,000</td>
<td>$10,500,000</td>
<td></td>
</tr>
<tr>
<td>Ceiling Price</td>
<td>$12,500,000</td>
<td>$12,500,000</td>
<td></td>
</tr>
<tr>
<td>Share Ratio</td>
<td>75/25</td>
<td>$250,000</td>
<td></td>
</tr>
<tr>
<td>Actual Profit</td>
<td>TBD</td>
<td>$1,750,000</td>
<td></td>
</tr>
<tr>
<td>Final Price</td>
<td>TBD</td>
<td>$10,750,000</td>
<td></td>
</tr>
</tbody>
</table>
## FPI Example - Actual Performance (Under-run)

<table>
<thead>
<tr>
<th></th>
<th>Negotiated</th>
<th>Scenario 1</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Target) Cost</td>
<td>$10,000,000</td>
<td>$9,000,000</td>
<td>$1M Under-run</td>
</tr>
<tr>
<td>(Target) Profit</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>Original Profit Target</td>
</tr>
<tr>
<td>(Target) Price</td>
<td>$11,500,000</td>
<td>$10,500,000</td>
<td>Unadjusted Price</td>
</tr>
<tr>
<td>Ceiling Price</td>
<td>$12,500,000</td>
<td>$12,500,000</td>
<td>Absolute $$ value not to be exceeded</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Share Ratio</th>
<th>Actual Profit</th>
<th>Final Price</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>75/25</td>
<td>$1,750,000</td>
<td>$10,750,000</td>
<td>Final price is $750K less than target 75% is Government share of $1M under-run</td>
</tr>
</tbody>
</table>

25% share of $1M under-run

Actual profit increases by share of under-run
### FPI Example - Actual Performance (Over-run)

<table>
<thead>
<tr>
<th></th>
<th>Negotiated</th>
<th>Scenario 2</th>
<th>Comment</th>
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<tbody>
<tr>
<td>(Target) Cost</td>
<td>$10,000,000</td>
<td>$11,000,000</td>
<td>$1M cost overrun</td>
</tr>
<tr>
<td>(Target) Profit</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>Original Profit - to be decremented</td>
</tr>
<tr>
<td>(Target) Price</td>
<td>$11,500,000</td>
<td>$12,500,000</td>
<td>Unadjusted Price</td>
</tr>
<tr>
<td>Ceiling Price</td>
<td>$12,500,000</td>
<td>$12,500,000</td>
<td>Absolute $ value not to be exceeded</td>
</tr>
<tr>
<td>Share Ratio</td>
<td>75/25</td>
<td>($250,000)</td>
<td>25% share of $1M over-run - Reduces fee to $1.25M</td>
</tr>
<tr>
<td>Actual Profit</td>
<td>TBD</td>
<td>$1,250,000</td>
<td>Reduced Target Profit by Share</td>
</tr>
<tr>
<td>Final Price</td>
<td>TBD</td>
<td>$12,250,000</td>
<td>Actual cost plus final profit</td>
</tr>
<tr>
<td></td>
<td>Negotiated</td>
<td>Scenario 3</td>
<td>Comment</td>
</tr>
<tr>
<td>------------------------</td>
<td>------------</td>
<td>------------</td>
<td>----------------------------------------------</td>
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<tr>
<td>(Target) Cost</td>
<td>$10,000,000</td>
<td>$12,250,000</td>
<td>$2.25M cost overrun</td>
</tr>
<tr>
<td>(Target) Profit</td>
<td>1,500,000</td>
<td>1,500,000</td>
<td>Original Profit - to be decremented</td>
</tr>
<tr>
<td>(Target) Price</td>
<td>$11,500,000</td>
<td>$13,750,000</td>
<td>Unadjusted Price</td>
</tr>
<tr>
<td>Ceiling Price</td>
<td>$12,500,000</td>
<td>$12,500,000</td>
<td>Absolute $ value not to be exceeded</td>
</tr>
<tr>
<td>Share Ratio</td>
<td>75/25</td>
<td>($562,500)</td>
<td>25% share of $2.25M over-run - reduces fee to $937.5K</td>
</tr>
<tr>
<td>Actual Profit</td>
<td>TBD</td>
<td>$250,000*</td>
<td>Additional fee decrement of $687.5K necessary to stay within ceiling</td>
</tr>
<tr>
<td>Final Price</td>
<td>TBD</td>
<td>$12,500,000</td>
<td></td>
</tr>
</tbody>
</table>
2 Variations of Fixed Price Incentive

• Fixed Price Incentive, Firm (FPIF)
  – Don’t say “Fixed Price Incentive Fee” - WRONG!!!!
  – Simply means a firm incentive target has been established at the outset

• Fixed Price Incentive, Successive Targets (FPIS)
  – Same “initial” elements as a FPIF - cost elements termed as “initial” targets
  – Identifies a point in contract performance where “initial targets” are converted to “firm” targets
  – Often a production point where some performance experience has been collected
  – Can have multiple future points (successive targets)
• Same basic motivations and behaviors exist as in FFP

• Buyer may be slightly more flexible to changes given sharing and ceiling

.... Nonetheless....

• Must protect budget and profit position through cost control
Cost Plus Incentive Fee (CPIF)
Cost Plus Incentive Fee (CPIF)

• Provides for an initially negotiated fee to be adjusted later based on relationship of actual costs to target costs.

• Similar to FPI except no ceiling price in CPIF
  — all allocable and allowable costs reimbursed

• Opportunities for increases or decreases in fee intended to motivate the contractor for efficient performance
Cost Plus Incentive Fee (CPIF) Elements

- Target Cost
- Target Fee
- Minimum Fee - at which fee is “fixed” (floor)
- Maximum Fee - at which fee is “fixed” (ceiling)
- Fee Adjustment Formula - Share Ratios
Cost Plus Incentive Fee (CPIF) Elements

- Fee increases when actual cost is less than target cost
- Fee is decreased when actual costs are more than target cost
- Fee is only decreased to the “minimum” - may be $0
- “Range of Incentive Effectiveness” - the points between minimum and maximum fee
- CPIF referred to as a “objective” incentive - fee determined by fact and formula
When/Why Use CPIF?

• When allocation of risk cannot be determined such that high probability of appropriate profit/fee results

• When neither party has reliable knowledge of the exact work required

• When SOW’s and Specifications are “open”
  – “..... As required .....”
  – “..... Contractors best efforts ....”
  – “... If necessary ...”

• Often used in Research and Development programs, SDD & LRIP Programs
CPIF Example

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Target Cost</td>
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</tr>
<tr>
<td>Target Fee</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Minimum Fee</td>
<td>400,000</td>
</tr>
<tr>
<td>Maximum Fee</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Share</td>
<td>80 / 20</td>
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Final Fee

Final Price (Total CPIF)
<table>
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<td>Target Cost</td>
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<td>$8,000,000</td>
<td></td>
</tr>
<tr>
<td>Target Fee</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Minimum Fee</td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Fee</td>
<td>1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>80 / 20</td>
<td>400,000</td>
<td></td>
</tr>
<tr>
<td>Final Fee</td>
<td></td>
<td>1,400,000</td>
<td></td>
</tr>
<tr>
<td>Final Price (Total CPIF)</td>
<td></td>
<td>$9,400,000</td>
<td></td>
</tr>
<tr>
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<td>Negotiated</td>
<td>Scenario 1</td>
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<td>------------</td>
<td>----------------------------------------------</td>
</tr>
<tr>
<td>Target Cost</td>
<td>$ 10,000,000</td>
<td>$ 8,000,000</td>
<td>$2M under-run</td>
</tr>
<tr>
<td>Target Fee</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Minimum Fee</td>
<td>400,000</td>
<td></td>
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</tr>
<tr>
<td>Maximum Fee</td>
<td>1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>80 / 20</td>
<td>400,000</td>
<td>20% of $2M under-run adds to target fee</td>
</tr>
<tr>
<td>Final Fee</td>
<td></td>
<td>1,400,000</td>
<td>Under-run share plus target - is within max fee</td>
</tr>
<tr>
<td>Final Price (Total CPIF)</td>
<td></td>
<td>$ 9,400,000</td>
<td>Actual Cost ($8M) plus final fee</td>
</tr>
</tbody>
</table>
## CPIF Example (Over-run)

<table>
<thead>
<tr>
<th></th>
<th>Negotiated</th>
<th>Scenario 2</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Target Cost</strong></td>
<td>$10,000,000</td>
<td>$11,500,000</td>
<td>Contract over-run by $1.5M</td>
</tr>
<tr>
<td><strong>Target Fee</strong></td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td><strong>Minimum Fee</strong></td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Maximum Fee</strong></td>
<td>1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Share</strong></td>
<td>80 / 20</td>
<td>(300,000)</td>
<td>20% of $1.5M over-run - is decrease to fee</td>
</tr>
<tr>
<td><strong>Final Fee</strong></td>
<td></td>
<td>700,000</td>
<td>$1M target less $300K share of over-run</td>
</tr>
<tr>
<td><strong>Final Price (Total CPIF)</strong></td>
<td></td>
<td>$12,200,000</td>
<td>$11.5M cost plus $700K fee</td>
</tr>
</tbody>
</table>
## CPIF Example (Over-run)

<table>
<thead>
<tr>
<th></th>
<th>Negotiated</th>
<th>Scenario 3</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Target Cost</td>
<td>$10,000,000</td>
<td>$7,000,000</td>
<td>$3M under-run</td>
</tr>
<tr>
<td>Target Fee</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Minimum Fee</td>
<td>400,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Fee</td>
<td>1,500,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share</td>
<td>80 / 20</td>
<td>600,000</td>
<td>20% of $3M under-run</td>
</tr>
<tr>
<td>Final Fee</td>
<td></td>
<td>1,500,000</td>
<td>Max fee cap applies @ $1.5M even though $1M target plus $600K share</td>
</tr>
<tr>
<td>Final Price</td>
<td></td>
<td><strong>$8,500,000</strong></td>
<td></td>
</tr>
</tbody>
</table>
• Less contentious than fixed price

• Contractor still “cautious” of changes, but more accommodating

• Buyer tempted to ask for more, feels he bears majority of cost increases (he does, depending on share)

• Seller (Contractor) still looking to preserve and increase fee position

• Recognition that procurement documents (specifications, SOW) more open
Today’s Agenda

• The Recent DoD Buzz - Incentive Contracting

• A few Thoughts on “Better Buying Power 1.0 and 2.0”

• An Industry Perspective: How Do Incentive Arrangements Align With The Profit Motivation of Business?

• An Overview Tutorial On Incentive Contracting Arrangements
  – FPI
  – CPIF

• **An Overview Tutorial On Award Fee Contracting Arrangements**

• Questions and Wrap-up
Cost Plus Award Fee (CPAF)
Cost Plus Award Fee (CPAF)

- A cost reimbursement contract that provides for a fee consisting of:
  - A base amount fixed @ negotiation of the contract - does not vary with performance
  - An award amount that the contractor may earn in whole or in part based on performance

CPAF - Was a Fairly Popular Contract Type For Both Product and Service Contracting
Cost Plus Award Fee (CPAF)

- Used as a motivational tool to encourage efficient performance through the possibility of additional fee

- CPAF contracts provide for evaluation of contractor performance at stated intervals and the award of fee (or not) based on this performance
  - Regular intervals provides feedback on the quality of performance
  - Allows contractor the opportunity to address short comings or continue positive aspects

Less Popular As A Result of Recent Scrutiny of Awards Not Matching Performance.
Elements of a CPAF Contract

Estimated Cost
Base Fee
Maximum Fee
Award Periods
Evaluation criteria
Award Procedure

“The Award Fee Plan”

• Base Fee represents a floor on fee - incentive is all in the “Award Fee Pool” -
  – All incentive, no penalties
  – (Well, in reality, the penalty occurs by not earning the incentive!)

• Award Fee Pool - The dollar value of the difference between the maximum fee and the base fee.
The Award Fee Plan

• A written document attachment to the contract that defines ...

- The amount of award fee available, by period and for the total contract
- The award fee periods
  • Usually 6 months or longer to be meaningful
  • Often 11 months in a large, multi-year development effort
  • Cannot exceed 12 months (without agency exception)
- The accomplishment criteria for each period
- The Customer’s award fee process - Procedures for determination - how and who
  • Fee Determining Official (FDO) - a named individual
  • Award Fee Review Board - representatives from
    – Program Office
    – Technical Office
    – PCO (Contracts)
    – Finance
    – Security
    – Support Contractors
The Award Fee Plan and Evaluations and Determinations

• The award fee evaluation and determination is SUBJECTIVE
  
  – It is based largely on relationships between Contractor Program personnel at all levels and their Government counterparts
  – It is the determination of one individual based (maybe) on the collective inputs of other individuals
    • with all the “human baggage” an individual carries

• The award fee determination can be $0 - ouch!!!!!!!
**Award Fee Pool Capture Example**

**Given:**
- $1.0M award fee pool
- Five equal periods of 1/5th of pool

<table>
<thead>
<tr>
<th>Award Period</th>
<th>Amount Available $’s</th>
<th>Award Fee Rating</th>
<th>Dollar Capture</th>
<th>Cumulative Award Fee $’s</th>
<th>Award Fee $’s Lost *</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>200,000</td>
<td>70%</td>
<td>140,000</td>
<td>140,000</td>
<td>60,000</td>
</tr>
<tr>
<td>2</td>
<td>200,000</td>
<td>50%</td>
<td>-0-</td>
<td>140,000</td>
<td>200,000</td>
</tr>
<tr>
<td>3</td>
<td>200,000</td>
<td>86%</td>
<td>172,000</td>
<td>312,000</td>
<td>28,000</td>
</tr>
<tr>
<td>4</td>
<td>200,000</td>
<td>90%</td>
<td>180,000</td>
<td>492,000</td>
<td>20,000</td>
</tr>
<tr>
<td>5</td>
<td>200,000</td>
<td>94%</td>
<td>188,000</td>
<td>680,000</td>
<td>12,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,000,000</strong></td>
<td></td>
<td><strong>680,000</strong></td>
<td><strong>320,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

As %

- 100%
- 68%
- 32%

* Award Fee Lost Assumes No Rollover – Recent DoD Direction Precludes Rollovers
• “Award fee plan describes the organization, criteria, standards and procedures for evaluating contractor performance for determining and awarding an award fee, if any ...”

• “Provides an incentive for contractor to produce timely, high quality outputs that meet or exceed the requirements of the contract while stimulating efficient contractor performance”.

• Involves subjective determination(s) of Award Review Board (ARB) and Fee Determining Official (FDO).

• Determination made on their impression of your performance and what you tell them (informally and formal self-evaluation)
**CPAF Example**

Estimated Cost
- $10,000,000

Base Fee (2%)
- $200,000

Maximum Fee (12%)
- $1,200,000

Award Periods (See Plan)

Evaluation Criteria (See Plan)

Award Procedure (See Plan)

Award fee pool is $1,000,000

- **Under-runs to estimated cost simply means Government pays less**
  - Hopefully, under-run is through good performance and thus high award fee captures

- **Over-runs to estimated cost means Government must pay more and may reflect in AF capture.**
More Real Life Award Fee Plan Examples

Program Specific Award Fee Data

Evaluation Periods and Fee Allocations:

<table>
<thead>
<tr>
<th>Period</th>
<th>Evaluation Period</th>
<th>Available Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Contract Award to PDR</td>
<td>13%</td>
</tr>
<tr>
<td>II</td>
<td>PDR to CDR</td>
<td>15%</td>
</tr>
<tr>
<td>III</td>
<td>CDR to TRR</td>
<td>22%</td>
</tr>
<tr>
<td>IV</td>
<td>TRR to TRR plus 6 months</td>
<td>18%</td>
</tr>
<tr>
<td>V</td>
<td>TRR plus 6 months to end</td>
<td>32%</td>
</tr>
</tbody>
</table>

- Evaluation period ends at Milestone completion
- Government may UNILATERALLY change criteria PRIOR to start of period, and only by mutual agreement during a period.

Contractor Must Manage to the Criteria
## More Real Life Award Fee Plan Examples....

### Performance Evaluation Areas, Emphasis and Weightings

<table>
<thead>
<tr>
<th>Area</th>
<th>Period I</th>
<th>Period II</th>
<th>Period III</th>
<th>Period IV</th>
<th>Period V</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management</td>
<td>40%</td>
<td>30%</td>
<td>30%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Technical</td>
<td>25%</td>
<td>35%</td>
<td>35%</td>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>Cost</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Schedule</td>
<td>15%</td>
<td>15%</td>
<td>15%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Available Award Fee**

- Period I: 13%
- Period II: 15%
- Period III: 22%
- Period IV: 18%
- Period V: 32%
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Closing Thoughts

✓ When Properly Applied, Incentive Contracting Arrangements Can Be Powerful Motivators

✓ Risk and Reward Must Be Balanced

✓ Contract Structure Must Be Equitable – Must Encourage Efficient Performance
QUESTIONS?