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RESEARCH, DEVELOPMENT AND ACQUISITION
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MEMORANDUM FOR DISTRIBUTION

Subj: CONTRACT INCENTIVES, PROFITS AND FEES

One of our key responsibilities as acquisition professionals is to ensure Department of the Navy (DoN) acquisition programs satisfy the requirements they were established to address and do so within their planned funding profiles. The starting point for any successful acquisition program is determining valid and achievable cost and schedule targets. Once valid targets are agreed upon, the profit/fee and incentive arrangements we use in our contracts play an important part in determining how successfully we meet this responsibility.

Over the last year and a half, I have repeatedly emphasized the need to structure contracts in ways that will maximize the government's and the contractor's efforts to meet technical and schedule performance requirements and to control costs. Efforts to link technical and schedule performance to incentives and targets will ensure the government team has, at an early stage, the required thorough understanding of program risk, technical hurdles, cost and a detailed schedule which illuminates the critical path. Once valid, mutually agreed targets and incentives are established, the government and industry team will have to work together to avoid unfunded requirements change and to carefully manage integration issues such as government furnished items. I encourage you to share the following guidance throughout our acquisition workforce and carry it out within your organization.

- When incentive contracts are appropriate, aggressive cost sharelines should be included wherever appropriate. This is true for both fixed-price-incentive (FPI) contracts and cost-plus-incentive-fee (CPIF) contracts. Aggressive sharelines should provide for the contractor to share a substantial portion of any savings when costs are less than the target costs and a substantial portion of any additional costs when costs exceed the target. In most cases a shareline of at least 50/50 should be considered. The sharelines can be moderated within a

reasonable region of uncertainty around the target, but should be steeper above and below this region.

- Greater contractor shares may be particularly useful in encouraging underruns and preventing significant overruns. Use of sharelines that increase the contractor's share if cost savings or overruns increase should be considered. For example, in many cases it may be appropriate to use a 50/50 share line for cost outcomes that are within plus or minus 5% of the target costs and 40/60 or 30/70 for other cost outcomes. Similarly, in certain circumstances, a "broken" shareline can be an effective tool to focus contractor management attention on avoiding cost overruns. A broken shareline can provide a substantial increase (or reduction) in profit based on achieving (or not achieving) a specific cost threshold. For example, if target profit were set at 10%, a contract might provide for no adjustment to profit for cost outcomes within ± 2% of target cost, but an immediate increase of 1% for staying under 98% (or reduction of 1% for exceeding 102%). These steps in the profit will focus aggressive management attention on controlling costs if the estimate at completion begins to rise above the target. Negotiated share ratios would then govern above 102% and below 98%. Incentive arrangements that decrease the contractor's share if overruns increase should not normally be used since they may weaken contractors' resolve to control costs if cost overruns grow.

- Performance incentives, based on measurable and objective criteria, should be considered for use in all contracts for other than routine, well-defined requirements where performance goals have already been achieved. When FPI or CPIF contracts are used, consideration should be given to splitting the total profit/fee potential into two parts, with one part tied to cost performance and the other tied to technical and/or schedule performance. For example, if weighted guidelines support a target profit of 14% for a FPI contract, the target profit included in the contract for the cost incentive might be 7%, with the remaining 7% available for objective, measurable performance incentives. In crafting these arrangements, contracting officers need to carefully consider the range in which incentives will be most effective and to balance the various incentives to ensure they work together effectively to support the objectives of the acquisition across the entire term of the contract.

- Award fees, in either fixed price or cost-reimbursement contracts, may be used in circumstances where it is appropriate to evaluate the contractor's performance, in part, on the basis of subjective, judgmental factors. In these cases, a significant portion of the evaluation should also be based on objective, measurable criteria.

- If minimum/base fees are included in CPIF or award-fee contracts, they should be sufficiently limited to ensure they do not undermine the effectiveness of the incentive or award structure. Incentive structures that provide for either no minimum fee or even a negative fee may be appropriate in some cases.

Please note that the use of these incentives will emphasize the importance of the responsibilities of DoN program managers, specifically, to manage all government-responsible aspects of the program so that industry is in a position to meet its milestones and contract obligations. Program managers must manage government furnished equipment (GFE), government testing and government facilities on a comparably detailed schedule to ensure we meet our contractual commitments, upon which contractors rely in order to achieve or exceed all contractual milestones. In this regard, government program managers must pay careful and responsive attention to issues presented by industry regarding potential impacts from GFE delivery, unfunded requirements change and uncoordinated DoN prioritization of other work within a facility.

As noted above, this memorandum highlights strategies and considerations for DoN contracting officers and acquisition teams in using their sound business judgment to select the most appropriate contract type and structure, as discussed in Part 16 of the Federal Acquisition Regulation (FAR) and the Defense FAR Supplement. There may be circumstances that justify a strategy at variance with these positions. In such cases, different arrangements may be pursued, but the rationale for their use should be fully supported in the relevant acquisition planning documents.

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This memorandum expands upon similar guidance issued by the Deputy Assistant Secretary of the Navy (Acquisition Management) in April 2003. I welcome your ideas on how we can continue to improve the effectiveness of our acquisitions in supporting the warfighter.

John J. Young

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