



SECRETARY OF THE AIR FORCE
WASHINGTON

04 APR 2006

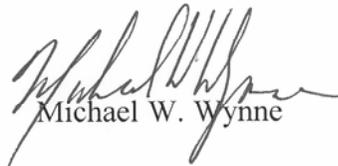
MEMORANDUM FOR SEE DISTRIBUTION

SUBJECT: Contract Incentives (Policy 06A-003)

It is critically important our Air Force acquisition activities implement contract incentive strategies to consistently motivate excellent contract performance while ensuring cost, schedule, and technical performance control. On 29 March 2006, the Department of Defense (DoD) released a policy (Attachment) on "Award Fee Contracts (FAR 16, DFARS 215, DFARS 216)." In compliance with that DoD policy, I am convinced the way to accomplish this is through implementing 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.

As a first step, we must make a cultural shift in the way the Air Force incentivizes contractors. In some cases, our current process has resulted in high award fees for performance that does not merit such a fee. We must change this practice! Incentives must emphasize cost, schedule and technical performance as they relate to program outcomes and successful end-item delivery or performance. When implementing incentive type contracts, we should initially focus on incentives based wholly on objectively verifiable criteria (i.e., Fixed Price Incentive Fee/Cost Plus Incentive Fee contracts). Award Fee contracts, when used, should be structured to motivate superior contractor performance and then award earned fee only for realized successful performance. Award fee contracts should be structured to include a base fee as well as a combination of objective (performance related) and, as appropriate, subjective criteria. The proper combination of these criteria will work to ensure contractor emphasis on program success and to provide the program manager the flexibility required to incentivize performance. For future contracts and to the extent current contracts can be adjusted, I expect award fee recommendations to reward only realized superior performance leading to successful end-item delivery or performance. Additionally, award fee decisions will be consistent with Contractor Performance Assessment Reports (CPAR) and System Metric and Reporting Tool (SMART) data when available.

I understand there is no "one size fits all" with regard to incentive strategies, but we must use methods to reward performance motivating the contractor to deliver all contractual requirements in a superior manner. To this end, we are revising our contract incentive guides to address these issues. We all must continue to pursue ways to accomplish our goal to incentivize exceptional contractor performance. Along with you, I will continue to work with our industry partners to ensure our incentive strategies have the desired outcomes as we move forward to implementation.


Michael W. Wynne

Attachment:
USD(AT&L) Policy, 29 Mar 06

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MAR 29 2006

ACQUISITION,
TECHNOLOGY
AND LOGISTICS

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
(ATTN: ACQUISITION EXECUTIVES)
DIRECTORS OF THE DEFENSE AGENCIES

SUBJECT: Award Fee Contracts (FAR 16, DFARS 215, DFARS 216)

Award fee contracts must be structured in ways that will focus the government's and contractor's efforts on meeting or exceeding cost, schedule, and performance requirements. The ability to earn award fees needs to be directly linked to achieving desired program outcomes. In December 2005, the Government Accountability Office (GAO) issued a report, entitled "DEFENSE ACQUISITIONS: DoD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes" <http://www.gao.gov/new.items/d0666.pdf>, which made a number of recommendations on how to improve the use of award fees.

In the DoD response dated December 12, 2005, the Department generally concurred with the recommendations in the report and agreed to issue a policy memo by March 31, 2006, to (1) address desired outcomes and the role the award fee should play in the overall acquisition strategy; (2) remind the acquisition workforce to follow existing policies; (3) provide guidance to the acquisition workforce on "rollover"; and (4) develop a communication plan to share proven incentive strategies across the entire DoD acquisition workforce. These actions correspond to Recommendations 1, 2, 4 and 7, respectively, in the GAO report. Separately the Department will respond to Recommendations 3, 5 and 6 of the report at a later time. While award fee contracts are intended to be flexible, this memorandum provides additional guidance on the proper use of award fees.

Link Award Fees to Desired Outcomes (GAO Recommendation 1)

While award fee contracts are used when it is neither feasible nor effective to devise predetermined objective performance targets, it is imperative that award fees be tied to identifiable interim outcomes, discrete events or milestones, as much as possible. Examples of such interim milestones include timely completion of preliminary design review, critical design review, and successful system demonstration. In situations where there may be no identifiable milestone for a year or more, consideration should be given to apportioning some of the award fee pool for a predetermined interim period of time



based on assessing progress toward milestones. In any case, award fee provisions must clearly explain how a contractors' performance will be evaluated.

Award Fees Must Be Commensurate with Contractor Performance (GAO Recommendation 2)

While award fee arrangements should be structured to motivate excellent contractor performance, award fees must be commensurate with contractor performance over a range from satisfactory to excellent performance. Clearly, satisfactory performance should earn considerably less than excellent performance, otherwise the motivation to achieve excellence is negated. However, because base fees are typically limited to no more than three percent of target cost (DFARS 216.405-2), it is appropriate to award a portion of the award fee pool for satisfactory performance to ensure that contractors receive an adequate fee on our contracts. Performance that is less than satisfactory is not entitled to any award fee.

Rollover of Award Fees (GAO Recommendation 4)

An element of many award fee plans is the ability to "roll over" unearned award fee money from one period to another. The following limitations on the use of "rollover" are established:

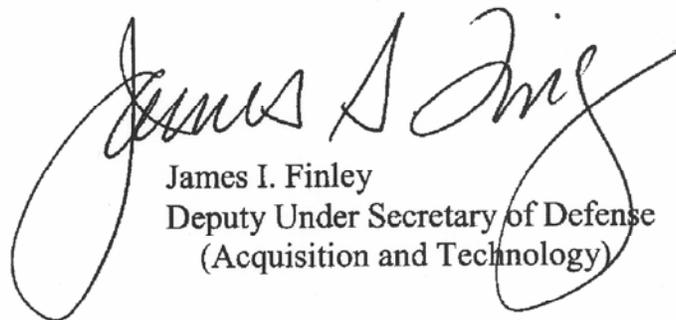
- Use of a "rollover" provision should be the exception rather than the rule.
- Use of an award fee rollover provision is a business decision and should be addressed in the acquisition strategy, including the rationale as to why a rollover provision is appropriate.
- If "rollover" is used, the contractor may only earn a portion of the fee that was rolled over, even for subsequent excellent performance. Factors to consider in determining how much to reduce the available rollover fee include, how close the contractor came to meeting the scheduled milestone, in terms of cost, schedule and performance. For example, the reduction in rollover fees for missing a milestone by a year should be significantly greater than for missing a milestone by 30 days.
- If the Fee Determining Official approves the use of "rollover," the official contract file must be documented accordingly and the contractor must be notified.

Communication Plan (GAO Recommendation 7)

In order to facilitate discussion and to share proven incentive strategies across the entire acquisition workforce, the Department has established the "Award and Incentive Fees" Community of Practice (CoP) under the leadership of the Defense Acquisition University (DAU). The CoP will serve as the repository for all related materials including policy information, related training courses, examples of good award fee

arrangements, and other supporting resources related to this policy memorandum. The CoP is available on the DAU Acquisition Community Connection at <https://acc.dau.mil/awardandincentivefees>.

This policy memorandum is effective immediately. The DFARS and/or its PGI supplement will be revised to reflect the policy contents of this memorandum. Please direct any questions to Michael Canales at 703-695-8571 or e-mail Michael.Canales@osd.mil.

A handwritten signature in black ink, appearing to read "James I. Finley". The signature is stylized with large loops and a long horizontal stroke extending to the right.

James I. Finley
Deputy Under Secretary of Defense
(Acquisition and Technology)