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Advisory

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Incentive Strategies for Performance-Based Contracting

Office of Federal Procurement Policy (OFPP) Policy Letter 91-2 (Service Contracting) *requires agencies to use performance-based contracting*. This includes the careful selection of "acquisition and contract administration strategies, methods, and techniques that best accommodate the requirements." This policy was reinforced last year when "Raines' Rules"[1] called for agencies to adopt acquisition strategies that properly allocate and manage risks between the government and its contractors.

Irrespective of current policies, however, it simply makes good business sense to provide the proper contract motivations to encourage high-quality contractor performance. One way to accomplish this business goal is to "craft" acquisition strategies that make effective use of incentives. The appropriate selection and use of incentives can "make-or-break" acquisition success — especially when acquiring high technology services. *What types of incentive structures can be employed by agencies?*

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There are seven broad types of incentives[2] that agencies should consider in developing a performance-based acquisition strategy. They are:

- ◊ Use of Incentive Contracts,
- ◊ Modular Strategies,
- ◊ Options as Incentives,
- ◊ Multiple Awards,
- ◊ Payment Strategies,
- ◊ Value Engineering, and
- ◊ Past Performance Evaluation and Recognition.

Use of Incentive Contracts

Determining the *type of contract* to use is normally the first (and, arguably, the most important) type of incentive considered. This is because contract types differ in their allocation and balance of cost, schedule, and technical risks between government and contractor. As established by FAR Part 16 (*Types of Contracts*), contract types vary in terms of:

- ◊ The degree and timing of the risk and responsibility assumed by the contractor for the costs of performance, and

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◊ The amount and nature of the profit incentive offered to the contractor for achieving or exceeding specified standards or goals.

The government's obligation is to assess its requirements and the uncertainties involved in contract performance and select from the contractual spectrum a contract type and structure that places an appropriate degree of risk, responsibility, and incentives on the contractor for performance.

At one end of the contractual spectrum is the firm-fixed-price contract, under which the contractor is fully responsible for performance costs and enjoys (or suffers) resulting profits (or losses). At the other end of the spectrum is the cost-plus-fixed-fee contract,[3] in which allowable and allocable costs are reimbursed and the negotiated fee (profit) is fixed — consequently, the contractor has minimal responsibility for, or incentive to control, performance costs.

In between these extremes are various incentive contracts, including:

◊ *Fixed-price incentive contracts* (in which final contract price and profit are calculated based on a formula that relates final negotiated cost to target cost): these may be either *firm target* or *successive targets.*

◊ *Fixed-price contracts with award fees* (used to "motivate a contractor" when contractor performance *cannot be measured objectively*, making other incentives inappropriate): this contract type was not specifically described in the FAR until this past March (when it was added by Federal Acquisition Circular 90-46).

◊ *Cost-reimbursement incentive contracts* (used when fixed-price contracts are inappropriate, due to uncertainty about probable costs): these may be either *cost-plus-incentive-fee* or *cost-plus-award-fee*.

Incentives need not be limited to *cost*; they can vary depending on the acquisition and performance goals, requirements, and risks. For example, agencies can also incorporate *delivery* incentives and *performance* incentives — the latter related to contractor performance and/or specific products' technical performance characteristics, such as speed or responsiveness. *Incentives are based on target performance standards, not minimum contractual requirements.*

Clearly, the decision about the appropriate type of contract to use is closely tied to the agency's need and can go a long way to motivating superior performance — or contributing to poor performance and results. For example, if an agency decided against (the more suitable) cost-reimbursement-type contract and instead adopted a firm-fixed-price structure for a complex software deliverable, the contractor *could* conclude during performance that a dollar "saved" by delivering substandard performance equals a dollar of profit. The result could well be a marginal product and an unhappy customer.

One final point. The decision on contract type is not necessarily either-or. Hybrid contracts — those with both fixed-price and cost-type tasks — are becoming more common, especially when acquisitions are constructed modularly.

Modular Strategies

Modular contracting is an important incentive strategy. Rather than awarding mega-contracts that give contractors a lock on huge amounts of agency business for years — (the incentive being to win the contract, not necessarily to provide superior performance after award) — the agency instead constructs its acquisition strategy in successive "chunks." Under modular contracting, future business is much more dependent on successful contract or task performance, and contractors have an increased incentive to perform at a high level so they are awarded the next task, option, or contract. So, concurrent with the contract-type decision, is the consideration of whether modular strategies are appropriate.

[Note: For more on this topic, see the February 1997 *Advisory* on modular contracting. Refer also to the Index in your *Acquisition Directions* binder. In addition, ASI is assisting the General Services Administration in development of guidance on modular contracting; you should have received from us the "white paper" document for information and comment.]

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Use of Options

An option is the government's unilateral right (within a specified time) in a contract to purchase (or not to purchase) additional supplies or services — or to extend (or not to extend) the term of the contract.

To increase contractor incentive and motivation, the solicitation and contract should indicate that the government's future decision to exercise contractual options for additional quantities, tasks, or time is, in significant part, contingent on the contractor's successful performance. The more specific the standards of performance, the more likely the contractor will achieve them — because at stake are *both* successful performance evaluation and additional business under the contract.

Multiple Awards

It is often advisable — and sometimes required[4] — to make multiple awards in order to maintain competitive pressure during contract performance. Competitive pressure, before and after award, acts as an incentive on contractors.

Multiple award is generally preferred under FAR 16.504(c) for indefinite-quantity contracts. These types of contracts provide for "an indefinite quantity, within stated limits, of supplies or services to be furnished during a fixed period, with deliveries or performance to be scheduled by placing orders with the contractor." Task order contracts are indefinite-quantity contracts.

Payment Strategies

Another incentive strategy is to "tie pay to performance," not just by the use of incentive and award fees, but also by tailoring to performance objectives the acceptance provisions (and thus payment) for contract deliverables. If the requirement is framed as a series of deliverable products or specific services, then *performance and acceptance precede payment*. This is in sharp contrast to time-and-materials contracts, labor-hour type contracts, and some task order

contracts, in which the government pays monthly for hours used rather than for products delivered.

Value Engineering

Value engineering (FAR Part 48) is a process used by contractors (normally in research and development or production efforts) to suggest to the government methods for performing more economically; under the process contractors share in the resulting savings. Value engineering typically involves an analysis of the functions of a program, project, system, product, item of equipment, building, facility, service, or supply of an executive agency. The purpose is to eliminate anything that increases acquisition, operation, or support costs, without impairing essential functions or characteristics. For value engineering to be effective, agencies must have an accurate baseline of current costs.

[Note: Contractors rewarded under other contract incentives are *not* also eligible for value engineering benefits, as described in FAR 48.105.]

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Past Performance Evaluation and Recognition

Because of the increased importance the government now places on past performance in selecting contractors for award, contract performance evaluation has become a powerful incentive. Agencies are *currently* required to evaluate contractor performance on all contracts valued in excess of $1,000,000.[5]

FAR 42.1501 describes past performance information as “relevant information, for future source selection purposes, regarding a contractor’s actions under previously awarded contracts.” It includes, for example, the contractor’s:

◊ Record of conforming to contract requirements and to standards of good workmanship,
◊ Record of forecasting and controlling costs,
◊ Adherence to contract schedules, including the administrative aspects of performance,
◊ History of reasonable and cooperative behavior and commitment to customer satisfaction, and
◊ Business-like concern for the interest of the customer.

To the extent possible, the government’s approach to evaluating these measures of conformance and quality, timeliness, cost control, responsiveness, and customer satisfaction should be described in the solicitation and contract.

Other evaluation-related incentives may lie outside the contractual effort and should not be overlooked. Consider, for example, the prestige and publicity associated with the Department of Commerce’s Malcolm Baldridge National Quality award. Agencies may add to their incentive arsenal by establishing “award” programs for contractors, such as a competition for “contractor of the year” or designation to a “five-star contractor” list.

Related Elements: Acceptance and Quality Assurance

An important aspect of incentivizing performance is describing what is acceptable. Acceptance is the government's "acknowledgment that the supplies or services conform with applicable contract quality and quantity requirements." Acceptance may or may not involve quality assurance processes (FAR 46), and typically precedes payment (unless contract financing methods are used).

Best Practices

In an article published in the February 1995 issue of *Contract Management*,[6] Gregory A. Garrett identified fifteen best practices related to contract incentives. They are:

- ◊ Think creatively.
- ◊ Avoid rewarding contractors for simply meeting contract requirements.
- ◊ Recognize that developing clear, concise, objectively measurable technical performance incentives will be challenging. Plan accordingly.
- ◊ Create a proper balance of objective incentives — cost, schedule, and technical.
- ◊ Ensure that the performance incentives focus the contractor's efforts on the most important objectives.
- ◊ Make performance incentives challenging but attainable.
- ◊ Ensure that incentives motivate the contractor to measurable quality control processes.
- ◊ Consider linking on-time delivery to technical performance.
- ◊ Recognize that not everything can be objectively measured.
- ◊ Encourage open communications and permit contractors to comment on the performance-based work statement (PWS).
- ◊ Consider including socio-economic incentives.
- ◊ Use clear, objective formulas for determining the technical performance incentives.
- ◊ Use a combination of positive and negative incentives.
- ◊ Include incentives for overhead cost control.
- ◊ Make sure that applicable FAR fee limitations are not exceeded.

To these we would add:

- ◊ Consider acquisition history — what factors contributed to past successes and failures in meeting goals and fulfilling needs?
- ◊ Identify the magnitude of technical, cost, and schedule risks.
- ◊ Involve users, program, technical, acquisition, and financial staff in incentive planning.
- ◊ Make sure that incentives are closely related to the performance objectives in the PWS — and that those objectives reflect the agency's program planning under the Government Performance and Results Act (GPRA) as well as the IRM strategic plan.
- ◊ Keep the focus on performance; limit other requirements.

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◊ Keep the structure and administration as simple as possible.

◊ Be sure to include incentives for quality, even though they are difficult to describe.

◊ Remember that subjective evaluation has its place in encouraging and recognizing outstanding performance — how else could "business-like concern" for agency needs be assessed?

Conclusion

Development of an incentive strategy is an important aspect of an acquisition strategy, especially in performance-based contracting. *Appropriate incentives vary* based on the agency's specific needs — and are most effective when integrated within the solicitation and contract, and with strategic program (GPRA) and investment planning.✧

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Note: This *Advisory* is the third in a series on performance-based contracting. See also *Performance-Based Contracting* (June 1997) and *Performance as a Framework for Acquisition* (July 1997).

[1] See the January 1997 *Update* and March 1997 *Advisory*.

[2] Note that incentives should be balanced by disincentives, which are often the "flip side" of incentives — such as reduced fees under incentive contracts, poor ratings on performance evaluations, lapsed options, and unextended contracts. Other disincentives include, for example, liquidated damages provisions, maintenance (downtime) credits, and contract terminations.

[3] The cost-plus-a-percentage-of-cost contract is prohibited by law [10 U.S.C. 2306(a) and 41 U.S.C. 254(b)].

[4] The Federal Acquisition Streamlining Act of 1994 requires multiple awards of task order contracts for advisory and assistance services that will exceed three years and $10 million (including all options).

[5] By memorandum on December 16, 1996, OFPP suspended for an indefinite period the requirements of FAR 15.605 and 42.1502, that would otherwise mandate performance evaluation on contracts less than $1,000,000.

[6] Garrett, Gregory A., "Performance-Based Contracting Incentives: Myths, Best Practices, and Innovations," Contract Management, February 1995.

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