EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

OFFICE OF FEDERAL
PROCUREMENT POLICY

December 4, 2007

MEMORANDUM FOR CHIEF ACQUISITION OFFICERS
SENIOR PROCUREMENT EXECUTIVES

FROM: Paul A. Denett
Administrator

SUBJECT: Appropriate Use of Incentive Contracts

Incentive contracts are used throughout the Federal Government to encourage contractors to perform efficiently and effectively. Using incentives appropriately and applying strong project and acquisition management practices are vital to accomplishing mission needs, minimizing waste, and maximizing value. The purpose of this memorandum is to request your assistance and leadership to ensure incentive fee contracts are used to motivate excellent contractor performance. Specifically, please review your agency's acquisition policies to ensure that: 1) incentive fees are linked to acquisition outcomes such as cost, schedule, and performance results; and 2) incentive fees are not earned if the contractor's performance is judged to be below satisfactory or does not meet the basic requirements of the contract.

The Federal Acquisition Regulation (FAR) states that incentive fee contracts, which include award fee contracts, should be used to achieve specific performance objectives established prior to contract award, such as delivering products and services on time, within cost goals, and with promised performance outcomes. Awards must be tied to demonstrated results, as opposed to effort, in meeting or exceeding specified performance standards.

Recently, the Government Accountability Office (GAO) identified programs and supporting contracts in which incentive fee payment practices did not result in achievement of contract objectives. GAO identified the following practices that reduce the effectiveness of fees as a motivational tool: 1) evaluating contractors on incentive criteria that are not directly related to cost, schedule, and performance goals; 2) paying contractors a significant portion of the available fee for what is considered acceptable or satisfactory performance; and 3) giving contractors additional opportunities to obtain initially unearned fees, also known as rollover fees.

As part of acquisition planning, when determining whether to use incentive fee contracts, the contracting officer should conduct risk and cost benefit analyses. Contract type is generally determined based on a consideration of risk to the government and the contractor. In addition to risk, cost benefit analyses related to use of incentive contracts should consider the amount of planning required to implement an incentive type contract and the amount of additional resources required for monitoring and determining awards. Risk and cost analyses related to the use of award and incentive contracts should be prepared in writing and approved at a level above the contracting officer or as determined by the agency.

Incentive fees must be predetermined in writing and processes for awarding the fees must be included or cross-referenced in the acquisition plan (see FAR 7.105(b)(4)(i)). This incentive fee plan should include standards for evaluating contractor performance and appropriate incentive fee amounts. When considering the incentive fee arrangement, the plan should distinguish between earning potential for satisfactory versus excellent performance. Metrics should clearly describe what is required and at what point a contractor is considered successful. Additionally, agencies should develop guidance on when it is appropriate to award rollovers of unearned fee to a subsequent evaluation period. Rolling over fees is not the preferred method for incentivizing the contractor to perform above satisfactorily and should be permitted on a limited basis and require prior approval of the appropriate agency official.

Using the attachment as a guide, Chief Acquisition Officers should review and update existing agency guidance on incentive fee contracting practices to ensure that fees are awarded in accordance with current regulations and that the guidance addresses the concerns of this memorandum. In addition, during an agency's internal audit process, incentive fee contracts should be reviewed as part of the program management review process. Information on how well incentive fees are achieving their intended purpose and other related lessons learned can be found and shared on the Acquisition Community Connection on https://acc.dau.mil/CommunityBrowser.aspx?id=105550&lang=en-US.

To help develop best practices, guidance, and templates, OFPP requests that agencies identify an incentive and award fee point of contact. These individuals may be asked to contribute examples and lessons learned to an interagency working group or to assist in communication and awareness efforts. Please submit the person's name, title, telephone number, and e-mail address to Susan Truslow at OFPP by January 7, 2008.

Please ensure broad dissemination of this memorandum among agency personnel who have responsibilities for the effective planning, execution, and management of your acquisitions. Questions may be referred to Susan Truslow at (202) 395-6810 or struslow@omb.eop.gov or Pat Corrigan at (202) 395-6805 or pcorrigan@omb.eop.gov .

Thank you for your attention to this important matter.

Attachment

cc: Chief Information Officers

Attachment

Incentive Contract Checklist

- Consult agency policy and guidance that supplement FAR 16.4, Incentive Contracts.
- Ensure market research documentation and the acquisition plan sufficiently state desired outcomes, performance requirements, milestones, risks and cost benefits associated with choice of contract type (FAR 7.105).
- Conduct and document risk and cost/benefit analyses that support use of an incentive type contract:
  - Conduct a risk assessment and ensure incentive strategies are consistent with the level of risk assumed by the contractor and motivate the contractor by balancing awards with negative consequences;
  - Determine whether administrative costs associated with managing the incentive fee are outweighed by the expected benefits; and
  - Ensure sufficient human resources are available to properly structure and monitor the contract.
- Ensure evaluation factors are:
  - Meaningful and measurable;
  - Directly linked to cost, schedule, and performance results; and
  - Designed to motivate excellence in contractor performance by making clear distinctions in possible award earnings between satisfactory and excellent performance.
- Ensure the incentive fee plan:
  - Defines clearly the standards of performance for each rating category (e.g., satisfactory, above satisfactory, excellent);
  - Defines clearly the percentage of fee the contractor should be paid for each of these rating categories;
  - Documents roles and responsibilities for those involved in monitoring contractor performance and determining award fees;
  - Provides detailed guidance on steps in the evaluation process for agency representatives and contractors;
  - Establishes a base fee. Good business practice allows the contractor more than 0% for base fee. This way, the award fee promotes above average performance; and
  - Obtains appropriate approval in accordance with agency policy.
- Ensure rollover fees are allowed only in limited circumstances in accordance with agency policy.