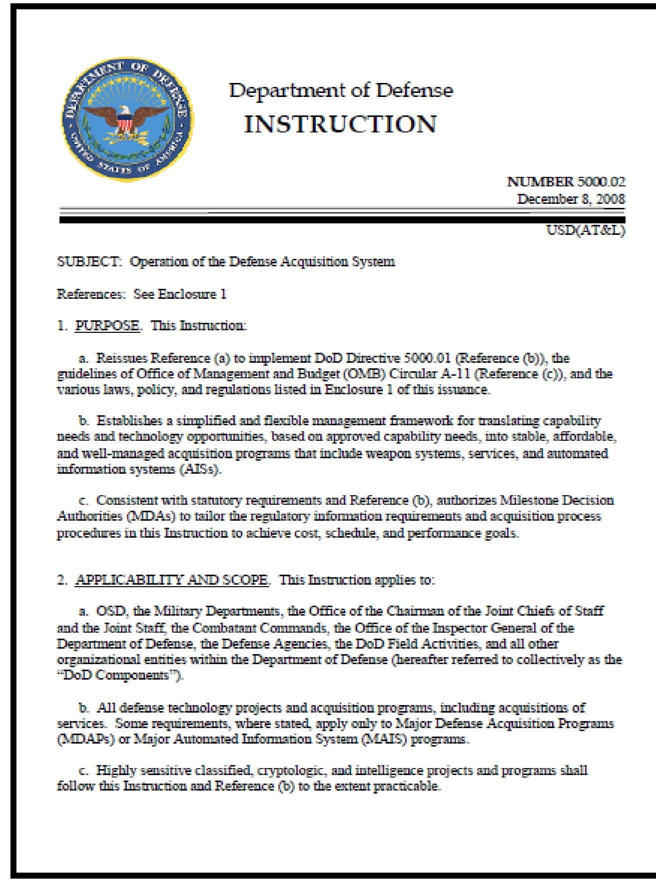
Product Support Manager Conference
June 2012

Presentation on:

Contracting Strategies and Incentives

What is an Acquisition Strategy?

- An Acquisition Strategy is a high-level, but comprehensive, integrated business and technical management approach that the Program Manager will follow to manage program risks and to achieve program objectives within specified resource constraints
- The Acquisition Strategy explains the essential aspects of a program which must include:
  - The cost, schedule and performance implications or trades related to risks and risk mitigation
  - The planned contract incentive structure to be used for each phase of the program
  - How the PM plans to employ contract incentives to achieve required cost, schedule, and performance outcomes and mitigate the associated risks in each program phase
  - How any multiple incentives will complement and not interfere with one another



Department of Defense
INSTRUCTION

NUMBER 5000.02
December 8, 2008

USD(AT&L)

SUBJECT: Operation of the Defense Acquisition System

References: See Enclosure 1

1. PURPOSE. This Instruction:

a. Reissues Reference (a) to implement DoD Directive 5000.01 (Reference (b)), the guidelines of Office of Management and Budget (OMB) Circular A-11 (Reference (c)), and the various laws, policy, and regulations listed in Enclosure 1 of this issuance.

b. Establishes a simplified and flexible management framework for translating capability needs and technology opportunities, based on approved capability needs, into stable, affordable, and well-managed acquisition programs that include weapon systems, services, and automated information systems (AISs).

c. Consistent with statutory requirements and Reference (b), authorizes Milestone Decision Authorities (MDAs) to tailor the regulatory information requirements and acquisition process procedures in this Instruction to achieve cost, schedule, and performance goals.

2. APPLICABILITY AND SCOPE. This Instruction applies to:

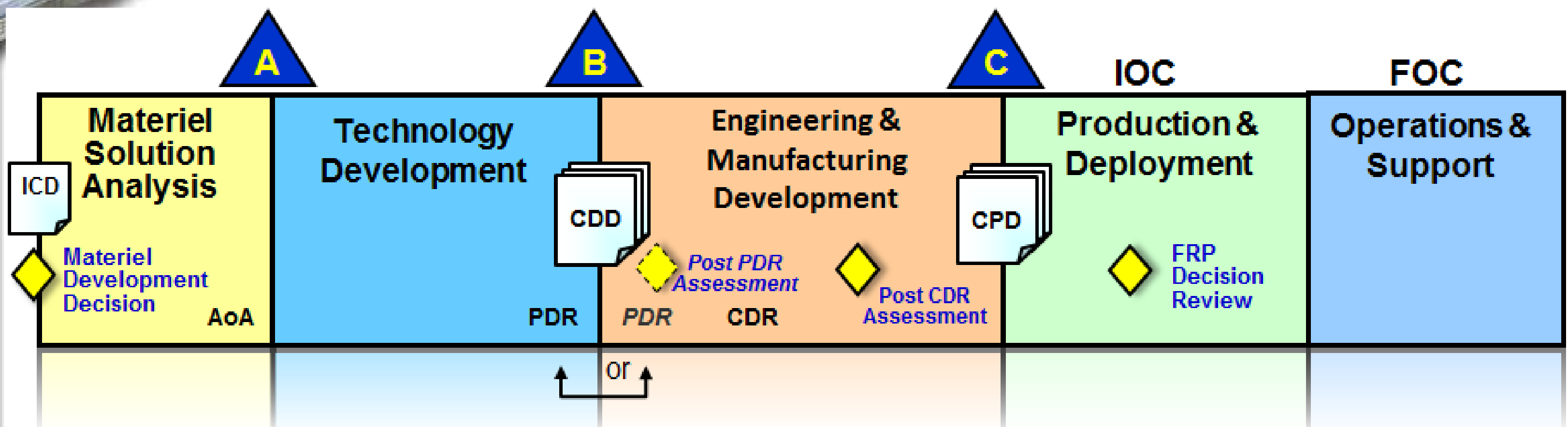
a. OSD, the Military Departments, the Office of the Chairman of the Joint Chiefs of Staff and the Joint Staff, the Combatant Commands, the Office of the Inspector General of the Department of Defense, the Defense Agencies, the DoD Field Activities, and all other organizational entities within the Department of Defense (hereafter referred to collectively as the "DoD Components").

b. All defense technology projects and acquisition programs, including acquisitions of services. Some requirements, where stated, apply only to Major Defense Acquisition Programs (MDAPs) or Major Automated Information System (MAIS) programs.

c. Highly sensitive classified, cryptologic, and intelligence projects and programs shall follow this Instruction and Reference (b) to the extent practicable.

DoD Instruction 5000.02

The Acquisition Life Cycle Continuum



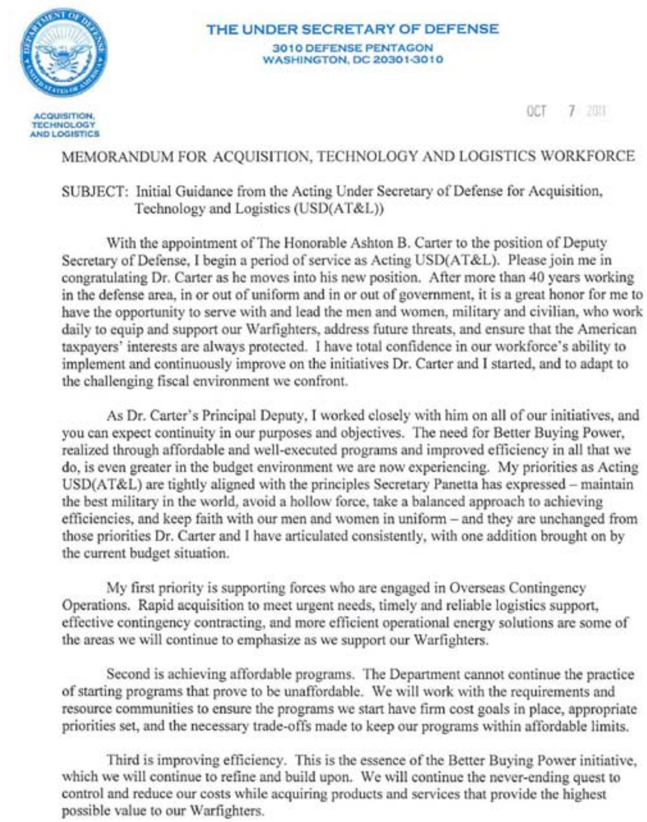
Acquisition Strategy Considerations during the Life Cycle . . .

- Formulate clear objectives based on market research, industry evaluation, available resources and real world conditions
- Perform contract type and incentives trades-offs based on the most important programmatic objectives, goals and outcomes the PM desires to achieve and based on an assessment of associated risks
- Weight cost, schedule or technical incentives as necessary to efficiently achieve desired outcomes and risk reduction for each program phase

- **Acquisition Strategy will drive the Contract Incentive Strategy**
- **Strategies evolve as systems evolve through each life cycle phase**

Importance of Contract Incentive Arrangements
USD(AT&L) Priorities – *Oct 7, 2011*

- Achieving affordable programs. Ensure the programs we start have firm cost goals in place, appropriate priorities set, and the necessary trade-offs made to keep within affordable limits.
- Improving efficiency. The essence of the Better Buying Power initiative. Control and reduce our costs while acquiring products and services that provide the highest possible value.
- Strengthening the industrial base. Means a profitable industrial base ***but also*** a lean and efficient base that provides good value for the taxpayers' defense investments and that increases in productivity over time. We will execute contracts with industry that include appropriate incentives and drive fair business deals that protect the taxpayers' interest, while providing industry with reasonable profit opportunities and without putting industry at unacceptable risk.



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ACQUISITION, TECHNOLOGY AND LOGISTICS

OCT 7 2011

MEMORANDUM FOR ACQUISITION, TECHNOLOGY AND LOGISTICS WORKFORCE

SUBJECT: Initial Guidance from the Acting Under Secretary of Defense for Acquisition, Technology and Logistics (USD(AT&L))

With the appointment of The Honorable Ashton B. Carter to the position of Deputy Secretary of Defense, I begin a period of service as Acting USD(AT&L). Please join me in congratulating Dr. Carter as he moves into his new position. After more than 40 years working in the defense area, in or out of uniform and in or out of government, it is a great honor for me to have the opportunity to serve with and lead the men and women, military and civilian, who work daily to equip and support our Warfighters, address future threats, and ensure that the American taxpayers' interests are always protected. I have total confidence in our workforce's ability to implement and continuously improve on the initiatives Dr. Carter and I started, and to adapt to the challenging fiscal environment we confront.

As Dr. Carter's Principal Deputy, I worked closely with him on all of our initiatives, and you can expect continuity in our purposes and objectives. The need for Better Buying Power, realized through affordable and well-executed programs and improved efficiency in all that we do, is even greater in the budget environment we are now experiencing. My priorities as Acting USD(AT&L) are tightly aligned with the principles Secretary Panetta has expressed – maintain the best military in the world, avoid a hollow force, take a balanced approach to achieving efficiencies, and keep faith with our men and women in uniform – and they are unchanged from those priorities Dr. Carter and I have articulated consistently, with one addition brought on by the current budget situation.

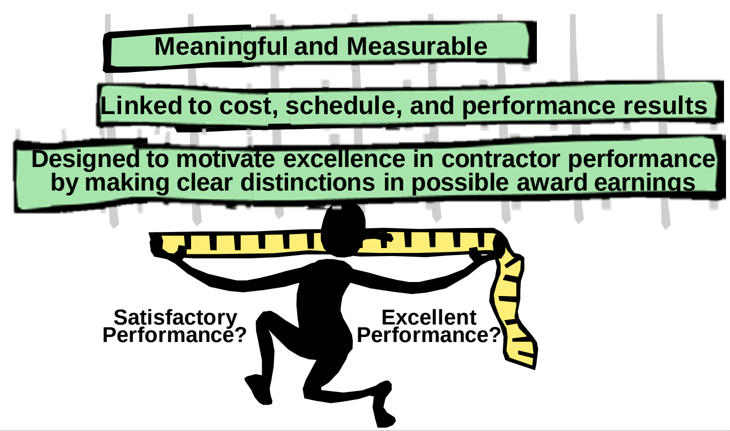
My first priority is supporting forces who are engaged in Overseas Contingency Operations. Rapid acquisition to meet urgent needs, timely and reliable logistics support, effective contingency contracting, and more efficient operational energy solutions are some of the areas we will continue to emphasize as we support our Warfighters.

Second is achieving affordable programs. The Department cannot continue the practice of starting programs that prove to be unaffordable. We will work with the requirements and resource communities to ensure the programs we start have firm cost goals in place, appropriate priorities set, and the necessary trade-offs made to keep our programs within affordable limits.

Third is improving efficiency. This is the essence of the Better Buying Power initiative, which we will continue to refine and build upon. We will continue the never-ending quest to control and reduce our costs while acquiring products and services that provide the highest possible value to our Warfighters.

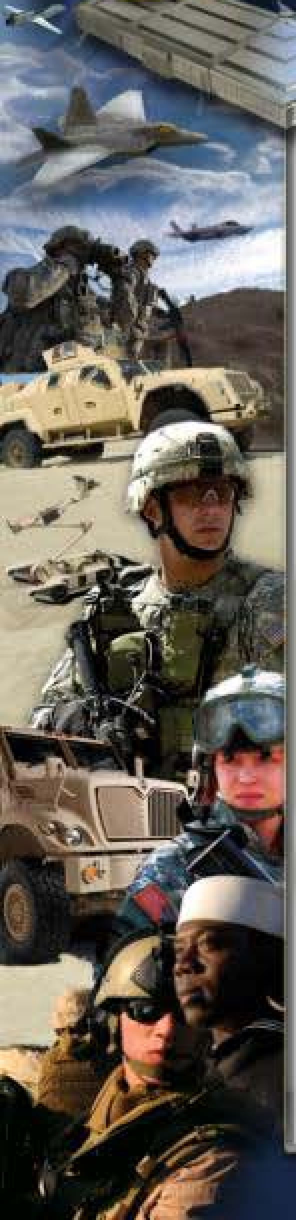
How Can DoD Achieve These Objectives?

- Engage Program Managers and requiring officials to think through what's important and what's not so that we incentivize what's important
- Effective incentive contracting
  - Stimulates such desired action and motivates the contractor to achieve performance that is in the best interest of the Government
  - Must be based on the facts and circumstances of each acquisition and be tailored to what defines success for that acquisition
- Profit objective and incentives must be tied to delivering the required capability on time and at the expected cost
  - Reward contractors through increased profit for attaining objectives more beneficial for the Government than expected
  - Penalize contractors through reduced profit for less than expected levels of performance
- Contract incentives must depend upon measurable outcomes
- Intent is NOT to reduce contractor profitability, but to reduce Government cost



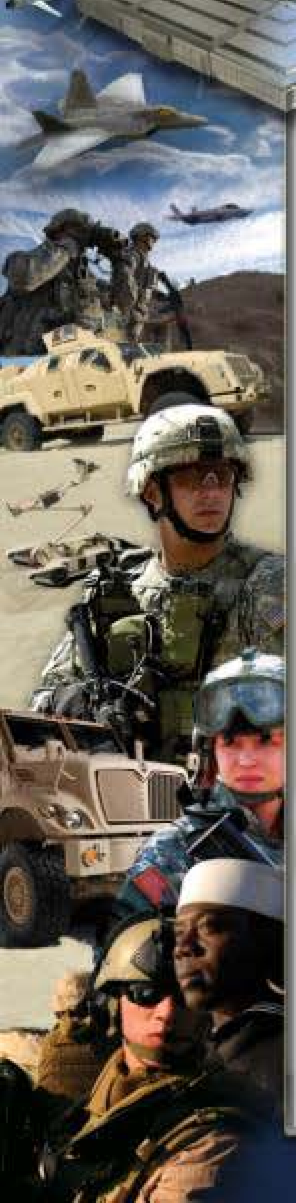
Incentive Contracting Essentials
(from an industry perspective)

- Clear objective requirements regardless of Cost-Plus or Fixed-Price Incentive type contracts
  - Well defined performance work statements
- Contract type aligned with product and program maturity
  - Acknowledgement of technical readiness level (TRL) and technological capabilities
- Incentives with a direct relationship to conditions
  - Compensation not at risk for elements outside a Contractor’s control, or
  - Outside the contract’s period of performance
- Incentives – more of a “Carrot” rather than a “Stick”
  - Realistic and achievable



Structuring Contract Incentives

- What are the key goals or desired results of the acquisition?
  - Rather than just assuming to incentivize cost, schedule and/or performance, carefully investigate what is important to the customer and in what priority those desired results may be if there is more than one. Incentives ought to be tied to our highest priority desired outcomes.
- Will the enhanced performance (quality, technical performance, earlier delivery, lower cost, etc.) add value to the mission?
  - Just because an incentive seems to be good doesn't mean it will enhance the mission or the desired result.
- Is the proposed incentive pool large enough to motivate the contractor(s) to achieve the desired result? Will it provide meaningful return to industry; is it worth the effort and potential cost to achieve the incentive?
  - Just because we offer a pool of dollars contractors and establish an incentive clause does not necessarily mean they will go after the incentive. Too small a reward or too costly a price to pay to achieve can render an incentive moot.
- What is motivating the contractor(s): Profit or Fee, Cash Flow, Return on Investment (ROI), Future Business, Market Share, Remaining in business, etc.?
  - Don't assume that more profit or fee is the only thing motivating the contractor(s). Differing business conditions can modify the situation markedly. Sometime a guarantee of additional future business (more product or additional services) is a greater motivator.
- Is the potential incentive realistic and attainable?
  - Even though the customer may greatly desire a specific outcome, it may not be realistically achievable. If the contractor(s) have to spend far too much to achieve the outcome, don't waste time establishing an incentive.



Structuring Contract Incentives

- Will the incentive permit the contractor to obtain a portion of the reward for achieving some of the desired performance, or is it an “all or nothing” situation?
  - Often it is prudent to structure the incentive to permit the contractor to obtain part of the reward without meeting the maximum performance desired. But, such lesser outcome must still provide an adequate return to both parties.
- Does the incentive clearly define the performance criteria at the start, such as minimum performance, maximum performance, and negative performance? Does the incentive provide for both positive (rewards) & negative (penalties) incentives?
  - Often we tend to accentuate the positive side only and forget about the downside of not achieving performance; e.g., do we pay for earlier delivery or an earlier system capability and not introduce a penalty for not achieving required delivery or system capability.
- Does the contract clause adequately define how the incentive award or penalty will be earned?
  - Contract clauses must be well thought out and establish all the ingredients of the incentive. Focus on defining all the aspects that can impact the incentive calculation. Also, an example calculation with formulas in the clause is a great tool to ensure future contractor and Government personnel will know how to calculate the incentive outcome correctly.
- Has the Contracting Officer “war-gamed” the incentive outcomes? Has the KO performed sufficient potential outcome scenarios and calculated the results?
  - Often we build incentive structures and clauses and then don’t take the time to run a number of “what if” scenarios. These can be very instructive and point to places where problems could occur in contract administration and actual outcomes.
- Will differences in contract type result in different management of incentives?
  - CPIF: contractor may be motivated to pursue additional performance or schedule incentives at the expense of cost if no limitation is placed on the contract
  - FPIF: contractor may be motivated to minimize performance in order to decrease cost and thereby increase realized profit

DoD Peer Review Team Best Practices and Recommendations

- The amount or percent allocated for each performance incentive event should be gradual in nature, so the fees are not front-loaded and ample fee is left through contract completion

- Ensure that no meaningful cost incentive target fee is earned unless the contractor achieves a specified minimum level of mission performance
- Negative incentive structures provide a strong incentive to the contractor to maintain service levels at or above target performance criteria
- Positive performance incentive dollars allocated for events required by the contract T&Cs should be minimal, if used at all

- Preclude achieving performance and/or schedule incentive if large cost overrun
- Link strong contract incentives to the required performance
  - For programs: lower cost in production and sustainment
  - For services: improved or acceptable services at lower cost
- Incentivize key program goals to stress schedule & technical requirements

- Incentivize contractors to identify and create cost reductions
- Develop creative incentives to motivate industry to provide higher productivity
- Positive and negative incentives must be substantiated with their associated value
- DoD wants improved performance/schedule at a reduced cost

Summary

- Start by thinking through what's most important, then incorporate into:
  - Simplified Source Selection Evaluation criteria to
  - Meaningful incentives (not just cost) that will motivate industry to perform
- Contract incentives in the sustainment phase requires balancing the value of:
  - Speed/responsiveness (to achieve mission readiness); with
  - Quality/reliability; and
  - Cost