THE UNDER SECRETARY OF DEFENSE

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ACQUISITION AND
TECHNOLOGY

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MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
COMPONENT ACQUISITION EXECUTIVES
DIRECTORS, DEFENSE AGENCIES

SUBJECT: Use of Performance-Based Payments (PBP)

The Department has had the authority to make performance-based payments to contractors under sole source fixed-price contracts for several years, but with the exception of their significant use with "other transactions," this financing technique has not been used widely. Recently, the Federal Acquisition Regulation was changed to remove the prohibition on using PBPs on research and development and competitively negotiated acquisitions, and to permit prime contractors with cost type contracts to use PBPs on fixed-price subcontracts (FAC 97-16).

There are many significant advantages to be gained from the use of PBPs instead of cost-based progress payments. The Department must take maximum advantage of the benefits of performance-based payments as the preferred means of providing contract financing under fixed-price contracts by making this form of payment the primary and most commonly used form of contract financing. For fiscal year 2002, we must ensure PBP is the primary form of contract financing in at least 25% of contracts valued at $2 million or more. By fiscal year 2005, this method of financing should be the most prevalent form used in fixed-price contracts, such as those for complex services or for production efforts.

In fiscal year 1999, there were 195 contract actions valued at $5.6B that used this form of contract financing. By fiscal year 2005, this method of financing should be used in most contracts that provide financing. Exceptions to the use of this contract financing technique should only be agreed to by the contracting officer when supported by a sound business case justification. The attached summarizes PBP policy and lessons learned.

As with many of the acquisition reforms that we are pursuing, changing the predominant way we provide financing payments under fixed price contracts will require all of us to become more sophisticated customers. To that end, I have directed the Deputy Under Secretary of Defense for Acquisition Reform to lead the development and distribution of a guidance document that will assist contracting officers and program managers in the selection and valuation of meaningful technical progress indicators to use in conjunction with performance-based financing payments. I look forward to your enthusiastic and effective implementation of the actions necessary to successfully transition our contract financing practices to this new paradigm.

J. S. Gansler

Attachment:
As stated

The Case for Performance-Based Payments (PBP)

Policy - Statute and Regulation

The authority to make performance-based payments to contractors resides in 10 U.S.C. 2307(b), which states: "Whenever practicable, payments under subsection (a) shall be made on any of the following bases:

(1) Performance measured by objective, quantifiable methods such as delivery of acceptable items, work measurement, or statistical process controls.
(2) Accomplishment of events defined in the program management plan.
(3) Other quantifiable measures of results."

This statutory authority implemented in FAR Part 32.10 states: "Performance-based payments are ***the preferred Government financing method*** when the contracting officer finds them practical, and the contractor agrees to their use."

Advantages of Using PBP

Using PBP as the principle method of furnishing contract financing under fixed price contracts has many potential benefits for both the Government and contractors. Among them, are the following:

Enhanced Technical and Schedule Focus.

PBP focuses attention on the accomplishment of meaningful and measurable technical progress and on meeting program schedule commitments. By contrast, cost-based progress payments reward incurring cost with only a tangential relationship between those costs and actual, demonstrable progress and schedule results. By linking a contractor's financing payment to critical aspects of technical and schedule performance prior to contract award, PBP reinforces the primacy of technical and schedule connectivity for successful performance. To be successful, parties need to negotiate, at the time of contract formation, the events or accomplishments to be measured, how those measurements will be made, and what value these events or accomplishments will have for financing payment purposes. Thus, both parties will have, in effect, converted appropriate portions of the program plan and schedule into meaningful criteria that will be used throughout the life of the contract to make financing payments. Financing payments will occur only when meaningful, objectively determinable performance accomplishments are achieved.

Broadened Contractor Participation.

Traditional cost-based progress payments can only be used with those contractors who have approved accounting systems. This practice may unintentionally reduce the array of potential contractors with whom the Department can do business. When PBPs are used, however, the contractor's accounting system is no longer a pre-condition of the financial relationship between the parties. Many of today's leading technology firms do not regularly perform under Government contracts and, therefore, have no need for government compliant accounting systems. Use of PBP allows the Department to eliminate one potential barrier to wider supplier participation in the Defense marketplace.

Reduced Cost of Administration and Streamlined Oversight.

Reductions in the oversight and compliance costs of both the Government and contractors are feasible when using PBP. Because the accounting system is not an integral part of the contract financing process, the Government does not require auditors to review payment requests for accounting consistency and compliance with oversight systems, such as cost principles and material management accounting systems. Similarly, contractors' financing requests are event or accomplishment driven and contain no financial information that must be prepared according to financial regulations and practices dictated by the Government. Both parties should be able to reduce non-value added cost-based oversight.

Enhanced and Reinforced Roles of Program Managers and IPTs.

PBP is a management tool that allows the program manager to link financing to performance in fixed price contracts because the contractor is entitled to agreed-upon payments only when specific measurable events have been accomplished. The IPT comprised of government program management, contracting officer, technical and logistic managers, Defense Contract Management Agency (DCMA) and the respective contractor team members jointly develop the PBP plan.

The program manager, supported by IPT members, gives the "thumbs up or down" regarding the assessment of the contractor's technical and schedule results. "Thumbs-up," the program manager verifies to the contracting officer that the contractor is meeting the event requirement and is entitled to payment in accordance with the jointly agreed to performance schedule. "Thumbs-down," the contractor does not receive payment for that event. The Government's business and technical managers are directly involved in all aspects of the process.

PBP is in effect, "self policing" because the contractor is entitled to the agreed-upon payments ***only when*** he accomplishes the paying event and the program manager confirms it before the disbursement is made.

Competition Considerations.

In a competition where the solicitation invites offers to propose PBPs, the contracting officer should ensure that each offeror's PBPs comply with FAR 32.1004 and are reasonable and consistent with other technical and cost information in the offeror's proposal. If the contracting officer anticipates that the cost of providing PBPs will have a significant impact on the selection of the best value offer, the solicitation should provide for the adjustment of proposed prices to reflect the estimated cost to the Government of providing each offeror's proposed PBPs.

Cash Flow Advantages.

Structuring effective performance-based events or accomplishments can provide significant cash flow advantages to a successfully performing contractor. PBP can, under current FAR provisions, be made for up to 90 percent of the contract or line item's **price** whereas cost-based progress payments are currently limited to a fixed percentage of **incurred costs** (currently 75 percent). This can be advantageous from a cash flow perspective. For instance, assume a fixed price contract for $10.0 million that has a potential profit of 15 percent as negotiated and one deliverable item. Under PBP, the total amount financed could be as much as $9.0 million. Using the current progress payment limit of 75 percent, traditional cost-based progress payments could amount to slightly more than $6.5 million. The difference in cash flow over the life of the contract is $2.5 million or a 38 percent improvement with PBP over traditional progress payments. Conversely, if significant technical or schedule accomplishments are not being achieved as originally contemplated, the contractor's cash flow picture can be markedly disadvantaged under PBP versus traditional progress payments. However, this is another reason why the Government should prefer to use PBP as another means to motivate good performance by its contractors and realistic technical and schedule plans by both parties.

Importance of Realistic Performance Milestones.

While it is important to ensure that performance-based payment "triggering" events be carefully chosen to reflect meaningful contract progress, it is important to keep in mind that the events are being selected to make financing payments. To this end, acquisition personnel should consider that, during the early stages of a project, the contractor's rate of expenditure might be high. Therefore, selection of meaningful payment milestones and values during the early phases of a contract is necessary to ensure that the contractor's cash flow needs are adequately addressed. Experience has shown that early performance based payments are important to motivate contractor effort and assist in meeting the cash flow needs that typically arise during the early stages of performance. However, contracting officers should also ensure that PBPs not be structured to result in payments that are in excess of the expected value of performance events, and that they not be designed to result in an unreasonably low level of contractor investment in the contract.

Are there any drawbacks?

Effective planning is key to success and decisions and agreements must be reached during the contract formation phase. The parties have to identify and agree upon which events or accomplishments will be used as a basis for contract financing payments, how they will be measured or confirmed, and the values of the events. In reality, however, all programs have projected technical plans and schedules when the contract is being negotiated so the parties could agree upon milestones that will become the basis for PBP. Setting valuations for the events selected is a unique requirement under a PBP approach. However, even this added activity has a beneficial impact in clearly setting technical and schedule success as the key contract goals. It is important to remember that PBP is a financing tool that is only available for use under fixed-price contracts, so the degree of uncertainty for price and schedule commitments should be low. In order to use PBP effectively, guidance and focused training on the selection and valuation of meaningful payment events is critical. A PBP guide will be available for the acquisition workforce by November 2000 on the acquisition reform web page (www.acq.osd.mil). A distance learning module is also under development and will be reviewed with the Services prior to release to the workforce.