

CHANGE REQUEST COVER SHEET

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Title: Incentive Contracts Guide

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Policy OR Guidance: Guidance

Section/Text Location Affected: T3.2.4 (new Appendix 4)

Summary of Change: Clarifying existing guidance for various types of incentive contracts

Reason for Change: Editorial/clarification

Development, Review, and/or Concurrence: Acquisition Policy Division; Legal; and Contracting Organizations at FAA HQ, Centers, and Regions (ARC).

Target Audience: FAA Contracting Workforce and Program Offices

Potential Links within FAST for the Change: None

Briefing Planned: No

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Potential Links within FAST for the Change: None

Links for New/Modified Forms (or) Documents (LINK 1) [null](#)

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SECTIONS ADDED:

Procurement Guidance:

T3.2.4 - Types of Contracts

Appendices

Section 4 : Appendix - Incentive Contracts Guide [\[New Content\]](#)

SECTIONS ADDED:

Procurement Guidance:

T3.2.4 - Types of Contracts

Appendices

Section 4 : Appendix - Incentive Contracts Guide

1. Introduction

The purpose of this guide is to further explain incentive contracts, provide examples, and other considerations for using incentive contracts. This guide:

- Provides general guidance on when an incentive contract may be appropriate;
- Describes elements of the required cost incentive and how the elements influence profit/fee earned by a contractor, depending on the cost incurred;
- Describes the general characteristics of a performance incentive and delivery incentive;
- Provides general guidance for structuring multiple (i.e., having a cost incentive and performance and/or delivery incentives) incentive contracts;
- Provides general guidance on Fixed-Price Incentive (FPI) contracts including the importance of the Point of Total Assumption (PTA);
- Provides general guidance on FPI contracts with a firm target, and FPI with successive targets;
- Provides general guidance on Cost-Plus-Incentive-Fee (CPIF) contracts including impact of minimum and maximum fee established;
- Provides general guidance on negotiating changes to incentive contracts including possible negotiation methods and circumstances in which they would be appropriate.

2. General

(a) Incentive contracts are appropriate when supplies or services can be acquired at lower costs, and in certain instances with improved delivery or technical performance, by relating the amount of profit/fee payable under the contract to the contractor's performance. Incentive contracts are designed to obtain specific program objectives by:

(1) Establishing reasonable and attainable targets that are clearly communicated to the contractor; and

(2) Including appropriate incentive arrangements designed to motivate contractor efforts that might not otherwise be emphasized, and to discourage contractor inefficiency.

(b) When predetermined, formula-type incentives on technical performance or delivery are included, profit/fee:

- (1) Increases only for achievement that surpasses the targets, and
- (2) Decreases to the extent that such targets are not met.

The incentive increases or decreases are applied to performance targets rather than minimum performance requirements.

(c) The two basic categories of incentive contracts are fixed-price incentive and cost-plus-incentive-fee.

(d) Fixed-price incentive contracts are preferred when contract costs and performance requirements are reasonably certain. It is usually in the Government's interest for a contractor to assume substantial cost responsibility and an appropriate share of the cost risk, thus the preference for fixed price incentive contracts.

(e) Award-fee contracts are a separate type of incentive contract and are discussed separately under Appendices 2 and 3 of this Section T3.2.4.

3. Cost Incentives

(a) Most incentive contracts include only cost incentives, which take the form of a profit or fee adjustment formula. Cost incentives are intended to motivate the contractor to effectively manage costs. An incentive contract cannot provide for other incentives without also providing a cost incentive (or constraint).

(b) Incentive contracts include a target cost, a target profit or fee, and a profit or fee adjustment formula that provides (within the constraints of a price ceiling or minimum and maximum fee):

- (1) Actual cost that meets the target will result in the target profit or fee;
- (2) Actual cost that exceeds the target will result in downward adjustment of target profit or fee; and
- (3) Actual cost that is below the target will result in upward adjustment of target profit or fee.

(c) *An example of a cost incentive (in a fixed-price incentive contract) based on the above is as follows:*

Target Cost	\$10,000,000
Target Profit	\$1,000,000
Target Price	\$11,000,000
Share Ratio	70/30 (Government/contractor)
Ceiling Price	115% of Target Cost (\$11,500,000)

-Actual cost of \$10,000,000 would meet target cost. This results in the contractor earning the target profit of \$1,000,000 because the contractor met the target cost. \$11,000,00 would be paid to the contractor in total (\$10,000,000 target cost + \$1,000,000 target profit).

-Actual cost of \$11,000,000 would exceed target cost. This results in the contractor being responsible for its share of 30% of the amount over the target cost (\$1,000,000 X 30% = \$300,000). This amount of \$300,000 is deducted from the target profit of \$1,000,000 for a total of \$700,000 profit. Instead of being paid a total of \$11,700,000, the contractor would be paid \$200,000 less because of the ceiling price (\$11,500,000) – reducing the profit from \$700,000 to \$500,000.

-Actual cost of \$9,000,000 would be under target cost. This results in the contractor earning an additional 30% of the amount below the target cost (\$1,000,000 X 30% = \$300,000) in addition to the target cost for a total of \$1,300,000 profit. \$10,300,000 would be paid to the contractor in total.

4. Performance Incentives

(a) Performance incentives may be considered with specific product characteristics (e.g., a missile range, an aircraft speed, an engine thrust, or a vehicle maneuverability) or other specific elements of the contractor's performance. These incentives should be designed to relate profit/fee to a contractor's achievement, compared with specified targets.

(b) When practicable, positive and negative performance incentives should be considered with service contracts for performance of objectively measurable tasks when quality of performance is critical and incentives are likely to motivate the contractor.

(c) Technical performance incentives may be particularly appropriate in major or complex systems, both in development (when performance objectives are known and the fabrication of prototypes for test and evaluation is required) and in production (if improved performance is attainable and highly desirable to the Government).

(d) Technical performance incentives may involve a variety of specific characteristics that contribute to the overall performance of the end item. Accordingly, the incentives on individual technical characteristics must be balanced so that no one of them is exaggerated to the detriment of the overall performance of the end item.

(e) Performance tests and/or assessments of work performance are generally essential in order to determine the degree of attainment of performance targets. Therefore, the contract must be as specific as possible in establishing test criteria (such as testing conditions, instrumentation precision, and data interpretation) and performance standards (such as the quality levels of services to be provided).

(f) Because performance incentives present complex problems in contract administration, the Contracting Officer (CO) should negotiate them in full coordination with Government technical and pricing specialists.

(g) It is essential that the Government and contractor agree explicitly on the effect that contract changes (e.g., pursuant to the applicable Changes clause) will have on performance incentives.

This will be dealt with in more detail in Section 11 below.

(h) The CO must exercise care, in establishing performance criteria, to recognize that the contractor should not be rewarded or penalized for attainments of Government-furnished components.

(i) *A basic example of a performance incentive is as follows:*

Maintenance Hours per Operational Hour – Total Possible Incentive \$120,000
Minimum Value – 10 hours – 0% of incentive earned
Average Value – 5 hours – 50% of incentive earned (\$60,000)
Maximum Value – 2 hours – 100% of incentive earned (\$120,000)
Penalty if > 10 hours -\$10,000

In the example above, if the contractor failed to meet the minimum value of 10 hours per operational hour, they would not receive any of the possible \$120,000 in incentives. Additionally, a negative incentive of \$10,000 would be deducted from the negotiated value of the contract.

5. Delivery Incentives

(a) Delivery incentives should be considered when improvement from a required delivery schedule is a significant Government objective. It is important to determine the Government's primary objectives in a given contract (e.g., earliest possible delivery or earliest quantity production).

(b) Incentive arrangements on delivery should specify the application of the reward-penalty structure in the event of Government-caused delays or other delays beyond the control, and without the fault or negligence, of the contractor or subcontractor.

(c) *A basic example of a delivery incentive is as follows:*

The total schedule incentive available must be defined in the contract with specifics as to Contract Line Item, Period of Performance etc. as needed. For this example, the total incentive amount available is \$100,000.

Delivery Incentive Milestones:

Positive Incentives

20% of available incentive for completion of Critical Design Review (CDR) at least two (2) weeks ahead of schedule (\$20,000)

20% of available incentive for passing Design Qualification Test (DQT) at least two (2) weeks ahead of schedule (\$20,000)

15% of available incentive for passing site acceptance test at least two (2) weeks ahead of schedule (\$15,000)

45% of available incentive for achieving Initial Operational Capability (IOC) at least two (2) weeks ahead of schedule (\$45,000)

Negative Incentives

20% of available incentive for not achieving completion of Critical Design Review (CDR) on schedule (-\$20,000)
45% for not achieving IOC on schedule (-\$45,000)

The schedule for the milestones as well as what the achievement of each milestone involves must be clearly defined in the contract. For example, if the contractor fails to meet the first milestone, they lose \$20,000 due to the negative incentive. If they do not meet the second, there would be no impact as there is no negative incentive. If they meet the third at least two weeks ahead of schedule, there would be a positive incentive of \$15,000 earned. Meeting the last and most important milestone at least two weeks ahead of schedule would earn \$45,000 for total schedule incentive earnings of \$40,00.

6. Structuring Multiple-Incentive Contracts

A properly structured multiple-incentive arrangement should-

- (a) Motivate the contractor to strive for outstanding results in all incentive areas; and
- (b) Compel trade-off decisions among the incentive areas, consistent with the Government's overall objectives for the acquisition. Because of the interdependency of the Government's cost, the technical performance, and the delivery goals, a contract that emphasizes only one of the goals may jeopardize control over the others. Because outstanding results may not be attainable for each of the incentive areas, all multiple-incentive contracts must include a cost incentive (or constraint) that operates to preclude rewarding a contractor for superior technical performance or delivery results when the cost of those results outweighs their value to the Government.
- (c) While not requiring as much administrative effort as an award fee contract, an incentive contract with multiple incentives requires some administrative effort to track how the contractor is performing in relation to the cost incentive and to the performance and/or delivery incentive. Before entering into a multiple incentive contract, Agencies must determine whether the amount of additional administrative effort is offset by potentially improved performance by the Contractor.
- (d) *A basic example of a multiple incentive contract is as follows (applicable to either Fixed-Price Incentive or Cost-Plus-Incentive-Fee):*

Target Cost \$100
Target Profit (Fee) \$7
Target Price \$107
Share Ratio 75/25
Performance Incentive Reward +\$3
Performance Incentive Penalty -\$1
Schedule Incentive Penalty -\$1

-Cost of \$84 and maximum performance on schedule – profit is \$14 (\$16 under Target cost X 25% share = \$4 + \$7 Target Profit +\$3 Performance Incentive Reward).

-Cost of \$116 and acceptable performance with late delivery – profit is \$2 (\$16 over Target Cost X 25% share = \$4 subtracted from \$7 = \$3 less \$1 Schedule Incentive Penalty)

-Cost of \$116 and maximum performance with late delivery – profit is \$5 (\$16 over Target Cost X 25% share = \$4 subtracted from \$7 = \$3 less \$1 Schedule Incentive Penalty plus \$3 Performance Incentive Reward)

7. Fixed-Price Incentive (FPI) Contracts

(a) *Description.* A FPI contract is a fixed-price contract that provides for adjusting profit and establishing the final contract price by application of a formula based on the relationship of total final negotiated cost to total target cost. The final price is subject to a price ceiling, negotiated at the outset.

(b) *Application.* A FPI contract is appropriate when-

(1) A FFP contract is not suitable;

(2) The nature of the supplies or services being acquired and other circumstances of the acquisition are such that the contractor's assumption of a degree of cost responsibility will provide a positive profit incentive for effective cost control and performance; and

(3) If the contract also includes incentives on technical performance and/or delivery, the performance requirements provide a reasonable opportunity for the incentives to have a meaningful impact on the contractor's management of the work.

(c) *Billing prices.* In FPI contracts, billing prices are established as an interim basis for payment. These billing prices may be adjusted, within the ceiling limits, upon request of either party to the contract, when it becomes apparent that final negotiated cost will be substantially different from the target cost.

(d) *Point of Total Assumption.* The Point of Total Assumption (PTA) in FPI contracts is the point where cost increases that exceed the target cost are no longer shared by the Government according to the share ratio. At the PTA, the contractor's profit is reduced one dollar for every additional dollar of cost. The PTA is calculated as follows:

$$PTA = (\text{Ceiling Price} - \text{Target Price}) / \text{Government Share} + \text{Target Cost}$$

An example of a PTA calculation is as follows:

Target Cost	\$50,000,000
Target Profit	\$4,500,000 (9%)
Target Price	\$54,500,000
Ceiling Price	125% of Target Cost = \$62,500,000
Share Ratio	70/30

$$PTA = (\$62,500,000 - \$54,500,000) / 70\% + \$50,000,000$$

$$PTA = \$8,000,000 / 70\% + \$50,000,000$$

$$PTA = \$11,428,571 + \$50,000,000 = \$61,428,571$$

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Thus, cost increases beyond the PTA of \$61,428,571 are no longer shared by the Government in accordance with the share ratio – the contractor's profit will be reduced one dollar for every additional dollar of cost beyond the PTA.

(e) *General Considerations:*

(1) The higher the Government share and the higher the ceiling price, the lower the overall incentive for the contractor to control costs since they have more ability to recover such costs; and

(2) Conversely, the lower the Government share and the lower the ceiling price, the higher the overall incentive for the contractor to control costs since they have less ability to recover such costs

8. Fixed-Price Incentive (Firm Target)

(a) *Description.* A fixed-price incentive (firm target) contract specifies a target cost, a target profit, a price ceiling (but not a profit ceiling or floor), and a profit adjustment formula. These elements are all negotiated at the outset. The price ceiling is the maximum that may be paid to the contractor, except for any adjustment under other contract clauses. When the contractor completes performance, the parties negotiate the final cost, and the final price is established by applying the formula. When the final cost is less than the target cost, application of the formula results in a final profit greater than the target profit; conversely, when final cost is more than target cost, application of the formula results in a final profit less than the target profit, or even a net loss. If the final negotiated cost exceeds the price ceiling, the contractor absorbs the difference as a loss. Because the profit varies inversely with the cost, this contract type provides a positive, calculable profit incentive for the contractor to control costs.

(b) *Applicability:* A fixed-price incentive (firm target) contract is appropriate when the parties can negotiate at the outset a firm target cost, target profit, and profit adjustment formula that will provide a fair and reasonable incentive and a ceiling that provides for the contractor to assume an appropriate share of the risk. When the contractor assumes a considerable or major share of the cost responsibility under the adjustment formula, the target profit should reflect this responsibility.

(c) *Limitations.* This contract type may be used only when-

(1) The contractor's accounting system is adequate for providing data to support negotiation of final cost and incentive price revision; and

(2) Adequate cost or pricing information for establishing reasonable firm targets is available at the time of initial contract negotiation.

(d) *Contract schedule.* The CO should specify in the contract schedule the target cost, target profit, and target price for each item subject to incentive price revision. Following the completion of performance, the parties negotiate the final cost, and the final price is established by applying the formula.

(e) *An example of a Fixed-Price Incentive (Firm Target) contract is under Section 7 above.*

9. Fixed-Price Incentive (Successive Targets) Contracts

(a) *Description.*

(1) A fixed-price incentive (successive targets) contract specifies the following elements, all of which are negotiated at the outset:

(i) An initial target cost.

(ii) An initial target profit.

(iii) An initial profit adjustment formula to be used for establishing the firm target profit, including a ceiling and floor for the firm target profit. (This formula normally provides for a lesser degree of contractor cost responsibility than would a formula for establishing final profit and price.)

(iv) The production point at which the firm target cost and firm target profit will be negotiated (usually before delivery or shop completion of the first item).

(v) A ceiling price that is the maximum that may be paid to the contractor, except for any adjustment under other contract clauses providing for equitable adjustment or other revision of the contract price under stated circumstances.

(2) When the production point specified in the contract is reached, the parties negotiate the firm target cost, giving consideration to cost experience under the contract and other pertinent factors. The firm target profit is established by the formula. At this point, the parties have two alternatives, as follows:

(i) They may negotiate a firm fixed price, using the firm target cost plus the firm target profit as a guide.

(ii) If negotiation of a firm fixed price is inappropriate, they may negotiate a formula for establishing the final price using the firm target cost and firm target profit. The final cost is then negotiated at completion, and the final profit is established by formula, as under the fixed-price incentive (firm target) contract.

(b) *Application.* A fixed-price incentive (successive targets) contract is appropriate when-

(1) Available cost or pricing information is not sufficient to permit the negotiation of a realistic firm target cost and profit before award;

(2) Sufficient information is available to permit negotiation of initial targets; and

(3) There is reasonable assurance that additional reliable information will be available at an early point in the contract performance so as to permit negotiation of either (i) a firm fixed price or (ii) firm targets and a formula for establishing final profit and price that will provide a fair and reasonable incentive. This additional

information is not limited to experience under the contract, itself, but may be drawn from other contracts for the same or similar items.

An example of a situation where this contract type may be appropriate is where long lead time requirements may make it necessary in the acquisition of a new system to contract for a follow-on quantity before design or production stability has been achieved.

(c) *Limitations.* This contract type may be used only when-

(1) The contractor's accounting system is adequate for providing data for negotiating firm targets and a realistic profit adjustment formula, as well as later negotiation of final costs; and

(2) Cost or pricing information adequate for establishing a reasonable firm target cost is reasonably expected to be available at an early point in contract performance.

(d) *Contract schedule.* The CO should specify in the contract schedule the initial target cost, initial target profit, and initial target price for each item subject to incentive price revision.

(e) Overall considerations for the use of fixed-price incentive (successive targets) are as follows:

(1) Successive targets are used when uncertainties do not permit the negotiation of a firm arrangement;

(2) The ability to establish a firm pricing arrangement is not limited by the availability of cost or pricing data from the contract itself.

(3) Data may be drawn on as it becomes available from other contracts for the same or similar equipment/services; and

Because this type of contract is negotiated when cost and pricing information is not sufficient to allow negotiation of a firm arrangement, contract performance uncertainties are greater than they would otherwise be the case in a fixed-price type of contract. A realistic pricing arrangement would thus not provide as great a degree of contractor cost responsibility as under a FPI contract.

A basic example of a Fixed-Price Incentive (Successive Targets) contract is as follows:

Initial Target Cost	\$15,000,000
Initial Target Profit	\$1,200,000
Initial Target Price	\$16,200,000
Initial Share Ratio	95/5
Ceiling on Firm Target Profit	\$1,350,000
Floor on Firm Target Profit	\$1,050,000
Price Ceiling	\$19,500,000

At the production point in the contract, if the cost is \$14,500,000, the firm target profit would be determined as follows:

Initial Target Cost	\$15,000,000
Negotiated Cost	\$14,500,000
Difference	\$500,000 (decrease)
Contractor's Share	\$25,000 (increase)
Initial Target Profit	\$1,200,000
Firm Target Profit	\$1,225,000

At this point, there are two alternatives: Using the negotiated cost of \$14,500,000 and the firm target profit as guides, a firm-fixed-price may be negotiated. If this is not possible, or if the parties agree that uncertainties under the remaining part of the contract make this unfeasible, a fixed-price incentive with firm targets may be negotiated. The ceiling price cannot be *increased* at this point but it may be *decreased* where firm target costs are lower than initial target costs. With a revised ceiling price of \$16,700,000 and a new share ratio of 60/40 negotiated, the following is established:

Target Cost	\$14,500,000
Target Profit	\$1,225,000
Target Price	\$15,725,000
Ceiling Price	\$16,700,000
Share Ratio	60/40

The final settlement at contract completion would be done as for the firm target contract described in Section 8.

If the parties negotiated an estimated cost of \$17,000,000 at the production point, firm target profit would be determined as follows:

Initial Target Cost	\$15,000,000
Negotiated Cost	\$17,000,000
Difference	\$2,000,000 (increase)
Contractor's Share	\$100,000 (decrease)
Initial Target Profit	\$1,200,000
Firm Target Profit	\$1,100,000

If a FFP contract was not appropriate, and a sharing formula of 75/25 were negotiated, a firm incentive agreement could be set up as follows:

Target Cost	\$17,000,000
Target Profit	\$1,100,000
Target Price	\$18,100,000
Ceiling Price	\$19,500,000
Share Ratio	75/25

10. Cost-Plus-Incentive-Fee (CPIF) Contracts

(a) *Description*. The CPIF contract is a cost-reimbursement contract that provides for the initially negotiated fee to be adjusted later by a formula based on the relationship of total allowable costs to total target costs. This contract type specifies a target cost, a target fee,

minimum and maximum fees, and a fee adjustment formula. Unlike FPI contracts, there is no ceiling price under this contract type.

After contract performance, the fee payable to the contractor is determined in accordance with the formula. The formula provides, within limits, for increases in fee above target fee when total allowable costs are less than target costs, and decreases in fee below target fee when total allowable costs exceed target costs. This increase or decrease is intended to provide an incentive for the contractor to manage the contract effectively. When total allowable cost is greater than or less than the range of costs within which the fee-adjustment formula operates, the contractor is paid total allowable costs, plus the minimum or maximum fee.

(b) Application.

(1) A CPIF contract is appropriate for services or development and test programs when-

(i) A cost-reimbursement contract is necessary where uncertainties in the work under contract make a FPI contract impracticable; and

(ii) A target cost and a fee adjustment formula can be negotiated that are likely to motivate the contractor to manage effectively.

(2) The contract may include technical performance incentives when it is highly probable that the required development of a major system is feasible and the Government has established its performance objectives, at least in general terms. This approach also may apply to other acquisitions, if the use of both cost and technical performance incentives is desirable and administratively practical.

(3) The fee adjustment formula should provide an incentive that will be effective over the full range of reasonably foreseeable variations from target cost. If a high maximum fee is negotiated, the contract must also provide for a low minimum fee that may be a zero fee or, in rare cases, a negative fee.

(c) Limitations. No CPIF contract shall be awarded unless the contractor has an adequate accounting system for that type of contract.

(d) Additional considerations for use of this contract type are as follows: Because of the interrelationship between negotiated fee levels and the sharing arrangement, the wider the range between minimum and maximum fees, the greater the contractor's share percentage under the formula without limiting the range of cost variation over which the incentive is effective.

Examples of a CPIF contract are as follows:

Target Cost	\$10,000,000
Target Fee	\$750,000
Maximum Fee	\$1,350,000
Minimum Fee	\$300,000
Share Ratio	85/15

(1) Actual cost of \$10,000,000 results in the contractor earning the target fee of \$750,000 since the contractor has met the target cost. \$10,750,000 would be paid to the contractor in total.

(2) Actual cost of \$11,000,000 above the target cost results in the contractor being responsible for 15% of the amount over cost (\$150,000) which is deducted from the target fee for a total of \$600,000 fee. This is within the minimum and maximum fee limits specified above.

(3) Actual cost of \$9,000,000 below the target cost results in the contractor earning an additional \$150,000 in fee above the target fee (\$900,000). This is within the minimum and maximum fee limits specified above.

11. Impact of Contract Changes

When work required under a contract is changed under the "Changes" clause or other appropriate clause of an incentive contract – either increased or decreased – adjustments may be negotiated to the target cost, target fee, share ratio, etc. as appropriate. Performance and/or schedule incentives may also be similarly renegotiated. Since late definitizations of contract changes can adversely affect the integrity of the incentive contract structure, agreements on the pricing and incentive aspects of contract changes should be negotiated as soon as possible.

Four possible methods of making equitable adjustments to incentive contracts are as follows:

(a) Constant dollar – where the same dollar adjustment is applied to target, maximum and minimum fee or profit and ceiling price;

(b) Constant percentage – where the percentage of minimum and maximum fee or the percentage of ceiling price over target cost is held constant. The constant dollar and constant percentage methods are similar except for differences in fee/profit earned at the extremes of ranges above or below the target cost;

(c) Individual element – determining the effect of the change on each element such as target cost, target fee, and ceiling price individually. This is appropriate where the degree of uncertainty varies significantly between the original contract and the changed portion. There is a flexibility to tailor the specifics of the incentive to the change; however, the disadvantage is that more administrative effort is often needed to evaluate and negotiate each individual element; and

(d) Severable change – where the change is isolated from the incentive provisions with a separate agreement reached on the change portion. This method is most appropriate where the changed portion is completely different in terms of technical and cost risk than the original contract. For instance, the contract may be CPIF while the new work may be FPI.

Overall, the method chosen depends on the extent and nature of the change as well as its impact upon the individual incentive contract elements.