PROBLEMS OF INCENTIVE TYPE CONTRACTS IN AN R&D ENVIRONMENT

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These comments are based solely upon personal experiences with Army, Navy, and Air Force agencies of the Department of Defense and should not be construed as necessarily reflecting upon experiences with our host agency here. Additionally, these are personal observations and not policy positions of either a company or an industrial association.

Incentive contracting today is applied almost totally in current procurements. Certainly this exists in Government prime contracts and also to the same proportion in subcontracts issued by these prime contractors to their suppliers.

With such a total acceptance and application how can there be problems? Perhaps that's one of the problems.....Is incentive contracting a panacea and cure-all? Is it a true contractual remedy or is it an overworked fad soon to pass away like price redetermination?

Before we get into the problems, let us stop for a moment, and excuse me for being elementary and fundamental, but what is incentive contracting and why has it come about?

Thomas D. Morris, Assistant Secretary of Defense in a June 1961 speech before the National Security Industrial Association announced the main reasons for the proposed use of incentive contracts as being "to promote contractor efficiency and to cut procurement costs." The Air Force joined the trend towards the usage of incentive contracts in October 1961 and urged certain segments of industry to suggest applicable incentives and bases which could be mutually agreed upon and negotiated. To prove that it was serious, the Air Force revealed it would be willing to reward excellent contractor performance by permitting profits up to 15 percent as opposed to the 9% normally considered as excellent in the past.

On March 15, 1962, the Assistant Secretary of Defense (Installations and Logistics) directed the issuance of Revision No. 8 to the Armed Services Procurement Regulation. This revision was devoted exclusively to Section III, Part 4 of ASPR, entitled "Types of Contracts."

A quick summary of Revision 8 is as follows:

Concern over the rising costs of weapons and military equipment has resulted in concerted and aggressive efforts to achieve cost reductions in procurement and has necessitated a complete re-evaluation of the policies governing the selection of contract types.

The overall objective of assuring a fair and reasonable price is continued, but the contents of this Revision are redirected toward this objective by providing maximum incentives for superior performance by the contractor through the exploitation of the profit motive.

Now, there, I've said the word--"profit"--the lifeblood of industry's existence; and it is neither a dirty nor an unpatriotic word. If the management of a company cannot expect a reasonable profit return, then why should this company stay in this type of business. There is normally a large capital investiment involved, not only in facilities but also in people, specialized and highly trained people. If this investment cannot return a reasonable profit, then why should not the same capital investment be placed in reasonably safe securities which would net far more, with less

headaches and little or no overhead; but of course this would not satisfy the requirements and services needed by the Department of Defense.

To provide needed flexibility, a wide selection of contract types is contained in Revision No. 8. The order in which they appear was rearranged in a significant manner in the order of a decreasing cost responsibility of the contractor; from the firm fixed-price contract, which offers the maximum incentive to produce efficiently, to the cost-plus-fixed-fee contract where the incentive is minimal. Between these extremes are other contract types which provide varying degrees of contractor cost responsibility. As to these, it is required that those types be used which offer the greatest degree of cost responsibility available under the circumstances pertaining to each procurement.

Your particular attention is invited to some of the paragraph's involved:

3-403 (c) - expresses the policy that development should ordinarily be preceded by the necessary research and that the contract type should generally be of the cost-plus-incentive-fee type, and should include performance as well as cost incentives.

3-404.4 - The fixed-price incentive contract is directed for use when the firm fixed-price contract is not appropriate, and when it is possible to negotiate a contract providing for partial cost responsibility under circumstances where there is a reasonable opportunity for the incentive provisions to have a meaningful impact on the manner in which the contractor manages the work.

3-405.4 - Most development projects will be accomplished by use of cost-plus-incentive-fee contracts, in which performance and cost incentives are appropriately included.

3-405.5 - The use of a cost-plus-a-fixed-fee contract is drastically limited.

Thus, with the formal issuance of Revision 8 to ASPR, Department of Defense's intent to maximize the utilization of incentive contracts became a reality. This directive reflected the Department of Defense's belief that the profit motive, which is the economic spur to business achievement, will be effectively harnessed. Further, incentive contracts were expected to tighten the reins on galloping defense costs.

Now to the record. During the last four years, the percentage of Department of Defense CPFF awards has gone from a highpoint of 38% of the total Department of Defense obligations to the 1966 fiscal year percentage of 7.9%.

In the Research and Development category alone, the Department of Defense Research and Engineering section indicates that for the 1966 fiscal year, CPFF contracts were down to 20% of the total R&D contract dollars awarded.

The Department of Defense goal of more contractor assumption of risk is being realized at a rapid rate.

Industry had to familiarize itself with the March 1962 ASPR rules governing the selection of the proper type of contract. Revision 8 left four major profit bearing types of contracts for use by contracting officers---firm fixed price, fixed price incentive, cost plus incentive fee and cost plus fixed fee.

Further, although not explicitly stated, said Revision 8 appears to relate the contract type(s) to certain stages of procurement as follows:

Type of Procurement	Normal Type of Contract
Research	CPFF
Development	CPIF
Initial Manufacturing	FPI
Follow-on Manufacturing	FFP

Of course the ASPR's can emphasize or infer or suggest the desired types of contracts as indicated above but problems can and will arise in a majority of cases due to the specific and special nature of the contract to be awarded.

Let's look at some of the complexities involved with Research and Development procurements:

Normal type of contract in research procurement is the CPFF. Where degrees of level of effort can be identified and agreed upon in advance of performance, incentives are to be considered.

Normal type of procurement for development program is a CPIF contract. Under this ASPR concept the prices must find a way to avoid pitfalls in area of lack of a definitive work statement with the inevitable lack of reliable cost estimates. Therefore, it is apparent that two separate requirements for the undertaking of an incentive contract containing a development project are: (1) no unresolved state of the art problems; and (2) a definitive work statement or specification.

Again, all research problems should be solved before a procurement agency enters into a development procurement cycle.

Other problems which may be faced in a combined R&D effort are that:

a. The use of an incentive contract assumes that development work under these conditions is primarily a matter of management of technical manpower, that the technical risks have been removed. However, a certain residue of technical difficulties normally exist which require the expenditure of substantial additional sums of money to research a solution. When this situation exists on an incentive contract, profit is lost through the incentive share formula application to the target cost overrun.

b. A second problem is the contractor's and the procuring activity's inability to separate research from development in incentive procurements. In these cases, unsolved technical problems and badly defined scopes of work will tend to operate to the contractor's detriment and ultimately to the Government's detriment because it will be hard to hold the contractor responsible for the complete job and will force a minimal contractor effort when he's faced with a major overrun and minimum fee.

And so when the incentive contract is used for a combined R&D contract, such difficulties can be readily foreseen.

The greatest potential for avoidance of incentive problems is, obviously, at the point prior to the award; so what are the criteria for the use of incentive contracting.

ASPR generally fails to give guidance on the prerequisites for the use of incentive contracts and their respective provisions. In the incentive contracting situation, one of the most critical factors is the underlying condition of the procurement at the time the contract is negotiated. Unless certain conditions are present, both contracting parties assume greater risks in the use of an incentive contract, a risk taking type of contract.

Therefore, it is imperative for both parties to analyze the prerequisites for the use of incentive contracts so that some insight can be gained into the problems created by the form of contract and the pitfalls which should be avoided.

The major prerequisites for the use of incentives are:

a. Firm Specifications

b. Ability to Estimate Costs

c. Management Ability of the Contractor

d. Management Freedom

e. Time

Firm Specifications

The primary element of any procurement is a Firm Specification or Work Statement. It is the heart of any contract and must be sufficiently definitive to permit a contractor to prepare a priced proposal and to preclude or minimize future disputes as to either the scope of work, or the authority of the Government to direct changes to that work scope without altering the price. This requirement is most necessary in a firm fixed price contract (greatest risk) but equally important to any form of contract. Therefore, the impact of this prerequisite and any other ones to incentive contracts is a relative matter depending on the amount of risk involved in the particular incentive contract in question.

No contractor in his right mind should accept an incentive type contract citing an agreement to perform work, the scope of which is to be agreed on at a later date, regardless of the program's urgency. Why? Because it places him in a position of offering to do an unknown quantity of work on a cost sharing basis (under the operation of the incentive formula.)

Another similar technique to be avoided is the technical direction procedure which is often used in R&D situations. Although technical direction is limited theoretically to directions within the scope of work, it is to be noted that where the scope has been broadly stated, that this clause frequently gives the Government the right to prescribe the method of performance and the amount of work to be done. This type of contract arrangement is not compatible with the incentive contract since it takes most of the job control away from the contractor. Further, a contractor should not be expected to assume risks unless he can control his actions and costs.

Ability to Estimate Costs

This prerequistie follows closely after the requirement for firm specifications. In some cases if the specifications are firm, estimating can be performed well; however, there are other cases where the specifications are firm but the ability to estimate properly is lacking because the particular stage of development or initial manufacturing requires efforts never experienced by the contractor. Accordingly, he does not have any historical costs on which to base his cost estimates.

This prerequisite serves as the basis for arriving at the contract's target cost. Seldom is the original estimate considered totally acceptable. In most cases the target cost negotiation becomes a matter of negotiation table strategy and bargaining power. The most likely result is that target cost will not reflect a reasonable cost of doing the work. Whether the contractor makes a "windfall" or incurs a substantial overrun, the incentive portion of the contract has been nullified. If a contractor's target cost is too high, he will have very little or no incentive to further reduce his costs. If his target costs are too low, he will work as if he had a CPFF contract and not a CPIF, or he will make "trade-off" decisions to sacrifice performance for cost savings. Negotiation of a target cost based on poor cost estimates work to both the Government and contractor's disadvantage.

One point which is overlooked quite often is that "the Government's estimating ability" must be as good as the contractor's ability. All too often, the Government agency does not truly estimate a job in advance, so that negotiations are reduced to a process of questioning the contractor's cost estimate. Such a procedure is a poor one because the Government is placed on the defensive. The other half of the same problem is the tendency of the Government not to estimate a job, but to "forcefit" the price to a preconceived budget or appropriation, which might just be the amount of money left over, bearing no relation to the job at hand. When faced with this position, too often the Government negotiator or audit review team resorts to the selection of an arbitrary figure substantially lower than the contractor's cost estimate and moves from said figure with great reluctance. Negotiations are prolonged unnecessarily and often result in low target costs due to the strong bargaining power of the Government. The need for a real true estimate of costs by the Government before the Contracting Officer approaches the negotiation table is readily apparent.

Management Ability of the Contractor

We all know that an incentive contract is awarded with the firm purpose to reward a contractor for better management of work. A proper incentive contract will motivate him to undertake a definite program to perform work efficiently and economically. Therefore, uncontrolled costs should be minimal.

Managerial ability is normally determined by a pre-award survey. Contractors must have a system that generates and disseminates timely information on the progress of work under contract on a regular basis (i.e., cost incurred, cost to complete, variations forecasts from program plan etc.). The contractor must then be able to use the information generated. PERT or PERT/Cost are two techniques and the extent of usage is based on the contractor's best judgment and the contract size and complexity.

Before a decision is made to accept an incentive contract, the following question must be answered, "Will any possible savings to be encouraged by this type of contract be offset by the cost of initiating additional management effort on the job?" Gentlemen, look to your requirements for reports and software. They may be interesting, but are they really worth the dollars they will cost?

Management Freedom

As was indicated previously all of the criteria for the use of incentives are relative to the type of contract contemplated. A contractor needs freedom of operation in order to successfully perform an incentive contract. He must use his own initiative. If he cannot make decisions, he cannot manage his work; if he cannot manage his work, it is senseless to pay him incentive profit or penalize him for poor performance.

Make or Buy approvals, overtime approvals, subcontract approvals and design review approvals, extraneous administrative requirements and meetings are examples of limitations to management freedom which were common during the CPFF era and which must be eliminated. These limitations are not compatible with incentive contracts and are contradictory to the basic principles of incentive contracting. The elimination of these limitations will aid in the achievement of true management freedom. The word is "disengagement by the Government."

Time

The administrative time to allow the parties to prepare a proposal, to negotiate the contract and the performance time reflected in the contract to enable the contractor to take the type of management action necessary to operate the incentive contract, is the final prerequisite.

At this point, let me ask the Government procurement people here to think in terms of the length of time involved in the preparation of a procurement package before

it arrives on the desk of the Contracting Officer and prior to the Request for Quotations from industry. Think of the changes, the delays and the rewrites. It is inconceivable that after all this sincere time and effort expended by the Government prior to the Request for Quotation, that all that time is literally wasted when the procurement hits the street and the selected companies are asked to submit a quote in two weeks on an elaborately complicated development program, and no extensions in this bid period will be permitted because a fiscal obligation commitment must be made. It is patently clear that the insufficient time will not permit the preparation of proper proposals and will also induce some well qualified sources to reply "no bid."

Combine this insufficient time for proposal preparation with an arbitrary delivery requirement and we certainly have not prepared the foundation for a workable contract program. We are all aware that this happens all too often.

Government procurement offices who use letter contracts as a solution for the lack of sufficient administrative time, allow the performance to run for a year prior to definitizing, thereby nullify the operation of any incentive arrangement.

There must always be *sufficient time allowed for a contractor to perform an* incentive contract and to permit full opportunity to effect efficiencies and earn the incentive profit.

In summary, the five incentive contract criteria should be aimed at following principles:

a. Give the contract definite goal(s) in terms of work to be performed and target cost.

b. Give the opportunity to increase profit by efficient performance.

c. Remove restrictions to management freedom.

d. Provide potential profit incentives commensurate with risk and responsibility. Reward or penalize based upon a contractor's own actions.

e. Permit realistic time for performance based on the actual requirement.

Problems Within Industry

In general, Industry had to attempt to resolve several overall problems with the introduction of incentives! Some of them are ---

a. How to educate contractor personnel in the basic and finer theories and current Government regulations pertaining to incentive contracting.

b. How to work with the Government to harness the profit motive to work for the truly effective and economical contract performance required in the interest of national defense.

c. How to present the Government with incentive proposals which will satisfy the existing need and will provide profit commensurate with the risk involved, etc.

d. How to evaluate a company's overall contractual and technical experience in a given area and relate it to the most realistic and competitive incentive proposal.

e. How to evaluate a company's actual ability to propose incentives other than cost alone, i.e., delivery and performance.

f. How to make subcontractors share directly in the negotiated incentives.

g. How to obtain necessary adjustments and changes to standard type Government clauses.

Specific Industry Problems with Government

Once these problems were resolved, Industry was prepared to submit meaningful incentive proposals and proceeded to meet the Government at the negotiation table in an attempt to negotiate incentive type contracts. Again, problems still arise as the following:

a. Application and indiscriminate use of incentive contracts without due regard to the varying nature of the work to be done, i.e., its position in the research, development, and production spectrum.

b. Difficulty of writing incentive contracts containing meaningful and attainable performance incentives without adequate program definition (detailed work statements and specifications).

c. Delay in removing excessive administrative controls during contract performance which are incompatible with the philosophy and effective operation of incentive arrangements.

d. Lack of recognition and provision for adjusting price and other affected provisions of incentive contracts when costs or delays are incurred beyond the contractor's responsibility or control, and were not within the original range of cost.

e. Need for elimination of inconsistencies, ambiguities, and delays in the implementation of contract changes.

f. Inadequacy of profits under incentive contracts both from the aspect of statutory and regulatory limitations as well as retention of earned profit.

g. Difficulty the Government has in conveying specific contractual responsibilities and delivery dates to interfacing Government agencies which do not come under the direct jurisdiction of the procurement agency, and very specifically the DCASR and DCAA organizations, which we'll come back to.

During the negotiation period, a contractor has to achieve a common understanding with his Government negotiator in the incentive areas of cost, and/or delivery, and/or performance, or a combination, known as multiple incentives. This is done by discussing what considerations were given to the following areas:

Cost Incentive

a. The complexity and size of the job.

b. The normal contingencies required based on past experience.

c. The number and relative importance of state of the art breakthroughs that are required.

d. The degree to which the proposed work has been preceded by research and/or earlier development phases.

e. The initial negotiating position of both the Government and the contractor regarding target cost.

f. The establishment of minimum and maximum expected target costs.

g. The analysis of the proposed incentive arrangement by plotting the incentive formula over a span of costs to determine the actual dollars of profit which will be paid at each cost level.

Delivery Incentive

a. What is the total (dollar) delivery pool?

b. Should the schedule incentive hinge on a final completion date?

c. Should interim objectives be cited, dated and agreed on?

d. If interim delivery goals are selected, what objectives will be appropriate in light of the nature of the procurement?

e. How should these objectives be weighted?

f. How should the monetary effect of each objective be expressed?

g. How can realistic target dates be established, agreed on, and met?

h. Assuming the contract calls for the manufacture of more than one deliverable item, is it desirable to weight the items so that those at the beginning of the delivery schedule carry a heavier weight than those at the end?

i. And lastly, what benefits will accrue to the contractor for early delivery? What losses will accrue for late delivery?

Performance Incentive

a. Nature of the customer's requirement

b. Realism of performance range

c. Avoidance of duplication or redundancy

d. Clarity of definition

e. Ability to measure performance by delineation of terms and conditions

Multiple Incentives

Consideration must be given to the previously discussed points and also the realistic weighting of incentives per the Government's actual requirements to enable proper management and management freedom to make trade-off decisions consistent with the goals of the Government and the contractor.

If the Government and contractor are not able to reach a mutual level of agreement in these areas, the negotiation cycle is prolonged and, needless to say, the program is delayed accordingly.

Basic Proposal or Negotiation Check-List

Industry and the Government can preclude many contractual problems by "nipping them in the bud" during the negotiation period. The contractor's proposal to the Government is the first indication as to whether or not the contractor understands the Government's work statement, ultimate goals, and key value areas. It should reflect, and be further amplified during negotiations to include, the following:

a. A clear understanding of the items or services to be supplied and their respective quantities. Where ambiguities, conflicts, or errors arise, they should be highlighted in the proposal.

b. A clear understanding of all of the specifications related to each deliverable item. Where a specification cannot be met, the contractor should say so, give the reasons, and suggest alternate solutions. If the contractor's price is predicated on utilization of a given specification, indicate this fact in the proposal. The time for specification changes is prior to the execution of the contract. Remember, a contractor's request for waiver or change of a specification or any part thereof during the course of a contract is usually followed by a Government request for consideration.

c. A definitive statement of all end item testing requirements.

d. A procedure that defines what must be done if ambiguous test data is derived when the end item undergoes final acceptance testing by Government personnel.

e. A procedure that covers additional contractor time and testing (when the end results or conclusions indicated that poor or unreliable date was generated when outside of the control of the contractor, inexperienced personnel or improper handling of the equipment occurred.)

f. A statement defining the responsibilities of the contractor with regard to submission of reports (technical, financial, etc.), the use of facilities, the method by which end items are to be measured in order to determine compliance with the contract specifications, warranty expense, interface areas with others, and input from other sources, etc.

g. A thorough and concise pricing exhibit.

h. A procedure for handling excusable delays and contract changes, which will reflect a means to extend the contract delivery dates and to make equitable adjustments to the contract's target cost, target fee or profit, and target price.

i. A procedure for expeditious handling of such items as preliminary design data approvals. This procedure should define the time required by the Government to approve the data, what adjustments would be made to delivery and price should approvals be delayed by the Government, and the method by which these adjustments would be contractually implemented.

j. A definition of required Government furnished property which would include the actual hardware and also the ancillary items such as cables, fittings, etc. A detailed timetable for delivery of Government furnished property to the contractor must be provided in the contract.

k. A procedure for the expeditious repair or replacement and applicable contractual coverage of Government furnished property not in operable condition. The above also applies to Government furnished data!

l. A precise statement of areas wherein the contractor requires freedom of action in order to maximize his ability to earn fee or profit such as approval of overtime, make or buy decisions, and subcontracts.

m. A precise statement of required funding and where applicable, a time scale for incremental funding.

n. A procedure to cover circumstances which occur beyond the contractor's control and preclude the establishment of the end item's ability to meet its contractual requirements. An example of such a mishap is the destruction of a missile by a range officer due to an improper launch. How can the contractor who furnished a sub-assembly assure himself of payment for his unit?

This proposal and negotiation check list can be a useful tool to both parties if used. Contractors must realize that the Government will be able to award better

contracts on a timely basis if these basic areas are covered in all proposals. Further, more timely and economical contract completion must be the end products of these efforts.

Contractor Problem Areas

What we have just discussed is, of course, the never-never land, the ground rules for writing the perfect contract, where there can be no problems. We know that we have not yet reached this era of paradise, so let us be very practical and consider some of the problems that do occur. The following are substantial and significant problem areas which every contractor must face.

If I were to categorize the major problems that industry faces, I would set them forth as follows:

a. The effect of third party participation

b. Time delays as the Government's contribution to the contractor's difficulties

I firmly believe that Contracting Officers must recognize the economic dollar impact that third party agencies such as DCASR and the Defense Contract Audit Agency cause by their actions or inactions in all contracts. Are you aware that either one or these agencies has the right of approval or rejection of the basic management systems of any company? For instance, the estimating system, the purchasing system, the quality control system, the production control system, the accounting system. Are you also aware that the guidelines or "regulations" of particularly the audit agency, that specifically provide the basis for this approval or rejection are not made public and that industry has no means of gaining access to these requirements or even to comment on them prior to their implementation. Even proposed changes to ASPR's are discussed in great length with representatives of industry and industrial associations prior to their implementation. It should be apparent, therefore, that a real vacuum exists in the area of the delegation of specific responsibility and authorization to DCASR's and the audit agencies. It is certainly no longer proper for a Contracting Officer to consider his job accomplished when he merely indicated that "Administrative cognizance of this contract is hereby assigned to DCASR be it either New York, Dallas, Los Angeles or points in between." It is also obvious that a contractor should insist that the contract state in a most detailed manner the specific duties and standards that these two agencies will be required to comply with. This vacuum should no longer be permitted to be filled improperly, extra-contractually, and sometimes arbitrarily. When a contract is being negotiated, the intention of the contracting parties becomes very clear and specific, and no third party at a later date should be permitted to abrogate that intention unilaterally and arbitrarily. Further, the third party responsibility must be considered as an effect on the ultimate negotiated contract price.

A second major problem being faced by industry is the time delays contributed by the Government during the administration of an incentive contract. The contractor has been incentivized by very real means; namely, dollars, to cut costs and improve delivery and performance. It follows, therefore, that the Government in the true spirit of incentive contracting should not be permitted to place obstacles in the contractor's way to achieve those incentives. Some of these obstacles may be very obvious, others are quite subtle. Contractual questions and problems must be formalized and answered promptly. Specification questions also require immediate action, for these are the type of problems that can effect the program decision-making process which determine the steps necessary to achieve the desired milestones. The furnishing of Government furnished equipment including data is a contractual obligation assumed by the Government and should be discharged as such. Either the equipment or the data is available or it is not, in the required time. If it is not available, or not in suitable operating condition, a decision must be made quickly as to the course of action. The Governmental deliberation over a problem for long periods of time automatically will destroy any incentive structure previously formulated. Design approvals must be made within the required time, and that time should be specified by the contract.

If inspection and/or acceptance responsibility and authority are given to third parties, the accept/reject criteria for the items must be clearly defined. When equipments are delivered FOB destination, the right of the Government is limited to either the acceptance or the rejection of the items based on the contract specifications and there must be a timely communication to enable prompt payment or corrective action. The Contracting Officer cannot escape his responsibility to pay for services and equipments delivered, by hiding behind the failure of a field destination to acknowledge receipt. Items received in the field require a formal acknowledgment or else the Government will be receiving free services and equipments and, of course, that's not what was contracted for.

Another great area of delay is the inability of contractors to have directed changes or spare parts or AGE equipments priced out once performance has been directed by the Government. The contractor may well have completed performance of the change or delivered all his shipments before the Government is ready to negotiate. Sure, this is after-the-fact pricing and it is not proper and is against the rules, but what is his relief? The contractor may well be exposed for millions of dollars of accrued receivables; and, if he manages to stay in business, what kind of negotiating position is he in, if a Government auditor refuses to complete his price analysis report until he see the actuals. We used to call this cost plus percentage of cost contracting. Today, it is described as satisfying a "Certificate of Current Pricing" or "the truth in negotiation statute." But basically, it is a poor substitute for an honest-to-goodness negotiation!

This is the same auditor, of course, who could have disapproved the estimating system or purchasing system, and now by merely delaying a submission of his price analysis report on this proposal, could put you in a situation of pricing after a substantial portion of costs were known. Perhaps it is time to reassert that the sole authority to amend the contract and to attest to the reasonableness of negotiated prices is with the Contracting Officer and that these other agencies' services are merely advisory. It was never intended that the Contracting Officer surrender his responsibility and become merely a rubber stamp of the advisory reports made available to him. In this light, I submit that it is only proper that the Government recognize and accept interest charges as an allowable cost to cover monies borrowed when required for the performance in Government contracts which are not definitized or priced-out within a reasonable period of time. The reasonable period of time should be a condition of the original contract.

Let me summarize very quickly the basic principles for avoiding problems in an incentive contract:

a. The incentives should be placed directly on the most important program objectives. In other words, incentivize the ends, not the means of the program. Thus, the Government is assured that the contractor's management really directs its energies to meet the objectives and at the same time the contractor is permitted flexibility in making trade-offs internal to the major objective of the contract.

b. The incentive arrangements should be so aligned that the contractor's general motivation and self-interest is in parallel with the Government's general motivation and self-interest. For example, cost incentives should be arranged so that the lowest cost to the Government will bring the highest profit to the contractor. Delivery incentives should not be over-emphasized if quality is really of greater interest.

c. The program objectives obviously should be clearly reflected by the balancing of the various incentives involved. It is very easy to foresee where the net effect of contractual incentive provisions in a complex situation can be negative rather than positive. The most common case is probably where incentives are too heavily applied to cost and delivery and insufficiently to quality, reliability and overall technical performance.

Finally, let us face the facts. The earning of an incentive by a contractor reflects a gain for both parties, the contractor and the Government, because for the additional profit dollars received by Company A, the Government has achieved lower costs or better performance or quicker delivery. If a contractor wins or earns an incentive, it certainly doesn't mean that the procuring agency has lost a bet.....The best interests of both parties have really been served!