

# **PGI 216.4 -INCENTIVE CONTRACTS**

**Parent topic:** [PGI Part 216 - TYPES OF CONTRACTS](#)

## **PGI 216.401 General.**

(c) Incentive contracts. DoD has established the Award and Incentive Fees Community of Practice (CoP) under the leadership of the Defense Acquisition University (DAU). The CoP serves as the repository for all related materials including policy information, related training courses, examples of good award fee arrangements, and other supporting resources. The CoP is available on the DAU Acquisition Community Connection at <https://acc.dau.mil/awardandincentivefees>. Additional information can be found on the MAX website maintained by the Office of Management and Budget at: <https://max.omb.gov>.

(e) Award-fee contracts.

(i) It is DoD policy to utilize objective criteria, whenever possible, to measure contract performance. In cases where an award-fee contract must be used due to lack of objective criteria, the contracting officer shall consult with the program manager and the fee determining official when developing the award-fee plan. Award-fee criteria shall be linked directly to contract cost, schedule, and performance outcomes objectives.

(ii) Award fees must be tied to identifiable interim outcomes, discrete events or milestones, as much as possible. Examples of such interim milestones include timely completion of preliminary design review, critical design review, and successful system demonstration. In situations where there may be no identifiable milestone for a year or more, consideration should be given to apportioning some of the award fee pool for a predetermined interim period of time based on assessing progress toward milestones. In any case, award fee provisions must clearly explain how a contractor's performance will be evaluated.

(iii) The head of the contracting activity for each defense agency shall retain the D&F for (a) all acquisition category (ACAT) I or II programs, and (b) all non-ACAT I or II contracts with an estimated value of \$50 million or more. The head of the contracting activity shall forward the D&Fs for ACAT I programs to Defense Pricing, Contracting, and Acquisition Policy/Contract Policy directorate (DPCAP/CP) within 1 month of the end of the quarter. Copies of D&Fs on all contracts shall also be included in the contract file.

## **PGI 216.402 Application of predetermined, formula-type incentives.**

### **PGI 216.402-2 Technical performance incentives.**

Contractor performance incentives should relate to specific performance areas of milestones, such as delivery or test schedules, quality controls, maintenance requirements, and reliability standards.

## **PGI 216.403 Fixed-price incentive contracts.**

### **PGI 216.403-1 Fixed-price incentive (firm target) contracts.**

#### *(1) Use of FPIF contract.*

(i) *Not mandatory.* DFARS [216.403-1\(b\)\(1\)](#) directs the contracting officer to give particular consideration to the use of fixed-price incentive (firm target) (FPIF) contracts, especially for acquisitions moving from development to production. DFARS does not mandate the use of FPIF for initial production and each acquisition situation must be evaluated in terms of the degree and nature of the risk presented in order to select the proper contract type.

(ii) *Considerations.* Volume 4, chapter 1, of the Contract Pricing Reference Guide provides a detailed discussion of the considerations involved in selecting the proper contract type. For example:

(A) It is not in the Government's best interest to use FPIF when the cost risk is so great that establishing a ceiling price is unrealistic.

(B) It is also not in the Government's best interest to use firm-fixed-price (FFP) contracts on production programs until costs have become stable. Therefore, FPIF contracts should be considered in production and sole source follow-on programs where actual costs on prior FFP contracts have varied by more than 3-4 percent from the costs considered negotiated. Contracting officers are reminded that actual costs on prior contracts for the same item or essentially the same item, regardless of contract type or data reporting requirements of the prior contract, are cost and pricing data on the pending contract, and must be obtained from the contractor on production programs when certified cost or pricing data are required.

(C) For sole source major systems procurements, contracting officers should utilize FPIF contracts instead of FFP contracts unless the reasons for significant variation are well understood and actions have been taken to ensure that significant variation will not recur. In addition, when options are included as described in PGI [217.202](#) (2), the use of FPIF contracts is both highly recommended and encouraged, because both parties will be assuming more risk in pricing multiple years of requirements.

(2) *Incentive arrangement.* DFARS [216.403-1\(b\)\(2\)](#) directs the contracting officer to pay particular attention to share lines and ceiling prices for fixed-price incentive (firm target) contracts, with 120 percent ceiling and a 50/50 share ratio as the point of departure for establishing the incentive arrangement. While DFARS does not mandate the use of these share ratios or ceiling percentage, it is not unreasonable to expect that upon entering into production, risks have been mitigated to the point that the DFARS recommended point of departure for an FPIF incentive arrangement would be normal.

#### *(3) Analyzing risk.*

##### *(i) Quantification of risk.*

(A) The first step is establishing a target cost for which the probability of an underrun and overrun are considered equal and therefore, the risks and rewards are shared equally, hence the 50/50 share is the point of departure. Equally important is determining that the contractor has a high probability of being able to accomplish the effort within a ceiling percentage of 120 percent. In accomplishing both these steps, the analysis of risk is essential.

(B) Too often, risk is evaluated only in general terms without attempting to quantify the risk posed by the various elements of cost. Also, a contracting officer may incorrectly fall back on the share ratios and ceiling percentages negotiated on prior contracts or other programs, without examining the specific risks.

(C) Whether being used to select the proper contract type or establishing share lines and ceiling price on an FPIF contract, the analysis of risk as it pertains to the prime contractor is key. From a contractor's perspective, all risks, including technical and schedule risk, have financial ramifications. Technical and schedule risks, if realized, generally translate into increased effort, which means increased cost. Therefore, all risk can be translated into cost risk and quantified. Risk always has two components that must be considered in the quantification: the magnitude of the impact and the probability that it will occur.

(D) When cost risk is quantified, it is much easier to establish a reasonable ceiling percentage. The ceiling percentage is applicable to the target cost on the prime contract. It is important to understand the degree of risk that various cost elements pose in relation to that target cost. A discussion of the major cost elements and the risk implications follows in paragraphs (3)(ii) through (iv) of this section.

(ii) *Subcontracts and material cost and risk.*

(A) In many prime contractors' contracts, a substantial amount of risk is borne by subcontractors, not the prime contractor, via negotiated firm-fixed-price (FFP) subcontracts. In the case of FFP subcontracts, the subcontractor is obligated to deliver at the negotiated price. The risk to the prime contractor is the supplier's failure to perform or perform on time. Generally, that risk is considered to be low by both the prime and the subcontractor as evidenced by the FFP contract type. In addition, the prime contractor will normally have priced effort for material management or subcontract administration to ensure timely performance on the part of the suppliers. This effort may be bid directly or indirectly (e.g., as part of an overhead expense) depending on the contractor's accounting practices.

(B) The impact of negotiated FFP subcontracts on the prime contractor's risk can be significant. A prime contract with a 120 percent ceiling price provides overrun protection to the prime contractor equal to 20 percent of the target cost on the contract. However, if FFP subcontracts represent half of the total contract cost, then half of the target cost is subject to little or no cost risk on the part of the prime contractor. Therefore, the overrun protection provided by 20 percent of the target cost is really closer to 40 percent protection of the prime's cost that is truly at risk to the prime contractor, which likely is significantly overstated. Thus, a ceiling price less than 120 percent in this risk situation would be more appropriate.

(C) For subcontracts that have not yet been negotiated between the prime and subcontractor at the time of negotiation of the prime contract, the degree of risk is essentially limited to the difference between the price proposed by the subcontractor and the subcontract value included in the prime contractor's proposal.

(D) For subcontracts that are not FFP, the risk to the prime is based on the risk represented by the subcontractors' contractual relationship with the prime. If the subcontract is FPIF and has a 50/50 share ratio and 120 percent ceiling, the prime's risk is 50 percent of each dollar of overrun up to the ceiling amount. An analysis of the subcontractor's risk would be necessary to determine the probability of reaching the ceiling price.

(iii) *Direct labor cost and risk.*

(A) The risk in direct labor is in the hours needed to perform the effort and the risk in the labor rates paid to employees. There is generally little risk in the direct labor rates. However, there are various levels of risk in the direct labor hours needed by the prime contractor to accomplish the contract requirements. This risk can be driven by a number of factors including technical complexity, schedule constraints, or availability of personnel, parts, or tooling. Risks vary by task and the key is to identify the major tasks and assess the “what if” impact at the total contract cost level.

(B) Schedule is often correctly cited as a risk factor, but it is important to understand and quantify the probability and impact of a potential schedule slip. Generally, any schedule slip can only affect the prime contractor’s in-house cost. Therefore, any schedule impact should be assessed on the impact it would have on the prime contractor’s performance of its tasks.

(C) However, it is wrong to assume the worst-case scenario that a schedule delay results in an extension of the entire prime contractor workforce for the period of the delay. A responsible contractor will take steps to minimize both the delay and the impact of that delay. For instance, a production schedule assumes an optimal sequencing of tasks which presumes the timely arrival and availability of parts from suppliers or other in-house sources. A delay in receiving parts as planned could require a resequencing of tasks and could adversely affect the efficiency of performing a number of tasks, but it will not cause the entire workforce to be idle during the delay.

(iv) *Indirect (e.g., overhead) cost and risk.* Overhead and other indirect costs (e.g., general and administrative expense) can represent a significant portion of the prime contractor’s in-house cost. Indirect expense (hereafter referred to as overhead) poses potential cost growth risk or the opportunity for cost reduction from the following two perspectives:

(A) *Actual overhead rate.* (1) First, the actual overhead rate could be different than that proposed. Proposed overhead rates, even those covered by a forward pricing rate agreement, are based on forecasts of overhead expenses and the bases to which they are applied. The final overhead rate that is actually applied (charged) to a contract will be based on the actual overhead expenses and the actual base, each of which could be considerably different than estimated. The net effect could be a higher or lower overhead rate than estimated.

(2) In general, the risk in an overhead rate tends to be driven more by fluctuations in the base than in the expenses. This is because overhead expenses are made up of expenses that consist of “fixed” (e.g., depreciation) and variable (e.g., fringe benefits) in nature. When the actual base turns out to be lower than the estimated base, the fixed costs are spread over a smaller base resulting in a higher overhead rate. In general, if the actual base is greater than estimated, a lower overhead rate will result.

(3) In assessing this risk, the contracting officer should consider the contractor’s ability to predict overhead rates based on comparing proposed versus actual rates for prior years. In making this comparison, it is important to do so in a manner consistent with the proposal being reviewed. For instance, if the majority of overhead costs on the proposal being reviewed occur two years in the future, the comparison should look at the contractor’s accuracy in predicting overhead rates two years in advance. For example, in looking at the 2009 actual overhead rate, what did the contractor propose for 2009 in its 2007 forward pricing rate proposal?

(B) *Actual base cost.* If the actual base cost on the contract (e.g., direct labor dollars) is different than that proposed, the contract will be charged overhead costs according to the actual base costs on that contract. If the contractor overruns direct labor, even if the actual labor overhead rate was the same as proposed, that rate would be applied to a higher base resulting in increased overhead dollars on that contract. The opposite would be true if the contractor underruns direct labor on the

contract. Since this aspect of risk is tied to the base cost on the contract, the risk is the same as it is for those base costs (e.g., direct labor, material).

## **PGI 216.403-2 Fixed-price incentive (successive targets) contracts.**

The formula specified in FAR 16.403-2(a)(1)(iii) does not apply for the life of the contract. It is used to fix the firm target profit for the contract. To provide an incentive consistent with the circumstances, the formula should reflect the relative risk involved in establishing an incentive arrangement where cost and pricing information were not sufficient to permit the negotiation of firm targets at the outset.

## **PGI 216.405 Cost-reimbursement incentive contracts.**

### **PGI 216.405-1 Cost-plus-incentive-fee contracts.**

Give appropriate weight to basic acquisition objectives in negotiating the range of fee and the fee adjustment formula. For example—

- (1) In an initial product development contract, it may be appropriate to provide for relatively small adjustments in fee tied to the cost incentive feature, but provide for significant adjustments if the contractor meets or surpasses performance targets; and
- (2) In subsequent development and test contracts, it may be appropriate to negotiate an incentive formula tied primarily to the contractor's success in controlling costs.

### **PGI 216.405-2 Cost-plus-award-fee contracts.**

(1) Although weighted guidelines do not apply per DFARS [216.405-2\(3\)\(ii\)](#) when definitizing a contract action, the contracting officer shall, nevertheless, separately assess and document the reduced cost risk on the contract for—

- (i) The period up to the date of definitization; as well as
- (ii) The remaining period of performance (see DFARS [217.7404-6](#)).

(2) Normally, award fee is not earned when the fee-determining official has determined that contractor performance has been submarginal or unsatisfactory.

(3) The basis for all award fee determinations shall be documented in the contract file.

(4) The cost-plus-award-fee contract is also suitable for level of effort contracts where mission feasibility is established but measurement of achievement must be by subjective evaluation rather than objective measurement. See Table 16-1, Performance Evaluation Criteria, for sample performance evaluation criteria and Table 16-2, Contractor Performance Evaluation Report, for a sample evaluation report.

(5) The contracting activity may—

- (i) Establish a board to—
  - (A) Evaluate the contractor's performance; and
  - (B) Determine the amount of the award or recommend an amount to the contracting officer; and
- (ii) Afford the contractor an opportunity to present information on its own behalf.

## PGI 216.470 Other applications of award fees.

The “award amount” portion of the fee may be used in other types of contracts under the following conditions:

- (1) The Government wishes to motivate and reward a contractor for—
  - (i) Purchase of capital assets (including machine tools) manufactured in the United States, on major defense acquisition programs; or
  - (ii) Management performance in areas which cannot be measured objectively and where normal incentive provisions cannot be used. For example, logistics support, quality, timeliness, ingenuity, and cost effectiveness are areas under the control of management which may be susceptible only to subjective measurement and evaluation.
- (2) The “base fee” (fixed amount portion) is not used.
- (3) The chief of the contracting office approves the use of the “award amount.”
- (4) An award review board and procedures are established for conduct of the evaluation.
- (5) The administrative costs of evaluation do not exceed the expected benefits.

TABLE 16-1, PERFORMANCE EVALUATION CRITERIA

		Submarginal	Marginal	Good	Very Good	Excellent
A Time of Delivery.	(A-1) Adherence to plan schedule.	Consistently late on 20% plans	Late on 10% plans w/o prior agreement	Occasional plan late w/o justification.	Meets plan schedule.	Delivers all plans on schedule & meets prod. Change requirements on schedule
	(A-2) Action on Anticipated delays.	Does not expose changes or resolve them as soon as recognized.	Exposes changes but is dilatory in resolution on plans.	Anticipates changes, advise Shipyard but misses completion of design plans 10%.	Keeps Yard posted on delays, resolves independently on plans.	Anticipates in good time, advises Ship- yard, resolves independently and meets production requirements.

	(A-3) Plan Maintenance.	Does not complete interrelated systems studies concurrently.	System studies completed but constr. Plan changes delayed.	Major work plans coordinated in time to meet production schedules.	Design changes from studies and interrelated plant issued in time to meet product schedules.	Design changes, studies resolved and test data issued ahead of production requirements.
B Quality of Work.	(B-1) Work Appearance.	25% dwgs. Not compatible with Shipyard repro. processes and use.	20% not compatible with Shipyard repro. processes and use.	10% not compatible with Shipyard repro. processes and use.	0% dwgs prepared by Des. Agent not compatible with Shipyard repro. processes and use.	0% dwgs. Presented incl. Des. Agent, vendors, subcontr. Not compatible with Shipyard repro processes and use.
	(B-2) Thoroughness and Accuracy of Work.	Is brief on plans tending to leave questionable situations for Shipyard to resolve.	Has followed guidance, type and standard dwgs.	Has followed guidance, type and standard dwgs. Questioning and resolving doubtful areas.	Work complete with notes and thorough explanations for anticipated questionable areas.	Work of highest caliber incorporating all pertinent data required including related activities.
	(B-3) Engineering Competence.	Tendency to follow past practice with no variation to meet reqmts. job in hand.	Adequate engrg. To use & adapt existing designs to suit job on hand for routine work.	Engineered to satisfy specs., guidance plans and material provided.	Displays excellent knowledge of constr. Reqmts. considering systems aspect, cost, shop capabilities and procurement problems.	Exceptional knowledge of Naval shipwork & adaptability to work process incorporating knowledge of future planning in Design.
B Quality of Work (Cont'd)	(B-4) Liaison Effectiveness	Indifferent to requirements of associated activities, related systems, and Shipyard advice.	Satisfactory but dependent on Shipyard of force resolution of problems without constructive recommendations to subcontr. or vendors.	Maintains normal contract with associated activities depending on Shipyard for problems requiring military resolution.	Maintains independent contact with all associated activities, keeping them informed to produce compatible design with little assistance for Yard.	Maintains expert contact, keeping Yard informed, obtaining info from equip, supplies w/o prompting of Shipyard.
	(B-5)	Constant surveillance required to keep job from slipping—assign to low priority to satisfy needs.	Requires occasional prodding to stay on schedule & expects Shipyard resolution of most problems.	Normal interest and desire to provide workable plans with average assistance & direction by Shipyard.	Complete & accurate job. Free of incompatibilities with little or no direction by Shipyard.	Develops complete and accurate plans, seeks out problem areas and resolves with assoc. act. ahead of schedule.

C Effectiveness in Controlling and/or Reducing Costs	(C-1) Utilization of Personnel	Planning of work left to designers on drafting boards.	Supervision sets & reviews goals for designers.	System planning by supervisory, personnel, studies checked by engineers.	Design parameters established by system engineers & held in design plans.	Mods. to design plans limited to less than 5% as result lack engrg. System correlation.
	(C-2) Control Direct Charges (Except Labor)	Expenditures not controlled for services.	Expenditures reviewed occasionally by supervision.	Direct charges set & accounted for on each work package.	Provides services as part of normal design function w/o extra charges.	No cost overruns on original estimates absorbs service demands by Shipyard.
	(C-3) Performance to Cost Estimate	Does not meet cost estimate for original work or changes 30% time.	Does not meet cost estimate for original work or changes 20% time.	Exceeds original est. on change orders 10% time and meets original design costs.	Exceeds original est. on changing orders 5% time.	Never exceeds estimates of original package or change orders.

TABLE 16-2,  
CONTRACTOR  
PERFORMANCE  
EVALAUTION  
REPORT

Ratings	Period of _____
Excellent	Contract Number _____
Very Good	Contractor _____
Marginal	Date of Report _____
Submarginal	PNS Technical Monitor/s _____ _____

CATEGORY	CRITERIA	RATING	ITEM FACTOR	EVALUATION RATING		CATEGORY FACTOR	EFFICIENCY RATING
	A-1 Adherence to Plan Schedule	_____	x	.40	=	_____	
	A-2 Action on Anticipated Delays	_____	x	.30	=	_____	
	A-3 Plan Maintenance	_____	x	.30	=	_____	
	Total Item Weighed Rating	_____	x	.30	=	_____	
B	QUALITY OF WORK						
	B-1 Work Appearance	_____	x	.15	=	_____	
	B-2 Thoroughness and Accuracy of Work	_____	x	.30	=	_____	
	B-3 Engineering Competence	_____	x	.20	=	_____	
	B-4 Liaison Effectiveness	_____	x	.15	=	_____	
	B-5 Independence and Initiative	_____	x	.15	=	_____	
	Total Item Weighed Rating	_____	x	.40	=	_____	

C EFFECTIVE-NESS IN CONTROL-LING AND/OR  
REDUCING COSTS

C-1 Utilization of Personnel \_\_\_\_\_ x .30 = \_\_\_\_\_

C-2 Control of all Direct Charges Other than  
Labor \_\_\_\_\_ x .30 = \_\_\_\_\_

C-3 Performance to Cost Estimate \_\_\_\_\_ x .40 = \_\_\_\_\_

Total Item Weighed Rating \_\_\_\_\_ x .30 = \_\_\_\_\_

TOTAL WEIGHT RATING

\_\_\_\_\_

Rated by:

\_\_\_\_\_

Signature(s)

\_\_\_\_\_

NOTE: Provide supporting data and/or justification for below average or outstanding item ratings.