Subpart 16.4 - Incentive Contracts

Parent topic: Part 16 - Types of Contracts

16.401 General.

(a) Incentive contracts as described in this subpart are appropriate when a firm-fixed-price contract is not appropriate and the required *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 or fee payable under the contract to the contractor's performance. Incentive contracts are designed to obtain specific *acquisition* objectives by-

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

(2) Including appropriate incentive arrangements designed to-

(i) motivate contractor efforts that might not otherwise be emphasized; and

(ii) discourage contractor inefficiency and waste.

(b) When predetermined, formula-type incentives on technical performance or delivery are included, increases in profit or fee are provided only for achievement that surpasses the targets, and decreases are provided for 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 contracts (see 16.403 and 16.404) and cost-reimbursement incentive contracts (see 16.405). Since it is usually to the Government's advantage for the contractor to assume substantial cost responsibility and an appropriate share of the cost risk, fixed-price incentive contracts are preferred when contract costs and performance requirements are reasonably certain. Cost-reimbursement incentive contracts are subject to the overall limitations in 16.301 that apply to all cost-reimbursement contracts.

(d) A determination and finding, signed by the *head of the contracting activity*, *shall* be completed for all incentive- and award-fee contracts justifying that the use of this type of contract is in the best interest of the Government. This determination *shall* be documented in the contract file and, for award-fee contracts, *shall* address all of the suitability items in 16.401(e)(1).

(e) Award-fee contracts are a type of incentive contract.

(1) *Application*. An award-fee contract is suitable for use when-

(i) The work to be performed is such that it is neither feasible nor effective to devise predetermined objective incentive targets applicable to cost, schedule, and technical performance;

(ii) The likelihood of meeting *acquisition* objectives will be enhanced by using a contract that effectively motivates the contractor toward exceptional performance and provides the Government with the flexibility to evaluate both actual performance and the conditions under which it was achieved; and

(iii) Any additional administrative effort and cost required to monitor and evaluate performance are

justified by the expected benefits as documented by a risk and cost benefit analysis to be included in the Determination and Findings referenced in 16.401(e)(5)(iii).

(2) *Award-fee amount*. The amount of award fee earned *shall* be commensurate with the contractor's overall cost, schedule, and technical performance as measured against contract requirements in accordance with the criteria stated in the award-fee plan. Award fee *shall* not be earned if the contractor's overall cost, schedule, and technical performance in the aggregate is below satisfactory. The basis for all award-fee determinations *shall* be documented in the contract file to include, at a minimum, a determination that overall cost, schedule and technical performance in the aggregate is or is not at a satisfactory level. This determination and the methodology for determining the award fee are unilateral decisions made solely at the discretion of the Government.

(3) *Award-fee plan*. All contracts providing for award fees *shall* be supported by an award-fee plan that establishes the procedures for evaluating award fee and an *Award-Fee Board* for conducting the award-fee evaluation. Award-fee plans *shall*-

(i) Be approved by the FDO unless otherwise authorized by agency procedures;

(ii) Identify the award-fee evaluation criteria and how they are linked to *acquisition* objectives which *shall* be defined in terms of contract cost, schedule, and technical performance. Criteria *should* motivate the contractor to enhance performance in the areas rated, but not at the expense of at least minimum acceptable performance in all other areas;

(iii) Describe how the contractor's performance will be measured against the award-fee evaluation criteria;

(iv) Utilize the adjectival rating and associated description as well as the award-fee pool earned percentages shown below in Table 16-1. *Contracting officers may* supplement the adjectival rating description. The method used to determine the adjectival rating *must* be documented in the award-fee plan;

Table 16-1

Award-Fee Adjectival Rating	Award-Fee Pool Available To Be Earned	Description
Excellent	91%-100%	Contractor has exceeded almost all of the significant award-fee criteria and has met overall cost, schedule, and technical performance requirements of the contract in the aggregate as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period.
Very Good	76%-90%	Contractor has exceeded many of the significant award-fee criteria and has met overall cost, schedule, and technical performance requirements of the contract in the aggregate as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period.

Award-Fee Adjectival Rating	Award-Fee Pool Available To Be Earned	Description
Good	51%-75%	Contractor has exceeded some of the significant award-fee criteria and has met overall cost, schedule, and technical performance requirements of the contract in the aggregate as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period.
Satisfactory	No Greater Than 50%	Contractor has met overall cost, schedule, and technical performance requirements of the contract in the aggregate as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period.
Unsatisfactory	0%	Contractor has failed to meet overall cost, schedule, and technical performance requirements of the contract in the aggregate as defined and measured against the criteria in the award-fee plan for the award-fee evaluation period.

(v) Prohibit earning any award fee when a contractor's overall cost, schedule, and technical performance in the aggregate is below satisfactory;

(vi) Provide for evaluation period(s) to be conducted at stated intervals during the contract period of performance so that the contractor will periodically be informed of the quality of its performance and the areas in which improvement is expected (*e.g.* six months, nine months, twelve months, or at specific milestones); and

(vii) Define the total award-fee pool amount and how this amount is allocated across each evaluation period.

(4) *Rollover of unearned award fee*. The use of *rollover of unearned award fee* is prohibited.

(5) *Limitations*. No award-fee contract *shall* be awarded unless-

(i) All of the limitations in 16.301-3, that are applicable to cost-reimbursement contracts only, are complied with;

(ii) An award-fee plan is completed in accordance with the requirements in 16.401(e)(3); and

(iii) A determination and finding is completed in accordance with 16.401(d) addressing all of the suitability items in 16.401(e)(1).

(f) *Incentive- and Award-Fee Data Collection and Analysis*. Each agency *shall* collect relevant data on award fee and incentive fees paid to contractors and include performance measures to evaluate such data on a regular basis to determine effectiveness of award and incentive fees as a tool for improving contractor performance and achieving desired program outcomes. This information

should be considered as part of the *acquisition planning* process (see 7.105) in determining the appropriate type of contract to be utilized for future *acquisitions*.

(g) *Incentive- and Award-Fee Best Practices*. Each *agency head shall* provide mechanisms for sharing proven incentive strategies for the *acquisition* of different types of *products* and services among *contracting* and program management officials.

16.402 Application of predetermined, formula-type incentives.

16.402-1 Cost incentives.

(a) Most incentive contracts include only cost incentives, which take the form of a profit or fee adjustment formula and are intended to motivate the contractor to effectively manage costs. No incentive contract *may* provide for other incentives without also providing a cost incentive (or constraint).

(b) Except for award-fee contracts (see 16.404 and 16.401(e)), incentive contracts include a target cost, a target profit or fee, and a profit or fee adjustment formula that (within the constraints of a price ceiling or minimum and maximum fee) provides that-

(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.

16.402-2 Performance incentives.

(a) Performance incentives *may* be considered in connection 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 or fee to results achieved by the contractor, compared with specified targets.

(b) To the maximum extent practicable, positive and negative performance incentives *shall* be considered in connection 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 systems* contracts, 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 should* negotiate them in full coordination with Government engineering 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 Changes clause) will have on performance incentives.

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

16.402-3 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.

16.402-4 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.

16.403 Fixed-price incentive contracts.

(a) *Description*. A fixed-price incentive 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. The two forms of fixed-price incentive contracts, firm target and successive

targets, are further described in 16.403-1 and 16.403-2 below.

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

(1) A firm-fixed-price 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 fixed-price incentive 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.

16.403-1 Fixed-price incentive (firm target) contracts.

(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) *Application*. 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 *contracting officer shall* specify in the contract schedule the target cost, target profit, and target price for each item subject to incentive price revision.

16.403-2 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 (see 16.403-1 above).

(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.

(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 *contracting officer shall* specify in the contract schedule the initial target cost, initial target profit, and initial target price for each item subject to incentive price revision.

16.404 Fixed-price contracts with award fees.

Award-fee provisions *may* be used in fixed-price contracts when the Government wishes to motivate a contractor and other incentives cannot be used because contractor performance cannot be measured objectively. Such contracts *shall* establish a fixed price (including normal profit) for the effort. This price will be paid for satisfactory contract performance. Award fee earned (if any) will be paid in addition to that fixed price. See 16.401(e) for the requirements relative to utilizing this contract type.

16.405 Cost-reimbursement incentive contracts.

See 16.301 for requirements applicable to all cost-reimbursement contracts, for use in conjunction with the following subsections.

16.405-1 Cost-plus-incentive-fee contracts.

(a) *Description*. The cost-plus-incentive-fee 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. 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 cost-plus-incentive-fee contract is appropriate for services or development and test programs when-

(i) A cost-reimbursement contract is necessary (see 16.301-2); 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 *shall* also provide for a low minimum fee that *may* be a zero fee or, in rare cases, a negative fee.

(c) *Limitations*. No cost-plus-incentive-fee contract *shall* be awarded unless all limitations in 16.301-3 are complied with.

16.405-2 Cost-plus-award-fee contracts.

A cost-plus-award-fee contract is a cost-reimbursement contract that provides for a fee consisting of (1) a base amount fixed at inception of the contract, if applicable and at the discretion of the *contracting officer*, and (2) an award amount that the contractor *may* earn in whole or in part during performance and that is sufficient to provide motivation for excellence in the areas of cost, schedule, and technical performance. See 16.401(e) for the requirements relative to utilizing this contract type.

16.406 Contract clauses.

(a) Insert the clause at 52.216-16, Incentive Price Revision-Firm Target, in *solicitations* and contracts when a fixed-price incentive (firm target) contract is contemplated. If the contract calls for *supplies* or services to be ordered under a provisioning document or Government *option* and the prices are to be subject to the incentive price revision under the clause, the *contracting officer shall* use the clause with its *Alternate* I.

(b) Insert the clause at 52.216-17, Incentive Price Revision-Successive Targets, in *solicitations* and contracts when a fixed-price incentive (successive targets) contract is contemplated. If the contract calls for *supplies* or services to be ordered under a provisioning document or Government *option* and the prices are to be subject to incentive price revision under the clause, the *contracting officer shall* use the clause with its *Alternate* I.

(c) The clause at 52.216-7, Allowable Cost and Payment, is prescribed in 16.307(a) for insertion in *solicitations* and contracts when a cost-plus-incentive-fee contract or a cost-plus-award-fee contract is contemplated.

(d) The clause at 52.216-10, Incentive Fee, is prescribed in 16.307(d) for insertion in *solicitations* and contracts when a cost-plus-incentive-fee contract is contemplated.

(e) Insert an appropriate award-fee clause in *solicitations* and contracts when an award-fee contract is contemplated, provided that the clause-

(1) Is prescribed by or approved under agency *acquisition* regulations;

(2) Is compatible with the clause at 52.216-7, Allowable Cost and Payment; and

(3) Expressly provides that the award amount and the award-fee determination methodology are

unilateral decisions made solely at the discretion of the Government.