C**ontract Types**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **FIXED-PRICE FAMILY** | | | | | |
|  | **FIRM**  **FIXED-PRICE**  **(FFP)** | **FIXED-PRICE**  **WITH ECONOMIC**  **PRICE ADJUSTMENT**  **(FP-EPA)** | | **FIXED-PRICE**  **INCENTIVE**  **(FPI)** | **PRICE**  **REDETERMINATION** | |
|  | Government pays price which is not subject to any adjustment  regardless of  contractor’s cost experience.  Place maximum risk on con-tractor.  Contractor has greatest incentive to control costs.  Minimum administrative bur-den on parties.  Preferred contract type.  **Level of Effort**: Payment is based on effort expended rather than results achieved. Contractor provides specified effort over a stated period for fixed price. | The price paid by the  government may be revised upward or downward if certain contingencies exist.  Provides for price adjustment to protect parties against  significant economic  fluctuation or changes in  contractor’s established  prices.  EPA provisions can be based on established (published) prices, actual costs, or cost index.  Adjustments based on  established prices restricted to Industry-wide contingencies.  Adjustment based on labor or  material costs limited to  contingencies beyond the  contractor’s control. | | **Firm Target**:  Government pays price that is the sum of final negotiated cost and final profit. Final profit determined by  comparing final negotiated  cost to target cost and  adjusting target profit IAW formula (share-ratio). Final price cannot exceed ceiling price.  **Successive Targets**:  At predetermined production point, firm target cost is negotiated and firm target profit is determined IAW adjustment formula; either an FFP or FPI(F) can be negotiated. | **Prospective**: Government pays fixed price for goods or services for a given period, but price is subject to revision at stated times during performance of contract.  **Retroactive**: Government pays price (subject to ceiling), that is negotiated after contract  performance. | |
|  | Price | Price  EPA Clause | | **Firm Target**:  Target Cost  Target Profit  Ceiling Price  Sharing Formula  **Successive Targets**:  Initial Target Cost  Initial Target Profit  Ceiling Price  Target Profit Adjustment  Formula | **Prospective**:  Price  Ceiling (Optional)  **Retroactive**:  Ceiling Price | |
|  | When fair and reasonable prices can be established at outset.  Particularly suitable for standard or modified commercial items or military items for which sound prices can be developed.  **Level of effort**: R&D investigation or study. | When contingencies resulting from unstable market or labor conditions can be identified and covered by a separate price adjustment clause. | | Where assumption of a degree of cost responsibility by con-tractors will provide incentive for effective cost control.  Can combine with incentives on performance and schedule. | **Prospective**: Quantity production or services when a fair and reasonable price can be negotiated for initial period but not entire contract period.  **Retroactive**: When fair and reasonable FFP cannot be negotiated and low value or short period of performance renders other types impracticable. | |
|  | **Level of effort**: Used only when work cannot be clearly defined but effort desired can be agreed upon. |  | | Sole purpose cannot be to shift  cost responsibility to  government; requires  simultaneous agreement on all elements of pricing structure. | **Prospective**: FFP not feasible; pricing periods conform to  contractor’saccounting system;  assurance that price  predetermina-tion will be taken promptly.  **Retroactive**:Reasonable assurance that price  Redetermination will be taken promptly; requires HCA  Approval | |
|  |  | | **Not for use with sealed bid method**  Adequate Contractor Cost Accounting System | | |

**Contract Types**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **COST-REIMBURSEMENT FAMILY** | | | | |
|  | **COST-PLUS-**  **INCENTIVE-FEE**  **(CPIF)** | **COST-PLUS**  **AWARD-FEE**  **(CPAF)** | | **COST-PLUS-**  **FIXED-FEE**  **(CPFF)** | **COST**  **AND COST**  **SHARING** |
|  | Government pays allowable cost and incentive fee.  Incentive fee determined by comparing actual cost to target cost and adjusting target fee IAW fee adjustment formula (share ratio).  Performance incentives should be incorporated if development is feasible and government performance objectives have been determined. | Government pays allowable cost, base fee, and award fee.  Contractor earns a base fee which does not vary with performance and all or part of an award fee based on subjective evaluation by government of contractor’s performance.  Amount of the award fee is unilaterally determined by the government and generally is not subject to Disputes Clause.  Evaluation of performance and corresponding partial payment of fee made at stated intervals. | | Government pays allowable cost and fixed fee.  Fixed fee does not vary with actual costs.  Fixed fee may be adjusted for changes in work to be performed.  Minimum incentive for contractors to control costs.  **Completion Form**: Requires contractor to deliver end product (preferred form).  **Term Form**: Requires specified level of effort over stated period of time. | **Cost**: Government pays allowable cost, no fee.  **Cost Sharing**: Government pays only a portion of allowable cost as agreed to by both parties. Contractor absorbs portion of the cost with expectation of gaining other benefits from the effort. |
|  | Target Cost  Target Fee  Sharing Formula  Minimum Fee  Maximum Fee | Estimated Cost  Base Fee  Award Fee | | Estimated Cost  Fixed Fee | Estimated Cost |
|  | Development and test where a profit incentive is likely to provide motivation for more effective management. | Level of effort (R&D or Production)  Method of proving fee which motivates excellence in such areas as quality, timelines, technical ingenuity, and cost-effective management.  **Award fee may be used in conjunction with other types of contracts.** | | Research  Preliminary exploration or study.  Development and test where CPIF not practical. | **Cost**: Non-profit institutions/ organizations and facilities contracts.  **Cost Sharing**: R&D efforts with either profit or non-profit contractors. |
|  | Adjustment in fee is limited by minimum and maximum fees negotiated. | Base Fee shall not exceed 3 percent of estimated cost.  Weighted guidelines (for determining profit objective) shall not be applied.  Shall not be used in lieu of CPFF or CPIF when objective measurement is feasible. | | Fee shall not exceed 15 percent of estimated cost for R&D or 10 percent of estimated cost for other  contracts.  Price of A/E contract shall not exceed 6 percent of estimated cost of the public work or utility project. | **Cost Sharing**: Not applicable for effort specified by government or that has only minor relevance to commercial activities of the contractor. |
|  | **Not for use with sealed bid method**  Adequate Contractor Cost Accounting System | | **Not for use with sealed bid method**  Adequate Contractor Cost Accounting System | | | |

**Contract Types**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **OTHER TYPES**  **SPECIAL USES** | | | | |
|  | **Time and**  **Materials**  **Labor Hours** | **Letter**  **CONTRACT** | | **INDEFINITE**  **DELIVERY** |  |
|  | Government pays fixed hourly rate for supplies or services.  With contractor furnished material. Provided at cost.  **Labor Hours** differs only in that no material is supplied by contractor. | Preliminary contractual instrument that authorizes immediate commencement of effort.  Method of payment corresponds to type of contract contemplated when definitized | | **Definite Quantity**:  Provides for definite quantity of specified supplies or services for a fixed period with deliveries at designated locations upon order  **Requirements**: Provides for furnishing all actual requirements of specified supplies or services during a specified period as ordered by designated activities  **Indefinite Quantity**: Provides for furnishing indefinite quantifies of specified supplies or services during a specified time but government must order a stated minimum quantity. |  |
|  | Hourly labor rate  Ceiling Price |  | | Firm Fixed Price, Fixed Price with EPA, or Price Redetermination |  |
|  | Engineering and design services, repair, maintenance, or overhaul, emergency situations | When interests of national defense demand that work commence immediately and insufficient time available to negotiate a definitive contract | | **Definite Quantity**: Where definite quantity of supplies or services required during a specified period are readily available  **Requirements:** When impossible to determine in advance the precise quantities needed during a definite period of time  **Indefinite Quantity:** Same as requirements but government is only committed to minimum quantity |  |
|  | Determination that no other type of contract is suitable | Written determination that no other type suitable  Price ceiling required if award based on price competition  Must be defined within 180 days or prior to completion of 40% of work  Maximum government liability cannot exceed 50% of estimated cost at outset | |  | . |
|  | **Not for use with sealed bid method** | | **Not for use with sealed bid method** | | | |

**Another Look at Award Fee Contracting**

*When coupled with recent procurement reform initiatives, award fee contracts may no longer be the most advantageous incentive to offer contractors.*

BY MARGARET BRANDIS

About the Author

MARGARET BRANDIS is the director of contracts at Applied Resources, Inc. She is a member of the NOVA chapter of NCMA

Award Fee contracting first appeared in the 1960s when NASA developed it as a variation on incentive fee arrangements.1The government, wanting to provide incentives in certain areas of contract performance that did not lend themselves to objective measurement, created the award fee contract. Under an award fee arrangement, contractor performance is evaluated on a regular basis, and a portion of the award fee is allocated to the contractor ac. The purpose of award fee contracting is to motivate the contractor to obtain (or exceed) specific acquisition objectives. This article examines the use of award fee contracts in federal procurements.

**Contract Types**

The *Federal Acquisition Regulations* classify award fee contracts as one type of incentive contract that is distinguished primarily by the qualitative nature of the award fee criteria versus the more straightforward quantitative assessment of performance under incentive fee arrangements.2 Incentive fee contracts contain formulas based on objective, measurable standards to calculate cost, delivery, or performance incentives. Award fee contracts entail regular assessments of contractor performance by the government—a feature that adds to the administration of an award fee contract but that also is cited as a major benefit. In the days before “past performance” entered the acquisition reform vernacular, regular performance evaluations were one way to improve communications between contractors and the government. By requiring periodic evaluations and supplying award fee determinations that were based on the results, the government gave contractors specific feedback and monetary incentives that were based on the quality of their performance.

Award fee contracts may be used with either fixed price or cost plus contract vehicles. In fixed price award fee (FPAF) contracts, the fixed price is paid when the contract is satisfactorily completed regardless of the actual cost to the contractor.3The award fee (if any) is allocated to the contractor above and beyond the fixed price. A cost plus award fee (CPAF) contract provides a base fee (which may be zero), reimbursement of allowable contractor costs, and an award fee.4In both FPAF and CPAF contracts, the award fee determination is made unilaterally by the government according to award fee criteria that are stated in the contract. These criteria may be unilaterally adjusted by the government over the course of contract performance.

The award fee contract represents a sort of middle ground between full contractor cost risk at the fixed price end of the continuum and minimal contractor cost risk under cost plus fixed fee arrangements. By pegging all or some of the contractor’s profit or fee to performance, the outcome of the contract cost ceases to be the only measure of success or failure. The desirability of this more moderate contract mechanism and its concomitant motivational thrust are shown by the award fee contract’s increasing popularity. CPAF contracts are now the most commonly used contract vehicle at NASA.5In other agencies, award fee contracting is increasingly used, particularly with service contracts in which it may not be feasible to quantify measurable performance standards.6

**Components of an Award Fee Contract**

An award fee contract consists of the following components:

* an estimated cost;
* a base fee, paid on a regular basis and not tied to any evaluation of service;
* an award fee, which is the difference between the maximum fee and the base fee;
* a payment plan indicating how often contractor performance will be evaluated; and
* award criteria that describe the general areas in which the contractor will be evaluated.

The base fee can range from zero to three percent; it is comparable to the minimum fee on an incentive contract in that it is paid as long as satisfactory performance occurs. A number of agencies do not allow any base fee amount in certain situations. For example, NASA now prohibits base fee on service contracts and discourages it in any circumstances where the evaluations are considered interim in nature.7 (Presumably, this restriction guards against paying fees throughout the contract and then discovering at the end that the final product fails.) The Air Force Materiel Command does not allow base fee in fixed price award fee arrangements8 (perhaps, because it assumes the contractor has already received some level of profit that was built into the fixed price). Contractors, particularly small businesses, prefer base fees because the regular receipt of money helps improve the organization’s cash flow.

The maximum fee a contractor can earn is the sum of the base fee (if any) and the award fee. The award fee portion of the maximum fee must be large enough to motivate the contractor and must be distributed appropriately across the key performance areas so one facet of performance does not overshadow the others. For example, if meeting accelerated schedules is emphasized too much in the award fee criteria, then quality, costs, ,or both may suffer. A balance in the criteria must be achieved to ensure a balance in performance.

The timing of award fee evaluations should be spelled out in the contract. Typically, award fee boards meet every four or six months. If the award periods are too close together, the contractor does not have time to improve between evaluations, and the government does not have adequate time to conduct the evaluations. For many agencies, three or four evaluations per year may be too burdensome; a twice-a-year or once-a-year schedule may be more manageable. Often, the contractor provides substantial input to the award fee deliberations (e.g., amassing performance data, preparing materials, delivering presentations, etc.), so award periods that are too frequent also create a burden for the contractor. In contrast, when award fee determinations are not made frequently enough, the contractor loses the use of the award fee money to which he or she would have been entitled. Infrequent award fee determinations also pose a greater risk that important milestones or extenuating circumstances that occurred in the distant past will be overlooked. The Air Force Materiel Command does not permit award periods of more than six months for small businesses; large businesses must be evaluated at least once a year.9However, even with good intentions and guidelines that express clear evaluation periods, many contractors experience considerable delays in being evaluated and in receiving their results.

Award fee criteria will vary depending on the nature of the contract and the areas that would benefit from additional motivation. Note that award fee criteria are completely different from the evaluation factors used to decide who will get the contract. The latter are contained in Section M of any Request for Proposals (RFP) and are used by source selection officials to evaluate proposals and determine the winner. Typically, the award fee criteria are based on the scope of work and the deliverables contained in the original RFP. The most common areas evaluated in award fee contracts are cost, schedule, quality, and management. Similar to incentive fee arrangements—where measurable performance and delivery criteria may be added to cost incentives—NASA requires cost to be one of the factors in the evaluation of the award fee portion of contracts. This proviso is included to ensure that contractors do not focus on one area of performance (e.g., quality) to the detriment of another (e.g., increased costs).

Over the course of a long-term contract, it is not uncommon for the original scope of work to resemble less and less the actual work being done. This transformation is particularly true in the information technology field where rapid change is the norm. When the award fee criteria do not evolve to reflect the current nature of the work being done, contractors may lose award fee dollars even though they are performing as the agency desires.

An example of actual award fee criteria, taken from the award fee plan of an RFP for systems engineering and technical assistance services, is shown in Table 1. In this Plan, Financial Management is one of the main categories to be evaluated; cost-related considerations also appear secondarily under the Management Performance category which includes Hour Management, Management of Hours, Other Direct Costs, and Subcontract Management. The award fee plan from this RFP also indicates that the contractor will be informed at the beginning of the evaluation period of the relative order of importance of the criteria and specific factors that may be considered in the evaluation. See Table 1 for sample award fee criteria.

Once the criteria are defined, the contractor’s performance is rated against the criteria. A sample rating scale from the same RFP is shown in Table 2. Although these particular examples came from a service contract, they are written broadly enough that they could apply to almost any aspect of almost any type of contract.

An overall score for the performance period is calculated and the amount of award fee is determined by the government, using some mechanism to translate the contractor’s performance score (points, colors, grades, adjectives) into a dollar amount of award fee. Some plans may use a one-to-one correspondence: If the contractor has an overall score of 91, for example, then 91 percent of the award fee for that period would be allocated to the contractor. Other conversion methods exclude performance at the low end of the scale (e.g., the “Inadequate” rating in Table 2) from any award fee and distribute the award fee linearly over the remaining rating levels (e.g., “Adequate” to “Excellent”). In Table 2, anything below a 50 rating might receive a $0 award fee; performance ratings from 50 to 100 points would be calculated at 2 percent of the potential award fee amount per rating point. A rating of 91 percent would result in a fee amount of 82 percent (91 − 50 × 0.2).

From the government’s perspective, this approach is logical because the government does not want to reward unsatisfactory performance by allowing an award fee to be paid for substandard work. However, from the contractor’s perspective, the decks are stacked against the contractor because only a perfect score of 100 on all evaluation items will result in full fee. For every point below 100, the award fee percentage drops disproportionately (two to one in this example).

In a recent decision by the U.S. Court of Appeals for the Federal Circuit, the conversion method used by the fee determining official was at issue.10This case involved a CPAF contract that was awarded to Burnside-Ott Aviation Training Center by the Navy for aircraft maintenance and repair. Burnside-Ott earned an overall performance rating of 93.65 but received an award fee of only 84.15 percent because the conversion method used by the government did not include an award fee for ratings below 60 (labeled “Submarginal”). Thus, instead of a one-to-one correspondence between the performance rating (93.65) and the amount of the award fee (93.65 percent) that Burnside-Ott argued for, the government used a conversion method of 2.5 percent per rating point for evaluation ratings of 60 and above.

This sort of disconnect between a very good performance evaluation and a mediocre award fee amount is a common problem for contractors. The issue is not confined to short-term monetary rewards, however. It can also extend to future business potential when past performance data that is required by RFPs include total award fee pools versus the actual award fee received. Unless the contractor annotates the requested award fee data with an explanation, the contractor’s past performance may be misinterpreted.

Although Burnside-Ott lost the case (the court declared that the conversion method was left to the government’s discretion and that the decision was not arbitrary or capricious), they won a much bigger battle because the court also found that contract language that removes contractual matters from the Contracts Disputes Act is illegal and unenforceable. Before Burnside-Ott, language in the *FAR* that flowed to award fee contracts was always clear: Award fee decisions were not subject to the “Disputes” clause of the contract. Contractually, contractors had no right to protest award fee decisions, a limitation that, when coupled with the unilateral authority of the government to establish evaluation criteria, change evaluation criteria, and apply evaluation criteria, put contractors at a distinct disadvantage. The court sought to restore the balance between the government and its contractors when it found that the government could not put language in its RFPs and contracts that refused contractors the protections of the Contract Disputes Act. As a consequence of the Burnside-Ott decision, Federal Acquisition Circular (FAC) 97-15 (December 27, 1999) has now deleted the phrasing “not subject to the Disputes clause of the contract” from the *FAR* references to award fee contracts. Parenthetically, the Burnside-Ott decision may have even wider repercussions if this same reasoning is applied to protests of task-delivery order awards that the *FAR* currently does not allow except for a few limited grounds. This repercussion may have been what Robert D. Witte was alluding to when he referred to the “far-reaching consequences” of the Burnside-Ott case.11

Although the general areas covered by the government’s performance evaluation should be stated in the contract, the specific award fee plan may not be a part of the contract. The award fee plan documents the methodology the government will use: the criteria, the weightings, and the way in which the contractor’s evaluation scores are converted to an amount of fee awarded. The plan is often kept outside the contract so the government has maximum flexibility to change the award criteria as program needs change.

This flexibility to adjust criteria and their weightings over time is another difference between incentive fee contracts and award fee contracts. Generally, all methods of performance assessment are laid out—by formula—in incentive fee contracts and remain in force over the course of the contract. If mission objectives change midway through an award fee contract, however, the government may unilaterally alter the award fee criteria as long as the contractor is given sufficient notice prior to the next evaluation period.12 Thus, contractors may discover that the assumptions on which their risk was originally calculated could be changed without recourse on their part.

Although problems stemming from this loophole do not appear common, contractors could conceivably find themselves caught in this bind. Suppose, for example, that a contractor bids and wins an award fee contract containing award fee incentives for cost and schedule. The government has emphasized timeliness in its award fee criteria because delays have been a chronic problem in the past. The contractor accepts the schedule risks because the contractor has innovative techniques for improving delivery times. A year into the contract, the contractor has performed better than the standards set for schedules without increasing costs. Now that delays are no longer an issue, the government shifts its focus to improving the quality of the product and changes the evaluation criteria accordingly. The contractor, however, has no methods for improving quality without affecting cost or schedule. In fact, the contractor was able to speed up delivery precisely because the product was not expected to change. Suddenly, the performance requirements are different, and the contractor could lose substantial award fee amounts through no fault of its own.

**Selection Criteria**

Given the different contract types and variations among types, when is an award fee contract appropriate? As mentioned earlier, award fee contracts are used when the government wishes to motivate contractor performance but cannot use incentive fee arrangements because objective (quantifiable) measures are not feasible. The government expends more resources to administer award fee contracts; thus, the benefits to be gained (in terms of improved product, reduced costs, or timely delivery) must outweigh the administrative costs. Because of this extra administrative burden, award fee contracts should be reserved for large contracts, contracts that are critical to the agency’s goals, or both.

CPAF contracts are subject to the same *FAR* limitations (adequate accounting system, government surveillance to ensure cost controls) as all cost reimbursement contracts.13 The *FAR* requires FPAF contracts to have award fee procedures already established, including designated award fee board members. The *FAR* also requires approval at the level above the contracting officer for FPAF contracts.14The limitations placed on award fee contracting in the *FAR* are indicative of some of the potential pitfalls the government is trying to avoid: inappropriate use of the contract type as well as lack of planning and preparation.

A number of different “hybrid” contract types have sprung up in recent years, combining elements of several contract types into one. One form has an objective, formula-based incentive for cost and a subjective award fee provision for qualitative measures such as technical excellence or customer satisfaction. Although not specifically identified in the *FAR*, these types of contracts are referred to as cost plus incentive fee/award fee (CPIF/AF) or fixed price incentive/award fee (FPI/AF). They are possible only when enough certainty in estimating costs exists to allow establishment of a target cost and, therefore, measurement of the cost incentive by formula. At the same time, subjective appraisal of other aspects of performance is considered an important incentive.

Hybrid contracts such as CPIF/AF and FPI/AF are administratively burdensome both for the government and the contractor. Not only must the procedures for both award fee and incentive fee be followed but also payment from the different fee pools must be billed and tracked separately. Because of these constraints, CPIF/AF and FPI/AF contracts should be used only if the dollar value and mission importance warrant them.

The Department of Energy uses performance-based incentives in combination with award fees on its management and operating contracts.15 These contracts have a base fee and an award fee, a portion of which applies to performance-based incentives. These objective measures are evaluated on a regular basis by subject matter experts, and achievement of the specific measures is confirmed before release of the fee. The remainder of the award fee pool is applied to subjective evaluations. Hybrid contracts often evolve when objective cost incentives are desired but insufficient information is available at the time of award to specify those targets precisely. For example, an award fee contract might be combined with Value Engineering provisions that allow the contractor to share in cost savings initiatives without first establishing a target cost and share ratio at contract inception.16

The *FAR* also authorizes FPI (successive targets) contracts that provide some flexibility in determining the target cost.17This contract type allows cost experience under the contract (and other contracts) to be taken into account during contract performance in negotiating a realistic, firm target cost and profit at some point other than prior to contract award. As Indefinite Delivery/Indefinite Quantity (ID/IQ) contracts have become more popular, award fee provisions are finding their way into these contractual vehicles. It is not uncommon to see CPAF, FPAF, and fixed price task-delivery orders all possible under the same ID/IQ contract.

**Procedures and Personnel**

A number of different government personnel become involved in an award fee contract.18A fee determining official (FDO) is typically a high ranking government official who may head the contracting activity or may be the head’s designee. The FDO makes the final award fee decisions with input from an award fee board (sometimes called a performance evaluation board). The board usually ranges from three to six or more people who are appointed by the FDO. These people tend to be senior level managers who will approach the fee determination from a broader perspective. The board includes the contracting officer and others with knowledge in the broad areas being performed. These people are charged with reviewing performance evaluation data collected by specialists in their areas (e.g., quality control, cost analysts). The board must synthesize the evaluation information from performance monitors and come up with a fully justified and documented recommendation concerning the award fee. Performance monitors are those people who have frequent contact with the contractor and the contractor’s work. They must apply the standards by which the contractor’s performance is to be evaluated.

Sometimes board members are selected from outside the agency or even outside of the government. Depending on the knowledge and background of the members, the award fee board may help, hinder, or be neutral with respect to contract performance. The relationship between the contracting officer and the rest of the board is also a factor in the fair administration of an award fee contract. The contracting officer should apprise the board of changes in the direction of the contract and other factors beyond the contractor’s control. Contracts commonly evolve over the course of several years, either through the government’s direction or by natural progression. The award fee board, however, will keep going back to the original criteria that was established prior to or shortly after the contract award to evaluate performance. Even though the evaluation criteria could be updated unilaterally, this updating does not often happen. Unless the contracting officer ensures that the board is aware of changes in the contract, the contractor may be judged by criteria that are no longer applicable.

**Time and Money**

A very real cost is associated with award fee contracting. The regular performance evaluation aspects are an ongoing resource drain. NASA estimates an average cost to the government of $38,700 per evaluation period for an award fee contract.19This estimate includes the time of five monitors, six board members, one recorder, and one contracting officer. Although no mention of contractor cost is made, one can fairly assume that contractor costs could meet or exceed this estimate in cases where the contractor must gather and report extensive data on performance. Sometimes, the contractor and staff are present at the board meetings (which can last several days) to answer questions and present material. When board members are not familiar with the work area, it is in the contractor’s best interest to expend additional effort to brief the members so they understand the circumstances and constraints of the work. As monetary and personnel resources in the government dwindle, award fee contracts may become harder and harder to justify.

Time lines for the process are stated on the optimistic side. Some guidelines indicate that the FDO’s decision should be made within 45 days of the end of the award fee period with payment to the contractor authorized within 60 days.20A sample of actual contract documents suggests an even shorter period: 30 days for the FDO determination and 5 days after to modify the contract adding the award fee amount.

In practice, many contractors experience extensive delays. A natural time lag occurs while cost and other performance data is gathered. Additional time may be needed to analyze the data and write up findings. Sometimes, assembling the award fee board is difficult because of conflicting schedules and competing demands. The board’s deliberations can be lengthy as can the final determination and documentation of the decision. Finally, the award fee amount for the evaluation period cannot be billed until it is added to the contract through issuance of a modification. Then the contractor must wait to be paid.

**Conclusion**

From the government’s perspective, award fee contracts offer several benefits. First, many government personnel believe that the monetary incentive is a strong one; it focuses the contractor’s attention on the areas that are most important to the government. Second, the government often touts award fee contracts because of their flexibility. Specific formula-based criteria do not have to be determined before the contract starts as in CPIF or FPIF arrangements. Furthermore, award fee criteria may be changed unilaterally by the government to reflect changing circumstances and priorities. A third advantage cited for award fee contracts is enhanced communication between the government and the contractor. Finally, the argument is often proffered that, generally, higher fees are seen in award fee contracts and that these higher fees add to the contractor’s motivation.

The use of award fees as incentives to the contractor may occur in theory, but not always in practice. First, the amount of the fee has to be large enough to make a difference.21The government should not expect to negotiate award fees on the same terms as the fee amounts in CPFF contracts, for example. Second, when the base fee is removed from the equation, the award fee ceases to be the carrot that will induce better performance but, instead, becomes a stick with which to dictate to the contractor. When some amount of base fee is guaranteed, the contractor has a choice regarding extra or creative effort. When an entire fee is tied to the award fee criteria, this freedom does not exist. Additional problems occur over time as the contract evolves or when the project officer gives direction in one way and the award fee board cleaves to the old criteria. The contractor is forced to make a choice: follow the project officer or work to the original criteria for maximum award fee.

The flexibility of award fee contracts may simply disguise a lack of planning. Award fee contracts should not be used to avoid the effort of specifying before the contract awardexactly what the government needs and how it will determine the extent to which those needs were fulfilled. As we have seen, changing criteria midstream may penalize the contractor; however, not making such a change may cause serious issues with respect to fulfilling the contract. If the government cannot articulate what its requirements are because of technical uncertainties or because of the developmental nature of the work, then a CPFF contract may be more appropriate than an award fee contract.

Improved communications between government and contractor was a legitimate goal in the 1960s when award fee contracts first originated. However, the requirements of past performance information make that advantage seem redundant. When the annual performance reviews of contracts are finally fully carried out, the more burdensome and time-consuming evaluation for award fee may no longer be necessary. Although past performance reviews are not directly tied to a monetary value, the importance of good reports is taken very seriously by contractors interested in obtaining new contracts. Past performance reviews have further advantages because they are done by someone close to the contract and they allow the contractor to comment or rebut. With the advent of Burnside-Ott, the government may find their award fee decisions being challenged more often, further consuming scarce resources.

The extra administrative burden imposed on both the government and the contractor makes an award fee contract a much less desirable contract type in this era of procurement personnel downsizing. When coupled with recent procurement reform initiatives such as past performance information, award fee contracts may no longer be the best solution to current acquisition issues.

Printed by permission: “Contract Management”, February 2001.**Table 1. Sample Award Fee Criteria**

A. Technical Performance

1. Quality of Work

2. Timeliness of Performance

B. Management Performance

1. Program Management

2. Hour Management

3. Customer Services

4. Other Direct Costs

5. Management of Hours

6. Subcontract Management

7. Property Management

8. Configuration Management

9. Planning

C. Financial Management

1. Cost Management of ODC

2. Budget Forecasting

3. Funds Requirements are Projected Correctly and Accurately on Contract Funds Status Reports (CFSR), if required

D. Security

**Table 2. Sample Rating Standards**

|  |  |  |
| --- | --- | --- |
| Adjectival Rating | Grade | Definition |
| Excellent (86–100) | A | • Contractor has exceeded adequate performance by a substantial margin in all elements of the evaluation.  • Deficiencies are minimal or nonexistent. |
| Good (70–85) | B | • Contractor has exceeded adequate performance by a substantial margin in most elements of the evaluation.  • Deficiencies are minor, relatively unimportant, and easily cured. |
| Adequate (50–69) | C | • Contractor’s performance in the aggregate meets the minimal acceptable standards of performance overthe elements of evaluation.  • Any deficiencies are offset by exceptional performance in other areas. |
| Inadequate (0–49) | F | • Contractor performance is less than adequate overthe elements of evaluation.  • Deficiencies are pervasive throughout evaluation areas and not offset by areas of exceptional performance. |

**Endnotes**

1. John Cibinic, Jr. and Ralph C. Nash, *Formation of Government Contracts*, 3rd ed. (Washington, D.C.: The George Washington University Press, 1988), 1148.

2. FAR 16.4, Incentive Contracts.

3. FAR, 16.404(a)(1), Fixed-price contracts with award fees.

4. FAR, 16.405-2, Cost-plus-award-fee contracts.

5. National Aeronautics and Space Administration (NASA), *National Aeronautics and Space Administration Award Fee Contracting Guide*, December 2, 1997), 1. Retrieved February 6, 2000, from the World Wide Web: **http://www.hq.nasa.gov/office/procurement/regs/afguide.html**

6. Cibinic and Nash, *Formation of Government Contracts*, 1148; Air Force Materiel Command (AFMC), *Air Force Materiel Command Award Fee Guide* revision 2, March 1997), 3; and *NASA Award Fee Contracting Guide*, 6.

7.NASA, *NASA Award Fee Contracting Guide*, 9.

8.AFMC, *AFMC Award Fee Guide*, 8.

9. Ibid., 25.

10. *Burnside-Ott Aviation Training Center v. John H. Dalton, Secretary of the Navy*, U.S. Court of Appeals for the Federal Circuit No. 96-1227, February 25, 1997.

11. Robert D. Witte, “Award Fees and Discretion,” *Contract Management*, July 1999, 43.

12. AFMC, *AFMC Award Fee Guide*, 31.

13. FAR 16.405-2(c)(1), Cost-plus-award-fee contracts.

14. FAR 16.404(b), Fixed-price contracts with award fees.

15. Acquisition Reform Net Electronic Forum: Water Cooler. October 29, 1998 from Charlie Dan, Subject: Performance based contracting. Retrieved March 2, 2000 from The World Wide Web: **http://www.arnet.gov/Discussions/Water-Cooler.html**.

16. Acquisition Reform Net Electronic Forum: Water Cooler. August 17, 1998 from Chuck Solloway, Subject: Guidance sought on negotiated contract type. Retrieved March 2, 2000 from The World Wide Web: **http://www.arnet.gov/Discussions/Water-Cooler.html**.

17.FAR 16.403-2, Fixed-price incentive (successive targets) contracts.

18. NASA, *NASA Award Fee Contracting Guide*, 11–14; and AFMC, *AFMC Award Fee Guide*, 17–22.

19. NASA, *NASA Award Fee Contracting Guide*, 7.

20. AFMC, *AFMC Award Fee Guide*, 36.

21.AFMC, *AFMC Award Fee Guide*, 8; and NASA, *NASA Award Fee Contracting Guide*, 9.

Award-term: The Newest Incentive

BY VERNON J. EDWARDS

About the Author

Vernon J. Edwards writes and teaches about Federal contracting. He may be reached at

[Vernon.edwards@worldnet.att.net](mailto:Vernon.edwards@worldnet.att.net). Send comments on this article to cm@ncmahq.org

The award-term incentive is a relatively new development in government contracting, one that was first used in 1997 and that is not yet described in the *Federal Acquisition Regulation* (*FAR*). It is modeled after the award fee incentive described in FAR § 16.405-2, but instead of rewarding a contractor for excellent performance with additional fee, it rewards the contractor by extending the contract without competition. Under an award-term incentive, a government team monitors and evaluates the contractor’s performance on the basis of contractually stipulated criteria and reports their findings to a government term determining official. The term determining official decides whether the contractor’s performance was good enough to merit an extension. The extension is (or should be) conditioned upon the government’s continuing need for the service and the availability of funds.

The award-term incentive was the inspiration of Thomas Jordan, a senior U.S. Air Force civilian employee at Kelly Air Force Base. Its first use was on a task order contract that the Air Force’s Aeronautical Systems Center awarded to the McDonnell Douglas Corporation in October of 1997, for simulation services for the F-15C aircraft. The contract has a seven-year base period, which the contractor can extend to 15 years by providing excellent service. Since that first use, at least 25 acquisitions have included or plan to include award-term incentives.

**Not an Option**

A true award-term incentive rewards the contractor with legal entitlement to a contract extension, not an additional option. An option is a unilateral right of the government; a contractor is not entitled to the exercise of an option. But under a true award-term incentive, if the contractor’s performance meets the award-term criteria stipulated in the contract, and if any stipulated conditions such as continuing need and availability of funds are met, then the government must either extend the contract or terminate it for convenience or default. Several contracts have included incentives that have been labeled award-term, but that should be called award option or incentive option because the contractor’s reward is not an actual extension but merely a government option to extend.

Agencies have used award-term incentives when acquiring a variety of services, including technical and logistics support, laundry and dry-cleaning, depot-level maintenance, aircraft maintenance, grounds maintenance, janitorial services, real property maintenance and repair, and training. The incentive has been used with several different pricing and delivery arrangements such as fixed-price, cost-reimbursement, indefinite-delivery-indefinite-quantity, and requirements. Award-term has also been used in combination with other incentives such as cost-plus-incentive-fee and cost-plus-award-fee.

The U.S. Air Force, the National Aeronautics and Space Administration, the Naval Facilities Engineering Command, the Naval Sea Systems Command, the Army’s Ft. Drum in New York, and the General Services Administration have all conducted or announced plans to conduct acquisitions that include award-term incentives. Those acquisitions include or plan to include provisions that will enable the contractor to extend its performance for periods ranging from seven years to 20 years.

**A More All-Encompassing Incentive**

The award-term incentive may provide a solution to one of the most vexing shortcomings of contractual incentives—that they do not work as advertised. The contractual incentives described in FAR Part 16 are all profit incentives; they reward excellent performance by paying more money. But since the early 1960s, researchers have concluded that such profit incentives do not produce the results predicted by incentive theory. Studies conducted by Harvard University, the Rand Corporation, the Logistics Management Institute (LMI), the U.S. General Accounting Office, and a number of independent researchers have concluded that there is little evidence that profit incentives have been effective.1

Why don’t the standard contractual incentives work? In a 1968 study, J. Ronald Fox of LMI reported that

Extra-contractual considerations dominate over profit or fee. A contractor rarely seeks to maximize profit during the short run of a single contract. He is more interested in taking actions that will expand company operations, lead to increased future business, enhance company image and reputation, benefit his nondefense business, or relieve such immediate problems as loss of skilled personnel and a narrow base for fixed costs.2

If the researchers are right and contractual incentives have had little effect on contract performance outcomes, then the award-term incentive is a promising development. The award-term incentive rewards a contractor with additional *business*, which satisfies four of the long-term goals identified by LMI in its 1968 study: 1) enhanced company image and reputation, 2) increased future business, 3) retention of skilled personnel, and 4) the maintenance of an allocation base for fixed costs. The award-term incentive gives a contractor a chance to earn a more all-encompassing reward than short term profit dollars: a long-term business relationship.

**Advantages of Long-Term Business Relationships**

Aside from the potential for motivating contractors to perform excellently, there are at least three other advantages to using award-term incentives to establish long-term business relationships:

* increased operational efficiency and effectiveness,
* increased contractor investment, and
* reduced acquisition transaction costs.

Government service contracts are becoming more complex as government agencies outsource more of their internal functions. As service requirements more complex and require performance over an extended period of time, it becomes exceedingly difficult to write statements of work and contract clauses that fully describe all of the government’s requirements and that cover all of the contingencies that may affect performance. Legal scholars and economists refer to such complex, long-term contracts as *relational contracts* and *incomplete contracts*, and have produced a large body of scholarly writing about them.3

Complex, long-term contracts have gaps in their terms, and wise business managers know this. During the course of a cooperative long-term relationship, the parties will fill in the gaps by adapting their expectations to prevailing contingencies and making cooperative, ad hoc adjustments. They will do so through formal contract modifications, to be sure, but also through informal, undocumented daily cooperation. As the parties work together, they develop a shared body of knowledge about the contract work and an informal protocol of cooperation that will enable them to respond to new conditions and to solve new problems as they arise. Their shared knowledge and cooperative protocol become a part of the culture of their relationship. By consciously recognizing the fact that their contract is incomplete, being willing to adapt their expectations to new conditions, and adopting a cooperative approach to ad hoc decision-making, the parties can satisfy their needs and increase the efficiency and effectiveness of their joint endeavor. In short, a long-term, cooperative relationship facilitates team development and effectiveness. If the relationship works poorly, then a change in contractors may be necessary. But if it works well, a change in contractors may degrade performance, at least temporarily.

Advocates of the award-term incentive also believe that long-term business relationships will motivate contractors to invest in performance-enhancing technologies, to take steps to attract and retain the best workers, and to stay abreast of the latest developments in their fields. Re-competitions of on-going requirements are costly to contractors and entail considerable business risk. The government source selection process requires firms to compete against one another without full knowledge about who their competitors are and what their competitors are offering. Incumbent contractors have lost competitions despite good performance records and good relationships with their government customer because their written technical essay was not as impressive as a competitor’s, or because a competitor that did not know about all of the costs of performance offered a lower price. Competitive uncertainty arising from these conditions may discourage contractors from making long-term capital or workforce investments. Award-term incentives may have the potential to significantly reduce that uncertainty.

A third benefit of a long-term relationship is a reduction in acquisition transaction costs. Government contract formation is often a long and expensive process for both the government and competing offerors. New awards are expensive to plan, proposals are expensive to solicit, prepare, and evaluate, and contract award may be delayed by a protest. Agencies can reduce their transaction costs by reducing the frequency with which they conduct new competitions for continuing service requirements. That is one reason why agencies use options. The Competition in Contracting Act does not prohibit the use of award-term incentives, any more than it prohibits the use of options. However, reducing the frequency of competitions for continuing service requirements can be justified on business grounds only if there is an overall net savings to the government.

# Disadvantages of Long-Term Relationships

A potential disadvantage of a long-term relationship is the possibility that the agents of the contracting parties will begin to conduct business on a personal basis instead of a proper professional basis. Contractual relationships are, after all, human relationships. People who have come to know and like one another in the course of time may relax their standards and overlook performance deficiencies for the sake of their personal relations. They may become reluctant to criticize or to take an action that could hurt the other person. On the other hand, a change in personnel may bring conflict as the parties try to adapt to new personalities and changes in long-standing ways of seeing, understanding, and doing. These sorts of developments are probably a natural and unavoidable byproduct of long-term business relationships.

Another potential disadvantage of long-term business relationships is the possibility that they will reduce the number of business opportunities in the government marketplace, making it less attractive or even untenable to firms that lose competitions. Such firms may be forced to leave the government marketplace, making it less competitive. A less competitive marketplace could make government agencies too dependent upon a few contractors, which could lead to increased costs and poor quality.

# Commercial Idea, Government Rules

The award-term incentive is an attempt to use a commercial idea within a framework of government rules. The commercial idea is to use the prospect of a long-term business relationship and the sales to motivate the contractor to provide excellent service. This is something that commercial organizations generally do implicitly and informally, usually without writing it into a contract. It goes without saying in the commercial sector that a customer will stick with a contractor that performs well and charges reasonable prices.

But to comply with the Competition in Contracting Act (CICA) when using an award-term incentive to extend a contract, a government agency must ensure that prospective award-term extensions are included within the scope of the original competition. In ruling on the use of options to extend the term of a contract, the General Accounting Office (GAO) has long insisted that agencies meet three conditions:

* The solicitation must state that the contract will include options and the maximum length of the contract as extended by the options;
* The government must solicit prices for each option; and
* The government must evaluate the option prices during the source selection for the original contract.

The GAO will not go along with the use of unpriced options.4

It is likely that the GAO will insist upon the same conditions for the use of award-term incentives. Thus, to comply with CICA as interpreted by the GAO, government agencies must do something that commercial organizations need not do—they must make the award-term incentive express and formal by writing it into their solicitations and resulting contracts.

# Problems Arising from Contractual Formality

The need to make the award-term incentive express and formal gives rise to contract writing problems that commercial firms do not have to face, since no sensible business person would make an *irrevocable* legal commitment—enforceable in court—to a long-term business relationship. Markets and organizations can change rapidly in today’s highly dynamic global market; it is very difficult to predict conditions even two years from now, and almost impossible to predict the state of a market or organization 10 to 15 years in the future. A deal that is highly advantageous today can be utterly worthless or bad business two years from now. Consequently, government agencies using an award-term incentive must simultaneously write the contract to meet the demands of CICA and the GAO, provide a real incentive, and include provisions for exiting the deal so that the parties do not become locked in a legal death grip. Failing to provide enough exit opportunities would be a serious mistake, but providing too many might undermine the incentive.

First and foremost, the contract must condition any award-terms upon a continuing need for the service and the availability of funds. The contract must enable the government to cancel any or all award-terms that the contractor has earned if the government no longer needs the service or Congress does not appropriate funds to pay for it. Aside from those conditions, there may be other reasons why the government would want to renege on an award-term; inconsistent performance is one such example.

Some award-term contracts provide for a base year and four option years. with the contractor to earn a one-year award-term extension in each of those first five years as a reward for excellent performance. Suppose that a contractor renders excellent performance during the first year and earns an award-term extension, but renders only acceptable performance during the second year. Such inconsistent performance then continues throughout the first five years, so that by the end of that time the contractor has earned only two of the five available award-terms. Should the government remain in a relationship with such an inconsistent performer? What provision if any should the contract make for inconsistent performance?

Government agencies also face the possibility that the contractor may be deemed no longer responsible as defined by FAR 9.101 when an award-term is scheduled to begin. What if the contractor was debarred or suspended for reasons that have nothing to do with the contract? Should the government be contractually obligated to continue to do business with such a firm? If the contract allows the government to get out of the award-term in the event that the contractor is no longer responsible for some reason, and if the contractor is a small business, would the Small Business Administration’s Certificate of Competency Program apply?

Contract pricing poses another challenge. Should an award-term extension be contingent upon the continuing reasonableness of the award-term prices? What if a price that was fair and reasonable at the time of the original source selection is no longer fair and reasonable 10 years later? What provision should the contract make for this possibility? In the commercial sector, firms aren’t required to negotiate prices far in advance. They can agree to negotiate them later, or they can agree on baseline prices and then renegotiate them as the need arises. But in light of the GAO’s position that agencies must obtain and evaluate prices for option periods, and evaluate those prices during source selection, it is likely that the GAO will insist upon the same conditions for prospective award-term extensions. Moreover, the GAO is also likely to object to any contract provision that would allow the parties to renegotiate the award-term extension prices, since it has objected to the renegotiation of option prices. It has insisted that such renegotiations are sole source contract actions for which justification and approval are required in accordance with CICA.5

Because most agencies that have used or that plan to use award-term incentives have provided for as many as 10 to 15 years of performance, the GAO’s requirement to price those years at the time of initial contract award and its objection to renegotiating those prices poses a daunting problem to agencies and contractors. It is hard to imagine any business person making a firm commitment to prices 10 to 15 years in advance without some provision for price adjustment or escape from the deal. Economic price adjustment clauses (as described in FAR § 16.203) can help, but they usually do not cover all exigencies that could affect prices significantly. Thus, agencies that are contemplating the use of award-term incentives must develop another solution, one that will meet with the approval of the GAO. One such solution may be for the parties to agree on ceiling prices that are subject to downward adjustment based on clearly stipulated terms and conditions. Upward adjustments of such ceilings could be based on economic price adjustment provisions or some other reasonable basis.

The government can always get out of a contract by terminating it for convenience. But it would seem that fairness demands that the contractor should have a way out, too. Contract law aside, is it good business to compel a contractor to perform an award-term even though the contract no longer serves its interests or is harmful to its interests? What about the government’s notoriously long acquisition administrative lead times? If the contract allows the contractor to opt out of an award-term, how much notice should it require the contractor to give the government? Six months? A year? Two years? These considerations pose two significant challenges to persons writing contracts that contain award-term incentives.

# Conclusion

It is too soon to say whether the award-term incentive is a good idea and will receive widespread acceptance within the acquisition community. One thing is clear: The effective use of an award-term incentive demands a high level of contracting knowledge and skill. It requires that acquisition planners effectively solve many complex incentive design problems. It requires that the contracting parties communicate clearly and work together effectively when negotiating contract terms and drafting contract language to ensure a common understanding of the nature of their undertaking. They must remember that they are thinking and writing for people who will not have been a part of the original negotiation. It requires a new approach to contract management, one in which the parties openly acknowledge that they cannot see or plan far into the future, and that their contract is incomplete. It is a process in which they agree to learn together, adjust their expectations when necessary, and engage in cooperative, ad hoc decision making during the course of performance.

The need to make award-term incentives express and formal and subject to contract enforcement, as well as the speed with which technology and the modern global economy change demands that we consider the prudence of entering into formal 10-, 15-, or 20-year contracts. Does it make good business sense to do so? The answer ultimately depends on how effectively award-term incentives actually work to motivate contractors to provide and maintain a high level of service performance at fair and reasonable prices and to reduce acquisition transaction costs. The effectiveness of award-term incentives will undoubtedly depend on the wisdom and skill with which agencies and their contractors plan, design, and manage them. All we can say for certain at present is that the award-term incentive is an interesting experiment.

**Endnotes**

1. See Scherer, F. M., *The Weapons Acquisition Process: Economic Incentives* (Boston: Harvard University, 1964); Fisher, I. N., *A Reappraisal of Incentive Contracting Experience*, Memorandum RM-5700-PR (Santa Monica: The Rand Corporation, 1968); Logistics Management Institute, *An Examination of the Foundations of Incentive Contracts*, LMI Task 66-67, May 1968; Fox, J. R. *Arming America: How the U.S. Buys Weapons* (Boston: Harvard University, 1974); and, U.S. General Accounting Office, *Incentive Contracts: Examination of Fixed-Price Incentive Contracts*, GAO/NSIAD-88 (Washington, DC: 1987).
2. Logistics Management Institute, *An Examination of the Foundations of Incentive Contracts*, LMI Task 66-67, May 1968, cited by Fox, J. R. op. cit., p. 241. Frederic Scherer had reached similar conclusions in 1964. Scherer, F. M., op. cit., pp. 159-162, 268-269, and 321-323.
3. For an overview of the legal analyses of relational contracts see: Speidel, R. E., “The Characteristics and Challenges of Relational Contracts,” *Northwestern University Law Review*, Spring 2000, p. 823.

For GAO’s own analysis of these issues, see: *The Honorable Caspar W. Weinberger, The Secretary of Defense*, GAO file number B-217655, April 23, 1986.

1. See *Magnavox Electronic Systems Co.*, Comp. Gen. Dec. B-231795, 88-2 CPD ¶ 431: “An agency is not permitted to negotiate with the awardee to reduce the option prices stated in the contract price if price competition for the option quantity is available.” Also see: *Varian Associates, Inc*., Comp. Gen. Dec. B-208281, February 16, 1983, 83-1 CPD ¶ 160; request for reconsideration denied, 83-2 CPD ¶ 78. The GAO’s position on the renegotiation of option prices is reflected in FAR 17.207(f), which requires that options must be exercisable at prices that are “reasonably determinable” from the terms of the basic contract.

cording to the government’s (subjective) assessment of the contractor’s performance that period

Printed by permission: “Contract Management”, February 2001.