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Contractor Incentives for Success in Implementing Performance-Based Logistics: A Progress Report

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- Joint with my students at University of Alabama in Huntsville, Mike Eagan, Josh King, and Jim Platt
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- This presentation is a progress report on the work done so far.

What is PBL and How is it Being Used?

- PBL is a relatively new product support strategy which makes the program manager responsible for the total life cycle costs.
- It is different from older procurement methods because they focused solely on the early phases of development.
- PBL is structured around the performance or the outcomes of the contract rather than details specifications of the “how to do the work”.
- PBL has become the desired product support strategy in the DoD and it is being integrated into legacy programs as well as into new contracts.

Why is the Government Mentality Changing?

- A new product support structure is needed to reduce the Total Life Cycle costs.
- As a result, PBL focuses on Total Life Cycle Systems Management (TLCSM)
- TLCSM means the program managers focus on the entire life cycle, firmly linking acquisition and sustainment activities into an integrated process.

Implementing PBL Successfully

- In order for PBL to effective the contractor has the be motivated to meet or exceed the performance requirements.
- To ensure effective implementation of PBL, it is important to provide the right incentives to encourage the best contractor performance.
- New incentives need to be developed and applied to address this shift in how government procurement and sustainment is done.

Why are New Incentives Needed?

- PBL is significantly different from its predecessor programs.
- Since it focuses on the total life cycle, different problems are encountered so different solutions are required.
- The right mix of incentives means the contractor will be happier and, as a result, the Government customer will get the product it wants.

Giving Incentives Properly

- Incentives should be given based on the type of contract and the scope of responsibilities of the contract.

- The two main types of contract types are:
  - Fixed-Price
  - Cost-Plus

Contract Types

- Firm-Fixed-Price Contract
  - Shifts risk of cost overruns to the contractor because they are paid a flat amount and exceed that amount at their own risk

- Cost-Plus
  - Shifts risk of cost overruns, to a certain degree, to the Government because the actual costs is unknown so the contractor will be compensated based on the costs incurred.

Incentives Based on Contract Type

- Fixed-Price
  - Fixed Price Incentive Fee (FPIF)
  - Fixed Price Award Fee (FPAF)

- Cost Reimbursement (Cost-Plus)
  - Cost Control Incentives

Forms of Incentives

- Incentives come in many different forms and combinations so overarching examples are:

  -Monetary

  -Ex. Cash award

  -Non-monetary

  -Ex. Good review, follow on contracts etc.

Framework for Incentive Types

- Cost-based Incentives
  - Incentives based on contract costs or profit-sharing based on performance
- Time-based Incentives
  - Incentives based on duration of the contract and the renewals based on performance
- Scope-based Incentives
  - Incentives that are based on the scope of the contract and expanding of the scope of the contract based on performance.

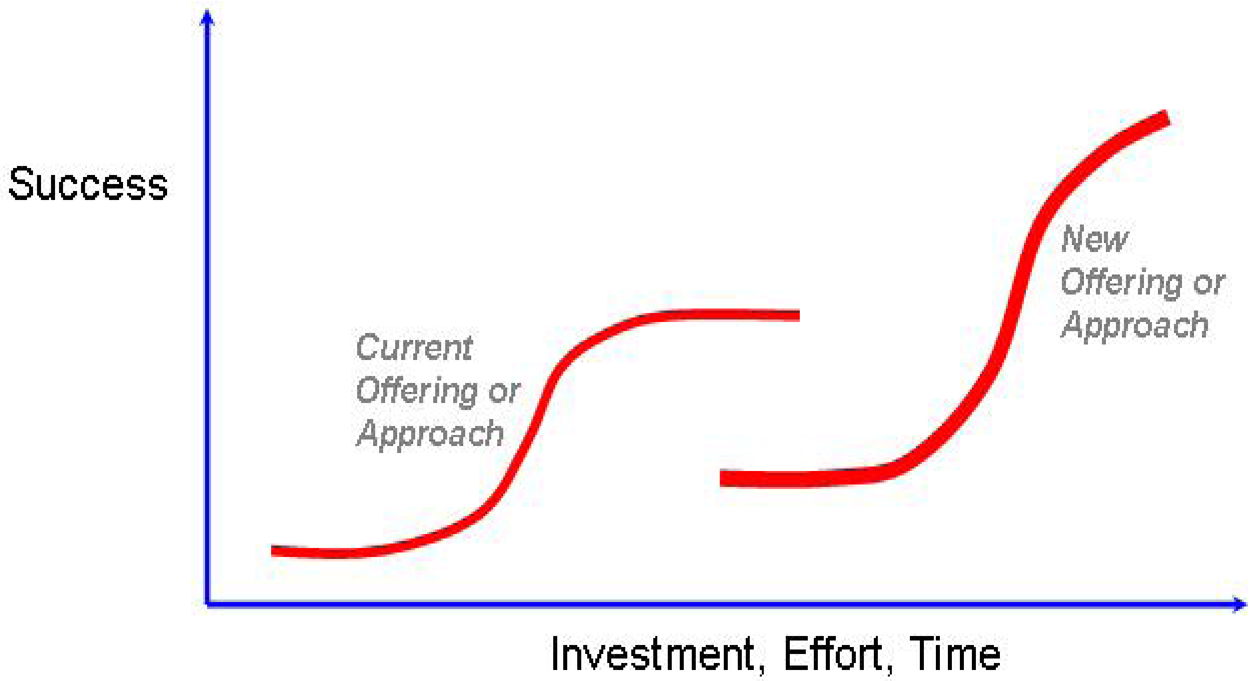
Types of Cost Based Incentives

- Award Fee
- Cost Control Incentives
- Reliability-Based Profits
- Shared Savings

Types of Time Based Incentives

- Continuation of Contract
- Contract length that allows recoup of investments and development new products.
- This brings to mind the S-Curve which shows how companies recoup investments in new technologies and develop new ones. An example S-Curve is on the following slide.

S-Curve


Success
Current
Offering or
Approach
New
Offering or
Approach
Investment, Effort, Time

Risk

- Detailed specifications shift financial risk to customer (government)
- Less-detailed specifications shift financial risk to the contractor
- Detailed specifications shift operational risk to the contractor
- Less-detailed specifications shift operational risk to the customer (government)

Private/ Public Sector

- Profit is primary incentive for the commercial contractor, though long-term oriented
- Breaking even is the focus of the government (e.g. depot), reducing costs
- PBL seeks to change the relationship to incorporate more private sector incentives into the public sector (FAR part 12)

Short-term vs. Long-term

- Profits should meet or exceed the expectations of the investor, otherwise stock prices will fall weakening the contractor's ability to borrow (higher interest rates).
- Short-terms profits are the focus of the speculative investor driving quarterly performance measures and stock valuation.
- Long-term investors seek high long-term profits. Short-term fluctuations are tolerated.

Short-term vs. Long-term (continued)

- Short-term profits are crucial to maintaining timely cash flow.
- Private industry is more likely to have shorter product lifecycles.
- Long-term profits are necessary to justify capital expenditures.
- Lengthy product lifecycles are typical in government contracts and complex product development.

Contractor Created Incentives

- Requires reform of existing contract vehicles
- Contractors must be proactive in creating incentives (more likely to occur at subcontracting level where dollar thresholds are lower, causing less government scrutiny)
- Product spin-offs (e.g. Tactical Operations Center Intercommunications Network)
- Enhanced reputation
- Creative and responsible cost accounting

Conclusions

- PBL is the result of an evolutionary process
- PBL articulates basic strategy for contract performance
- Improved technology has enabled more comprehensive and accurate performance measurement (metrics)
- Contract type dictates performance

Conclusions (continued)

- Creative Incentives are risky and require reform of existing contract guidelines (FAR, DFARS, TINA)
- Contractual type should reflect applicable point in product lifecycle
- PBL deployment requires customer (government) to relinquish control
- Reform of Government culture is crucial

Conclusions (continued)

- Contractors prefer long-term contracts to recoup capital investment
- The customer (government) desires capital investment from the contractor, but long-term contracts increase customer risk
- Improved metrics resulting from improvements in technology will enable PBL

Conclusions (continued)

- More investigation, analysis, and modeling. Interviews, statistical analysis, and scientific method should be applied to determine PBL effectiveness and behavioral change.
- We are continuing to work on this and can use your inputs, ideas, and support.

Thank you for Listening

Questions?