

UNDERSTANDING THE USE OF INCENTIVES IN PERFORMANCE-BASED SERVICE CONTRACTING

By Ron Romonchuk

The objectives of Performance-Based Service Contracting (PBSC) clearly call for a business relationship that is based on “*shared common goals.*” In a performance-based contracting environment, the business case must drive the development of the incentive relationship/strategy. The approach to incentives and disincentives stems from FAR 37.6, which states: “*performance-based contracting methods are intended to ensure that required performance quality levels are achieved and that total payment is related to the degree that services performed meet contract standards*” – which can only be implemented through the use of incentives and disincentives.

Defining incentives/disincentives first necessitates considering the business case and the business relationship between the Government and contractor. The following provides a few examples of both:

Incentives – Defines how the contractor will be rewarded or subsidized for performance above the required performance quality levels (e.g. +0.5% of monthly fee, Processing of progress payment on time, etc.)

Disincentives – Defines how the contractor will be penalized, or reprimanded for performance below the required performance quality levels (e.g. -3% of monthly fee, Processing of progress payment deferred until the following month, Contractor must re-administer training at own expense until standard is met, etc.).

There are two types of incentives allowed in the FAR, which are:

Performance Incentives. These may be considered in connection with specific product or service characteristics (e.g., a missile range, aircraft speed, performance at a specified level, etc.) 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.

Cost Incentives. 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).

The following are some of the typical types of incentives currently used in Government contracting:

Incentive Fees – Defines specific service levels or parameters prior to beginning work and a base profit/fee is agreed upon contingent to the contractor meeting certain performance requirements or metrics. Additional or less profit/fee is applied as incentives or disincentives for contractor performance.

Share in Savings – This type of incentive is used to encourage contractors to apply ingenuity and innovation to complete the planned work early. The government and the contractor share the monetary savings.

Early Completion Bonuses – A negotiated profit/fee is pre-established and a specified monetary value is established for early completion of the contract/task order.

Profit/Fee Pools – A specified percentage of the profit/fee is held back and used to pay for monetary incentives.

Award Term – The length of the contract or task order is defined upfront and, based on established performance parameters, the duration can be lengthened or shortened based on contractor performance.

The Quality Assurance Surveillance Plan (QASP), used in conjunction with the Performance Work Statement or contractor proposed SOW, provides a dynamic structure for the execution of quality and performance management processes. In addition, when used at the project-level, joint use of the QASP with the contractor can help minimize the burden on the Government and provide early warnings and insights to the application of incentives/disincentives by the government.

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