

TESTIMONY OF

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UNDER SECRETARY OF DEFENSE

(ACQUISITION, TECHNOLOGY & LOGISTICS)

BEFORE THE UNITED STATES SENATE

COMMITTEE ON ARMED SERVICES

READINESS AND MANAGEMENT SUPPORT SUBCOMMITTEE

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**Testimony of
The Honorable Kenneth J. Krieg
Under Secretary of Defense
(Acquisition, Technology and Logistics)**

Chairman Ensign, Senator Akaka, and Members of the Committee:

Thank you for the opportunity to appear before you and to discuss an important aspect of Department of Defense acquisitions, namely, the need to ensure that contract incentives paid to contractors are linked to contract performance. This issue was recently highlighted in a Government Accountability Office (GAO) report (GAO-06-66), which made several recommendations. The Department largely agrees with the GAO recommendations, and has begun to take action to strengthen the link between monetary incentives and acquisition outcomes on DoD contracts, which I will address below. Before describing our planned actions, I would like to emphasize that contract incentives need to be considered within two broader contexts.

Contract Incentives Are One Facet of the Overall Acquisition System

First, it is necessary to keep in mind that despite contract performance problems, DoD contractors develop and deliver weapon systems that are the envy of the world and provide our warfighters with significant technological advantage. Thus, we need to ensure that contractors earn a reasonable return on DoD contracts, so that we maintain a viable, reliable defense industrial base capable of developing and producing superior weapon systems well into the future. One of my recently established goals addresses

this—i.e., “Reliable and Cost-effective Industrial Capabilities, Sufficient to Meet Strategic Objectives.” One of the primary outcomes under this goal is to ensure “contract finance and profit policies drive desired results,” which is consistent with the GAO recommendations.

Second, it is important to view contract incentives within the context of the broader acquisition system, which includes variables that impact contract performance that are beyond the control of contractors, such as program stability. Another one of my goals addresses these broader strategic acquisition issues — Strategic and Tactical Acquisition Excellence. This goal distinguishes between what we euphemistically refer to as the “Big A” acquisition, i.e., what we decide to acquire at the strategic level, and “little a” or tactical acquisition, i.e., how we develop, test, produce and sustain individual weapon systems. Advancing in both areas is absolutely critical to success. This includes balancing risk, outcomes, schedule, and cost when planning and adjusting portfolios, programs, and procurements. Such balancing should facilitate a better linkage between contract incentives and contract performance.

Award and incentive fee contracts are typically used on our most challenging development contracts, which often involve considerable program instability. The Department must address improving the stability of programs, otherwise technical, schedule and cost risks will continue to hamper contract performance. For example, one initiative that has been identified in the recent Quadrennial Defense Review and Defense Acquisition Performance Assessment is the need to have considerably greater integration among the requirements, budgeting and acquisition communities. The objective will be

to pursue development of new weapon systems in a manner that reduces technical and schedule risk in order to deliver weapons to the warfighter sooner and at more predictable costs. This will include securing stable long term funding, and setting requirements in recognition of technology readiness. By ensuring sufficient technical maturity and pursuing development efforts in more measured, evolutionary spirals, the DoD will increase the probability of contract success.

While the GAO mention that award and incentive fees are part of the broader context of the acquisition system, the report's conclusions don't fully appreciate the impact of the other variables on contract performance.

Use of Award and Incentive Contracts

A brief description of when and how award fee and incentive contracts are used is beneficial. Award fee and incentive fee contracts are usually used on complex research and development contracts in order to share the risk of performance with contractors. While these types of contracts are not used on that many contracts, they are usually very high value contracts (the GAO report found that these contracts constituted about 5% of the contracts but accounted for 20% of contract dollars).

Cost-plus-award-fee contract: A cost-reimbursement contract that provides for a fee consisting of a base amount fixed at inception of the contract (usually 3% or less) and an award fee amount, based upon a judgmental evaluation by the government, sufficient to motivate excellent contractor performance. The amount of the award fee to be paid is determined by the Government's judgmental evaluation of the contractor's performance

during the award fee period based on specified criteria. This determination and the methodology of determining the award fee are unilateral decisions made solely at the discretion of the Government. The Government can adjust the criteria during contract performance to emphasize areas most needing of attention. While award fees are intended to motivate excellent contractor performance, paying some of the award fee for satisfactory or good performance is justified considering that the base fee is typically less than 3% and not a reasonable total fee for satisfactory performance.

Contractors may earn award fees in whole or in part during performance and such fees are intended to provide motivation for excellence in the areas such as quality, schedule, technical performance, and cost management. Award fees are tied to performance outcomes, but it is important to note that one criterion for using cost-plus-award-fee is that it is neither feasible nor effective to devise predetermined objective incentive targets for the cost, technical performance, or schedule of the contract effort. An additional criterion is that 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. Hence, Cost Plus Award Fee contracts are often used when the nature of the work to be performed is such that there is a wide range of potential outcomes, many of which may be beyond the contractor's control. In view of these performance uncertainties, we use award fees, at least in part to motivate contractors to perform in ways that will result in the best possible outcomes under the circumstances. Essentially we use award fees to motivate

outstanding management in order to mitigate the impact of known and unknown risks. In these cases, then, tying a portion of award fee to contractor management and responsiveness makes good business sense and is in the Government's best interest.

Rollover: The process of moving unearned award fee from one evaluation period to a subsequent period or periods, thus allowing the contractor an additional opportunity to earn that unearned award fee. Hence, rollovers provide a motivation to contractors to achieve contract outcomes, albeit late.

Incentive contract: A contract used to motivate a contractor to provide supplies or services at lower costs and, in certain circumstances, with improved delivery or technical performance, by relating the amount of fee to contractor performance.

DoD Response to GAO Report

The Department largely concurred with the seven GAO recommendations in the report and has initiated action for each. We have commenced an intradepartmental review of our policy on award and incentive fees. We recently issued a policy memorandum to the DoD acquisition workforce in this area. Among the areas that are emphasized in the policy is that award fees should be linked to desired outcomes. We must make it clear to all parties, including our contractors, what role the award and incentive fees play in a program's acquisition strategy. Guidance on award fee "rollover" is another issue addressed in this policy. This policy memorandum imposes a number of limitations on the use of "rollover," including that the rollover of award fees should be an exception rather than the rule.

The GAO also recommended that the Department ensure that award-fee structures are motivating excellent contractor performance by only paying award fee for above satisfactory performance. While the purpose of award fee arrangement is to motivate excellent contractor performance, the existing guidance on award fee arrangements envisions paying award fees on a graduated scale since the guaranteed base fee is typically less than 3%. Therefore, it is reasonable to award some portion of the award fee pool on a graduated basis for satisfactory and good performance. For this reason, we only partially concurred with the GAO recommendation; however, we did agree that the policy should be to structure award fee arrangements so that contractors earn the preponderance of the award fee by providing excellent performance. Accordingly, the recent policy memorandum addresses the distinction between satisfactory performance and excellent performance, and the need to ensure that award fees are commensurate with contractor performance.

The GAO also recommended that the Department develop a mechanism to share proven incentive strategies across DoD. We concurred with this recommendation, and with the assistance of the Defense Acquisition University, we established a web-based Community of Practice for the DoD acquisition workforce to share good strategies for award and incentive fee arrangements..

In response to other recommendations in the report we recently established an intradepartmental group that will assess the feasibility of creating an award and incentive fee database, and developing performance measures to evaluate the effectiveness of award and incentive fees as a tool for improving contractor performance and achieving

program outcomes. In addition, the group will review existing guidance and conduct an analysis to determine what the appropriate approving official level should be for new contracts where an award and or incentive fee structure is utilized.

Summary

The Department largely concurred with the GAO recommendations and has commenced a review of our policies addressing award and incentive fee arrangements. We plan to complete these efforts by summer. Our review will consider award and incentive fee arrangements within the broader acquisition system context, including the many other factors beside the award and incentive arrangements that affect contract performance that are outside of the control of contractors. These include issues such as program instability, changes in requirements, and insufficient technical readiness. The Department plans to address these broader issues as part of implementing my goals and the guidance in the Quadrennial Defense Review. Finally, our contractors develop and deliver the best weapons systems in the world for our warfighters, which have given them a significant technological edge in warfighting capability.

In closing Mr. Chairman, thank you for the opportunity to explain the Department's activities with regard to the use of award fees and incentive fees in Department of Defense contracts. I am available to answer any questions you and the Members of the Committee may have.