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DEFENSE ACQUISITIONS

**DOD Wastes Billions of
Dollars through Poorly
Structured Incentives**

Statement of David M. Walker
Comptroller General of the United States





Highlights of [GAO-06-409T](#), a testimony before the Subcommittee on Readiness and Management Support, Committee on Armed Services, U.S. Senate

Why GAO Did This Study

With DOD spending over \$200 billion annually to acquire products and services that include everything from spare parts to the development of major weapon systems, our numerous, large, and mounting fiscal challenges demand that DOD maximize its return on investment and provide the warfighter with needed capabilities at the best value for the taxpayer. In an effort to encourage defense contractors to perform in an innovative, efficient, and effective way, DOD gives its contractors the opportunity to collectively earn billions of dollars through monetary incentives known as award and incentive fees. Using these incentives properly—in concert with good acquisition practices—is a key to minimizing waste, maximizing value, and getting our military personnel what they need, when and where they need it.

The subcommittee asked GAO to testify on DOD's use of award and incentive fees and the role they play in the acquisition system. This statement highlights the risks of conducting business as usual and identifies the actions DOD needs to take to use these fees more effectively. DOD concurred or partially concurred with the seven recommendations GAO made in a previously issued report on award and incentive fees. GAO looks forward to seeing DOD turn these promised steps into actual policy and practice.

www.gao.gov/cgi-bin/getrpt?GAO-06-409T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Katherine Schinasi at (202) 512-4841 or schinasi@gao.gov.

DEFENSE ACQUISITIONS

DOD Wastes Billions of Dollars through Poorly Structured Incentives

What GAO Found

DOD's use of award and incentive fees is an issue at the nexus of two areas that GAO has designated "high risk" for DOD—contract management and weapon system acquisition. Contract management has been a long-standing business management challenge for DOD because it often cannot assure that it is using sound business practices to acquire the goods and services the warfighter needs. For weapon system acquisitions, the persistent and long-standing nature of acquisition problems has perhaps made a range of key decision makers complacent about cost growth, schedule delays, quantity reductions, and performance shortfalls. DOD's strategies for incentivizing its contractors, especially for weapon system development programs, reflect the challenges in these areas.

DOD programs routinely engage in award-fee practices that do not hold contractors accountable for achieving desired outcomes and undermine efforts to motivate contractor performance, such as

- evaluating contractors on award-fee criteria that are not directly related to key acquisition outcomes (e.g., meeting cost and schedule goals and delivering desired capabilities to the warfighter);
- paying contractors a significant portion of the available fee for what award-fee plans describe as "acceptable, average, expected, good, or satisfactory" performance; and
- giving contractors at least a second opportunity to earn initially unearned or deferred fees.

As a result, DOD has paid out an estimated \$8 billion in award fees on contracts in GAO's study population, regardless of whether acquisition outcomes fell short of, met, or exceeded DOD's expectations. Despite paying billions of dollars, DOD has not compiled data or developed performance measures to evaluate the validity of its belief that award and incentive fees improve contractor performance and acquisition outcomes.

These issues, along with those GAO has identified in DOD's acquisition and business management processes, present a compelling case for change. By implementing the recommendations GAO has made on award and incentive fees, DOD can improve incentives, increase transparency, and enhance accountability for the fees it pays. At the same time, by working more broadly to improve its acquisition practices, DOD can set the right conditions for getting better acquisition outcomes and making more efficient use of its resources in what is sure to be a more fiscally constrained environment.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the Department of Defense's (DOD) use of monetary incentives known as award and incentive fees. With DOD spending over \$200 billion annually to acquire products and services that include everything from spare parts to the development of major weapon systems, our numerous, large, and mounting fiscal challenges demand that DOD maximize its return on investment and provide the warfighter with needed capabilities at the best value for the taxpayer. In an effort to encourage defense contractors to perform in an innovative, efficient, and effective way, DOD gives its contractors the opportunity to collectively earn billions of dollars through monetary incentives known as award and incentive fees. Using these incentives properly, in concert with sound acquisition practices, is a key to minimizing waste, maximizing value, and getting our military personnel what they need, when and where they need it. Unfortunately, DOD has not used these incentives effectively. How they have been used and how we believe they should be used is the focus of my statement today.

To put the issues related to DOD's use of award and incentive fees in context, I want to step back and look at some of the broader management challenges that confront DOD. The department is facing a significant number of recurring problems in managing its major weapon acquisitions. Although U.S. weapons are the best in the world, DOD's acquisition process for weapons programs consistently yields undesirable consequences—dramatic cost increases, late deliveries to the warfighter, and performance shortfalls. These problems occur, in part, because DOD tends to consistently overpromise and underdeliver in connection with major acquisition efforts. In addition, DOD's weapons programs do not capture, early on, the requisite knowledge that is needed to efficiently and effectively manage program risks. For example, programs lack clearly defined and stable requirements, move forward with unrealistic program cost and schedule estimates, use immature technologies in launching product development, and fail to solidify design and manufacturing processes at appropriate junctures in development. As a result, wants are not always distinguished from needs; expectation gaps are the norm; problems often surface late in the development process; and fixes tend to be much more costly than if they were caught earlier.

Cost increases incurred while developing new weapon systems typically mean that DOD cannot produce as many of those weapons as intended nor can it be relied on to deliver them to the warfighter when promised and with the initially advertised capabilities. In addition, military operations in

Afghanistan and Iraq are consuming a large share of DOD resources and causing the department to invest more money sooner than expected to replace or fix existing weapons. Meanwhile, DOD is intent on transforming military operations and currently has its eye on multiple megasystems that are expected to be the most expensive and complex ever. These new desires and long-standing acquisition and contract management challenges are running head-on into the nation's current imprudent and unsustainable fiscal path. At the same time, DOD's numerous business management weaknesses continue to result in reduced efficiencies and effectiveness that waste billions of dollars every year. These business management weaknesses touch on all of DOD's major business operations, ranging from the department's inadequate management of its overall business transformation effort to decades-old financial management and information technology problems to various contracting and selected supply chain challenges. In fact, all these areas and more are on GAO's 2005 "high-risk" list of programs and activities that need urgent attention and fundamental transformation to ensure that our national government functions in the most economical, efficient, and effective manner possible.

DOD's use of award and incentive fees is an issue at the nexus of two of these high-risk areas—DOD contract management and DOD weapon system acquisition. Contract management has been a long-standing business management challenge for the department. DOD is the government's largest purchaser, yet it is often unable to assure that it is using sound business practices to acquire the goods and services needed to meet the warfighter's needs. For example, we have found that DOD has not used various contracting tools and techniques effectively—such as performance-based service contracting, multiple-award task order contracts, purchase cards, and, most recently, award and incentive fees. For DOD weapon system acquisitions, we have found the persistent and long-standing nature of acquisition problems has perhaps made a range of key players both in the Pentagon and the Congress complacent about cost growth, schedule delays, quantity reductions, and performance shortfalls in weapon system programs. DOD's strategies for incentivizing its contractors, especially on weapon system development programs, reflect this complacency and are symptomatic of the lack of discipline, oversight, transparency, and accountability in DOD's acquisition process. As a result, DOD programs routinely engage in practices that undermine efforts to motivate positive contractor performance and that do not hold contractors accountable for achieving desired acquisition outcomes, such as meeting cost and schedule goals and delivering desired capabilities to the warfighter.

Specifics follow:

- DOD generally does not evaluate contractors based on award-fee criteria that are directly related to key acquisition outcomes. In addition, the link between the elements of contractor performance that are included in the criteria and these outcomes is not always clear. As a result, DOD paid out an estimated \$8 billion in award fees over the life of the contracts in our study population (from their inception through our data collection phase),¹ regardless of whether acquisition outcomes fell short of, met, or exceeded DOD's expectations.
- DOD programs engage in practices that undermine efforts to motivate excellent contractor performance by regularly paying contractors a significant portion of the available fee for what award-fee plans describe as "acceptable, average, expected, good, or satisfactory" performance. Although the definition of this level of performance varies by contract, these definitions are generally not related to outcomes. About half of the contracts in our sample, allowed 70 percent or more of the available fee to be paid for this level of performance.
- DOD award fee practices do not promote accountability. DOD programs gave contractors on about half of the award-fee contracts in our study population at least a second opportunity to earn an estimated \$669 million in initially unearned or deferred fees.

Taken together, DOD's acquisition, business, and contract management practices are contrary to the purpose of performance-based contracting concepts and have resulted and, if not corrected in both form and practice, will continue to result in wasting billions of dollars in taxpayer funds. My statement today will focus on what steps DOD must take to strengthen the link between monetary incentives and acquisition outcomes and by extension increase the transparency and accountability of DOD programs for fees paid and of contractors for results achieved. This testimony draws upon our recently issued report on DOD's use of award and incentive fees as well as the GAO High-Risk series and our body of work on weapon system acquisitions.

¹Estimates of total award fees earned are based on all evaluation periods held from the inception of our sample contracts through our data collection phase, not just those from fiscal years 1999 through 2003. The oldest award fee contracts in our sample were signed in fiscal year 1991. For some contracts, the data collection phase ended as early as November 2004. For at least one contract, data collection was not complete until April 2005.

GAO's many acquisition-related reports over the years raise serious questions about the reasonableness, appropriateness, and affordability of DOD's current investment plans; the soundness of the acquisition process which implements those plans; and the effectiveness of the practices DOD uses to manage its contractors, including the use of award and incentive fees. These reports collectively present a compelling case for change.

Appendix I contains information about the scope and methodology for [GAO-06-66](#), *Defense Acquisitions: DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes*. The work was conducted in accordance with generally accepted government auditing standards.

Background

Federal agencies, including DOD, can choose among numerous contract types to acquire products and services. One of the characteristics that vary across contract types is the amount and nature of the fee that agencies offer to the contractor for achieving or exceeding specified objectives or goals. Of all the contract types available, only award- and incentive-fee contracts allow an agency to adjust the amount of fee paid to contractors based on the contractor's performance.²

Federal acquisition regulations state that award- and incentive-fee contracts should be used to achieve specific acquisition objectives, such as delivering products and services on time or within cost goals and with the promised capabilities. For award-fee contracts, the assumption underlying the regulation is that the likelihood of meeting these acquisition objectives will be enhanced by using a contract that effectively motivates the contractor toward exceptional performance. Typically, award-fee contracts emphasize multiple aspects of contractor performance in a wide variety of areas, such as quality, timeliness, technical ingenuity, and cost-effective management.³ These areas are

²Other contract types do not provide this same level of control over fees and profits. The two most prevalent DOD contract types (based on the number of contract actions) are firm-fixed-price and cost-plus-fixed-fee. Under firm-fixed-price contracts, DOD and the contractor agree on a price and the contractor assumes full responsibility for all costs and the resulting profit or loss. Under cost-plus-fixed-fee contracts, DOD provides payment for the contractor's allowable incurred costs, to the extent prescribed in the contract, and the contractor receives a fee that was negotiated and fixed at the inception of the contract.

³Award-fee contracts are intended to be flexible, so award-fee plans allow contracting and program officials to change the fee criteria in these areas and the weight given to each criterion from evaluation period to evaluation period.

susceptible to judgmental and qualitative measurement and evaluation, and as a result, award-fee criteria and evaluations tend to be subjective.⁴ Table 1 provides a description of the general process for evaluating the contractor and determining the amount of award fee earned.

Table 1: General Process for Determining Award-Fee Amounts

1	DOD officials provide input on the contractor's performance for an evaluation period that just ended.
2	Program officials compile data and prepare briefing or summary for award-fee evaluation board. ^a
3	Award-fee evaluation board convenes meeting; contractor has option to submit a self-assessment and brief the board.
4	Award-fee evaluation board considers all the input and recommends a fee rating for the contractor.
5	Fee-determining official (usually outside the program) makes an initial fee determination and notifies contracting officer. ^b
6	Contracting officer notifies contractor of initial determination; contractor has the option to appeal the decision to the fee-determining official.
7	Fee-determining official makes final determination, including whether to roll over unearned fee, and notifies contracting officer. ^c
8	Contracting officer issues final determination to contractor and processes a contract modification authorizing payment.

Sources: Army Contracting Agency Award Fee Handbook, Air Force Award Fee Guide, Navy/Marine Corps Award Fee Guide (data); GAO (analysis).

^a Award-fee evaluation board members may include personnel from key organizations knowledgeable about the award-fee evaluation areas, such as: engineering, logistics, program management, contracting quality assurance, legal, and financial management; personnel from user organizations and cognizant contract administration offices; and the local small business office in cases where subcontracting goals are important. On major weapons programs, the boards are generally made up of personnel from the program office.

^b The fee-determining official is generally at a higher level organizationally than those directly involved in the evaluation of the contractor (e.g. award-fee board members). For instance, this official can be the program executive officer for a weapons system acquisition contract or a garrison commander on a base support services contract.

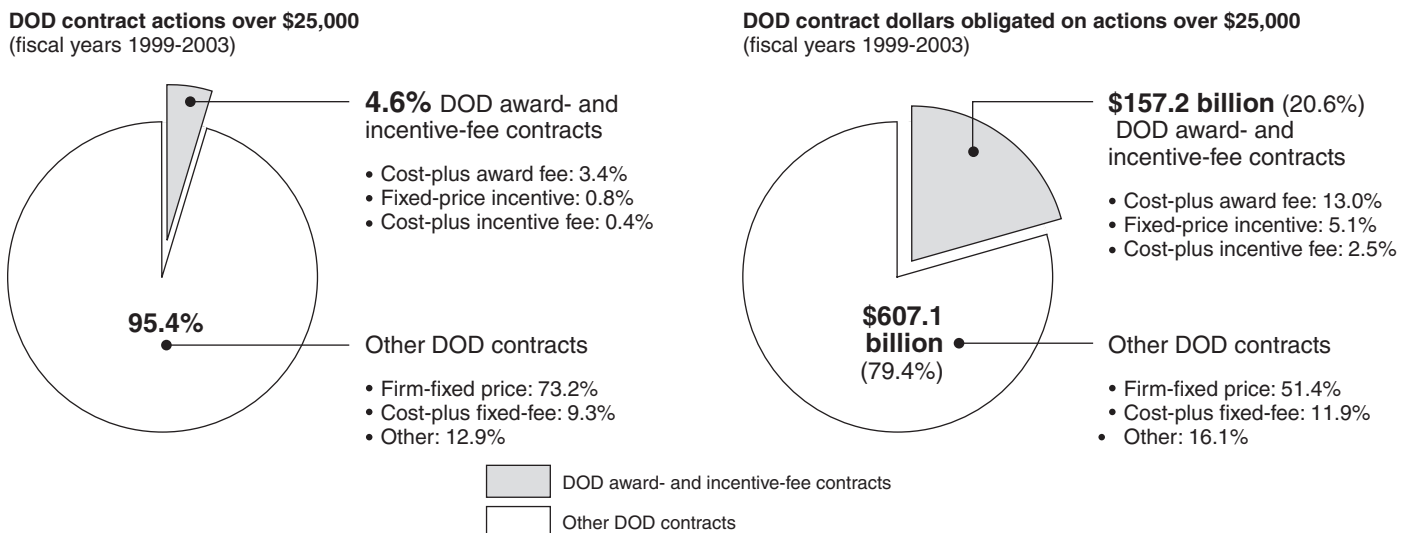
^c Rollover is the practice of moving unearned award fee from one evaluation period to a subsequent evaluation period or periods, thus providing the contractor an additional opportunity to earn previously unearned fee.

⁴The Navy Award Fee Guide suggests that objective measures also be utilized, to the maximum extent possible, to support the subjective evaluation of the contractor's performance.

Prevalence and Use of Award and Incentive Fees

From fiscal year 1999 through fiscal year 2003, award- and incentive-fee contract actions⁵ accounted for 4.6 percent of all DOD contract actions over \$25,000. However, when taking into account the dollars obligated—award- and incentive-fee contract actions accounted for 20.6 percent of the dollars obligated on actions over \$25,000, or over \$157 billion, as shown in figure 1. Our sample of 93 contracts includes \$51.6 billion, or almost one-third, of those obligated award- and incentive-fee contract dollars.⁶ These obligations include award- and incentive-fee payments as well as other contract costs.

Figure 1: Prevalence of Award- and Incentive-Fee Contracts, Fiscal Years 1999-2003



Sources: Federal Procurement Data System (data); GAO (analysis and presentation).

⁵Contract actions include any action related to the purchasing, renting, or leasing of supplies, services, or construction. Contract actions include definitive contracts; letter contracts; purchase orders; orders made under existing contracts or agreements; and contract modifications, which would include the payment of award and incentive fees.

⁶These contracts were selected as part of a probability sample of 93 contracts from a study population of 597 DOD award-fee and incentive-fee contracts that were active between fiscal years 1999 and 2003 and had at least one contract action coded as cost-plus-award-fee, cost-plus-incentive-fee, fixed-price-award-fee, or fixed-price incentive valued at \$10 million or more during that time.

DOD utilized the contracts in our sample for a number of purposes. For example, research and development contracts accounted for 51 percent (or \$26.4 billion) of the dollars obligated against contracts in our sample from fiscal years 1999 through 2003; while non-research-and-development services accounted for the highest number of contracts in our sample. Further, we estimate that most of the contracts and most of the dollars in our study population are related to the acquisition of weapon systems.

DOD has the flexibility to mix and match characteristics from different contract types. The risks for both DOD and the contractor vary depending on the exact combination chosen, which, according to the Federal Acquisition Regulation, should reflect the uncertainties involved in contract performance. Based on the results from our sample, about half of the contracts in our study population were cost-plus-award-fee contracts. The theory behind these contracts is that although the government assumes most of the cost risk, it retains control over most or all of the contractor's potential fee as leverage. On cost-plus-award-fee contracts, the award fee is often the only source of potential fee for the contractor. According to defense acquisition regulations, these contracts can include a base fee—a fixed fee for performance paid to the contractor—of anywhere from 0 to 3 percent of the value of the contract;⁷ however, based on our sample results, we estimate that about 60 percent of the cost-plus-award-fee contracts in our study population included zero base fee.⁸ There is no limit on the maximum percentage of the value of the contract that can be made available in award fee, although the 20 percent included in the Space-Based Infrared Radar System High development contract we examined was outside the norm. The available award fees on all the award-fee contracts in our study population typically ranged from 7 to 15 percent of the estimated value of the contract.

A System in Need of Reform

DOD's use of award and incentive fees is symptomatic of an acquisition system in need of fundamental reform. DOD's historical practice of routinely paying its contractors nearly all of the available award fee creates an environment in which programs pay and contractors expect to

⁷The two F/A-22 development contracts in our sample included a 4 percent base fee. The program office received a deviation from the Defense Federal Acquisition Regulation Supplement, which allows for a maximum of 3 percent base fee.

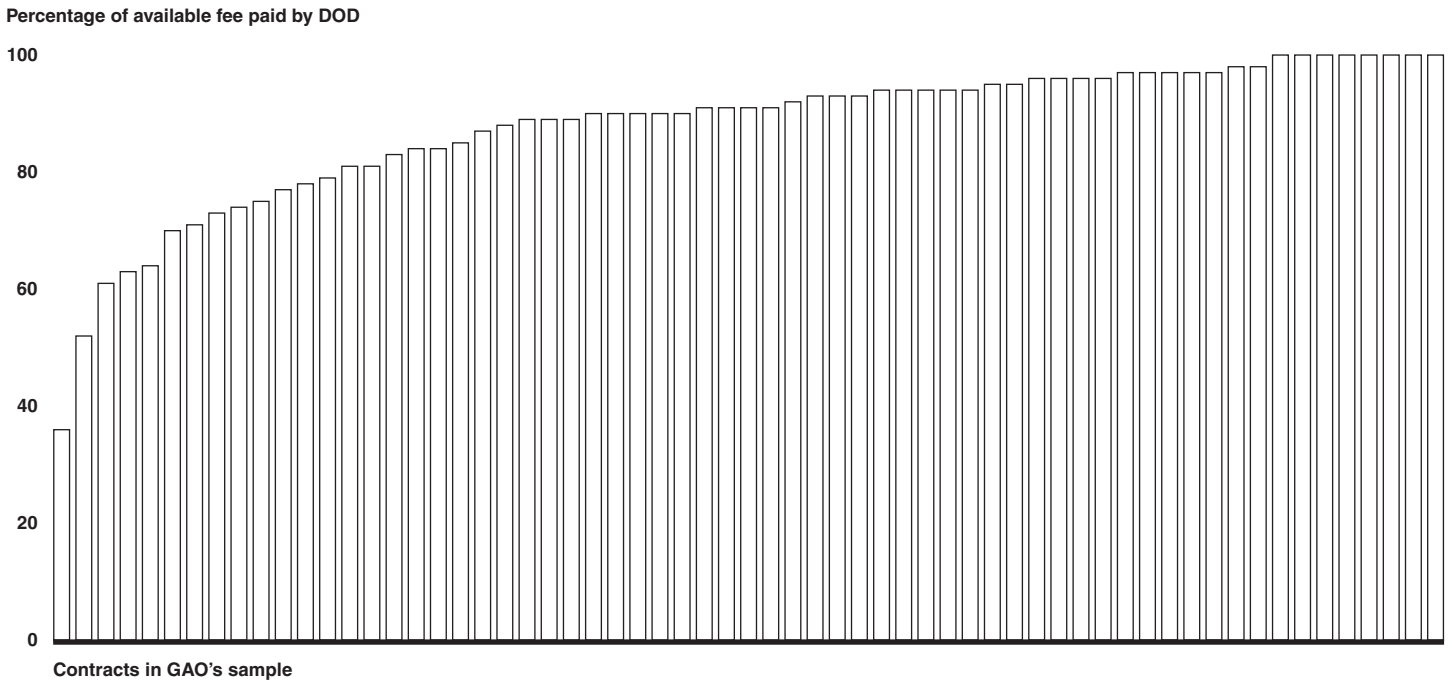
⁸The 95 percent confidence interval surrounding this estimate ranges from 46 percent to 73 percent.

receive most of the available fee, regardless of acquisition outcomes. This is occurring at a time when DOD is giving contractors increased program management responsibilities to develop requirements, design products, and select major system and subsystem contractors. Based on our sample, we estimate that for DOD award-fee contracts, the median percentage of available award fee paid to date (adjusted for rollover)⁹ was 90 percent, representing an estimated \$8 billion in award fees for contracts active between fiscal years 1999 and 2003. Estimates of total award fees earned are based on all evaluation periods held from the inception of our sample contracts through our data collection phase, not just those from fiscal years 1999 through 2003.¹⁰ Figure 2 shows the percentage of available fee earned for the 63 award-fee contracts in our sample.

⁹When calculating the percentage of award fee paid (i.e. percentage of award fee paid = total fee paid to date / (total fee pool – remaining fee pool)), we included rolled-over fees in the remaining fee pool when those fees were still available to be earned in future evaluation periods.

¹⁰The oldest award fee contracts in our sample were signed in fiscal year 1991. For some contracts, the data collection phase ended as early as November 2004. For at least one contract, data collection was not complete until April 2005.

Figure 2: Percentage of Available Fee Paid to Date for 63 Award-Fee Contracts in GAO's Sample



Sources: DOD submissions to GAO and contract documentation (data); GAO (analysis and presentation).

The pattern of consistently high award-fee payouts is also present in DOD's fee decisions from evaluation period to evaluation period. This pattern is evidence of reluctance among DOD programs to deny contractors significant amounts of fee, even in the short term. We estimate that the median percentage of award fee earned for each evaluation period was 93 percent and that the contractor received 70 percent or less of the available fee in only 9 percent of the evaluation periods and none of the available fee in only 1 percent of the evaluation periods.

**A Case for Change:
Moving Toward
Outcome-Based
Award-Fee Criteria**

Recommendations	DOD response
<ul style="list-style-type: none"> Move toward more outcome-based award-fee criteria that are both achievable and promote accountability for positive acquisition outcomes 	<ul style="list-style-type: none"> DOD issued a policy memo on March 29, 2006, emphasizing the need to link award fees to desired program outcomes.

Award fees have generally not been effective at helping DOD achieve its desired acquisition outcomes, in large part, because award-fee criteria are not linked to desired acquisition outcomes, such as meeting cost and

schedule goals and delivering desired capabilities. Instead, DOD programs structure award fees to focus on the broad aspects of contractor performance, such as technical and management performance and cost control, that they view as keys to a successful program. In addition, elements of the award-fee process, such as the frequency of evaluations and the composition of award-fee boards, may also limit DOD's ability to effectively and impartially evaluate the contractor's progress toward acquisition outcomes. Most award-fee evaluations are time-based, generally every six months, rather than event-based; and award-fee boards are made up primarily of individuals directly connected to the program. As a result of all these factors, DOD programs frequently paid most of the available award fee for what they described as improved contractor performance, regardless of whether acquisition outcomes fell short of, met, or exceeded DOD's expectations.

High award-fee payouts on programs that have fallen or are falling well short of meeting their stated goals are also indicative of DOD's failure to implement award fees in a way that promotes positive performance and adequate accountability. Several major development programs—accounting for 52 percent of the available award-fee dollars in our sample and 46 percent of the award-fee dollars paid to date—are not achieving or have not achieved their desired acquisition outcomes, yet contractors received most of the available award fee. These programs—the Comanche helicopter, F/A-22 and Joint Strike Fighter aircraft, and the Space-Based Infrared System High satellite system—have experienced significant cost increases, technical problems, and development delays, but the prime systems contractors have received 85, 91, 100, and 74 percent of the award fee, respectively to date (adjusted for rollover), totaling \$1.7 billion (see table 2).

Table 2: Program Performance and Award-Fee Payments on Selected DOD Development Programs

Acquisition outcomes	Comanche reconnaissance attack helicopter	F/A-22 Raptor tactical fighter aircraft	Joint Strike Fighter tactical fighter aircraft	Space-Based Infrared System High
Research and development cost increase over original baseline	\$3.7 billion 41.2 percent	\$10.2 billion 47.3 percent	\$10.1 billion 30.1 percent	\$3.7 billion 99.5 percent
Acquisition cycle time increase over original baseline	33 months 14.8 percent	27 months 13.3 percent	11 months 5.9 percent	More than 12 months ^a
Number of program rebaselines	1 ^b	14	1	3
Total award fee paid to prime systems contractor	\$202.5 million paid through 2004	\$848.7 million	\$494.0 million	\$160.4 million ^c
Percentage of award fee paid to prime systems contractor (adjusted for rollover) ^d	85 percent of available fee	91 percent	100 percent	74 percent
Total award fee paid to prime engine contractor	No engine contractor	\$115 million paid through 2004	\$35.8 million	No engine contractor
Percentage of award fee paid to prime engine contractor (adjusted for rollover) ^d	N/A	89 percent of the available fee	100 percent	N/A

Sources: DOD submissions to GAO, contract documentation, and [GAO-05-301](#) (data); GAO (analysis and presentation).

^aThe Air Force Space Command has not specified the acquisition cycle time for the Space-Based Infrared Radar System High program; however, the delivery of the first two satellites has been delayed by more than a year.

^bOverall, there were five rebaselines for the Comanche program; however, only one occurred after development start. The Comanche program was canceled in 2004.

^cThe program also utilizes incentive fees tied to cost and mission successes. The award fee paid does not include fee earned through mission success incentives. To date, the contractor has earned \$3 million in these fees and could earn over \$70 million over the life of the contract.

^dWhen calculating the percentage of award fee paid to date (i.e., percentage of award fee paid to date = total fee paid to date / (total fee pool – remaining fee pool)), we included rolled-over fees in the remaining fee pool when those fees were still available to be earned in future evaluation periods. For instance, even though the Joint Strike Fighter prime contractor has not been paid 100 percent of the award fee that was made available for each evaluation period, it retains the ability to potentially earn all of this unearned fee at a later date. By reflecting the continued availability of this unearned fee in the percentage calculation, it becomes clear that the contractor has, in essence, earned 100 percent of the total award fee to date.

DOD can ensure that fee payments are more representative of program results by developing fee criteria that focus on its desired acquisition outcomes. For instance, DOD's Missile Defense Agency attempted to hold contractors accountable for program outcomes on the Airborne Laser program. On this program, DOD revised the award-fee plan in June 2002 as part of a program and contract restructuring. The award-fee plan was changed to focus on achieving a successful system demonstration by December 2004. Prior to the restructuring, the contractor had received 95 percent of the available award fee, even though the program had experienced a series of cost increases and schedule delays. Importantly, the contractor did not receive any of the \$73.6 million award fee available under the revised plan because it did not achieve the key program outcome—successful system demonstration.¹¹

**A Case for Change:
Motivating Excellent
Contractor Performance
and Promoting
Accountability**

Recommendations	DOD response
<ul style="list-style-type: none"> Ensure that award-fee structures are motivating excellent contractor performance by only paying award fees for above satisfactory performance 	<ul style="list-style-type: none"> While DOD stated that award fee arrangements should be structured to encourage the contractor to earn the preponderance of fee by providing excellent performance, it maintains that paying a portion of the fee for satisfactory performance is appropriate to ensure that contractors receive an adequate fee on contracts. In its March 29, 2006 policy memo, DOD reiterated this position and emphasized that less than satisfactory performance is not entitled to any award fee.
<ul style="list-style-type: none"> Issue DOD guidance on when rollover is appropriate 	<ul style="list-style-type: none"> In its March 29, 2006 policy memo, DOD provided guidance and placed several limitations on the use of rollover.

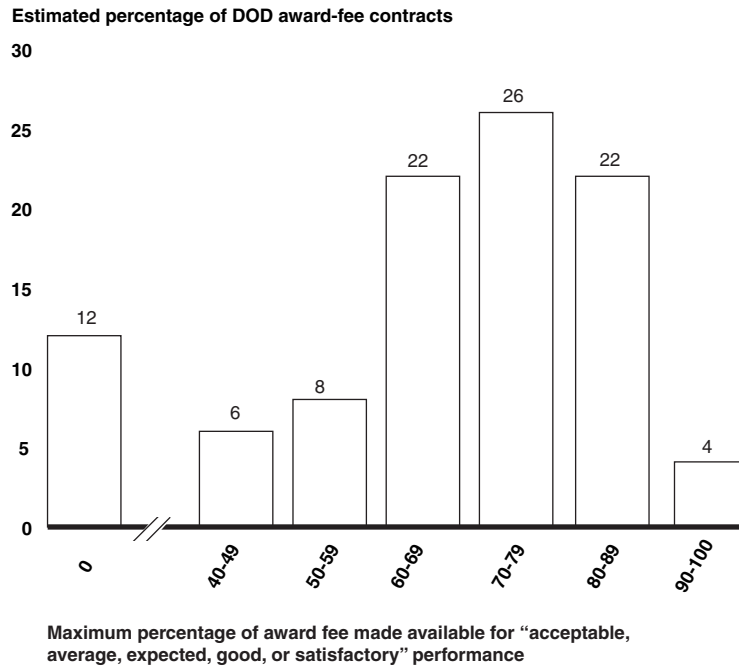
DOD programs routinely engage in award-fee practices that are inconsistent with the intent of award fees, reduce the effectiveness of these fees as motivators of performance, compromise the integrity of the fee process, and waste billions in taxpayer money. Two practices, in particular, paying significant amounts of fee for “acceptable, average, expected, good, or satisfactory” performance and providing contractors multiple opportunities to earn fees that were not earned when first made

¹¹According to DOD, the contract was restructured again in May 2004 and the cost ceiling was increased from about \$2 billion to \$3.6 billion and the period of performance of the contract was extended more than 3 years, from June 2005 to December 2008.

available, undermine the effectiveness of fees as a motivational tool and marginalize their use in holding contractors accountable for acquisition outcomes.

Although DOD guidance and federal acquisition regulations state that award fees should be used to motivate excellent contractor performance, most DOD award-fee contracts pay a significant portion of the available fee for what award-fee plans describe as “acceptable, average, expected, good, or satisfactory” performance. Although the definition of this level of performance varies by contract, these definitions are generally not related to outcomes. Some plans for contracts in our sample did not even require the contractor to meet all of the minimum standards or requirements of the contract to receive one of these ratings. Some plans also allowed for fee to be paid for marginal performance. Even fixed-price-award-fee contracts, which already include a normal level of profit in the price, paid out award fees for satisfactory performance. Figure 3 shows the maximum percentage of award fee paid for “acceptable, average, expected, good, or satisfactory” performance and the estimated percentage of DOD award-fee contracts active between fiscal years 1999 through 2003 that paid these percentages.

Figure 3: Maximum Percentage of Award Fee Available for “Acceptable, Average, Expected, Good, or Satisfactory” Performance and the Estimated Percentage of DOD Contracts That Paid These Percentages



Sources: Award-fee plans and contract documentation (data); GAO (analysis and presentation).

Note: Sampling errors for percentages in this figure do not exceed plus or minus 13 percentage points.

The use of rollover is another indication that DOD’s management of award-fees lacks the appropriate incentives, transparency, and accountability necessary for an effective pay-for-performance system. Rollover is the process of moving unearned available award fee from one evaluation period to a subsequent evaluation period, thereby providing the contractor an additional opportunity to earn that previously unearned award-fee. We estimate that 52 percent of DOD award-fee contracts rolled over unearned fees into subsequent evaluation periods,¹² and in 52 percent¹³ of these periods, at least 99 percent of the unearned fee was rolled over. Overall, for DOD award-fee contracts active between fiscal

¹²The 95 percent confidence interval for this estimate ranges from 40 percent to 64 percent.

¹³The 95 percent confidence interval for this estimate ranges from 34 percent to 69 percent.

years 1999 through 2003, we estimate that the total dollars rolled over across all evaluation periods that had been conducted by the time of our review was \$669 million.

**A Case for Change:
Ensuring Practice Is
Consistent with Policy**

Recommendations	DOD response
<ul style="list-style-type: none"> Requiring appropriate approving officials to review new contracts to make sure award-fee criteria reflect desired acquisition outcomes and award-fee structures motivate excellent contractor performance by only providing fees for above satisfactory performance 	<ul style="list-style-type: none"> DOD plans to conduct an analysis to determine what the appropriate approving official level should be for new contracts utilizing award fees and issue additional guidance if needed by June 1, 2006.

The inconsistent application of DOD’s existing policies on award fees and weapon system development reinforce the need for increased transparency and accountability in DOD’s management of award fees. Although DOD award-fee guidance and federal acquisition regulations state that award fees should be used to motivate excellent contractor performance, most DOD award-fee contracts still pay a significant portion of the available fee for what award-fee plans describe as “acceptable, average, expected, good, or satisfactory” performance.¹⁴ Air Force, Army, and Navy guidance that states rollover should rarely be used in order to avoid compromising the integrity of the award-fee evaluation process; however, about half of the contracts in our study population used rollover.

¹⁴According to FAR 16.404(a)(1), in a fixed-price-award-fee contract, the fixed price (including normal profit) will be paid for satisfactory contract performance. Award fee earned (if any) will be paid in addition to that fixed price. According to FAR 16.405-2(a)(2), a cost-plus-award-fee contract should include an award amount that is sufficient to provide motivation for excellence in such areas as quality, timeliness, technical ingenuity, and cost-effective management.

A Case for Change: Developing and Sharing Proven Incentive Strategies

Recommendations	DOD response
<ul style="list-style-type: none"> Develop a mechanism for capturing award- and incentive-fee data within existing data systems, such as the Defense Acquisition Management Information Retrieval system 	<ul style="list-style-type: none"> DOD will conduct an analysis of existing systems and determine which, if any, is best suited, to capture this type of data and at what cost. DOD expects to complete the study by June 1, 2006.
<ul style="list-style-type: none"> Develop performance measures to evaluate the effectiveness of award and incentive fees as a tool for improving contractor performance and achieving desired program outcomes 	<ul style="list-style-type: none"> DOD will review and identify possible performance measures and determine the appropriate actions by June 1, 2006.
<ul style="list-style-type: none"> Develop a mechanism to share proven incentive strategies for the acquisition of different types of products and services with contracting and program officials across DOD 	<ul style="list-style-type: none"> In its March 29, 2006 policy memo, DOD tasked Defense Acquisition University to develop an online repository for award- and incentive-fee policy information, related training courses, and examples of good award fee arrangements.

Very little effort has gone into determining whether DOD's current use of monetary incentives is effective. Over the past few years, officials including the Undersecretary of Defense for Acquisition Technology and Logistics and the Assistant Secretary of the Air Force for Acquisition expressed concerns that contractors routinely earn high percentages of fee while programs have experienced performance problems, schedule slips, and cost growth. However, DOD has not compiled information, conducted evaluations, shared lessons learned, or used performance measures to judge how well award and incentive fees are improving or can improve contractor performance and acquisition outcomes. The lack of data is exemplified by the fact that DOD does not track such basic information as how much it pays in award and incentive fees. Such information collection across DOD is both necessary and appropriate.

Conclusions

DOD's use of award-fee contracts, especially for weapon system development, reflects the fundamental lack of knowledge and program instability that we have consistently cited as the main reasons for DOD's poor acquisition outcomes. DOD uses these fees in an attempt to mitigate the risks that it creates through a flawed approach to major weapon system development. The DOD requirements, acquisition, budgeting, and investment processes are broken and need to be fixed. DOD's requirements process generates much more demand for new programs than fiscal resources can reasonably support. The acquisition environment encourages launching product developments that promise the best capability, but embody too many technical unknowns and too little

knowledge about the performance and production risks they entail. However, a new program will not be approved unless its costs fall within forecasts of available funds and, therefore, looks affordable. Further, because programs are funded annually and departmentwide, cross-portfolio priorities have not been established, competition for funding continues over time, forcing programs to view success as the ability to secure the next funding increment rather than delivering capabilities when expected and as promised.

The business cases to support weapon system programs that result from these processes are in many cases not executable because the incentives inherent in the current defense acquisition system are not conducive to establishing realistic cost, schedule, and technical goals. As a result, DOD has to date not been willing to hold its programs or its contractors accountable for achieving its specified acquisition outcomes. Instead, faced with a lack of knowledge and the lack of a sound business case, DOD programs use award-fee contracts, which by their very nature allow DOD to evaluate its contractors on a subjective basis. This results in billions of dollars in wasteful payments because these evaluations are based on contractors' ability to guide programs through a broken acquisition system, not on achieving desired acquisition outcomes.

Implementing our recommendations on award and incentive fees will not fix the broader problems DOD faces with its management of major weapons or service acquisitions. However, by implementing our recommendations, DOD can improve incentives, increase transparency, and enhance accountability for the fees it pays. In particular, moving toward more outcome-based award-fee criteria would give contractors an increased stake in helping DOD to develop more realistic targets upfront or risk receiving less fee when unrealistic cost, schedule, and performance targets are not met. To make this new approach to incentives function as intended, DOD would also need to address the more fundamental issues related to its management approach, such as the lack of a sound business case, lack of well-defined requirements, lack of product knowledge at key junctions in development, and program instability caused by changing requirements and across-the-board budget cuts. Working in concert, these steps can help DOD set the right conditions for more successful acquisition outcomes and make more efficient use of its resources in what is sure to be a more fiscally constrained environment as the nation approaches the retirement of the "baby boom" generation.

Recent DOD Actions

Last week, DOD issued a policy memorandum on award-fee contracts that takes steps towards addressing several of the recommendations made in our report, and the department has indicated that further actions are planned to address the remaining recommendations. This guidance is a positive first step, but, like so many prior DOD concurrences, its effectiveness will ultimately be determined by how well it is implemented. Identifying who will be responsible for ensuring it is carried out and how progress will be monitored and measured are key ingredients that are missing in the new guidance. We continue to believe that DOD must designate appropriate approving officials to review new contracts to ensure that award-fee criteria are tied to desired acquisition outcomes; fees are used to promote excellent performance; and the use of rollover provisions in contracts is the exception not the rule. Changing DOD award-fee practices will also require a change in culture and attitude. The policy memorandum's position that it is appropriate to pay a portion of the available award fee for satisfactory performance to ensure that contractors receive an "adequate fee on contracts" is indicative of DOD's resistance to cultural change. Finally, we encourage the department to fully implement our remaining recommendations including developing a mechanism to capture award- and incentive-fee data and developing performance measures to evaluate the effectiveness of these fees.

Mr. Chairman and Members of the Committee, this concludes my prepared statement. I would be happy to answer any questions you may have at this time.

Appendix I: Scope and Methodology

In this statement, we examine fixed-price and cost-reimbursable award- and incentive-fee contracts, as well as contracts that featured combinations of these contract types. These contracts were selected as part of a probability sample of 93 contracts from a study population of 597 DOD award-fee and incentive-fee contracts that were active between fiscal years 1999 and 2003 and had at least one contract action coded as cost-plus-award-fee, cost-plus-incentive-fee, fixed-price-award-fee, or fixed-price incentive valued at \$10 million or more during that time. Unless otherwise noted, the estimates in this statement pertain to (1) this population of award- and incentive-fee contracts, (2) the subpopulation of award-fee contracts, or (3) the evaluation periods associated with contracts described in (1) or (2) that had been completed at the time of our review. In the sample, 52 contracts contained only award-fee provisions; 27 contracts contained only incentive-fee provisions; and 14 contracts included both. Estimates of total award fees earned and total award fees that contractors received at least two chances to earn are based on all evaluation periods held from the inception of our sample contracts through our data collection phase,¹ not just those from fiscal years 1999 through 2003. Because the estimates in this report are derived from a probability sample, they are subject to sampling error. All percentage estimates from our review have margins of error not exceeding plus or minus 10 percentage points unless otherwise noted. All numerical estimates other than percentages (such as totals and ratios) have margins of error not exceeding plus or minus 25 percent of the value of those estimates.

¹For some contracts, the data collection phase ended as early as November 2004. For at least one contract, data collection was not complete until April 2005.

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