



# Tying Profit to Performance

## A Valuable Tool, But Use With Good Judgment

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One thing I enjoyed about working in industry was that everyone in the private sector understood the definition of success: It was profit. If something made a profit for a business, it was good. If something did not make a profit for a business, then it was not good. Profit is the fundamental reason that businesses exist: to make money for their owners or shareholders. Without profit, businesses die.

From industry's point of view, more profit is always better. Not being profitable makes a company unsustainable and will lead to bankruptcy. Declining profits make it harder for businesses to raise capital or to invest for their futures. These facts make profit the most powerful tool the Department of Defense (DoD) has to obtain better performance from industry. It is important, however, to recognize that this also implies that over-aggressive use of this tool can seriously damage the institutions we depend upon for products and services.

Sometimes—through some combination of incompetence, poor management, the realization of risk, or external factors—defense companies will lose money and even go out of business. That is the nature of capitalism. We do not have an obligation to protect defense companies from themselves, but we do have an obligation to treat them fairly and to try to balance our use of profit as a motivator for better performance with an understanding of the possible implications for those we expect and hope to do business with over the long term.

As we continue to work through a period of uncertain and declining budgets, we need to be especially careful. A recent study by the Institute for Defense Analyses shows very clearly that cost increases correlate strongly with tight budgets. Historically, programs initiated during tight budget periods had 3 times higher acquisition cost growth for production than those started during less constrained resource periods. We're working now to understand what causes this strong correlation, but one likely factor is that tight money motivates everyone to take more risk. A shrinking market and fewer bidding opportunities put pressure on industry to bid more aggressively. Government

budgeters and programmers are motivated to take risk also, or to buy into optimistic assumptions or speculative management fads as alternatives to having to kill needed programs. Industry may be incentivized to sign up for a low target—knowing that they might otherwise be out of that market permanently—and hoping that budget instability and/or changing requirements will provide a recovery opportunity. We can't entirely prevent industry from making high-risk bids in competition, but we should do what we can to ensure realism in our budgets and executable business arrangements that give industry a fair opportunity to make a reasonable profit.

The profit margins that DoD pays vary, but in the aggregate they are fairly stable. Large defense companies, in particular, have very little risk. Their markets are fairly predictable and stable. The government pays upfront for most product research and development costs, and provides excellent cash flow through progress payments, minimizing the cost of capital. Most development programs are also cost reimbursable, which significantly limits the risk to industry. Substantial barriers for new companies to enter the defense market also limit competitive risks. While there usually is competition early in product life cycles, many products end up as sole-source awards by the time they enter production. The primary defense market customer, DoD, is highly regulated, is not allowed to arbitrarily award contracts, and is subject to independent legal review if a bidder believes it has not been treated fairly. At the end of the day, it's not a bad business to be in, and we don't want to change these fundamental premises of government contracting. We do, however, want to get as much for the taxpayer and the warfighter as we can with the available resources. That means we must tie performance to profitability.

As we have tried to incentivize and improve industry's performance under the Better Buying Power (BBP) initiatives of the last several years, we have consistently followed two principles. First, BBP is not a "war on profit"—we are not trying to reduce profit as a way to reduce costs. We want to continue to give our industry suppliers a reasonable return. Second, we will use profit to motivate better performance, both as a carrot and a stick. In the balance of this article, I want to focus on this second principle.

How do we use profit effectively to obtain better results for the taxpayer and the warfighter? I'm going to address some specific cases I think are important: product development, early production, lowest price technically acceptable, commercial and commercial-like items, logistic support, and support services.

First, I would like to address the use of profit as an incentive in general. Before we solicit anything from industry, we need

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to think carefully about what the government really needs or desires and how we can effectively tie getting what we need to profit opportunities for industry. In product acquisitions, we need to decide whether higher performance or cost or schedule or some combination of these parameters matters to us. Often they are not independent, and we have to think about how those interdependencies are related to profit-related incentives. In services acquisitions, we often want a certain quality of performance; we may or may not be willing to pay more for higher-quality performance of the service, or we may only be interested in controlling cost at a set level of performance. As we emphasized in BBP 2.0, we have to start by thinking, in this case thinking carefully about what matters to us and about the extent to which fee or incentive structures can add motivation to behavior that achieves those government objectives and that wouldn't exist without the incentives.

We can use the full range of contract types to motivate performance. For products, we sometimes place the highest value on the schedule, sometimes on the cost, and sometimes on increased performance levels. Our contracts often inherently include a high degree of profit motivation without any special incentive provisions. For example, a firm-fixed-price contract provides a strong financial incentive to control costs.

However, we also need to think about how incentives that affect profit will play out over the life of the contract and the life cycle of the program. It is not just the immediate contract that we care about. We need to think through profit incentives not only under the expected scenario but under any alternative scenarios that may develop, including the realization of any foreseeable risks. A cost-plus development contract that has reached a point where nothing is left to be gained or lost in fee by completing the effort doesn't include much incentive.

We also need to think carefully about unintended consequences. Industry may look at the situation very differently than we do. We can assume industry will try to maximize its profit—by whatever means we make available. We also can assume industry will examine all the available scenarios—including ones we have not intended. That means we need to anticipate industry's behavior and make sure that we align industry objectives with the performance we intend. In general, we also can expect industry to argue for incentives that come sooner in the period of performance and are easier to achieve. Usually that is not what we should be rewarding.

We also must recognize there is no motivational value in incentive fees or profits that are impossible to earn—or conversely that are very easy to achieve. The bottom line is that this isn't simple, and, as in much of what we do as acquisition professionals, careful thought and sound judgment based on experience play major roles. One of the items I am most interested in when I read a program's Acquisition Strategy or a request for proposal is the incentive structure and how it ties profit to performance. I particularly look for why the program manager and the contracting officer chose the proposed approach. Now I'd like to discuss some specific cases.

**Product development:** On our major competitive development contracts, industry has been receiving final margins of about 5 percent or 6 percent—about half the levels seen in production. (Note that this isn't where we start out; the reality of the risk in development programs leads to this result. Also note that margins on sole-source development contracts are significantly higher.) Industry accepts this lower outcome because of two things. First, competitive pressures force industry to bid aggressively and take risks in the development phases. Second, winning subsequent production contracts, with their higher margins and decades of follow-on work, makes it worthwhile to accept lower returns in development. Most often, the inherent risk of development makes a cost-plus vehicle appropriate, and profit then is tied to the incentive fee structure we provide. If the situation still is competitive after award, winning the future engineering and manufacturing development or production contract provides all the motivation to perform we are likely to need. However,

in a sole-source situation, we need to structure profit potential to affect desired outcomes.

The data from recent sole-source contracts show that formulaic incentive structures with share ratios above and below a target price are effective in controlling costs on the immediate contract. Often, however, performance on the current contract is not what concerns us the most. We may want lower cost in follow-on production or sustainment, or we may want higher performance in the final product, or some combination of parameters. This is where we need to be very thoughtful and creative about how we use profit to motivate desired behaviors and outcomes.

**Early production:** Usually when we award these contracts, we have a relatively mature design and a specified performance we intend to achieve, so cost control tends to dominate our use of the profit incentive. We generally use formulaic incentive share ratio structures during this phase. In the first iteration of BBP, we encouraged consideration of 120 percent ceilings and 50-50 share ratios, as a starting point, adjusting these structures to the situation at hand. The key to effective incentive contracting is to motivate the contractor to reduce costs as quickly as possible.

In the past, we have not done as good a job as we should have done in establishing realistic target costs. When we negotiate challenging but achievable target costs, we create an incentive arrangement that allows industry to earn a higher share of any underruns in early production. DoD should reap the benefits in future lots through lower prices. In addition, industry has more at stake here than the government: As we move up or down share lines, industry gains or loses what it cares most about—profit—at a much higher rate than the DoD gains or loses what it cares about—cost. For this reason, we should provide share ratios above and below target prices that give industry greater incentives (e.g., more favorable share ratios for industry below target and less favorable ones above target) to control cost.

**Lowest price technically acceptable (LPTA):** Industry has expressed concern for some time about the effect of this source-selection criterion on selections and profitability. I recently provided some policy guidance on this subject (see the March-April 2015 issue of this magazine). DoD's policy is to use LPTA only when there is (1) an objectively measurable standard of performance, and (2) there is no desire for any performance above some defined level of acceptability in that standard. In all other cases, we should use another form of best-value source selection. If LPTA is used properly in competitive source selections, it will give us the performance we desire and constrain profit levels to those necessary for

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businesses to be viable. That is what competitive markets do. While we aren't trying to artificially force profit down to reduce cost, we also shouldn't pay higher margins than those determined by competitive market forces for this type of work and standard of performance.

**Commercial and commercial-like items:** This is a particularly difficult area in which to achieve the right balance. Our policy is simple: If a supplier sells us a commercial item and the supplier can demonstrate that it sells that item in substantial quantities to commercial customers, we will pay what other commercial customers pay for similar quantities. When we buy truly commercial items, we compare prices, try to get volume discounts, and let the market set the price (often using tools like reverse auctions). When we buy a commercial item, the reasonableness of the price we pay is important to us—not the profit level a commercial company may make when selling that item. We must understand that the risk posture of a commercial company selling commercial items in a competitive marketplace is dramatically different than that of the traditional defense contractors with which we deal.

When we purchase items that may be sold commercially, or which are close in design to items sold commercially (sometimes referred to as “commercial of a type”), but for which there is really no competitive market to establish prices and margins, we have an obligation to ensure that we obtain fair and reasonable prices for the taxpayers whose money we spend. Examples include aircraft parts that are similar in design, but possibly not identical, to the parts used on commercial aircraft. In those cases, we have processes in place for our buyers to establish whether the item is commercial, and if it is, the fairness and reasonableness of the price. If an item is commercial, we only inquire about costs (and profit margins) when we have exhausted the other available means of determining price reasonableness.

**Logistics support:** We started emphasizing Performance Based Logistics (PBL) in BBP 2.0 as a way to reduce costs and improve outcomes on product support contracts. As we went through the difficult fiscal year 2013 sequestration scenario, our use of these types of arrangements actually declined. Today I am tracking the use of PBL through quarterly reviews at the Business Senior Integration Group. PBL is an effective tool that ties profit to performance in a way that has been demonstrated to be a win-win for DoD and industry. PBL is harder to implement and execute than other business arrangements, but the payoff is well established by the historical results; PBL profit incentives work to enhance performance and reduce cost. **[Editor's Note: Also see PBL article beginning on p. 14.]**

**Support services:** In these contracts, we often buy some form of administrative or technical support to carry out routine functions that are not inherently governmental. There may be metrics of performance to which we can tie profitability, —and, if they are available, we should use them. Often, however, services are about the productivity and basic skill sets of individuals working on location alongside DoD military or civilian employees. At one point, we routinely used time-and-materials or firm-fixed-price contract vehicles for these types of support services. A preferred approach is often the use of cost-plus-fixed-fee arrangements to pay actual costs coupled with DoD contract manager oversight with discretion over the acceptability of assigned contractors. In these cases, quality can be controlled by rejecting contractor staff members who are not performing up to contract standards. Since profitability will depend on providing acceptable staff to bill for, the incentive to do so is high.

### Conclusion

Industry can be counted upon to try to maximize profitability on behalf of its shareholders and/or owners—that's capitalism. Our job is to protect the interests of the taxpayers and the warfighter while treating industry fairly and in a manner that won't drive businesses away from working for DoD. To achieve these complex objectives, we should strive to ensure that we create business deals that provide industry an opportunity to earn fair and reasonable fees/profits, while protecting the government's interests. Industry will respond to profit incentives if they are achievable with realistic effort. We will benefit if profit incentives provide effective motivation to industry and are tied to the goals we value.

There is plenty of room for creativity in this area because our business situations vary widely. It is up to each of us to determine how profit incentives should be structured so that reasonable profit margins can be earned with reasonable performance levels, superior performance results in higher margins, and inferior performance has the opposite effect. 🐼