

DEPARTMENT OF THE AIR FORCE
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

MAY 9 1967

MEMORANDUM FOR DR. FLAX, SAFRD

SUBJECT: Incentives for Satellite Projects

I have read the paper titled, "A Specialized Incentive Contract Structure for Satellite Projects" (Ref. No. SP142866, Revised 2/28/67) and agree with you that it is an excellent piece of work. Its concept should be applied whenever the conditions so warrant.

I have only two suggestions, which do not in any way change the basic concept. The first suggestion stems from the fact that I see no magic in assuring that the fee will never fall below zero and, particularly, I see no reason why unsatisfactory technical performance, coupled with a cost overrun or a schedule slippage, or both, should not result in a negative fee. I recognize, of course, that a "below zero" profit possibility creates contractor pressure for an "above 15%" profit, assuming a 7½% fee is considered normal. The answer is that a normal profit contemplates satisfactory performance, that the zero-to-15% range encompasses varying degrees of satisfaction within the spectrum of acceptable performance, but that unacceptable performance is not entitled even to a zero fee.

The desired result can be achieved by having the contractor continue to share in cost overruns (perhaps at a reduced share rate) after the cost and delivery penalties have reduced his performance reward to zero. Similar treatment with respect to "below zero" delivery penalties is not necessary because a delivery delay will automatically entail increased cost which would be shared by the contractor. If some such arrangement is not included, the contractor can be in the position, once his profit has been reduced to zero, where there is no further incentive to exercise fiscal discipline.

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The second suggestion has to do with cases where the contractor's performance on a flight cannot be demonstrated. The SAF-SP approach is to apply the average of the scores on flights for which performance is demonstrated to flights for which performance is not demonstrated, except in cases where the contractor is responsible for the failure that prevents demonstration. The result is that the contractor is rewarded (or penalized) for successes (or failures) that are not known to have occurred. The reward or penalty is unearned and it is not clear why either reward or penalty should apply where known performance does not merit it.

It may have been earned

I suggest that, instead of applying the demonstrated average to undemonstrated performance, it might be better to apply the pro rata part of the target fee so that neither reward nor penalty would be involved. Where the nominal target fee is set at the maximum (e.g., 15%), provision should be made to apply for this purpose a stipulated "real" target fee (e.g., 7½%) in lieu of the nominal target.

There is a range of possibilities here.



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Gen Martin:

You may be interested in Mr Charles' comments on your incentive plan.

I think the suggestion that fees might be allowed to go negative may be applicable to special circumstances such as

- 1) Post development

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phase in which for some reason F&E is inappropriate

- 2) Contract refunded after major overrun (negative fee survey has been used in this case)

The suggestion to use a "real" target for cases where there is no opportunity for the contractor to perform corresponds

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to what is now done in some white contracts (eg. F&E R&D contract). The persons concerned are not too apparent or favoring one or another approach.

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