



AIR FORCE CONTRACTING
SAF / AQC

AIR FORCE GUIDE

AWARD TERM / INCENTIVE OPTIONS

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SUMMARY OF CHANGES

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Practical Ideas for Using Award Term Provisions

Purpose

This guide provides general guidance on ways to use Award Term provisions in Air Force contracts. The guide discusses the pitfalls and important rules to satisfy, at a minimum, for non-cost incentives. Additionally, the guide provides examples of ways to structure non-cost incentives. SAF/AQCP will post sample clauses and Award Term plan language under SAF/AQC's contracting toolkit, as they become available.

<http://www.safaq.hq.af.mil/contracting/toolkit>

This guide is not a tutorial on contract types. Descriptions of the various contract types are located in Part 16 of the Federal Acquisition Regulation (FAR). Moreover, this guide does not address formatting and administrative issues related to writing an Award Term Plan. Existing command level guides already provide formatting and administrative guidance (e.g., AFMC's Award Fee & Award Term Guide).

Background

What are the advantages of Long-Term Contracts?

Companies are motivated to secure long-term contracts. Benefits of long-term contracts include:

- Increased operational efficiency;
- Increased contractor investment; and
- Reduced acquisition transaction costs

Increased operation efficiency relates to a contractor's enhanced long-term business relationship with their customers. These long-term business relationships facilitate contractors: a) investment in performance enhancing technologies; b) steps to attract and retain the best workers; and c) desire to stay abreast of the latest developments in their fields. Finally, companies incur lower acquisition transaction costs associated with the extended time between competitions.¹

Establishing long-term business relationships with superior contractors is usually in the best interest of the Air Force. Because of the above advantages, companies are more likely to offer their best prices, terms and conditions, and products. However, establishing long-term contracts with less than superior contractors may result in our war-fighting customer being dissatisfied with the acquisition process as a whole and possibly jeopardize our warfighting mission. Maintaining the highest levels of performance on long-term contracts requires contract incentives that motivate the contractor. The challenge is to structure contract incentives that meet the objectives of sustained performance over the entire life of the contract.

What are the advantages of non-cost incentives?

Aside from the fact that non-cost incentives do not require additional contract funding, non-cost incentives have two other key advantages. First, non-cost incentives recognize that non-monetary considerations also motivate contractors. Non-cost incentives reward contractors with the opportunity for increased future business. This opportunity: a) enhances the company's image and reputation; b) helps retain skilled personnel; and c) effects the maintenance of allocation base for fixed costs.²

Second, non-cost incentives include a disciplined process to determine if we want to continue a long-term business relationship with a contractor. Non-cost incentives provide an "off-ramp" or "irrevocable re-competition point" based on the contractor's performance against established criteria. Fee based incentives are inherently short-term and have no contractual mechanism to address long-term performance.

Fee based incentives are effective for the period of performance for which they apply. The result is a series of short-term fee decisions on a long-term contract. In this environment, a contractor may consciously choose to temporarily perform at less than an optimum level to better support more profitable or important customers. This "short term" decision by the contractor only affects the contractor's fee for that period and has no direct impact on future business under the existing long-term contract. The contractor may choose to improve performance in the next award fee period or continue to under-perform depending on the needs of the company.

Doesn't the Government's existing unilateral rights under options or orders issued under an IDIQ provide the same advantages?

Neither options nor orders under Indefinite Delivery/Indefinite Quantity (IDIQ) contracts include a disciplined process to determine if we want to continue a long-term business relationship with a contractor. Under the FAR, options and ordering provisions allow contract extensions to occur. FAR Subpart 17.207, Exercise of Options, does not require the Contracting Officer (CO) to address current performance. Moreover, a CO is not going to bypass exercising an option just because the contractor is an average (satisfactory) performer. As a practical matter, CO's are going to exercise options if the conditions of FAR 17.2 are satisfied.

Similarly, issuance of task or delivery orders does not depend on the contractor's current performance. For other than a requirements contract, the CO could decide not to issue an order against a competitively awarded Indefinite Delivery (ID) contract. However, the time and resources required to establish a long-term competitively awarded contract are significant. One of the benefits of ID contracts and contracts with options is they reduce the administrative time it takes to place in-scope future requirements on contract. This makes the original time investment worthwhile. The time and resources required to re-compete a contract often places an unreasonable manpower burden on the requiring activity. As such, barring truly substandard performance, the contracting activity will usually continue to place orders and exercise options through the end of the ordering period or optional periods.

Award Term is a tool to enhance our ability to establish long-term business relationships that promote sustained superior performance. Ideally, award term incentives eliminate periodic drops in the contractor's performance (sine wave performance). The ability to control price(s) is essential when considering the use of award term incentives. Additionally, AT incentives are most effective when used in competitive environments.

What is Award Term?

Definitions of Award Term have been provided in both the AFMC Award Fee & Award Term Guide (Dated: Nov 2000) as well as the National Contract Management Association (NCMA) *Contract Management* magazine (Feb 01, pp. 44-45). Provided below are excerpts from these publications:

AFMC Award Fee & Award Term Guide

*"Award term can be best described as a derivative of award fee. The difference is that the contractor **earns** additional periods of performance instead of award fee. The process for rewarding the contractor with the additional contract term is identical to award fee."*

NCMA's Contract Management Magazine

*"It is modeled after the award fee incentive described in FAR 16.405-2, but instead of rewarding a contractor for excellent performance with additional fee, it rewards the contractor by extending the contract without competition." The article goes on to say "A true award-term incentive rewards the contractor with **legal entitlement** to a contract extension, not an additional option...if the contractor's performance meets the award-term criteria stipulated in the contract, and if any stipulated conditions such as continuing need and availability of funds are met, then*

*the government **must** either extend the contract or terminate it for convenience or default.”*

Both definitions share a common understanding that the contractor **earns** something of value and has a **legal entitlement** to receive it. Because only a warranted contracting officer can legally bind the Government, the contractor’s legal entitlement arises only upon some overt contract action by the contracting officer, such as exercise of an option memorializing the award of an Award Term. The decision of the Term Determining Official (TDO) serves to notify the contractor of the Government’s intent to make the award, but the TDO’s decision does not create an enforceable entitlement.

Because of statutory and regulatory issues, SAF/AQC issued contract policy memo 02-C-01 dated 6 Mar 02 placing restrictions on the use of Award Term. These restrictions reduced the types of acquisitions that can implement award term incentives. Concurrent with the publication of this guide, new policy will remove the restrictions identified in policy memo 02-C-01.

Award Term and Incentive Options are examples of non-cost incentives. Non-cost incentives share common statutory and regulatory hurdles. A summary of the statutory and regulatory hurdles associated with non-cost incentives follow the examples provided below.

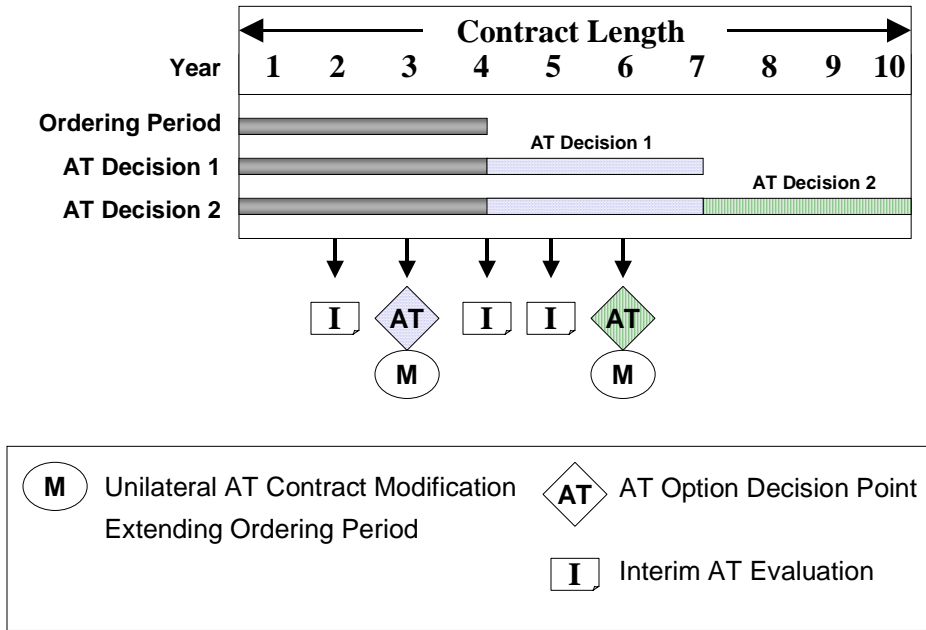
Discussion:

1. Example Approaches

The following examples are just that, examples. We encourage you and/or your team to develop your own approach, tailored to your acquisition. There is no one right way to write an Award Term contract. Using non-cost incentives does not preclude acquisitions from combining award terms with other incentives, such as an award fee. Issues regarding contract length, duration of base period, number of regular or incentive options, number of interim and award term evaluations will vary based on the needs of your acquisition. Tailor each variable to meet the needs of your acquisition to include establishing achievable performance criteria. Additionally, always schedule the award term decision(s) “acquisition” lead-time away to ensure time permits to complete a new acquisition (if needed).

Example 1 (Indefinite Delivery / Indefinite Quantity (IDIQ))

FIGURE 1



The example provided above is for a non-service IDIQ contract, with a contract length (effective period) of ten years. The ordering period is set for only four, not ten, years. The contractor may “earn” an extension to the ordering period by meeting the criteria of the AT plan.

In this example, the FDO makes two award term decisions, one decision at the three-year point and the other after six years. If the contractor is successful, the Contracting Officer will issue a contract modification extending the ordering period. If unsuccessful, the Contracting Officer will not issue the modification and is unable to issue orders after the four-year or seven-year point. This “irrevocable re-competition point” is a key concept to consider when structuring non-cost incentives. When triggered, the requiring activity needs to initiate actions to put a new contract in place. Again, plan the award term decision(s) well in advance of the ordering period’s expiration to allow for re-acquisition.

You may also award a requirements or definite-quantity (DQ) contract with an award term incentive. Under requirement contracts, the Government shall order from the contractor all the supplies and services specified in the Schedule. The Schedule includes the effective period of the contract. Changing the ordering period, as in the example above, does not alter the effective period of the contract. Accordingly, contract language must be included to identify award term decisions as an ordering “limitation” pursuant to FAR 52.216-21 (b) and (c). Additional guidelines

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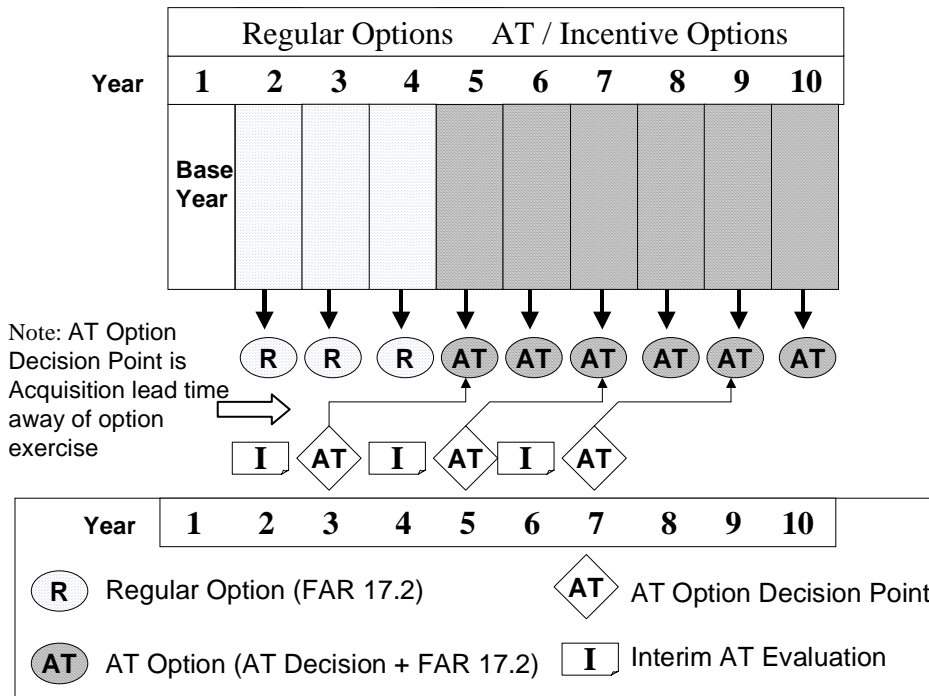
for using non-cost incentives on Indefinite Delivery contracts are provide under Section 5(b) of this guide.

A definite-quantity contract provides for delivery of a definite quantity of specific supplies or services for a fixed period, scheduling deliveries or performance at designated locations upon order. This type of contract structure limits the practical application of AT incentives. Regardless, there may situations where an AT incentive on a definite-quantity contract is appropriate.

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Example 2 (Fiscal Year Contract, AT Options or Incentive Options)

FIGURE 2



The example provided above is for a 1-year basic “C” contract with 9 annual options. In this example, the FDO makes three award term decisions. AT Decisions are made at the three, five, and seven-year points and each result in two one-year incentive options that are exercised separately IAW FAR 17.2. The AT plan shall include a description of the interim evaluations leading up to these decisions.

Under an Award Term Option (ATO) approach, the ATO is structured the same as a normal option with one exception. The Award Term decision serves as a precursor to exercising the Government’s unilateral rights IAW FAR 17.2. The contractor does not “earn” an award term option solely by meeting the criteria of the AT plan. A successful AT decision enables the evaluation of the award term option IAW FAR 17.2. Based on the terms and conditions of the contract, if the contractor fails to meet the criteria of the AT plan, the award term option is not available for the CO to evaluate (irrevocable re-competition point or off-ramp).

In other words, a successful Award Term Decision serves as a “bridge” to evaluate an award term option under FAR 17.2. If the award term option is not available to exercise, the requiring activity needs to initiate actions to put a new contract in place. Again, schedule award term decision(s) “acquisition” lead-time

away to ensure time permits to complete a new acquisition in the event the contractor fails to meet the criteria established in the AT plan.

2. Contract Length

While nobody sets out to write a contract in violation of law, non-cost incentives invoke many statutes and regulations, which create an environment where an unintended violation could occur. Listed below is a summary of the statutes and regulations that govern contract length. Your proposed approach (contract language, contract type & length) will determine which, if any, apply to your contract.

Table 1

Statute or Regulation	Applies to:	Contract Length Limitation
10 USC 2306b	Multiyear, Property	5 years, no options
10 USC 2306c	Multiyear, Services	8 years, 5 year basic, one three year option
10 USC 2304a	Task and delivery orders	None
10 USC 2304b	Orders (A&AS only)	5 years
Service Contract Act	Service Contracts	5 Years, each option constitutes new contract
FAR 17.204(e)	Options, Contracts (non-IT)	5 Years
AFFARS 5317.204	Options, Contracts (non-IT)	5 Years, identifies approving authority
Various fiscal statutes (e.g., bona fide needs, appropriations acts)	Depends on the statute and the type of appropriations	If O&M funds, period of performance cannot exceed 12 months. Other rules apply for other types of funds.

At a minimum, you should ask yourself the following questions when developing your approach: 1) does my approach buy more than one year's requirement (of a product or service) without having to exercise an option for each year (N/A for ID); and 2) does my approach establish a funded or unfunded contractor entitlement in a future year?

If yes to either of the above, expect your legal counsel to raise concerns over multiyear contracting. The type of document (agreement, indefinite delivery, or fiscal year contract) intended, affects the legal rights of the parties. Accordingly, you need to ensure that you have not unintentionally turned a unilateral right of the Government into a contractually binding entitlement for the contractor. If you have, you may have unintentionally structured an incentive that is in violation of statute and/or fiscal law.

3. Funding

Bona Fide Need: “Bona fide needs rule” limits use of an appropriation to satisfy only the needs of the year(s) for which that appropriation was made (31 USC §1502(a)). In order to avoid violation of this rule, a non-cost incentive, awarded on the basis of current year performance and performed and paid for in the future, is: 1) clearly divorced from any possibility that it is a “payment” for current year performance; and 2) not a future year’s contingent liability involving an obligation in advance of an appropriation.

This concept takes on significant meaning, especially when funding contracts that cross fiscal years. When this occurs, defining a contract as “severable” or “entire” (non-severable) influences the determination of which funds are proper. As you might gather, this aspect of appropriation law is complicated, and the best advice is to consult with your financial or legal experts.

4. Competition

The Competition in Contracting Act (CICA) (10 USC §2304) requires full and open competition unless one of the exceptions listed under FAR Part 6 apply. The same legal principle applies to incentive and AT options. Evaluate incentive based options, as with regular options, with the initial competition. Additionally, clearly state the specific future prices/price mechanisms in the solicitation and resultant contract.

If most offerors determine that market conditions are insufficiently stable to allow long term pricing then contract length should be a discussion item for early industry involvement. From a practical viewpoint, the ability to obtain proposals from a reasonable number of offerors is the good indication that meaningful competition for a long-term contract is possible.

5. Non-Cost Incentive Guidelines

Award Term and Incentive Options are non-cost incentives. Award Term incentives may or may not include options. Award Term Options differ from Incentive Options as follows:

- Complex Vs. Simple
 - Award Term is best suited when the incentive criteria are complex or management’s input is required.
 - Incentive Options are best suited when the incentive criteria is relatively straightforward.

- Term Determining Officer (TDO) Vs. PCO
 - The TDO determines if the contractor meets the requirements of the Award Term plan.

- The PCO determines if the contractor meets the incentive option provisions.
- Formal Plan Vs. No Formal Plan
 - Award Term provisions or options require an Award Term Plan. Additionally, the contract may include special clauses or tailored option/award fee clauses to establish the rights of the parties.
 - Incentive Options use contract language (Special Clause, Modify existing option or award fee clause) to establish the rights of the parties. No separate plan is prepared.

Changing FDO to PCO, “award term option” to “incentive option” and “award term plan” to “incentive option provision” converts Example 2 provided earlier to an incentive option.

To structure a non-cost incentive effectively, language in an Air Force contract must not create a contractual entitlement for the contractor in the advance of funds. Regardless of the type of non-cost incentive selected, the contract language must ensure that the “rights of the parties” are clear regarding entitlement.

a. Guidelines for Other Than ID Contracts

Other than indefinite-delivery (ID) type contracts may use non-cost incentives to add periods of performance provided:

(1) The award term takes effect only upon an overt contract action by the contracting officer, such as issuing a contract modification. The initial decision by the Award Term Determining Official, or other Government representative, constitutes only an advance notice of the Government’s intent to make the awarded term effective. Only the contracting officer can create a binding obligation on the Government;

(2) The contract stipulates all earned “periods of performance” are subject to availability of subsequent fiscal year funding and continuation of a valid contract requirement;

(3) The total of the basic and option periods may only exceed 5 years if an exemption from the contract length limitation of FAR 17.204(e) is granted in accordance with AFFARS 5317.204, unless otherwise approved in accordance with agency procedures; and

(4) If the contracting officer plans to award term extensions of more than one year of performance as a result of any single determination, the contracting

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officer must ensure specific statutory authority is granted for a multiyear contracts as provided for in 10 USC§2306b or 10 USC§2306c.

b. Guidelines for ID Contracts

Indefinite-delivery contracts (except for advisory and assistance services - see 10 USC §2304b(b)) may use non-cost incentives to add periods of performance provided:

(1) The PCO synthesizes the basic contract requirement and all potential award term periods. The SSET evaluates the proposed price or estimated cost for each potential award term before contract award except as justified and approved, as described in FAR 6.303, before awarding the additional ordering periods;

(2) The contract specifies the potential extension(s) of the initial/base ordering period;

(3) The contract specifies the maximum period the PCO may extend the contract, in months or years; and

(4) The contract provides for periodic evaluation of the contractor's performance against an award term plan. Periodic evaluation provides the basis for determination of extension or reduction of contract term. Periodic evaluation also communicates to the contractor the level of its performance and the areas in which improvement is expected.

c. Other considerations

Industry Partners/ Capital Investment Houses

Longer-term contracts may allow for contractor investment decisions beneficial to the government through reduced overall costs or increased performance. However, capital investment houses view contracts with a base year and single year options as a base year contract. Upon option exercise, the option period becomes the new base year. As a result, contractors may request contract language that establishes entitlement to address this problem. We encourage structuring non-cost incentives that maximize the benefits to all parties. However, be careful not to add "entitlement" based contract language.

Transition Period

Contracts that include "transition periods" need to address the impact the transition period has on the incentive criteria. The transition period may weigh

heavily on the AT decision or not at all. Regardless, the impact of the transition period should be clearly documented in the AT plan or contract language.

Discussions

Section M of the Request for Proposal (RFP) should address proposal evaluation impacts, if any, of the non-cost incentive. The RFP should indicate whether it is possible to receive positive evaluation consideration for exceeding the RFP's non-cost incentive criteria. Finally, the resultant contract should capture any proposed enhancements to the non-cost incentive criteria.

6. Summary

This guide does not limit the use of non-cost incentives to the specific examples provided. Individuals should use this information as a starting point in developing their tailored AT approach. Your major command may have additional guidance relating to content and format of your Award Term Plan.

Award Term is a tool to enhance our ability to establish long-term business relationships that promote sustained superior performance. Ideally, award term incentives eliminate periodic drops in the contractor's performance (sine wave performance). The ability to control price(s) is essential when considering the use of award term incentives. Additionally, AT incentives are most effective when used in competitive environments.

To structure a non-cost incentive effectively, language in an Air Force contract must not create a contractual entitlement for the contractor in the advance of funds. Regardless of the type of non-cost incentive selected, the contract language must ensure that the "rights of the parties" are clear regarding entitlement.

This guide discussed the pitfalls and rules that apply to structuring non-cost incentives. We provided examples of possible contract structure and language to demonstrate how to develop incentives, while avoiding the statutory and regulatory pitfalls.