DISCUSSION PAPER

Contracting ‘Cost’ Models
& Performance Based Contracting Concepts

Overview

1. A key component of the Strategic Reform Program’s (SRP’s) Smart Sustainment initiative aimed at delivering $5.2 billion in savings over the next five years is the more widespread use of performance-based contracts (PBCs) to facilitate the more efficient, effective and safe delivery of Defence sustainment outcomes.

2. Under a properly structured PBC, Defence should achieve better value for money when maintaining and enhancing its military equipment – including through lower prices – while successful suppliers can benefit through more reliable profits and greater continuity of work as a result of a series of rolling contract extensions (or ‘award terms’) if PBC proves effective.

3. As flagged in the earlier released discussion paper: Next Generation Performance-Based Support Contracts – Achieving the Outcomes that Defence Requires (Dec 2009), DMO is embarking on a staged development and implementation of what have been termed “new generation” PBCs, commencing with the anticipated December 2010 release of ASDEFCON (Support) v3.0.

4. Following the release of this template - which is designed primarily to achieve capability rather than total cost of ownership outcomes - the next phase of work will involve consideration and development of a range of PBC models with a view to accommodating the three main types of contracts generally used by DMO to deliver Defence sustainment outcomes – i.e. fixed price contracts and, less frequently, cost reimbursement and target cost incentive contracts.

5. This paper argues that the selection of an appropriate contracting model is a necessary, but not sufficient, condition for optimising sustainment outcomes, and that these outcomes can be further enhanced by structuring the contract (irrespective of its underlying cost model) as a PBC.

6. In this context, DMO defines a ‘PBC’ as a contract that:
   • has clearly defined and measureable outcomes directly traceable to users’ needs and aligned with Defence’s broader strategic objectives;

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1 The reference to ‘new generation’ PBCs recognises that while PBCs have been used in DMO for a number of years (particularly within the aerospace domain), the focus / design of these PBCs will likely be different to those implemented under this current important initiative. To date, PBCs have primarily (and often exclusively) focused on achieving capability-related (or operational) outcomes, whereas DMO’s ‘new generation’ PBCs will have the dual strategic focus of (i) enhancing Defence’s preparedness requirements; and (ii) reducing the total cost of ownership of the relevant material system (refer further Discussion Paper (Dec 09), sections 2 & 4).

2 A draft discussion version of ASDEFCON (Support) (v3.0) was released to industry for review / comment on 10 May 2010.
• focuses on the achievement of outcomes, rather than performance of individual activities – ie “what” must be delivered, rather than “how” it is delivered;
• incentivises contractor achievement of outcomes through an integrated and aligned package of rewards / remedies (which may be financial or non-financial);
• specifies performance standards for measuring and assessing the contractor’s performance of outcomes;
• contains clear lines of responsibility / accountability for the delivery of outcomes.

7. This paper demonstrates that the adoption of ‘PBC’ concepts is not limited to any specific contracting model. As shown in Attachment B, all contract types – whether a fixed price, cost reimbursement or an incentive contract – can effectively be structured as a PBC in the above described sense. Although PBC has recently been considered mainly in the context of sustainment contracts, it also has relevance to the acquisition area. Attachment B to this Paper outlines Defence’s early thinking on a possible PBC model for each type of contract.

8. DMO invites your written views on the models described in this Attachment. You are also invited to provide suggestions for suitable alternative models and make comment on any related matter that you think may assist DMO in further developing its thinking in this critical area.

9. An email response by end September 2010 would be appreciated. All comments received from industry will be treated as commercial in confidence.

10. Your response and any queries should be directed to liesl.omeara@defence.gov.au and thea.huber@defence.gov.au.

8 September 2010
Basic Contracting Models

11. At its simplest, Defence procurement teams acquiring sustainment products or services select from one of three basic contracting models, namely:\footnote{3}{Defence sometimes uses “hybrid” contracts that mix and match different contract types into a single contractual instrument. For example, under a hybrid contract, certain line items or services may be priced on a fixed price basis, while other higher risk line items or services may operate on a cost reimbursement basis. Combining these different contract types into a single instrument can avoid unnecessary delays and costs associated with separate contracts, while catering for varying degrees of risk and incentives for different phases of a contract or program.}
   • fixed price contracts;
   • cost reimbursement contracts; and
   • target cost incentive contracts.

12. Attachment A to this Paper sets out, in matrix format, the characteristics, benefits and limitations of each of these models.

Fixed priced contract

13. The contracting model most commonly used by Defence in the sustainment context is the fixed-price contract - and this is not expected to change with the more widespread use PBCs\footnote{4}{This preference for fixed price contracting reflects the nature and risk profile of most Defence procurements.}.

14. Under a fixed price contract, Defence pays a total price for an agreed scope of work. This price consists of a specified amount that covers the contractor’s costs of performing the work (including overheads), a contingency amount to cover the contractor’s risks and the contractor’s margin.

15. Under fixed price contracts, and particularly where the contract price is unalterable (ie a fixed and firm price contracts)\footnote{5}{It is common to provide for variation of the contract price in limited circumstances to address certain “uncontrollable risks” where it is inefficient for the contractor to bear such risks. For example, a fixed price Defence contract based on the ASD/DFCON Strategic or Complex contracting templates provide for variation to contract price to reflect movements in the cost of labour and materials measure by reference to agreed indices.}, the contractor carries (most of) the cost risk associated with performance of the contract. A fixed price contract therefore provides a powerful incentive for the contractor to maximise efficiency and minimise costs in performance of the contract, provided prices are set at reasonable levels. In this way, fixed price contracts (when coupled with competitive tender processes) can, and have, delivered significant benefits to Defence in terms of facilitating value for money procurement outcomes.

16. However, experience shows that fixed price contracts are not always appropriate or possible, and that cost reimbursement and target cost incentive contracts also have a place in Defence contracting, provided they are used appropriately.

17. As the McIntosh-Prescott report on the fixed price Collins Class Submarine Build Contract concluded:\footnote{6}{Report to the Minister for Defence on the Collins Class Submarine and related matters (1999).}:

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For a relatively routine product or one where the specifications are clear and unambiguous and where payment is made mostly on delivery, [a fixed price contract]...can work well.

However, for a large, complex and new project, for which a design does not exist in detail and for which generous up-front payments are made, its effect can be deleterious. Particularly in the later stages, it can encourage the supplier to contest the specifications, and their interpretation, and to avoid responsibility wherever possible to protect profit...

Fixed price contracts also tend to put substantial financial, and therefore technical, barriers between customers and sub-contractors.

Selecting the appropriate contracting model

18. Selecting the appropriate contracting model for a procurement involves careful consideration, and weighing in the balance, of the circumstances and objectives specific to the procurement, including the following matters:
   - the type and complexity of Defence’s requirement;
   - the urgency of Defence’s requirement;
   - the history / experience of the product being supported, including the maturity of the material and/or support systems;
   - the reliability of cost estimates and the degree to which price analysis can be used to provide realistic and accurate pricing;
   - the characteristics of the industry sector expected to supply the equipment or services, including potential suppliers’ technical/financial capabilities; and
   - the existence and degree of competition.

19. No single factor is determinative, although a significant factor in all cases is the overall risk associated with the procurement. The objective is to select the contract type that best accommodates the full range of risks associated with the procurement and facilitates the most appropriate risk sharing between the contractor and Defence.

20. The risk allocation of a fixed price contract is generally considered appropriate in the following situations:
   - where the relevant technology is mature or proven (e.g., ‘commercial-off-the-shelf’ or ‘military-off-the-shelf’ procurements);
   - where the scope of work or specifications and outputs required by Defence can be clearly defined and agreed upfront; and
   - where the schedule is relatively certain and considered achievable;
   - where there exists sufficient competition in the market.

21. Conversely, the risk allocation of a fixed price model is not appropriate – often proving to be unsustainable or illusory - for high risk procurements involving

\[\text{Note: over the course of a program involving a series of contracts, or a single long term contract, changing circumstances may make a different contract type appropriate in later periods than that which was used at the outset. For example, the initial stage or period of a contract could operate under a cost reimbursement or target cost incentive arrangement. However, with time and experience, resulting in greater certainty and less risk, it may be appropriate to transition to a fixed price arrangement.}\]
cutting edge, untested or developmental technology or which have highly uncertain or variable scope for other reasons. Experience has shown that using a fixed price contract in these circumstances may result in:

- the contractor building a significant contingency (risk premium) into its contract price, ultimately resulting in a higher overall price that no longer provides Defence with value for money; or
- as the contractor struggles to perform the agreed work (for the fixed price):
  - placing at risk delivery of contracted outcomes as the contractor attempts to renegotiate price, scope and/or schedule requirements; and
  - compromising capability (including safety and quality) as the contractor may look to ‘cut corners’ in an attempt to minimise costs and preserve profits.

22. For any procurement with significant cost, schedule or technical uncertainty (and hence risk), a cost-reimbursement or target cost incentive contract may offer a preferable cost-risk sharing arrangement more conducive to achieving value for money outcomes for Defence.

Cost reimbursement contracts

23. Under a ‘standard’ cost reimbursement contract, Defence agrees to reimburse the contractor for actual costs properly incurred in performing the contract, together with an agreed fee. The contractor’s fee may be a pre-agreed amount or determined as a percentage of actual costs. However, the later formulation is generally avoided, as there is no incentive for the contractor to minimise costs.

24. Under this contracting model, Defence bears all the cost risk and there are minimal (if any) incentives for the contractor to control costs. Hence, these types of contracts are infrequently used and, when they are, Defence generally looks to include some forms of cost control (albeit limited) through mechanisms such as the following:

- reimbursing only defined categories of ‘allowable’ costs (and excluding certain costs);
- imposing limits on the recoverability of certain cost categories;
- specifying unit pricing for certain inputs (e.g., fixed hourly rates for labour);
- controlling the scope of work through specific tasking arrangements.

Target cost incentive model (TCIM)

25. The TCIM is a variant of the ‘traditional’ cost reimbursement contract but with further explicit cost controls and incentives designed to provide Defence with

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8. As contractual risk is shifted to the contractor, the contractor is motivated to increase the price of the contract to limit or mitigate its financial exposure. That is, a contractor will often increase its profit margin (or cost base through inclusion of contingency / management reserve) in order to mitigate the increased risk of financial loss. As a result, Defence can actually pay a higher overall price under a fixed price contract than under an alternative, ostensibly riskier contract model (e.g., cost-reimbursement contract or TCIM).

greater cost control and cost certainty. The primary incentive component of the TCIM involves the painshare:gainshare mechanism that operates to adjust the contractor’s fee according to its performance against an agreed target cost.

26. Whilst there are many variants of the TCIM, all models include the following key elements:

- a target cost – which should be the parties’ best estimate of the total costs of performing the required scope of work;
- a target fee\(^{10}\) - which is the amount of fee payable without adjustment if actual costs ultimately equal the target cost;
- a painshare:gainshare formula - which determines and apportions between Defence and the contractor any excess of costs (overruns) or cost savings (underruns) in relation to the target cost.

27. If actual costs exceed the target cost, the contractor receives its actual costs, plus target fee, less its proportion of the overrun (determined in accordance with the share formula). If actual costs are less than the target, the contractor is paid its costs, plus target fee, plus a proportion of the under-run. For example, a 50/50 cost-sharing ratio means that Defence will pay 50% and the contractor 50% of costs in excess of the target cost. Conversely, if costs turn out less than target cost, Defence and the contractor share the savings in the same ratio.

28. There is ample scope for variation in the ‘basic’ TCIM consistent with the circumstances and objectives of a specific procurement. For example,

- different share ratios may apply\(^{11}\):
  - depending on the extent of the cost overrun or underrun; or
  - according to whether a cost overrun or underrun and/or the type of costs - ie whether fixed or variable costs.
- there may be a ‘buffer’ above and below the target cost before the pain:gainshare mechanism applies;
- a price ceiling may be specified, above which one party (generally the contractor) bears 100% of the cost risk; and/or
- a price floor may be specified, below which one party (generally Defence) retains 100% of cost savings.

Designing all contracts as a PBC

29. Selection of the ‘right’ contracting model is undoubtedly fundamental to achieving efficient procurement outcomes and a major contributor to the overall success of the contract.

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\(^{10}\) Target fee will generally represent the contractor’s profit margin plus an agreed amount on account of corporate overhead (ie overhead expenses not directly attributable to the contract). However, for some procurements, it may be appropriate for target fee to equal (only) profit.

\(^{11}\) In all cases, the sharing of cost risk through the pain:gainshare mechanism should reflect the relative risk levels of the parties, the incentives that Defence considers should be provided to the contractor in the context of the project’s goals and the extent to which the contractor may be entitled to relief from contract requirements (eg ‘postponement’ or ‘excusable delay’ mechanism).
30. However, Defence considers that selection of the ‘right’ contracting model is only the first step for optimising procurement outcomes, and that outcomes can be further enhanced by structuring the contract (irrespective of its underlying cost model) as a PBC.

31. Attachment B to this paper shows DMO’s early thinking on how each contract type can be developed as a PBC – comprising a mix of both financial and non-financial performance drivers aimed at motivating contractor performance of Defence’s key contract outcomes.

32. In addition, all PBC models outlined in Attachment B have been designed (and will be further developed) in accordance with Defence’s minimum requirements and objectives for its ‘new generation’ PBCs, namely:

- all contract outcomes must be traceable to users’ needs and aligned with Defence’s strategic objectives of (i) enhancing preparedness and (ii) reducing the total cost of ownership (for further information refer Next Generation Performance-Based Support Contracts – Achieving the Outcomes that Defence Requires (Dec 09), sections 1, 5 & 7);
- all components of the model (ie performance incentives / disincentives) must be fully integrated and aligned to motivate contractor performance of all contract outcomes – ie not provide opportunities for the contractor to ‘game the system’ by focusing on select KPIs at the expense of others;
- safety remains paramount. The PBC framework must not operate to compromise safety or undermine critical safety processes;
- the model should be as simple and straightforward as the circumstances allow. Simplicity (and useability) are recognised as key factors of success;
- the model should encourage innovation in service delivery and promote a culture of continuous improvement;
- wherever possible, performance measures (KPIs) used to measure and assess contractor performance should be specific, measureable, aligned, attainable, relevant and timely;
- the total number of capability-related (operational) KPIs should fall somewhere in the 3 – 5 range;
- cost visibility / transparency and open book accounting are essential for successful implementation and operation of the model;
- the model should be subject to regular review and adjustment (as necessary) to ensure it remains effective and appropriate for meeting Defence’s requirements;
- support contracting strategies should continue to promote competitive tension to the maximum practicable extent, commensurate with value for money and Defence’s broader strategic imperatives in relation to the security of supply and diversity of supply.

33. Importantly, all proposed PBC models will necessarily operate within a broader contractual framework. This broader framework will almost certainly contain a
range of other contractual mechanisms also aimed at managing and incentivising contractor performance. These ‘other’ mechanisms may include:

- liquidated damages for extended delays or performance shortfalls;
- warranty obligations for defective supplies;
- indemnities for loss caused by contractor default; and/or
- stop payment rights, step in rights and termination rights.

34. Noting this broader context, the challenge that DMO faces is to develop an overall consistent and coherent performance management framework that efficiently and effectively drives contractor behaviour towards achievement of all required outcomes, consistent with the requirements and objectives set out in paragraph 32, and without exposing the contractor to ‘double jeopardy’ with respect to any single performance failing.

35. DMO does not underestimate the challenges and complexities that are involved in further developing and implementing its desired ‘next generation’ PBCs. Many of these challenges (and associated issues) were extensively discussed in Defence’s earlier released discussion papers\(^\text{13}\). While a discussion of these issues is not repeated in this paper, they remain very much live and under careful consideration as part of this next phase of work.

36. Notwithstanding these challenges, DMO remains fully committed to this important initiative and continues to seek industry’s ongoing support and assistance in meeting these challenges. This is both essential and desirable, noting the imperatives of the SRP and the potential significant benefits that are on offer to both Defence and industry via the move to ‘new generation’ PBCs.

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\(^{13}\) Refer “Incentive Contracting in Defence Procurement: An Updated Approach Incorporating Performance-Based Measures (Oct 09)” and “Next Generation Performance-Based Support Contracts – Achieving the Outcomes that Defence Requires (Dec 09), especially, section 6.
## ATTACHMENT A

### Comparison of Contract Types

<table>
<thead>
<tr>
<th>Description</th>
<th>FIXED PRICE</th>
<th>COST REIMBURSEMENT</th>
<th>TARGET COST INCENTIVE</th>
</tr>
</thead>
</table>
| **Description** | Contractor is paid a definite sum of money for carrying out the work regardless of the costs the contractor actually incurs. | Contractor is paid:  
- an amount reflecting ‘allowable’ costs incurred in carrying out the work;  
- an agreed fixed fee or (less commonly) percentage representing the contractor’s profit and overhead. | Contractor is paid:  
- actual ‘allowable’ costs incurred in carrying out work;  
- an agreed fee (or percentage representing the contractor’s costs), but adjusted according to the pain:gainshare mechanism (reflecting cost overruns / underruns). |

| Benefits for Defence | • Certainty  
• Contractor bears risk of cost overruns or changes in prices of inputs  
• Simple pricing structure  
• Allows comparison in competitive market testing;  
• Lowest administration costs | • Avoids paying contingency for cost risk - only pay for actual costs incurred  
• Provides control over the amount of profit (contractor does not receive a windfall gain as may be the case for a fixed price contract)  
• Visibility of costs  
• Flexible – easy to adjust the scope or make variations without significant problems. | • As for cost reimbursement, but also provides incentive to minimise costs.  
• Aligns interests of contractor and Defence  
• Suitable for repetitive contracts such as sustainment contracts where the contractor should be able to absorb more cost risk (as the contractor has good knowledge of the work and its cost).  
• Risk allocation can be adjusted over time through the sharing ratio (ie sharing of pain / gain between the contractor and Defence). |

| Issues | • Contractor may price too much "contingency" into fixed price to cover financial risk exposure, if the parameters of a project are difficult to specify before a contract is signed and work on a project commences  
• Fixed price may be deliberately underpriced – contractor may | • No incentive to control costs – in fact may incentivise contractor to maximise costs;  
• Defence budget uncertainty;  
• Difficult to evaluate tenderers in market testing  
• Increased contract administration burden to verify (and monitor) costs | • Success of TCIM depends on negotiation of reasonable cost & fee targets. TCIM should ideally be accompanied by competition. Market rivalry performs important role of establishing a robust target cost & target fee.  
• However, need to be wary of how industry approaches TCIM in a competitive market. For a contractor in survival model or attempting to gain foothold in new program area, competition could generate unrealistic or overly ambitious cost target. This would result in an |


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<tr>
<th><strong>FIXED PRICE</strong></th>
<th><strong>COST REIMBURSEMENT</strong></th>
<th><strong>TARGET COST INCENTIVE</strong></th>
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</table>
| look for ways to renegotiate price or avoid work (that is, on the basis it is not within scope)  
• Variations to contract or scope – may lose benefit of fixed pricing.  
• Inappropriate in long term / developmental contracts where there is significant "project risk" because this will translate into cost and/or schedule risk. | May be difficult for contractors to accept "open-book" accounting | approved contract with overstated requirements and understated costs.  
• May be difficult to get contractor to absorb cost risk in the absence of competition (eg in a sustainment contract where there is limited options) or in highly risky contracts. Alternatively, this may affect degree of cost sharing.  
• Difficult to develop target cost (& hold the contractor to it) where scope is ill-defined.  
• If scope changes, target costs will need to be renegotiated, which may undermine original incentive.  
• As the contractor is taking on some cost risk (albeit shared), contractor may:  
  o include contingency in management reserve;  
  o hide contingency in target cost;  
  o look for ways to renegotiate target cost / target fee or avoid work.  
• Increased contract administration costs |

**Comments**  
Fixed price may be effective if:  
• work scope clearly defined; &  
• it is efficient for the contractor to bear the cost risks.  
Forcing contractor to accept fixed price where scope is ill-defined or significant uncontrollable risk exists means:  
• a significant contingency in fixed price; or  
• risks to the performance of the contract  
Cost reimbursement model may be effective if:  
• there is no effective competition to enable a fixed price to be developed;  
• scope of work is not clear or cannot be predicted but work can be controlled through tasking (so as to enable Defence to manage cost risk).  
May be effective when combined with other cost controls.  
As with fixed price model, the effectiveness of this model may depend on how risk-averse contractors are. If contractors simply do not want to bear cost risk, then may result in more overall cost then would be the case under a tightly managed cost-plus model.  
Not efficient for low-value, low risk procurements.
## ATTACHMENT B

### A PBC Model for each Contract Type

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Bid process</th>
<th>Duration</th>
<th>Components of PBC Model&lt;sup&gt;14&lt;/sup&gt;</th>
<th>Performance KPIs</th>
<th>Best fit</th>
</tr>
</thead>
</table>
| Fixed Price      | Generally competitive Tender | 3-5 yr initial term with multiple award terms | Non-financial:  
  - Award terms – contract extension dependent on contractor’s ‘overall’ performance.  
  - Efficiency Implementation Program – encourages contractor to identify efficiency savings / productivity improvements.  
  - Repatriation of services / scope adjustment – removal of poor performing service lines from work scope for any award term.  
  
Financial:  
  - Performance payment – portion of fixed fee (profit+) ‘at risk’ dependent on performance against Operational KPIs.  
  - Periodic Cost Review – end of period cost review used to re-baseline costs and adjust margin for next period. That is, contractor’s profit is increased / decreased based on movement in the cost base over the previous term.  

(Refer further Annex (i) of Attachment B) | Operational KPIs<sup>15</sup> - moderate a portion of fixed fee (‘at risk component’) payable within the term.  
  - Cost/Capability/Relationship KPIs – determine contractor entitlement to award term. | • Mature industry / platform / service  
  • Adequate competition  
  • Mature product & well articulated support concept - good understanding of requirements  
  • Open book essential |

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<sup>14</sup> It is not essential that all components of each model are included within a single contract. The various individual components may be mixed and matched (and adapted) to suit the specific requirements of the individual contracts.

<sup>15</sup> Operational KPIs may include system readiness (availability), mission success (reliability), and assurance of supply (supportability). Generally, Operational KPIs will be weighted to reflect their relative importance in terms of meeting Defence’s capability requirements.
<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Bid process</th>
<th>Duration</th>
<th>Components of PBC Model(^{14})</th>
<th>Performance KPIs</th>
<th>Best fit</th>
</tr>
</thead>
</table>
| Cost reimbursement | Generally sole source | 3-5 yr initial term with multiple award terms. | **Non-financial:**  
  - *Award terms* – contract extension dependent on contractor’s overall performance.  
  - *Efficiency Implementation Program* – encourages contractor to identify efficiency savings / productivity improvements.  
  - *Repatriation of services / scope adjustment* – removal of poor performing service lines from work scope for any next term.  
  **Financial:**  
  - ‘Standard’ cost reimbursement arrangements, with fixed fee (profit+);  
  - *Performance payment* – portion of fixed fee ‘at risk’ dependent on performance against Operational KPIs.  
  *(Refer further Annex (ii) of Attachment B)* | *Operational KPIs* - moderate a portion of fixed fee (at risk component) payable within a term.  
*Cost/ Capability/ Relationship KPIs* – determine contractor entitlement to award term. | - Immature industry, platform, service.  
- Minimal competition.  
- Immature product / poorly defined support concept / understanding of requirements. |
| TCIM | Generally competitive tender or, in some circumstances, sole source | 3-5 yr initial term with multiple award terms;  
  or  
  longer term contract with multiple performance periods. | **Non-financial:**  
  - *Award terms* – contract term extension dependent on contractor’s ‘overall’ performance.  
  - *Efficiency Implementation Program* – encourages contractor to identify efficiency savings / productivity improvements.  
  - *Repatriation of services / scope adjustment* – removal of poor performing service lines from work scope for any next term / period.  
  **Financial:**  
  - *Operational KPIs* - moderate progressive payments on account of fee; may also reduce target fee and adjust contractor’s share of any cost variance between actual costs and target costs.  
  *Cost/ Capability/ Relationship KPIs* – determine contractor’s | *Operational KPIs* - moderate progressive payments on account of fee; may also reduce target fee and adjust contractor’s share of any cost variance between actual costs and target costs.  
*Cost/ Capability/ Relationship KPIs* – determine contractor’s | - Immature industry.  
- Immature platform/service.  
- Minimal competition.  
- newly developed product, with reasonably articulated support concept, although immature understanding of the |
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<th>Type of contract</th>
<th>Bid process</th>
<th>Duration</th>
<th>Components of PBC Model[^14]</th>
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<th>Best fit</th>
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<td></td>
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<td>• target cost estimate, target fee, share ratios, cost ceiling (cap) and floor agreed at start of period;</td>
<td>entitlement to award term / further period.</td>
<td>supply requirements.</td>
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<td>• during period:</td>
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<td>• Poor understanding of requirements.</td>
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<td>o <em>cost reimbursement</em> - contractor reimbursed actual ‘allowable’ costs monthly in arrears;</td>
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<td>o <em>performance pay</em> - amounts on account of fee paid monthly (or quarterly), adjusted for performance against Operational KPIs</td>
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<td>o <em>cost reconciliation</em> (actual costs v TCE) to determine contractor’s entitlement to fee and any pain:gainshare amount.</td>
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<td>(Note: share ratios and target fee may be subject to adjustment based on contractor’s overall performance against Operational KPIs)</td>
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<td>o 100% of costs above target cost (generally) at contractor’s risk.</td>
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<td>o Contractor’s share of savings capped by floor.</td>
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<td><em>(Refer further Annex (iii) of Attachment B)</em></td>
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Non-financial components:

Award Term

- Initial contract term of between 3 – 5 years\(^{16}\).
- Rolling contract extensions (award terms) of additional [12] months, dependent on contractor’s performance during relevant review period.
- KPIs for ‘award term’ decision cover cost, relationship and operational dimensions of contractor’s performance.
- Any Defence decision not to grant a contract extension will necessarily be followed by approx 2 year ‘off ramp’ period allowing time to select and transition-in new provider.

Efficiency Implementation Program

- Program requiring contractor to monitor and report on potential efficiency initiatives (productivity improvements) arising from adjustment to extant work practices / processes / procedures.
- These initiatives may involve changes to SPO, contractor and / or third party arrangements – and may be funded by Defence (wholly or part).
- Contractor’s performance against this program will factor into Defence’s decision to grant (or not grant) an award term.

Repatriation of Services / Scope adjustment

- Work scope for any future term (or performance period) may be adjusted by removing poor performing (or non-competitive) service lines.

Financial Components:

Payments

- Contractor receives progressive (monthly) payments of fixed price as per agreed payment schedule.

Performance payments

- A portion of each (monthly) payment is ‘at risk’ dependent on contractor’s performance.
- Operational KPIs operate to determine contractor’s entitlement to the ‘at risk’ amount, applying ‘weighted performance score’ (WPS).
- Actual payment adjustment may occur monthly, quarterly or at end of term.

Periodic cost review / cost re-baseline / margin adjustment

- End of term (independent) cost review to establish / verify movement in cost base over the term.
- For any next term, the contractor’s profit margin will increase or decrease based on the movement in the cost base during the current term.
- For example: if actual costs are less than contractor’s estimated ‘fixed’ costs for the term, the variance is treated as a windfall gain to the Contractor. However, the reduced cost base achieved during the term becomes the agreed ‘fixed’ cost base for the next term (ie Defence shares in any savings accrued over the term). In recognition of the reduced cost base, Defence increases the contractor’s profit margin (%) for the

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\(^{16}\) Work may be programmed / priced over shorter performance periods (ie contract term may comprise multiple performance periods). A ‘strategic’ (or VFM) review could occur at the end of each performance period, following which CoA makes decision on whether to grant an award term.
next term. The net result is that the overall contract price reduces whilst the profit margin increases.

- Similarly, Defence reduces the contractor’s margin for any next term as a result of any increase in cost base over the term – minimising overall impact on contract price.

Diagram: Integrated financial & operational performance model:
ATTACHMENT B – Annex (ii)
Cost Reimbursement PBC Model

Non-financial components:

Award Term
- Initial contract term of between 3 – 5 years.
- Rolling contract extensions (award terms) of additional [12] months, dependent on contractor performance.
- KPIs for award term cover cost, relationship & operational dimensions of contractor performance.
- Any decision not to grant a contract extension will necessarily be followed by approx 2 year ‘off ramp’ period allowing time to select and transition-in new provider.

Efficiency Implementation Program
- Contractor to monitor / report on potential efficiencies (productivity improvements) arising from adjustment to extant work practices / processes / procedures.
- These initiatives may involve changes to SPO, contractor and / or third party arrangements - and may be funded by Defence (wholly or part).
- Contractor’s performance against this program will factor into Defence’s decision to grant (or not grant) an award term.

Repatriation of Services / Scope adjustment
- Work scope for any next term adjusted by removing poor performing (or non-competitive) service lines.

Financial Components:

Payments
- Cost reimbursement arrangements – ‘allowable’ costs reimbursed monthly in arrears.

Performance payments
- Monthly (or quarterly) payments of fixed fee are ‘at risk’ dependent on contractor performance
- Operational KPIs operate to determine contractor’s entitlement to the ‘at risk’ amounts, applying ‘weighted performance score’ (WPS).
- Actual payment adjustment may occur monthly, quarterly or at end of period / term.

Financial and Operational KPI integration:

[Diagram showing the integration of profit, costs, weighted performance score, and KPIs with equations for profit moderation during each term]
Non-financial components:

Award Term
- Initial contract term of between 3 – 5 years\(^{17}\).
- Rolling contract extensions (award terms) of additional [12] months, dependent on contractor performance during relevant review period.
- KPIs for award term decision cover cost, relationship and operational dimensions of performance.
- Any Defence decision not to grant a contract extension will necessarily be followed by approx 2 year ‘off ramp’ period allowing Defence time to select and transition-in new provider.

Efficiency Implementation Program
- Program requiring contractor to monitor and report on potential efficiency initiatives (productivity improvements) arising from adjustment to extant work practices / processes / procedures.
- These initiatives may involve changes to SPO, contractor and / or third party arrangements - and may be funded by Defence (wholly or part).
- Contractor’s performance against this program will factor into Defence’s decision to grant (or not grant) an award term.

Repatriation of Services / scope adjustment
- Work scope for any future terms (or performance periods) may be adjusted by removing poor performing (or non-competitive) service lines.

Financial Component:

Start of period:
- Parties agree a target cost, target fee (ie profit +), share ratios (eg 50% (Defence) / 50% (contractor)); ceiling and floor at start of each period.

During the period:
- Cost reimbursement – contractor reimbursed actual ‘allowable’ costs monthly in arrears, up to agreed cap.
- Performance pay – amounts on account of fee are paid monthly (or quarterly), adjusted for performance against Operational KPIs – ie operational KPIs apply to moderate (reduce) scheduled payments applying ‘weighted performance score’.
- Adjustment of target fee – target fee is reduced by any forfeited amounts.

End of period:
- Cost reconciliation – contractor’s cost performance is assessed against target cost to determine contractor’s entitlement to target fee and any pain:gainshare amount.
- Pain:gainshare amount - any variance between target cost and actual costs (ie ‘pain’ or ‘gain’) is shared between Defence and the contractor based on agreed share ratios (eg 50 / 50).

\(^{17}\) Work may be programmed and priced over shorter performance periods.
• The initially agreed share ratios (e.g., 50/50) are subject to adjustment depending on contractor’s overall performance against Operational KPIs during the relevant period.
• For example, in the event of poor overall performance against Operational KPIs, the contractor’s proportional share of any cost savings (i.e., ‘gain’) may be reduced from, say, 50% to 40%.
• Final payment: if actual costs exceed target cost (overrun), the contractor is paid an amount equal to target fee less its (adjusted) proportional share of the cost overrun. If actual costs are less than target costs, the contractor is paid target fee plus its (adjusted) share of cost underrun (savings).

Diagram: Integrated financial & operational performance model