DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
(RESEARCH, DEVELOPMENT AND ACQUISITION)
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MEMORANDUM FOR DISTRIBUTION

SUBJECT: Department of the Navy Policy on Investment Incentives for Highly Capitalized Programs

To support shipbuilding investment and improved performance it was determined appropriate to issue guidance on contracting methods for providing incentives for capital expenditure and process improvement; to clarify the Department of the Navy's (DON) priorities and objectives and clearly communicate effective contract incentive clauses and structures; and establish standardized methods for business case analysis and other governing and costing mechanisms inherent in special incentive clauses. Additionally, it is important to identify the intended goals and objectives of investment incentives, criteria for using incentives, and methods for validating outcomes.

Accordingly, the attached guidance is provided to assist DON Program Managers, Contracting Officers and other acquisition personnel in working together to develop effective investment incentives.

While the guidance was written with a focus on shipbuilding, the principles can be applied to other highly capitalized programs.

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Facility Investment Incentives:

This general policy provides guidance to Navy Contracting Officers and Program Managers in developing and applying investment incentives.

Applicability:

It is the objective of the Department, through special contract incentives and maximum use of fixed price contracts to establish and foster a positive environment for corporate investment.

Incentives are used to encourage and motivate optimal contractor performance in areas deemed critical to an acquisition program's success, typically in performance, cost and schedule. There are several tools commonly used to incentivize contractors including contract type, incentive fee, profit policy and payment provisions. Incentives should reflect the risks and uncertainties involved in contract performance and the environment.

Contractors are expected to provide all necessary labor, capital equipment, facilities and working capital necessary to perform a contract. Under certain circumstances, a potential Contractor investment may greatly benefit the Government by an increase in capabilities and efficiencies, or to maintain the status quo in response to increasing Government requirements, but may not sufficiently reward the Contractor to make the investment. Under those conditions, Navy Contracting Officers should explore contract incentives as a means to ensure private contractors make facility investments.

The policy does not define a minimum desired level of cost reduction or return on investment due to the need for Program Managers and Contracting Officers to retain maximum flexibility in responding to unforeseeable types of investments that neither add capability nor efficiency but must be created in order to maintain the status quo or to respond to increasing or changing requirements (increase in hulls/ships per year or design features). However, where cost savings is the primary focus of the investment the Program Manager should ensure that the cost savings exceed the capital expenditure incentive provided.

The Contracting Officer should validate the stages of investment based milestones in buying/building the asset. Cost savings and efficiency outcome metrics should be obtained, when practicable, and validated for anticipated savings after the investment is complete. The policy

encourages the evaluation of the outcome using the agreed upon metrics before final payment of the incentive or to recoup incentive payments in the event cost savings/avoidance are not achieved.

Examples of program conditions that may benefit from a facility investment incentive are low rate production; sole source or limited source contractor; and no reasonable expectation of market growth. Contributing factors are economic periods experiencing low interest rates (Treasury Rate), substantial production capital investment, and high barriers to market entry.

Navy shipbuilding programs exhibit most (if not all) of these conditions. This policy is mainly intended to address facility improvement incentives in Navy shipbuilding contracts. However, other programs with the same conditions may adapt these practices when appropriate.

NOTE: Regardless of the program conditions, the Contracting Officer must still be careful to avoid affecting a contractor's normal (market driven) capital investment decision process.

Reasons for Incentives:

Typically, in a sole source/no growth environment, contractors have reduced ability to realize the long term benefits (revenue, cash flow or profit) of facility capital improvement when the facility capital cost of money does not appreciably increase the return on investment. Any investment in production improving facilities will result in capital expended by the shipbuilder (or parent firm) that may result in initial cost savings on existing contracts. The shipbuilder will share in a portion of those savings through cost incentive arrangements such as those found in firm fixed price, fixed price incentive fee or cost plus incentive fee contracts. However, it is the business practice for the Navy to negotiate follow-on contracts that recognize all savings resulting from past efficiencies, be it investments or other improvements. Essentially 100% of the investment savings is expected to be captured by the Navy on the current contract with little or no recurring cost benefit to the shipbuilder. Usually, the shipbuilder's evaluation period for investment decisions are as long as the period of performance of contracts in existence at the time of the investment as future contracts are not guaranteed. Therefore, a shipbuilder that cannot expect to gain market share outside of the Navy's business through further capital investment often has a disincentive to outlay capital for facility efficiencies.

As a result, the Navy Program Manager and Contracting Officer may consider creating facility investment incentives that either add facility capabilities or maintain current capabilities, provided that the investments will increase efficiencies for their program when the return on that investment alone is not sufficient for the shipbuilder. Investment decisions and resource allocations will be based on business cases that compare relative attractiveness of different projects. The challenge is to determine what contractor behavior one wants to motivate and then structure the proper incentive to effectively motivate that behavior.

Best Practices for Facilities Investments:

Examples of Practices used to create Facility Investment Incentives:

- **Accelerated Depreciation: Allowing the depreciation expense (and resulting shorter payback period) for a capital facility investment to offset revenues at an accelerated rate. Accelerated depreciation essentially increases the cash flow generated by an asset.**
    - Requires approval by the Cost Accounting Standards Board since it is a deviation from the Cost Accounting Standard at 48 CFR 9904.409 Depreciation of Tangible Capital Assets.
    - Allows a company to deduct a greater percentage of depreciation in the earlier years after purchase.
    - Depreciates a tangible capital asset in such a way that the amount of depreciation taken each year is higher during the earlier years of an asset's life.
    - Generally used when an asset is expected to be much more productive during its early years, so that depreciation expense will more accurately represent how much of an asset's usefulness is being used up each year.
    - Provides a way of deferring corporate income taxes by reducing taxable income in current years, in exchange for increased taxable income in future years.
    - Provides a valuable tax incentive that incentivizes businesses to purchase new assets.

- **Early Release of Progress Payment Retentions (Unusual Progress Payments): When progress payments are employed under fixed-price type contracts, the Government accumulates retentions that incentivize future contractor performance to completion of the effort. When in the best interest of the Government, unusual progress payments may be calculated to release a portion of those retentions (i.e., increase cash-flow to the contractor) in exchange for appropriate consideration. In exchange for facilities investment or any other appropriate consideration, the amount of retention release carries a time value of money to the contractor which can increase the resulting profitability of an existing contract without an increase in appropriated funding.**
    - Early release of retentions are unusual progress payments that require the approval by the Assistant Secretary of the Navy (Research, Development and Acquisition) DASN (A&P) in accordance with SECNAVINST 7810.12C dated 23 December 2005.

- The contracting office must demonstrate that sufficient retentions remain to protect the Government's interest.
- The time value of money associated with issuing Treasury securities (increased Government debt) required to fund the retention release should be considered as offsetting the value of the consideration (i.e., facility investment).

- **Special Capital Expenditure (Production Equipment Investment) Incentive: A capital investment incentive takes into account evidence of the contractor's investment(s) in industrial plant and production facilities that will result in current and future production efficiencies and resulting savings to the Government. Special incentives require a portion of the program's appropriated funding to be set aside for such purpose. Depreciation of the improved facility would be measured, assigned and allocated in accordance with the applicable Cost Accounting Standard(s). The incentive process requires three basic phases:**

  - Phase I – Business Case Analysis (BCA) Development: For each capital investment under consideration, the contractor must provide a detailed business case analysis demonstrating a set of reasonable alternatives for a production equipment improvement. One of the alternatives must be "do nothing". The BCA must present an estimate of all cash inflows and outflows discounted over time using an agreed to "hurdle" rate. The hurdle rate should be the contractor's weighted average cost of capital and must represent industry norms. For highly complex BCA's, the contracting officer/program manager should consider obtaining outside audit support to verify the cash flow estimates and the resulting calculations. A Net Present Value (NPV) of After Tax Cash Flows must be included as part of the BCA process.
    - The program manager must be cognizant to balance the type and quantity of BCAs pursued by the contractor in order to avoid wasteful spending of taxpayer funded program budgets.
    - The BCA should include metrics that can be used to measure cost savings.

  - Phase II – For each of the BCAs, the program manager/contracting officer must evaluate which investments result in a positive NPV, zero NPV or negative NPV. For positive and zero NPVs, the program manager should pursue a commitment from the contractor to pursue the investment without further incentive. For projects with negative NPV, the program manager should evaluate and prioritize

the short term/long term utility value of each facility improvement. Based on the available incentive funding to the Government and estimated negative NPV, the program manager and contracting officer may consider providing an incentive equal to the negative value that would improve the resulting return on investment for the contractor and thus result in improved efficiencies for the program.

- Phase III – Implementation of the incentivized improvement is evidenced by the contractor's capital outlay, the purchase/installation of the capital improvement and the initiation of the equipment in production. At each step in the capital improvement, all or a portion of the incentive may be paid to the contractor with terms that would allow recoupment if the capital equipment is never put into production.
  - The contracting officer must structure the incentive to allow consideration of the effectiveness of the capital improvement prior to payment of the incentive and/or to allow for recoupment of paid incentives if the facility improvement fails to provide the benefit estimated by the BCA.

- **Contracting Officers should avoid creating facility incentives that deviate from the Contractor's Cost Accounting Standards (CAS) practices such as the Contractor's Disclosed Cost Accounting Practices for allocation of depreciation and/or application of Facilities Capital Cost of Money (FCCM).**

  - The contemplated incentives are not to supplant the Contractor's capital investments; thus there should be no effect on indirect costs or facilities capital investment charged to the Navy. FCCM shall be accounted for in the corporate BCA to determine NPV of all positive and negative cash flows resulting from a contemplated capital improvement. Therefore, FCCM should be accounted for in accordance with CAS. However, this policy does not prohibit pursuit of a waiver of CAS should good business judgment require such an approach.

- **The incentive and the impact to the pricing structure should be addressed in the business clearance.**

- **All BCAs should be adequately documented in the contract file.**

- **Other incentives as considered appropriate to motivate the contractor should be considered, reviewed and approved consistent with acquisition regulations, policies and procedures.**

Ensuring Cost Savings are Achieved:

The minimum desired cost reduction is dependent on the circumstances of each program, contract and facility, but Contracting Officers should ensure that facility investment incentives will achieve the desired outcome (savings, return on investment or cost avoidance). Contracting Officers should also establish, in the incentive agreement, expected efficiency improvements or cost reductions with the ability to measure results. The incentive language should allow for evaluation of the outcome (using the agreed upon metrics) before final payment of the incentive or a recoupment provision in the event cost savings/avoidance are not achieved. These provisions should be incorporated into the contract and approved (i.e., addressed in the business clearance) prior to contract award.