Pricing - Target Cost Incentive Fee

Constraints

None.

Authoritative Guidance Summary

1. A Target Cost Incentive Fee (TCIF) pricing arrangement may be used in both non-competitive and competitive situations.

2. It provides a powerful incentive to contractors to reduce costs and final prices while maintaining profit margins at reasonable levels providing the Target Cost (TC) is set at a challenging but achievable level.

3. It is generally more appropriate for longer duration, higher value contracts where there may be opportunities to benefit from continuous cost improvement.

4. TCIF has behavioural as well as economic benefits. It is consistent with the More Effective Contracting (MEC) strategy and other initiatives that seek to change cultures and improve the way the Ministry of Defence (MOD) and Industry work together to deliver defence capability.

5. TCIF arrangements should be considered where:
   
   a. the difference between the mean cost outturn and the highest cost outturn (at 95% confidence) is greater than 10% but still less than 25%;

   b. the risks can be 'owned' and quantified in monetary terms; and

   c. both parties have confidence in the outcome of a price within a particular range.

6. MOD’s preference is for a Maximum Price Target Cost (MPTC) arrangement.

7. Change can be a difficult aspect of TCIF and to ease its operation consideration may be given to pricing change outside the TCIF arrangement when appropriate.
Authoritative Guidance

8. A Target Cost Incentive Fee (TCIF) pricing arrangement may be used in both non-competitive and competitive situations.

9. TCIF contracts set an estimated Target Cost (TC) within agreed levels of confidence, ideally derived from a robust three-point estimate. Cost savings or overruns against the TC are shared between the contractor and MOD on a pre-agreed basis. TCIF arrangements provide a powerful incentive to contractors to reduce costs and final prices while maintaining profit margins at reasonable levels providing the TC is set at a challenging but achievable level.

10. MOD will seek to cap its liability through a Maximum Price beyond which 100% of cost overrun will fall to the contractor (known as Maximum Price Target Cost - MPTC).

11. The Target Fee applied to the TC should normally be the standard baseline rate of profit from the latest Government Profit Formula (GPF). The new GPF arrangements introduced following the 2003 General Review (effective date 1 July 2004) for automatic profit/loss sharing on firm/fixed price contracts over £5M (five million pounds sterling) should not be confused with TCIF. TCIF is a separate pricing approach for relatively 'riskier' projects, where it remains appropriate and necessary for MOD's liability to be capped by a Maximum Price.

12. TCIF provides an incentive because the contractor can increase his profit through his share of a cost underrun, whereas cost overruns diminish his return. It is generally well suited to longer duration contracts where there may be opportunities to benefit from continuous cost improvement. While there is no threshold for using TCIF arrangements, full consideration should be given by both parties to the pricing risks and cost recording requirements for contracts valued at less than £1M (one million pounds sterling) with a relatively short duration, where the pricing risks may be correspondingly lower.

13. TCIF has behavioural as well as economic benefits. It is consistent with the More Effective Contracting (MEC) strategy and other initiatives that seek to change cultures and improve the way MOD and Industry work together to deliver defence capability, whilst giving taxpayers value for money and shareholders a fair return.

14. TCIF requires openness and a focus on risk management. The TC must be based on a sound specification and assumptions underpinning the arrangement must be recorded in a joint Equality of Information (E of I) Pricing Statement. There must be agreement on robust project and financial
reporting, through Earned Value Management (EVM) or a similar technique, and joint visibility of incurred costs through the submission of Cost Certificates.

15. It is important to ensure that the contractor’s cost recording system is capable of supporting the cost reporting requirements for a TCIF arrangement. For larger value contracts in particular, Cost Assurance and Analysis Service (CAAS) should be invited to examine and perhaps audit the contractor’s cost recording system. This to provide confidence that the system is able to allocate actual costs to the contract to the level of detail required, so that it will support MOD’s cost management requirements. This is particularly important where TCIF contracts are operating alongside fixed or firm contracts with the same contractor and where there exists the potential for cost migration between the contracts.

16. Change can be a difficult aspect of TCIF and to ease its operation consideration may be given to pricing change outside the TCIF arrangement when appropriate. Where this is not sensible and the original TC is altered by contract amendment, MOD will need to achieve consistency with the original target provisions to ensure that neither party is disadvantaged. This can be a particular feature where the TCIF prime contractor’s target fee is a composite rate based on differential returns to provide an incentive to supply chain partners.

**When Should TCIF Be Used In Preference To Firm/Fixed?**

17. For contracts that involve only moderate risk and which are of short/medium duration MOD’s normal preference remains a firm or fixed price, but only if this can be negotiated without excessive pricing contingencies.

18. As a guide, a firm or fixed price is a realistic and sensible proposition where a robust three-point estimate indicates that the difference between the mean cost outturn and the highest cost outturn (at the 95% confidence level) is less than 10% in value. This indicates a sufficient understanding and mitigation of the risks to justify a firm or fixed price contract.

19. However, pricing high-risk work at the outset under NAPNOC, or at an early stage in the programme in other cases, is a demanding and challenging activity. Whilst CAAS (formerly known as Cost Assurance Service (CAS)) usually estimate the man-hours content within 5% or 10% of outturn, any inaccuracy at this level will be exaggerated by the impact of overhead rates that may be four or five times the direct labour cost. Moreover, estimating of materials and subcontract costs with precision can be difficult. This leads to risk at both ends of the spectrum, particularly when projects proceed on a firm/fixed basis without adequately addressing technical or programme risks.
The contractor may include too much or too little contingency, resulting in MOD paying excessive prices or the contractor suffering excessive losses.

20. In these cases, where confidence in the estimates is less certain, it would be better to share pricing risk rather than accept the possibility of unnecessary contingencies becoming excess profit, as in a fixed or firm price arrangement. Accordingly, TCIF should be considered where:

a. the difference between the mean cost outturn and the highest cost outturn (at 95% confidence) is greater than 10% but still less than 25%;

b. the risks can be 'owned' and quantified in monetary terms; and

c. both parties have confidence in the outcome of a price within a particular range (called the Cost Incentive Range).

21. Where the range of uncertainty is greater than 25%, or the most optimistic and most pessimistic estimates of cost cannot be agreed, then other contracting techniques will need to be considered, such as risk reduction studies.

22. TCIF has beneficial behavioural consequences, as well as economic benefits, particularly where both sides see benefit in working more closely together on a long duration contract. The cost sharing arrangements and the visibility these provide on incurred costs (through the submission of interim Cost Certificates) means that TCIF contracting should facilitate more innovation and closer dialogue between MOD and its contractors than firm/fixed pricing has typically achieved.

23. The successful utilisation of a TCIF arrangement is very dependent upon the establishment of a challenging but achievable TC. An unrealistic TC can lead to just as many problems as a firm or fixed price contract that has too much or too little contingency. If the TC is set unrealistically low then the contractor will have little prospect of increasing his profit and the incentivisation aspect will be lost from the outset. If it is set too high then the contractor can bring down costs and make increased returns with little effort. Whilst MOD may also appear to 'win' through sharing the underrun and paying less, the likelihood is that MOD has still paid more than it should have done had a realistic TC been set. It is therefore essential that the TC be set with care, after close dialogue with the contractor and only after arriving at a clear, mutual understanding about costs and risks.
Essential Reading

- MOD/Industry Commercial Policy Steering Group (CPSG) Guideline No 7 - Target Cost Incentive Fee Arrangements

Further Reading

- DEFCON Guide No 5 - Incentive (Target Cost) Contracting
- More Effective Contracting topic
- Pricing - Equality Of Information topic
- Pricing - Post Costing topic (for information on the submission of Cost Certificates and Cost Summaries)
- Pricing - Government Profit Formula topic (for information on the submission of Cost Certificates and Cost Summaries)
- DEFCON Guide No 1 - The Planning And Cost Management Of Major Development Contracts
- DEFCON Guide No 2 - Planning And Monitoring Of Minor Development Contracts Reface