



DEPUTY SECRETARY OF DEFENSE
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October 16, 2006

MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
CHAIRMAN OF THE JOINT CHIEFS OF STAFF
UNDER SECRETARIES OF DEFENSE
ASSISTANT SECRETARIES OF DEFENSE
GENERAL COUNSEL OF THE DEPARTMENT OF DEFENSE
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DIRECTORS OF THE DEFENSE AGENCIES
DIRECTORS OF THE DOD FIELD ACTIVITIES

SUBJECT: Executive and Senior Level Pay and Performance Management System

We just closed out our second full-year under a pay for performance management system for our Executives and Senior Leaders. High-quality performance management is a fundamental and significant leadership responsibility. The purpose of this memorandum is to remind you of some important elements of the appraisal process and provide funding guidance to appropriately reward our executives and senior professionals.

An essential part of our system's design is the link of salary increases to performance and accountability, two hallmarks of the President's Management Agenda. Please keep these considerations in mind when evaluating performance this year:

- Supervisors must make meaningful distinctions in performance ratings. Rigorous assessments of executive performance will help make these distinctions and support appropriate pay decisions. However, quotas or forced distributions are not authorized.



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- Executives' pay must be linked to their performance ratings. Basic pay adjustments, bonuses and levels of pay must recognize individual contribution, organizational performance, and /or team performance.
- Communicate clearly, candidly, constructively, and fully on expectations and accomplishments. The Department expects senior leaders to devote time and attention to this effort, so clear your schedules and make yourselves available.

Under our performance management system, DoD uses a pay pool concept to manage, control, and distribute performance-based pay increases and bonuses. To ensure sufficient funds are allocated to reward executives appropriately, be fiscally responsible, and provide you some flexibility in managing pay pools, the Department is establishing a Pay Pool Factor of 10 percent. The Pay Pool Factor may be increased to no more than 12 percent to address any unintended consequences or unusual characteristics of a pay pool. If you need to exceed the 10 percent ceiling, please discuss your reasons with my office prior to making any payouts.

The Department appreciates the efforts of your staff to help us model this benchmark. In fact, their work informed my decision. DoD modeled a 10 percent Pay Pool Factor and found that performance can be adequately rewarded at that funding level. In fact, while the average 2005 Pay Pool Factor was nearly 15 percent, a significant portion of the performance budget was not spent. On average, the actual distribution of Pay Pool funds was slightly more than 10 percent.

This year, DoD has the opportunity to exceed level III of the Executive Schedule and pay up to \$165,200 per year. This will help relieve some of the longstanding pay compression for executives who may be at or near the top of the pay range, who have demonstrated superior performance, and are serving in positions with significant responsibilities. At the same time, the Department must exercise discipline to avoid a rush to the new pay cap. Within the standards established by our performance management regulation (SC 920 paragraphs A7 and B7), each Component is required to establish appropriate compensation strategies to ensure fair and appropriate compensation based on the level of work, performance and contribution to organizational performance. Pay for performance works only with adequate safeguards, including transparency and appropriate accountability mechanisms in place to ensure its fair, effective and responsible implementation. The combination of your judicious compensation approaches and an appropriate Pay Pool Factor will help maintain the integrity of our contemporary performance management system.

On a final note, as part of the Under Secretary of Defense (Personnel and Readiness) 2006 validation process, please share the basis for your Pay Pool calculation and compensation strategies. The Department has a great deal to learn from one another

in these new and important areas. High-performing organizations continually review and revise their systems to support their strategic goals. In that spirit, the Department should remain open to making modifications in the future based upon our experiences to date.

Thank you for your continued support.

A handwritten signature in black ink, reading "Andrew England". The signature is written in a cursive style with a large, stylized initial "A" and "E".