in our opinion

A two-edged sword

Performance-based initiatives

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WHEN CONSIDERED IN THE abstract, the inclusion of performance-based incentives in a supply contract seems to make a great deal of sense. However, the performance of the public sector in conducting incentive programs has not been encouraging. In one often-quoted 1997 study, prepared by the Office of Inspector General at the United States Department of Energy (DOE), numerous deficiencies were identified in the administration of performance-based schemes.

Since the DOE is quite possibly the world's largest non-military contracting entity – and it certainly enjoys this status in the US government – the problems that it identified raise a near universal concern for the management of contracts by public authorities. These problems included:

- The payment of excessive incentive fees, when contrasted with the overall cost of the work or supply concerned. For instance, in one case, an incentive fee of US$225,000 was paid to replace a ventilation fan when the cost of this work for the year was only US$25,000.
- Payment for performance that was completed before the incentive scheme was introduced. For instance, an incentive of US$4.3 million was paid for a work force reduction that took place prior to the contract creating the cost reduction program.
- Setting the bar too low. For instance, a fee of US$150,000 was paid for the pumping of 1,500 gallons of solution from a tank. However, the work was completed only six days after the contractor proposed the incentive, and just two days after the incentive was approved.
- Payments of performance fees for non-measurable results, or results that could be assessed only on highly subjective criteria. Unless there are well-defined performance criteria and methods of measurement suppliers are unlikely to be sufficiently motivated to seek and implement methods of improving performance. The goals of any incentive program must be clearly stated, and results-oriented. They must offer specific incentives for efficient and effective cost savings.

There were also problems with improper administration of the performance scheme, which included payments being made before the establishment of the performance objective and payments being made for work not completed by the contractor.

Contracts incentives are intended to encourage significantly superior performance. They are not intended to reward the ordinary performance or even performance that is slightly above average but nevertheless well within the range of what would normally be expected of a competent supplier. They must be structured so that they do not encourage harmful shortcuts, such as risks to safety or the environment. Care must be taken to match any incentive scheme to the genuine needs of the customer. For instance, from a customer perspective, performance incentives designed to expedite performance make sense only where early delivery has a benefit to the customer. Early delivery of a product or the early completion of a building may result in cost savings, or they may result in unexpected costs, such as storage costs, increased insurance premiums, and earlier than expected financing costs. Where the supply contract incorporates a cost-plus element, early delivery may result in unanticipated over-time charges and similar unbudgeted expense.

A performance incentive scheme cannot be well run in the absence of a sound system of contract administration. A public authority must properly resource the process of contract supervision, in order to confirm that payment of the performance incentive is justified.

Generally, performance incentive schemes will not work in the absence of a formal program of performance evaluation. Confirmation of work and audit of claims are an integral part of any such evaluation. The costs of administering the scheme must be balanced against the savings and performance improvements that are generated through the scheme. If only in the interests of transparency, there must be clear and objective standards that must be satisfied before any incentive is paid. A failure to implement such measures inevitably leads to excessive cost for what is often no more than adequate performance, and wasteful management practices.

It is also often argued that any performance incentives scheme must be balanced by a corresponding scheme of disincentives for poor performance. Finally, where two or more different suppliers are contributing towards some overall project, any scheme of performance incentives must be integrated, taking into account the global requirements of that project, rather than just the specific elements of the individual supply contracts.

Tying all of the above together, a given performance incentive scheme might specify that suppliers are expected to perform within a given range. A supplier who can document performance above that level will be entitled to an earned bonus (which should be tied in some way to the value of the benefit to the customer that the superior performance generates). A supplier who falls outside the band would be subject to an off-setting penalty. The floor and ceiling of the band would be adjusted periodically, to reflect the improvements in average supplier performance resulting from the incentive scheme. In this way, the program would serve a long-term organizational need of the customer, rather than being linked to anecdotal occasional incidents of above average work.

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