

# Supplier Incentivisation



Successful incentivisation in the contract was a key mechanism for achieving the mutual success of both organisations and aligning success and objectives (James Jacobson, Commercial Manager of the Olympic Delivery Authority).



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### Introduction

Incentivisation as a technique can be applied to achieve superior or improved performance for both supplier and buyer and leads to benefits such as lower cost, early delivery, inventory reduction, increased sales, reduced costs, improved labour utilisation, better technical solutions, safer product or higher quality product (CIPS: Purchasing and Supply Management. Incentivisation). This can be achieved through introducing rewards (Archibald, 2008) and mutually agreeing on targets in relation to cost, schedule, quality, safety, inventory reduction, increased sales, reduced cost, improved labour utilisation, or better technical solutions (CIPS: Purchasing and Supply Management: Incentivisation; Hughes et al., 2012).

Supplier Relationship Managers are usually responsible for drafting clauses associated with supplier performance improvement incentivisation and mal-performance disincentivisation, that is, risk/reward mechanisms (Interim Management: Purchasing, 2006). The reward sharing contracts differ from a normal fixed-price or unit-cost contract where there may be little incentive for the supplier to improve their performance (Supply Management, 2005).

Despite its benefits, incentivisation should only be used where appropriate. For example, it is important that (1) the cultures within both the supplier and client organisations are compatible; (2) there is wide acceptance across organisations, stakeholders and all management levels; and (3) the buyer has the ability to pay. The latter point highlights the importance for buyers to carefully assess all steps and the likely cost of incentivisation. If incentivisation is open-ended and does not have some form of cap, there is a risk of exceeding the funds allocated for incentivisation purposes. This could have negative consequences, particularly if incentivisation is associated with budget constraints (CIPS: Purchasing and Supply Management. Incentivisation).

### Definition

Incentivisation is the term used to align the motivations of the client with the supplier and vice-versa by and stimulating supplier's performance improvement in return for enhanced reward. Incentivisation can lead to a purchasing partnering relationship (CIPS: Purchasing and Supply Management: Incentivisation).

### Successful Application

Successful incentivisation implementation requires a detailed dialogue with the supplier and greater attention to performance and contract management than for traditional contracts. The higher investment in incentivisation must be balanced against the additional benefits and savings to be achieved (The Sussex Innovation Centre, 2011).

### Steps to Successful Application

- Set clear objectives and deliverables when incentivising a contract.
- Baseline setting: get the buyer to establish the total cost of the existing service.
- Identify whether the improvement in quality and/or cost reduction can be achieved without incentivising the contract.
- Establish expected benefits.
- Decide whether incentives will be financial (e.g. those which have a monetary value) or related to some contractual benefit (e.g. a longer contract with larger scope).

- Post award monitoring: manage contract and conduct post implementation reviews.

### Hints and Tips

- Paying incentives on the basis of notional, rather than actual, performance targets should be avoided. It is also important to decide how to deal with the supplier if it does not achieve them (Supply Management, 2005).
- To ensure a successful incentivisation process it is important to develop and set effective measurements and targets for both parties (CIPS: Purchasing and Supply Management. Incentivisation).
- Effective contract management is essential to ensure successful incentivisation (Ejohwomu, 2011).
- There is a need for transparent structures in respect of cost and performance by both parties (CIPS: Purchasing and Supply Management. Incentivisation).
- Willingness on the part of the supplier to participate in the incentivisation scheme is always helpful and makes process more efficient (Hughes et al., 2012).

### Potential Advantages

- Incentivisation can help buyers reduce costs and achieve earlier delivery and better quality of safety levels (Archibald, 2008).
- Incentivisation of suppliers can result in greater certainties regarding delivery time, cost and/or quality (CIPS: Purchasing and Supply Management. Incentivisation).
- Supplier incentivisation can reduce the time spent resolving contractual disputes (Archibald, 2008).

### Potential Disadvantages

- Establishing an incentivisation system requires buyers to invest a considerable amount of time (Archibald, 2008).
- There is always a risk that the effort involved in establishing an incentivised arrangement will not equate with the additional benefits (Hughes et al., 2012).
- The practice of incentivisation requires making a judgment on commercial risk. Therefore, it is essential that risks in the contract are understood (Archibald, 2008; Ejohwomu, 2011).

### Performance Monitoring

- Key Performance Indicators (KPIs) are fundamental to successful incentivisation. KPIs are measures of business-critical deliverables and measure: a) achieving the scope of work within budget, b) delivering the required amount of deliverables per month every month, and c) performing work without any safety and production critical maintenance work every month (in a manufacturing setting) (CIPS: Purchasing and Supply Management. Incentivisation).
- Quality measures: the number of deviations requested, accuracy of paperwork, field campaigns, or the suppliers cost of quality (Miller, 1998).
- Inspection measures: based on the number of rejects versus lines inspected (Miller, 1998).
- Operational performance measures: on-time delivery, quality, lead times, responsiveness (rescheduling, order status), inventory turns, customer service call response time (Gordon, 2005).

### Case Studies

- Thames Water's purchasing partnership with Efficio, the company that undertakes all procurement functions (except construction material), has resulted in a range of advantages. The benefits have been largely achieved due to the inclusion of commercial incentives for delivering a good deal as part of the contract: the better deals made by Efficio, the better terms the company gets (Leach, 2012).
- Marks and Spencer has introduced a Supplier Sustainability Award. Through such creative supplier incentivisation, the company achieves supply chain cost saving, supplier loyalty and "greener" products for the ultimate consumer (Young, 2012).
- The construction and agricultural equipment maker, Deere & Co., acknowledges the efforts of its top suppliers every year as part of its Achieving Excellence programme. The programme has been adopted by 35 Deere factories globally and includes around 1,200 suppliers and 250 awards presented across several categories each year. It allows the company to successfully work with suppliers through difficult environments (e.g. capacity issues or problems at the bottom of the cycle), provides a vehicle to measure supplier performance and rewards them by offering a little extra business (Zubko, 2008).

### Further Reading/References

#### Web Resources

- Contracting and incentivisation strategy: Nuclear Decommissioning Authority  
<http://www.nda.gov.uk/strategy/criticalenablers/contracting-incentivisation/index.cfm>
- Overview of incentivisation  
[http://www.incentivise.com/news\\_resources/guide\\_building\\_business\\_case.php](http://www.incentivise.com/news_resources/guide_building_business_case.php)
- Incentive-based cost reduction programmes  
<http://www.ism.ws/pubs/proceedings/confproceedingsdetail.cfm?ItemNumber=11206>
- Incentivisation and supply chain sustainability  
<http://www.2degreesnetwork.com/groups/supply-chain/resources/9-steps-supply-chain-sustainability-incentives-engagement/>
- Aligning incentives in supply chains <http://hbr.org/2004/11/aligning-incentives-in-supply-chains/ar/1>

#### Books

- Managing Quality and Delivery Reliability of Suppliers by Using Incentives and Simulation Models: Patrick Neise - Managing suppliers by using incentives and simulation models
- Supplier Evaluation and Performance Excellence: Sherry Gordon - Examples of best practice and performance measurements
- Balanced Sourcing: Cooperation and Competition in Supplier Relationships (J-B BAH Strategy & Business Series): Timothy M. Laseter - Developing a dynamic strategy based on the strengths and resources of supply base.
- Excellence in Supplier Management: Stuart Emmett and Barry Crocker
- Supplier management handbook: James L. Bossert

#### References

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- Zubko, N. (2008) Rewarding Relationships. Industry Week. 1 September.

## Video

HP earns supplier of the year award

<https://www.youtube.com/watch?v=dLSI7EF1jUs#t=16>

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