

P&SM: Incentivisation



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Introduction

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This document is about incentivisation in P&SM.

Definition

Incentivisation is the term used to align the motivations of the client with the supplier and vice-versa, so that the supplier is stimulated to improve their performance so as to benefit the client. This is usually in return for enhanced reward for the supplier, whether this is of a financial nature or takes the form of some other benefit to the supplier. It involves a process of mutually agreeing targets, often with respect to cost, schedule, quality and safety or other measurable benefits to the client's business such as:

- inventory reduction
- increased sales
- reduced cost
- improved labour utilisation
- better technical solutions

The objective is to achieve superior or, at the very least, improved performance which can be shared as a benefit to both parties for which the supplier will receive additional reward. The outcomes of the superior performance (whether lower cost, early delivery, safer product or higher quality product) are of value to the buyer. Incentivisation might lead to a purchasing partnering relationship but this is not always the case.

Background

Benefits of incentivisation:

From the client organisation/buyer's point of view, the benefits are likely to include:

- Lower cost
- Earlier delivery leading to an earlier revenue stream
- Improved quality or safety
- Greater certainties regarding delivery time, cost and/or quality
- A more knowledgeable and skilful workforce arising from the experience of open book costing
- Additional services from the supplier and possibly a longer relationship with a good supplier
- Less time spent resolving contractual disputes

- Better technical solutions to problems as suppliers will be encouraged to apply specific expertise to the issues.

From the supplier's point of view, the benefits are likely to include:

- Increased revenues or faster payment
- Better reputation
- Possibly longer relationships with the buyer
- Less time spent on contractual disputes

Failings of Incentivisation

For the supplier, there is the risk of investing time and not winning any long term business. For the buyer, there is the investment of time with many suppliers, when only one supplier may become the preferred supplier. There is also the risk that the effort involved in establishing an incentivised arrangement will not equate with the additional benefits from this arrangement.

Incentivisation involves making a judgement on commercial risk so it is essential that the risks in the contract are understood.

Explanation

Key features and conditions

CIPS believes that the key factors in successfully using incentivisation as a technique are:

- A firm and detailed basis for costing a contract both for the buyer and the supplier
- Effective measurements and setting of milestones and targets for both buyer and supplier. This means that a good quality specification is essential and there should be a good audit trail
- The need for effective contract management within an incentivised contract which commences at the correct time
- A requirement for transparent structures in respect of cost and performance by both parties operating within this sphere
- Good payment procedures to ensure that payment is made as agreed
- Willingness on the part of the supplier to participate in the incentivisation scheme

Incentivisation is contractually based and CIPS believes that it should be established on a foundation of agreement and trust between buyer and supplier. Without a genuine meeting of minds, an incentivised contract is likely to be seen in a negative light, most probably by the supplier, who could see it as simply another contractual device imposed by the buyer to compel performance. This means that the reward which the supplier receives must be commensurate with the extra effort required, i.e. the reward must be valued and fair. Conversely, the value from the incentivisation which the buyer receives should be commensurate with the amount to be paid.

The incentivisation must be seen by both parties to be win-win, and there should be no hidden agendas. CIPS believes that mutual trust and a drive to continuously improve are essential. For

example, where the incentives are concerned with cost minimisation, there will be a need for both parties to practice some degree of open book costing.

There can also be an incentive to avoid a negative consequence. The most usual form of negative consequence in a contract is likely to be liquidated damages. Other examples could be loss of reputation, no further business etc. In these circumstances, the supplier is compelled to meet obligations in order to avoid undesirable consequences. However, CIPS believe it would be beneficial for most organisations to attempt to move to a more positive motivational stance with respect to their suppliers, in order to improve or maintain relations.

CIPS also believes that contractual incentive schemes need to reflect the business objectives of the client and these should align with the business objectives of the supplier. They should be simple and measurable so as to avoid dispute both about their meaning and their attainment and should preferably be based on outputs so that deliverables can be easily identified. They should also take account of what might happen during the life of the contract.

CIPS believes that successful incentivisation requires closer and more detailed dialogue between the buyer and supplier in the pre-contract stage and during post-contract management. This is because of the greater need to attend to performance and its measurement if the milestones associated with the incentives are to be unequivocally attained, thus clearly justifying payment of the incentive. Lack of clarity associated with the attainment of a milestone can breed mistrust and this will sour relationships.

Incentivisation arrangements are not an end in themselves and they should only be used where appropriate. This means that the cultures which exist within both the supplier and the client organisation must be compatible. Above all, the concept needs wide acceptance within many departments and at many levels of management in both organisations. It often needs to include all stakeholders. Agreement simply between the buyer's purchasing and contracts department, and the supplier's sales department will not work.

Incentivisation is also dependent on the buyer's ability to pay. This requires the buyer to carefully assess the likely cost of any incentivisation and to take steps to ensure that the purchasing organisation provides the funds to make any payment. If the incentivisation is open ended and does not have some form of cap there is a risk of the amounts of payment exceeding the funds allocated for this purpose. This could have severe repercussions, particularly if the incentivisation is associated with completion according to the budget constraints of some projects. A possible funding mechanism to resolve this issue is to use part of the savings realised previously from incentivised agreements to fund or at least to pump prime future rewards.

Whilst incentivisation can be multi-target in nature (i.e. there could be more than one target for the supplier to achieve) CIPS believes that the achievement of each target must be considered individually. Failure to achieve one target does not impact on the supplier's reward for some other target should that target be achieved. The supplier is thus not de-motivated by a failure and, because the overall scheme is fair, it might be that motivation is enhanced. It may be advisable for there to be some flexibility for the supplier to trade-off variable performance metrics.

Incentivisation of many contracts within a project requires careful management. CIPS believes that multiple incentivisation must lead to complementary outcomes if disruption is to be

avoided. This is because all the parties in a project tend to rely on each other and the consequence of uncoordinated incentivisation can upset this balance.

Incentivisation can work across a series of contracts and CIPS believes that this assists in the learning of the buyer and the supplier, assuming the same supplier has been used for each of the contracts, which can lead to greater efficiencies in the later contracts. Organisations which have not previously used incentivisation need to proceed with caution until a level of experience is achieved and CIPS believes that a policy of keeping it simple is generally advisable.

The buyer also needs to consider carefully the implications to all the participants (client, contractors, consultants, key subcontractors, ultimate customers, etc.) of the incentivisation process. For example, there is little point in independently incentivising an aspect of a contractor's contract if that part is crucially dependent upon another party, such as a consultant or the client, who are not party to the incentivisation. The involvement of the other participants might require them to be incentivised themselves; the most likely examples are subcontractors and consultants. Additionally, especially in the case of clients, there is a need for awareness and an understanding of the effect the incentivisation will have and the reasons for it.

Reasons for using incentives

There are many reasons as to why organisations may decide that incentivisation is a useful approach. For example, incentivisation can be the product of circumstances which act to unite the client and supplier into a team devoted to the resolution of a problem. In essence, the problem is seen as a common enemy which can only be overcome by the pooling of client and supplier resources. The problem can be a result of previous failure, for example the collapse of a construction works, which affects adversely the reputations of the parties. It could also arise from financial difficulty which threatens to overwhelm the existence of both parties or the outcome of a legal threat etc.

Incentivisation can also be purely financial. For example, early delivery of a product or service (whether a facility of some sort, such as a building or off-shore installation, or simply the supply of goods) could be financially beneficial to the client and the client might be prepared to share some of the anticipated financial gain with the supplier as a reward for the effort needed to make an earlier delivery.

Another simple example is that of a company considering the re-decoration of a room. The lead times quoted by the decorating suppliers would mean that the buyer would have to hire a room elsewhere for some important function. If the buyer could strike a deal with the supplier whereby the buyer would pay the supplier extra for earlier completion of the room, then, providing the extra amount paid to the supplier was less than the cost of hiring another room, both parties would gain.

Financial incentivisation could also be used to stimulate suppliers to beat any cost targets embodied in the contract. This is appropriate where the target cost acts as a cap to the amount that the buyer is prepared to pay. If the supplier can deliver the requirements of the contract for less cost than the target cost, the difference can be divided in some agreed proportion between the buyer and the supplier.

The above examples all suggest that incentivisation may only be used for projects or as a component of contracts for discrete services. This does not need to be the case; incentivisation can be a part of contracts to produce goods. In this case, the incentivisation could be to reduce cost, improve design, reduce stocks, speed delivery etc.

While incentivisation is often of this straightforward financial nature, there are occasions when non-financial benefits are generated. These may include the assurance of continuity of business which could act as the incentivisation. Similarly, some suppliers could gain kudos from an association with an outstandingly successful contract and this can also be an incentive.

From the buyer's point of view, incentivisation is used to foster improvement by binding good suppliers with the expectation of even better reward. For the buyer, incentivisation offers the possibility of self-financing benefits from improved supplier performance and it also attracts good suppliers who see the potential for better rewards for their efforts and capabilities.

The supplier might expect to gain extra financial reward but also an improved reputation as a successful supplier (which should lead to more work from the original buyer or from other buyers in the market place). In some markets, the possibility of a long term multi-contract relationship involving some form of partnership sourcing is possible. This is not so likely in the construction field where most relationships are single project based.

A further reason for incentivisation is that it is likely to involve less conflict.

Making it happen

Planning is the key factor. The client must have a clear view of what it wants to achieve as part of the procurement strategy formulation and business case.

CIPS believes that Key Performance Indicators (KPIs) are fundamental to successful incentivisation. They are measures of business critical deliverables. They include:

- Achieving the scope of work within budget
- Delivering the required amount of deliverables per month every month
- Performing work without any safety and production critical maintenance work every month (in a manufacturing setting)

KPIs must be easily measurable and comprehensible as they are critical to the success of the contract and business. The supplier's profit and overheads, and even direct costs, could be at risk if the contractual KPIs are not met. They can be graduated so that poor, satisfactory, good and excellent performance may be graded accordingly. The supplier earns, for example, a lesser amount of profit/overhead (or none at all) for poor performance as opposed to excellent performance when they might have expected to receive the normal margin plus the extra amount. How much profit /overhead the supplier is prepared to risk under incentivisation and the reward actually received will vary on performance. Both parties need to assess their expectations realistically before negotiating the incentive arrangement.

Conclusion

CIPS believes that incentivisation is not a panacea to the many problems which can afflict large value, long term contractual arrangements. It is not easy, nor is it a quick fix because it requires

time, considerable thought and planning for it to work effectively. It works best as a co-operative and collective approach rather than a unilateral process and should not be imposed by a purchasing department. It needs the support and active participation of colleagues within the client organisation (including those outside purchasing), and the supplier. When incentivisation takes this approach it can be a very useful motivational tool.

For each situation and set of circumstances an astute buyer will need to assess the benefits and risks of incentivisation. In particular, the buyer will need to evaluate the possibility of investing a lot of time with a number of suppliers, some of whom may turn out to be unsatisfactory. By the same token, a supplier engaged on the incentivisation process runs the risk of investing time with buyers who may well decide to go elsewhere for the product or service concerned. As in most business situations the natural desire to maximise margins should be tempered by the consideration of potential risks.

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