

Performance-Based Contracting: Results, Performance Standards, Incentives

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Abstract. Performance-based contracting (PBC), sometimes referred to as performance-based service contracting (PBSC) or performance-based service acquisition (PBSA), is a good method and often fits especially well when buying services.

The primary essential elements for using PBC are

- Describing the requirements in terms of results rather than methods of performance

- Using measurable performance standards (e.g., terms of quality, timeliness, etc.) and quality assurance surveillance plans

- Including performance incentives where appropriate (positive and negative)

In the past, most statements of work (SOWs) required the contractor to perform the work in a specific way, often using detailed specifications for production items or specifying key personnel to be provided and methods to be used for service contracts. However, PBC describes the work in terms of the results to be achieved and looks to the contractor to best organize the workforce to achieve those results.

Introduction. Performance-based contracting (PBC) has been described in laudatory terms especially in the past few years and especially for service contracts, where it is sometimes referred to as performance-based service contracting (PBSC) or performance-based service acquisition (PBSA). The method is a good one and does often fit especially well when buying services, but it can also be used in other areas.

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In general, PBC is an acquisition method that structures all aspects of an acquisition around the purposes of the work to be performed as opposed to either describing the manner by which the work is to be performed, or with broad or imprecise statements of work. In the past, most statements of work (SOWs) required the contractor to perform the work in a specific way, often using detailed specifications for production items or specifying key personnel to be provided and methods to be used for service contracts. However, PBC describes the work in terms of the results to be achieved and looks to the contractor to best organize the workforce to achieve those results.

When not using PBC, the contractor's performance was considered a success if it followed the specifications or methods prescribed. The actual results were to flow from this performance, but even if results were poor, the contractor would not be at fault, as long as it had done as it had been told. Under PBC, the contractor is told of the result desired and is responsible for producing that result.

To encourage even higher levels of performance when using PBC, performance incentives may be made a part of the contract. They may be monetary or non-monetary and may be either positive or negative.

Integrated teaming, not an ad hoc work group, is critical to a successful PBC. Cross-functional teams are especially needed to establish the requirements, the measures, and evaluation methods for PBC. It is important that such teams work together to solve the issues related to the contract rather than defending their traditional silo organizations.

Literature Review. In the federal government, PBC received official status in 1991 when the Office of Federal Procurement Policy (OFPP) issued Policy Letter 91-2, which established the policy of using PBC methods to the maximum extent practicable when acquiring services. (Ausink, Camm, Cannon, 2001) These principles were contained the 1997 reissue of the Federal Acquisition Regulation (FAR) in July 1997.

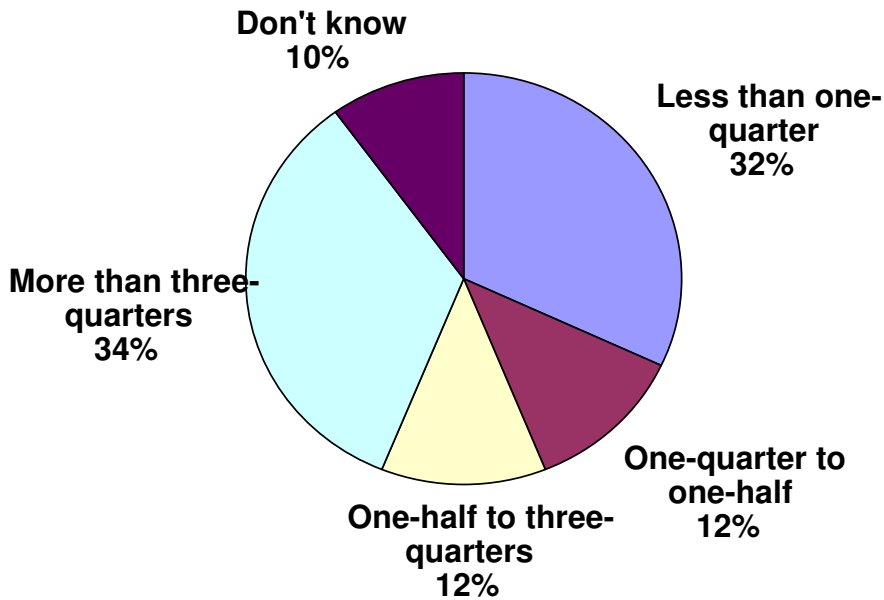
With much of the initial push for performance-based contracts coming from the federal government (although their use is not and should not be restricted to government contracting) a good place to start is with FAR Part 37, Service Contracting; the coverage on performance-based contracting is contained in Subpart 37.6. It provides policies and procedures for use, starting with a general discussion of PBC contracting methods being used to ensure achievement of required quality levels and relating total payment to either the degree that services are performed or outcomes are achieved. The FAR cites four items

- Describing results in terms of results rather than methods of performance
- Using measurable performance standards and quality assurance plans
- Specifying procedures for price or fee reductions when requirements are not met
- Including performance incentives where appropriate

One area for which PBC may be especially well suited is in buying information technology (IT) services. In a recent survey, 41 percent of IT managers in the US federal government said they are using PBC for IT services, with only 35 percent saying that they do not (24 percent said they did not know). (Walsh, 2005) In a similar survey 2 years earlier, the publication reported that only a quarter understood what a PBC was or how to write one. Then, 51 percent said the biggest problem was changing the government contracting culture, including getting procurement officers to change. Now, however, 51 percent said that their agency had not found it difficult to transition from a traditional contracting environment to a performance-based contracting environment. Finally for those agencies that did use PBC to acquire IT services, 55 percent reported that over half of their service contracts are performance-based, as shown in Figure 1.

Within the US government, an interagency-industry partnership of the General Services Administration (GSA), the Department of Defense (DoD), Department of the Treasury, the US Department of Agriculture (USDA), the Department of Commerce, and a company, Acquisition

Figure 1. Proportion of Service Contracts that are Performance-Based



Solutions, Inc., developed the Seven Steps to Performance-Based Service Acquisition. This has become a well-known and referenced resource within the government, but is also available to all at www.acqnet.gov/Library/OFPP/BestPractices/pbsc/. The seven steps they describe are

1. Establish an integrated solutions team
2. Describe the problem that needs solving
3. Examine private-sector and public sector solutions
4. Develop a performance work statement (PWS) or statement of objectives (SOO)
5. Decide how to measure and manage performance
6. Select the right contractor
7. Manage performance

As we discuss the process below, the seven steps will be covered.

Necessary Conditions. A key element that needs to be in place to develop a PBC is an integrated solutions team. The members of this team should be drawn from a wide variety of functional areas to be sure all areas of the requirements for the contract are covered. Important requirements are to

- Ensure senior management involvement and support
- Tap multi-disciplinary expertise
- Define roles and responsibilities
- Develop rules of conduct
- Empower team members
- Identify stakeholders and nurture consensus
- Develop and maintain the knowledge base over the project life
- “Incent” the team: Establish the link between program mission and team members’ performance

Certain functional areas of expertise will be a part of each team, with other functions being brought in when required by the service being procured. The necessary teaming members and relationships for building and sustaining any PBC

- Program Official: monitors the project officer.
- Project Officer: reports performance and results to the Program Official.
- Contracting Officer: monitors performance and applies incentives or remedies.
- Contractor: reports performance to the Project Officer.

Large acquisitions are very likely to require more functional expertise and more team members than the basic team outlined noted above. They are very likely to require contracting officer's representatives (CORs) or contracting officer's technical representatives (COTRs), in addition to Quality Assurance Evaluators (QAEs), and Task Monitors for task-order contracts. (Task order contracts allow for individual task orders to be issued for separate segments of the work.)

Results-Oriented. The most important part of a PBC and what distinguishes it from other contracting methods is in describing the results that are desired. Traditionally, the outcome has been directed by the buyer in the form of exact specifications or in the form of requiring "key personnel" to be assigned to a service contract. Attempts by the contractor to suggest alternative ways of approaching the work have been viewed with the suspicion that the contractor is only trying to reduce costs to increase profits and will provide an inferior outcome, and thus are usually rejected.

With performance-based contracting, usually the results required of the contractor are described in one of two ways, using a Performance Work Statement (PWS) or a Statement of Objectives (SOO). A PWS is more similar to the traditional SOW, in that each prospective contractor will be given the same information, will prepare its offer based on that information, and, if awarded the contract, will carry out the contract following the PWS.

A PWS is to be written as a concise, declarative, verb-driven document as a statement of required services in terms of outcomes that has a measurable performance standard for each outcome, and has an acceptable quality level (AQL) for each outcome. The common components of a PWS

Introduction—general description of the acquisition

Background (if any)—Information that helps in understanding the nature and history of the requirement

Scope—overview of the PWS, relates the important aspects of the requirement

Applicable Directives (if any)—referenced documents or directives that are either mandatory or informational for the procurement

Performance Requirements—what is required to be done, the performance standards, and the acceptable quality levels

Information Requirements—Reports, software, deliverables, and formal requirements that must be submitted as part of the contract

A SOO also provides the same information to each company, but then each organization's offer differs as each company responds in its proposal with the specifics as to how it will meet the desired objectives. For the offer chosen, the company's description on how it will meet the

SOO will become a part of the contract. In this case each company will have made a slightly different offer, based on how it viewed its best response to the SOO.

Cost estimation is an important part of each acquisition's planning. It involves preparing (rolling up) the cost or price estimates from all analysis activities. This may include using historical and current costs or prices, and gathering marketplace information for commercial services. In addition, it may be necessary to use formal estimating methodologies for complex services.

Performance Standards and Quality Assurance Surveillance Plans. For performance-based contracting to work, the actual performance of the contractor must be measured against some standards that have been set. These standards must be set by the buyer before the solicitation is sent to prospective contractors so that they can propose in a way that will meet the standards. *Performance indicators* specify essential characteristics of performance that is acceptable. *Performance standards* describe a definite level or degree of quality for measuring performance. Performance standards must be measurable, achievable, relevant, and controllable.

The buyer should determine at least one performance indicator and standard for each task (and perhaps subtask) and deliverable and link them to a description of acceptable quality (AQL). An acceptable quality level (AQL) must be determined by the buyer so that the contractor can be evaluated against this pre-established level as work on the contract proceeds. The AQL establishes a maximum allowable variation (or error rate) from the standard. The AQL must be realistic and determinable.

Quality surveillance methods (for example, random or stratified sampling, 100 percent or periodic inspection, customer feedback or surveys) are used to evaluate whether the buyer's standards have been met for the performance of work.

The quality assurance surveillance plan (QASP) is the guide that will be followed by both buyer and seller as the contract is managed throughout its life. It provides the methodology for monitoring performance against standards for required work. It provides for scheduling, observing, and documenting contractor performance against standards; accepting service; determining causes for deficiencies; and calculating payment due (formulas).

Similar to the QASP is the contractor's Quality Control Plan (QCP). The QCP will be developed by the contractor and will be submitted as part of the proposal for evaluation by the government. After contract award, the QCP will be the plan the contractor is to follow during the performance of the contract. These two documents, the QASP and the QCP, are the control documents for the contract.

Performance Incentives. Most PBCs are firm-fixed price (FFP) contracts. This is appropriate when results can be objectively measured and risks managed, which is the usual case for using this contracting method. However, one alternative that does provide for incentives is a fixed-price/award fee (FPAF) type of contract. The same general consideration would apply as with a FFP, but the award fee incentive arrangement is added. An award fee contract provides a method in fixed-price contracts to motivate a contractor when other incentives cannot be used because contractor performance cannot be measured objectively. Such contracts usually

- Establish a fixed price (including normal profit) for the effort. This price will be paid for satisfactory contract performance. The award fee earned (if any) will be paid in addition to that fixed price; and
- Provide for periodic evaluation of the contractor's performance against an award-fee plan.

Award fee or other performance incentives are not required for PBC to work, but they are often viewed as a mechanism that will make it work better. Performance incentives may be positive or negative and they may be monetary or non-monetary. They may be based on cost control, quality, responsiveness, or customer satisfaction.

A post-award orientation conference has often been found to be useful for several reasons. One of these reasons is leadership orientation—making sure all parties understand the contractual requirements and working situation in the same way. In addition, the conference agenda should

- Reiterate the buyer's performance expectations
- Clarify the contract administration's role and the key players—discussing potential problems
- Review any incentive arrangement that may be in place
- Reinforce any partnering arrangement on (either informal or formal)

Summary. PBC are often the best way establish service contracts but they're not necessarily easy to put in place in that they require describing the requirements in terms of the results expected, while buyers and vendors are typically used to having the methods of that work so frequently described. PBC requirements are based on

Results—Described requirements in terms of results rather than methods of performance

Performance Standards—Use measurable performance standards (e.g., terms of quality, timeliness, etc.) and quality assurance surveillance plans

Incentives—Include performance incentives where appropriate (positive and negative)

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