

Executive Summary

Across the globe, governments are opening up traditional public services to the competitive marketplace. The government of the future will be more a focuser of resources than an owner, and more a purchaser and manager of services than a supervisor of personnel and direct service provider.

This dramatic change in the nature of government requires fundamental organizational changes. For governments to avoid failures and mishaps, they must concentrate on becoming smarter shoppers.

This means creating contracting systems that are outcome based; writing contracts that contain clear performance standards; incorporating financial incentives and penalties into the contract; and developing advanced measurement techniques. Such state-of-the-art contracting is often referred to as “performance-based-contracting.” When properly structured, performance-based contracting holds great promise to reduce contracting costs while increasing service quality.

Performance-based contracting systems have several key components:

1. Outcome Based Contracts

Performance contracts clearly spell out the desired end result expected of the contractor, but the manner in which the work is to be performed is left to the contractor's discretion. Contractors are given as much freedom as possible in figuring out how to best meet government's performance objective.

Example: The Air Force saved 50 percent by modifying its statement of work for a janitorial contract. Previously, the agency required the contractor to strip and rewax floors weekly. Now it requires the floors to be clean, free of scuff marks and dirt and have a glossy finish.

2. Performance Standards

The process of drawing up the Request for Proposal is a great way to focus a manager's mind on exactly what it is the agency wants accomplished from the delivery of a service, operation of an enterprise, or running of a program.

Example: A Navy contract for aircraft maintenance doesn't specify how many mechanics or parachute riggers must be on a crew, but it does hold the contractor accountable for achieving precise and measurable performance standards, such as a ground abort rate of less than 5 percent and meeting 100 percent of flight schedules.

3. Financial Incentives and Penalties

Privatization gives public officials the freedom to creatively design contractor payments to correspond with certain performance pegs. Incentives to increase productivity, cut costs and raise service quality can be built into the contract.

Incentive-based contracts shift much of the risk onto the contractor, who is rewarded for productivity improvement and penalized for poor performance or rising costs. Example: After the California earthquake, Caltrans, the state transportation agency offered the contractor substantial performance incentives and penalties for rebuilding a highway overpass: a \$200,000 per day bonus for completing the project ahead of schedule and a \$200,000 a day penalty for each day the project was behind schedule.

4. Advanced Monitoring and Measurement Techniques

As more governments rely on private companies to deliver public services, monitoring and assessing these outside partnerships becomes vital to achieving an administration's goals.

The monitoring plan defines precisely what a government must do to guarantee that the contractor's performance is in accordance with contract performance standards.

Different services require different types and levels of monitoring. For highly visible services that directly affect citizens such as snow removal and garbage pickup, poor service will be exposed through citizen complaints. For complex or technical services, it may make sense to hire a third party to monitor the contractor.

The contractor should be considered a strategic partner and given incentives to innovate, improve, and deliver better customer service.

Summary

Implementing state-of-the-art performance-based contracting requires new evaluation techniques, new management approaches, improved top-level know-how on designing and managing contract relationships, better logistics systems, and a whole new set of skills for public officials. Perhaps most important of all, what is needed is a changed mindset where public managers are rewarded for effectively managing projects and networks of contractors rather than for the number of public employees under their command.

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Part 1

Introduction

From Albany to Sacramento and from Buenos Aires to Melbourne, governments are opening up traditional public services to the competitive marketplace. Competitive contracting has emerged as one of the most popular management tools for governments to cut costs and increase service quality.

Assuming current trends continue (and there is no reason to think they won't), the government of the future will be more a focuser of resources rather than owner, and purchaser and manager of services rather than supervisor of personnel and direct service provider.

Contracting or “outsourcing” is also rapidly transforming the private sector. Vertically integrated structures are giving way to more flexible “networked” companies, where organizational charts resemble a web of partnership arrangements with other firms. Business management guru James Bryant Quinn calls this the “shamrock corporation.” Many CEOs of companies large and small, now talk of outsourcing up to 50 percent of their current functions in future years.

Outsourcing has emerged as a favored strategic management tool, allowing businesses to focus on their core functions while support functions are performed by companies that specialize in those activities. Increasingly the rule of thumb is that if a company can't deliver “best in the world” quality and price of a given task or service in-house then that work should be outsourced. “Eventually, everything will be outsourced except what a company really does,” says a senior manager of the consulting firm Arthur D. Little. “If it doesn't offer you a competitive advantage, you won't be doing it.”¹

The dramatic increase in the scope and quantity of public and private-sector outsourcing requires fundamental organizational changes. This realization has spurred the private sector to focus significant attention and resources on how to manage outsourcing relationships for highest value

¹ Bill Kelly, “Outsourcing Marches On,” *Journal of Business Strategy*, July-August 1995.

and service quality. The public sector, however, has been slower to respond to the need for more sophisticated approaches to contract administration, measurement and monitoring. Poorly designed contracting procedures and systems can lead to privatization failures.

As governments subject an increasing percentage of their services to competition they must concentrate on becoming smarter shoppers. This means creating contracting systems that are outcome-based; writing contracts that contain clear performance standards; incorporating financial incentives and penalties into the contract; and developing advanced measurement techniques. Such state-of-the-art contracting is often referred to as **performance-based contracting**. When properly structured, performance-based contracting holds great promise to reduce contracting costs while increasing service quality.

By describing best practice methodologies in the public and private sectors—and examining the reasons for several contracting failures—this study is intended to provide a set of guidelines to assist public managers with designing and implementing performance-based contracting systems.

A. What is Performance-Based Contracting?

Increasingly governments are fundamentally rethinking the way they contract out services. Previously, contracts tended to emphasize inputs: procedures, processes, the wages to be paid, amount or type of equipment, or time and labor used. “Performance-based contracting,” on the other hand, is an output and outcome-based approach to contracting.

Performance contracts clearly spell out the desired end result expected of the contractor, but the manner in which the work is to be performed is left to the contractor's discretion. Contractors are given as much freedom as possible in figuring out how to best meet government's performance objective.

Along with the increased autonomy comes greater accountability for delivering the predetermined set of outputs and/or outcomes. For example, a number of cities and states—Indianapolis, New York, Connecticut—contract with a private company called America Works to place welfare recipients in jobs. America Works is paid about \$5,000 for each person placed in a private sector job. America Works receives no payment for the time it puts into training, counseling and job searches for clients unless they are placed in a job for at least six months.

By measuring a contractor's performance against a clear standard, performance contracting shifts the emphasis from a focus on process to a focus on product. Government's management role changes from prescribing and monitoring inputs to collecting and generating the results-based data needed to measure the impact of the work performed.

The Federal Government's Pilot Projects in Performance Contracting



Performance-based competitive contracting is a maturing field. Governments—and even private firms—are at very different levels of sophistication in this arena.

The federal government has had an active performance-based contracting effort since late 1994, when 26 federal agencies signed a voluntary pledge to convert almost 90 service contracts—with a \$1.2 billion value—to a performance-based approach. “This project is unique in enabling government to measure price, performance, and competition in service contracting,” said Steve Kelman, the director of the initiative.

The project is being coordinated out of the Office of Federal Procurement Policy. Veteran federal contracting experts Linda Mesaros and Stanley Kaufman are providing training and hand holding to the dozens of agencies involved in the project. The defense agencies, NASA, the Railroad Retirement Board and the Department of the Interior have been the most aggressive in adopting performance contracting, while the Department of Energy has begun to train its employees in the concept. “We’re inventing this as we go along,” says one senior department official.²

The early results from the federal pilot projects are impressive. Savings from previous contract costs range from 8 percent to over 50 percent. The Air Force, for example, saved 50 percent by modifying its statement of work for a janitorial contract. Previously, the agency required the contractor to strip and re wax floors weekly. Now it requires the floors to be clean, free of scuff marks and dirt, and have a glossy finish.³

² Bill Loveless, “DOE Works to Train Staff in Nuances of Performance-Based Contracting,” *Inside Energy/with Federal Lands*, McGraw Hill, December 18, 1995, p. 13.

³ “A Guide to Best Practices for Performance-Based Service Contracting,” Office of Federal Procurement Policy, Office of Management and Budget, interim edition, April 1996, p. 19.

Part 2

Determining What You Want to Buy: Designing the RFP and Contract

When public officials decide to purchase a service, they still have two important tasks. First, they need to make sure they ask for what they want. Then they have to make sure they get what they asked for.⁴

This isn't as easy as it may sound. When contracting fails, it is almost always because government has failed at one or both of these two critical tasks.

A. Job Task Analysis

The first step in making sure you ask for what you want is determining your agency's needs. This involves answering questions such as: What services and outputs do we want provided? What do we hope to accomplish by providing the service or program? Termed the job analysis, this stage provides the foundation for all subsequent stages of the performance contracting process. The six basic elements of a job analysis are described in Table 1.

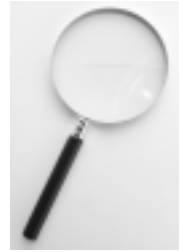
The job analysis forces departments to take a close, fresh look at their operations. Work processes have to be broken down to their lowest levels, which isn't easy. "The job task analysis is the most brutal part of the process," says Linda Mesaros, Deputy Procurement Policy Administrator for the Federal Government. "You have to figure out how to break down the work; how to flow chart it; and how to do the tree diagram."⁵

⁴ William D. Eggers and John O'Leary, *Revolution at the Roots: Making Our Government Smaller, Better, and Closer to Home*, (New York: The Free Press, 1995), p. 353.

⁵ Linda Mesaros, interview with the author, May 1996.

The Six Steps of Conducting a Job Analysis

1. **Agency or Activity Analysis.** A review of the agency's needs and required outputs from contractor.
2. **Work to be Performed by Contractor.** Work is broken down to its lowest task level and tasks are linked in a logical flow of activities. A tree diagram is often used to divide a job into parts or subparts, each of which contributes to a final output.
3. **Performance Standards.** A performance requirement is assigned to each task. Performance standards and quality levels are specified.
4. **Directives.** All potential directives are screened in order to eliminate those that are unnecessary or excessive.
5. **Data Gathering.** The government must be able to provide accurate data to the contractor of the workload to be performed and the services and equipment that will be furnished to the contractor. Historical workload data must be gathered and should be used as a baseline to estimate future contractual work requirements.
6. **Cost.** To the extent possible, accurate, fully-allocated in-house costs should be computed for the service in question.



Source: Adapted from "A Guide to Best Practices for Performance-Based Service Contracting," Office of Federal Procurement Policy, OMB, April 1996.

An important—but often underperformed—component of the job analysis is the data gathering phase. Governments sometimes decide to contract out a service due to sub-par in-house performance. To bring the service up to an acceptable level, the agency may need to purchase a higher level of service than is currently being delivered. Unfortunately, due to poor recordkeeping of workloads and inventories, this is often not made explicit in the Request For Proposal (RFP) or in contract negotiations.

Poor Inventory of Workload Data Causes Contract Controversy in LA County

For example, in the largest-ever local government fleet maintenance contract, in 1988, Los Angeles County contracted with Holmes and Narver Services, Inc. (HNSI) to maintain its entire fleet; 6,500 county vehicles, 1,800 heavy vehicles and the entire fleet of the sheriff's department. Due to contract disputes, the contract was eventually terminated.

The root of the problem was that the county underestimated the amount of actual work that needed to be performed by the contractor by over 50 percent. County records of the actual number of backlogged vehicles and of the actual condition of the fleet were inaccurate,

Standard Performance Indicators

1. Quality Measures
2. Customer Satisfaction
3. Productivity
4. Costs
5. Continuous Improvement

resulting in HNSI being unable to keep the backlog to expected levels.⁶ The problem could have been avoided if the county had gathered more accurate historical workload data and included the data in its RFP.

B. Performance-Based Statements of Work (SOW)

The new focus on outputs and outcomes requires paying more attention to formulating more precise Statements of Work (SOWs). “Nothing degrades a contracting experience more than a lousy work statement,” says Bert Conklin, president of the Professional Services Council.⁷ Poor work statements can lead to poor performance, protests and ultimately disputes. A performance-based SOW consists of a statement of required services in terms of an output or outcome—or both—and measurable standards to judge whether the outcome is being met.

Outcome Indicators:

Hard Services

<u>Service</u>	<u>Indicator</u>
• Grass Mowing	• Length of Grass
• Street Repair	• Smoothness of Streets
• Water	• Number of Days Meeting Standards
• Fire	• Containment Rate of Fires per Number of Fires



Soft Services

- Number of adoptions
- Number of welfare recipients placed in jobs for at least 6 months
- Percent of families kept intact
- Percent of families with no new incidence of “substantiated” abuse or neglect
- Percent of children with no new incidents of recidivism



Writing a simple description of what you're buying will help in preparing the objectives of the RFP. To contract for trash pickup, don't prepare a contract that describes current practice. For instance, don't contract for five trucks and nine workers to pick up trash according to a predetermined route. Contract to have the trash removed and incorporate rigorous performance standards into the contract. Allow the contractor to determine the best way to meet your requirements. Or, if you want to contract out the management of your airport, a desired outcome might be lower passenger cost and increased service.

The process of drawing up the RFP is a great way to focus a manager's mind on exactly what it is the agency wants accomplished from the delivery of a service, operation of an enterprise, or running of a program. The trick is to ensure that the SOW is specific enough to ensure you get what is wanted in terms of service delivery, but without saddling the contractor with detailed procedures that must be followed to

⁶ Lynn Scarlett and Robert W. Poole, Jr., “Cutting State Deficits: The Role of Privatization,” Reason Foundation Policy Study No. 132, November 1991, p. 14.

⁷ *Federal Contracts Report*, October 17, 1994.

achieve the specific outcome. For instance, in the case of grass cutting, one city was initially contracting to have their grass cut every six weeks. But seasonal weather variations make such a criterion meaningless—grass grows much faster during the spring.⁸ Furthermore, checking up on contractors is tedious—you have to track them down to make sure they're really mowing when they claim they are.

Then the city grew more sophisticated. After all, the city didn't really want their grass cut every six weeks—they wanted their grass to be kept short. Now, they contract with a company to keep their grass less than 3 inches high and pay by the acre. Monitoring is easier, too. At random times, someone simply goes out with a ruler.

CASE STUDY: Navy Performance Contract for Aircraft Maintenance



One of the largest of the federal government's performance-based contracting pilot projects is a five-year, \$350 million contract for maintenance of the Navy's T-34C and T-44A turboprop aircraft (used for training student Naval aviators). The contract involved providing a broad range of maintenance-related functions including flight servicing, engine repairs, painting, material management, logistics, general engineering support and aircraft launch and recovery.⁹

A tricky step in transitioning this contract to a performance-basis was rewriting the statement of work (SOW). In theory the new SOW could have been as simple as "maintain T-34C and T-44A aircraft safe for flight," but such a description was judged too simplistic—and too high a risk—for a contract that covers 357 aircraft at 12 different locations.¹⁰ Work processes were broken down and separate tasks defined and priced—propeller overhaul, for example.

The contract doesn't specify how many mechanics or parachute riggers must be on a crew, but it does hold the contractor accountable for achieving precise and measurable performance standards. For example:

- Aircraft are 80 percent mission capable;
- The ground abort rate is less than 5 percent;
- One hundred percent of flight schedules are met; and
- Turnaround times are limited for aircraft condition inspection.

Failure to meet certain performance standards will result in financial penalties. For example, one standard is that at any time at least 75 percent of the aircraft will be ready for flying. If the contractor fails to attain this level and has only 60 percent of aircraft ready for flight then this would result in a 20 percent reduction in contract payments. This has not been a problem to date.

The end result of converting aircraft maintenance to performance-based contracts has been an immediate 26 percent savings of \$25 million a year, a shortened time interval between the issuance of the RFP and the award, greater contractor accountability and the potential for significant additional savings thanks to the existence of the positive and negative financial incentives.¹¹

⁸ Eggers and O'Leary, *Revolution at the Roots*, pp. 353–354.

⁹ William John, "Performance-Based Contracting for Aircraft Maintenance," *Contract Management*, March 1996, p. 25.

¹⁰ Ibid.

¹¹ Ibid.

Think Outside the Box

Don't simply contract to have a service delivered the same way it was performed previously. The bid process provides an opportunity to think creatively about how the service would be delivered if you were to start from scratch.

When the City of Indianapolis wanted to lower costs and increase service in their mass transit agency, originally the plan was to simply contract out existing bus services. But city officials soon discovered that, despite three decades of providing bus service, no one had ever really asked what public interest the transit agency was supposed to be satisfying. After asking this question, it became apparent that the real goal of the agency was managing mobility in the regional marketplace, particularly for low-income and physically dependent citizens. In response, the city put out a bid for a firm to act as a “mobility manager,” whose responsibilities would include redesigning and rebidding various government-subsidized forms of transportation. The winning firm helped the city cut costs by one-third, *saving* \$3 million while *expanding* service by 500,000 rides.

C. Give the Contractor Maximum Autonomy to Achieve Results

Politicians are often tempted to stick contractors with all kinds of requirements they like so much to impose on their own departments. These include: “buy American” requirements, veterans and minority hiring preferences, and stipulations about the “appropriate” level of wages and fringe benefits the contractor can pay their employees. Contractors may even be required to employ all affected city personnel at the same level positions for the same pay for a certain length of time. If possible, avoid traveling down this road.

One reason why government doesn't operate as efficiently and effectively as the private sector is the public sector's myriad of hiring and firing procedures. If they are to achieve cost savings and productivity gains, private contractors must be given the freedom to operate outside this restrictive framework.

Consider a principal finding of *Bureaucrats in Business*, a landmark World Bank study of privatization and management contracts:

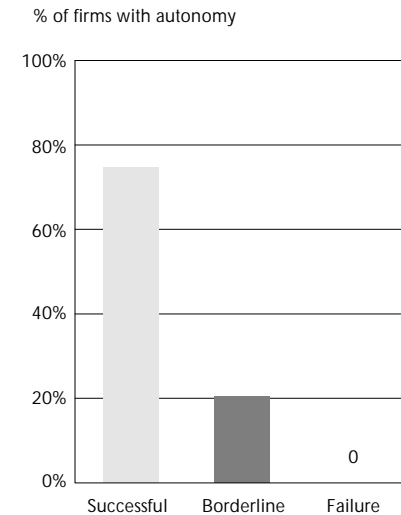
...the more successful contracts enabled contract managers to pursue contract objectives independent of government policy, while the less successful contracts made returns to the contractors dependent on government decisions outside their control.¹²

¹² World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership*, (New York: Oxford University Press, 1995) p. 143.

According to the study, governments interfere with personnel policies more than any other area of contractor decisionmaking, almost always having a negative effect on performance. All but one of the unsuccessful or borderline management contracts studied by the World Bank limited the contractor's freedom and authority over labor (see Chart 1). In contrast, nearly all the successful contracts gave the contractor maximum autonomy to hire and fire personnel, and to set wages.

In one purportedly outcome-based RFP for social services, a county government required potential contractors to possess at least 4.5 full-time staff either with a Masters in Social Work or an M.A. in the human services field. Not only does such a requirement have little to do with outcomes, it closes off competition from those nonprofits that operate successful programs without credentialed social service professionals.

CHART 1: Contract Effects of Autonomy in Employment Decisions



Source: World Bank

CASE STUDY: Baltimore's Failed Experiment in Education Management Contracting Requiring Responsibility without Providing Autonomy

In November 1995, the Baltimore school board cancelled its \$44 million contract with Education Alternatives, Inc. (EAI), the for-profit management company running 12 public schools. There were many reasons for the failure of this contracting experiment, but a central one is that EAI had very little control over its most important employees, the teachers. EAI not only could not hire or fire teachers (or have any say in teacher evaluations) but most of the teachers were openly hostile to the private company. The one area where EAI did have control over hiring and firing was in support services like maintenance and custodial. In this area it is uniformly acknowledged that EAI did an excellent job cleaning up the schools.

Says Bill DeLoache, co-founder of Alternative Public Schools, the private company running a public elementary school in Pennsylvania, "EAI went into a hostile group of employees to retrain and remotivate them. To me, that's just suicide. It's essential that the teachers at the school be on board."

EAI learned this lesson the hard way. The company now refuses to enter into a contract with a district unless it has some say over hiring and teacher evaluations.

Other private education management companies such as Sylvan Learning Systems, which provides remedial education services, and Ombudsman Educational Services, which teaches at-risk youth, both insist on supplying their own employees, as do Alternative Public Schools and The Edison Project, two private education management companies, which run public schools in Wilkinsburg, PA and Boston, MA.

Such freedom enables the private companies to control their labor costs and introduce innovations in the education curriculum. The Edison Project, for instance, has regrouped teachers into teams, expanded the school day and teaches a highly respected math curriculum created by the University of Chicago in all its public schools.¹³

¹³ Thomas Toch, "Do Firms Run Schools Well?" *U.S. News and World Report*, (January 8, 1996), p. 49.

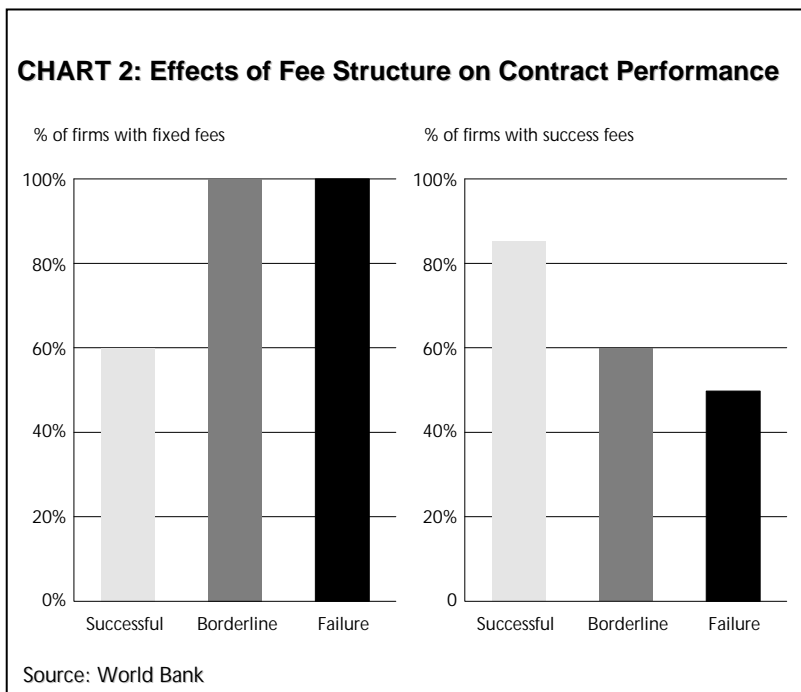
Part 3

Incorporating Performance Incentives (and Penalties) into the Contract

A. Introduction

Generally, private-sector compensation is based to a much larger degree on performance than compensation in the public sector. A 20 percent increase in a business unit's productivity or a doubling in sales will typically result in substantial bonuses and/or salary increases. This almost never occurs in the public sector.

The potentially powerful effects of incentive pay provides a compelling reason for performance contracting. Privatization gives public officials the freedom to creatively design contractor payments to correspond with certain performance pegs. Incentives to increase productivity, cut costs and raise service quality can be built into the contract.



Available evidence suggests that contracts are more likely to achieve desired results if they incorporate performance incentives. In the World Bank study noted earlier, the most successful management contracts all included success fees based on a composite of performance measures. (See Chart 2). In Indianapolis, city offi-

cials contend that inte-grating more sophis-ticated performance criteria and financial incentives into their more recent privatization transactions has led to considerable improvements in the city's competitive contracting program.¹⁴

Incentive-based contracts shift much of the risk onto the contractor, who is rewarded for productivity improvement and penalized for poor performance or rising costs.

Performance-Linked Prison Privatization in Australia



By entering into performance-based contracts with three private prison operators, the state of Victoria in Australia is getting three brand new state-of-the-art prisons without putting up a dime of capital spending.

The three private prison operators, Corrections Corporation of Australia, Wackenhut Correction Services and Group Four, are responsible for taking over all risk associated with the facilities, including for the design, construction, ownership and management of the prisons, as well as the finance risks associated with changes in interest rates and taxes, insurance, and government indemnities.¹⁵

In return, the private operators receive three streams of income from the government, one of which is a performance-linked fee, which represents the return on the company's equity investment, meaning the profit that can be earned that makes the investment worthwhile.

By linking the return on equity to meeting a set of performance goals, the Victoria government is trying to closely tie the firm's long term interests in the facility with the government's interests in best in the world quality services.

As long as the company scores 90 percent or higher on the performance indicators, they receive the full payment. If they score under 90 percent, the performance fee drops, but not proportionately. A score of 60 percent or under would mean the company receives nothing. "It's a rather harsh formula," says one private prison executive, "but it's all based on rolling public sector averages and we always say we can perform better than the public sector, so we really can't complain."

Victoria Prison Privatization	
Contract Payments	Government Safeguards
The right to re-tender the contract for correctional services every 3 years.	Accommodation Services Charge
Performance guarantees in the event of contract termination	• Provision of correctional facilities
Contract payments based on performance	Correctional Services Fee
Clear step-in rights	• Operators of prisons and corrective services
	Performance Linked Fee
	• Investment return on the contract

B. Speeding Up Product Deliverables through Financial Incentives: The 1994 Northridge (CA) Earthquake Case Study

¹⁴ Tom Olsen, interview with the author, June 18, 1996.

¹⁵ For a full accounting of the privatization see: William D. Eggers, "Breaking Open Victoria's Prisons Monopoly," *Infrastructure Finance*, December/January 1996.

For services or projects in which time may be critical, financial incentives can be provided for early project completion.

When the 1994 Northridge earthquake resulted in the collapse of two bridges on the Santa Monica Freeway, the world's busiest, it was estimated that it would take from nine months to two years to open the damaged sections of the roadway if the bridge repairs were to go through the normal bidding process. The estimated cost: \$1–3 million a day to the local economy.

**Performance Incentives:
Calif. Earthquake Repair Case Study**

Financial Incentives

- \$200,000/day (bonuses and penalties)
- \$13.8M in performance incentives

Savings

- \$74 M to local economy
- \$12 M on contract administration

Construction Time

- 2 months (versus estimated 9 to 24 months)



To speed up the process, Governor Pete Wilson gave Caltrans, the state transportation agency, extraordinary authority to shorten normal contracting processes. This allowed the agency to advertise the jobs for less than the required two weeks before bid opening and to accept bids from only five prequalified contractors for each job. In addition, the agency offered substantial performance incentives and penalties: a \$200,000 per day bonus for completing the project ahead of schedule and a \$200,000 a day penalty for each day the project was behind schedule.¹⁶

Due to the streamlined contracting process, repair work began the day after the January 17 earthquake. The financial incentives, meanwhile, resulted in the overpasses being replaced in a little over two months, 74 days ahead of the June 24 deadline. To complete the project so early, the contractor used up to 400 workers a day and kept crews on the job 24 hours a day. The \$13.8 million the contractor received in performance bonuses were more than offset by the estimated \$74 million in savings to the local economy and \$12 million in contract administration savings thanks to the shortened schedule.¹⁷

C. Sharing the Savings

Private firms typically are able to generate much higher collection rates than the public sector for a host of revenue collection activities, such as child support payments, utility payments and parking ticket collection. To provide incentives for the contractor to maximize revenues, governments can negotiate a contract that allows contractors to keep a certain percentage of the increased collections.

¹⁶ David B. Rosenbaum, "Fast Quake Recovery Redeemed State Transportation Department," *Engineering News Record*, January 16, 1995, p.33.

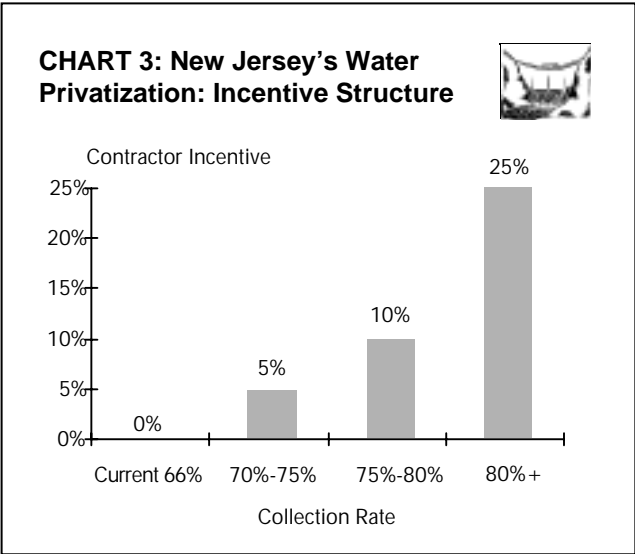
¹⁷ Ibid.

In May 1996, Jersey City, New Jersey turned over the operation of its water system to United Water. When the system was run by the city, only 66 percent of the water produced was actually being paid for.¹⁸ The new contract provides financial incentives for the contractor to increase this percentage. If the percentage rises to 70 to 75 percent, United Water gets to keep 5 percent of the increased collections. If it rises to 75 to 80 percent, United Water keeps 10 percent of the increase in collections and if the collection rate exceeds 80 percent, this percentage rises to 25 percent of the increase in collections (see Chart 3 below).¹⁹

The city estimates increased water revenues of \$17 million and increased sewage collection of \$32 million from the profit sharing arrangement.²⁰

Another option is to negotiate a guaranteed level of savings from the contractor and then share any additional savings. This offers a powerful incentive for the contractor to search out ways to continually reduce costs over time. Such arrangements are used frequently when outsourcing many process-oriented support functions such as information technology, billing and payroll.

This concept can also be creatively applied to non-support services. In 1995, the Indianapolis airport became the largest privately-managed airport in the United States when BAA USA, Inc won the bid to manage the airport. BAA guaranteed a minimum of \$32 million in savings over a ten-year period, but hopes to achieve savings of \$105 million. All savings over the \$32 million baseline is shared by BAA and the Indianapolis Airport Authority, whose share ranges from 60-70 percent over the life of the contract.



D. Performance Penalties

Financial penalties imposed on the service provider can take the form of reduced charges for the period in which the poor performance occurred or a credit against future charges.

¹⁸ Alexander Volokh, "Jersey City Privatizes Water Department," *Privatization Watch*, Reason Foundation, No. 235, July 1996, p. 6.
¹⁹ Above what they would be at a 70 percent rate.
²⁰ Assuming that the collection rate increases to 75 percent in the first year and 80 percent in the second year.

In setting up the penalty structure, the contractor will be justifiably concerned that the penalties not be used simply as a means of reducing payments for every minor glitch in performance. The client, on the other hand, has a strong interest in protecting himself against any service problems. A number of approaches have been developed to reconcile these interests, including “earn back” provisions and “positive performance” credits.

“Earn back” refers to giving the contractor the opportunity to “earn back” assessed penalties by exceeding performance standards in a future time period or by exceeding performance standards in other areas during the same time period.²¹ “Positive performance credits” enable the contractor to exceed performance during a specified “look back” period. These could also be used to offset any negative performance penalties that may occur during a defined “look forward” period.²²

Performance Penalty Provisions

- Earn Back
- Positive performance credits
- Negative performance penalties
- Dual-set Weighting Factors

Source: Fenwick and West law firm

For these mechanisms to work, individual performance standards must also be weighted according to importance, termed “dual-set weighting factors.” Otherwise the contractor could conceivably take advantage of the “earn back” and “positive performance” provisions by performing poorly in important areas and exceeding performance standards in less important areas.

CASE STUDY: Performance-based Educational Management Contract in Minneapolis

In 1994, the Minneapolis Public Schools hired a consulting firm known as the Public Strategies Group (PSG) as their new superintendent. Under the terms of the three-year contract, PSG is paid a base salary of \$5,000 a month, but could earn as much as \$716,500 over the course of the contract if it meets certain outcomes such as improving test scores, reducing suspensions, and increasing community trust in the districts schools.²³

Eighteen months into the contract PSG had partially achieved many, but not all, of the goals spelled out in the performance agreement. PSG was paid 66 percent of the \$716,500 that it would have received if each goal had been fully achieved. Goals achieved by PSG included:

- ✓ A drop in suspension rate;
 - ✓ Increase in attendance;
 - ✓ Rise in family involvement in children's education;
 - ✓ Development of baseline measures for assessing student performance; and
 - ✓ Development of strategic plan for school district.
- Two goals were not fully realized by PSG, so the company didn't receive payment for them: 1) Improving student test scores and 2) Negotiating the new teacher's contract to the district's satisfaction.

²¹ David L. Hayes, “Advanced Issues in Outsourcing Agreements,” Fenwick and West law firm, 1994.

²² Ibid.

²³ Janet R. Beales, “Performance-Based Education,” *Privatization Watch*, Reason Foundation, July 1994, p. 1.

E. Incentivizing In-House Units

Depending on a jurisdiction's union contracts and specific civil service rules, performance incentives can also be built into compensation packages for cases in which in-house units win the bidding competition.


The City of Indianapolis has incorporated financial performance incentives into bids won by city units in services from street repair to waste collection. The city's five-year experience in executing public-private competitions demonstrates the importance of incorporating clear and meaningful performance incentives and penalties.

Indianapolis' fleet maintenance department had done 10 years of total quality management. It was widely acclaimed to be the most efficient central garage in Indiana. The mayor decided to bid it out anyway. Three of the biggest players in the country bid on the contract. That's when the department got really serious; they eliminated \$2.5 million dollars out of their overhead, increased their productivity per mechanic by 22 percent, reduced the cost to other city agencies, and won the bid for a total cost savings of \$4.6 million.

The fleet maintenance employees discovered that government's scheduling of days off—where each worker is entitled to the same, and frequent, holidays—affects their competitiveness, so they asked for more flexibility in this area. To increase their productivity—and minimize down time of vehicles—they asked to be able to keep some workers on the job during scheduled holidays.

The union employees also agreed to forego some automatic cost-of-living increases and take a portion of their compensation in performance bonuses. Offset against this are contractual, financial penalties if the department misses certain pegs on the contract. “They live and die by the performance measures,” says Deputy Mayor Charles “Skip” Stitt. “Real dollars come out of each employee's pocket if they fail to perform to contract specifications.”

In the first year the department surpassed its cost containment goals, entitling the employees to over \$75,000 in incentive payments (but only after deducting penalties for failing to fully comply with certain other performance goals).

Indianapolis Fleet Maintenance: 

Before and After Competition

	<u>Before</u>	<u>After</u>
Cost	\$5.3 M	\$3.8 M
Productivity/Mechanic	Negligible	Up 22%
Employee Compensation	Automatic Cost of Living Increases	Performance Bonuses
Ratio of Workers to Mngrs	1.1 to 1	4 to 1
No. of Employees	119	82
No. of Complaints	24	5
No. of Vehicles Serviced	2,104	2,202

F. Shifting Away from Cost-Plus Contracts

Cost-plus contracts provide managers with considerable flexibility. When service problems occur or needs change, it's easy to persuade contractors to make major adjustments because they know they can simply bill the government for any extra costs incurred. Fearing the loss of such flexibility, it is not surprising then that many managers are reluctant to switch from cost-plus to fixed-price contracts.

Unfortunately, cost-plus contracts provide virtually no incentive for contractors to hold down their costs. The result is typically escalating costs that the government as customer has no ability to control. Cost-plus contracts also require substantial government auditing because all the contractor's charges, invoices and reimbursement requests must be approved by the government agency.

Fixed price, performance contracts shift the financial risk from the public agency to the contractor, who, in order to keep costs down and increase profits, has powerful incentives to improve performance and increase productivity. When the Department of Treasury's Federal Law Enforcement Training Center in New Mexico converted five cost-reimbursement contracts to fixed-price contracts in 1994, savings ranged from 8 percent to 55 percent per contract (see Table 1 below).

	Cost-Plus	Fixed-Price	Savings
Laundry & uniform	\$364,000	\$165,000	\$199,000
Firearms	243,000	114,000	129,000
Classroom support	207,000	190,000	17,000
Logistics	<u>324,000</u>	<u>224,000</u>	<u>100,000</u>
	\$1,138,000	\$693,000	\$445,000

1. Human Services: The Promise of Capitated Contracts

Transitioning from cost-plus contracts to incentive-based payments has played a critical role in reducing the rapid growth of health care costs. Increasingly funders are asking providers to deliver health and social services under a “capitated” arrangement, meaning they agree to deliver the services in bundles for a fixed price per case. By providing a fixed payment in advance for a certain outcome, capitation shifts much of the burden of performance—and risk—to the provider.

For example, traditionally many state Medicaid programs gave nursing homes more money for bedridden patients. Not surprisingly, such incentives caused large increases in the proportion of bedridden nursing home residents. By rewarding an input—in this case additional care—

rather than an outcome or output, Medicaid created an incentive for large increases in inputs—and in costs.²⁴ Under a capitation arrangement, a standard fee per patient could be paid to the nursing home, providing an incentive to improve the health of residents rather than confining them to beds. The result: the purchase of a preferable output (better health) at a lower cost.

In **Wisconsin**, Milwaukee's welfare program has been opened up to competitive bidding. The city was carved into six regions and public, private and nonprofit firms were allowed to bid on contracts to administer the different regions. Each contractor is paid a flat amount to screen, train, and place clients in jobs. This offers a powerful incentive to find work for the clients because otherwise the contractor could lose money. "Serious economic consequences exist if we are not successful," says Larry Townsend, Vice President of Maximus' welfare division. "It's sort of like capitated welfare."

Kansas' Managed Care Privatization Model for Child Welfare Services



The concept of managed care and capitated contracts is also swiftly moving into the child welfare arena. According to a survey by the Child Welfare League of America, about half of all states are in the process of introducing capitated payments and/or performance-based contracts into child welfare contracts, tying bonuses and/or penalties to achieving specified goals and benchmarks.

Furthest along is Kansas which this year became the first state in the nation to turn all of its adoption, foster-care, and family-preservation services over to the private sector. Kansas' performance-based privatization model provides strong incentives for the private providers to rapidly move children out of foster care and into permanent homes. In all three areas, the contractors are paid a one-time, lump sum rate per child. Drawing from the managed health care model, the contractor must agree to deliver the services for a fixed price per case, regardless of how troubled the child is or how long they have been in the system. For family preservation services, for example, contractors receive the same rate regardless of whether the family requires a handful—or hundreds—of visits.

Previously, providers were paid on a fee-for-service basis. With this payment scheme, neither the state social workers nor the private providers had much incentive to quickly move a child out of the system because once the child left foster care, the state agency and the contractor were out all the federal money for the child (federal funding rewards states on a per day, per child basis). In effect, they had a financial incentive to keep children *in* foster care.

Kansas' new managed care approach turns the incentives upside down. Each provider's bottom line is now directly tied to preventing such foster care drift.

Linked with the new financial incentives are demanding outcome and performance standards. For example, the adoption contractor must meet five adoption outcome measures in order to have its contract renewed. The most important is placement. Previously the state was placing only one-fourth of children in homes within six months of the child being freed for adoption. The private contractor must increase the placement rate to 70 percent within 180 days and 90 percent within a year or it risks losing the contract.

While this is a major challenge, Kansas nonprofits are confident that over time they will vastly improve on the state's performance.²⁵

²⁴ Wehrle-Einhorn, p.5.

²⁵ William D. Eggers, "There's No Place Like Home," Policy Review, May/June 1997, pp. 43–47.

Part 4

Tips For Selecting The Right Contractor

Many privatization failures can be attributed to the public sector doing a poor job choosing the best service provider. Prior to Progressive Era reforms, for example, contractors were often chosen on the basis of political (or familial) connections rather than based on their abilities. Such practices are relatively rare today, though not unknown.

Nowadays, contract problems often surface because a contractor was selected simply on the basis of low price. By not adequately taking into account other factors such as track record, references, organizational compatibility and quality of employees, quality may be sacrificed.

An entire literature documents the appropriate procedures to follow in vendor selection (**see Appendix**). This literature should be consulted for more detailed guidelines on this topic. What follows below are a few simple suggestions for avoiding some of the most frequent mistakes made when choosing a service provider.

A. Ask For Qualifications and References of Potential Contractors.

In New York City a small equipment supplier called RMI & Sons was declared ineligible for city contracts due to poor performance on previous contracts. The enterprising individuals at RMI renamed the company “Discount Machinery” and won several new contracts—only to be barred once again from city contracts when the scam was discovered. Undeterred by these setbacks, the company changed their name again and rose again to win new contracts as “Diversified Products of New York.”

Unfortunately, this was not an isolated case. Over a two-year period, New York City awarded four separate contracts to a company called Cipretto-Tolisano Associates which had previously been stripped of its corporate status by the state for failing to pay taxes.

CASE STUDY: Softub Reviews Potential Outsourcers in the Field

Softub, a California-based \$15 million a year maker of hot tubs, was having a difficult time with its outsourcers. In one case, the vendor went belly-up, costing Softub \$500,000 and a lot of headaches in trying to service damaged tubs themselves. "If we had done a better job surveying suppliers," reasoned owner Tom Thornbury, "this wouldn't have happened."²⁶

To rectify the problem, Thornbury created an audit team to go out in the field and interview potential outsourcing partners. The team spends anywhere from a couple of hours to several days with a prospect thoroughly reviewing their operations and getting a good feel for the way they do business. To guide the audit team, Thornbury created an audit survey form. "It forces the team to focus on specific areas so we don't forget anything when we're on a visit," says Thornbury.²⁷ One outsourcer was once knocked off the short list when an engineer who had been given a survey discovered a potential quality problem.

After all the information is in—and after the supplier's performance has been checked out with three prior customers—management picks an outsourcer. Since introducing the new approach vendor turnover has been cut in half.

To avoid such blunders, spend time methodically checking qualifications and references of potential contractors. A two-step process can be used: 1) Contractors are pre-qualified and; 2) Later only pre-qualified contractors can submit proposals. Alternatively, contractors can be asked to include their qualification information with their proposal and considerable weight can be given to their qualifications when making the award. This can save a lot of headaches later. Customer references are most important, but also ask for credit, financial and supplier references, resumes of key personnel, and legal problems.

It isn't hard for a contractor to manipulate the reference checking process by giving the public agency only a small number of contacts who have already been called in advance and prepped for the call. To stay in control of the process ask for a list of 10–20 references and pick which calls to make. If possible, site visits should be made to at least a handful of the references before choosing the contractor (see related case study). These safeguards will make it less likely that you pick a vendor who can write a good proposal but doesn't deliver a high quality service. This said, don't insist on unnecessary qualifications or requirements that won't guarantee you a better end result. Doing this will merely serve to limit competition.

B. Subject The Service To Competition.

Philadelphia was leasing Class C office space from a landlord that was looking for an 11 percent increase. When Mayor Ed Rendell found out that the city was being asked to pay \$33 per square foot, he threatened to move out. "I didn't care if we went to the City Hall Courtyard and erected a tent and put kerosene heaters in, we were getting out of that lease." With the possibility that the city might go elsewhere, the landlord negotiated a new lease—at \$7 dollars a square foot. "The vendor in this case was ripping off the city of Philadelphia to the tune of \$26 per square foot," says Mayor Rendell. "You have to convince your vendors that they have to perform if they want to keep their contract."

²⁶ *Inc.*, April 1995.

²⁷ *Ibid.*

Remember that it is competition, not the magic of the private sector, that makes contracting so effective. Consider carefully before you award a sole-source contract to anyone.²⁸

Don't define the desired end-result or scope of work so narrowly that only one contractor qualifies. There are very few services that are so special that only one company can provide them.

The decision to contract out is not a one-time decision. The goal is to maximize competition. Subjecting a service to regular competition forces current providers to sharpen their pencils and give you a better deal. Don't renew a contract unless you have clear information that the service was performed well under the last contract, and at a competitive price. Remember that companies are interested in profits, and it is up to government to see that they use competitive forces of the market to get citizens the best deal possible.

The City of Manhattan Beach, California, for example, had long contracted with the same waste hauler to pick up trash for its 12,000 residential units. Because there were no service problems with the hauler, several city councilmembers proposed to simply renegotiate the current contract. However, after a protracted debate, a majority of the council opted to open up the bidding to other firms.

Once all the bids were in, the city publicly revealed them for all the bidders to review. The bidders were then told: "Here is your chance to make your proposal better—go ahead and see what you can do."²⁹ This enabled firms to revise their proposals based on what other bidders had offered, and in the process created more competition.

In the end, the city's current waste hauler won the bidding war, but it was the city that was the big winner. Savings from the previous contract amounted to \$1 million a year.

Another way to increase competition is to break up the service area into grids and bid out numerous contracts, stipulating that no one contractor will be awarded all the bids. Such yardstick competition allows public officials to verify information supplied by each of the firms and assess the impact of certain common factors on relative performance.³⁰ It also increases the public sector's leverage over contractors because they can easily turn over the contract to one of the other vendors in the event of poor performance.

²⁸ Eggers and O'Leary, *Revolution at the Roots*, p.356.

²⁹ William D. Eggers, ed, "Competitive Government for a Competitive Los Angeles," Reason Foundation Policy Study No. 182, (November 1994), p.31.

³⁰ World Bank, *Bureaucrats in Business*, p. 157.

Part 5

Monitoring and Evaluating Contractor Performance

For politicians and the media, the exciting part of privatization projects is doing the new deals. Managing and monitoring the contract relationships is a lot more pedestrian and a lot less sexy. But make no mistake about it, it is every bit as important.

—Tom Olsen, Director, Enterprise Development, City of Indianapolis³¹

A. Introduction

As more governments rely on private companies to deliver public services, monitoring and assessing these outside partnerships becomes vital to achieving an administration's goals.

While monitoring and measurement systems are becoming more refined, the public sector, in particular, still has a long way to go in becoming a better purchaser and overseer of service delivery. “Public sector decision makers have yet to learn from the private sector the significance of managing outsourcing,” explains Dr. Jonas Prager of New York University. “Efficient monitoring, though costly, pays for itself by preventing overcharges and poor quality performance in the first place, by recouping inappropriate outlays, and by disallowing payment for inadequate performance.”³²

Even when governments do an adequate job monitoring a contractor, it is often only in terms of monitoring inputs, which provide little information about the actual quality of service delivery. “We do a fine job of monitoring contractors. We make sure they have the number of employees they say they have and that their pencils are sharpened and that forms are filled out

³¹ Tom Olsen, interview with the author, June 18, 1996.

³² Jonas Prager, “Contracting Out Government Services: Lessons from the Private Sector,” *Public Administration Review*, March/April 1994, Vol.54, No.2, p.182.

Best Practices for Monitoring and Managing Outsourcing Contracts

In conjunction with Andersen Consulting, the New York-based Outsourcing Institute has identified seven common elements of well managed outsourcing relationships. These are:

1. Objective performance criteria that are negotiated, measured and reviewed.
2. Formal reporting structure.
3. Performance-based pricing.
4. Internal training and communications on the company's business goals and on how to manage the relationship.
5. Vendor training on a customer's business environment and goals.
6. Cultural normalization (the provider must understand that every organization has its own culture).
7. Ongoing exchange of knowledge and expertise.

Source: The Outsourcing Institute, New York, NY. 1-800-421-6767

correctly,” says one county director of social services. “What we don't do a good job of is *evaluating* the contractor's performance.”³³

How many people are needed to monitor contracts? What should they be doing? What kinds of internal structures are needed as governments shift from service provider to service facilitator and purchaser? These are the types of questions that must be addressed in a systematic way as governments embrace competitive service delivery.

B. Establish a Monitoring Plan Before You Contract

Think about how you are going to monitor the service/contract *before* you issue the RFP or sign the contract. The monitoring plan, sometimes called a Quality Assurance Plan (QAP), defines precisely what a government must do to guarantee that the contractor's performance is in accordance with contract performance standards.

Consequently, the better the performance standards, the easier it will be to effectively monitor the contract. “The design of the deal can make an enormous difference in the future success of monitoring the contractor,” says Tom Olsen of the City of Indianapolis. “Strategic thinking on monitoring needs to begin at the time a deal is structured, not after.”³⁴ Such interdependence means it makes sense to write the performance standards and the monitoring plan simultaneously.³⁵

³³ Anonymous source, interview with the author, October 1995.

³⁴ Tom Olsen, interview with the author, June 18, 1996.

³⁵ Office of Federal Procurement Policy, “Performance-Based Contracting,” p.23.

The monitoring plan should be quantifiable and specific and include reporting requirements, regular meetings with minutes, complaint procedures, and access to contractor's records (if necessary). Decide how many persons are needed to monitor the service and who these individuals are.³⁶ The plan should focus on monitoring and evaluating the major outputs of the contract so monitors don't have to waste too much time and resources monitoring mundane and routine tasks that aren't central to the contract.

1. Problems in Fairfax County

The lack of a well-thought-out monitoring plan can doom a privatization. In March 1994, the Fairfax, Virginia County Board of Supervisors contracted out its fleet-maintenance operations at the West Ox garage to Johnson Controls World Services. But plagued by problems and political opposition to privatization, the contract was terminated by the board just three-and-a-half months later.³⁷

Why did the privatization effort fail? The causes are complex, but one contributing factor was that the county used displaced—and disgruntled—former garage foremen to monitor the performance of the contractor.

The quality-control inspectors rejected 40 percent of the repaired vehicles they inspected. Johnson Controls contends that the inspectors were unreasonably strict and often arbitrary. Prior to the contract, the county had not conducted quality-control inspections. And once notification was given that the Johnson Controls contract would be terminated, the quality-control inspections by the county ceased.

Fairfax County failed to follow two of the cardinal principles of effective contract monitoring: objectivity and independence. The contract administration unit should be located in a ~~different department from the~~ one recently delivering the service and the contract monitors should not have a vested interest in returning the service to in-house delivery.

<p>Monitoring Methods</p> <ul style="list-style-type: none"> • Percent Inspections • Random Sampling • Periodic Inspection
--

- Customer Surveys
- Outside Firm

C. Tailor Monitoring Strategies to Each Individual Service

Theoretically, governments could expend an almost infinite amount of resources on contract monitoring. Because taxpayer dollars are scarce resources, however, governments must develop priorities for which services need monitoring and at what levels.

³⁶ Eggers and O'Leary, *Revolution at the Roots*, Appendix A.

³⁷ *Privatization 1995*, John O'Leary (ed), Reason Foundation, 1995, p. 16.

Different services require different types—and levels—of monitoring. Monitoring strategies that would be very effective for street resurfacing may be inappropriate for data processing.

Some services require less overt monitoring than others. For highly visible services that directly affect citizens such as snow removal and garbage pickup, poor service will be exposed through citizen complaints. For complex or technical services, it may make sense to hire a third party to monitor the contractor.

Determining the appropriate technique for and level of monitoring for a given service depends on several factors, one of the most important being the level of acceptable risk for nonperformance. Where there exists a high level of risk for even minor problems—aircraft maintenance, for example—high-cost and high-control preventive monitoring techniques are necessary.

D. Create a Partnership of Trust with your Contractor

In addition to choosing the wrong people to monitor the contract, Fairfax County also made another mistake. Monitoring was viewed in an adversarial fashion, rather than as a preventive function. The contractor should be considered a strategic partner and given incentives to innovate, improve, and deliver better customer service.

For this to happen, performance targets must be mutually understood. Another private education management contract that went sour was between EAI and Hartford, Connecticut. Hartford's contract with EAI to help manage the city's 32 public schools was mutually ended after 16 months.

In addition to having no control over personnel—as in Baltimore— a poorly written contract resulted in a lack of a mutual understanding of desired outcomes. Hartford's contract with EAI called for the company to be paid from any savings it could generate. One problem: they couldn't agree on what actually constituted a savings during the contract.” The key thing that did the experiment in was the lack of specificity about roles, responsibilities, payments, and outcomes,” says John McLaughlin, an expert on education privatization.³⁸ In other words, establishing a trust relationship requires structuring the right risks, rewards, benefits and opportunities in the early stages of the contract negotiation stage.

1. Clearly Defined Escalation Procedures

The vendor and contractor should each designate individuals to communicate on a regular basis. Many private companies schedule meetings once a month to review the status of the outsourcing relationship.

³⁸ Donna Harrington-Lueker, “The High Flyer Falls,” *The American School Board Journal*, April 1996, p.32.

Another common practice is to form permanent free-standing committees that provide an institutional forum for resolving problems and evaluating the partnership. Often, organizations will set up a multi-tier structure to facilitate issue resolution. One committee is responsible for operational issues; one for technical issues; and a senior executive committee may meet quarterly or twice a year to discuss strategic issues.³⁹ At Eastman Kodak, which outsources its information technology functions to IBM, a management board of senior Kodak and IBM officials meets at least twice a year to hash out issues, while an advisory council of technical people gathers once a month to hammer out more tactical and operational issues.⁴⁰

From a legal standpoint, it is helpful to have an agreement for solving disputes before they go to the courts. Explains Vaughn Hovey, director of information processing services at Kodak:

*Outsourcing is a collaborative relationship that has to be worked on. The lawyers are very helpful in structuring a contract. Our job is to make sure we don't need them throughout the year. When the inevitable financial tensions arise, we have been able to have a "closed door" meeting of several financial people from both sides and share our mutual objectives...Both sides feel a lot better when it is over.*⁴¹

One option is to create a partnership agreement of mutually developed performance goals and dispute resolution procedures signed by both parties. Such agreements clearly define escalation procedures (for example, line manager to functional executive to the senior executive team). The goal is to create "buy in" from both parties. Experience suggests such partnering agreements can produce more timely performance, less paperwork and fewer disputes.⁴²

In addition, both parties can agree in the contract to use Alternative Dispute Resolution (ADR) techniques—facilitation, mediation and mini-trials—instead of resorting to litigation. The Navy has used ADR techniques for almost 15 years and has been able to resolve disputes in nearly all cases in which it was used.⁴³

2. The Nike Model

In building a relationship of trust, public officials might take a cue from the private sector, where many companies have built successful partnerships with their outsourcers. The Nike Corporation, for example, has had tremendous success outsourcing many important aspects of their operations.

³⁹ Mike Corbett, Outsourcing Institute, interview with the author, July 8, 1996.

⁴⁰ F. Warren McFarlan and Richard L. Nolan, "Outsourcing at Kodak," *Sloan Management Review*, (January 1995).

⁴¹ Ibid.

⁴² "Guide to Best Practices," Office of Federal Procurement Policy, p. 31.

⁴³ Ibid., p.33.

Nike doesn't even make their flagship product: Air Jordans. It outsources 100 percent of its athletic footwear manufacturing to production partners abroad. To ensure top quality in its products, Nike puts its own people in each factory to monitor the contractor's performance. These Nike “expatriates” become permanent personnel in each factory producing Nike footwear, usually staying for several years.⁴⁴

Similarly, when the City of Indianapolis decided to outsource its entire information technology (IT) system to the SCT corporation, it retained the position of chief information officer (CIO). Sitting on the CIO's staff, is SCT's site director for the outsourcing contract. The director remains an SCT employee but has been integrated into the city's organizational structure.

Successful organizations like Nike and the City of Indianapolis have close personal contact with their contractors at the floor level and firm mutual understanding of needs and expectations at the top management level.

E. Invite Prospective Contractors to Explain How to Assess their Performance

Though public officials are ultimately responsible for determining what outcomes and outputs they want achieved, contractors can provide helpful advice in developing the performance indicators that tie a vendor's performance to these objectives.

An informal survey of contractors can assist public officials in figuring out which performance indicators are important for a particular service. In many cases, the individuals drawing up the RFP or contract may be unfamiliar with the intricacies of the service and thus unaware of the full range of possible performance indicators.

One advantage to this approach is that it reduces the likelihood of serious misunderstandings arising over the nature of the performance standards during the course of the contract. Furthermore, it should result in a more precise Statement of Work which in turn should increase competition because all contractors will be submitting proposals based on mutually developed performance indicators rather than on differing interpretations.

Take care, however, to keep your ears open for self-serving suggestions. Don't talk exclusively with one contractor, or rely too much on contractors for writing the specifications.⁴⁵

F. Create a Management Information System to Evaluate Contractor Performance

⁴⁴ Eggers and O'Leary, *Revolution at the Roots*, p. 354.

⁴⁵ *Ibid*, p. 357.

The best performance indicators in the world are useless unless they are accompanied by a system to track whether the standards are being met. In *Privatization: The Key to Better Government*, E.S. Savas writes of how during the 1980s, New York City drew up exacting performance standards for its street-light maintenance contractor. For example, all lights had to be fixed within ten days of being reported or a daily financial penalty would be levied.⁴⁶ Unfortunately, the city didn't have a clue about whether the standards were actually being met because no records were being kept of how long it took to repair the lights.

In the private sector, Intel, Hewlett Packard and other computer companies have developed elaborate software systems to monitor, track and record the performance of their outsourcers.

Another possibility is to link the evaluation system with a citizen complaint hotline. This is a good way of obtaining data on customer satisfaction. For maximum impact, the results of an analysis of a random sample of calls can be presented in the weekly cabinet meetings.

1. Indianapolis Initiative Management (IM) Review Process

By the time the City of Indianapolis had competed out nearly 70 different services over a five-year period, keeping track of the performance of all these relatively new projects had become a daunting task. In essence, the city had a portfolio management problem. With a number of contracts soon coming up for rebidding, Mayor Stephen Goldsmith decided he needed to get a better idea of actual contract performance and of the quality of the city's monitoring and evaluation systems.

“We needed reconfirmation that each of the deals was being managed effectively,” explains Tom Olsen, a senior city official. To meet this challenge, Initiative Management Reviews (IMRs) were launched. Indianapolis' Enterprise Development Group, the in-house unit responsible for initiating many of the competition projects, was put in charge of conducting performance and risk assessment reviews of city privatization and competition projects.

One task of an IM team is to determine the adequacy of current contract resources, personnel, procedures and monitoring systems for any given service. The review team also takes a hard look at performance measures, comparing actual performance to the measures. When appropriate they will recommend changes in existing measures.

One IM review of a three-month old parking enforcement contract found the contractor's productivity to be below expectations. Fault could be placed both with the city—for equipment failure and a repair backlog—and with the contractor—for problems in recruitment

⁴⁶ E.S. Savas, *Privatization: The Key to Better Government*, (Chatham, NJ: Chatham House Publishers, Inc, 1987), p. 270.

and training. Soon after the IM team highlighted the problem, there was a sharp uptick in productivity.

A major element of the review process is determining the relative risk of each of the outsourcing projects. The higher the risk of nonperformance, the higher priority the initiative will be for an IM review.


Internal sourcing agreements—services for which in-house units have won the bidding competition—are considered to carry a greater risk of performance failure due to the heightened difficulty of establishing accountability for outcomes when an organization is essentially monitoring itself. Accordingly, these services are top priorities for the reviews. “It’s especially important to have a third party involved because of all the complex intramanageial issues involved in the internal sourcing agreements,” says Olsen. “We see the need for auditing and evaluating these services to be even greater than for those services being delivered by a private vendor.”⁴⁷

The IM review team’s goal is to achieve an average review cycle time of 2.5 weeks per review. At four staffers and 42 net weeks a year, this would amount to 67 reviews a year.

G. When Possible Organize the Service such that Quality is Ensured by Market Incentives

In the private sector, the market naturally provides quality feedback—sometimes painful feedback—that tells a firm how it is doing. If a company isn’t treating their customers right, they go elsewhere. But a government monopoly, such as the Department of Motor Vehicles, the Post Office or a public school, has about the same demand regardless of service quality. There’s nowhere customers can go.

Two Models of Performance Measurement



<u>Funder Evaluation</u>	<u>Consumer Evaluation</u>
1. Funder	1. Consumer
2. Supply Driven	2. Demand Driven
3. Funder	3. Consumer
4. Contract Termination	4. Consumer Exit
5. Administrative	5. Market-Like
6. Limited	6. Varied

The most powerful way of ensuring high-quality service delivery from providers is by giving customers the power of exit. Numerous public services can be organized so individual customers have the power to choose their own provider and leave them if they are unhappy with the service quality.

1. Internal Markets

⁴⁷ Tom Olsen, interview with the author, June 18, 1996.

For internal support services—building repair, fleet maintenance, computer maintenance, printing and training—market forces can be brought to bear by allowing internal customers to reject the offerings of internal service providers if they don't like their quality or if they cost too much. These are called internal markets.

In the early 1990s, Milwaukee Mayor John Norquist was hearing complaint after complaint about the cost and quality of the city's internal services from department heads: they had to wait weeks for a repair; the training wasn't tailored to their needs; the garbage trucks were breaking down and so on. The department directors felt frustrated; there wasn't anything they could do about the poor service quality because they couldn't take their business elsewhere.

Ann Spray Kinney, Milwaukee's former Director of Administration, explains it this way:

It was akin to going shopping for a new car, say you want a Jeep, but someone has already given your money to the Buick dealer, which doesn't make Jeeps. What's more, chances are you're going to get what the Buick dealer wants you to have when they want you to have it because they already have your money.

To rectify the problem, Mayor Norquist turned to the market. The city began letting departments purchase six different internal services, with a total budget of over \$43 million, from private firms instead of city departments if they could obtain a lower price and/or better quality.⁴⁸ Rather than setting rules and guidelines for improving the quality of their services, the program essentially says to internal units, "If you want to survive you must become competitive."

Milwaukee's Internal Market Project

\$ Worth of Services

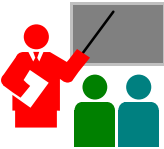
- \$43 Million

Internal Services

- Computer maintenance, building repair, training, printing, fleet maintenance

Results

- Cost savings, improved service and morale, ripple effect



The program, launched in 1992, quickly produced results. In the first few months, the private-sector bids were much lower in every case—averaging 44 percent less.

One service bid out was the painting of the interior of a fire station garage. Over the years, the building maintenance department had always scheduled the painting for November when diesel-engine trucks couldn't be kept outside due to the cold. Thus, painters, using brushes and rollers, were interrupted each time the trucks came into or left the station house.

When the Fire Department went out to the marketplace, a private bidder quickly figured out that if the job were done in the summer then the trucks could be parked outside and the walls

⁴⁸ Eggers and O'Leary, *Revolution at the Roots*, p. 117.

could be spray painted, thus dramatically lowering labor costs. And for the first time, the Fire department got to pick the color. The lightbulb went on for the buildings department. They should be scheduling to meet their customers' needs, not their own.

Many private companies have also created internal markets to force their support units to adopt a more customer-oriented philosophy. Thompson Fulfillment Services, which handles telemarketing, list management, and customer service for Washington, DC-based Thompson Publishing has to compete against outside firms for all its work with its parent company. This keeps the junior partner on its toes. "I see them as my best clients and harshest critics," says Karen Lankford, Thompson Fulfillment's general manager. "They expect more from us than an outside vendor, and we try to give them more."⁴⁹

⁴⁹ Tom Peters, *Liberation Management: Neccessary Disorganization for the Nanosecond Nineties*, (New York: Knopf Publishers, 1992).

Part 6

Outsourcing Management and Personnel Issues

A. Create A High-Level Executive Position and Specialized Unit to Manage Outsourcing Relationships

The successful operation of a given government increasingly depends on being able to manage a network of service providers and market-based arrangements (vouchers, internal markets and public-private partnerships). Doing so effectively requires creating a new high-level position whose responsibilities include establishing, maintaining and cultivating outsourcing relationships. This individual would have experience in, or be trained in, the following:

- ✓ Identifying privatization opportunities and potential contractors;
- ✓ Overseeing the Request for Proposals (RFP) process;
- ✓ Evaluating vendor proposals;
- ✓ Managing outsourcing relationships; and
- ✓ Monitoring contractor performance.

To be sure, most government organizations have individuals in their purchasing department with some or all of these skills. However, as privatization becomes an increasingly important component of a government's mission, more senior, politically-connected individuals are needed to standardize the process, develop performance standards that adhere to the administration's mission, and drive the privatization process through the bureaucracy. These new government executives will have to handle a variety of complex issues and relationships like employee transitions; asset transfers; developing outcomes, performance goals and penalties; termination; dispute resolution; and risk management.⁵⁰

In addition, a centralized unit, where a critical mass of knowledge over privatization issues is developed, should be established to manage the privatization process. Such a unit would also

⁵⁰ Michael Corbett, *The Source*, The Outsourcing Institute, Fall/Winter 1994, p.5.

act as an institutional advocate for privatization—publicizing successes and riding herd over departments that drag their feet.

B. Incentivize the Monitors

Any student of governmental systems shouldn't be surprised by the difficulty some governments have setting up effective monitoring and evaluation systems. The institutional constraints and lack of incentives that hamper governmental efficiency and service quality do not disappear when governments monitor contracts with private companies.

While such constraints can never be wholly eliminated, several techniques can be used to improve incentives for contract monitors.

The incentives should include the right combination of carrots and sticks. One option is to link monitors' performance evaluation and bonuses to the contractor's performance. The idea is to create an incentive for the monitor to work closely with the contractor to ensure high quality performance. Doing this can be tricky because you want to avoid creating an incentive to inflate the results of contractor performance. It's also important to avoid a situation that induces the kind of hyperzealous contract enforcement that will inevitably sour the contractor-contractee relationship. The Federal Office of Procurement Policy recommends giving an incentive award to contract monitors based on criteria such as amount of savings achieved, quality, timeliness, customer satisfaction and a minimum amount of technical contract changes.⁵¹

Another possibility is to contract with a third party to monitor a service contract. This is increasingly used by governments for large, complex and specialized services, where they lack in-house expertise to effectively monitor the contract. For example, the City of Philadelphia hired a firm specializing in nursing home care to monitor its nursing home contract.

⁵¹ "A Guide to Best Practices for Contract Administration," Office of Federal Procurement Policy, Office of Management and Budget, Executive Office of the President, October 1994, p. 17.

Part 7

Conclusion

Bringing competition to bear on public services through privatization, competitive contracting, internal markets, vouchers and other techniques holds tremendous promise to dramatically reduce costs and increase service quality. Realizing these benefits, however, requires putting considerable thought into devising the right mix of performance standards, financial incentives and contract administration, monitoring and measurement systems.

Implementing state-of-the-art performance-based contracting requires new evaluation techniques, new management approaches, improved top-level know-how on designing and managing contract relationships, better logistics systems, and a whole new set of skills for public officials. Perhaps most important of all, what is needed is a changed mindset where public managers are rewarded for effectively managing projects and networks of contractors rather than for the number of public employees under their command.

Part 8

Appendix

Additional Resources

William D. Eggers and John O'Leary, *Revolution at the Roots: Making Our Government Smaller, Better, and Closer to Home*, (New York: The Free Press, 1995).

John Rehfuss, "Designing an Effective Bidding and Monitoring System to Minimize Problems in Contracting," Reason Foundation *How To Guide* Number 3, 1993.

"A Guide to Best Practices for Performance-Based Service Contracting," Office of Federal Procurement Policy, Office of Management & Budget, April 1996.

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World Bank, *Bureaucrats in Business: The Economics and Politics of Government Ownership*, (New York: Oxford University Press, 1995) p. 143.

"The Executive Success Kit," New York, The Outsourcing Institute, 1996.

Susan A. MacManus, *Doing Business with Government*, (New York: Paragon House, 1992).

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