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Provides performance contract desired performance?

John de Croon *24 January 2014*

Sometimes it happens that a title of an article triggers immediately. That is what the title “Public district board seeking for ideal performance contract" did in the Dutch magazine 'Maintenance' of last December. Indeed, the title implies that the idea of a performance contract is already chosen. The question is whether a performance contract does always make sense for the asset intensive businesses.

tatiecontracten voor het uitbesteden van onderhoud aan rwzi's. DI-WCM bracht ze in contact met de Universiteit van Tilburg.

Waterschap op zoek naar ideale prestatiecontract

Voor wie het nog niet wist: de waterschappen staan behoorlijk onder druk. In 2011 wilde een meerderheid in de Tweede Kamer de waterschappen nog opheffen. Eerste stap zou zijn om het aantal waterschappen terug te dringen via fusies om vervolgens stapsgewijs over te gaan naar vijf nieuwe landsdelen. Het is nog niet duidelijk of dit voorstel daadwerkelijk wordt ingewilligd, maar het geeft wel aan onder welke druk de waterschappen moeten presteren. De taken van de waterschappen zijn het eenvoudigste te omschrijven als de

terschapsbedrijf Limburg sloten de geleden om gezamenlijk te onderzoeken welke uitbestedingsvorm het beste aansloot bij hun wensen. DI-WCM bracht de partijen in contact met de Universiteit van Tilburg en vond een match in de persoon van Bart Vos, NEVI-hoogleraar Inkoopmanagement binnen het departement Organisatie en Strategie aan de Universiteit van Tilburg. Samen kwamen zij tot het Purgatio-project: een onderzoek naar het werken met prestatiecontracten voor onderhoud van grote afvalwaterzuiveringsinstallaties.

partijen en analyseren waar die belangen kunnen botsen.'
In april 2013 zijn studenten van Tilburg University gestart met een quick scan. Vanaf september 2013 is een promovendus aan de slag gegaan met het verdere onderzoek. In 2017 wordt het promotieonderzoek afgerond. Dit is de eerste keer dat er op deze manier in Nederland onderzoek wordt gedaan naar prestatiecontracten bij waterschappen.

Nieuw regime

Source: Dutch magazine ‘Maintenance’ December 2013

We will first briefly describe the idea of a performance contract. In such a contract the performance of the supplier is made measurable and objectively assessable. Based on the supplied performance will be settled between the client and the supplier. Is the supplier performing better than the defined target, then a bonus is paid and a penalty is granted when the agreed performance is not met.

In asset management we distinct different roles[1]. In a performance based contract, the supplier to whom the services are outsourced receives the roles of asset manager and service provider. The contracting party becomes the asset owner role.

For a client the underlying purpose of a performance contract is a lower total cost of ownership and / or a higher performance of the assets and there is nothing wrong with that. In our sector performance contracts often include a long-term horizon, so the supplier is guaranteed with work for a longer period (think of DBFM: Design, Build, Finance, Maintain). So a performance contract sounds like a nice win-win situation for the client and the contractor, in which the client is cared after as well. Fine, right?

To adopt such an agreement first proper performance indicators are needed. The article cited correctly states that you must first make the interests of the parties very clear. That is quite right.

In the article in Maintenance it is also mentioned that traditional contracts contain no incentive to work more efficiently. We however do not always agree. We know that there are infrastructure managers who outsource work to different service providers and benchmark the services of the service providers on an annual basis. This then is input for improving efficiency. These contracts generally have a term of 5 to 7 years, of which the efficiency improvement is a part.

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[1] See our column of 2 December 2011 on the sense and nonsense of splitting roles

Performance contracts may have disadvantages: some considerable risks can be introduced. For example, what happens if in advance the performance indicators are not made very clear or the contractor can meet the required performance relatively easy? We have actually seen that the contractor was 'having a party' during several years in a row because a big bonus was secured every year. The client (so asset owner) scratched behind his ears disillusioned and a discomfort feeling remained[2]. The KPIs were not defined ambitiously enough, and there was no room left in the contract to increase the required performance......

Because the performance contract in the asset intensive sector often include a long-term horizon, this means that the client and the supplier are committed to each other for a long term. Characteristic of the lifetime of assets is that these often last more than 50 years; (much) longer than the period of the performance contract. When the discomfort remained with the asset owner in the example just mentioned, this asset owner wanted to outsource the services to another party at the end of the contract period. However, when the asset manager role is outsourced to a third party, the knowledge to assess risks and determine whether the mitigation measures have the most added value is outsourced as well. And not only that, detailed information to perform risk analysis is not available for an asset owner. This kind of knowledge is not obtained easily. In short, the expected benefit can fairly easily be offset by the learning curve when the supplier for asset management services is changed. This learning curve does not only deal with the less efficient execution of the service for a number of years, but also in case of a failure a not (yet) competent contractor requires a lot more time to find the root cause of the failure and put the asset back into operation.

Sometimes asset owners have not yet clear what the objectives of the assets should be in the long term. After all during the contract term a lot can change. Yet in such a case it happens that asset owners close performance contracts without an option for an escape. We do not have all the wisdom, but why in such a case a performance contract would be better than a contract with limited duration and a fixed price or even in time and material, someone should to explain to us.

The title of this column is formulated as a question. The answer depends on whether the assets are unique and critical. For critical (but not unique) assets a substitute can be arranged. But for unique critical assets this is not the case and we find it unwise to outsource asset management on basis of a performance contract. The potential disadvantages far outweigh the intended benefits: you need to manage unique critical assets yourself. So in this case there is no need to seek for a performance contract.

Does a performance contract never make sense? Yes it does, for ancillary equipment (e.g. think grass mowing, facility maintenance) it may indeed be interesting, as well as for critical assets for which a replacement (or substitute function) is available. But here is a caveat: in order agree a performance contract, it is important to have a stable organization (and associated processes of course) in your own organization. It is often thought that in case of outsourcing an 'in control' problem is solved, but that is not the case!

The last sentence in the article in Maintenance gives us some comfort, you should always need to be aware for generalization. We heartily agree, except in the case of this column.

John de Croon is partner at AssetResolutions BV, a company he co-founded with Ype Wijnia. In turn, they give their vision on an aspect of asset management in a weekly column. The columns are published on the website of AssetResolutions, www.assetresolutions.nl/en/column

[2] It was about gas turbines, generators, boilers, etc.