This installment introduces the reader to the performance relationship shared between and among contracting and logistics. Primary emphasis is focused on performance-based contracting/acquisition.

Part II — Merging Acquisition and Logistics in a Performance-Based Environment

This publication is Part II of a 4-part series providing key insights into performance-based logistics (PBL). Part I of this series introduced us to key logistics concepts and an overview of supply chain management (SCM) supporting the rise and acceptance of PBL as a natural extension of SCM. This installment introduces the reader to the performance relationship shared between and among contracting and logistics. Primary emphasis is focused on performance-based contracting/acquisition. Part III is devoted to a review of performance-based logistics as a viable strategy that inherently employs industry best practices to achieve program cost, schedule, and performance improvements. This series closes with an eye on leadership's role as change agents in the quest for continued improvements in both the public and private logistics sectors.

Throughout its 25-year existence, the supply chain continues to be an elusive concept. Beginning as a term referring to the chain of suppliers that sold raw materials, the supply chain expanded as transportation and logistics became increasingly integrated to include other related and mutually supportive functions such as warehousing, materials management, and information technology. Largely speaking, a supply chain is nothing more than a network of companies that cooperate with each other—collaborate—for mutual gain. We refer to this day-to-day cooperation as supply chain management. The means for this collaboration is at the center of this installment.

So, why is it important to integrate supply chain management and performance-based contracting? In short, performance; specifically, attaining optimal performance. If logistics leaders are to expect organizations to act interdependently, the processes must first be aligned and linked together, thereby integrating critical flows—e.g., information, materials, and cash—between them. As the processes further extend and more deeply integrate, sole ownership of key processes is suspended in favor of collaboration. The supply chain is such an amalgamation. Optimal supply chain performance, therefore, depends on the execution of a precise set of mutually agreeable

actions. Regrettably, independent actions are not always in the best interest of interdependent members in the supply chain. As many can attest, well-meaning supply chain members naturally tend toward a self-serving focus, optimizing their own objectives at the peril of the most advantageous performance; however, optimal performance can be achieved by contracting a set of member-endorsed objectives aligned with the supply chain's overall objective(s).

A significant challenge, according to the work of Vitasek, Geary, Cothran, and Rutner (2006), is devising the appropriate contracting strategy. Generally, Vitasek, et al, contend, "the objective is to achieve a fixed price contract; it is a natural fit for buying designated performance outcomes at a predetermined price." The reality, however, is altogether different. Cost reimbursement contracts are typically necessary in the early phases of a performance-based implementation. This deviation permits the cost and resource baselines to mature until appropriate incentive metrics are developed and pricing risks are minimized. Such a shift in thinking demands, for some, a strikingly unfamiliar approach. It is no longer enough to simply attend to the planning stages of acquisition in the hope momentum will keep the project going in the right direction. Performing market research, defining requirements, and writing a performance-based statement of work, though critical components of a tradition contracting approach, will do little more than allocate risks to ensure the contractor or supplier complies with the terms and conditions of the contract. Indeed, terms and conditions are important to secure desired outcomes; however, a myopic view wrongly focuses attention on the issues of compliance, forgetting the primary objective of the contractual arrangement is to achieve stated outcomes. Consequently, a performance-based contract in a compliance environment is apt to fail without extensive and deliberate follow-through coupled with proper, long-term administration.

By emphasizing an innovative contractual structure that rewards performance (and penalizes failure), a focus on outcomes rather than precise methodology is achieved. A sound, results-oriented, performance-based approach answers the question, "Did we get what we paid for?," keeping in mind results are not defined in terms of what is done but, rather, by the impact of what has been accomplished. In today's era of results-oriented contracting, contracts should spell out anticipated results, effectively measure contractor performance, specifically tie payment to performance (results), and maximize accountability. Holding contractors accountable for results is at

the crux of future contracts. But the story does not end there. Those same contractors must be given the flexibility to determine how best to succeed. That means the government, in particular, must learn how to control its appetite for micromanagement, create—and accept—accountability to the customer and, in its quest to responsively measure success, resist the propensity to create new reporting requirements without eliminating old ones. We shall revisit this notion of accountability. For now, suffice it to say accountability is critical; it constitutes the foundation for both the legitimacy and support that government needs to carry out its work. Focusing on results of that work may mean the contractor must perform many inherent government functions, perhaps in government facilities. Given that potentiality, it remains highly probable parties up and down the supply chain still have a lot to learn.

What, exactly, makes a contract performance-based? A performance-based contract is one wherein government describes the final product but leaves to the contractor any discretion for achieving the objective. Such contracts give public officials the opportunity to craft public-private agreements specifically tied to performance objectives. This approach is best described as an effective way to acquire quality goods and services, within available budgetary resources, to maximize performance, innovation, and competition. Requirements are articulated, typically in a statement of objectives (SOO), using anticipated results rather than methods of performance. Moreover, measurable performance standards (i.e., in terms of quality, timeliness, quantity, etc.), quality assurance plans, and specific procedures for reductions of fee or price when services are not performed or do not meet contract requirements are necessary. Perhaps the most important obligation is to embrace positive incentives for performance exceeding the minimum standard, wherever appropriate, in the contract.

Performance-based contracting enjoys a discriminating palette; several characteristics distinguish it from the more traditional types of government contracting. Typically, performance-based contracting:

- Solicits bids on the basis of what RESULTS (e.g., output, quality, and outcomes) to achieve rather than how the work is performed
- Defines clear performance expectations (e.g., due dates and milestones)
- Uses measurable performance standards (baseline vs. expected results) and quality assurance plans
- Provides incentives for performance
- Grants flexibility in exchange for accountability for results
- Is monitored to insure performance is achieved
- Expressly ties payment to outcomes

What are some of the expectations for performance-based contracting?

Because the intent is to pay contractors based on outcomes and performance rather than the processes or methodology used to deliver goods and services, positive expectations and benefits often associated with performance-based contracting are plentiful. In general, performance-based contracting:

Achieves cost savings
Benefits government and contractor
Cuts recurrent expenses
Demonstrates results
Encourages collaborative environment
Facilitates purpose-driven monitoring
Generates better competition
Helps control costs
Improves performance
Justly rewards good performance
Keeps reporting requirements to a minimum
Largely increases likelihood of meeting mission needs
Maximizes contractor buy-in
Needs less day-to-day monitoring
Ordinarily gives the contractor more flexibility to achieve desired results
Promotes contractor innovation
Quickly pursues better outcomes
Results in cost-effective procurement
Spawns better value and
Transfers risk to contractors
Ultimately streamlines contract administration
Values appropriate financial incentives to contractor
Wisely exploits shared interests
Yields better than hoped for results
Zeroes in on performance

What is the contract management process for performance-based contracts? Performance-based contracting, referred to as performance-based acquisition (PBA) by some, is a procurement strategy that structures all aspects of an acquisition around the *purpose* of the work to be performed. The contract requirements are set forth in clear, specific, and objective terms with measurable outcomes. The use of the word acquisition, rather than contracting, reflects the broader scope and the broader community that are a necessary part of the process. For contractors to be successful in this environment, they must embrace innovation, control costs, and still deliver a quality product. The Office of Federal Procurement Policy (OFPP) has published seven steps (below) to pave the way for program performance, improvement, and innovation (2001). Some minor variations are seen in the planning steps (e.g., Lampkin, et. al (2003), focuses on five key planning areas). However, all research underscores the importance of introducing the effort, creating a team, deciding what and how to measure, analyzing outcomes, and utilizing results.

OFPP's Seven Steps of Performance-Based Acquisition (2001)

1) Establish an integrated team.

2) Describe the problem that needs solving.

3) Examine private-sector and public-sector solutions.

4) Develop a PWS or SOO.

5) Determine how to measure and mange performance.

6) Select the right contractor.

7) Manage performance.

Logistics leaders extending supply chain management to the next logical horizon, performance-based logistics (discussed in greater detail with the next installment of this series), must gain a familiarity with the Federal Acquisition Regulation (FAR), specifically Subpart 37.6, if they are to better understand the mandatory elements of PBA:

1. A performance work statement (PWS). The statement of objectives defines requirements in clear, concise language taking into account the period of performance, deliverable items, and desired degree of performance flexibility.
2. Measurable performance standards to assess contractor performance.
3. The use of performance and financial incentives, when appropriate, in a competitive environment to encourage competitors to develop and institute innovative and cost effective methods of performing the work, and avoid combining requirements into a single acquisition that is too broad for the agency or prospective contractor to manage effectively.

Prudence suggests the reasoned logistics leader be prepared to handle the skeptics of a performance-based approach. Specifically, a performance-based approach "does not mean the government absolves itself of its responsibility. Rather the government focuses on what it knows best: its objectives, and looks to industry partners to propose solutions—based on their experiences and knowledge of the market place—that will best meet those objectives" (Mather & Nelson, 2006).

Skeptics notwithstanding, what implementation issues and barriers must be addressed to assure that performance-based contracting is successful? Performance-based acquisition has evolved over a period of robust trial and error in its association with performance-based logistics. Along the way, a number of issues and problems have surfaced. Awareness may help preclude repeating some of them:

- The newness and difficulty of measuring outcomes
- The fear of change

- A lack of knowledge about performance-based contracting (e.g., new terminology and an unfamiliar contracting approach)
- Identifying and developing meaningful, measurable performance standards that are not difficult to understand and/or complicated to implement
- Reluctance on the part of contractors to engage in a performance–based approach (e.g., non-performance leading to non-payment of expenses incurred)
- Data cannot be gathered and interpreted without good management information systems
- The shift of emphasis from processes to outputs
- Selling vendors on the concept of performance-based contracting (many have no experience with it)
- Performance requirements may be contingent on factors outside of the contractor's control
- Contractors may have limited financial resources and capacity to assume risk
- Contractors fear a cash flow crisis and financial uncertainty
- Contractors fear letting go of a system they know
- Contractors need to be given the opportunity to provide input in developing performance measures
- Contractors may have underdeveloped client and financial information management systems
- Contractors need assurance that it is a collaborative process
- Success depends on buy-in from contractors
- The anticipated risk or effort for contractors exceeds their return
- Multiple and even conflicting requirements may exist if a contractor has multiple contracts
- Performance measures must be balanced with compliance-based federal mandates
- Few examples of how to structure RFP and contract
- Developing a performance-based payment structure (e.g., fiscal penalties based on non-compliance)
- Overcoming state laws/mandates that restrict contractor's flexibility to execute performance-based contracts

These and similar challenges need not be daunting. Collaborative relationships (e.g., partnerships and teamwork) based on trust, open communications, and strong leadership are at the heart of the supply chain and need to be formed. At times, it may make perfect sense to establish such a relationship with former competitors. Staffs—and contractors—need to be brought up to speed with relevant performance-based training and education. Examples include:

- How to identify key performance indicators
- Establishing performance measures
- How to prepare a statement of objectives or, for the contractor, a performance work statement
- Incentives and penalties

Planning is another important element. We cannot overemphasize the need for sufficient planning before implementing a performance-based logistics contract. Planning efforts should consider identifying appropriate participants, establishing performance measures and desired outcomes in tandem with contractors and vendors, determining the current performance level, recognizing potential risks, evaluating what services and programs will benefit the most from a performance-based approach, and developing an implementation plan. A strategic plan may be helpful. Noticeably absent from this planning list is the notion of incentives.

Peter Drucker wisely suggests, *"What gets measured, gets done; what gets recognized gets done even better."* It becomes imperative, therefore, to carefully craft incentives for a performance-based contract that appropriately motivate the contractor to deliver the desired results. This may require going as far as encouraging offerors to propose them. What better way to align incentives with desired outcomes while demonstrating an understanding of the linkage between measurements and operational objectives? After all, the preferred performance-based logistics contracting approach is best satisfied through long-term contracts expressly tied to performance, where contractors provide integrated packages of logistics (Blumberg, 2006a). If they provide the integrated logistics package, why not have them suggest appropriate incentives?

An example may be helpful. Under PBL contracts let by the DoD, vendors are given incentives to meet or exceed measurable outcome metrics, and they can be penalized for falling short (Blumberg, 2006a). Because the DOD is paying for the results, PBL causes "a significant shift in risk to the contractor, who is accustomed to progress payments and minimal risk taking" (Blumberg, 2006b). "In reality," says John Kotlanger (2006), Partner in Performance-Based Logistics Programs (www.pblprograms.com), a consultancy advising commercial contractors on risk management with performance-based logistics,

> they've not been prepared to do it. It's a different business model than cost-plus, where the contractor can deliver inadequate products and services, as long as they meet the contract terms, and still the government pays them. Often, the government pays them to correct mistakes they made in earlier deliveries.

So, why make the effort? The short answer is money. As Kotlander points out, "a PBL [contract] can generate a 20 to 30 percent profit margin, yields far larger than the 5 to 7 percent margin common to traditional contracting. The risk is greater, and so is

the reward." In Kotlander's view, "The key to successful PBL contracting is risk assessment." That's why he suggests "the government can't buy PBL on the fly; the contractor has to understand [the] risk." No matter how complex a logistics acquisition, in a performance-based environment, this shift in risk is fundamental; it serves to align the interests of contractor(s) with those of the government.

To better accommodate this shift, *successful* PBL contracts generally have a statement of objectives (SOO) versus a statement of work (Blumberg, 2007). A PBL contract, according to Vitasek (quoted in Blumberg, 2006b), "outlines desired outcomes and criteria for understanding success. But it doesn't tell you in anal-retentive detail how to get there like traditional transactional contracts [do]. The contractor has flexibility on the details to hit the numbers." Consequently, contractors in a performance-based environment find ways to deliver better system performance at lower total ownership costs; they find themselves motivated to invest in infrastructure to increase the reliability of the parts they provide, to enhance system availability, and to create more efficient supply chains, yielding faster response times (Blumberg, 2006a).

How can the government ensure the logistics service provider will meet the required expectations? Conversely, how can the contractor ensure the government's expectations are clearly understood? When it comes to logistics, it is essential to keep customers satisfied. The preferred method is to establish key performance indicators (KPIs), high-level snapshots of a business or organization based on specific predefined measures. They are likely to include real-time supply chain information that focus attention on the tasks and processes deemed most critical to the government's success. Examples include on-time delivery, order-picking accuracy, on-time shipping, loss or damage.

KPIs are perhaps the most powerful tools logistics leaders have at their disposal to change the organization and move it in a new direction; they can drive unparalleled improvements or plunge the organization into chaos and confusion. The advantages of contractually establishing KPIs with logistics service providers are plentiful; however, the following eight reasons are among the most important to both supply chain managers and logistics service providers (Charron, 2006):

Characteristics of Effective KPIs
(Eckerson, 2006)

Aligned
Owned
Predictive
Actionable
Few in number
Easy to understand
Balanced and linked
Trigger changes
Standardized
Context driven
Reinforced with incentives
Relevant

1. KPIs establish the customer's expectations in terms of performance.
2. KPIs can provide an incentive (e.g., a bonus or gain share) to motivate better performance from the service provider.
3. KPIs offer an objective way to assess performance.
4. KPIs result in more consistent standards of performance across all logistics service providers in the supply chain.
5. KPI reports will enable the customer to compare the performance of one service provider to other providers of the same services—past, present, and future.
6. KPI reports can help identify the cause of on-going service failures.
7. KPI reports can increase customer communication and improve service over time.
8. KPIs can help companies avoid or reduce the number of disputes and the resulting costs.

When it comes to writing the KPIs into the PBL contract, *reasonableness* and *flexibility* are key considerations. For any number of reasons, implementing every known KPI and mandating their strictest compliance is not the best course of action for improving or standardizing logistics performance. Given the complexity—or uncertainty—of the program support, better ways to achieve the desired result are available.

What, exactly, are some of the key challenges of performance-based logistics contracting? The more serious challenges include the color of money (different fund sources require coordination), and how to define, measure, and reward high quality. Other challenges (Behn & Kant, 2006) emerge when performance-based logistics contracting:

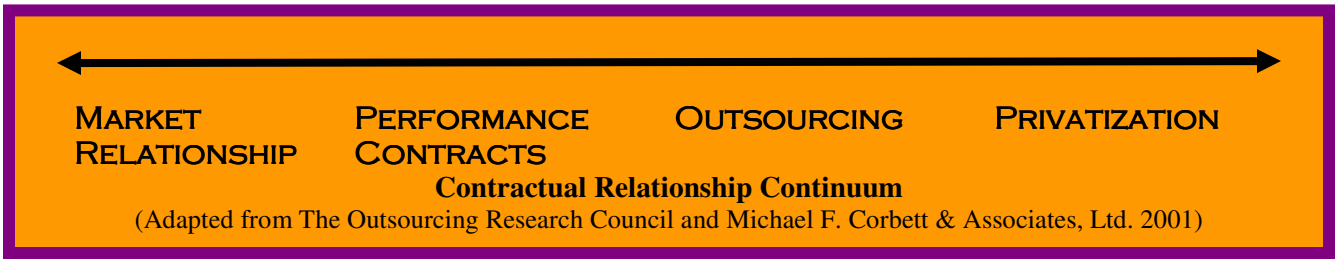
- Inhibits experimentation with new service delivery techniques to minimize uncertainty
- Encourages innovation in cost cutting but not in service delivery (i.e., what incentive does the contractor have to deliver a better product than is called for in the contract?)
- Inhibits a friendly, mutually beneficial relationship between government, contractors, and subcontractors. In the private sector, companies have an incentive to establish collaborative relationships with their subcontractors (e.g., in government, strict adherence to fairness prohibits such relationships from developing).
- Rewards promises rather than performance (unreasonable contractor claims go unchecked).

- Relies on measures that may distort behavior (imprecise objectives lead to less-than-desirable results).

How might some of the pitfalls be avoided? There are a number of ways to avoid many of the pitfalls. A few rules of thumb, as provided by Dr Michael LaFaive of the Mackinac Center for Public Policy (2000), follow. For instance,

- Selecting the right contractor is as important as writing a sound logistics contract. Ask for qualifications and references of potential logistics service providers to weed out those with little or no previous experience.
- Write provisions into contracts that require monitoring of specific services. Methods for monitoring, as outlined by the Reason Foundation, a policy research organization in California, can include everything from periodic and surprise inspections to customer surveys. An important point to remember is that some logistics contracts require more or less monitoring than others, and it is sometimes profitable to simply specify the desired result and let logistics contractors find a way to accomplish your goals.
- Time and materials contracts have been gradually abandoned in favor of performance-based contracts designed with incentives to reduce volumes of both time and materials.
- Most importantly, provide, when practical, market-style incentives for contractors.

In the PBL environment, *relationships*, not terms and conditions, make contracts work effectively. Contracting offers a variety of mechanisms to protect the government and reward the logistics service providers. Incentives and metrics should link directly and positively to risk, uncertainty, and complexity factors. Obviously, the greater the risk, uncertainty, and complexity, the greater the need to involve the contractor for a determination of the most practical incentive required to ensure the contractor will be successful. A two-step process for assessing performance may be useful. First, assess the incentive structure of the contract, the financial rewards, and the length of time available for contract extensions. Second, assess logistics performance metrics as the appropriate means to improve the value of contracted services by emphasizing objective, measurable, mission-related requirements from the contractor.



Contractual Relationship Continuum

(Adapted from The Outsourcing Research Council and Michael F. Corbett & Associates, Ltd. 2001)

A performance-based approach, Spong (2001) advocates, redefines Federal-contractor relationships by requiring logistics organizations to determine what is needed from its contractors, and then allowing the contractor's logistics leadership decide how best to accomplish work in accordance with mutually established program objectives, goals, and metrics. To get the most from performance-based logistics contracts, agencies must give their contractors greater flexibility in how work is to be done while holding them accountable for meeting those objectives, goals, and mutually established standards to measure performance (i.e., metrics). In so doing, the government benefits by receiving better performance, lower cost, reductions of contract time, and fewer administrative burdens, while logistics contractors benefit by having more control over their ability to earn profits based on performance. As time elapses, logistics leaders can expect this shift to performance-based contracting to result in clearer expectations for performance, better communication between the agency and its vendors, greater accountability for results, flexibility, and innovation, and reduced costs overall.

In our next installment, as we continue our journey through the contractual relationship continuum (above) from a logistics point of view, we will explore the basic tenets of performance-based logistics as a viable strategy that inherently employs industry best practices to achieve program cost, schedule, and performance improvements. As we improve our technique, it becomes highly probable PBL will best serve us as a springboard to the higher realm of logistics outsourcing, ultimately leading the government to a better understanding of the relationships inherent in logistics privatization—relationships where trust between customer and contractor is paramount (Blumberg, 2007). Bringing us back to a more practical level for the time being, Geary (2006) reminds us "performance-based logistics represents an entirely new way of thinking about the supply chain—one where the emphasis shifts to the customer's needs, not the supply chain's performance."

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