

Assessing service contracts against best practice

A diagnostic instrument from PCI Group

PCI has developed an instrument for assessing mission-critical service contracts against best practice



This document outlines an instrument to assess key service contracts against best practice:

- Self-assessment against best practice / against a wider user group
- Identify strengths & areas for improvement
- Promote awareness / action in 'blind spots'

Started with one of Australia's largest infrastructure owners:

- PCI study of trends & best practice in critical peer-group contracts (Attachment 1)
- Initially oriented to physical assets (Attachment 2)
- Instrument to assess contract design and performance (Attachment 3)
- Applies to any mission-critical service contract intended to:

Keep operations running well in real-time – at minimum whole-of-life cost

PCI's service contract assessment instrument calibrates 20 attributes against best practice in four critical areas



Scope and term:

- Does the scope of services under the contract – and contract term – enable the supplier to have a real influence on outcomes desired by the client?

Compensation framework:

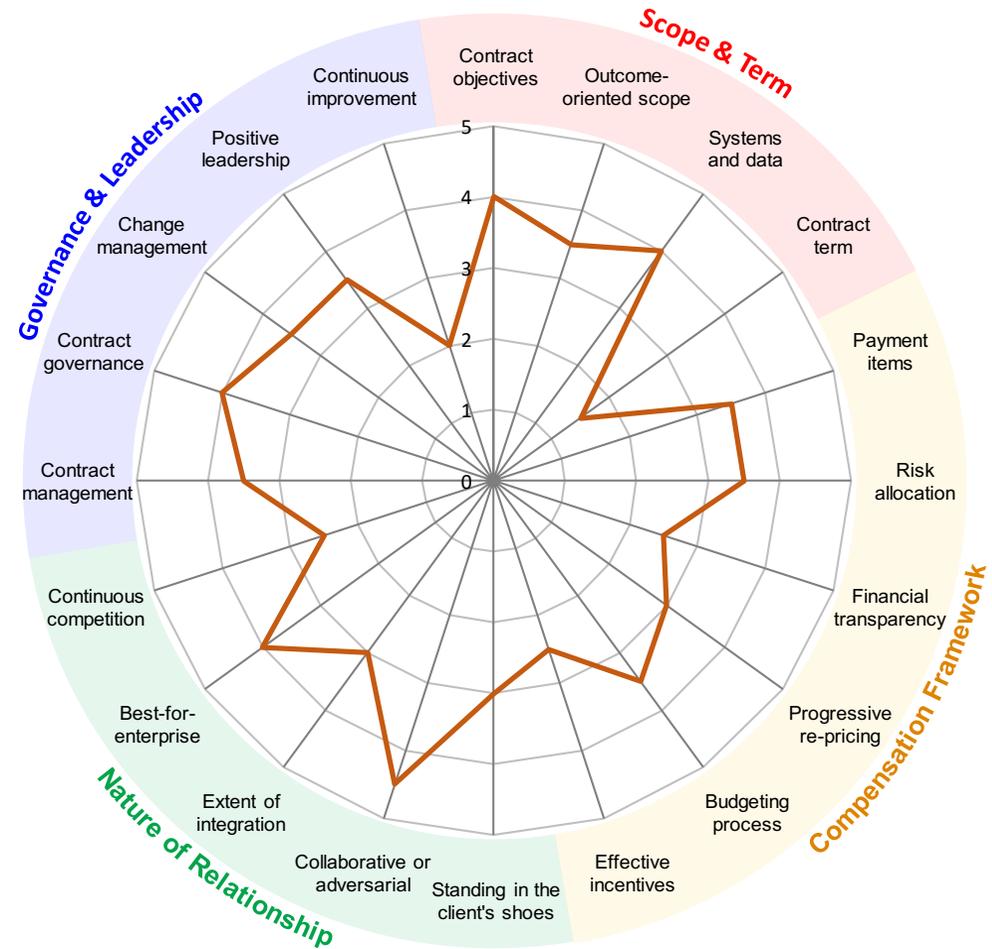
- Is the service provider paid to do the right things? Do implicit and explicit incentives align the parties' interests?
- Are financial arrangements fully open, and do they enable periodic efficient re-pricing?

Nature of relationship:

- Are inter-entity relationships positive or negative?
- Does the relationship support the service provider to genuinely work in the client's best interests or for selfish benefit?

Governance and leadership:

- Are contract management and governance arrangements clear and effective?
- Does the enterprise have the quality of leadership required to get the best from the team and drive continuous improvement?



Rating 0 = poor practice / 5 = best practice

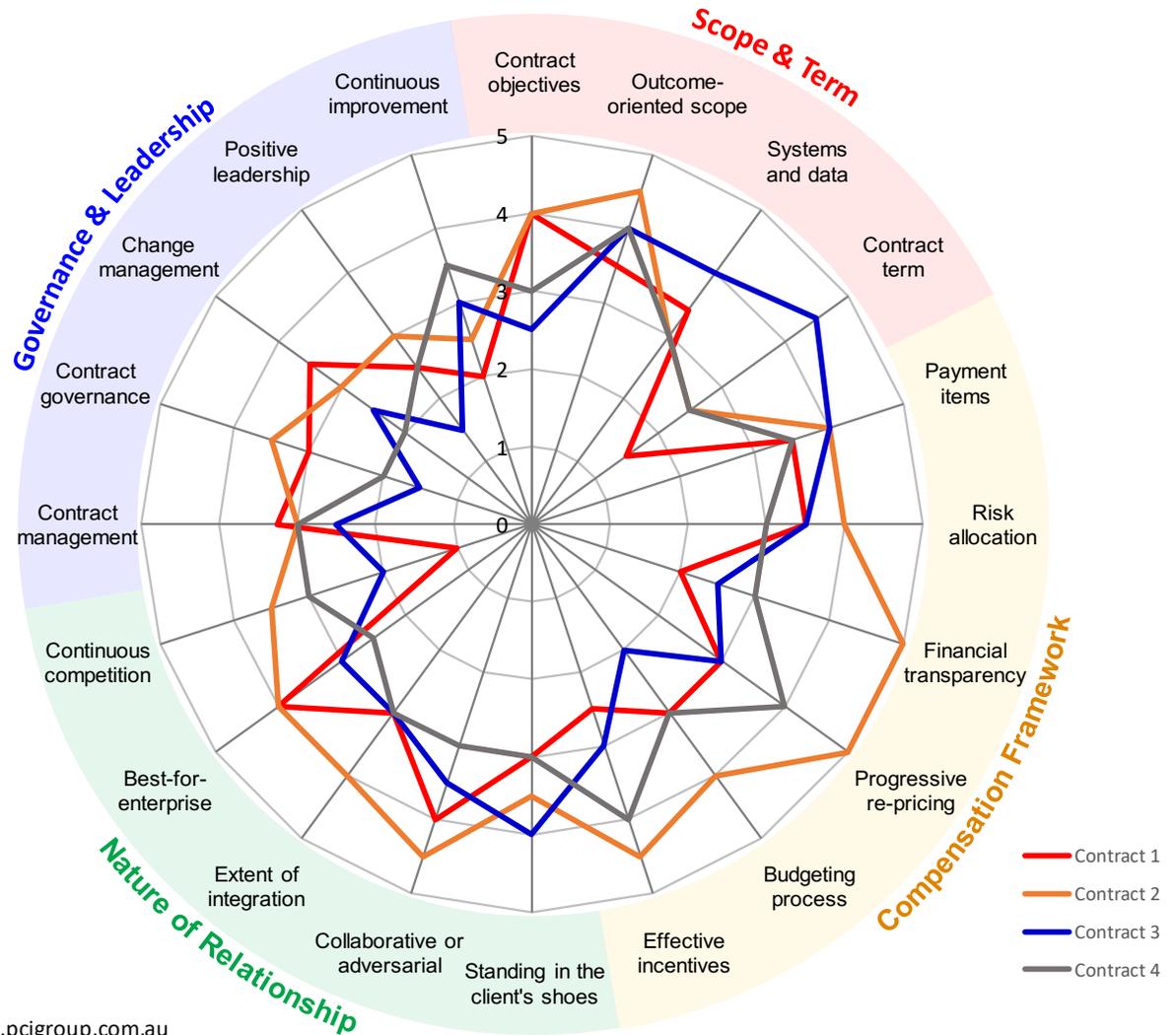
Assessing a portfolio of contracts can identify systemic opportunities for client-side improvements



This example compares several major service contracts managed by one organisation

Common themes for this client:

- Relatively strong scope & objectives
- Term of most contracts indicates insufficient confidence to commit
- Highly variable compensation arrangements
- Fairly good contract relationships
- Consistent weakness in Governance & Leadership attributes



For further information contact:

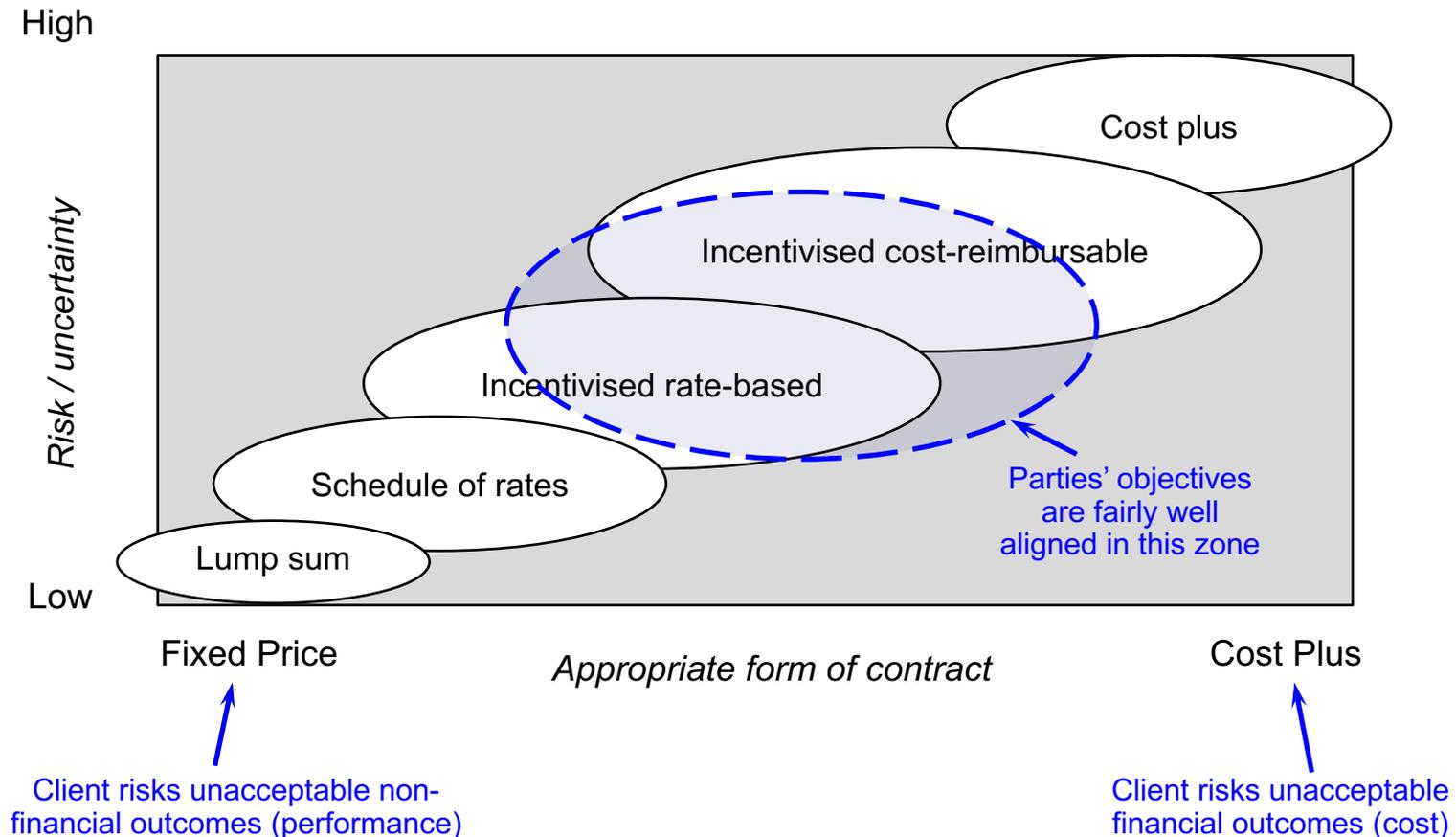


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Attachment 1: Critical service contract review showed that risk or enterprise uncertainty is key in selecting appropriate form of contract



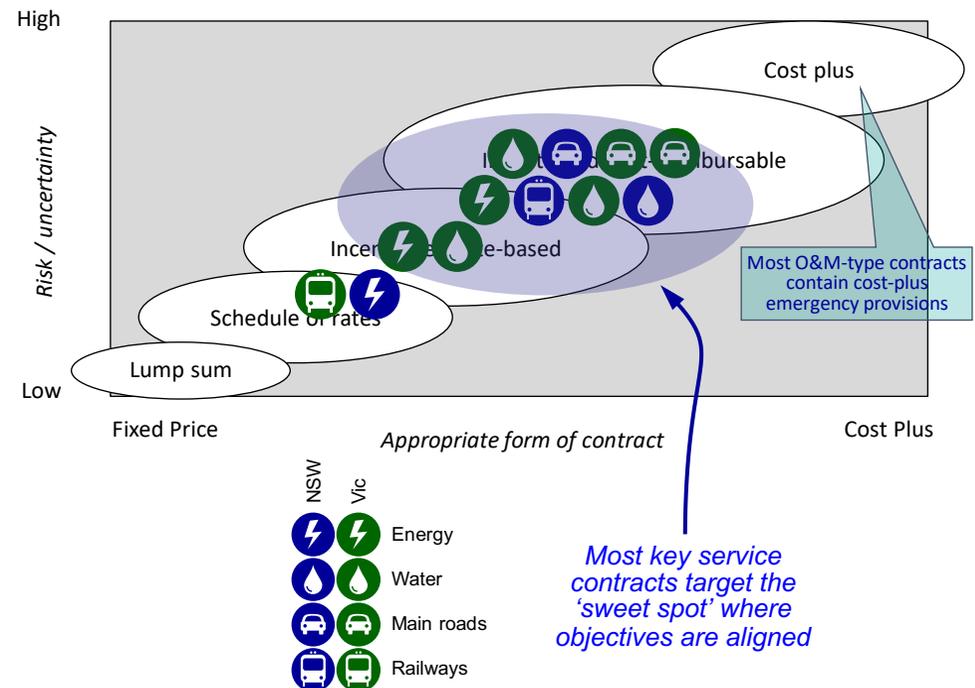
Format of service contract mainly driven by level of uncertainty re costs/inputs to achieve required outcomes – e.g. fixed price is fine for low-risk operations, but where uncertainty is high and performance is critical, clients typically retain more financial risk in order to reduce non-financial risks



Attachment 1 (continued): There is a distinct theme in evolution of major service contracts



- Clear preference for long-term arrangements in middle ground between fixed price and cost-plus (i.e. risk-share formula)
 - Consistent intention to align parties' interests i.e. avoid incentives to under- or over-service
 - Terminology less consistent than 'attributes'
- Long-term arrangements promote the right behaviours – but bring their own complications:
 - Difficult to fix long-term cost to achieve client's desired outcomes – need ongoing 'price' evolution
 - Risk of 'client capture' or gravitating to cost-plus – needs good contract relationship management skills
 - Service management decisions often need to involve both parties
 - Creates requirement for continuous improvement – success is patchy
- Many examples support need for strong relationships:
 - Broad evidence that positive relationships generate better & more sustainable client outcomes
 - Building trust – but not blind trust



Attachment 2: Examples of enterprise-critical service contracts across a range of industries reviewed by PCI



Privately-owned gas distribution network:

- 4-yr contracts (2 parallel contractors); combined 5-yr extension (best of two incumbents)
- Scope: routine & emergency maintenance plus non-exclusive capital works (limited asset mgmt.)
- Form of contract: cost-reimbursable + incentives
- Open book with 3rd-party audit
- Target cost = tendered rates for repetitive activities (routines & faults) & quoted costs for capex
- Contractor shares volume risk (faults work)
- Incentives: share of over/under-runs against target cost plus margin at risk on KPI performance
- Includes major KPI for client satisfaction – tailored to address prevailing issues & contractor response

Large regional rail network:

- 10-yr contract commenced 2012
- 300 people transferred from government to contractor
- 2,400 km rail track, hundreds of bridges, >1,000 level crossings (etc.)
- Scope includes network asset management, operations & maintenance & capital upgrades
- negotiated Annual Works Plan and target outturn cost (TOC)
- Profit exposed to share of cost over/under-run + 'quality'-related KPIs
- Open-book target cost model with independent audit process
- Mechanisms for controlling cost/budget migration & demonstrating value-for-money
- Significant effort fostering good relationship

Multi-site heavy industry:

- Evergreen maintenance contracts in place since early 2000s
- Major sites have different contractors but near-identical contract models
- Form of contract: Cost-reimbursable + incentives
- Profit at risk based on cost and KPI performance
- Good reliability outcomes - 'committed environment'
- Annual target cost based on negotiated schedule of rates
- Rates cover activities & resources
- Overhead budget fixed for +/-10% volume tolerance – i.e. shared work volume risk
- Joint approach to determining work priorities & budget management
- Excellent safety & reliability record
- Emphasis on relationships & planning for mutual success

Metro roads network:

- Client wanted the benefits of a performance-specified arrangement without losing control of longer-term asset condition
- 3 parallel zone-based contracts to give contractors real ownership, plus ongoing competition
- Contract terms extendable up to 10 years
- Contractors encouraged to innovate re inputs required to achieve defined outcomes
- Client controls long-term asset strategy, contractor controls short/med-term
- Mix of payment mechanisms depending on work type – fixed price for defined scope; target price for broad scope; cost-plus for emergencies
- KPI framework to focus contract management process and ensure overall outcomes are achieved

Attachment 3: Service contract attribute rating assessment summary

	Attribute	Level 1	Level 2	Level 3	Level 4	Level 5
Scope & Term	1. Clarity of client's objectives for the contract (intention of services, outcomes to be achieved through the contract)	Contract objectives are not articulated (either in contract documents, contract mission/vision statements or similar)	Contract states client objectives but limited outcome-orientation OR poorly related to 'Services'; no further vision statement etc.	Contract states 'Services' are intended to achieve stated objectives; vision statement (etc.) exist but limited practical impact	Contract gives equal status to desired outcomes and ('not limited to') defined activities, vision statement has prominence	Scope is primarily defined as to achieve defined objectives, jointly-developed vision (etc.) has real influence on conduct
	2. Alignment between desired outcomes and scope of contract (business process view, whole- of- process)	No alignment, scope is purely functional, cross- border process perform poorly, fractured accountability for client	Some alignment, scope largely functional but cross- border process managed carefully enabling some accountability for client	Fair alignment, cross- border processes are fairly seamless and contractor is happy to be largely accountable for outcomes	Good alignment, cross- border processes are minimised or highly reliable so contractor is substantially accountable for	Full alignment, scope of contract designed to enable contractor to be in virtually full control of critical outcomes
	3. Systems & data (clarity of responsibility for each IT system, effectiveness of interfaces, asset-related)	No clear strategy re which party owns each system, limited IT connectivity, asset data not specified or systematically captured	Evolving strategy re key system ownership, clunky IT interfaces, asset data capture spec not clear or applied consistently	System strategy fairly clear but not fully adopted, some clunky IT interfaces, asset data mostly specified and captured	IT accountabilities clear, working well with joint development path, most interfaces OK, specified asset data captured	Clear accountabilities reflecting parties' core competences, good interfaces, asset data captured consistently and utilised
	4. Contract term (term, extension options, criteria & process to adjust term)	Up to 2 years firm tenure and no extension options or clear extension criteria	3- 4 years firm tenure but no extension options or clear extension criteria	5- 6 years firm tenure with extension options but no clear process or criteria	6- 8 years tenure with clear process and criteria for changing term	8+ years or evergreen with clear process and criteria for rollover, curtailment, or scope adjustments
Compensation Framework	5. Basic payment items (inputs (resources) / outputs (tasks, jobs) / outcomes (client results)) (either fixed price)	50+% of base payment items are for inputs (e.g. various resources \$/hr, <50% are outputs (e.g. fixed \$/item)	25- 50% of base payments for inputs, 50- 75% for outputs (defined tasks e.g. pole replacement)	<25% of base payments are for inputs (e.g. for non- itemised work), 75%+ are for output items (fixed cost per item)	<10% of base payments for inputs, 75%+ outputs, <10% for outcomes (e.g. fixed monthly fee for faults restoration)	Nil base payments for inputs, <75% for outputs, 25+% for outcomes
	6. Appropriateness of risk allocation in basic pricing mechanism (which risks are transferred & for how long)	Excessive risk transfer via long- term fixed unit rates OR insufficient risk transfer via unwarranted use of input rates	(Volume risk / volume- related cost risk transferred regardless of service provider ability to manage volume)	Rates adjusted via input cost escalators (labour, fuel etc.) hence unknown risks / opportunities transferred to contractor	(Volume risk / volume- related cost risk shared to the extent that neither party can control volume)	Optimal balance between medium- term performance obligations (1- 3 years) and longer- term unknowns
	7. Extent of financial transparency (open book both day- to- day and when prices or scope need to be updated)	Closed book, client only hears about commercial performance when contractor is suffering financially	Open book intention and simple T&Cs but limited detail and little or not practical usage	Open book audit rights but little or no contractual definition of " cost" and only sporadic audit	Full open book intention, contractual definitions of cost, initial independent audit conducted but no regular audit plan	Full open book process, contractual definitions of cost, independent audit process in place and working well
	8. Process for progressive re- pricing in long- term contracts (i.e. agreeing updated cost per unit to cater for long- term)	No (formal) mechanism or process other than periodic re- tender OR periodic process relying solely on relative	Starts out as risk- transfer but gravitates to cost- plus through uncontrolled concessions and growing incumbent	Clear mechanism for periodic re- pricing via a mixture of bargaining power and reasonable open- book information	Annual re- pricing mechanism progressively moving from competitively tendered price path towards historic	Annual re- pricing mechanism progressively moving from tendered price path towards fair and reasonable efficient
	9. Process for periodic budgeting (clear process / timelines / affordability / optimising choice of work to be performed)	Unclear process / blurring asset management planning and supplier price re- negotiation	Process fairly clear, paradigm is expert client / dumb contractor, often runs late, some elements of price re- negotiation	Clear annual process, contractor helps to review options & realistic affordability, but seldom asked to provide suggestions	Disciplined annual process, not bogged by price negotiations, contractor has the opportunity to input to program design	Clear annual process & timeline combining realistic costings and asset management decisions agreed peer- to- peer
	10. Effective incentives (extent of contractor profit linked to client's outcomes, effectiveness of cost & non-	No incentive other than inherent in basic payment items (e.g. fixed unit price incentivises cost minimisation)	<15% of nominal margin depends on achieving client- defined targets OR targets poorly aligned to client's desired	>15<40% of nominal margin linked to client- defined targets which are partly focussed on client's desired outcomes	40- 80% of nominal margin linked to client- defined targets which are mainly focussed on client's desired outcomes	Costs separated from margin, margin 100% linked to desired outcomes (both fair cost targets, & outcome- based KPIs)
	11. Measures to encourage the contractor to think and behave as if standing in the client's shoes	None – contractor solely focussed on delivering specified tasks and maximising short- term profit (dumb contractor)	Some intention to align contractor with owner's viewpoint but balance of incentives substantially limit contractor's	Contractor encouraged to act intelligently but practical opportunity somewhat limited by client's processes & restrictions	Contractor encouraged to act on the client's behalf and given substantial freedoms and incentives to do so (within	Overt measures e.g. contractor discretion re discovered defects, joint asset management process, shared risk on fault
	12. Collaborative or adversarial relationships (terms and conditions, extent of friction or trust at operational and	No attempt to collaborate, transactional, master/servant, plenty of friction / disputes (informal or formal), mutual distrust	Some intention to collaborate but limited in practice, adversarial behaviours by key individuals go unchecked, limited trust	Significant attempts to collaborate but inconsistent with contract terms OR undermined by specific problems / disputes	Sustained collaborative efforts consistent with T&Cs, good communications and dispute management, fairly good trust level	Collaborative T&Cs, constructive dialogue, good dispute management, " your success is my success" high levels of trust
	13. Extent of integration (people & process, planning, problem- solving, co- location)	No attempt at integration; clunky interfaces, segregated responsibilities, contractor kept at arms' length, blame	Broad / initial intent to integrate, interfaces are functional but few other steps taken, contractor still held at arms' length	Fully functional process integration, some joint planning & problem- solving, teams still segregated but regular joint forums	Strong and effective process integration, regular joint working / problem- solving, key operations co- located	Extensive integration, seamless business processes, open dialogue, high degree of shared decision- making, full co- location
	14. Best- for- enterprise processes and behaviours (principles & process used for shared decisions affecting both parties)	No shared / agreed principles to guide decisions; all contentious issues argued from parties' selfish perspectives	Best- for- enterprise (or similar) language used between the parties but no agreed principles or processes to make it practical	Acknowledged goal of best sustainable solution for client, but difficulty in fairly considering contractor impact	Agreed principles which are fair to both parties but lack of process (e.g. independent review) limiting success	Best- for- enterprise principles manifestly driving behaviours & decisions (including contentious items)
15. Continuous competitive tension (supply options, termination for convenience, demobilisation obligations)	No competition (during tenure), termination involves significant compensation payments, significant demobilisation	'Benchmark' competition only, little or no practical supply alternative, significant exit barriers	Periodic / partial competition (e.g. some but not all scope price- tested every year); T4C but limited handover obligations	Regular competitive pricing (e.g. parallel contracts) & scope adjustments or T4C without penalty, key handover obligations	Continuous competition to inform re- pricing; T4C with demobilisation costs only, comprehensive handover obligations	
Governance & Leadership	16. Contract management (responsibilities, process / tools / data, consistency, reactive or proactive focus)	Sporadic / reactive, not seen as value- adding, performance data not systematically available or unreliable /	Basic regular process of review but data is limited (sometimes disputed) and dialogue is not particularly constructive	Clear responsibilities, good performance data, monthly joint review process (mainly backward- looking)	Well- designed process, reliable and well- presented performance data, consistent agenda, pro- active intention	Excellent process, smart performance dashboard, monthly meetings with improvement focus, positive relationships
	17. Governance structures and processes (senior management oversight to ensure operations stay on track &	No effective governance, day- to- day contacts are the only inter- party contacts prior to formal dispute proceedings	Governance largely confined to dispute resolution, meetings ad- hoc, limited effective senior management oversight	Governance structure in place to provide pro- active oversight and address disputes but in practice largely reactive	Governance structure and process provides reasonably good oversight and direction including avoidance of most	Documented governance roles, cultural guidance, all potential disputes isolated from day- to- day operations and resolved
	18. Change management (orderly process & documentation, means to ensure value for money)	No clear or consistent process, poor documentation / records, changes lead to higher contractor margins	Process could be clearer, inconsistently applied, tends to be a negotiation	Clear process but not always applied consistently, patchy record- keeping (some disputes), negotiation- based valuation	Change process is clear and applied fairly consistently, good documentation record, fair if simple approach to valuation	Changes are handled smoothly, records are complete, changes are valued fairly with independent review where required
	19. Positive leadership (creating positive vision, promoting collaborative behaviour, celebrating success,	No effective positive leadership, contract managers left to fight it out in the trenches, no succession planning	Some elements of positive leadership but not bilateral and/or inconsistent; limited / reactive succession planning	Fairly good leadership at governance level but modest impact at contract management / operational levels; active	Consistent positive leadership at governance levels with good impact on operational behaviours; senior succession	Great leadership which is gets the best from the operating team, positive succession management to periodically
	20. Continuous improvement (expectations, processes, goal- stretching, bi- partisan support, experience in	No contractual obligation or expectation of continuous improvement, no management focus or regular improvement process	Occasional activities by contractor (or joint) aimed at performance improvement but not systematic and not widely supported	Informal client desire for continuous improvement but limited processes in practice and limited senior attention	Very clear that continuous improvement is part of the job, reasonable process & reporting, some tangible results	Contractual obligation to constantly improve performance, continuing shared focus on this, strong examples, happy