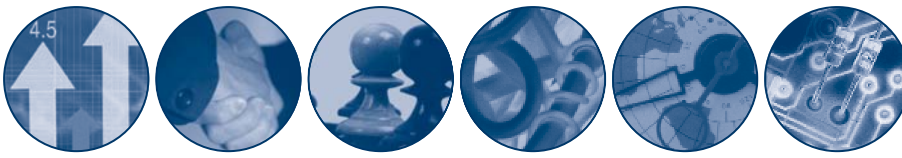

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Update

Using a Performance Points Model for Your KPI "Incentive" Scheme

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There are several approaches to setting key performance indicator (KPI) incentives in outsourcing arrangements. The term "incentive"[1] is used in this *Executive Update* to reflect the financial risks and rewards that are allocated to the service provider by the client regarding KPIs. Incentives over the provider can be negative (risk) and/or positive (rewards). Such incentives encourage providers to meet expectations and, where desired, to deliver outstanding service.

One approach to setting KPI incentives that is becoming more widespread is the use of a performance points model. This model is popular due to its ease of calculation as well as it being less complex to administer than many traditional incentive schemes. As some of you may have experienced, the calculation of KPIs and the corresponding amounts owed can get quite complicated. Many clients of such systems seem to forget that the purpose of these schemes is not to get as much money back as possible; rather, it is to motivate good performance.

In fact, if you've had to apply negative incentives (i.e., recourse) for more than three months, your scheme is not working — good performance is not happening. Something is wrong either with the KPIs (e.g., they were never realistic in the first place, they cannot be objectively measured, or the service provider is not in full control), or at the service provider, and diagnostic and treatment of the root cause of performance failure is required.

In a basic point scheme, negative (-) points are assigned to the service provider for failure to meet the minimum KPIs specified in the agreement. In more complex schemes, positive (+) points are available as well for meeting target KPIs, which are also specified in the agreement. Such targets should only be set where there is a tangible benefit to the client; thus, they are likely to apply to only a few KPIs.

Table 1 presents an example of this positive/negative approach for telecommunications connections. As shown in the example, the provider loses two points for every 1% service debasement, but wins 10 points if it meets the target.

[1]The term "incentive(s)" is used because the terms "penalties" and "liquidated damages" have a special meaning in the laws of most countries — typically required to be a genuine pre-estimate of loss due to the failure. Most KPI financial schemes are not estimates of loss but rather reflect amounts intended to motivate the provider to perform well. Substitute terms sometimes used include "rebates," "fee adjustments," and "invoice credits."

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Table 1 — A Positive (+)/Negative (-) Performance Points Example

			Calculation			Performance Points	
KPI	**Minimum Standard**	**Target**	**Frequency**	**Formula**	**Source Data**	**Failure to Meet Minimum Standard**	**Target Met**
Connections	95% of authorized services connected within 1 business day	100% of authorized services connected within 1 business day	Monthly	# authorized services connected within 1 business day/# of connection requests	Connection request log	-2 points for every 1% below the minimum standard	+10 points
	100% of authorized services connected within 2 business days			# authorized services connected within 2 business days/# of connection requests			

Table 2 — An Order Delivery Performance Points Example

		Calculation			
KPI	**Minimum Standard**	**Frequency**	**Formula**	**Source Data**	**Performance Points for Failure to Meet Minimum Standard**
Delivery days	10 business days from order date to being delivered at the Client site	Monthly	Delivery days = delivery date - order date	Order system	10 points for every business day late or portion thereof per order equal to or greater than US $50,000
					5 points for every business day late or portion thereof per order under US $50,000

In this method, the points are typically set to reflect the commensurate business impact of KPI performance. Table 2 shows an example of this within a delivery time KPI (recourse only).

Each performance point has an agreed dollar value specified in the contract (typically the SLA). At balance day, the points are tallied and the amount owed is calculated.

The benefit of this approach is that the balance date does not necessarily have to be every month. Rather, it is more commonly once every four, six, or 12 months. In this spirit, the organizations allow the service provider to “clawback” negative points if subsequent performance is above the minimum KPI threshold or meets the target.

This avoids the paper war often associated with monthly recourse schemes. In a traditional arrangement, the service provider invoices for the work in a particular month, but the KPI performance report for that month comes in after the invoice has been raised. After receiving the KPI report, the client typically raises an invoice credit based on its determination of the amounts owed due to failure to meet KPIs. More often than not, the service provider does not agree with the calculation and raises a credit adjustment. This can go on every month!

By its very nature, a recourse scheme that allows this sets the scene for disputes. Once the service provider raises an invoice, the revenue is booked on its accounts — and it wants that money. Once the client raises an invoice credit, its costs have been reduced on its accounts — and it wants that money. To avoid costly disputes, it’s best to keep the KPI incentive scheme “off the books” with only a periodic tallying up. Consistent contract outcomes — not cash back — is what the smart client wants.

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In more complex arrangements, the client may also operate under a set of KPIs. This is particularly so in an alliance or partnering-style relationship. Such client KPIs tend to reflect their responsibility to the service provider in such areas as approval turnaround times, delivery of information to deadlines, and even attendance at meetings. Like the points attributed to the service provider, both positive and negative points can occur depending on whether the client has met the KPI minimum standards and/or targets.

Whatever scheme you use, it should be explicitly specified in your contract. As KPIs are typically within the SLA[2] schedule to the contract, the point scheme is logically placed there. Figure 1 shows an example specification.

1. Application of the Performance Points

1.1 (**Calculation**) The Client will calculate Performance Points:

a. no less than thirty (30) days after receiving the KPI report from the Contractor basis;
b. using the formulas specified in the KPI Tables; and
c. report the positive, negative, and net Performance Points calculated to the Contractor.

1.2 (**Point value**) A value of US $1,000 for each Performance Point has been set by the parties.

1.3 (**Annual tally**) Prior to 1 February of each year, the Client will present the net Performance Points for the previous year to the Contractor. At that time, the amounts payable by the party owing will be agreed.

1.4 (**Caps**) The Rebates and Bonuses shall be capped per year as follows:

a. the Bonus payable by the Client is capped at US $200,000; and
b. the Rebate payable by the Contractor is capped at US $400,000.

1.5 (**Payment**) Payment shall occur as follows:

a. for a Bonus, the Contractor will raise a special February invoice; or
b. for a Rebate, the Client will raise a February credit to be offset against moneys owed the Contractor in accordance with the offset rights in the Contract.

1.6 (**No limitation on other rights**) The Rebate does not in any way limit the Client's rights in relation to any additional remedial actions and remedy in the Contract.

Figure 1 — A performance points provision example.

Those organizations that have used a performance points system to determine the effects of KPI achievement (or nonachievement) have never gone back. The calculation's simplicity, straightforward logic, and administrative ease mean that both parties can focus on getting results, rather than disputing the arcane mathematics found in more traditional approaches.

ABOUT THE AUTHOR

Sara Cullen is a Senior Consultant with Cutter Consortium's Sourcing & Vendor Relationships and Enterprise Risk Management & Governance practices. She is currently the Managing Director of The Cullen Group, a specialist organization offering consulting, training, and methodologies regarding commercial agreements. Dr. Cullen was a former national partner at Deloitte in Australia, where she ran the outsourcing consulting division, and she received her PhD from Melbourne University in the field of outsourcing. She has consulted to 110 private- and public-sector organizations, spanning 51 countries, in more than 130 outsourcing projects with contract values up to $1.5 billion per year.

Dr. Cullen is a widely published author. Her publications include Intelligent IT Outsourcing, Outsourcing: Exploding the Myths, Contract Management Better Practice Guide, Best Practices in ITO, Lessons Learnt in Outsourcing, Service Provider Management, Outsourcing Guidelines, *and* Outsourcing: What Auditors Need to Know, *in addition to research with various universities since 1994, including the London School of Economics, Melbourne, Oxford, and Warwick. She has been featured in such publications as the* Australian Financial Review, Business Review Weekly, Computerworld, Directions in Government, European Journal of Information Systems, Information Economics Journal, Journal of Strategic Information Systems, Information Technology Report, Insurance Directions, Oxford Handbook, MIS, *and* MISQ Executive. *Her expertise is globally recognized, and she performs peer reviews regarding outsourcing research for the* Harvard Business Review, California Management Review, *and the* European Conference on Information Systems.

Dr. Cullen has lectured at many universities, including Melbourne, Monash, Swinburne, Queensland University of Technology, and the Royal Melbourne University of Technology. Dr. Cullen earned a BS in accounting from St. Cloud State University (US); she was awarded a Masters of Management (Technology) from Melbourne Business School; and earned her PhD from the University of Melbourne. She is also a Chartered Accountant in the US. She can be reached at scullen@cutter.com.

[2]For more information on service-level agreements, refer to my *Executive Report* "Service-Level Agreements: Articulating What Will Make a Successful Deal" (Vol. 7, No. 5, May 2006).

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