

## **Content of Performance Contracts**

The content of a PC may be brief or very long, depending on the wishes of the country's policy-makers. While the details of the contents may vary, a PC should contain certain important conditions and statements which are discussed in this chapter.

Essentially, the PC should reflect the following:

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|----------------------|---|
| Long-term contents : | <ol style="list-style-type: none"> <li>1. Mission</li> <li>2. Objectives</li> </ol>   |
| Short-term contents: | <ol style="list-style-type: none"> <li>3. Performance criteria</li> <li>4. Performance criteria weights</li> <li>5. Targets against criteria</li> </ol> |
| Mutual obligations : | <ol style="list-style-type: none"> <li>6. Obligations of PEs</li> <li>7. Obligations of government</li> </ol>   |

### **Statement of Mission and Objectives: Nature and Purpose**

A PC system is adopted primarily to ensure that the performance of a public enterprise is judged, not merely with reference to its financial performance, but also with reference to all the social objectives which have been assigned to the enterprise. Therefore, the PC should clearly set out the mission of the public enterprise which represents its long-term goal. The objectives should highlight the short-term benefits which the government expects from the public enterprise and these objectives, as far as possible, must be quantifiable. Where they cannot be quantified, some measurable surrogates have to be identified. In achieving the objectives the public enterprise would expect certain assistance or help from the government and such expectations should be set out in some detail.

The mission and objectives do not change in the short run and therefore remain constant for a reasonably long period. The remaining conditions which mention the targets to be achieved may change frequently.

## **Mission**

All public enterprises are presumed to serve the public. There is a tendency therefore to state a mission in very broad terms and in such a way that anything which is considered good for the public is included. There is also a tendency to describe the mission in grandiose terms. For example, the mission of a public enterprise which is in the consultancy business is set out "to be the most important international consultancy organisation in the world". While there is nothing wrong in setting out the mission somewhat ambitiously, there is the need to make it realistic and achievable in the next 20 to 25 years. For example, a refinery which is set up to process crude oil in a particular region can state its mission as: "to process the crude from such and such region in a more efficient manner and work towards the total utilisation of all the by-products and stimulate the growth of petro-chemicals in the region." The growth of petro-chemicals may not be possible in the near future but is a distant possibility which can be kept in view by the PE.

In writing a mission statement, there should be a judicious balance between the great expectations on the one hand and the achievable results on the other hand. A simple way to write up the mission is to ask why was the public enterprise set up. Or simply to ask: What business are we in? In the memorandum or Act setting up the enterprise, some mention of the mission is normally made, but such a statement is usually lumped together with several things that the enterprise could do. The precise mission statement has to be 'extracted', from the general statements. Sometimes a public enterprise purpose should be modified to reflect the managerial considerations for setting up a particular unit.

When a PE is established through an Act of Legislature, the mission statement is drawn up more in political terms. In the PC this statement should be interpreted in managerial terms. Normally a mission statement should not exceed a few lines. It is a good practice to get the Board to consider the mission and approve it.

## **Objectives**

Objectives are concrete results or outcomes that are expected by the public enterprise in the short run or during the period covered by the PC. It should be a complete list in order of priority of the results or achievements expected from the public enterprise. For example, in the consultancy firm earlier referred to, the objectives may be in terms of achievement of consultancy, e.g. increase in consultancy operations in specific areas, such as urban transport. In the case of the manufacturing unit, they may be the products which are to be manufactured and their market share. Objectives should be the achievements which further the mission. There should be coherence between the objectives and the mission.

## **The commitments of public enterprise**

The next part deals with the real substance of the contract and this should be discussed each year. It sets out the performance targets which are agreed on by the public enterprise and the government. The values and the relative weightages of these targets should also to be specified. There is a temptation among professionals, especially PC experts, to have too many targets.

The real issue is that targets should be such that they not only describe the static operational efficiency but also take care of the dynamic effects. It is obvious that it is easy for a manager or chief executive to achieve higher static performance targets which may have an adverse dynamic effect. For example, a higher level of operating hours can be achieved in the case of an electricity generating plant or road transport vehicles by skipping the normal maintenance operations for a year. However, this will lead to the equipment breaking down and may lead to major repairs in a few years' time.

One of the key reasons for performance targeting is the need to give adequate weightage to social obligations contributed by the public enterprise. These are obligations which are not captured by the annual financial accounts. It is therefore important that the performance criteria should include those relating to such social obligations.

It is also necessary to give some weightage to project implementation efficiency whenever the PE has a new project under construction, as the impact of such efficiency will not be captured by the balance sheet in the short run. The efficiency of project implementation usually has a serious long-term effect.

Sometimes the preparation of a corporate plan is also included as a performance criterion. Of course, the normal commercial and financial performance criteria such as the market share of the company's product, its total profitability etc. are included as criteria.

In designing the PC system, great attention should be given to the number of criteria that are to be included in the PC. A larger number of criteria, with various weightages attached to them, leads to a fuzzy and vague interpretation of real performance. It is important to emphasise the need to identify a very limited number of clearly measurable criteria. A recent Conference of Public Enterprise Chief Executives in India (1993), which reviewed the experiences of the MOU system in India, recommended that the total number of criteria should not be more than five. Generally, the most important elements for evaluation of the public enterprise performance are: production, profitability and employment. The dynamic effects should be captured by including criteria such as R&D, maintenance efficiency, staff training and development etc. The social benefits, if any, expected

#### **Box 4.1: Principles of Performance Target Setting**

The principles on which the targets are set by the Experts' Advisory Cell (in Pakistan) are:

1. Efficient target setting should be carried out in a participatory process. Without this approach, targets tend to take the form of formal directives which are often overtly accepted and covertly resisted.
2. Targets should be clear-cut.
3. Targets should neither be too low nor too high. This could give wrong signals to the managers.
4. Each enterprise must be looked at in its own unique environment which must be taken into account.
5. The targets for incentives should ensure that generation of a surplus is significantly more than distribution by way of bonus.
6. Targets must take into account the social tasks which enterprises are invariably asked to carry out.

*Source: I. Mehdi, op.cit, p.9*

from a public enterprise could be specified separately. Some scholars have frowned on the practice of regarding targets for the welfare of the public enterprise workers as social benefits. Social benefit targets should be special targets such as, the benefits given to the local community by way of training their youth or providing opportunities for the community to acquire skills. Human resource development is one of the very important elements which will affect the dynamic efficiency of an organisation but it is not a social benefit.

#### **Assigning weightage to criteria**

After agreement is reached on the criteria to evaluate performance, weights have to be attached to indicate the relative priority of the criteria. For example, as in Pakistan, if a PE has an expansion programme, in the PC it negotiates the three agreed criteria which may be:

- (i) production;
- (ii) profits; and

(iii) completion of the expansion project on time.

But the parties may give the relative priority to these criteria in terms of weights as:

Production	30%
Profit	50%
Project implementation	20%

The weights may be specified as percentages when they should add to 100. Alternatively, the weights may be fractions adding up to one. In the example above, in decimal fractions the weights would be specified as 0.30, 0.50 and 0.20, adding up to 1.00.

**Box 4.2: Structure of Performance Contract in Ghana**

From 1991, the structure of the performance contracts in Ghana was standardised around five main heads:

- objectives of the enterprise (a statement of mission);
- performance indicators to be monitored and annual targets to be achieved during the contract period;
- mutual undertakings of Government and enterprise;
- critical assumptions made in setting specific targets; and
- reporting requirements.

*Source: W.A.Adda, op. cit, p.4*

Each year, after agreement has been reached on the criteria to evaluate the performance, weights have to be assigned to each of the criteria. This is important because criteria selected are not of equal importance and the importance of one criterion may also vary from year to year. One could say that profitability is the most important criterion in a particular corporate entity but it may be production in another company. India started with a low of 20 per cent weightage for profitability in most companies. It has now been increased to 50 per cent weightage to all companies. In the first phase of its PC, The Gambia assigned a weight of 60 per cent to quantitative indicators and 30 per cent to qualitative indicators. The remaining 10 per cent was assigned to overall performance. During the second phase, the weights assigned to quantitative and qualitative indicators were 60 per cent and 40 per cent respectively. It should be noted that while the process may appear easy on the surface, it is in fact generally difficult to agree on weightages. The discussions invariably lead to long arguments on all sides. For example, the

market share may be given very high weightage by one party to the PC while the other may consider the profitability to be of greater importance and should therefore attract higher weightage. The important requirement is that an agreement should be reached on the relative weightage and be accepted by the PE and the government.

An example from an actual PC showing the large number of criteria and their relative weightage is given below:

Criteria	Weightage
<b>I. Profit Related (50%)</b>	
New profit/capital employees (%)	30
Gross margin (\$ million)	20
<b>II. Production/Turnover Related (25%)</b>	
Product I ('000 tonnes)	10
Product II ('000 tonnes)	10
Exports (\$ million)	05
<b>III. Dynamic Efficiency (15%)</b>	
R&D expenditure	05
Project implementation	10
<b>IV. Social Obligation (10%)</b>	
Expenditure on green belt	05
Training of local community (No. of persons trained)	05
	----- 100 -----

### Fixing the Target Value

After settling the criteria and their weightages, the value for the criteria or targets in specific numbers have to be prescribed. For example, net profit/capital employed

may be fixed at 18 per cent and the gross profit \$240 million. Similarly, for each criteria, the values in the relevant numeraire have to be settled.

In the case of a PC with the three criteria referred to above, the PC should spell out clearly the target level of production, profit and index of project implementation efficiency, say, expenditure on new project implementation, e.g.

Production	20,000 tonnes
Profit	20 million currency units
Project implementation expenditure	200 million currency units.

If the enterprise performance at the end of the contract period reached these target levels in all three indicators, it can be awarded 100 per cent marks during evaluation. If the profit is zero, then the PE can only get 30 per cent for production and 20 per cent for project implementation to make 50 per cent performance if the PE has performed well on those two scores. In real life, different enterprises may fulfil the targets to different levels and to get a relative evaluation of these enterprises, the targets are arranged on a three-point scale; which of the two scales is selected is entirely subjective. We will discuss both.

In a three-point scale, the target level considered very good may be kept in the middle of the three points. Let us say a specified percentage above the contracted target is considered excellent and kept as 1, and a level below the target is considered unsatisfactory and kept as 3:

Performance Level	1	2	3
Score	1.0	0.8	0.5
Indicator 1 - Production (tonnes)	>25,000	20,000	<10,000
Indicator 2 - Profit (currency units)	>22.0	20.0	<15.0
Indicator 3 - Project Implementation (currency units)	>240.0	200.0	<100.0

(Note that the scores for excellent and unsatisfactory are subjective.)

In such a scoring system the maximum will be 1.0 and the minimum 0.5. If all the three targets are reached, the unit would get 0.8 or 80 per cent. A score of 1.0 or 100 per cent is only possible when the performance is above the targets and at a level considered excellent. Let us see how. Let the actual performance be:

Production:	26.000 tonnes
Profit:	12 million
Project implementation:	210 million

In respect of production and project implementation, the achievement is above target but in respect of profits it is far below target. How to evaluate the performance and give a composite score will be explained in Chapter Five.

Similarly, in a five point scale, we could make 1 as excellent and 5 as poor as follows:

1 Excellent	>target
2 Very Good	target
3 Good	a little below target
4 Just satisfactory	minimum acceptable level
5 Poor	unacceptable

### **The target for different scores**

One would have to settle on what would be the performance assessment for deviations from the target. This need not be the same for all criteria. For example, a 10 per cent deviation in profitability may not be valued in the same way as a 10 per cent deviation in production or in R&D expenditure. On an agreed scale, the criteria values should be settled. While the easiest way would be to have a three point scale, the five point scale seems to be the preferred one. Say, at the evaluation stage, the achievement of the target is considered very good. As 10 per cent above the target could be considered excellent or outstanding, 10 per cent below would be considered as good, but 20 per cent below would be considered as just satisfactory and anything more as very poor. In order to make the evaluation transparent, it is necessary that the criteria values are specified clearly. An illustration is provided in Chapter Five.

There is yet another system where the maximum points awarded is set at three times the score for target achievement and all the scores are enumerated on a number of points. (This is used on a limited scale.)

Indicator		Rating Score
	Return of Capital Employed (ROCE)	
<b>Target</b>	18.0%	30
	17.0%	25
	15.5%	20
	14.5%	15
	<b>13.5%</b>	<b>10</b>
	11.5%	5
	10.0%	1

### Obligations

The next part of the PC spells out the assistance required from government by the PE. Usually, this lists the powers to be delegated to the enterprise. Often, the enterprise will seek delegation of power to sanction projects up to a particular limit say \$0.5 million or to sanction staff up to a particular salary level. It could be also a request for a release of funds according to certain deadlines.

The third part of the PC contains the methods and dates of evaluation agreed upon. If a reward and penalty system has been approved as part of the PC system this will also indicate the penalties and rewards which the public enterprise will get on achieving the targets set at the beginning of the year or the penalties for poor performance or non-attainment of agreed targets.