Goals and Incentive Compensation

The IPD concept seeks to align a project team with the owner's goals—by stipulating them, defining the metrics for measuring them and providing incentives for achieving them. Incentive rewards (or penalties) are typically shared by the IPD Team proportionate to their participation in the project.

IPD is a good idea. It works because it causes the owner to focus on a clear statement of goals and sends strong, clear messages. Attaching money to the message makes it infinitely more convincing. Incentive compensation amplifies the message.

However, it is crucial for managers of IPD Teams to realize that these incentives have the potential to create conflict as well as alignment. Every action has a reaction; every goal that affects incentive compensation is a potential source of disagreement. If goals are set or managed ineptly, they have the potential of driving a wedge of discord between the owner and the IPD Team—the reverse of what is intended.

For instance, if there are goals of cost and schedule, and if there is a change in scope during the project, the IPD Team and the owner must negotiate a change order that may cause traditional unspoken feelings of adversarial relationship to surface. An incentive to save money may create a perception of self-interest and distrust when the IPD Team suggests an economy. The owner may feel that the IPD Team is being rewarded to cheapen the project—again weakening the collaborative trust that is fundamental to IPD.

A project will have many goals. In addition to the classic trio of schedule, quality and scope, goals might include safety, sustainability, HUB participation, local business participation, minority hiring. Some goals will be particularly hard to measure, such as consideration of users, community relations and management response to unpredictable events.

Incentivizing some of these goals may cause the IPD Team to neglect others. Think of the classic child’s toy that is a small plank on legs with pegs that protrude vertically. There is a little hammer that a child can use to beat a peg down into the plank. But as one peg goes down, others go up. Rewarding goals on a project has the same characteristic. You can’t reward one goal without affecting others.

The Cost Goal

Probably the most common goal focuses on meeting the budget. It is also the one with the greatest potential of serious unintended consequences. An IPD contract is likely to be cost-reimbursable with a target price or a guaranteed maximum price (GMP). An incentive clause may stipulate that the IPD Team will share in the savings (the difference between the final cost and the target price or GMP). It may also stipulate that the IPD Team must pay a part or all of any overrun. (If the contract is a GMP contract, the IPD Team must pay the entire overrun.)

In a lump-sum contract with a GC who has bid a fixed price on a complete set of plans and specs, a Shared Savings clause makes sense. It is an agreement to compensate the GC for initiative in finding something that doesn’t meet the current plans and specs but would be acceptable to the AE and the owner and would save money.

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But a Shared Savings clause with a cost-reimbursable target price or GMP contract may have undesirable results. Here’s what can happen:

The owner typically selects the IPD Team based on qualifications and fee before the project is designed. The owner agrees to reimburse the IPD Team for design, management, General Conditions cost, subcontractor costs and in some cases self-performed construction. The IPD Team controls the cost and the scope of these items.

The IPD Team may bid some of the subcontracts, estimate the cost of the un-bid contracts, estimate the General Conditions and add a contingency. They must manage the whole to come within the target price or the GMP – and produce an incentive reward. Construction company estimators will not intentionally jeopardize their firm if there is a GMP and will certainly be aware of the incentive if there is a target price. Knowing that prices always have an unpredictable element,
the estimate of the un-bid contracts and the General Conditions will be conservative—there will be a pad. So in most cases the “savings” are likely to come from the contingency, from the conservative pad built into the estimate for the un-bid subcontracts and from the conservative estimate of General Conditions construction. So the larger the pad, the greater the incentive reward to the IPD Team. That is hardly in the owner’s interest. So a Shared Savings clause holds the seeds of conflict. If the budget is set before design, it is a clear incentive to cheapen the design and reduce scope. During design, the IPD Team will be motivated to estimate subcontracts and the General Conditions conservatively. That might cause the owner to reduce the project scope—perhaps needlessly. Then the project may eventually be delivered well under the budget. The IPD Team receives the reward and the owner receives less scope. Of course, scope can be one of the goals too. But then the IPD Team may put pressure on the owner to reduce the quality of systems and materials.

**Absolute Goals**

Some goals may be a matter of degree. Safety targets, minority hiring or sustainability may be measured in degrees. An owner may want a building “as soon as possible and as economically as possible.”

But the same goals could be absolute. There may be a date certain for occupancy, such as the opening of a school semester. Or there may be a fixed appropriation for cost so the project can’t exceed the budget, but the owner would like to use all of the money that’s been appropriated for the project.

If that is the case, those goals must be contractually absolute. If the owner has a fixed budget and a date certain, the IPD Team must have a contractual obligation to meet them. These hard things always have undesirable consequences, but when they are part of an owner’s reality they must be part of the IPD Team’s reality as well.

**The Contingency**

There must be a contingency to cover unpredictable events. Some IPD projects have a contingency fund that if unused is shared by the owner and the IPD Team. The convincing thought behind that arrangement is that the IPD Team will treat the project budget as its own money—as indeed it is. However, it is an asymmetrical alignment. The owner has two opposing incentives to balance—the desire to save money and the desire to have a quality project. If there is only a cost goal, the IPD Team is incentivized for only one.

On a cost-reimbursable project the contingency should also be available to pay for mistakes made by the IPD Team. Inexperienced owners will do a double take on this point: “Why should I pay for mistakes?” But if an AE negotiates a lump sum contract for services or if a GC bids a lump sum on a design-bid-build project, they will include a contingency within the lump-sum for mistakes they know will occur. So in a cost-reimbursable contract, such a clause is common because mistakes are common.

The contingency may be outside of the incentive compensation pool. If the IPD Team gets to keep part of the unused contingency, an owner is reluctant to let it be very large. Yet a small contingency creates risk for the IPD Team—particularly if the contract carries a GMP. If there is risk, candor is driven underground—project transparency is clouded. Team members are driven to their corners.

One good approach is to give the IPD Team time to take bids on most of the work, provide an adequate contingency and require that the entire unused contingency be returned to the owner and that it be set outside of incentive formulas.

**SATISFACTION FEES**

So the incentive compensation should be for meeting broad project goals and may have a bonus for exceptional performance.

The best approach is for the owner to establish a broad, prioritized list of goals. They may then be periodically reviewed (and may be modified) with the IPD Core Team. Then the owner reviews the IPD Core Team’s performance in reaching the goals.

Too often owners fail to review performance with the project team during the project. They realize they must get along with the team members so they don’t want to alienate them by criticizing them. Likewise, the project team doesn’t want to criticize their client. So embedded, reoccurring problems don’t get fixed. But reviews happen if they’re contractual and if money is attached. This is not always true. Lee Evey used a significant incentive fee in motivating the program manager and the design-build contractor to finish the reconstruction of the Pentagon after 9/11. The team earned 100% of the fee.

The review should be reciprocal. The IPD Team should be asked to review the owner’s performance. Mutual criticism should be expected and solicited.
When? Although it may be argued that it’s not clear that the goals are met until the end of the job, it doesn’t make sense to wait until then to review performance. Holding periodic reviews during the project is important. It’s smart to have feedback when the team can respond. Nobody can change the past. The meetings should include the project managers from the owner and the IPD Team, along with the principal executive management of each organization. Developing a brass-to-brass relationship is crucial.

The incentive fee should be parcelled out and awarded to the IPD Team periodically, perhaps quarterly, based on the owner’s review of goals. The owner grades the IPD Team and distributes the fee for that period. A good approach is to parcel out a portion of the fee as the project progresses and indicate what portion will be earned at the end of the project if the project finishes with current performance.

For instance, the distribution of the award fee might be as follows:

- 10% at the start of construction
- 10% at topping out
- 10% at completion of building envelope
- 60% at substantial completion
- 10% at punch list completion

A project team might be only slightly ahead of schedule and earn only part of the award for a given period (say 5% instead of 10%). However, if they pick up the schedule and meet the criteria for exceptional performance at the next milestone, they may recover the lost 10% and get 25%. Conceivably, they could fall short throughout the program but finish in a blaze of performance and collect the entire fee.

How Much? Normally, the incentive fee should not be large. Large amounts, particularly in a large owner bureaucracy, will attract attention from multiple sources, draw significant pressures to justify paying it and force the owner’s management team to justify some subjective decisions.

A small amount will have a good effect. The people working on the project are now conscious that there is a report card. If they earn the bonus, there is clear evidence of their good performance within their organizations. They can tell their top management that the client clearly likes their performance.

Some of the most important aspects of performance can’t be measured. An owner who sets an incentive fee for meeting goals must stipulate that there is a subjective element in the evaluation and that the owner’s decision is final.

The Biggest Incentive

Cost incentives – indeed all of the incentivized goals – often work well despite the negative, unintended motivations to cheapen work, pad estimates, negotiate change orders unfairly, or whatever. Of course, professionals will object stridently to these “unintended consequences.” They will claim that they are professional and will not interpret a Shared Savings clause as a “bribe to cheapen the building,” etc., and that they will do the right thing. Indeed they are right: most CMs and AEs are staffed with good people who make responsible decisions in the owner’s interest. But then the question arises: “If everybody will do the right thing, why have incentives in the first place?”

It’s a good question. The clearest answer is that it causes the owner and the IPD Team to clarify the goals and discuss them. That causes integration.

The answer is that defining incentives defines goals and defining the goals produces good results. Attaching money to a goal makes it serious and not just cheap talk. The money is the message.

The other reason it works is that good people have been selected on the basis of qualifications. Good people want repeat work and will work to build or uphold their reputation. The most important issue for any organization is survival. Since the IPD Team is selected on qualifications, they know they can be selected again if they do a good job or that a reputation for collaborative response to a client will be enhanced by their good performance. Their primary motivation will be future work. Good references and an opportunity for repeat work are far more valuable than a killing on incentive compensation.

So the most important incentive that an owner has is the promise of repeat work and their testimony to the IPD Team’s good performance. But since repeat work and testimony are unlikely to be a matter of contract, there must be a strong perception that repeat work will follow good performance.

An owner’s biggest form of incentive compensation is a carrot. CM