United States General Accounting Office

GAO

Report to Congressional Requesters

January 2003

CONTRACT MANAGEMENT

Commercial Use of Share-in-Savings Contracting

GAO-03-327

January 2003

CONTRACT MANAGEMENT

Commercial Use of Share-in-Savings Contracting

GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-03-327, a report to Congressional Requesters, House of Representatives

Why GAO Did This Study

The Congress and federal agencies are increasingly turning to performance-based contracting methods to enhance the delivery of government services. Share-in-Savings (SIS) contracting–in which the contractor assumes more risk by investing upfront costs but also receives a share in any savings generated by its efforts–is one performance-based technique that Congress is trying to promote. We were asked to examine its use by industry in terms of whether there were any key conditions that needed to be in place to make this technique successful.

In conducting our review, we found that the form of SIS used in a commercial contract varied by contract. Some contracts employed a basic SIS approach, in which a contractor's total compensation was paid entirely through sharing a portion of a client's savings or increased revenues. And some employed a tailored approached in which contractors were paid for at least some portion of their time and materials costs, even if savings or increased revenues were not realized. We performed a detailed analysis on four specific contracts to identify conditions that fostered success.

What GAO Recommends

We did not make recommendations in this report.

www.gao.gov/cgi-bin/getrpt?GAO-03-327.

To view the full report, including the scope and methodology, click on the link above. For more information, contact David Cooper (202) 512-4125, CooperD@gao.gov.

What GAO Found

SIS can be a highly effective contracting technique to motivate contractors to generate savings and revenues for their clients. But to be successful, clients and their contractors need to be specific and in agreement in their goals and objectives, as well as how to achieve them. This can be a difficult task for more complex services, but the companies we spoke with found that pursuing this type of arrangement was worth the extra effort.

Conditions that Facilitate Success

- ***An Expected Outcome Is Clearly Specified.*** By outcomes, we mean such things as generating savings by eliminating inefficient business practices, realizing savings through conservation measures, or identifying new revenue centers. Because the success of SIS relies heavily on the ability to identify and track savings or revenues, it is critical that a contractor and client have a clear understanding of what they are trying to achieve.
- ***Incentives are defined***. Both the client and the contractor need to strike a balance between the level of risk and reward they are willing to pursue. A pure SIS arrangement offers attractive benefits, such as no upfront investment on the part of a client and a bigger return for a contractor. But there are real risks, particularly for a contractor, if savings or revenues are not realized as anticipated. As a result, clients and contractors need to work through incentives and risks and come to agreement on how far they would take their SIS arrangement.
- ***Performance measures are established***. By its nature, SIS cannot work without having a baseline and good performance measures to gauge exactly what savings or revenues are being achieved. Agreement must be reached on how metrics are linked to contractor intervention. For some services, such as energy management, they are relatively easy to define. For more complex services, such as those in the information technology industry, this can be a much more difficult task.
- ***Top management commitment is secured.*** This is paramount in any SIS arrangement. A client's top executives need to provide contractors with the authority needed to carry out solutions, since change from the outside is often met with resistance. They also need to help sustain a partnership over time since relationships between the contractor and client can be tested in the face of changing market conditions, legal pitfalls, and other barriers.

To date, federal agencies have made limited use of SIS contracting. Officials we spoke with noted that these arrangements may be difficult to pursue, given potential resistance and the lack of good baseline performance data. However, it may be worthwhile for agencies to examine ways to overcome potential problems to achieve better outcomes.

GAO
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

January 31, 2003

The Honorable Tom Davis
Chairman
Committee on Government Reform

The Honorable Jim Turner
Ranking Minority Member
Subcommittee on Technology
and Procurement Policy
Committee on Government Reform
House of Representatives

The Congress and federal agencies are increasingly turning to performance-based contracting methods as a way to enhance the delivery of government services. You requested that we determine how Share-in-Savings (SIS) contracting, one performance-based technique, is used in the commercial sector. This report responds to your request by examining four commercial SIS contracts and identifying common characteristics that made them successful. For the purposes of this report, we have defined SIS contracting as an agreement in which a client compensates a contractor from the financial benefits derived as a result of contract performance. Financial benefits can come from either contractor-generated savings or revenues.

Results in Brief

We found variations in the forms of SIS used in the four commercial contracts we studied. The forms ranged from a basic SIS approach, in which a contractor's total compensation was paid entirely through sharing a portion of a client's savings or increased revenues, to a tailored approach in which contractors were paid for at least some portion of their time and materials costs, even if savings or increased revenues were not realized.

We also found, in the commercial SIS contracts we reviewed, that four key conditions facilitated the development and execution of the SIS contracts. First, the client and contractor clearly defined an expected outcome from the arrangement, such as generating savings by eliminating inefficient business practices, realizing savings through conservation measures, or identifying new revenue centers. Second, both client and contractor had incentives to use this contracting technique. SIS contracting is attractive to

clients who (a) do not have the funds for, or choose not to pay, some or all of the up-front costs of a needed project and (b) are willing to pay the premium SIS contractors charge for putting some or all of their compensation at risk. Contractors, on the other hand, must have confidence that the financial benefits they can produce are sufficient to cover their costs and provide a profit that rewards them for the increased risk they incur. Third, a baseline and performance metrics could be established to define a client's costs and/or revenue prior to, and after, contractor intervention. Fourth, the client's management contributed to success by committing to execute the project and implement contractor recommendations.

Overall, the commercial companies we studied, along with other users of SIS, have noted that, even when the right incentives and measures are in place, other issues could impact a company's use of SIS contracting. For example, parties may blame each other, when savings or increased revenues are lower than expected. As a result, before going into such an arrangement, both client and contractor need to carefully consider the potential risks and rewards of an SIS arrangement and whether the conditions that facilitate success are present–something that may not be easily achievable in government, which frequently is unable to calculate a baseline. On the other hand, companies have found it worthwhile to overcome potential barriers to SIS contracting because successful arrangements have generated savings and revenues–in one case highlighted in this report, $980,000 in annual energy savings, which otherwise would not have been realized.

This report does not contain a recommendation.

Background

In its basic form, SIS contracting is a contracting and financing technique in which a contractor, rather than a client, funds the up-front cost of a project, and, in return, receives a percentage of the savings that the contractor generates for the federal agency. SIS contracting effectively shifts the risk of contract performance to the contractor because, in addition to providing the up-front capital, the contractor receives payment only after savings are realized. In short, a contractor is paid only for results, not just effort. The attraction of this technique to the federal government is the ability to capitalize on modern technology, while not incurring the up-front expense. Conversely, the attraction to a contractor is the potential for a greater return, because of the increased risk, than from a traditional contract. Both parties involved in an SIS contract

anticipate that a contractor's potential to earn more will generate an incentive to save more, thereby creating a win-win situation.

The appeal of SIS contracting has generated congressional interest to expand its use within the federal government. For example, the Clinger-Cohen Act of 1996 authorized pilot programs to (1) contract on a competitive basis with a private sector source to provide the federal government with information technology solutions for improving mission-related or administrative processes of the federal government and (2) pay the private-sector source an amount equal to a portion of the savings derived by the federal government from any improvements. The recent E-Government Act of 2002 expands authority to enter SIS contracts in fiscal years 2003 through 2005 and also provides for incentives to federal agencies.[1]

Despite this interest to expand its use, there are few documented examples of SIS contracting in the federal government. One of the best-known examples of federal SIS contracting is in the Department of Energy (DOE). The National Energy Conservation Policy Act, as amended by the Energy Policy Act of 1992, and subsequent executive orders require federal agencies to reduce their consumption of energy in federal buildings. This law provided that federal agencies may enter into SIS contracting as a way of encouraging industry to help achieve this goal and required DOE to establish methods and procedures to implement this authority, which allows federal agencies to realize energy efficiencies with minimal up-front costs to the government. Accordingly, DOE's Federal Energy Management Program crafted an energy savings contract under which energy service contractors are expected to contribute the up-front costs identifying a federal facility's energy needs and buying, installing, operating, and maintaining energy-efficient equipment to cut energy bills. In return, the companies get a share of energy savings generated by the improvements.

Forms of SIS Varied by Contract

We found various forms of SIS were used in the four commercial contracts we studied. The forms ranged from a basic SIS approach, in which a contractor's total compensation was paid entirely through sharing a portion of a client's savings or increased revenues, to a tailored approach

[1] Public Law 107-347, December 17, 2002.

in which a contractor was paid for at least some portion of the time and materials costs, even if savings or increased revenues were not realized. The difference between the approaches was the level of risk the contractor assumed and the portion of the contractor's compensation tied to the savings and/or revenue generated.

Of the four situations presented in this report, two used a basic SIS approach in which the contractors' compensation was entirely at risk–unless they produced results, and two used a tailored approach. The basic SIS approach was used by (1) the Massachusetts Institute of Technology (MIT) and its contractor, Alliant Energy Integrated Services/Cogenex, to reduce utility costs in MIT's 100-building campus and (2) Texas Online Authority and its contractor, BearingPoint,[2] to create an Internet Web site to provide state and local government services to Texas businesses and citizens. The tailored approach was used by (1) Best Buy and its contractor, Accenture, to identify cost reduction opportunities and potential new revenue centers and (2) Harley-Davidson and its contractor, Henkel Chemical Management, to reduce Harley-Davidson's chemical management costs.

Certain Conditions Facilitated the Use of SIS

For the commercial SIS contracts we studied, four conditions emerged as playing a key role in facilitating the development and execution of the SIS contracts. As shown below, the client and contractor (1) defined an outcome, (2) determined whether SIS incentives were appropriate, (3) established a baseline and performance metrics tied to their desired outcome, and (4) obtained client commitment to success.

An Expected Outcome Was Clearly Defined

SIS contracting was considered only after the client and contractor defined an expected outcome, such as realizing savings through energy conservation measures, identifying new revenue centers, or generating savings by eliminating inefficient business practices. A clearly defined outcome was required so that contractors could focus their resources, knowledge, and expertise on obtaining solutions to their clients' needs and/or business problems. To define an outcome, the client and contractor examined the client's existing systems and/or business processes to determine whether opportunities existed to generate savings and/or

[2] Formerly KPMG Consulting.

revenues for the client. The examination process involved an open exchange of information and took, in one case, 6 months to complete.

Table 1: How Clients and Contractors Defined an Expected Outcome

Client/contractor	How an expected outcome was defined
MIT/Alliant Energy Integrated Services/Cogenex	Outcome: Reduced utility costs. In 1987, MIT recognized the need to reduce utility costs by upgrading its inefficient lighting, heating, and air conditioning systems. Because managing such a project is not an MIT core competency, MIT solicited the assistance of Alliant/Cogenex. Alliant/Cogenex is an energy service company whose expertise is to reduce energy costs by determining whether energy inefficiencies in facilities exist and, if so, executing the changes needed to eliminate the inefficiencies. Through its energy audit, Alliant/Cogenex determined that enough energy savings (the amount MIT would have paid if improvements were not made) could be accomplished over 10 years to pay for the improvements. In the end, MIT saved $980,000 annually over what it would have paid had the improvements not been made.
Texas Online Authority/BearingPoint	Outcome: Enable on-line access to government services. The Texas Online Authority was established to satisfy an unfunded state legislative mandate to create an Internet site[a] to provide the services of state agencies, counties, cities, and institutions of higher learning to Texas businesses and citizens. The intent of the legislation was to provide a variety of online services such as driver license and motor vehicle registration renewals, occupational license and permit renewals, and college tuition payments. BearingPoint responded to a Request for Offer and was awarded the contract to develop and operate the Web site at no cost to the state. BearingPoint's confidence that it could meet the contractual requirements, recover its costs,[b] and earn a profit rested on (1) state legislation encouraging/requiring the use of online services[c] and (2) a Texas Online survey of potential users revealing that business and citizens were willing to pay the additional fees required to allow BearingPoint to recover its costs and earn a profit.
Best Buy/Accenture	Outcome: Higher revenues and reduced costs. Best Buy wanted to identify cost reduction opportunities and new revenue centers because, in 1996, Best Buy faced a dilemma: fast, furious growth but sagging profits, which, if left uncorrected, would result in operational losses that could drive the company into bankruptcy. Best Buy recognized that it was best served by entering into a consulting agreement with an organization whose retailing experts could independently study Best Buy operations and business processes. Accordingly, Best Buy contracted with Accenture to perform a study of their operations and business processes. The purpose of the study was to determine if Accenture could (a) identify inefficiencies contributing to Best Buy's sagging profits, and, if so, (b) if Accenture, working in partnership with Best Buy, could eliminate such inefficiencies. As a result of that study, which lasted 6 months, Accenture determined that there were cost reduction opportunities and potential new revenue centers not recognized by Best Buy.

Client/contractor	How an expected outcome was defined
Harley-Davidson/Henkel Chemical Management Group	Outcome: Reduced costs for indirect materials. Harley-Davidson wanted to realize cost savings from the indirect materials and services needed for the maintenance, repair, and operations of their facilities. Examples of indirect services and materials include building repair, janitorial services, vehicle maintenance, plumbing, and chemical management. Through 1998, Harley had been spending about $85 million annually with more than 3,500 suppliers for such indirect materials and services. To help realize cost savings, Harley contracted with Henkel. The Henkel Chemical Management Group has a core competency in chemical management. Examples of indirect materials and services, which Henkel could help achieve cost savings over what Harley had been paying, include oils/greases, coolants, washer/cleaning fluids, adhesives, and paint additives/chemicals to name a few. After reviewing Harley's chemical management program, Henkel determined it could deliver cost savings through improved pricing by leveraging buying power and the introduction of new usage and disposal efficiencies.

Sources: MIT/Alliant Energy Integrated Services/Cogenex; Texas Online Authority/BearingPoint; Best Buy/Accenture; and Harley-Davidson/Henkel Chemical Management Group.

[a]A high available Internet facility and portal.

[b]Forty-three million dollars for capital equipment plus $15 million to $20 million for operations and variable expenses, as of December 4, 2002.

[c]One example is Texas Senate Bill 645 (enacted by the 77th Legislature), which requires 23 occupational licensing entities to use a common Internet licensing system on Texas Online.

Incentives to Use an SIS Contract Were Identified

Once the outcome had been identified, both the client and the contractor determined that it was in their individual best interest to engage in an SIS contracting arrangement and they struck a balance between the level of risk and reward they were willing to pursue. For a client, SIS contracting is attractive because it enables a company to initiate a project without borrowing or investing its own funds. Moreover, it ties contractor compensation to results rather than just contractor recommendations that may not translate into the savings or increased earnings a client expects. But a client may hesitate at pursuing a basic SIS approach because that would require foregoing savings generated, and instead opt to finance some up-front costs or to partially compensate the contractor for effort in order to obtain a greater share in the savings. For contractors, SIS arrangements provide an opportunity to earn a return on investment that is higher than a traditional contract. But the contractor faces the risk that savings or increased revenues will not be realized after investing heavily in the project or will be realized more slowly than anticipated. To mitigate that risk, the contractor may also decide not to pursue a basic SIS arrangement. In each of the cases we examined, the client and contractor were able to work through these issues and come to agreement on how far they would take their SIS arrangement.

Table 2: How Clients and Contractors Determined Incentives Were Appropriate

Client/contractor	How incentives were determined to be appropriate
MIT/Alliant Energy Integrated Services/Cogenex	MIT entered into an SIS contract because it (1) allowed MIT to reduce utility costs without having to lay out any cash for needed upgrades and (2) provided that Alliant/Cogenex compensation be made entirely through sharing a portion of the savings realized. Alliant/Cogenex installed and maintained energy efficient equipment and assumed the risk that enough savings would be realized to compensate for the up-front costs[a] incurred and provide a profit commensurate to the risk undertaken. Alliant/Cogenex's confidence that the SIS contract would be profitable rested on its MIT energy audit and its experience in providing energy-savings measures in over 3,200 customer buildings. Those energy-saving measures included the installation of energy efficient lighting, motors, chillers, boilers, building automation systems, and air conditioning systems. In the end, MIT saved $980,000 annually over what it would have paid had the improvements not been made.
Texas Online Authority/BearingPoint	The State of Texas, through Texas Online, found a vehicle to offer Internet-based services to its businesses and citizens from state agencies and local governments, without spending general revenue funds. BearingPoint agreed to provide the equipment, setup, and ongoing operation of the Web site–including hardware, software, and staffing–at no cost to the state. In addition, once operational, Texas Online was designed to be self-supporting through the use of fees to use the service. BearingPoint determined that it could recover its investment by 2006 and would achieve the returns that would reward it for the risks it took in funding the project. The investment recovery projection was based on (1) the commitment made by the state (see table 4) and (2) numerous assumptions, including those pertaining to the continued growth in using the Internet as a medium to acquire government services.
Best Buy/Accenture	Best Buy entered into a gain-sharing contract with Accenture because, with their operational losses, Best Buy did not want to risk entering into a typical fee-for-service contract which could have resulted in paying for a consultant's advice that may not have led to improved profits. To reduce that risk, Best Buy wanted to partner with a consultant committed to success through the sharing of project risks and benefits by being paid, at least in part, for results achieved. Accenture, through its Best Buy business process study, was confident it could help deliver needed change in areas such as supplier consolidations, price negotiation strategies, advertising, inventory levels and in-stock performance, and buyer support and tools. Further, Accenture convinced Best Buy's top management that it had the resources, knowledge, and experience to deliver the needed change. Finally, Accenture was willing to share risk by reducing its standard consulting fee in consideration for receiving 20 percent of the Accenture-caused earnings growth, up to a contractual cap.

Client/contractor	How incentives were determined to be appropriate
Harley-Davidson/Henkel Chemical Management Group	Harley entered into an SIS agreement with Henkel because Henkel committed to provide a cumulative savings of 68 percent over a 5-year period, compared to what Harley had been spending for the products and services, which Henkel now provides. After the total savings commitments for the contract term are achieved, Harley and Henkel will share in Henkel-caused savings on a 50/50 basis. In addition, to the cost savings, the SIS agreement allows Harley to concentrate on its own core competency of manufacturing motorcycles, while simultaneously benefiting by having Henkel be the single source for chemical management to include products/services, technical support, and environmental compliance. Henkel's confidence that the SIS agreement would be profitable for them was based on their (1) study of Harley's chemical acquisition, usage, and disposal programs; and (2) experience with other manufacturing clients. Henkel officials said additional incentives include continued growth in their core competency of chemical management and the goodwill generated by having Harley-Davidson as a client.

Sources: MIT/Alliant Energy Integrated Services/Cogenex; Texas Online Authority/BearingPoint; Best Buy/Accenture; and Harley-Davidson/Henkel Chemical Management Group.

[a]Alliant/Cogenex borrowed $8 million to finance the project's up-front costs.

A Baseline and Performance Metrics Were Established

Because contractor payment was derived directly from savings and/or revenues generated, the ability to link the financial benefits generated for the client back to contractor-implemented recommendations was critical. Accordingly, both the client and the contractor agreed on (1) a performance baseline to determine the performance the client would have experienced without contractor intervention and (2) metrics to measure how contractor-implemented recommendations generate savings and/or revenue. When required, the baseline took into account market factors outside of the client and contractor's control. For example, energy savings are impacted by weather and energy prices, neither of which a client or contractor can influence.

We found that it is easier to establish a baseline and performance metrics in the energy industry than in other industries because it is easy to measure energy usage, through the use of metering devices. In the information technology industry, on the other hand, calculating the baseline can be more complicated. It can be difficult, for example, to isolate the direct savings from a reduction in the time an employee spends on a new task that replaces one or more old tasks. Also, the information necessary to calculate the baseline may simply not be available.

Table 3: How Clients and Contractors Established a Baseline and Performance Metrics

Client/contractor	How a baseline and performance metrics were established
MIT/Alliant Energy Integrated Services/Cogenex	MIT and Alliant/Cogenex agreed that energy reduction would be defined as the difference between energy consumed prior to Alliant/Cogenex's intervention (the baseline) compared to energy consumed after Alliant/Cogenex installed energy efficient equipment. Energy measurement was based on metering, which is the direct tracking of energy according to engineering protocols. The advantage of metering is its accuracy. In addition to metering, MIT and Alliant/Cogenex agreed to adjust the baseline due to changes outside of either party's control, such as unanticipated changes in operating hours, electrical loads, user participation, equipment performance, operation, maintenance and repair, and equipment replacement.
Texas Online Authority/BearingPoint	The established and agreed upon performance measures are based on providing online services in exchange for fees to use the service. Because this service is new, all transaction revenue is attributed to the contractor. How contractor-implemented recommendations generate revenue from a typical user fee transaction follows. A user inputs information. After user identity is authenticated, appropriate parties validate electronic charges made either by credit card or electronic check. The services are fulfilled and payments are distributed. Of the gross revenues generated, the state receives 10 percent and BearingPoint receives 90 percent, until its initial costs are recovered. After BearingPoint's initial costs are recovered, revenue sharing will be made on an equal 50/50 basis.
Best Buy/Accenture	Best Buy and Accenture agreed on a baseline defined as the 12-month historical performance of net sales, cost of goods sold, profit margins, and appropriate variable expenses. The historical performance was adjusted by existing growth/decline trends and inflation. For example, if audio had historically experienced an annual sales growth rate of 8 percent,[a] then the audio baseline (net sales, cost of goods sold, profit margins, and appropriate variable expenses) for the following year would include the 8 percent growth rate. With implemented Accenture recommendations in place, improvement over that baseline would be attributed to Accenture. After adjusting for factors outside of Accenture control, such as inflation, a joint Best Buy/Accenture team computed benefits on a monthly basis. For example, because increasing inventory turns increases revenue, Accenture introduced an optimized in-stock management model to receive merchandise based on rate-of-sale and out-of-stock risk versus the previous method of pushing inventory into stores. Success was measured by the increased in inventory turns over the established baseline, as determined by the Best Buy/Accenture team.
Harley-Davidson/Henkel Chemical Management Group	The baseline against which cost savings are measured is Harley's 1998 cost of chemicals, or the last price paid, whichever is higher. The information sources are paid invoices. For new items, the average of three viable quotations established the baseline. Henkel cost savings and calculations are submitted to Harley on a monthly basis, reviewed by a management team composed of managers from both Harley and Henkel, and approved when a reduction in the total cost of conducting business can be documented. Cost savings projects can occur in several areas, such as item/transaction cost reduction, product substitution, inventory reduction, waste reduction/elimination, and machine wear improvement.

Sources: MIT/Alliant Energy Integrated Services/Cogenex; Texas Online Authority/BearingPoint; Best Buy/Accenture; and Harley-Davidson/Henkel Chemical Management Group.

[a]Data based on information contained in Best Buy's annual audited financial statements filed with the Securities and Exchange Commission.

Client Management Committed to Success

Although commitment by management is necessary for a successful relationship with any contractor, it was particularly critical with the SIS contractors. Top managers needed to commit to change the way the company did business. Moreover, because SIS arrangements can be long-term, top managers needed to help sustain the business relationship. In the cases we looked at, managers helped facilitate success through frequent meetings with their contractors, backing contractor recommendations, and investing staff with the authority needed to carry out contractor recommendations.

Table 4: How Client Management Committed to Success

Client/contractor	How client management committed to success
MIT/Alliant Energy Integrated Services/Cogenex	MIT's president was committed to energy efficiency and decided to give control of executing an energy savings SIS project to Alliant/Cogenex. MIT was focused on outcomes and wanted to create an incentive for Alliant/Cogenex to develop optimized energy efficient improvements by linking their compensation to the savings achieved through their work. MIT recognized, through its commitment to let Alliant/Cogenex decide project details, that it was depending on the capabilities and experience of Alliant/Cogenex for success and believed that Alliant/Cogenex was in the best position to execute the project.
Texas Online Authority/BearingPoint	The commitment of Texas Online Authority management is reflected in state legislation that encourages/requires online services. One example is Texas Senate Bill 645 (enacted by the 77th Legislature), which requires 23 occupational licensing entities to use the common Internet licensing system on Texas Online. In addition, in January 2002, the State of Texas Web site was merged into Texas Online, providing "one-stop shopping" for government information and services. Further, each participating government agency is charged to inform potential users about Texas Online as a new service channel and to encourage its use.
Best Buy/Accenture	Accenture required, and Best Buy agreed to, the active participation of its top management to include the chief executive officer, the chief operating officer, and the chief financial officer. These officers, with Accenture support, provided the direction and commitment by reviewing monthly overall progress in areas such as supplier consolidations, price negotiation strategies, innovative advertising, optimal inventory levels, and buyer support. Best Buy top management also empowered their staff to implement the recommended changes. Best Buy top management agreed to partner with Accenture because it recognized that implementing Accenture initiatives would require changing behaviors, standard practices, supplier performance, and cultural norms. Best Buy also recognized that such changes are difficult because they can run afoul of existing behaviors, practices, and procedures.

Client/contractor	How client management committed to success
Harley-Davidson/Henkel Chemical Management Group	Management commitment, by both Harley and Henkel, is manifested in a two-tiered organizational structure to ensure SIS contract success. The first tier is a steering team managed by Harley's Director of Operations for Purchasing and Logistics and the Henkel Chemical Management Group's Operations Director. The purpose of the steering committee, which meets monthly, is to develop an overall strategy/business plan to meet operational goals and make financial commitments, sign contracts, and dedicate appropriate personnel to ensure success. The second tier is a site team consisting of Harley plant management and a Henkel site representative. The site team's role is to realize the steering team's operational goals by managing individual savings efforts.

Sources: MIT/Alliant Energy Integrated Services/Cogenex; Texas Online Authority/BearingPoint; Best Buy/Accenture; and Harley-Davidson/Henkel Chemical Management Group.

Other Issues Can Impact SIS Opportunities

Officials from companies we contacted, and others knowledgeable about SIS contracting, noted that other issues could pose challenges to, or promote SIS use. One issue identified was that SIS contracts could put a strain on a business relationship when savings or increased revenues are lower than expected. Further, when contractor-generated savings and revenues are greater than originally anticipated, some clients may want to re-negotiate because, they believe, the contract's sharing agreement turned out to be inequitable, allowing the contractor to reap too large a windfall. Also, legal issues can affect the use and structure of SIS contracts. For example, in the health care industry, due to the potential conflict of interest between providing high-quality hospital care and reducing costs, civil monetary penalty and anti-kickback legislation[3] was enacted that restricts the use of SIS arrangements[4] by hospitals and physicians.

Within the federal government, there may be additional barriers to using SIS contracting. For example, according to GSA officials, federal agencies have difficulty in measuring baseline costs. Without a baseline agreed to by contractor and client, savings cannot be measured, leaving a contractor in a risky position with no confidence that the savings needed to cover costs and provide a profit will be realized.

[3] Social Security Act, as amended, 42 U.S.C. sec. 1320a-7b(b)(1)-(2).

[4] SIS arrangements are referred to as gainsharing arrangements in the health care industry. Gainsharing arrangements are designed to align incentives by offering physicians a portion of a hospital's cost savings in exchange for implementing cost-saving strategies.

Also, our previous work on energy-savings SIS contracting,[5] together with our work on this audit, revealed that DOE headquarters officials believe such contracts are a viable option only when federal funding is unavailable. The DOE considers direct appropriations as the first option to pay for capital energy renewal projects, since all of the savings would then accrue to the government.

Conclusions

In the contracts we studied, an SIS contract was a highly effective contracting technique to generate savings and revenues. But to be successful, clients and their contractors had to be specific, and in agreement in their goals and objectives, as well as how to achieve them. Moreover, top management commitment was paramount—not only to provide the authority needed to carry out solutions, but to help overcome additional barriers and problems that can arise and to sustain the partnership. Federal agencies may find it even more difficult to engage in these arrangements given the lack of good baseline performance data. However, it may be worthwhile to examine ways to overcome potential problems in order to achieve the benefits possible through SIS contracting.

Agency Comments

In December 2002, we requested comments on a draft of this report from the Director of OMB. In official oral comments on the report, staff from the Office of Federal Procurement Policy, an office within OMB, stated that

- The report's findings will be taken into account in structuring future policy on the use of share-in-savings contracting, including implementation of section 210 of the E-Government Act.
- Agencies need to heed the lessons learned by industry to achieve success with this technique. Namely, there must be thorough and deliberative planning, as well as management commitment, to identify clear outcomes and measures that are agreed upon by both parties to a share-in-savings contract.

[5] *Energy Conservation: Contractors' Efforts at Federally Owned Sites* (GAO/RCED-94-96, Apr. 29, 1994).

Scope and Methodology

To find information regarding commercial sector use of SIS contracting and identify companies that use or have used SIS contracting, we searched numerous electronic databases and queried several professional organizations. Although these queries identified thousands of references, most were unrelated to the share-in-savings contracting concept. Excluding the energy industry, we found a limited number of references to companies or state agencies that use or have used the SIS concept. Because our focus was on the commercial sector, we contacted companies identified and asked them about their SIS contracting experiences.

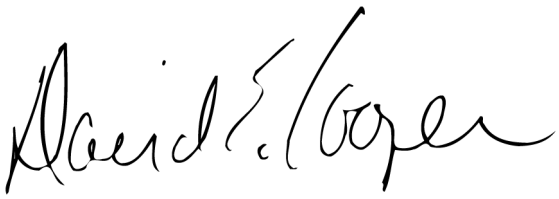
We then developed case studies on four SIS arrangements, which represent different industries, and were determined to be successful by the SIS clients and their respective contractors. For each case study presented in this report, we interviewed the clients and their contractors to obtain their views on when this type of contracting method is best used, the risks associated with SIS contracting and how such risks are mitigated, the importance of developing baselines and performance measures, and other characteristics that distinguish SIS contracting from traditional contracting methods.

For information regarding the use of SIS in the federal government, we used our previous work on SIS contracting, searched government web sites, including those belonging to the General Services Administration (GSA) and the Office of Federal Procurement Policy (OFPP), and had discussions with GSA and OFPP officials.

We conducted our review from November 2001 to January 2003, in accordance with generally accepted government auditing standards.

As agreed with your offices, unless you announce the contents of this report earlier, we will not distribute this report until 30 days from its date. At that time, we will send copies of this report to other interested congressional committees, the Secretaries of Education and Energy, and the Administrators of the GSA and OFPP. We will also make copies available to others upon request. In addition, the report will available at no charge on the GAO Web site at http://www.gao.gov.

Please contact me at (202) 512-4125, or Ralph Dawn at (202) 512-4544, if you have any questions regarding this report. Major contributors to this report were Marie Ahearn, Cristina Chaplain, Daniel Hauser, Mary Jo Lewnard, and Russell Reiter.



David E. Cooper
Director
Acquisition and Sourcing Management

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily E-mail alert for newly released products" under the GAO Reports heading.

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:
Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, managing director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548