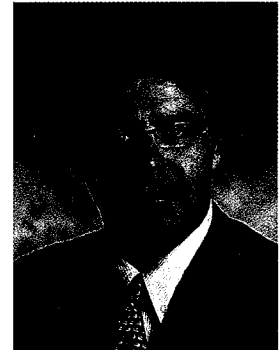


Performance-Based Contracting – Part I

How to get the most out of your suppliers in long-term contracts



Denis Chamberland

A recent commentary by the C.D. Howe Institute, entitled “A Bridge Over Troubled Waters: Alternative Financing and Delivery of Water and Wastewater Services” (dated May 2011), argues that municipal water and wastewater systems in Canada are not serving Canadians well, and lack the resources to address the challenges ahead. The commentary’s hard-hitting message is that municipalities often lack the resources to correct current failings, the professional capacity to plan infrastructure improvements, the capital to finance them, the skilled labour to operate the infrastructure, and – the *coup de grace* – the political will to do anything about it. The commentary reviews the market conditions that have led to this state of affairs, including the role and impact of public regulators, and makes the case that private water and wastewater companies may be well positioned to help tackle the many challenges faced by municipalities in this area.

One important area is the commentary’s focus on performance in accordance with contractual requirements. Once a private service provider

is in place, to ensure that efficiencies and cost savings do not come at the expense of performance, the commentary suggests, a municipality must put in place a binding contract that articulates robust performance standards, with clear consequences for failure to meet such standards.

While municipalities engage a growing number of suppliers to provide a growing range of products and services involving long-term contracts, as the commentary notes, all too often the contractual mechanisms needed to incent the right results are inadequate, or worse, are missing altogether. In this and the next two columns, I review some of the main features of performance-based contracting. Whether a municipality is contracting for water and wastewater management services, solid waste collection and recycling, or for the processing or organic waste, the contractual approach to ensuring performance share much in common.

Performance-based contracting was initially designed to help public organization reap the benefits of private sector innovation. Rather than

having a public organization micro-manage its contracts by prescribing in detail how it wants the goals to be achieved, in a performance-based setting, the public organization identifies what problem needs to be solved and allows the suppliers to submit proposals describing how they will provide the solution. The public organization’s job is to develop clear standards by which to measure the result, as well as the supplier’s performance over the course of the contract. The idea here is to allow the supplier the flexibility to be as creative as it can in providing the solution, and only pay the supplier based on solving the problem.

As the C.D. Howe Institute commentary notes, “... municipalities must insist on binding contracts that spell out performance standards and penalize non-compliance. As long as the performance metrics are clearly defined and easily measured and monitored, performance-based contracts give municipalities a simple, straightforward enforcement mechanism.” Table 1 shows an example of a structured contractual approach to penalizing failure by the supplier to perform adequately in a solid waste collection agreement.

Liquidated damages payable for failure to perform business tasks

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Table 1
Penalties for Failure to Perform

Incident	\$500/incident	\$1,000/incident	\$2,000/incident	\$3,000/incident
Failure to clean up spillage				each incident
Failure to submit reports	1-4 incidents	5-9 incidents	10-14 incidents	>14 incidents
Collecting waste beyond imposed container limit	1-4 incidents	5-9 incidents	10-14 incidents	>14 incidents
Failure to resolve damage claim to resident's property within specified time		each incident		

identified in the agreement should not, under any circumstance, prejudice any other remedy or action that may otherwise be available to the municipality, whether pursuant to the agreement, at law or in equity (before the courts). While the supplier's wrongful conduct may trigger the application of liquidated damages, as pre-determined in the agreement's table of liquidated damages, in the event that the same conduct causes serious damage to the municipality's premises, for example, the municipi-

ality will not want to be limited to the damages set out in the table of liquidated damages (be prepared for opposing counsel's argument that liquidated damages are intended as a genuine pre-estimate of the damages suffered, and therefore the entire remedy available to the municipality).

Performance-based contracts with financial penalties for poor performance create incentives to perform well. According to the commentary, the assurance that the municipality

can hold the supplier accountable for poor performance has been a key motivator to putting in place several long-term contracts in the water and wastewater sector. Because regulators tend to regulate more when private sector suppliers are providing the service than when the public sector is doing so, it is possible to achieve a higher degree of compliance through long-term contracts with the private sector suppliers. The commentary mentions how the Town of Canmore, Alberta, was fined \$15,000 for its own operator's failure to test and report on chlorine residuals in drinking water. The town apparently also had trouble retaining qualified staff to operate its new wastewater treatment plant. By entering into a contract with a private sector supplier, in a contract with clear performance measures and quantified penalties for poor performance, the town sought to achieve a higher level of compliance than it could on its own.

Next month, we'll review some important issues in preparing for performance-based contracting. MW



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