

Designing An Effective Compensation Plan That Rewards Performance
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I recently negotiated a labor agreement on behalf of an electric cooperative in which all of the compensation was based on achieving certain performance standards. This type of compensation plan is extremely rare for a unionized company and reflects an approach to compensation that can serve as a model for non-union employers as well.

The Cooperative was coming off of an 18 month wage freeze and felt it had some ability and need to fund a wage increase for its staff. The union had just been elected as the representative of a group of inside administrative staff and this was the first contract to be negotiated for that bargaining unit. The Cooperative had in the past done an effective job of rating each of the positions and placing them in graded wage ranges. The Cooperative also had a strong practice of using an effective annual performance evaluation.

The union's approach was of course to simply ask for wage increases regardless of skill or performance. We countered and were successful in getting the union to agree to a three year plan that had two components to it: (1) a 2% annual wage increase that was tied to the employees achieving certain performance standards, and (2) a 2% high performance incentive bonus that could only be achieved by reaching a high performance level. The performance incentive does not go on the base wage and needs to be earned each year.

The key to the system is an effective performance evaluation tool. A side committee negotiated with the union the evaluation form that was to be used so that it fairly reflected the important aspects of performance. While we were willing to negotiate changes to the evaluation form, we insisted that the process of evaluation itself would not be subject to the grievance procedure. In other words, however a supervisor evaluated an employee and whatever score they received on the evaluation, which directly affects their compensation, cannot be grieved or arbitrated.

There are several very effective aspects to this approach. The first is that the 2% annual wage increase is subject to meeting the basic performance standards. An effective score of 90% is necessary to receive the full 2%. The increase decreases proportionally based upon lower evaluation scores. The effect of this requirement is to marginally decrease the actual cost of the 2% increase since not all employees will achieve 90% or better. Moreover, the evaluation itself makes clear it that unsatisfactory performance as reflected on the performance evaluation is a basis for termination which is important in a union environment.

Secondly, the wage scales themselves have a built in progression for new hires with an anticipation of taking five years to achieve the top wage in their respective classification. Once again however, progression on the steps is also subject to the evaluation system so that a lower

performing employee will progress more slowly on the steps and may take significantly longer to reach the top wage.

The third aspect is the high performance incentive bonus. This is a bonus that is again only fully earned by achieving truly superior performance. While the standards need to be achievable, they are difficult and the expectation is that the average payout would be around 1%. This is the holy grail for union contracts, namely to find a way to truly reward performance in a system that seeks only uniformity. Significantly, the union members at the table bargaining for the contract were very comfortable with the concept of having to earn this incentive.

One of the appeals of this plan is that it looks more costly than it really is. A casual examination would suggest that this is a very costly plan for these times with a labor cost increases of 12% over three years. In reality however, the cost is significantly less than that. To begin with, the 2% performance incentive is a new cost only once. Since it doesn't go on base wages, after year one it is not an additional cost and, in fact, it can decrease if fewer employees achieve the incentive. Moreover, since all of the compensation is performance based, the actual costs will be less than the stated increases. Since the cooperative had a good history of doing performance evaluations and could then apply that historical performance against the compensation model, we were comfortable in projecting that the actual increase in labor costs due to wages of this approach was closer to 7% over the three year period. Other factors, such as turnover or force reductions, would reduce that cost even more.

While this plan was negotiated in a unionized environment, its components are equally applicable to non-union companies. As we climb out of this recession and look to rebuild our businesses, designing a compensation plan that creates incentives for good and even great performance and rewards our best employees is crucial to keeping our productivity and as a result our profitability high.