January 8, 2002

To:

Corporate Management Committee
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AU0212CG
Audit Services

Internal Audit Report

Performance Management:
Balanced Scorecard Implementation

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The objective of the audit was to evaluate the implementation of the Balanced Scorecard at BC Hydro and ascertain if the initiative has been successful in creating a performance-oriented culture while aligning company strategy to accountability, resource allocation and incentive compensation.

Accomplishments

The Balanced Scorecard initiative has been implemented in 16 out of the potential 39 business units in BC Hydro. Overall, management interviewees felt that the Balanced Scorecard, as a performance measurement tool, is useful. Literature and research has also confirmed that the Balanced scorecard is recognized as an effective management tool by many world class organizations. Major accomplishments include:

- The Balanced Scorecard has provided a company-wide framework and a common language to explain BC Hydro complex strategy and how it could relate to accountability, resource allocation, and incentive compensation.
- Tools and processes related to the “operationalization” of the overall company strategy have been standardized which enable the alignment of company-wide initiatives with the Corporate and SBU Strategic Business Plans and provide useful and comparable information to the Senior Management members in resource allocation decisions.
- The Value Based Management (VBM) team has shown leadership and vision during the scorecard implementation. The current team members are fully capable of supporting business units in developing Balanced Scorecards for the remaining 23 business units.
- Comprehensive training was provided to Senior Management, direct reports and the first line managers. The majority of the employees now understand the importance of a balanced performance measurement system and its relationship to BC Hydro’s strategy and long-term success.
Executive Summary

Major Findings

- Although the Balanced Scorecard initiative was “rolled-out” with unequivocal support and understanding of the various Corporate Management Committee members, there is a perception among interviewees that in practice, support and use of the Balanced Scorecard by the Senior Management in managing BCH, particularly in the last half year, was very limited.

- Interviewees believe that while BCH has a Balanced Scorecard, senior management has an undue focus on the financial measures such as Shareholder Value Added (SVA) and COMA per customer, to the exclusion of non-financial measures which are supposed to be the drivers of SVA and COMA. Also, perception exists that there is a major disconnect between the way resources are actually allocated and the way resources ought to be allocated according to the Initiative Prioritization Model, which is fully integrated with the Balanced Scorecard.

- Overall, the management feedback regarding the implementation, use and acceptance of the Balanced Scorecard has been mixed. The first line managers are somewhat positive. Among the Senior Management team, there are differing views. The direct reports are less positive. They view the major roadblocks in fully capitalizing on the potential benefits of the Balanced Scorecard are the “lack of accountability” culture at BCH, pending organizational changes, constraints in the compensation structure to link pay with performance and too many measures which divert attention away from the key business drivers.

- Many employees view the “strategy maps” to be overly complex and time consuming to prepare. For many, particularly those involved in providing support services, the strategy maps were considered an academic exercise that added little value.

- The program is now in its fourth year of implementation and has provided scorecards and strategy maps for 16 of the planned 39 business units. The total actual cost incurred to date is approximately $6 million, against a budget of $5.5 million.
Executive Summary

Major Recommendations

- Going forward, the balance scorecard framework can be effectively used in a line of business structure. However, it is critical that Senior Management make a decision, at its earliest, on whether it intends to truly use the Balanced Scorecard to manage BCH. Whatever the outcome of these deliberations, it should be clearly communicated to all employees.

- Clarify BCH's vision, mission, strategic priorities and infrastructure issues going forward. Once the strategic priorities have been finalized, communicate them in simple, understandable language and visible manner to the entire organization.

- If the company decides to use the Balanced Scorecard, improve the implementation as follows:
  - Reduce the number of performance metrics to no more than 8 - 10 and ensure that these are linked at all business levels in the organization. Simplify the “strategy maps” and the scorecard cascading process.
  - Develop a good mix of leading and lagging indicators that are meaningful and linked to strategic goals of BCH. Strengthen target setting based on desired performance level, scenario planning, and external benchmark data, where appropriate.
  - Strengthen the linkage of performance to employee reward and recognition to overcome the perception that there are insufficient consequences for non-performance.
  - Use the Balanced Scorecard to support Senior Management decisions such as allocating resources, rewarding employees, and following through on off-track performance. Report and communicate widely the Balanced Scorecard performance results.

- No management response to the recommendations has been included in this audit report, pending the decision by Senior Management whether to proceed with the Balanced Scorecard initiative within the “line of business” model currently under consideration.
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1. **Background**

- In 1998, Corporate Management Committee sponsored and adopted, with the approval of the Board, the Balanced Scorecard initiative to enhance BC Hydro’s readiness in a competitive business environment. Key goals were:
  - To communicate and “operationalize” the BCH strategic plan for all employees;
  - To enable the alignment of company-wide initiatives with the Corporate and Strategic Business Unit strategic business plans;
  - To provide useful and comparable information for Senior Management in their initiative prioritization and resource allocation decisions;
  - To focus BCH as a whole on the creation of long-term shareholder value via emphasis on financial and non-financial drivers; and
  - To implement an accountability framework as required by the Auditor General of BC.

- The original BCH Balanced Scorecard was based on five strategic themes: build shareholder value, secure the base, enhance customer focus, grow the business, and build a strong and capable organization. The Balanced Scorecard is being implemented in four distinct phases:

  - **Phase One**
    - Executive Team Commitment
    - BC Hydro Scorecard
    - Cascading - 4 SBU/KBU Scorecards
    - Initiative Prioritization Process
    - Planning Process redesign / integration of scorecards

  - **Phase Two**
    - Refresh BCH Scorecard
    - Cascading - 6 additional SBU/KBU / Subsidiary scorecards
    - Seminars

  - **Phase Three**
    - Complete/ refresh 11 Scorecards
    - Develop 5 scorecards internally
    - Seminars

  - **Phase Four**
    - Internal development/ refresh 16 existing scorecards
    - Complete remaining 23 scorecards
    - Standardize Process / tools
    - Plans to improve measures/ targets
    - Train the Trainer for Scorecard Coordinators

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2. Audit Objectives and Scope

Objective
- Provide assurance that the Balanced Scorecard implementation at BCH has been successful in:
  - Changing the organization’s culture from entitlement to performance based management;
  - Creating an integrated management framework for implementing BCH’s business strategy;
  - Developing and implementing a process and related tools to communicate corporate strategy;
  - Developing and implementing a process to measure and monitor the progress of BCH to its stated goals and objectives; and
  - Linking variable pay for Management and Professional employees to the achievement of strategic goals.

Scope
- The Balanced Scorecard Implementation was assessed along the following best practice standards:
  - Top Management Support, Consensus, and Communication of Strategy
  - Appropriateness of Chosen Performance Metrics
  - Targets that Stimulate Breakthrough Performance
  - Alignment of Performance Metrics
  - Accountability, Monitoring and Reporting of Performance Results
  - Linkage of Performance Metrics to Employee Reward and Recognition
  - Acceptance and Use of Scorecard to Achieve Desired Results
  - Communication, Training and Use of Information Technology
  - Project Management and Scorecard Implementation
2. Audit Objectives and Scope

A subject matter expert, Dr. Parveen P. Gupta, was retained to assist with this audit. Dr. Gupta, who is a full-time MBA professor at Lehigh University in U.S.A., has extensive research and consulting experience in various aspects of internal auditing and performance measurement including Balanced Scorecard, Business Process Reengineering, Total Quality Management and Integrated Risk Management. He has published a number of research articles in internationally renowned journals and is the author of two major research monographs in related areas. He was the primary interviewer and facilitator for this audit.

The evidence to assess the effectiveness of the Balanced Scorecard initiative was collected in the following ways:

- extensive interviews with the majority of the Senior Management members, including the President, conducted by Dr. Gupta;
- focus group meetings with the direct reports facilitated by Dr. Gupta;
- discussions with various members of the Value Based Management (VBM) team;
- a web survey of approximately 200 first line managers; and
- review of internal documentation supplied by the VBM team on the process and implementation of the Balanced Scorecard.
3a. Top Management Support, Consensus, & Communication of Strategy

Best Practice

- The senior management at the corporate and business unit level actively participates in designing measures for the Balanced Scorecard. Together, they share in the vision of the company, come to a consensus on its strategic priorities, and communicate the strategic priorities in a clear manner to the rest of the organization.

Findings

- Although approved by the Corporate Management Committee (CMC), many managers perceive that Senior Management did not actively participate in the development of the Balanced Scorecard initiative, and does not fully support its implementation and use. The following chart summarizes the response from CMC members, direct reports (DRs) and the first-line managers (MGRs) gathered during the audit:

  ![Top Management Support Chart]

- As part of the Balanced Scorecard implementation, the VBM team has made significant effort to communicate the BC Hydro strategy to managers across the organization through its management seminars.

- Vice Presidents, Direct Reports, and Managers all had difficulty articulating the Company strategy. Some stated that the company’s strategy keeps changing and lacks focus. Many believe that the strategy has been too broad and is a “negotiated settlement” as opposed to a “focused point of view”.
3a. Top Management Support, Consensus, and Communication of Strategy

Recommendations

- Since over half of the company has yet to fully embrace the Balanced Scorecard and the existing scorecards need to be refreshed in light of the pending changes in the company strategy going forward, it is critical that Senior Management make a decision, at its earliest, on whether it intends to truly use the Balanced Scorecard to manage BC Hydro. Whatever the outcome of these deliberations, it should be clearly communicated to all employees.

- Clarify BC Hydro’s vision, mission, strategic priorities and infrastructure issues going forward. Once the strategic priorities have been finalized, communicate them in simple, understandable language and visible manner to the entire organization.
3b. Appropriateness of Chosen Performance Metrics

**Best Practice**
- The company has a small, balanced portfolio of performance metrics that address all the four perspectives of a Balanced Scorecard: Financial, Customer, Internal Process, and Employees. The measures are a balance of financial vs. non-financial, cause vs. effect, outcome vs. driver, and leading vs. lagging indicators. Measures are dynamic, reflecting changing strategic priorities.

**Findings**
- Majority of the interviewees considered the concept of a house with strategic pillars to be somewhat helpful in depicting a complex strategy in a visual way. However, the strategy maps were perceived to be overly complex and difficult to understand - too many bubbles created a lack of focus, strategy maps are perceived as an academic exercise with no real value.

- All interviewees stated that the BCH Balanced Scorecard has too many measures. The Fiscal 2002 scorecard has a total of 5 categories, 23 strategic objectives and 22 measures. Some strategic initiatives are not clearly tied to performance measures and the cause and effect relationship of key measures is not clearly understood. Many interviewees were also unclear about how some non-financial measures ultimately impact BCH shareholder value as well as the relative weighting of each perspective (Financial, Customer, Internal Process, and Employees).

- Many interviewees expressed concerns that senior management has an undue emphasis on shareholder value and COMA per customer, without proper consideration of the drivers of these financial outcomes. In creating a “best-in-class” organization, one must not only focus on outcomes but also on the drivers of the outcomes.

- There is disagreement among managers on the relevancy of some performance measures. Some of the critical measures, such as Asset Health and System Constraints, have not been defined in measurable terms for a number of years. As a result, there are no achievable targets for these key measures on the BC Hydro Corporate Balanced Scorecard.
3b. Appropriateness of Chosen Performance Metrics

Recommendations

- Simplify or eliminate the “strategy maps” as they exist today. Consider replacing these with simple, cause and effect diagrams to demonstrate the linkages between the overall Corporate Strategy, the SBU strategy and the various performance measures.

- Reduce the BCH scorecard’s perceived complexity by significantly reducing the number of measures from 22 to the 8 - 10 range, with an appropriate balance of financial as well as non-financial measures. Before deciding on a measure, evaluate its relevance along the following best practice criteria:
  - How critical is the measure to the business and the stakeholders of BC Hydro?
  - If the measure is not tied to incentive compensation, how would it change behavior?
  - Does the data on the measure exist, and can be accurately and easily retrieved within the current information systems?
  - Is the measure an output or an outcome measure?

- Review all “To Be Developed (TBD)” measures and either set targets for their completion as soon as possible, or drop the measures from the scorecard if they are no longer applicable.

- Reach an agreement on the relative weight of each Scorecard perspective (i.e., financial, customer, internal business process, and employees) and then appropriately cascade the weights to individual measures within each perspective. Give due consideration to the non-financial perspectives and measures as they are the drivers of SVA in the end.
3c. Targets that Stimulate Breakthrough Performance

Best Practice

- High performing companies benchmark themselves with the performance of outside companies, both within and outside their industry, and then set aggressive targets with the objective to achieving better performance. They frequently incorporate scenario planning in their target-setting process and involve many levels of the organization in target setting to increase buy-in.

Findings

- The feedback from management shows that some CMC members, along with direct reports, view the target setting process could be strengthened:

  - At the BCH corporate level, the target setting process is still evolving. New measures continue to be developed to replace previous measures. For some measures, targets have not yet been established. Only 4 out of 22 measures show targets for three consecutive years. The basis for calculating many of the targets have changed. For example, prior to F2002, the COMA per Customer was a weighted calculation however, in F2002, equal weights were assigned to all customers. This change was not widely communicated. Very few employees realize that the target change from $204.9 in F2001 to $341.3 in F2002 was due to a change in the method of calculation, not as a result of stretching the target.

  - Currently, the use of external benchmarks or scenario planning is not fully incorporated into the target setting process.

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3c. Targets that Stimulate Breakthrough Performance

- During our discussions with Senior Management, we were informed that some targets (such as shareholder value, customer satisfaction, and public opinion) were stretched based on the environment the company was operating at the time, while some represent average performance over a number of years.

Recommendations

- Strengthen the target setting process and incorporate scenario planning in the development of targets early in the process. Determine which quartile BCH wants to perform in and benchmark to develop the stretch targets for that quartile of performance. Ensure that all the relevant internal as well as external stakeholders have “bought-into” the targets and there is unanimous support for the targets going forward. Align resource allocation to the targets accordingly.

- Once the targets have been established, communicate on a monthly basis the progress towards these targets in a visible manner to all the employees. Follow through aggressively on the causes of any deviation from the targets and accelerate performance in areas where the company is falling short of the targets.

- As soon as possible, decide which measures BCH will use to track its performance. In the event that the method of target calculation requires change, communicate the change clearly to employees and explain the reason for the change.
3d. Alignment of Performance Metrics

Best Practice

- High performing companies choose performance measures that are aligned with the organization’s strategic priorities and the critical business processes. Such an alignment is performed either on a periodic or an on-going basis.

Findings

- A review of some SBU Balanced Scorecards indicates that the alignment is to the specific performance measures rather than to the Balanced Scorecard perspectives (Financial, Customer, Internal Process, and Employees). Some managers complained that the “line of sight” to the BCH Scorecard is not clear, and there is confusion regarding what they are responsible for and what the Balanced Scorecard is measuring. This has led to the concerns whether the Scorecard as a tool is serving their needs.

- The management response below shows that first-line managers in general perceive a higher degree of alignment between performance metrics to the strategic priorities as oppose to the CMC members and the direct reports.

Recommendation

- As discussed earlier, eliminate the strategy maps and if need be, create cause and effect diagrams in their place. Ensure that there is a clear “line of sight” to the BCH Balanced Scorecard for all SBUs by aligning SBU measures to the BCH Balanced Scorecard perspectives rather than directly to the measures.
3e. Accountability, Monitoring and Reporting of Performance Results

**Best Practice**
- Senior management of high performing organizations focus performance discussions around the Balanced Scorecard’s four perspectives, with emphasis on the leading indicators, which are the “key drivers” of performance. To drive accountability, explanations are sought for deviations from those who are responsible along with “root causes”. The corporate and business unit performance is reported in a timely manner, in simple and understandable management reports.

**Findings**
- Feedback from the CMC members and Direct Reports indicate that the use of the scorecard to track and monitor performance requires more rigor and focus to drive accountability.
- The BCH performance results are reported around time frames (e.g. monthly, semi-annual) with no indication of the linkages to the Balanced Scorecard perspectives (Financial, Customer, Internal Process, and Employees). Very few employees read the BCH Corporate Balanced Scorecard results.
- Some interviewees believe that there is an undue focus on the financial performance by Senior Management. Attention to off-track non-financial performance measures appears to be somewhat weak. Consequently, the Balanced Scorecard has not been fully successful in changing behaviors at BCH.
3e. Accountability, Monitoring and Reporting of Performance Results

Recommendations

- Going forward, it is suggested earlier that Senior Management make a decision on whether it intends to truly use the Balanced Scorecard to manage BCH. If an agreement and commitment is reached on its potential usefulness, a concerted effort must be made to drive down accountability by holding employees at all levels responsible for delivering on strategic priorities and targets.

- The Senior Management team, as well as every manager, must be personally involved and visibly interact with the employees within their span of control to explain the Balanced Scorecard performance results at the BCH corporate level and their own business unit area. Frequent communication must take place not only on the “root causes” of below target performance but also on the causes of “superior” performance.
3f. Linkage of Performance Metrics to Employee Reward and Recognition

Best Practice

High performing organizations establish a clear link between the performance and the incentive compensation of its employees. Reward and recognition systems are kept as simple as possible to ensure ease of understanding by employees which in turn motivates them to deliver on the targets.

Findings

The management response below shows that CMC as well as Direct Reports believe that the linkage between performance and reward and recognition at BCH is lower than desired:

While a process exists that link the performance to the incentive compensation, many interviewees stated that the system is constrained and not effective in facilitating a behavior change among employees due to the following reasons:

- Non-performers are masked with the performers. As a result, they still participate in the majority of the incentive compensation which they should not be entitled.
- The variable pay, when distributed against a multitude of measures, is not large enough to motivate employees to go out of their way to deliver on the targets.
- Interviewees have expressed concern that they cannot influence some corporate performance measures which are linked to the incentive compensation. Only a few corporate measures are directly linked. The overall performance score was not explained. Employees generally have difficulty understanding the score or finding opportunities to further improve on the results.
3f. Linkage of Performance Metrics to Employee Reward and Recognition

**Recommendations**

- Charge the Corporate Human Resources group to initiate a wholesale review of the incentive compensation structure at BCH with the goal of aligning it with the Balanced Scorecard and creating a “pay for performance” culture in the company. Strengthen the linkage of performance to employee reward and recognition to overcome the perception that there are insufficient consequences for non-performance.

- Link relevant measures on the Balanced Scorecard directly to the incentive compensation in order for them to be meaningful.
3g. Acceptance and Use of Performance Metrics to Achieve Results

Best Practice

- High performing organizations secure a buy-in on the Balanced Scorecard measures from its employees through aggressive communication and explanation. A strong focus is maintained on long-term goals even as the management responds to short-term challenges. The senior management actively engages in gaining acceptance of the chosen measures.

Findings

- The use of Balanced Scorecard has resulted in some benefits but interviewees in general felt that the implementation of the Balanced Scorecard has not fully achieved its intended benefits, particularly relating to changing employee behavior.
- Management feedback shows a lower acceptance and use of the BCH Balanced Scorecard than the SBU Scorecards, particularly at the Direct Report level.
- As discussed earlier, a key concern among interviewees is the general perception of the lack of support from the top and the “lack of accountability” culture at BCH. Also, perception exists that there is a major disconnect between the way resources are actually allocated and the way resources ought to be allocated according to the Initiative Prioritization Model, which is fully integrated with the Balanced Scorecard.
3g. Acceptance and Use of Performance Metrics to Achieve Results

Recommendations

- The balance scorecard framework is recognized as an effective management tool by many world class organizations and can be effectively used in a line of business structure. As discussed earlier, Senior Management must agree upon the value of using the Balanced Scorecard and visibly use the Balanced Scorecard in its decision making activities such as initiative prioritization, resource allocation and incentive compensation. The use of the Scorecard must be clearly communicated to all employees.

- Clarify the role of the VBM team and the ownership of the Balanced Scorecard. Ownership of the Balanced Scorecard should rest with SBU's and their senior management. The VBM team should act as facilitators and a resource to support the business units.
3h. Communication, Training and Use of Information Technology

**Best Practice**

- High performing organizations conduct a gap analysis to identify who would need training and in what areas. Based on the gap analysis, scope of the training is determined as well as a delivery time table is established. Just-in-time training is provided to ensure minimal time lag between the training and the actual implementation of the Balanced Scorecard. The training program is designed to include extensive use of web-based tools including simulations to train employees.

**Findings**

- For the Balanced Scorecard Coordinators, the VBM team has developed a resourceful Balanced Scorecard training web-site as well as comprehensive training materials on how to develop, implement and refresh the Scorecard. Also, rigorous training was provided to direct reports and first line managers on the use of Balanced Scorecard to translate BC Hydro strategy into action. The feedback on the quality of training has been positive.

- While training has been rigorous, some employees have indicated difficulty in understanding some measures on the corporate scorecard (e.g., shareholder value, green house gas offsets).

**Recommendation**

- Once measures are refined, educate employees regarding the meaning of the chosen measures and how they are calculated. Also, provide some basic finance training to employees who may need it.
3i. Project Management and Scorecard Implementation

Best Practice

- High performing organizations conduct an “organizational assessment” to ensure that the critical success factors such as top management support and resources are available to “roll-out” the Balanced Scorecard. Also, a comprehensive project plan is developed which includes, the project scope and deliverables, clear time line, a communication strategy, and identification of all implementation issues.

Findings

- Project implementation was planned over 4 years, commencing June 1998. While this was a deliberate decision by the CMC, a strong view has emerged among senior management and direct reports that the implementation time has been too long. The benchmark for normal implementation, for an organization of BCH size, is approximately 18-24 months.

- The project was planned for delivery in four phases. We were informed that a total project budget for the four phases was not prepared initially because each phase required separate review depending on the project outcome. Instead, a business case and project plan with detailed timeline and deliverables were developed annually. To date, approximately $6 million has been invested over the past 3.5 years, against a budget of $5.5 million. Scorecards for 16 of the potential 39 business units in BC Hydro have been developed.

- During the initial project phase, external experts were retained to provide assistance in the implementation. These external consultants, Renaissance Worldwide, Inc, are very well respected in this field and are in fact the original developers of the Balanced Scorecard.

Recommendation

- If a decision is made to proceed with the implementation of the Balanced Scorecard, it is recommended that the progress of the project be regularly reviewed to ensure that it meets the established time table and expected deliverables.
4. Going Forward

- Going forward, BC Hydro has three choices pertaining to the Balanced Scorecard Implementation: status quo, abandon it completely, or modify it in light of recommendations of this report and finish deploying it in the rest of the organization. It is very important that this decision be made as soon as possible.

- Overall consensus of the interviewees is that the Balanced Scorecard is an effective tool in communicating an organization’s strategy to employees and other stakeholders.

- When asked whether the Balanced Scorecard should continue to be used, both the Direct Reports and First Line Managers were somewhat ambivalent about it:

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- Many concerns were expressed by Direct Reports and Managers regarding the upcoming business reorganization. It is important that the details of this be clarified and communicated to all BC Hydro employees as soon as possible.

- If the use of the Balanced Scorecard is confirmed by senior management, the following are some of the critical factors for successful Balanced Scorecard implementation at BC Hydro:
  - Clarify the business strategy of the BC Hydro during the transition period.
  - Clarify the role of the VBM team in sustaining the Balanced Scorecard at BC Hydro.
  - Reduce the number of performance metrics to no more than 8 - 10 and simplify the Scorecard cascading process.
4. Going Forward

♦ Develop a good mix of leading and lagging indicators that are meaningful and linked to strategic goals of BC Hydro. Use external industry benchmarks where appropriate.

♦ Strengthen target setting process with reference to desired performance level and external benchmark data.

♦ Strengthen the linkage of performance to employee reward and recognition and overcome the perception that there are insufficient consequences for non-performance.

♦ Report and communicate widely the Balanced Scorecard performance results.

♦ Use the Balanced Scorecard to support Senior Management decisions such as allocating resources, rewarding employees, and following through on off-track performance.