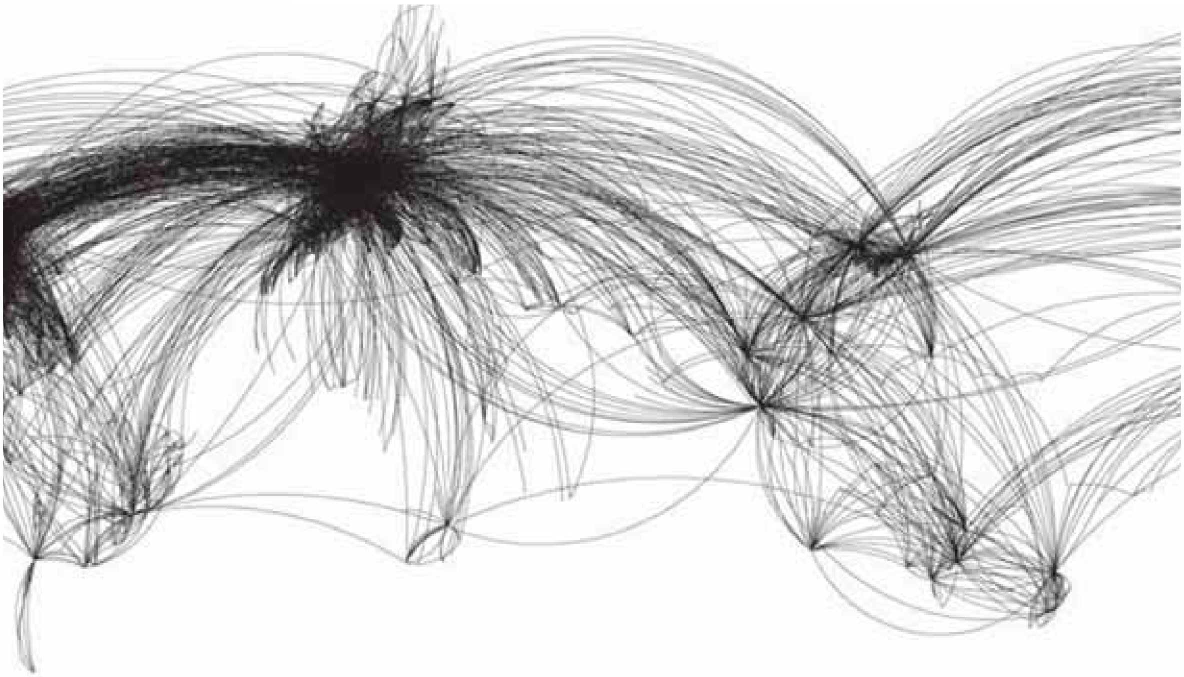
New Approaches for Managing Supply Chain Relationships



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Executive Summary

This White Paper outlines new developments in the economics of contracting. It diagnoses the contractual problems in value chain relationships. These are caused by bilateral dependency, measurement difficulties, weak property rights and disruptive change.

The principles of contract design are explained, and the criteria for choosing between contract forms.

A key insight is that all complex contracts are unavoidably incomplete. Relational arrangements are therefore needed to ensure that contractual relationships can respond to changes in the business conditions.

For organizations that master the logic of contract economics and relational strategy, there are a number of important benefits: faster speed to market with new products and services, more innovative solutions, improved flexibility to manage disruptive change, reduced costs, and capture of new market opportunities.

NEW CONTRACTING FRAMEWORKS ARE VITAL TO SUPPLY CHAIN SUCCESS IN THE 21ST CENTURY ECONOMY

Supply chains are moving towards closer and tighter networking, in response to customer preferences for better quality, service and traceability. In food supply chains for example, developing, signalling and monitoring quality across the chain has become a central issue.

The challenge facing supply chain partners is to figure out how to get self-interested firms in all industry supply chain to collaborate more closely in the delivery of increasingly complex and often, customized products and services. This is a particularly difficult task because individual firms within an industry network have incentives to maximize their own profits. The risk is that one firm attempts to increase its profits in the short-term at the expense of a firm upstream or downstream in the supply chain.

In light of the shift towards tighter integration across the supply chain, the next generation of major contracts will benefit from applying the new "relational" principles for managing supply chain / logistics relationships. Properly applied, they lead to less disputation, lower contracting costs, and greater value added.

So how can firms confidently rely upon one another, share information, or engage in other activities that result in productivity improvements for the value chain network as a whole? As the following sections of this Paper will describe, the approach to achieve these goals lies in adopting certain rules and "organizing" structures, but also consisting of semi-formal or relational arrangements to facilitate cooperation among supply chain members. The reality is that without the countless acts of cooperation that take place everyday between logistics transactors, most supply chains would break down.

DIAGNOSING THE PROBLEMS OF SUPPLY CHAIN CONTRACTS

The first step towards better management of supply chain relationships is to diagnose the various causal factors which lead to problems. These contractual hazards shown in Exhibit 1 are described as: "lock-in" or bilateral dependency, human factors, performance measurement difficulties, and the reality that all complex contracts are "incomplete" in some important ways.

<u>Exhibit 1 - What causes problems in supply chain relationships?</u>

Lock-in	▪ Once the contract is signed, each Party's ability to manoeuvre are limited ▪ Service delivery requires relationship-specific investments such as human capital and business assets
Human factors	▪ The Parties cannot foresee all possible outcomes ▪ Buyer or supplier may renege on commitments, under-invest, and mis-report the facts
Performance and measurement problems	▪ "Not everything that counts can be counted" - trust, quality, innovation, information sharing and responsiveness ▪ Incentives may be costly and risky ▪ Information asymmetries and gaps on both sides
Complex contracts are incomplete	▪ There are unforeseeable contingencies, and there are too many contingencies to write them all down ▪ Enforcement of contracts is imperfect

The "lock-in" problem

Most supply chain contracts involve specific investments which are made by one or both parties, and these have much less value in alternative uses. This gives rise to the "lock-in" problem. For example, lock-in raises the possibility that the effective terms of the deal may worsen for one Party after an investment is sunk into the deal by that Party.

Since the value of the relation-specific investments in facilities, equipment and people skills, depends on the continuation of the Buyer-Supplier relationship, the party that has not invested may expropriate some of the value of the investment by threatening to walk away from the relationship. If the potential investor cannot be assured of realizing the full value of the relationship-specific investment, efficient investments that reduce the cost of logistics or improve service will not be made. Valuable deals simply won't get done, leaving both Parties worse off.

Human factors are a reality in supply chain performance problems

Opportunism occurs when observed behaviours are inconsistent with some prior contract or agreement. For example, the Buyer or Supplier may renege on commitments, under-invest, and mis-report the facts. Opportunistic behaviour has important practical implications: if the risk of opportunism in a particular relationship is sufficiently high, considerable resources must be spent on complex and detailed contract design, as well as control and monitoring. The upshot is that these resources that could have been deployed more productively for other purposes.

Measurement difficulties exist in many contracts

Not everything that is counted, counts. Some important attributes of a supply chain service may not be directly observable to the Buyer or Supplier. Agility and responsiveness, reputation and trust, innovation and the quality of management account for much in the performance of the supply chain services. However, these attributes are difficult to measure, but are vital to success.

All complex contracts are incomplete

Contract Managers simply cannot foresee all possible outcomes over the duration of the contract. Conditions can change over time in ways that are not unforeseen by the managers. Unanticipated change plays havoc with contractual arrangements; for example induced by corporate re-organisation such as mergers and acquisitions, as well as by new technologies and regulatory changes.

The up-shot of major supply chain contracts is that they are incomplete, since there can be critical information gaps at the initial contract development stage. Often there are unforeseeable contingencies, or there are too many contingencies to write them all down. So it is not generally possible to craft a precise definition of the overall requirement and of the means to carry it out. The enforcement of contracts may also be imperfect.

A natural tendency of Buyers of supply chain services is to attempt to shore up the contract with more and more service level agreements (SLAs) or penalty clauses. However, adding SLAs is itself costly and they may make the contract too rigid, particularly since the future may develop in unexpected ways. The central challenge therefore of all major contracts is how to facilitate adaptation.

MASTERING THE LOGIC OF RELATIONAL STRATEGY

Many supply chain arrangements are based on the implicit assumption that accountability derives from the imprimatur of the Buyer, which in turn assumes that the Buyer is – unilaterally, hierarchically, and authoritatively – in charge. Perhaps this is the situation in some supply chain arrangements. However the reality is that key Suppliers play an extensive role in every dimension of supply chain performance outcomes.

The value of the relational model derives from the fact that real gains across the supply chain are possible when partners harness combined resources, and develop an advantage over competing firms who are unable or unwilling to do so. Relational advantage is a property of the pair of Buyer-Supplier firms, or more generally of a network of firms. It is not sufficient to have a relational capability that is housed within one of the Buyer or the Supplier firm. Both parties must use a relational approach to create value.

The contrast with arms-length market arrangements

In contrast to relational arrangements, arm's-length “market” relationships are characterised by non-specific asset investments, minimal information exchange, low levels of interdependence, and minimal investment in governance mechanisms. Under these conditions it is easy for Buyers to switch Suppliers with little penalty because other Suppliers offer virtually identical services.

A possible reason for Buyer choosing a “market power” strategy to pit a numerous Suppliers against each other is for the Buyer gets its logistics services at the very lowest price. Thus, the Buyer may be trading off service quality for lower cost inputs. This, of course, could be a viable strategy. However, the evidence is mounting that “commodity logistics” are a strategic “dead-end” in a world of more tightly integrated supply chain operations. They are incapable of generating value-added because there is nothing unique about the exchange relationship that enables the two parties to generate profits above and beyond what other Buyer-Supplier combinations can generate. Such relationships are not difficult to imitate.

This analysis suggests that logistics contracts generate competitive advantages only as they move the relationship beyond the arms-length logistics model. To do this requires the formation of both formal and semiformal arrangements which are the building blocks of relational advantage.

WHAT IS THE RELATIONAL MODEL OF CONTRACTING?

The relational model of competitive advantage has four building blocks:

1. Complementary resources and capabilities
2. Knowledge sharing routines
3. Relation-specific assets, and
4. Effective governance.

1. Complementary resources and capabilities

By leveraging the complementary skills of the Supplier, the Buyer can achieve a synergistic effect whereby the combined resource endowments are more valuable and difficult to imitate than they had been before they were combined. To achieve these gains the Parties require a high degree of compatibility in decision processes, information and control systems, and culture.

2. Knowledge sharing routines

A knowledge-sharing routine is a regular pattern of inter-firm interactions that permits the transfer, recombination, or creation of specialised knowledge. A supply chain with superior knowledge-transfer mechanisms among users and Suppliers of logistics services will be able to “out innovate” other networks with less effective knowledge sharing routines. A range of studies indicate that a firm's alliance partners are, in many cases, the most important source of new ideas and information that result in performance-enhancing technology and innovations. Therefore it is in the Buyer's interest maintaining a minimum level of logistics skills in-house in order to manage the partnership effectively.

3. Relation-specific assets

The Survey results reported in the following pages suggest that productivity gains in the supply chain are possible when supply chain partners are willing to enter into stronger bilateral arrangements and make relation-specific investments. Examples of these investments include: investment in customized equipment and facilities, and investment in human capital and know-how that enable effective coordination between the Parties.

A high degree of information sharing and trust results in higher levels of relation-specific investments because the parties discover new ways to enhance performance through specialized investments. Such investments pave the way to lower total value chain costs, increase product and service differentiation, deliver higher quality products and services, and create faster development cycles.

4. Effective governance

All complex contracts are unavoidably incomplete as discussed in the previous section. The implication is that supply chain partners need to engineer compensating arrangements to deal with changing needs and opportunities. This requires building in credible commitments, and complementing the formal contract with a governance approach based on developing shared goals, cultural alignment and skills to govern the contractual arrangements effectively.

Partners are more likely to make investments in relation-specific assets when they have designed effective governance safeguards against opportunism. The length of the safeguard (contract duration) and the volume of business transacted are key ways to influence the ability of partners to generate value through relation-specific assets.

SURVEY OF BUYERS AND SUPPLIERS OF CONTRACTED SUPPLY CHAIN SERVICES

In researching *New Approaches for Managing Supply Chain Relationships*, a questionnaire survey was conducted by Strategis Partners: 11 from companies that buy supply chain services and 18 from companies that offer supply chain services. The issues probed through the questionnaire included contract design, the quality of the relationship between Buyer and Supplier, the clarity of the service requirements, and the presence of relation-specific investments made by Suppliers and Buyers. The key findings are described below.

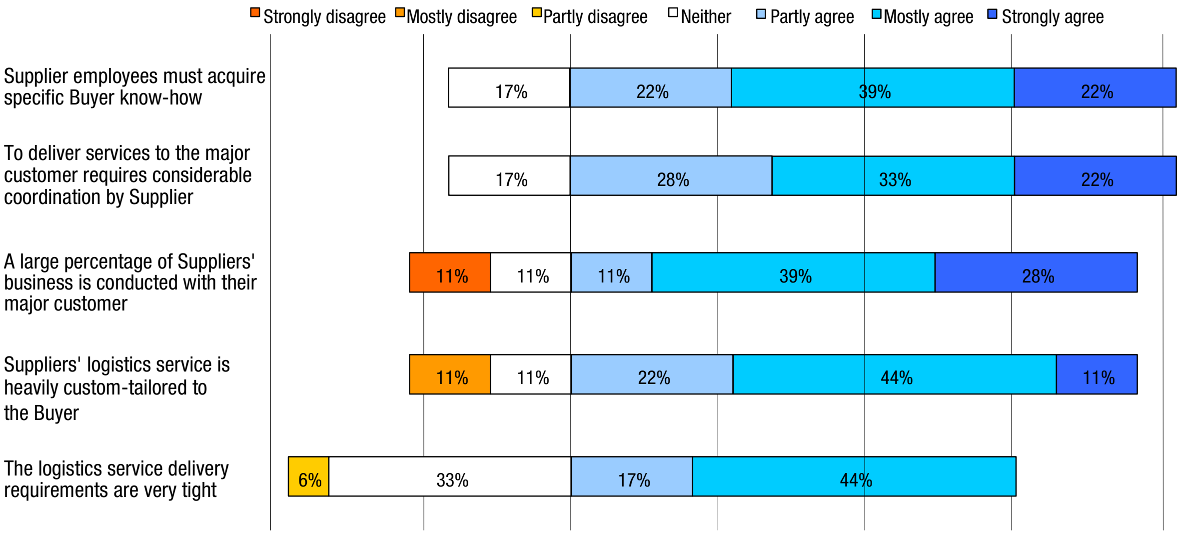
Supplier responses indicate presence of relationship-specific investments and "lock-in"

Through the Survey the vast majority of Suppliers revealed that they are making significant investment in specialised assets, both physical capital and human capital, to service their major Buyer's needs. Similarly, the Survey revealed that Buyers rely heavily on one or two Suppliers. These "lock-in" features are defined as the following:

- The Supplier's investment in employee skills and specific know-how to perform the logistics service function for the Buyer
- The share of the Suppliers' business which is conducted with their major customer, and the degree of customisation of the logistics services for the Buyer
- The level of coordination required to deliver the services and the "tightness" of logistics service delivery requirements of their major customer
- The reliance of the Buyer on one or two Suppliers for their most important logistics services, and the degree of difficulty in switching to different logistics Supplier(s).

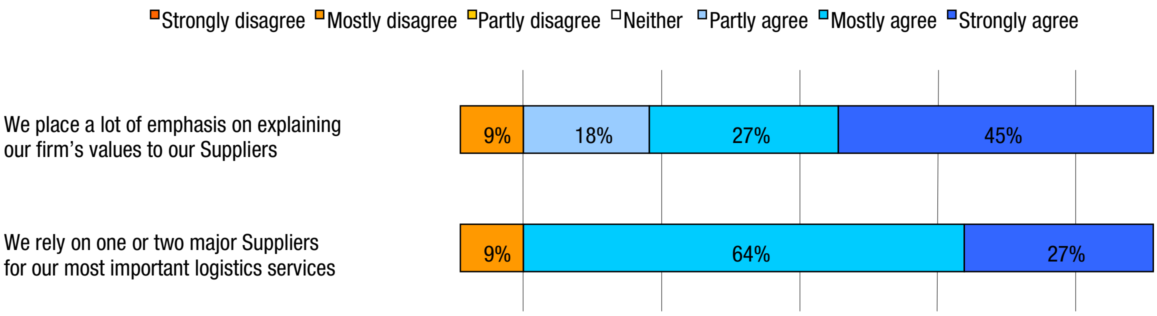
The overall finding is that three quarters of the Supplier respondents agreed (in part, mostly or strongly) that relationship-specific investments were a key element of the contracting arrangements. Exhibit 2 following shows that over half of the Supplier respondents *mostly agreed* or *strongly agreed* with the statements that their employees must acquire specific Buyer know-how and skills, that the logistics services are heavily tailored to the Buyer's special requirements, and that a large percentage of their business was tied up with their major customer. Similarly most agreed that the delivery requirements were very tight and required considerable coordination.

Exhibit 2 - Supplier's investments in the logistics arrangement



On the Buyer's side, the Survey results in Exhibit 3 indicate that Buyers place a lot of emphasis on explaining their firm's values to their Suppliers. Almost all Buyers rely on one or two Suppliers only for their most important logistics services.

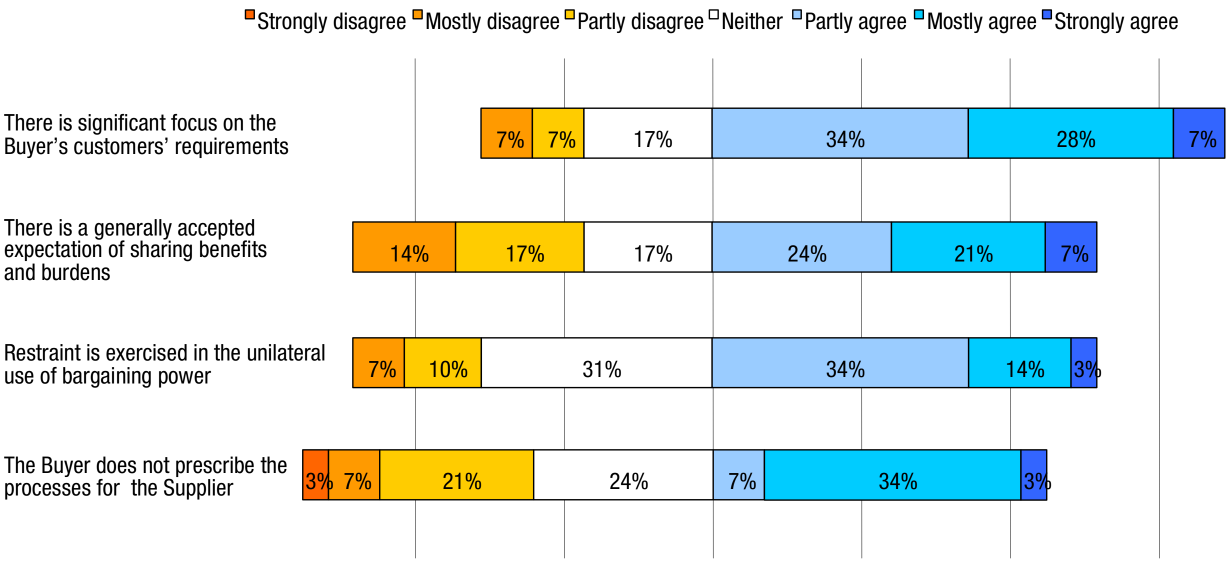
Exhibit 3 – Buyers' focus is on working closely with one or two suppliers



There does not appear to be a very strong relational focus in the supply chain contracts

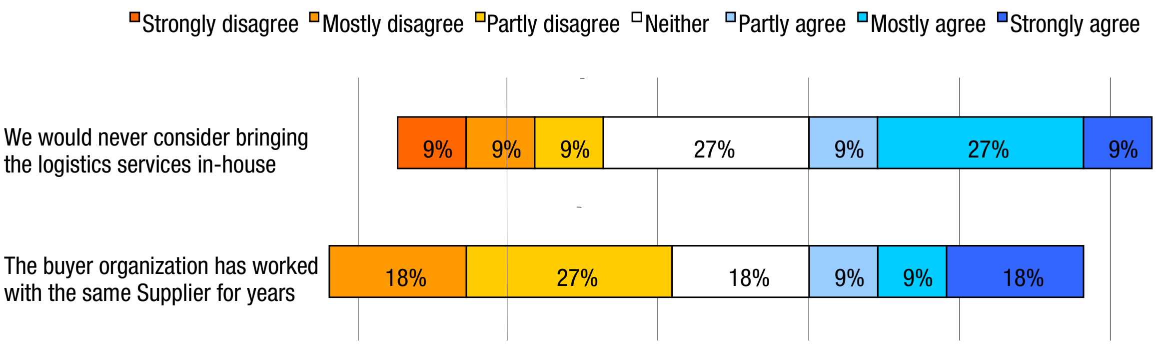
In spite of the strength of the "bilateral dependency" revealed in the previous section, the Survey results show that a strong relational focus is lacking in many supply chain arrangements. The following Exhibit 4 shows that for Suppliers, only half of the respondents agreed with the statements that sharing of benefits and burdens, that restraint is exercised in the unilateral use of bargaining power, and that the Buyer does not prescribe the process for the Supplier. However, one positive finding is that for the majority of contracts there is significant focus on the Buyer's customers' requirements; that is "whole-of-supply-chain" thinking seems to be working.

Exhibit 4- Supplier responses indicate relational focus is not that strong



On the Buyer side, there is considerable turnover in their use of Suppliers, and almost one-third of Buyers reported a leaning towards bringing the supply chain services back in-house, as shown in Exhibit 5 following.

Exhibit 5 – Buyers' attitudes are indifferent towards their Suppliers

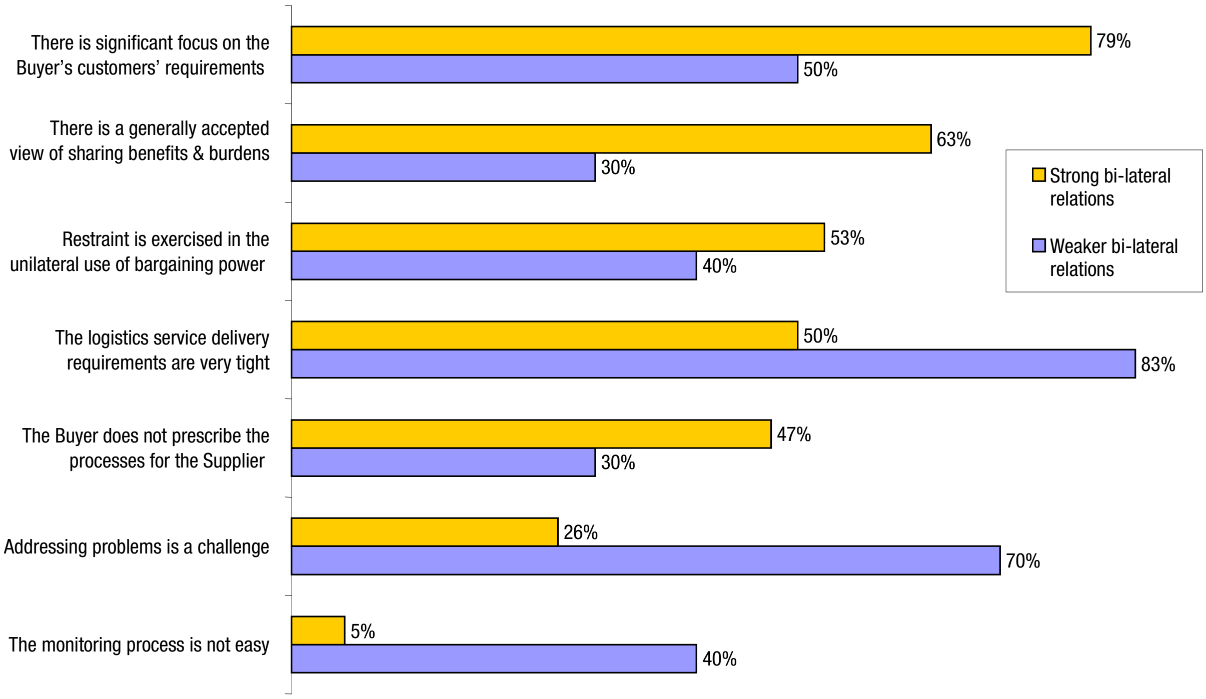


Advantages of strong bilateral arrangements

From the survey responses, Buyers and Suppliers were segmented into two groups: strong bilateral arrangements versus weak bilateral arrangements.

Strong bilateral arrangements were identified by the following criteria: Buyers who indicated that it would be very costly to switch to different Suppliers, and Suppliers for whom a large percentage of their business is conducted with their major customer. The remaining respondents surveyed were defined as having weak bilateral arrangements. The responses to a range of questions are shown in Exhibit 6 below.

Exhibit 6 – Bilateral dependency has its benefits in logistics contracting



The survey respondents with strong bilateral arrangements were more likely to report that there was a greater focus on the Buyer's customers' requirements, that there is a more generally accepted expectation of sharing benefits and burdens, and that greater restraint is exercised in the unilateral use of bargaining power. The Supplier respondents in this category were more likely to report that the Buyer does not prescribe the processes for the Supplier to follow.

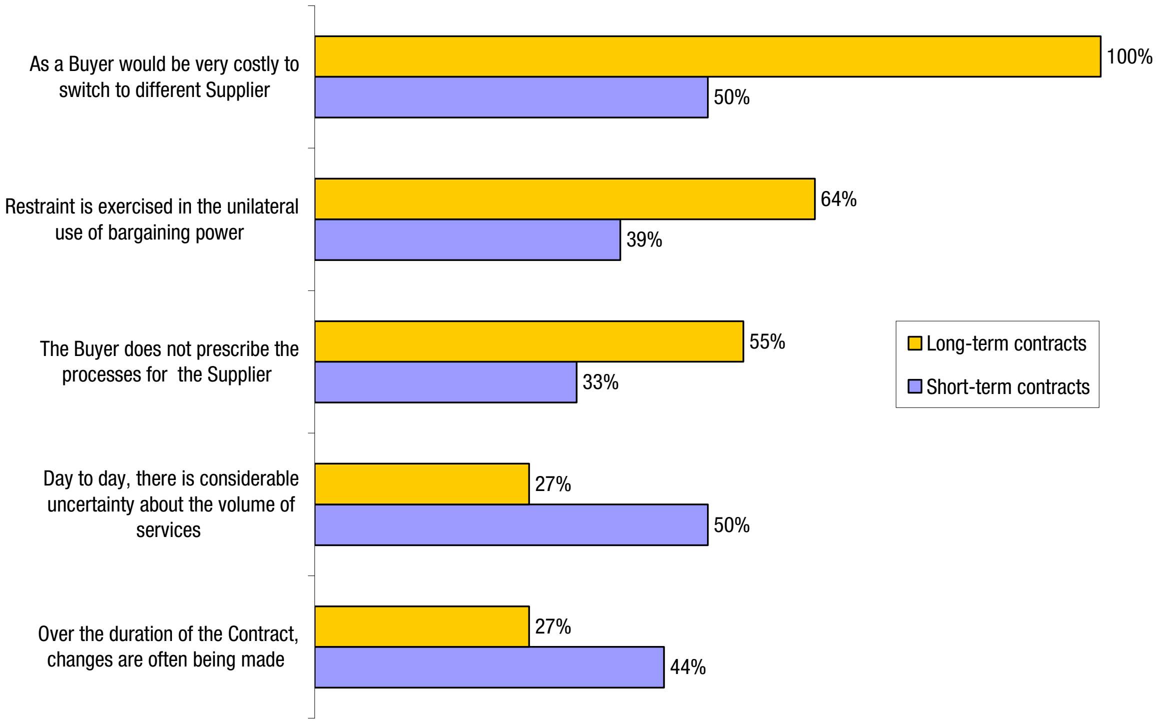
In contrast, survey respondents with weak bilateral arrangements were more likely to report that they faced tighter service delivery requirements; addressing problems that might arise in the relationship is a greater challenge; and that the contract monitoring process is not easy.

Longer term contracts are more likely to be associated with a relational approach

Approximately half of the supply chain contracts were one to three years' duration, while another third were longer than three years. The remaining contracts were either rolling contracts or less than one year's duration. Generally the longer term contracts are associated with a more complex contract design. Contract design refers to the detailing of roles and responsibilities to be performed, contingency planning, procedures for monitoring and penalties for non-compliance, and the definition of outcomes to be delivered.

Exhibit 7 shows the key differences between long-term contracts (greater than 3 year's duration) and short-term contracts (less than 3 year's duration). The long term contracts show a greater reliance of the Parties on each other, and more restraint in the exercise of bargaining power. In contrast, the short term contracts are associated with a greater level of uncertainty around the services.

Exhibit 7 – Key differences between long term and short term contract arrangements

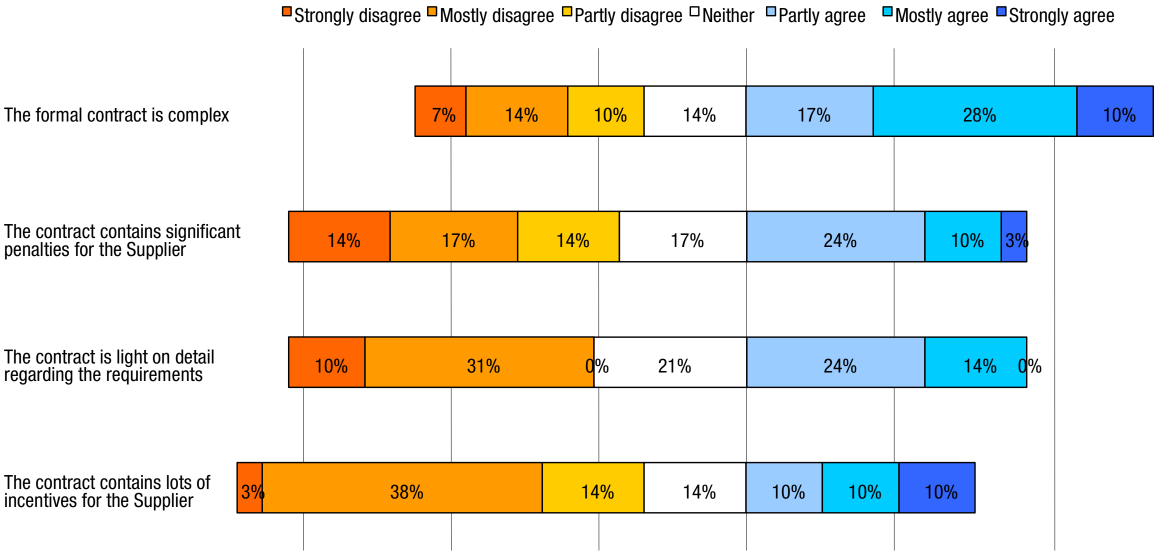


Contract design can be improved

The Survey results suggest that the design of supply chain contracts may be improved. Almost one-third of respondents *disagreed* with the statement that a contract management or governance structure is operating for Buyer and Supplier teams to deal with problems that might arise from time to time; to ensure that coordination is efficient and effective; and that overall relationship value is maximised. On the other hand many supply chain arrangements appear to be working well, with almost half of the respondents mostly agreeing or strongly agreeing that a governance structure is operating.

Exhibit 8 below presents the Survey results on contract design.

Exhibit 8 – Survey results suggest that contract design can be improved



Opportunities for improving contract design include reducing the complexity of the formal contract, providing greater clarity on the service requirements, and shifting the balance from Supplier penalties towards greater use of Supplier incentives.

BENEFITS OF THE RELATIONAL CONTRACTING FRAMEWORK

The relational contracting approach is practical, even hard-nosed. It focuses on minimising coordination costs and creating new forms of value between Buyer and seller, but it also recognises that mechanisms are needed to deal with opportunism and change.

The Survey indicates that contracting and relationship capabilities vary considerably across companies. So increasing the rate of learning on how to contract is essential now that supply chains are moving towards closer and tighter integrated modes of operation. A pair or network of firms that can develop superior contract-based relationships together is a new kind of competitive advantage. Such relationships are fundamental to success in the 21st Century economy.

The new generation of "relational" contracting principles lead the way to lower coordination costs, less disputation and greater value-added. For organizations that master the logic of the new contracting framework there are a number of important benefits: faster speed to market with new products and services, more innovative solutions, improved flexibility to manage change, reduced costs, and capture of new market opportunities.

About the Author

Jay Horton, Founder of Strategis Partners, is an adviser to companies and Governments on a wide range of strategic business issues, including value chain strategy and contracting, scenario planning and innovation.

During his twenty year management consulting career, he has worked with clients in Australia, Canada, China, Japan, Hong Kong, Indonesia, New Zealand and Singapore.

Jay has played a range of leadership roles:

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Founder and Managing Director of decision consulting firm ORG Pty Limited

McKinsey Consultant to top management in Australasia

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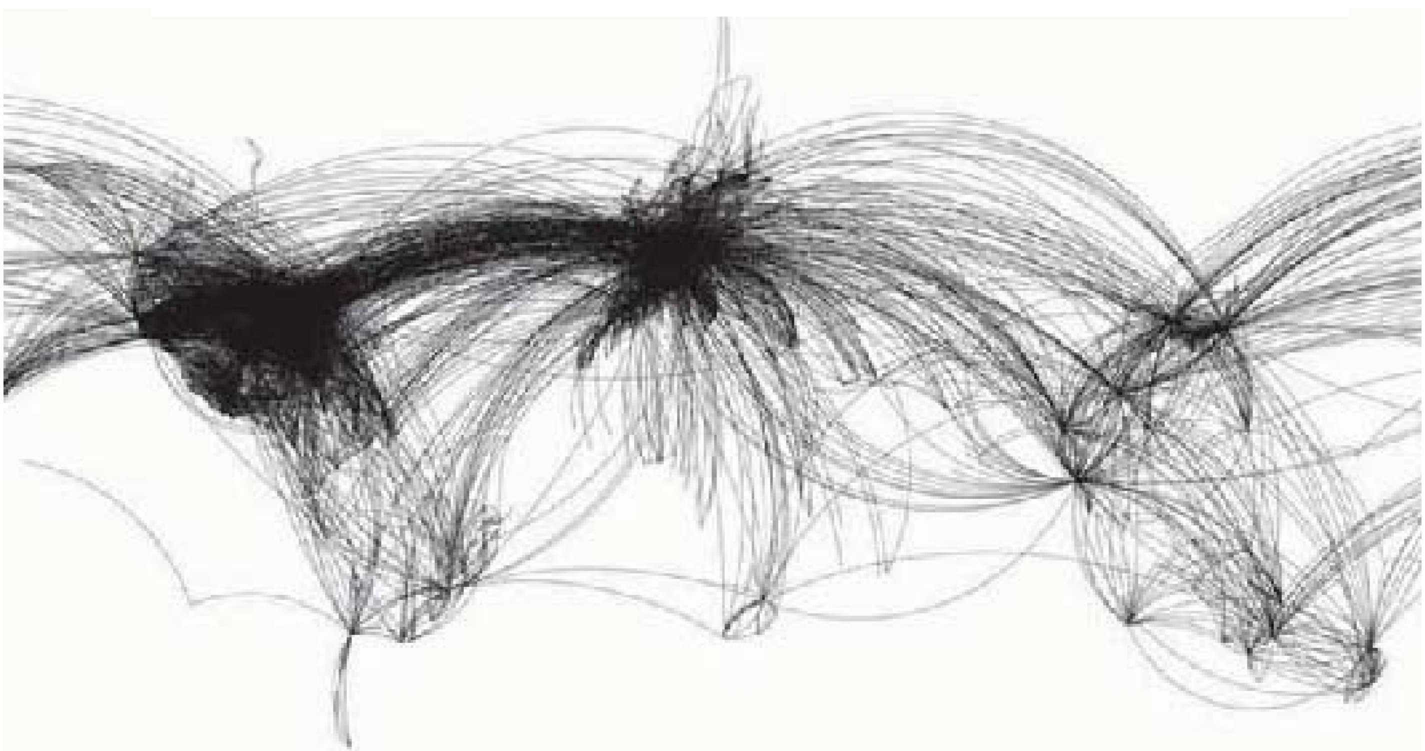

GLOBAL ALLIANCE NETWORKS

This diagram depicts the city pairs serviced by the three major airline alliances – oneworld, SkyTeam and Star Alliance – representing 32 airlines and over 60 per cent of the global air passenger market.

Image Courtesy of Massive Change

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