Strategis Partners

Discussion Paper

Contracting 2.0

Flexible agreements for an uncertain world

Keys to Successful Contracting

This latest Paper from Strategis Partners introduces ideas and actions for improving contracting strategy to benefit you and your organisation

Contracts that deliver complex systems and services underpin a huge amount of economic activity. Total public procurement alone is some 15% to 20% of GDP. In addition an estimated 80% to 90% of business goods and services are traded through extended-term contracts between companies.

But what if the dominant structures to procure big-ticket items and outsourced services are defective in critical aspects?

Downer EDI's unfolding difficulties with its Waratah railcar contract with the NSW Government highlight what happens when contracts go bad. So far Downer has taken a $190 million write-down on the contract.

Some years ago it was Leighton's nightmare on Spencer Street. The public-private partnership between Leighton and the Victorian government for the Spencer Street station refurbishment contract ran into difficulties. So much so that Leighton's chief Wal King described it, not as a partnership, but as a "master-slave relationship".

The series of deals that went bust – the Airport Rail link in Sydney, the Sydney Cross-City Tunnel and the Lane Cove Tunnel projects – underline the major difficulties in contracting for major programs.

Our view is that contracts – either private or public projects – are in need of a game change. Cost savings of 5-8% of the total value of procurement are available if governments and companies are prepared to rethink the way they procure.

WHEN TOO MUCH COMPETITION CAN BE BAD

Rigid competition in contracting can destroy value for the Buyer and Supplier alike. The mounting evidence is that for the procurement of complex projects, systems and services, the use of fixed price contracts awarded through competitive bidding is fundamentally flawed.

Why is this so? And what can be done to overcome the deficiencies of competitive auctions?

Competitive auctions tend to perform poorly when projects are complex and long term. What may seem like a good deal at the outset becomes dysfunctional over time; blown apart by false assumptions, unpredictable events and the dynamics of a complex project.

Corporate governance policies for procurement often require that the contract be awarded only on pre-specified, objective criteria such as lowest price compliant bid. Such rules are typically imposed to promote the appearance of fairness, and also aim to reduce price. But does this approach deliver real gains?

It is fairly straightforward for a Buyer to write a request for proposal for paper clips or motor vehicles that is detailed enough for suppliers to submit a bid. Applying this “completely specified” contract logic to procure complex, long term projects however, can be fatal.

The mounting evidence suggests that for complex projects, there is a downside to the use of competitive bidding. The value-destroying effects of limiting buyer discretion probably exceed the price reductions induced through rigid competition. And when the Buyer cares a lot about quality, using an auction mechanism is not very effective.

Here are two scenarios that tend to occur in competitive tendering: The first is where the bidder who finds the most design flaws or omissions in the tender documents – and adjusts her price accordingly – wins the bid. She then makes a fortune on the subsequent contract changes required.

The second is the “winner’s curse” scenario. The bidder who most overestimates the value of the contract wins at the auction but loses a fortune.

So if auctions perform poorly when projects are complex, what needs to be done to achieve lower contracting costs, less disputation and greater value-added?

Contracting 2.0 – the essentials

The more complex the contract, the more integrated governance arrangements need to be. Buyers need to couple customised contracts with high levels of ‘relational’ governance whereby joint actions are the foundation of contractual relations.

This interdependence aims to improve the ability of Buyer and Contractor to generate improvements in outcomes, by jointly adapting goals, long-term plans, responsibilities and expectations.

The new generation of inter-firm arrangements are based on “relational” contracting principles which aim to lower Buyer-Supplier coordination costs, less disputation and greater value-added. The principles include:

- Extensive information sharing, and use of “open book” principles;
- Investments in co-specialised assets - including knowledge transfer and joint skills development - to improve service and lower costs;
- Repeated transactions with a small set of partners, creating economies of transacting with a small supplier group;, and
- Establishment of goodwill and trust which are the ultimate effective contract safe-guards over a long time horizon.

Contracting 2.0 designs for “adaptively efficiency” so that companies can respond to a wide variety of changes in the operating environment. It also aims to lower coordination costs between firms, although continuous negotiation processes are necessary.

Contracting 2.0 has evolved to deal with the hazards of complex contracts generated by contract lock-in, performance measurement difficulties, and the dynamics of a changing business environment.

Relationship-specific investments in contracting

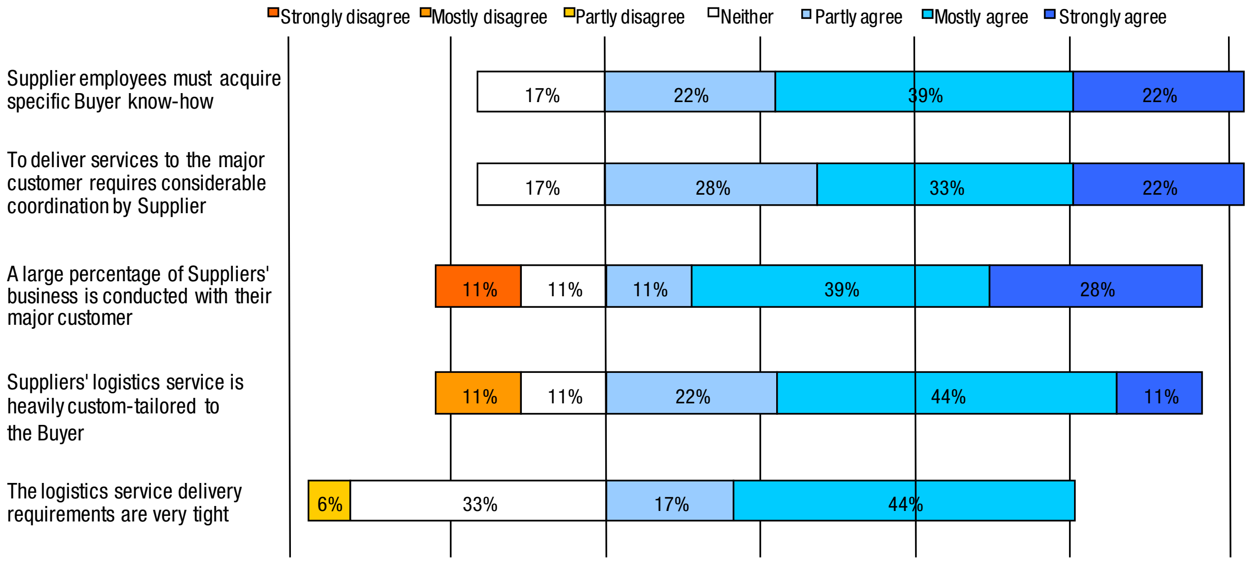
In a recent Strategis Partners’ survey of contracting arrangements in the logistics industry, some three quarters of the Supplier respondents agreed (in part, mostly and strongly) that relationship-specific investments were a key element of the contracting arrangements.

Exhibit 1 following shows that over half of the Supplier respondents *mostly agreed* or *strongly agreed* with the following statements that:

- Their employees must acquire specific Buyer know-how and skills;
- The logistics services are heavily tailored to the Buyer’s special requirements; and
- A large percentage of their business was tied up with their major customer.

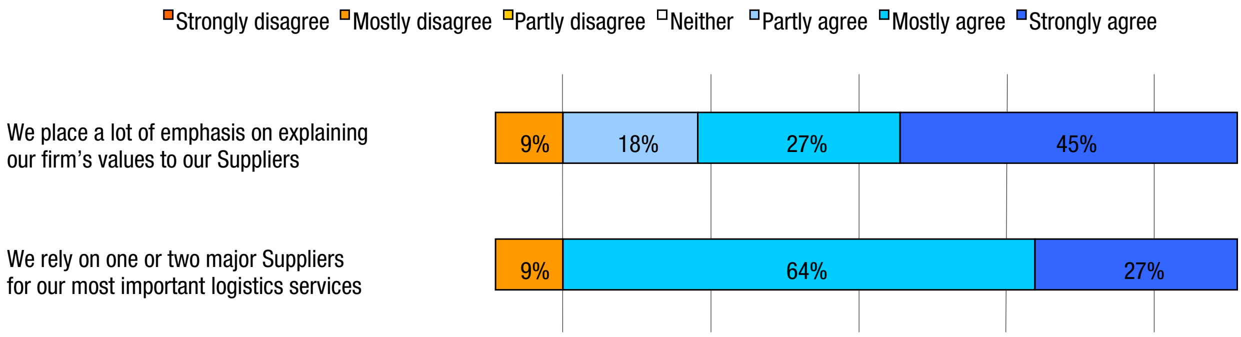
Moreover most agreed that the delivery requirements were very tight and required considerable coordination – a major reason why relationships are so critical in this industry.

Exhibit 1 – Supplier assessments of relationship-specific investments



On the Buyer's side, the Survey results in Exhibit 2 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 2 – Buyers' focus is on working closely with one or two suppliers



The importance of strong bilateral relationships

Bilateral dependency can create benefits in contracting. In the Strategis Partners' survey, Buyers and Suppliers were segmented into two groups: those with strong bilateral relations, and those with weak bilateral relations.

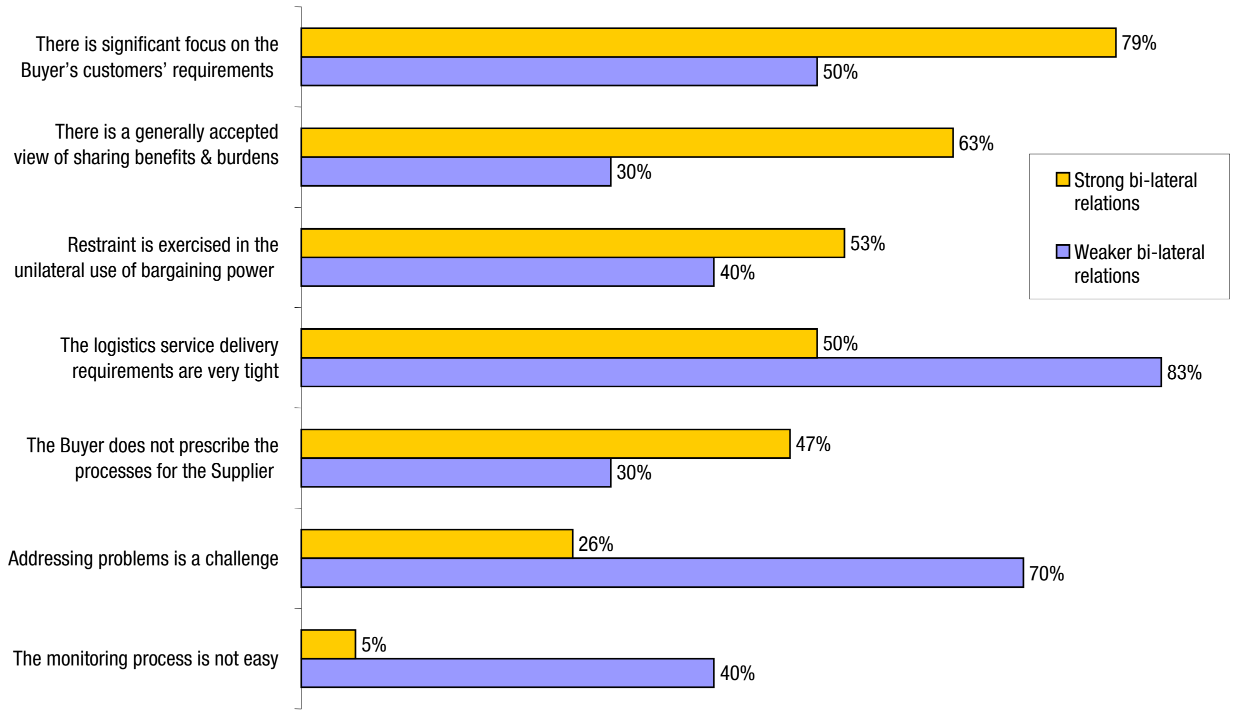
Strong bilateral arrangements were identified by the following criteria: Buyers who indicated that it would be very costly to switch to different logistics Suppliers, and Suppliers for whom a large percentage of their business is conducted with a major customer. The responses to a range of questions are shown in Exhibit 3 below.

The survey respondents with strong bilateral relationships were more likely to report that there was

- A greater focus on the Buyer's customers' requirements;
- A more generally accepted expectation of sharing benefits and burdens;
- Greater restraint is exercised in the unilateral use of bargaining power, and
- 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; that addressing problems that might arise in the relationship is a greater challenge; and that the contract monitoring process is not easy.

Exhibit 3 – Bilateral dependency has its benefits in logistics contracting



CONTRACTING: STRATEGY UNDER UNCERTAINTY

Contracting involves costly and irreversible commitments with uncertain outcomes, so you should manage it as a business investment decision with risk and uncertainty.

The aim of good contracting is to maximize deal value, taking into account the costs of designing, negotiating and adapting the arrangements to deal with an uncertain future. Both cost and contract flexibility should be used as key criteria for choosing between contracting strategies. Design involves a risky tradeoff between a more detailed contract which aims for completeness on the one hand, and a more flexible, higher-level agreement on the other. It involves choosing between three basic models:

1. A lump sum fixed price contract;
2. An incentive contract with fixed and reimbursable portions; or
3. A cost-reimbursable contract.

How to choose the right form?

The key is to match the contract design to the hazards of the deal. Hazards include: the uncertainty about delivering the performance required; the "lock-in" problem whereby specific investments need to be made by the Supplier or the Buyer; the difficulty in measuring outcomes; and the connectedness of the deal with other deals or projects.

As a general rule highly-specified contracts with ‘belts and braces’ are more costly to design. But they can provide greater guidance and certainty throughout the duration of the contract – provided the future outcomes are more-or-less predictable.

On the other hand, ‘relational’ contracts which allow for negotiations through the term of the contract reduce the costs of up-front design and make the agreement more adaptive. However, when contracts are incomplete, one party may try to ‘hold-up’ the other party and obtain a larger share of the value created through the deal – if there are no effective governance arrangements.

How to inject flexibility into the contract

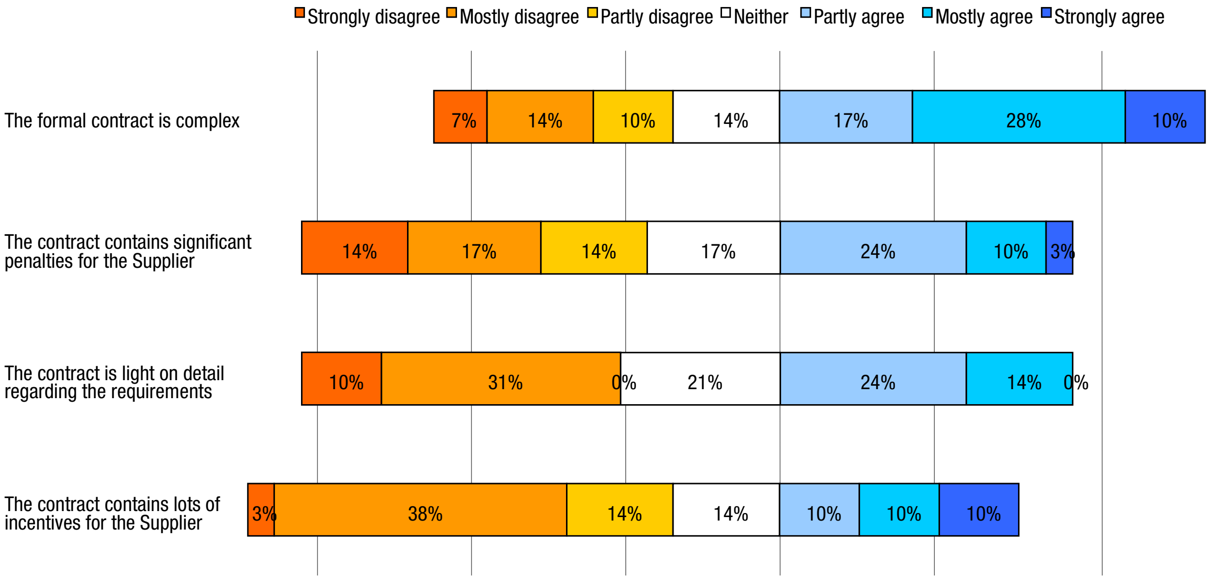
Make use of contractual tools such as “shock-absorber clauses” and “safety-net clauses”. Shock-absorber clauses are designed to facilitate low-cost, amicable renegotiation. For example change clauses in construction contracts allow the Buyer to make adjustments to the agreement during a project and let the Contractor recover costs associated with those changes. Safety-net clauses satisfy the need for security and provide protections in the event that renegotiations fail.

It may seem paradoxical but an essential feature of a well-designed contract is what is left out. If some aspects of performance are unverifiable and difficult to measure in the short-term, it is optimal to leave other verifiable aspects of performance unspecified.

How contracts can be improved

The Strategis Partners' Survey results identified where the design of contracts may be improved. See Exhibit 4 below.

Exhibit 4 – Survey results suggest that contract design can be improved



The key areas for improvement were identified as follows:

- Reduce the complexity of the formal contract;
- Add more / better incentives and penalties for suppliers to perform; and
- Add more clarity on the Buyer's requirements.

Building contracting capabilities from the top down

With an increasing volume of business activity is occurring via alliances or other complex contracts, contract design capabilities become a source of competitive advantage for firms. The design of a major project contract has a big impact on the economic success of both parties and on the behavior of the parties in their attempt to maximise their upside or protect themselves from a downside.

This importance of the contract for success in many companies means that it should not be a technical issue, but the concern of top management. Where might be the real deal-breaking dangers? How best to shape the project and provide the basis of the contract: specifications, price, schedule, payment terms, performance guarantees? Top managers themselves must understand and shape the business drivers upon which the contract is designed and the project is executed.

BENEFITS OF THE CONTRACTING 2.0 MODEL

In a world of faster, broader and more uncertain change, competitive advantage increasing depends on flexibility – and the ability to partner to deliver more innovative products and services.

Contracting 2.0 leads the way to lower coordination costs, less disputation and greater value-added. The new 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.

For Buyers, the relational governance model incorporates supplier-selection processes that demonstrate long-term commitment. Buyers must also be effective at benchmarking supplier capabilities; and at developing trust so that partners will be willing to share knowledge and make investments in the relationship.

For Suppliers, building a good reputation with counter parties and a customer-centric organisation become the strategic factors in winning work.

Companies that master the logic of the new contracting framework exhibit a number of competitive 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 recognised as a leading adviser to companies and Governments on a wide range of strategic business issues, including scenario planning, innovation, sourcing strategy and organization. During his twenty year management consulting career, he has worked with clients in Australia, Canada, Japan, Hong Kong, Indonesia, New Zealand and Singapore.

Jay has played a range of leadership roles:

Partner of PricewaterhouseCoopers, leading their Applied Decision Analysis practice in the Asia-Pacific

Founder and Managing Director of decision consulting firm ORG Pty Limited

McKinsey Consultant to top management in Australasia

Principal of Everest Group, international advisory firm on alliance partnering and outsourcing

Australian Volunteer Abroad in South East Asia.

Jay's qualifications include Master of Economics from Australian National University and a Bachelor of Engineering from James Cook University. He is a Fellow of the Australian Institute of Company Directors.

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