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Contracting for performance: Unlocking additional value

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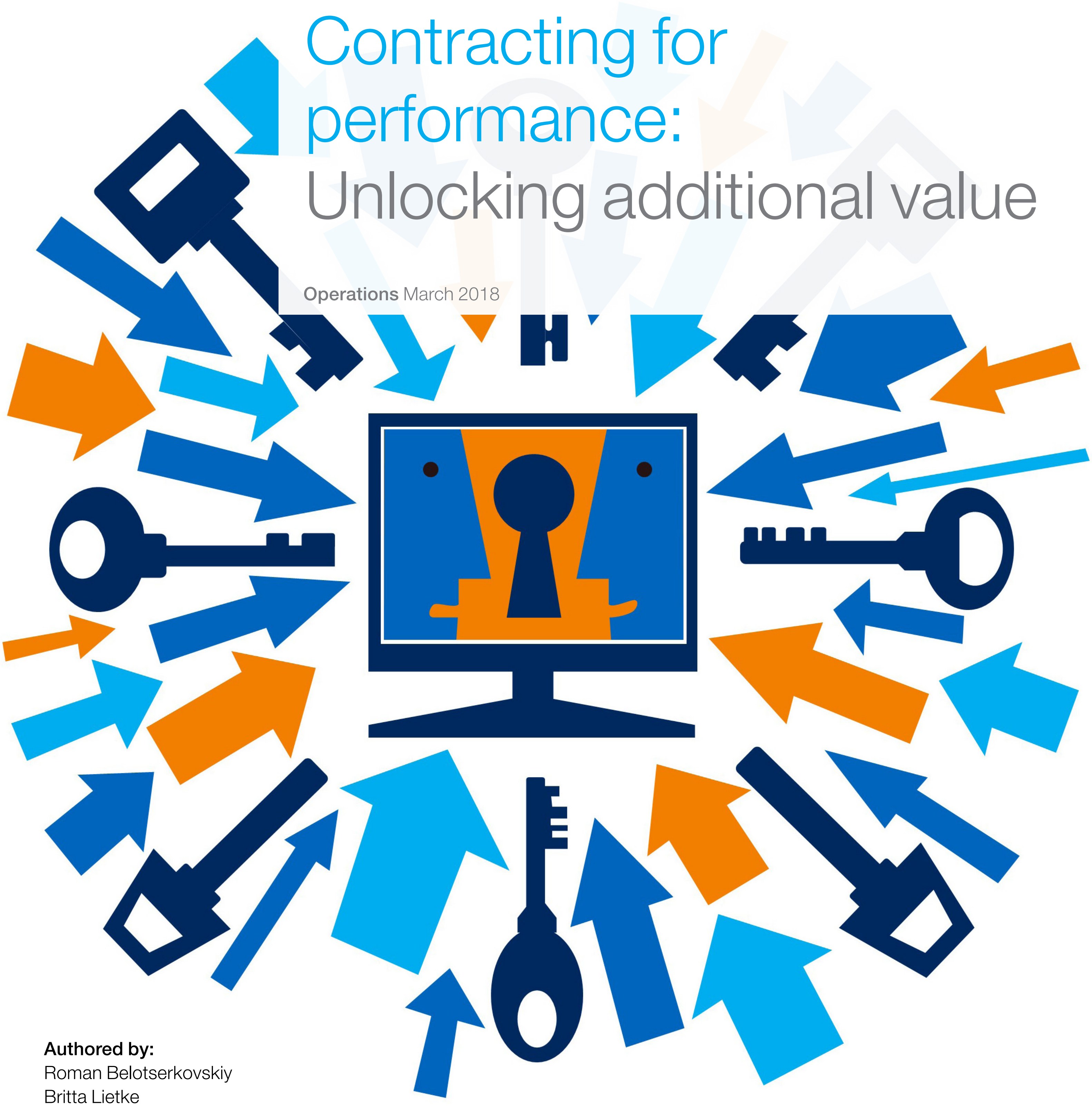

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Contracting for performance: Unlocking additional value

The majority of contracts are lacking basic elements that could enable better vendor performance and cost savings. Here's how companies can tighten the rein.

Most industries have a large majority of their spending locked in contracts: companies in utilities, aerospace and defense, and food manufacturing can have 90 percent or more of their annual revenues represented in contracts with suppliers and vendors. Despite this outsized share, the majority of organizations invest relatively limited resources in contract development and vendor management. In fact, across industries, total procurement operating expenses are typically less than 1 percent of total spending.[1] By underinvesting in this way, companies are overlooking a significant source of value: suboptimal contract terms and conditions combined with a lack of effective contract management can cause an erosion of value in sourcing equal to 9 percent of annual revenues. For *Fortune's* 2016 Global 500 companies, this 9 percent would have equaled $2.5 trillion in value.[2]

Several factors contribute to this lack of oversight and contract management: large procurement functions execute and monitor tens of thousands of contracts annually, on average, so the sheer volume can be overwhelming. Lack of procurement resources or ownership tends to shift contractor management to the users in the functions requiring the product or service who are usually not trained to do it effectively. In addition, 80 percent of procurement functions are not fully aware of competitive terms and contract structure.[3] Since contracts establish the "rules of the game" for the supplier relationship, they are a critical factor in generating value, particularly for services. Without a point of reference for what good looks like, bringing contracts in line with industry standards is not possible. Last, procurement often takes a narrow view of business value in setting terms and conditions, meaning that significant enablers for future value creation from demand, operations, contract management, or supply chain are often not incorporated into the contracts. All of these factors limit a company's ability to get better performance from their suppliers and vendors.

To determine specific contract areas where companies are falling short, McKinsey conducted research that examined every facet of contract development and execution and found that companies face challenges in three parts of the contracting process—precontracting, contract writing, and implementation and vendor management. In our experience, the key to optimizing the entire process is an approach called contracting for performance—a formal agreement with a supplier that sets specific rewards and penalties for achieving, or failing to achieve, performance levels that affect the bottom line. As a first step, companies must recognize the common pitfalls to writing and executing contracts as well as the essential elements of effective

1 "5 common references for procurement benchmarking," Purchasing & Procurement Center, accessed January 5, 2018, purchasing-procurement-center.com.

2 Global 500, *Fortune*, accessed January 5, 2018, fortune.com.

3 2015 IACCM Benchmarking Study, PWC.

contracts. Next, executives should seek to implement strategies that support more effective engagement in the precontracting, contract writing, and implementation and management phases. These actions can enable procurement organizations to build the capabilities and expertise to write contracts that deliver better performance.

The state of contracting

Over the past year, McKinsey's Rapid Procurement Contract Insights (RPCI) service line has reviewed more than 100 contracts against a comprehensive assessment grid of more than 60 criteria. This analysis revealed that the majority of procurement contracts fall well short on a range of basic contract elements related to performance. In general, contracts for indirect spending in our sample tended to be written more effectively than those for direct spending, but no particular industry or spending category outperformed others consistently. As most reviewed contracts represented some of the top-spending categories, it was more likely that the indirect spending contracts were centrally managed and therefore might have received greater scrutiny at the time of completion than their direct spending counterparts. For direct spending, we have observed that a lot of emphasis on getting the right product to the right place at the right time, so contracts tend to be more robust on product specifications and delivery terms as opposed to total cost of ownership. More specifically, our analysis assessed contracts across three dimensions:

1) General terms and conditions

More than 75 percent of contracts in our sample did not include an exhaustive set of key performance indicators (KPIs) and reporting processes linked to total cost of ownership. Procurement professionals cite various reasons for contract gaps with regard to KPIs and reporting. At the performance-measurement level, many professionals do not have the category expertise to measure overall vendor performance in a given category or effectively quantify how vendor performance affects costs. Others are unable to define easily measured KPIs or lack the capabilities and resources to track supplier performance. Still others believe their organization can't effectively negotiate performance KPIs with their suppliers, instead accepting vendor terms. Of the remaining 25 percent, contracts for indirect spending categories were more likely to have exhaustive sets of KPIs and reporting mechanisms included compared with contracts in direct spending categories. For direct spending, procurement professionals often assume that quality and performance are static requirements that should be evaluated on a pass-fail basis.

In addition, clauses that define rules for subcontracting were absent in one-quarter of the sample. Contracts related to direct categories had subcontracting rules that were more poorly defined, on average, compared with those in contracts for indirect categories. This effect can be explained in part by the fact that more direct spending contracts are supply contracts, whereas indirect spending contracts more often require vendors to perform services at a client's site. When third-party personnel gain access to client sites, the risks that come with subcontracting increase. But for direct contracts, the supplier is mistakenly often not seen as a potential risk.

2) Commercial terms and conditions

In our sample, eight out of every ten contracts did not contain any form of a benchmarking clause, which mandates a periodic review of pricing against industry standards or relevant indices to ensure that vendors and suppliers are charging prices in line with fair and reasonable market rates. Since a benchmarking clause would allow for much stronger cost controls, we regularly find opportunities for procurement to improve contracts in this regard. But all too often, benchmarking clauses feature generic language that allows the buyer to benchmark prices at similar companies only. A bottom-up cost benchmarking potentially linked to a “should cost” based understanding of supplier economics would be much more effective to determine additional opportunities to capture value.

Similarly, clauses that cap pricing adjustments for inflation were not included in nearly 40 percent of contracts. Indirect spending categories were twice as likely to have contracts with some form of inflation adjustment clause compared with contracts for direct categories. This omission is relevant for several reasons. Inflation rates are calculated based on Consumer Price Index (CPI) measurements. According to the US Bureau of Labor Statistics, the CPI typically measures “the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.” Depending on the specific product or service that a supplier may provide to a customer, the direct relationship of this good (or of some share of its cost) to a general basket of consumer goods and services is certainly questionable.

3) Partnership and governance conditions

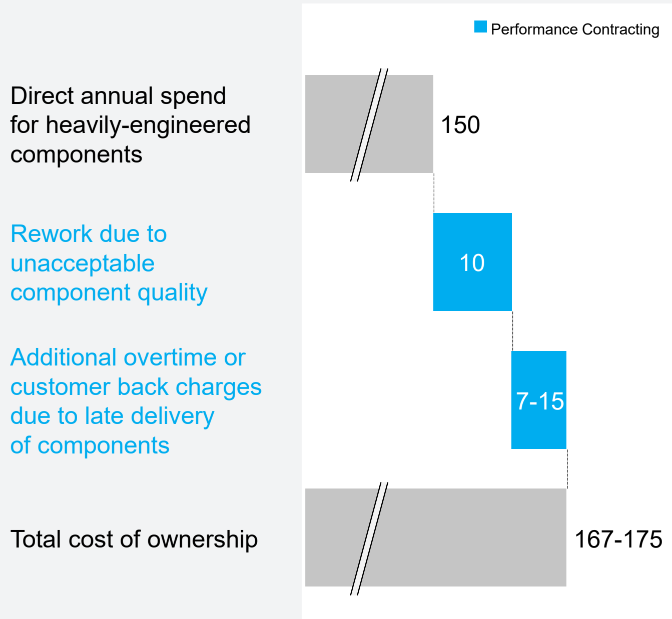
A critical lever in generating more value from contracts is partnership and governance conditions, which enable closer collaboration and contract governance between buyers and suppliers. Despite its importance, our analysis uncovered some key gaps: in almost 20 percent of cases, contracts did not contain any process definitions for continuous improvements. What’s more, half of all contracts we reviewed did not include clauses related to the establishment of governance bodies and escalation paths to manage contract life cycles. Many contracts include only very vague contract language stating that, for example, “the parties will work together on continuous improvement efforts.” Such language does not specify responsibility for achieving goals nor any details on how any of the tasks would be tracked, reviewed, or implemented.

An examination of the impact of these contracting gaps reinforces the value at stake: poor supplier performance can result in higher total costs of 10 to 20 percent in the contracted category (Exhibit 1). When suppliers fall short, it can result in shadow or downstream costs that lie beyond the view of procurement when negotiating the initial purchase price and contract terms that do not incorporate a life cycle total cost of ownership (TCO) perspective. For example, one industrial manufacturing company experienced significant rework in some commodity segments, resulting in additional costs equal to 30 to 50 percent of revenues. Late deliveries can have a knock-on effect, requiring manufacturers to pay additional overtime or credit customers for delays.

Exhibit 1

Examples of indirect costs resulting from poor supplier performance

Spend, $m



- Generally, unacceptable supplier performance can result in significant (10-20%) indirect costs
- Supply management organizations often have a difficult time tracking indirect costs and incorporating them into sourcing decisions
- Performance contracts bring these indirect costs sharply into focus and help reduce them over time

SOURCE: McKinsey

Contracting for performance

The myriad variables involved in negotiating, writing, and enforcing contracts means that incremental efforts to improve vendor performance will likely fail to capture significant value. Instead, a comprehensive approach to the contracting process and project delivery is required. Contracting for performance can help reduce costs and achieve value beyond the contract's original scope by shifting responsibility from buyer to supplier and specifying deliverables, performance monitoring, and management processes. These contracts define metrics and acceptable quality levels as part of the scope of work and establish a clear governance structure for reporting and monitoring continuous improvement. The distinctive advantage of performance-based contracts is that operational efficiencies are guaranteed by the supplier. Such assurance comes from not only the inclusion of performance metrics, penalties, and monitoring but also performance incentives and gain-share mechanisms that are typically common in partnerships.

When seeking to improve contract writing and vendor management, it can be instructive to segment the contract process into three phases—precontracting, contract writing, and implementation and management. In our experience, procurement organizations face a range of challenges in these areas, and contracting for performance can directly address them.

Precontracting

During the initial development of contracts, negotiations often fail to address all relevant aspects for contracting, implementation, and ongoing vendor management for a variety of reasons. Legal, contracting teams, and other stakeholders may not be involved early enough in contract negotiations or are not sufficiently engaged throughout the process. In some instances, a lack of time and resources can impede sufficient preparation among procurement, legal, and the business. In others, an overemphasis during negotiations on how responsibility and value will be divided can lead to lengthy, antagonistic negotiations that alienate the contracting parties and lead to a similarly lengthy and antagonistic vendor management process.

Companies that adopt contracting for performance can empower functions and stakeholders to clearly define priorities and performance targets. By getting all relevant parties involved at the outset of the process, procurement can start with a comprehensive perspective on TCO and value creation. Contract negotiations can then start by creating a shared vision or statement of intent that can be used as a basis to regularly revisit and emphasize integrative issues. Integrative issues are opportunities to expand the value for both sides ("win-win") or where the interests of both sides are aligned. An example of an integrative issue is the length of contract: it costs the buyer nothing (if properly written) and adds tremendous value to the supplier. Achieving consensus also facilitates other important tasks that can keep the contract on track throughout the process:

- Articulate scope of services with commercial and legal terms while removing ambiguity
- Ensure value capture is addressed and translated to the contracting priorities across all TCO levers over the expected life cycle of the product or service
- Develop a perspective on the main cost drivers of the product or service, and verify any adjustments or escalation clauses are linked to the right baseline cost elements
- Define performance based on mutually agreed upon targets
- Develop an appropriate reward and penalty structure for vendors (and potentially also the buyer) to encourage the expected performance
- Commit resources from the organization and suppliers to engage in a formal review process

Contract writing

The task of writing contracts is obviously affected, and sometimes complicated, by the results of the precontracting phase. When negotiation results are handed to legal with the direction to "just formalize the contract," the final document can consist of legal contract language that may be difficult for other stakeholders to understand and use to manage the vendor. Further, procurement may emphasize certain performance levels during the formulation of the contract that are not in alignment with business goals. Last, tight timelines can also produce contracts that are prepared in a rush without adequate consideration from relevant parties. To save time, for example, companies might opt to use a vendor template. All of these factors can undermine efforts to define vendor performance levels.

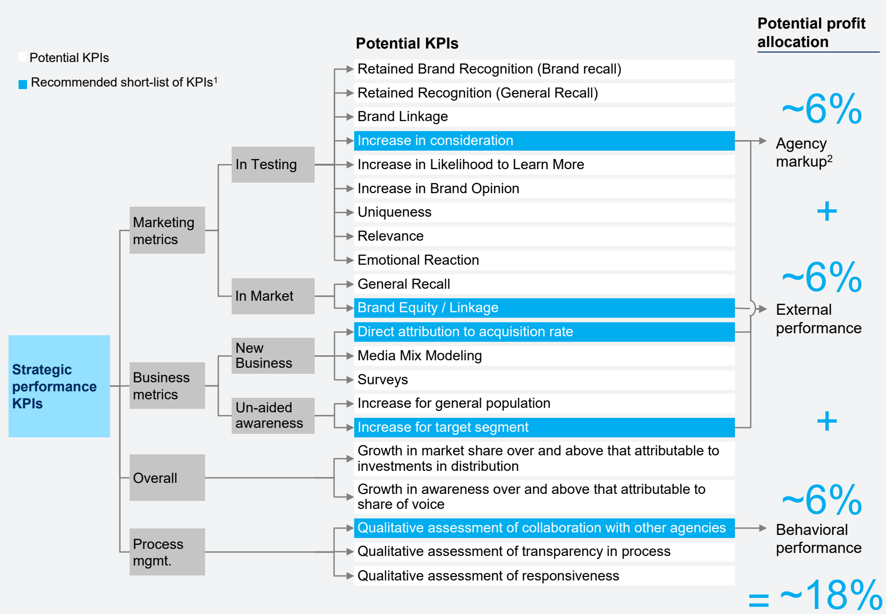
Contracting for performance includes specific, measurable performance improvement targets as well as incentives (for shared rewards) or liabilities (for damages based on performance against targets). For the four main areas of contract terms—TCO, reliability, quality, and innovation—companies should be sure to define corresponding KPIs. If a contract includes pricing terms based on annual price reductions and supplier pricing competitiveness, for example, KPIs could include the percentage of a price decrease or proximity to the lowest price in the market. Documentation of the process and cadence to measure these KPIs and determine performance-based pay should be clearly spelled out. (For more detail on KPIs, see sidebar, "Aligning KPIs to strategic objectives.")

Aligning KPIs to strategic objectives

To ensure that performance-based KPIs in contracts have the desired impact, procurement must tie them to the strategic objectives of the organization as a whole. When engaging a marketing agency, for example, one company identified specific metrics to gauge progress on strategic performance. These categories would then suggest a host of KPIs that reflect the scope of the agency's work. The trick is to home in on the specific KPIs that will have a tangible impact on the company's performance and attach the proper incentives for the agency to meet or exceed these targets.

In this case, the company identified an increase in customer consideration of its products or services as a KPI directly related to its overall marketing objectives and offered the agency a potential markup of 6 percent for progress in this area. Other measures of brand equity and market awareness were selected in a similar manner. Typically, agencies will want to earn about 12 percent guaranteed markup, but this percentage can be negotiated. By tying markups to specific performance targets and offering an upside for overperformance, a mutually beneficial performance partnership was created. In all, the marketing agency stood to earn an incentive of 18 percent on its services for exceeding targets (exhibit).

KPIs should reflect the company's strategic objectives and influence agency compensation



1 Note that actual KPI calculation and underlying metrics must be negotiated with strict formulas based on available info
2 Agencies will typically want to make 10% guaranteed though this can be negotiated – anchoring with a lower percentage
SOURCE: McKinsey

Contract implementation and ongoing vendor management

Process and workflow gaps between the contracting and the implementation teams (for example, a lack of transparency between procurement and legal) can lead to missed opportunities on contract implementation and execution. After an arduous process to draft and execute the contract, companies often fail to review and enforce terms on a regular basis. In addition, inflexible contracts make forward-looking vendor performance management difficult—instead of addressing root causes of performance issues, contracting partners blame each other. Further, without a basic level of collaboration, procurement will not have access to data and analytics that could manage vendor performance more effectively.

Vendor management is not a solitary, arbitrary, or one-off process. Instead, companies must commit to regular monitoring of contract performance against clearly defined targets. The focus should be on measuring total costs as well as supplier performance. If a supplier is underperforming, the customer must enforce a penalty, with repeated underperformance drawing increasing fines. Regular monitoring, communication, and corrective action are vital to ensuring contract performance, so companies must also commit the resources from the procurement organization and vendor to regularly complete that formal review process. This setup also enables the client to continually optimize the relationship—within as well as potentially beyond the contract scope.

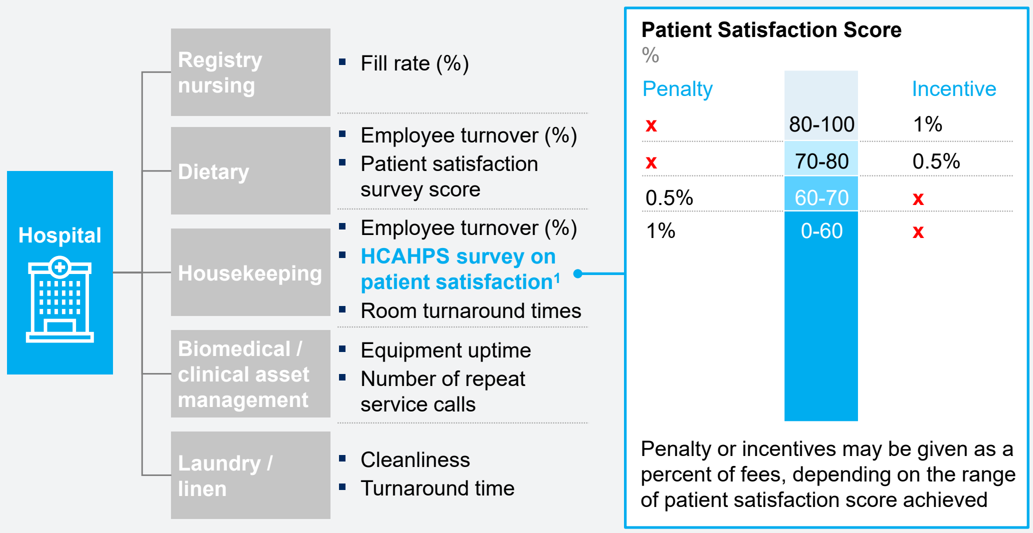
One hospital system, for example, laid out incentives and penalties for vendor performance on specific services. In housekeeping, the hospital uses several metrics including the employee turnover and room turnaround times. To get a more complete picture of the quality of housekeeping, the hospital also used a patient satisfaction survey, with specific incentives tied to positive patient scores (Exhibit 2). The combination of metrics enabled the hospital to focus on the KPIs that had a tangible impact on operations.

Exhibit 2

Incentive/penalty programs in contracts

Incentive / penalty programs can be **structured in many ways**, but involve a dollar amount of percentage of the contract price at risk. The program should be **tailored to the specific service contracted.**

Example incentive metrics



1 Accuracy of HCAHPS score as a metric may vary based on other factors, such as age of hospital. Client and vendor should work together to define other metrics during walkthroughs or create innovative program structures (e.g. absolute survey score versus change in score)

SOURCE: McKinsey; "Purchased services and supply management contracting strategy for hospital systems" (March 2016)

Shifting the organization to contracting for performance

Adopting the best practices discussed above will likely require procurement leaders to reevaluate their function's approach to contracting. The goal should be to put the processes in place so that procurement can handle every contract in a consistent manner. Although setting up a contracting-for-performance culture may seem like a daunting and lengthy task, organizations can take actions to incrementally enhance their suppliers' performance. Several initial steps can help to build momentum for a sustained effort.

Implement standard contract reviews and benchmarking practices. Greater visibility into existing contracts can enable the organization to write better contracts going forward. A semiautomated, basic screening process involves scanning contracts for keywords and phrases related to performance, value, and selected cost drivers. The aggregated findings are reviewed and validated by sourcing managers and local teams. Legal then verifies the analysis and conclusions of the review teams. The output of this process is a fact base that procurement can use to support focused negotiations with selected suppliers.

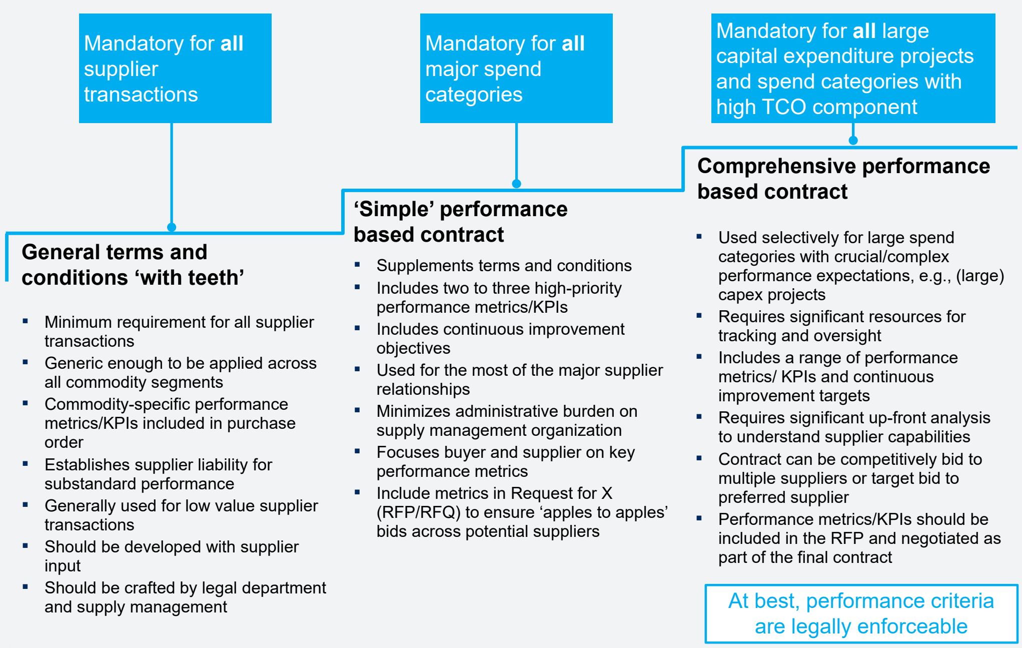
One company, for example, had retained a technology provider to customize its off-the-shelf product with specific features and functionality. The contract clearly linked all payments and incentives to the delivery of very specific outcomes, so when the technology provider proved incapable of tailoring its product in the defined ways, the company was able to claw back all payments, including all internal costs associated with the provider's nonperformance.

Differentiate contracting needs by category, spending levels, vendor relationships, and risk. Prior to writing the contract for a specific vendor agreement, procurement should collaborate with legal to create a standard checklist and language that reflect the requirements of both procurement and legal. This standard list should then be reviewed with the business partner in each contracting situation and adjusted to the specific business goals. When contracting with specific vendors, it is beneficial to write the contract and then request redline markups from vendors, since starting with their language could make it more difficult to negotiate. In parallel with writing the contract or editing legal's initial or standard template, procurement should formulate an approach to manage supplier performance.

To determine performance incentives, for example, procurement could use a three-tiered, contracting-for-performance approach based on spending levels (Exhibit 3). All contracts would start with basic terms and conditions for performance that serve as a minimum requirement for all suppliers and include penalties for substandard performance. The next tier, for major suppliers, would be a performance-based contract that includes a handful of KPIs to more specifically gauge performance. For large spending categories that are critical to the organization's success, a more extensive list of KPIs would be used to support continuous improvement efforts. While this type of contract requires substantial resources to develop and monitor, the size of the spend categories and potential savings more than justifies this level of involvement.

Exhibit 3

The type of spend category determines the appropriate level of performance incentives in the contract



SOURCE: McKinsey

Collaborate to increase coordination and transparency. Since coordinating the efforts of procurement and legal, among other stakeholders, is often a struggle, the contracting process can be used as a catalyst to define the collaborative relationship across all stakeholders. Setting up an integrated contracting, implementation, and vendor management organization that creates a strong feedback loop for the next contract negotiation can enable procurement and legal to work hand in hand. Further, procurement should establish a contract governance process that focuses on improving buyer-supplier relationships by using performance data and analytics to take corrective action at the first offense.

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Applying contracting for performance across the entire process can position procurement organizations to extract more value from their vendors and suppliers. The close alignment of procurement with other functions can support increased performance and continuous improvement efforts. Such closely coordinated monitoring and vendor management can also significantly reduce downstream costs such as cost overruns, scheduling delays, and poor quality.

A good place to start is to focus on performance requirements linked to clear objectives and quantitative metrics. A more ambitious program will likely require procurement to build additional capabilities, such as adding contract specialists; establishing standing, cross-functional teams; and implementing contract management and analytics software. Given the size of the potential cost savings, procurement leaders cannot ignore the opportunity.

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