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Seven ways to stop wasting money in contractor management

Getting the basics right not only saves cash, but also strengthens relationships with important suppliers.

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Since the 1990s, many organizations have rushed to outsource functions that they decided aren't part of their core competencies, contracting more and more of their overall labor spend to other entities. But too often, they've done so without a coherent strategy for optimizing the total cost of ownership. Instead, they commit to outsourcing without fully understanding the work they want to outsource, or whether doing so is in fact more effective and efficient than their best possible in-house option.

When that happens, in our experience, contracting costs rise. For example, some companies set up individual jobs in ways that require contractors to do unnecessary work, leaving even the best of them with no choice but to raise their prices as a hedge against risk. Other companies simply have no idea what the work they're outsourcing should cost, leaving them dangerously vulnerable.

Recent McKinsey research has highlighted the problem. We assessed individual jobs and invoices across more than 100 industrial sites on three continents, covering aerospace and defense, the public sector, petrochemicals, and manufacturing. Using a global network of operations experts and proprietary benchmarking tools, we found that companies were paying 30–50 percent more than they should for their contracted services.

We've seen striking evidence, too, of how better contractor management can have a significant impact on the bottom line, and ultimately lead to win-win performance-based partnerships.[1] One chemicals company has already captured annual savings of more than 20 percent—while also improving safety outcomes on site—by implementing a detailed planning process to estimate the cost of jobs before receiving contractor quotations. Another asset-intensive European manufacturer reduced cost by 25 percent by implementing a rigorous follow-up process to ensure that the work carried out was the work invoiced. A large North American utility cut its outsourced IT labor cost more than 25 percent by optimizing contracting and contractor management practices end-to-end, from demand origination through invoicing.

Although overall contracting strategies naturally vary across companies, it's surprising how often even well-known and well-functioning businesses still follow inefficient contractor-management practices. The results include imprecise work specifications, over- or understaffing, and inaccurate invoices—all of which lead to organizations spending millions more than needed.

[1] Jim Banaszak, Rob Palter, and Matthew Parsons, "Stopping the insanity: Three ways to improve contractor-owner relationships on capital projects," March 2017, www.mckinsey.com.

Here are seven of the most important practices that businesses need to change in their own organizations and build into their contract terms to make sure they get exactly what they they're willing to pay for. We've illustrated these practices with a few cartoons that show extreme examples—but they aren't that far removed from what we've seen at actual companies.

1 – Job definition and scoping

Companies that invest time in defining and agreeing on the scope of work before contractors start the job are much more likely to spend efficiently on just the end products they truly need, at bills that don't break the bank. Clear definitions, embedded into every document from the request for proposal to the final contract, let contractors submit bids that accurately reflect their cost to do the work, reducing any need for them to bake in additional risk allowances. When contractors don't know exactly what resources an effort will require, they understandably plan for a situation that might be more demanding than normal. For example, if a poorly-specced welding effort could take anywhere from a few hours to a few days, contractors will likely set their compensation to reflect the longer timescale.

Definitions also make it less likely that contractors will carry out work that they assume is needed (or would like to be requested), but that hasn't been authorized and probably isn't necessary, such as cleaning the site when the client already has a janitorial-services contractor (Exhibit 1). These extras are never free.

Exhibit 1

The chemicals company mentioned above also standardized how it stores and communicates information about its projects. In partnership with its lead engineer, the company defined an evidence-based scope for each job. As a result, jobs were specifically scoped for the right work from the start, with clear delineation between the features and capabilities that were must-haves and the ones that could be left to the contractors' discretion (such as the color of a paint job).

That rigor let the company work more closely with contractors to manage shared costs. For example, contractors were able to plan for the exact power tools and systems they would have to bring on site at each stage, so that people didn't waste time looking for items later on. We find that efforts such as these, which help incentivize contractors to reduce overall costs and work efficiently, can unlock tremendous value.[2]

2 – Understanding the work content

Ignorance isn't bliss: Instead, it can lead to substantial waste. Without a clear understanding of each job's work content, a contractor-management organization has no ability to analyze the contractor's price or recognize when costs could be lower. That's why the best managers make sure that their teams understand at least the basic content of all work (in terms of person hours and equipment required). High-level benchmarks aren't enough: job estimates need detail down to the length and number of bends in a pipe that's to be welded.

In more-open markets, this is less of an issue. A homeowner who wants her bathroom re-tiled can probably find at least five contractors to quote for the job. Even though she may not understand the work content, she can be broadly confident that she will receive a good price just by comparing the bids as they come in: there are many suppliers and there are comparatively few barriers to entry. These factors all help to impose a ceiling on the price that any tiler can charge.

However, in the specialized fields typical of heavy industry, markets are a lot less likely to be perfect. Often there are limited numbers of suppliers in the area, with significant barriers to entry. As a result, the best way to negotiate a good price for the work is to understand the work before engaging a contractor.

3 – Transparent invoices

When an invoice doesn't describe the details of the work completed, it's impossible to know if anything's been added or if the work is being done in the agreed way. We've seen invoices with line items like "associated repairs" priced at well over $70,000, with no further information on what was done, or why. That's not atypical. And it makes it much harder to agree on appropriate pricing or to manage contractor performance over time. Often this bundling of multiple jobs into one line item on an invoice prevents confirmation that the total billed is the total agreed to.

Companies should contractually require contractors to provide detailed invoices, listing the exact work done, and all of the resources required to complete it. Only by ensuring contractors list clear, manageable line items can companies start to reduce shared waste.

But it's hard to change invoicing practices after a contract has been signed. Instead, invoicing and reporting templates should be built into the contract's terms, so that they are discussed during negotiation and fully accepted by the parties. Each contract renegotiation thus offers a new opportunity to establish consistent reporting and invoicing ground rules for all suppliers.

4 – Checking invoices against negotiated rates

Even if a procurement team negotiates a fantastic contract, companies can still lose value because of inconsistent adherence to contract terms. Effective contractor managers fully understand the terms and conditions of the contracts they manage, and ensure that each invoice

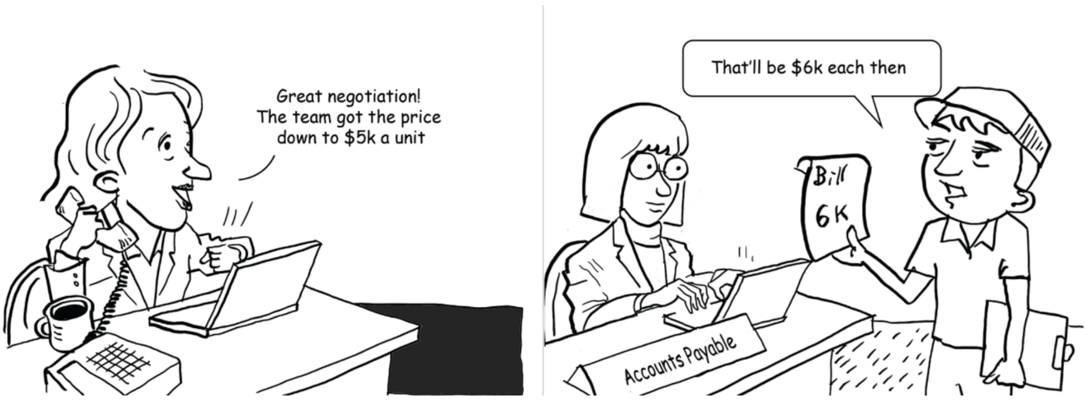
[2] Steffen Fuchs and Rafat Shehadeh, "Let's make a (better) deal: From cost to value in engineering services," May 2017, www.mckinsey.com.

reflects the contractual agreement that the procurement teams went to great lengths to negotiate. Digital tools can help automate this process.

Sometimes the rates contractors charge on invoices vary from the contractually specified terms—occasionally on purpose, but mostly by mistake. One large manufacturing company, for example, discovered that it had been charged well over $1 million for ladder rentals when the contract wording stipulated that there would be no additional charges for ladders or other tools.

This may sound like a simple issue, and that it should be rare. But in the complexity of the day-to-day operations of an industrial site, we often see significant savings just by ensuring that you pay what you agreed to every time (Exhibit 2). When a client invests the time and effort to review invoices for accuracy, the contractor is more likely to make a similar investment of its own.

Exhibit 2



5 – Letting contractors get to work

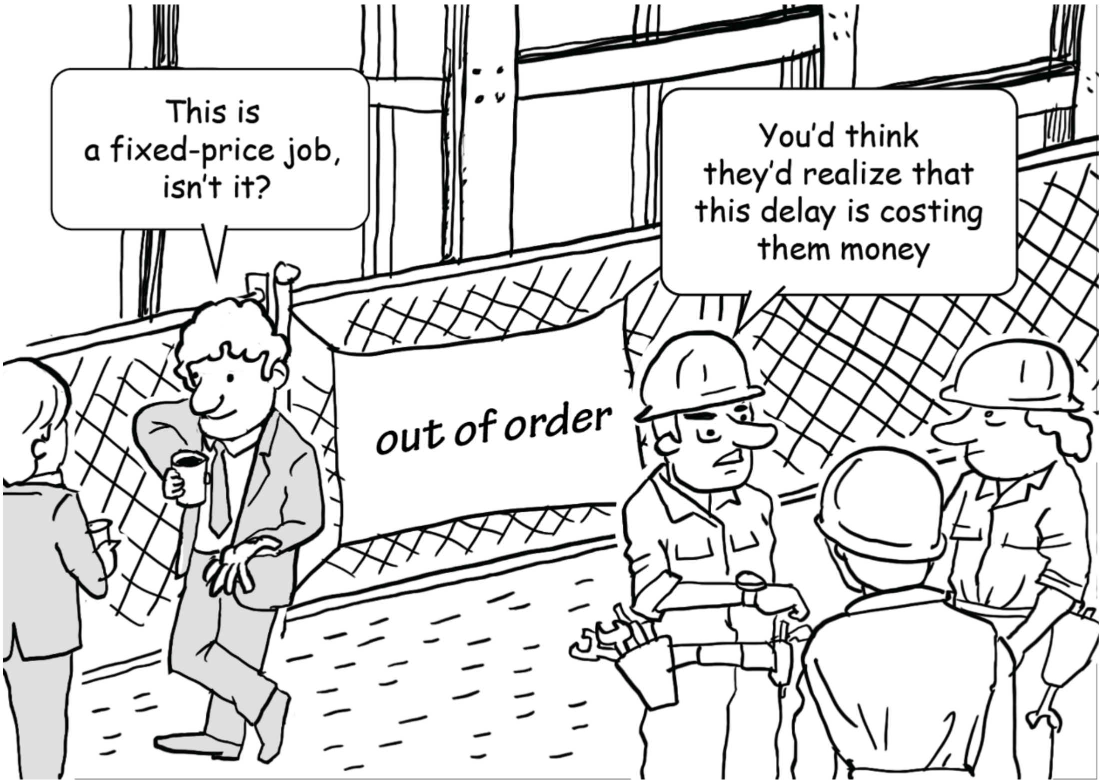
A good contractor manager always ensures that the contractor's work team is able to spend as much time as possible on value-added work.

As basic as that sounds, we've seen contractors waste hours at facility gates waiting for the client's staff to process the paperwork needed to get on site and start work. And it isn't limited to getting identity badges or work permits: it's also in redundant briefings, limited facility access, and delays while other work is completed, all of which drive up costs for no added benefit. It's a reason contractors are reluctant to accept fixed-price terms. As a result, the client company almost always ends up paying for the wasted time, which is either billed directly as hours "worked," or is baked into higher overall job rates (Exhibit 3).

One European oil refinery found that its contractor was billing significantly more for jobs than was reflected in the hours worked. On closer investigation, the company discovered that the problem wasn't caused by the contractor, but by how the company's own supervisors dealt with the site's safety system.

The system required contractors to be logged onto jobs in the specific area where they were working before they could start work. Because company supervisors often waited until the end of the day to remove all workers from jobs, contractor personnel could not be added to another area even when there was enough time left in the day for them to start another job. So the contractor had little choice but to implement an informal policy of one job per day, no matter how long the job actually took.

Exhibit 3

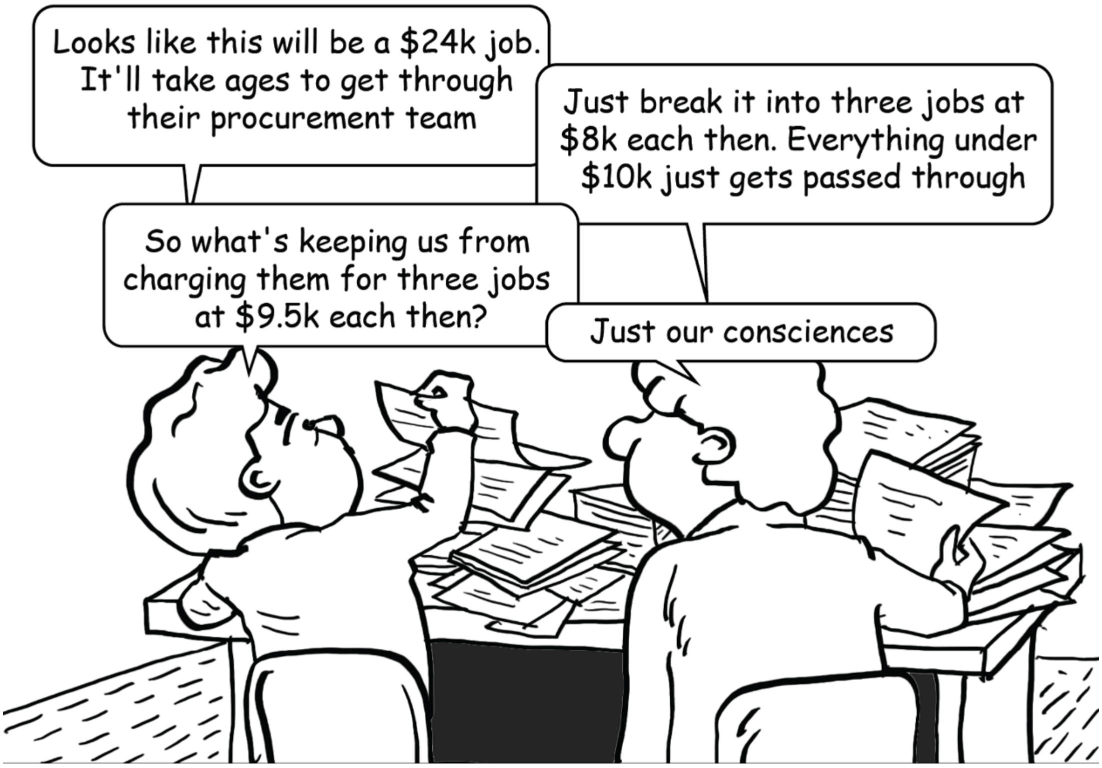


6 – Auditing even the small spend

In most situations, we find contractors have far more resources dedicated to managing the billing process than their respective customers have resources focused on managing the spend. A category manager may easily own hundreds of millions in spend across dozes of suppliers, while on the other side, the supplier has an entire sales team fully focused on that one category manager.

That imbalance may be exacerbated when companies adopt policies that call for signing off automatically on all bills below a certain threshold. Reducing back-office bureaucracy in this way can create an unintended incentive to break larger projects into smaller sub-jobs that fall below the critical threshold (Exhibit 4). Overcharges can then go unnoticed, and even the best-intentioned contractors will likely omit the detail that companies need to manage their sites effectively.

Exhibit 4



7 – Recording and monitoring deviations from agreements

Besides collecting detailed invoices and agreeing on the scope of the work in advance, the best contractor managers will also keep records of any deviations from earlier agreements. For example, if a building was supposed to be painted with one grade of paint, but in the end a higher grade was used, they'll specifically note that this was a change in the original plan.

That lets the contractor manager better understand each contractor's performance—information that can improve future contracting decisions. For example, in choosing among bids, the company may avoid a contractor that consistently underestimates the work or tools needed for a job. It also helps the company to better understand the true requirements of work on site, so as to make better decisions in the future about whether and how to outsource.

Building on success

Each of these seven practices will help contractor managers avoid waste, but there is more to success than a simple checklist. Contractor managers typically control budgets in the millions, but are rarely given any formal training (often being promoted from internal operations functions).

Organizations find it easy to remove formal contractor management roles to reduce their fixed costs, finding that the organization still functions well even without contractor managers. But over the course of a few years, the savings in fixed costs will likely be eroded by an increase in contractor spend.

We find that contractor managers work best when they work within an overarching strategy, and have the incentives and ability to operate efficiently. When one European industrial player reshaped its contractor-management practices in this way, it found that about 40 percent of the resultant savings came from improved contract control—in other words, from making sure it got what it paid for. The other 60 percent arose from improved job preparation that allowed the company and its contractors to complete work in the simplest and most efficient way possible.

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Contractor management is hard. It's operationally complex, technically dynamic, and commercially challenging. It's also hard to fix. Behaviors are embedded after many years, transformation requires departments to work closely together, and individuals will have to have difficult conversations with people they have worked with for a long time. But the reward is very large. Organizations willing to take action to fundamentally transform their contractor management function stand to save 30-50 percent on their contractor spend, often amounting reductions in the millions. And because contractors spend is a cash-out cost, those savings can be realized fairly quickly■

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