Aligning GOALS With INCENTIVES

The strategic use of contract terms can help supply management practitioners align supplier incentives with company goals to improve outcomes and increase value.

By Brad L. Peterson

Supply management practitioners can add value to and improve relationships with suppliers by using contract terms to align suppliers' incentives with their company's goals. Aligning incentives creates value by linking a supplier's success to the outcomes of your supply chain organization and company value. The supplier then delivers those outcomes as a natural part of pursuing its own success.

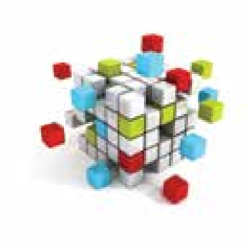
The stronger the link, the more the incentives will affect outcomes. Begin by asking and evaluating key questions, including:

1) What outcomes — cost, timeliness, speed, quality, safety, reliability, capacity, fit, function or agility — does your organization value?
2) How can you make it more likely that a supplier's results will vary based on whether you achieve those outcomes?
3) How can you increase the impact of your success or failure on the supplier's results?

Incentives in Standard Contact Terms

You can increase incentives using certain provisions in the body of a standard supply agreement. For example, the standard promise of timely delivery to specifications provides an incentive to deliver timely and to specifications. You can increase the incentive value of that delivery commitment by:

- Allowing the supplier to use your company name on its customer list only when delivery objectives have been met for the prior year
- Replacing weak delivery promises, such as reasonable efforts, with strong ones, such as representations and warranties
- Requiring prompt disclosure of any suspected failures
- Obtaining the right to require prompt correction of failures
- Obtaining the right to reimbursement of specified costs, including audit, rework, cover and recall costs
- Obtaining an indemnity so that the supplier also risks paying your legal costs
- Rejecting limitations on liability so the supplier bears more of the costs of its breach
- Including a discussion of any breaches on the agenda for executive governance meetings so the supplier's management team will become involved in solving problems
- Authorizing your supply management organization to be truthful about the supplier's performance when used as a reference with other customers (despite confidentiality clauses).



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While there may be some challenges to this approach, there also are solutions to help you meet those challenges. (See chart below.)

Shaping Incentives Through Pricing

Often the most powerful incentives are in the pricing structure. As they say, you get what you pay for. If you pay for resources, you get resources. If you pay for objects, you get objects. If you pay for activity, you get activity. If you pay for outcomes, you get outcomes.

You can leverage this principle to your company's advantage by thinking about how you could maximize your profits if you were the supplier under your pricing plan. Would you provide unreliable products for the fixed price and then make margin on your aftermarket parts business? Would you make design changes that reduce your costs although they increase costs elsewhere in the supply chain? If the supplier could maximize its profits by making changes that hurt you, you have an incentive problem to address.

One supply management practitioner faced the problem of how to contract for critical components for a new product offering with uncertain prospects. The standard approach would have been to obtain "volume discount" pricing that would reduce supplier margins if the product was successful. Instead, after an open, frank discussion with suppliers, the supply manager negotiated the opposite: pricing that is unprofitable for the supplier at low volumes but highly profitable at high volumes. As a result, the companies will thrive together or fail together. One key benefit has been a genuine collaboration and sense of partnership, with the supplier investing its own resources in innovation because it has a stake in the joint success.

Targeting Incentives for Ongoing Performance

Incentives can be provided for ongoing performance by choosing a desired level of performance, measuring actual performance and providing bonuses and credits for over/under-performing. Surprisingly, targeting performance incentives can be challenging because suppliers may try to exploit weak points in the contract and because performance often is not measured.

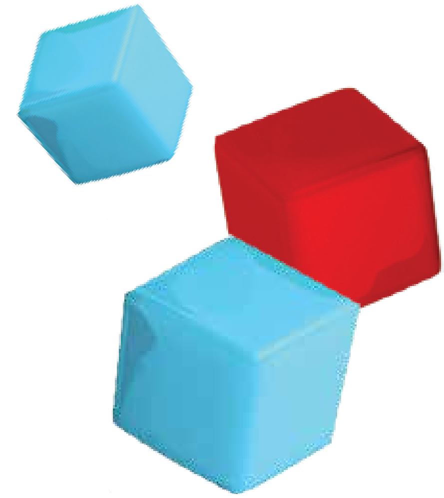
To overcome the challenges, supply management practitioners should consider the following measures.

Define a clear standard that measures value delivered to your organization. Find team members or business-unit partners who understand the product well, and ask probing questions, particularly regarding areas in which work needs to be correct and complete to provide value. For example, there may not be value in a product's availability unless the supplier's distribution network is also working.

Define a formula for calculating the end result. The formula might be the total number of measured items that meet the standard divided by the total number of measured items, expressed as a percentage. A specific formula will bring clarity to the definition and will be necessary for later steps.

Challenges and Solutions

Challenge	Solution
General terms typically provide incentives to comply, not to excel	Commit to positive outcomes for the supplier for results better than what the supplier can promise
Costs and delays in determining damages	Expedited arbitration to resolve issues quickly and at lower costs Predetermined credits to simplify damages calculations
Poor understanding of contract and contract law limits the value of incentives	Training "Please be reminded" messages
Supplier does not control the outcomes	Waive specified out-of-control events Design contract to reduce the effect of luck Use a "partnership" model involving a sharing of risks and rewards



Find a way to measure actual performance. If you cannot find a way to measure performance with a method that is accurate, inexpensive and easy to audit, go back to step one.

Define the incentive arrangement. For instance, consider a 5 percent reduction in price if more than 1 percent of the delivered product is late or defective during the month and/or a 5 percent bonus if less than 0.1 percent is late or defective. Watch out for common pitfalls, such as agreeing to a performance standard based on poor past performance that caused you to rebid the contract or based on the supplier's initial performance. Also, be careful not to create a "bad incentive." In call center outsourcing, for example, a supply management professional might set a service level of "answer 90 percent of calls within two minutes" without realizing that it creates an incentive to ignore any call that's gone over two minutes in favor of any call that could still be answered within two minutes.

Decide whether to include a continuous improvement obligation. In many areas, performance improvements have been obtained for decades, and suppliers can commit to them for years to come. In other areas, improvement in performance can be triggered by technology or process changes, such as a systems or component product upgrade.

Include provisions that drive toward immediate consequences. Require prompt analysis and correction of failures. Allow rapid escalations. Provide for quick payment of credits and allow termination for sustained poor performance.

Targeting Incentives for One-Time Performance

You can also include incentives for one-time performance, such as completing a part of a project. Again, the incentives can be negative or positive. (See chart.) The steps for creating incentives for one-time performance are similar to those for creating incentives for ongoing performance. They include the following:

1) Analyze the spectrum of outcomes, and estimate the value of each possible outcome. A common mistake is to set incentives in a binary way (on time or late) when value might vary along a spectrum — a month late having little effect but three months late having a dramatic effect.
2) Identify the tasks and deliverables for the project. Focus on those that deliver value and can be clearly defined.
3) Determine the desired role for the supplier, including the supplier's control and flexibility. Incentives work best when the supplier is willing and able to change.
4) Define the incentive structure. You might have a bonus for early performance (if that adds value), a price reduction for late performance, payments withheld until performance is complete and a commitment to repeat business for superior performance.
5) Stress test the incentive structure. For example:
   - Do incentives continue despite early successes or failures?
   - Is the result clear?
   - What is the role of luck?
   - Is the incentive strong enough?
6) Adapt as needed. The general rule in contracting with incentives is you are better served with a balanced collection of incentives than with a single solution. Also, monetary incentives only go so far, which is why it's also important to consider termination rights and other remedies in addition to monetary credits.

Negative and Positive Incentives

Negative Incentives

- Holding back payment until milestones are met
- Credits for delayed or incomplete milestones
- Reduced rates for delayed, over-budget or low-quality work
- Pain sharing

Positive Incentives

- Early payment for meeting milestones early
- Bonuses for early or more-than-promised success
- Increased rates for early, under-budget or high-quality work
- Gain sharing

The more you work with incentives, the more powerful a tool they will become. By using them effectively, you will be able to incentivize suppliers to achieve results they were unwilling to promise before, and you can become a customer of choice by rewarding their success. Managing performance will be easier because suppliers will be more likely to perform well on their own. Also, the proper incentives will allow you to add new protections for vital supply chain and company interests while developing closer and more collaborative relationships. ISM

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