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Delivering sustainability through supply contracts

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This is the fourth and final article in this series. In earlier articles, we described rapidly emerging environmental, social and governance (ESG) legal and regulatory requirements. In this article, we describe ways for buyers to meet those requirements in their supply chains.

Doing so will be challenging. Supply chains are already optimized for least cost, including as to the manner of production. ESG change increasingly requires changing the manner of production. Buyers generally have limited data on the manner of production or its cost. For suppliers, changes to the manner of production may increase cost, violate other agreements, or create other risks.

There are, however, opportunities. Technology is increasingly making it easier for technical, operational, user and business stakeholders to collaborate across companies to develop new solutions. The analytical power of scorecard methodologies, which assess performance against a range of metrics, is helping to allow goals, such as ESG, to be part of a balanced analysis. Board-level and C-level support for ESG are facilitating the necessary collaboration across traditional silos. Supply chain contracts are steadily more adaptive, flexible and nuanced, allowing broad change.

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The following are the four most practical ideas that we have seen for buyers generally to meet emerging ESG requirements in the supply chain. These may not be the best ideas for your company.

Using accepted legal or other standards

A first approach is to use accepted standards from laws and standard-setting bodies. Accepted standards are more credible and thus more likely to be adopted "as is" instead of being negotiated. Conforming to accepted standards is less costly and complex for suppliers than working with diverging standards from various buyers. Certifications may be available from reliable third-party audit or certification firms, avoiding the need for each buyer to do its own audit.

Accepted standards can be implemented using long-established contracting concepts. Supply contracts have long included clauses requiring suppliers to comply with designated standards, train their people in line with those standards, obtain third-party certification of compliance, and allow audits by buyers. Anti-corruption compliance is an early example of success at that approach in the supply chain, and privacy compliance is a more recent example.

However, accepted standards only take a buyer so far. They often are framed at the enterprise level, not the specific supply chain for a specific buyer as performed by a specific supplier. That may not satisfy regulatory or company requirements for the buyer because those requirements generally apply to the buyer's supply chain specifically, not merely to the companies in the buyer's supply chain. Also, audits at the supplier enterprise level may be unreasonably costly or intrusive and, in any event, it may be unreasonable for a single buyer to ask a supplier to modify its entire enterprise for that buyer.

As a result, buyers may seek to include contract terms beyond those typical in a supply contract. Typically, the negotiable topics are product, price, delivery time and delivery location. The manner of production – how the supplier will deliver – is generally left to the supplier.

Collaborative contracting

In collaborative contracting, the parties negotiate about far more topics. In those negotiations, buyers may make operational, technical and financial commitments beyond paying the agreed prices. For example, the buyer might agree to fund investment by the supplier in changing its manner of working and the ongoing costs, or to change its product requirements to reduce adverse ESG impact for the supplier.

Collaborative contracting often requires a substantial investment. Done right, it requires considerable time for the operational, technical, user, business and legal terms to be negotiated and agreed. There may be new, and more complex, terms on commitment, contribution, control and sharing of risks and rewards. In the context of ESG specifically, those obligations may be designed to allow the suppliers to profitably produce on a more sustainable basis. Also, it likely produces contracts that

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are inconsistent across suppliers, which may cause difficulties in integrating the resulting goods and services.

Managerial contracting

In managerial contracting, buyers manage supplier operations through contracts. Buyers obtain contractual commitments to compliance with detailed process requirements and use boots-on-the-ground inspections to ensure those commitments are satisfied. They control critical decisions, such as subcontracting work and sub-component sourcing. They use scorecards, incentives, meetings, reports and other managerial tools like those that they would have used if the buyer and the supplier were a single enterprise. This allows buyer to control, to some extent, the manner of production.

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Managerial contracting was developed for quality assurance, particularly for goods where quality is difficult to measure at delivery and thus engineered into the product. For example, cooling a component slowly and evenly may allow it to last 10 instead of five years. So, the buyer focuses on cooling speed instead of waiting five years to see what breaks.

Similarly, buyers could put in place process requirements as to use and disposal of materials, working conditions, and other ESG factors. The buyer could then use its preferred managerial approaches to create incentives for good results, for example by obtaining reports, holding regular meetings, awarding "ESG Supplier Excellence" awards, auditing, and increasing its buying from the suppliers who deliver better ESG impact.

Buyers using managerial contracting may incur a substantial cost in performing management tasks that could be avoided in a typical supply contract. In addition, suppliers may incur substantial expense in complying, which generally will be passed along to buyers in pricing. However, if the ESG program is well engineered and well managed, it could be a least-cost way to achieve ESG goals.

Digitalization and digital transformation

A critical part of making an ESG program effective and efficient across a supply chain is:

- Digitalization of sustainability by having suppliers capture sustainability data with sensors; and
- Digital transformation of sustainability by replacing the currently highly manual processes of analyzing and reporting on data with automated systems.

Doing so has numerous benefits. It facilitates effective, efficient contract governance and reporting to investors, regulators and other stakeholders. It reduces the risk of greenwashing and the costs of buyer verification. It accelerates progress by shortening feedback cycles.

Buyers may need to lead the way. Buyers need data in forms and formats useful to them and not merely data but the right data. Buyers may co-invest with suppliers in digital transformation of suppliers or provide a cloud-based tool for data entry along the supply chain. Industry consortia, likely funded by buyers, could help in creating the data infrastructure.

The road ahead

In furtherance of organizations' own ESG ambitions, the use of accepted standards, collaborative contracting, managerial contracting, digitalization and digital transformation can allow buyers to secure commitments from suppliers on ESG objectives and obtain reliable measurements of actual performance. In addition, ESG impact can become a separately priced feature. For example, the contract can provide price adjustments based on greenhouse gas emissions or the supplier's performance on the buyer's ESG scorecard. By making ESG impact both a contractual commitment and a priced feature, these approaches can allow supply chain professionals to use existing tools and techniques to meet ESG requirements efficiently and effectively across supply chains.

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