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Professional Perspective

Supply Chain Services Contracts: Mitigating Global Operational Risk

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Supply Chain Services Contracts: Mitigating Global Operational Risk

Contributed by Jonathan Todd, Benesch, Friedlander, Coplan & Aronoff

For today's global enterprises, smart management of third-party supply chain providers can help ensure efficient and error-free movement of goods. This article explores key contract strategies and operational risk mitigation practices used by traffic, supply chain, purchasing, and legal teams to manage provider performance. These include features such as tailored service level agreements, key performance indicators, management meetings, and root cause analysis procedures.

Use of Third-Party Providers

Third-party service providers handle material inputs, finished goods, and returns as products circle the globe every day. Providers include direct transportation companies such as motor carriers, railroads, ocean carriers, air carriers, and warehouses. They also encompass a wide range of intermediaries such as fourth- and third-party logistics providers, traditional freight brokers, non-vessel operating common carriers (NVOCCs), indirect air carriers (IACs), and international forwarders. Other supply chain services more closely resemble professional services such as customs house brokers. Service failures among any of these can be costly, regardless of the type of service under contract for a business unit, lane, operation, or facility.

Supply chain services are typically outsourced to support production, distribution, and sales. While an organization could develop and self-source many third-party services in the sector, this is often undesirable—due to lack of core competencies, operational flexibility, capital requirements, and perceived return on investment. On the other hand, successful deployment of third-party services can fulfill business goal while also minimizing risks. The wide range of interruptions, production delays, loss and damage to product, unforeseen cost, legal and contractual liability, customer service failures, and reputational damage that can result from unexpected events is tremendous.

While it's recommended to follow procurement best practices and exercise due diligence when vetting providers, ultimately the relationship and its balance of risks rests upon the contract structure and language negotiated between buyer and provider.

Contract Tools for Risk Mitigation

Thoughtful and well-tailored services contracts are the foundation of any strong enterprise-vendor relationship. Each party naturally seeks to enjoy the benefit of its bargain, whether through receipt of compensation or of a good or service, while minimizing surprises along the way. Supply chain services are no different, whether they involve transportation, logistics, distribution, fulfillment, or other critical operational needs.

Many of the traditional contract tools that are used in other sectors are equally applicable to supply chain services. Some are particularly valuable for aligning party expectations and minimizing operational risk. Mechanisms such as standard operating procedures, service level agreements, key performance indicators, root cause analysis, and periodic management meetings are available to buyers and sellers of supply chain services but are often underused. The next sections explore each tool and its potential value for supply chain services.

Standard Operating Procedures

Standard Operating Procedures refer to those process documents used to establish an enterprise's standardized method for a particular operation, issue, or scenario. SOPs are deployed as a best practice within companies large and small to harmonize processes, maximize performance, and minimize variance. For most supply chain services, neither party would wish to develop SOPs dictating the service provider's own internal policies, procedures, direction, instruction, or control over its operations and personnel. Each party naturally intends to perform its obligations under contract to the best of its ability and with sole responsibility over its operations. On the other hand, specialized SOPs may serve a great value.

SOPs can play a meaningful role in complex supply chain services relationships even while respecting the core competencies of each party. For example, buyer and seller may share an interest in defining the operational practices for any physical interactions between the two. The subject matter of those agreed-upon SOPs could be thematic or general in

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nature. An SOP could be developed for procedures upon receipt or delivery of product, technical requirements when performing kitting or light assembly, any safety requirements when personnel are present at the facilities or yards of another, and even for incident reporting between parties or their continuous improvement efforts. Alignment on these operational details at the outset of a relationship can both help to confirm the feasibility of party expectations and minimize the opportunity for surprises once traffic begins.

Service Level Agreements

Service level agreements refer to those contract terms that establish the precise performance expectations of the parties for certain high-impact metrics. SLAs are widely used in many service sectors but adoption lags in supply chain services applications. The principal value of deploying SLAs in the context of supply chain services is to gain mutual agreement on certain material expectations upon which the contractual relationship is based. The intent behind an SLA is not to penalize a provider but to establish the basic thresholds that can be confidently achieved.

SLAs may focus on those few metrics that are absolutely required for the service to be of value to the buyer's enterprise. This is particularly useful for new providers since the buyer may not have a strong history or visibility on the performance track record. Well-crafted SLAs may address metrics such as on time delivery and periodic reporting. The precise statement of each metric includes a period of time during which performance will be measured as well as the minimum performance target. SLAs are often best served when populated with only those key performance measures for which both parties agree that failure to perform would constitute material breach. If SLAs are not met over the designated period then disincentives may be available including termination for cause, remedial action, or damages.

Key Performance Indicators

Key performance indicators refer to those contract tools for measuring provider performance on a forward-looking basis relative to mutually agreed upon targets. Like SLAs, KPIs are widely used in many sectors but less so for supply chain services. Diligent use of KPIs can assist both parties by serving as a mechanism for visibility to operational performance data throughout the relationship and the trend lines that those elements yield. The reporting of KPIs often takes the form of a “scorecard” or other dashboard-style representations that can be shared and discussed at management meetings.

KPIs often address performance metrics with greater granularity than SLAs because they provide a different value for relationship management. Here, each party is seeking alignment on any number of data points that are useful to maximizing performance during the term. Precise line items may overlap with SLA metrics although, in contrast, KPIs tend to be populated with items that are not in and of themselves material to the relationship.

KPIs may include a wide range of specific metrics such as on time delivery, order accuracy, loss and damage frequency, claims resolution times, and billing accuracy. KPIs are often stated together with identification of the applicable data source, the frequency of review, starting baselines, targets, and variance thresholds. The statement of KPIs are typically not static measures due to changing operational needs of the parties. The parties may agree upon disincentives for poor performance on particular KPIs including, for example, adjustments to the service provider's compensation until performance is corrected. Termination may be available in the event of continued and egregious poor performance, but in many instances KPIs are intended to facilitate visibility and quality management rather than punitive remedies.

Root Cause Analysis

Root cause analysis is the method of examining an incident, acute poor performance, or other impactful non-conformity in order to determine the systemic cause so that it may be addressed. Supply chain and operations professionals are familiar with preparing root cause analysis reports as part of internal process improvement programs, but this mechanism is useful as a contract tool when applied in appropriate relationships. Contract provisions of this nature are beneficial when used as part of an escalation plan for deficiencies as determined by agreed upon SLAs or KPIs.

A service provider may, for example, commit to promptly investigating severe failures and developing written root cause analysis reports for discussion with the buyer. Additional requirements may include the development and implementation of effective corrective action plans. Those management teams that are particularly diligent often develop a written cadence for subsequent meetings, progress milestones, and results tracking until the service failure is corrected. The objective of this exercise is of course to eliminate the problem and to guard against its reoccurrence.

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Periodic Management Meetings

Periodic management meetings refer to the memorialization of party intent that senior management of the buyer and provider will meet at some frequency, often quarterly, to discuss performance and any operational changes. Many contract parties prefer to remain silent on the interaction between respective management teams, but setting expectations in advance can be valuable. Critical supply chain operations such as fulfillment and distribution are sometimes well served by management meetings because the operational, commercial, and reputational harm that can arise from poor performance can be tremendous. Any agreement on the frequency, content, and seniority of management meetings demonstrates at the outset each side's commitment to quality performance and creates the natural mechanism for addressing both positive and negative operational performance.

Considerations for Key Relationships

Simply put, in the event of an incident, one of the first places parties will look for a guiding path forward is the service agreement. The structuring of contract mechanisms and the balance of risks is by nature a pragmatic endeavor designed to speak to that universe of unknown possibilities. Like all aspects of supply chain management, the goal is to execute the required operation in an error-free fashion while meeting stated objectives. This real-world practicality is well served by risk-based approaches when drafting and negotiating contracts.

While the contract tools discussed in this article may not be suitable for all applications or all parties, the failure to consider their potential can yield missed opportunities for both buyer and seller. The risk management structure that is finally negotiated will of course depend on many internal and external factors, even when taking a pragmatic risk-based approach. Consider that enterprise accounting, legal, risk management, and even finance teams may have valuable input on risk potential and quantification.

Likewise, certain service providers may be due greater consideration than others based on the strength of their core competencies, their experience with the respective supply chain services, and their familiarity with the particular operations. Of course, the specific operational factors may also influence strategy. A heavily negotiated contract could be excessive depending on service, geography, product value, and risk of service interruption.

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