Is Contracting Keeping Up With The Times?

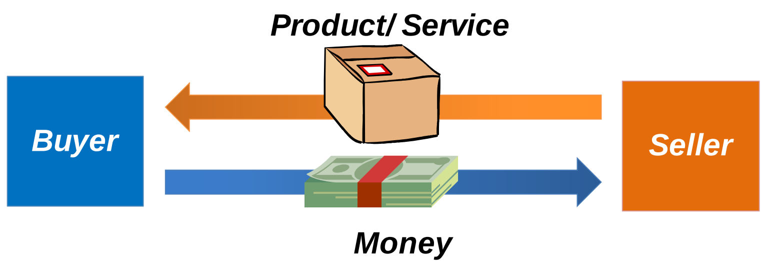
Good Morning everyone … it's great to be here.. ……

I thought I would start with a question……. Is contracting- the way it's generally done today ... keeping up with the times?

To begin to address this question, let's look at an exchange between a Seller and Buyer.

View of Exchange

Most Sellers and Buyers spend considerable time understanding the physical features of products and services. Sellers seek to understand how physical features of their products differentiate them in the marketplace and buyers' willingness to pay for them. And buyers seek to understand what features they want and need, and whether those features can help differentiate them.

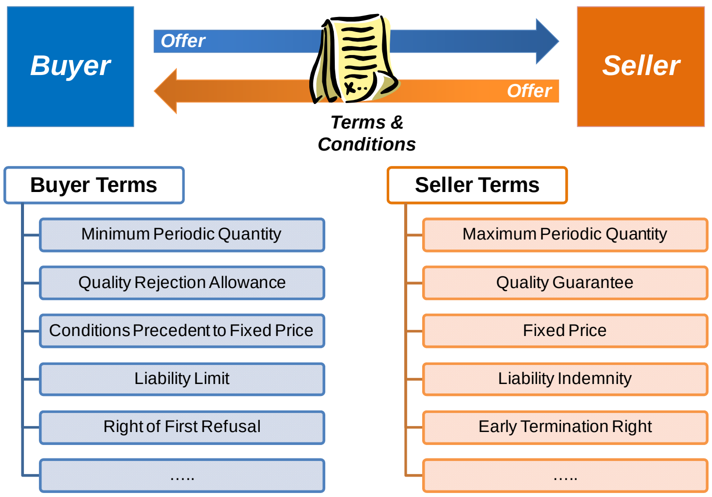


However, the fundamental product or service is only one aspect of the deal. Too often- Sellers and Buyers alike- only focus on the differentiating aspects of the physical products and services and fail to recognize the differentiating advantage that can be created by other aspects of the deal- i.e. terms and conditions of the contract.

Here- the Buyer has risks that the Seller can help address with contract terms. For example, the Buyer is uncertain about their demand. Demand could periodically be large and they are concerned about ready availability. The Seller might offer a guaranteed maximum periodic quantity. The Buyer is also concerned about the quality of the Seller's product- so the Seller could offer some form of quality guarantee. And price volatility, liability and an uncertain duration risks faced by the Buyer might be addressed by a Fixed Price, Indemnity and Early Termination Right respectively- from the Seller.

The Seller also has risks that the Buyer can help address through terms. The Seller is uncertain about the utilization of their production assets- and in particular - the utilization of capacity they dedicate to the Buyer. The Buyer might offer the Seller a guaranteed minimum periodic quantity. The Seller is also concerned about quality non compliances - so the Buyer could offer some form of quality rejection allowance. Other Buyer offerings to the Seller might include conditions precedent to the fixed price, a liability limit and a right of first refusal on the buyer's uncertain term of requirement.

So each party has a valuable contract offering to the other party.



These contract offerings are obligations or options that act upon and shape risks of the other party- so in fact - <u>they are 'risk product offerings'</u>.

Sellers– You <u>are</u> Sellers, but your' offering is bigger than the physical product and service you are selling. The terms you offer are features that wrap around your product or service. You should be thinking about their attractiveness to Buyers- and be curious about their worth to Buyers.

Buyers – You <u>are</u> Buyers; but you are <u>also</u> Sellers. The terms you offer are features that wrap around your spend. You should be thinking about their attractiveness to Sellers- and be curious about their worth to Sellers.

And if Buyers are Sellers, than Sellers… must also be Buyers!

So <u>both</u> parties are selling. And <u>both</u> parties are buying, which makes for an interesting- yet complex exchange.

This raises at least 3 questions……..

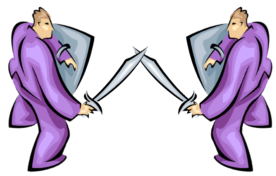
- What's the ***value*** of each offering?
- How do ***variations*** in the offerings impact values and price?
- What's the ***optimal*** exchange?

Too often contracting does not provide answers

Too often, there is little to no discovery of prices… or standards get in the way of discovering opportunities.

- Little to no discovery of value and prices

- Standards can get in the way of win-win opportunities



I am going to assume that all sellers and buyers are curious about prices…….so it must be that standards are getting in the way. For example - One company's standard commits to no volume, commits to no term and imposes full form indemnities on their counterparties. It also stipulates a meet or release provision- despite the fact that their company isn't really committed in any way. There are so many outs – that "deals" are really nothing more that spot deals masked as contracts.

Their head counsel was quite happy with the company's take absolutely no risk stance. I asked him how much they are paying for these terms. And whether an alternative might offer better them better economics? He looked at me someone puzzled and said he really did not know. He went on to imply that their sales people needed strict guidelines and that it would be "risky" to move away from their standards. We focused in on one area- product liability - and I asked him if he had any experience data on claims related to the product. He could not remember the last time a claim was actually made against the company.

The bottom line - this company implicitly either believes the protections and outs they are getting from their counterparties are free or the risk premiums they pay counterparties are lower than the costs to hold the risks themselves. In fact though- they really don't know.

Are your standards buffering your company from all possible risks –however remote- and constraining your ability to realize opportunities?

“I think, perhaps, we need to come up with a new approach to risk management.”

And if standards aren’t getting in the way, then what is? In a recent survey by IACCM, over 80% of negotiators believe that outcomes would be more successful if the traditional focus areas for negotiations could be changed… and this held for both the sell and buy sides.

Here- in this presentation- I will focus more on a methodology through which the negotiations agenda can start to change.

So why hasn't the agenda shifted? Is it trust?   Indeed a readiness to talk about risks and value depends in part on trust.

While lack of trust may be part of the cause, I suggest to you that the journey to begin changing the game may simply be a matter of shifting to a new risk ethos… guiding beliefs or principles fundamental to our profession.

New risk ethos

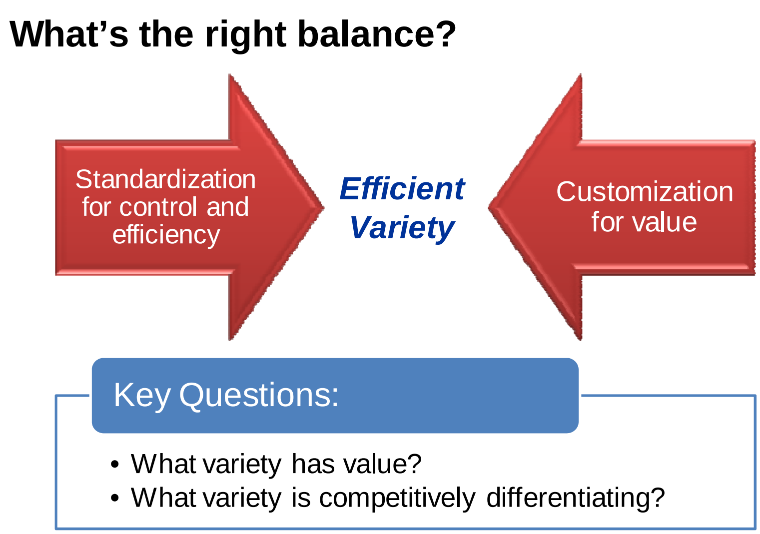
1. Both parties' risks are important to understand
2. Alternative ways to allocate risks can be opportunities
3. Prices for alternatives can and should be discovered
4. Terms can be traded to optimize my risk

Note that the principles are interlinked. For example if I believe that new alternative ways to allocate risks can be opportunities- I must also believe that knowing my counterparty's risks is important. If alternatives to allocate risks can be opportunities- I should try and discover their associated prices. Note also that the new risk ethos is about being curious. It entails asking how my behaviors are impacting the other party - and if I modified these behaviors- what's it worth to them. And if I shaped my counterparty's risk profile differently, what's it worth to them?

Standards certainly serve an important purpose. In the case of the Head Counsel- to achieve control. Indeed, without any standards, there would be chaos. But carried to an extreme, standards can come at the expense of value possible through customization. In cases of extremely rigid standards I've come across- I have wondered if it's more a reflection of management's lack of confidence or belief in their people- to deal with and manage even limited variety. And what it would be like if their confidence was bolstered.

Standards also mean efficiencies- which is a good thing. But this again- raises a question regarding the right balance with effectiveness- and Customization for Value.

So if we introduce variety into our contracts- what variety is efficient? What variety has value exceeding the cost of the variety? And what variety is competitively differentiating?



If we can understand the variety that's efficient, it can be standardized.   But it needs to start with a willingness to explore possible variety.

Step 1: Develop an efficient variety of alternatives

Menus are an efficient and effective way to delineate and test variety in obligations and options that effect risk allocations (including so called boiler plate terms, which often are negotiated separately from price!).

Commercial Menu ***Supplier Risk*** →

Provision	Lowest	Medium	Highest
Quantity Commitment	Fixed	Min/ Max	Max
Quality Guarantee	95%	98%	99.5%
Price Redetermination	Market Index	Index w Collar	Fixed
Raw Material Feedstock	A or B (Seller Option)	A	A
Liability Indemnity	Comparative	Intermediate	Full
Term Commitment	1+1 (Seller Option)	2 Yr	Buyer TFC
Price	$	$$	$$$

It's here- that we start to shift the nature of the conversation and change the game. Risk allocation- is less about the brinkmanship we will exert to arrive at a preconceived destination and more about a discovery process or journey to first understand possibilities and their prices.

A maintenance provider – who had always competed on the basis of a cost + fixed fee offer- now also offers a performance based fee option where they take on more risk- for upside (SOS). The two offers are made using a commercial menu and allow a cleaner separation of risks. The cost + option has the risks stripped completely out and in the performance option – the supplier takes on some risks – for a price.

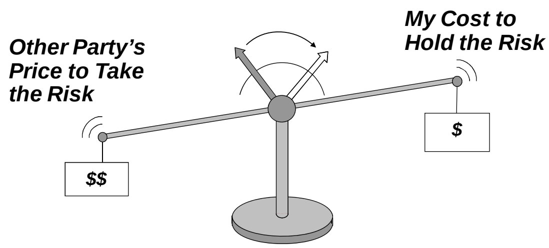
A railway company now offers 3 offerings to buyers- aligned with distinct value propositions- Low price- Flexibility and Immediacy. The basic service is transportation- but the offering versions for Flexibility and Immediacy were differentiated by special quantity options and service levels respectively.

I don't want to suggest that creating menus is simple or ad-hoc.   In fact- there's a science and best practices behind it that takes into consideration the interdependencies between terms and conditions- so they are carefully constructed.

But the key point I want to make here is that curiosity substitutes for omniscience regarding what you want and what the other party wants. Through menus you are saying …I am not sure. I am not sure what is best; but let's jointly discover the win-wins!

Step 2: Discover prices and understand economics

The next step is to discover prices and understand economics. When I say price discovery I am referring to either to your counterparty's prices to take risks Or their willingness to pay you to take on risks.. Remember- both parties are buying AND selling risk products. Here- I am comparing the other party's price to hold the risk to my cost to hold the risk.



A simple example: One buyer now versions the insurance requirement it imposes on sellers. The company had in the past used a blanket one size fits all insurance policy on all their suppliers. The same insurance requirement was being imposed on suppliers maintaining their plant facilities as was imposed on the landscapers mowing the lawns of their facilities. Obviously, this is an extreme case of very different risk profiles and very different prices for risks. Through price discovery, they realized they were paying more for the insurance requirement imposed on the landscaper than it would cost them to simply hold the risk. So they lowered the landscaper's requirement.

Many of you may be saying to yourselves- OK sounds simple. But you have not addressed the cost to hold a risk. Let me only say here that there are approaches and tools to understand costs of risks. They have not been adopted widely by the contracting community yet- and that's another example of where contracting may not be keeping up with the times, because both buyers and sellers continue to either demand or embed– albeit sometimes reluctantly- risk products into contract offerings. In these cases, they do so-without understanding the prices OR the costs. The message here is the same- the benefits of discovering prices and understanding costs for risks can be substantial. .

Step 3: Look for win-win trades

Now look for win – win trades. The alternatives proposed help create a trade space to discover win wins. They promote a dialogue for deal discovery and guide the exchange of value and risks.

Here, a change in a term -a tradable- to match a preference of one party, is offset with another tradable matching the other party's preference – and can result in a better deal for both.

In the actual example shown here- the buyer received a lower than typical fixed price in exchange for two supplier options- 1st, the supplier's right to renew the contract for a year- at the same fixed price. The supplier – a specialty chemical manufacturer- also obtained the right to substitute periodically- at the supplier's discretion- an oleo chemical feedstock for the traditional synthetic feedstock. Given that the two feed-stocks could switch in terms of price advantage from time to time, this was also a valuable option.

Supplier Risk →

Illustrative

Provision	Lowest	Medium	Highest
Quantity Commitment	Fixed	Min/ Max	Max
Quality Guarantee	95%	98%	99.5%
Price Redetermination	Market Index	Index w Collar	Fixed
Raw Material Feedstock	A or B (Seller Option)	A	A
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Price	$	$s	$$$

Key Trade

The buyer obtained a lower fixed price because the options allowed the supplier to better manage its costs, risks and margin.

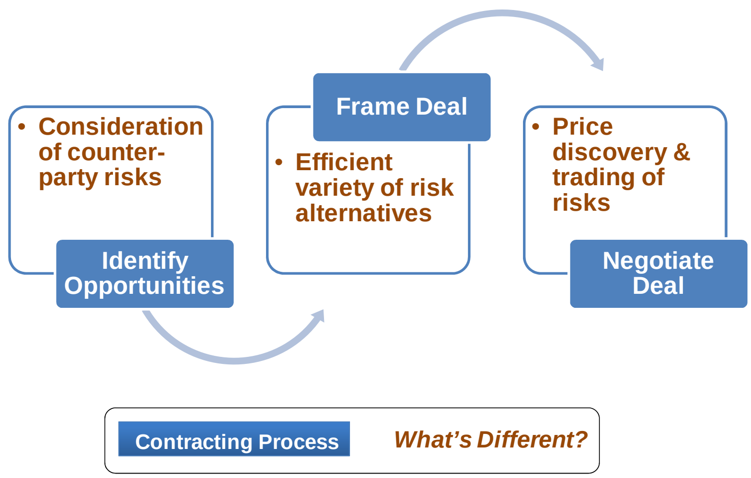
How does the contracting process change?

So what are the key changes to the contracting process change under the new ethos?

1st, I will work to understand my counterparty's risks – as a way to identify opportunities.

2nd, I will develop an efficient variety of risk allocation alternatives when I frame the deal

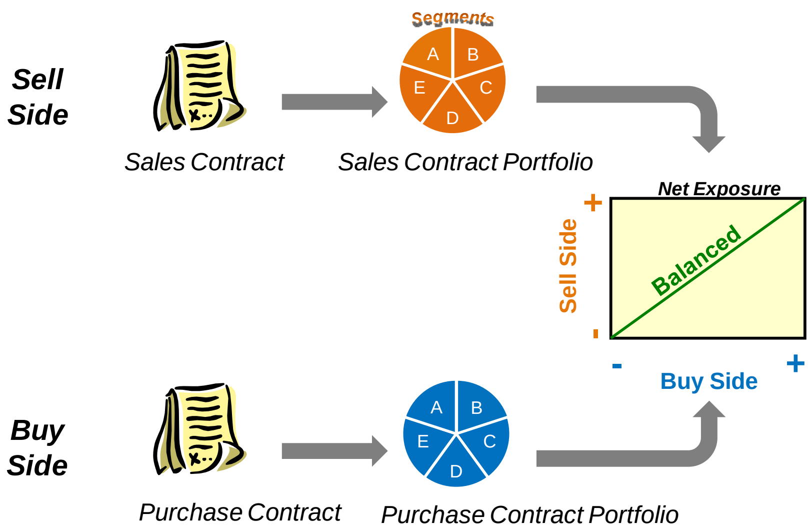
And 3rd- I will get price discovery on alternative and trade to optimize risks.



The next frontier… *Portfolio Thinking*

I would like to touch upon the next frontier- and in my mind a source of enormous value and big lever for risk management- Portfolio Thinking

Here- a company expands its field of view from the individual sales contract to the portfolio of sales contracts. They aggregate deals- into segments- with similar risk profiles. For example- these segments could be fixed price, cost +, milestone based or performance based. They then do the same for their purchase contracts- covering the raw materials and services they buy to produce their products.



The question is: what's their net exposure?

Are the company's exposures balanced?

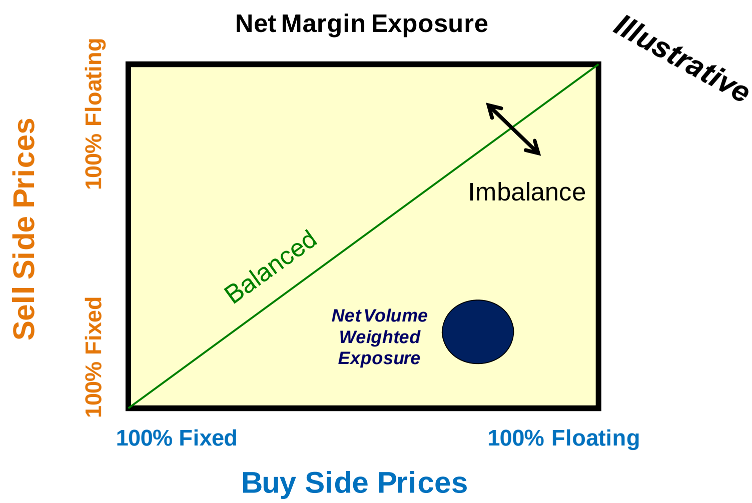
And if not, is it deliberate?

And if not deliberate, what are they doing to change the net exposure. What's the plan to reshape the enterprise's net exposure?

Looking at enterprise exposures reveals nature and size of imbalances

Let's look at an example of portfolio thinking.

Here- a company has drilled down on their buy and sell side price exposures and the blue dot depicts the volume weighted net margin exposure for the firm. Note that on the buy side, the firm has predominant floating market exposures. Price rises and falls with the general market. Whereas on the sell side, the firm's predominant exposure is fixed.



This imbalance means a potential margin squeeze. What's more, because the buy and sell side prices are positively correlated, they firm has actually introduced <u>more risk</u> into their margin than would be present if their sell side exposures were floating. What's their ability to handle a margin squeeze?

If the net exposure is not deliberate, why is that? Are the buy side people and sell side people in the firm talking to each other?

There are many other examples where net enterprise exposure is valuable to understand: 1) Quantities - Where are quantity commitments and options imbalanced? 2) where are service levels imbalanced?

As a service level example- consider Lead Time: One Buyer's transport contracts stipulate a standard one day lead time- with no alternative. On the sell side though, it was discovered that a large segment of their customers were satisfied with 2 day lead time. If this company were to version their sales contracts on lead time, they could match the different needs of their customers. And they versioned the buy side, they could match the service level they buy with the service level they sell- and realize a joint savings. Because 2 day lead time from their transportation providers was lower cost. The concept here is similar to matching assets with liabilities

Expanded risk role of Contract Professional

Traditionally- the contract professional's risk role has focused on understanding, tracking and managing contract risks and communicating risk events. They are commonly the bearer of bad news when things go wrong. And when things are going ok- they are largely ignored- at least when it comes to risks.

In adopting the new risk ethos- the role of the contract professional is expanded considerably and strategically:

1. Understand not just your risk- but also that of counterparties

2. Develop and propose alternatives: versioning terms according to value and risks

3. Obtaining price discovery regarding the value and prices of contract terms and conditions/ opportunities and relating that back to key internal stakeholders. "This is worth $X. Can we do that? How could we change our behavior to realize the opportunity. What would it cost us? Is there a net gain?

4. Build a trading play book of win-win trades to make trading more deliberate. What's the company's book of potential win- win trades? The contract professional would address this question.

The expanded role is a big opportunity for a company- and I think- big a lever for individual growth and advancement. Unfortunately the question is not so much "are there any takers for this role? But rather "are there any offers to create this role'? And I mean offers from you- the contracting professional. Because most companies don't have a written job description for this expanded role. But this is an opportunity to step out and shape the role. And in stepping out, you can help your company fill an important gap- because again- your company IS ALREADY BUYING AND SELLING RISK PRODUCTS. THEY MAY JUST NOT KNOW IT YET. So filling this gap is an important part of 'keeping up with the times".