CUTTING Fat... without CUTTING Substance

We gathered insights from 80 executives who represent over 60 key government defense suppliers to identify four cost drivers of unnecessary costs related to contracting, as well as four ways to reduce or even eliminate them.

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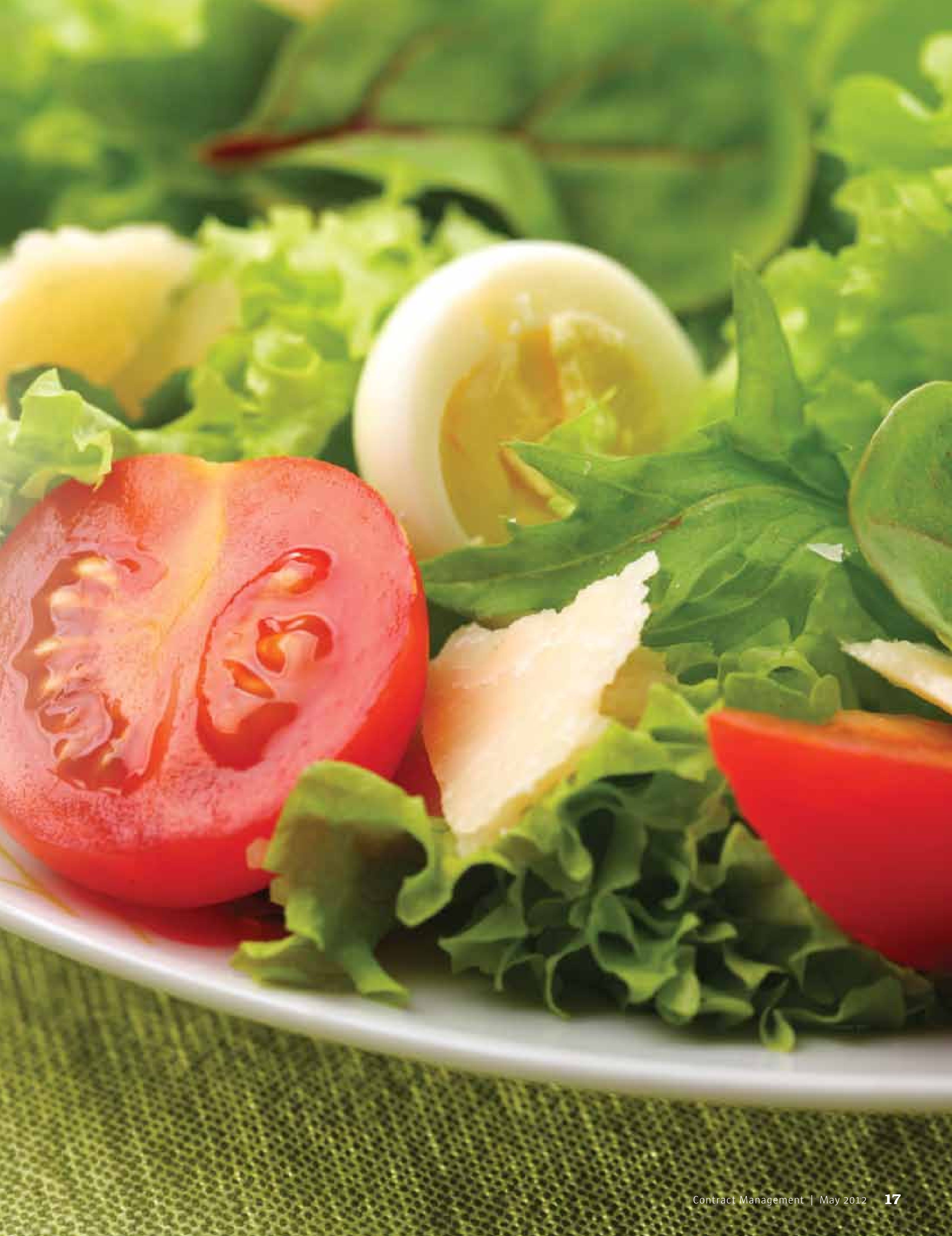


Most large organizations rely heavily on their suppliers to provide key inputs, and most of the money paid to those suppliers goes toward what is actually purchased—the "design and manufacturing costs" of producing the input. Yet, a significant portion of spending goes toward "transaction costs," which are additional expenses created when purchasing inputs.[1] Examples include administrative, legal, and other expenses created when writing requests for proposals (RFPs), evaluating RFPs, negotiating contracts, monitoring purchases, making changes, and resolving disputes. Some transaction costs are necessary, but others can be lowered or eliminated.

Our research team set out to learn how much U.S. government organizations spend on design and manufacturing costs versus transaction costs. We gathered input from 80 executives from over 60 key government suppliers. What these executives revealed was staggering: 75 percent of spending goes toward design and manufacturing and 25 percent goes toward transaction costs.[2] To us, 25 percent is not a trivial amount, and it suggests that the room for savings on transaction costs might be substantial.

Given that transaction costs are so large, we began to wonder what drives them, and what can be done to reduce them without excessive risk, so we asked those same executives for insights about what drives transaction costs and how they can be lowered to improve contract management performance. From our executive interviews and from studying a large body of academic research on transaction costs, we identified four key cost drivers that apply to government organizations and to large private sector companies.

Cost Drivers

1. Vague Requirements

Unless the inputs being supplied are mature, it is almost impossible to list all requirements within RFPs. Suppliers recognize this, but they believe that many buyers leave contract requirements less specific than they could and should be. Even if the technology is too new to describe *how* the product should work, it should be possible to describe *what* it should accomplish. Vague requirements raise costs because ongoing negotiation is needed to iron out differences between the buyer's changing interpretation of the requirements and the assumptions the supplier made when constructing their bid.

2. Inflexible Processes for Modifying Requirements

Even when buyers do the hard work up front and attempt to "nail" the requirements, some changes are inevitable. Contracts deal with the future and neither the buyer nor the supplier has a crystal ball to see the future with perfect clarity. Thus, as future events unfold, some contracts—due to the underlying requirements—will need to be changed. Changes are costly, however, and having inflexible processes to deal with changes only make things worse.

3. Unnecessary Reporting and Compliance Requirements

Suppliers despise (yes, *despise*) when there are inefficient processes that entangle contract management. Suppliers loathe (yes, *loathe*) when processes that are not embedded in the contract later surface and the buyer says "this is just the cost of doing business." The main villains are the development, collection, and generation of unneeded reports, documenting, and maintaining compliance processes, as well as educating/training staff on compliance processes.

Reports are never as easy to put together as one might think. They involve people and, generally, lots of time. The same goes for ensuring compliance. If a report costs $20,000 to generate, but does not generate more than $20,000 worth of insights and savings, it is, by definition, a waste of resources.

4. Adversarial Buyer-Supplier Relationship

The nature of supply relationships can introduce unnecessary costs into the contract management process. Adversarial relationships raise costs related to bidding and negotiations in contracts (think standoff) and slow down the process of coming to acceptable terms and conditions. What's more, high turnover in the core buying or supplying team can fuel dissent in relationships that are already on shaky ground, or reboot solid relationships and turn them adversarial.

Recommendations to Reduce Costs

It's one thing to identify problems, but it's the solutions that matter most. Fortunately, our executives and the research literature have a number of ideas on how to solve these problems. These four recommendations, we believe, are critical ways to cut fat without losing substance.

1. Rely More on Relational Contracting

Contracting among private-sector organizations is increasingly relational. "Relational contracting" is when buyers and suppliers make long-term commitments that facilitate trust and cooperation. Rather than treating each contract as a one-time event that must be closely monitored, the focus is on developing a long-term relationship across a series of contracts. Less oversight is needed because the relationship itself is valuable; it is not something suppliers will put at risk. The result is that rather than hoarding information to protect against exploitation, information and data are exchanged so that both sides can perform their roles better.

Research has demonstrated that relational contracting can reduce transaction costs in several ways.[3] With trust, buyers become less fearful of being cheated by suppliers, which decreases their reliance on costly reports and monitoring systems. Suppliers also become less fearful. Money can be saved when trust leads both sides to feel less obliged to write very detailed contracts.

As an aside, academic research has also tied relational contracting to a valuable change in the mindsets surrounding buyer-supplier relationships.[4] Historically, relationships have emphasized building structures and procedures for preventing *losses* due to misbehavior. In contrast, relational contracting emphasizes the potential *gains* that can be achieved through close collaboration. This not only improves efficiency, but also enhances effectiveness.

2. Where Appropriate, Monitor Suppliers' Outcomes Rather Than Their Behavior

Performance-based contracting is a contracting approach that involves giving performance specifications to suppliers and letting them figure out the best way to meet the specifications. Rather than the buyer dictating what needs to be accomplished and how, the buyer focuses on "what" and allows the supplier to decide "how." Because outcomes are easier and cheaper to monitor than behaviors, transaction costs are reduced.[5] Focusing on outcomes also gives suppliers the flexibility to work with their supply base in a way that suits them.[6] Using such contracts would also reduce problems related to vague requirements.

Recommendation	Potential Benefit
Rely more on relational contracting.	Long-term relationships reduce uncertainty and allow partners to collaborate with greater confidence, reducing the need for costly monitoring.
Ask "what," not "how."	Specifying outcomes is cheaper than monitoring processes. Allowing suppliers to figure out how best to reach their goals unleashes their motivation and creativity.
Move toward a best value approach.	Some firms have enjoyed significant improvements in both efficiency and effectiveness by moving away from a focus on cost and toward a focus on total value added for the customer.
Retain key people.	Organizations whose personnel have the strongest levels of knowledge, skills, and abilities have been found to be the most efficient and effective.

FIGURE 1. RECOMMENDATIONS AND POTENTIAL BENEFITS

3. Move Toward a Best Value Approach

Private-sector organizations have been transitioning away from stressing one metric within their supply chains—often cost or speed—toward a best value approach. Best value supply chains focus on delivering the maximum total value added to the customer across four metrics:

- Cost,
- Quality,
- Speed, and
- Flexibility.[7]

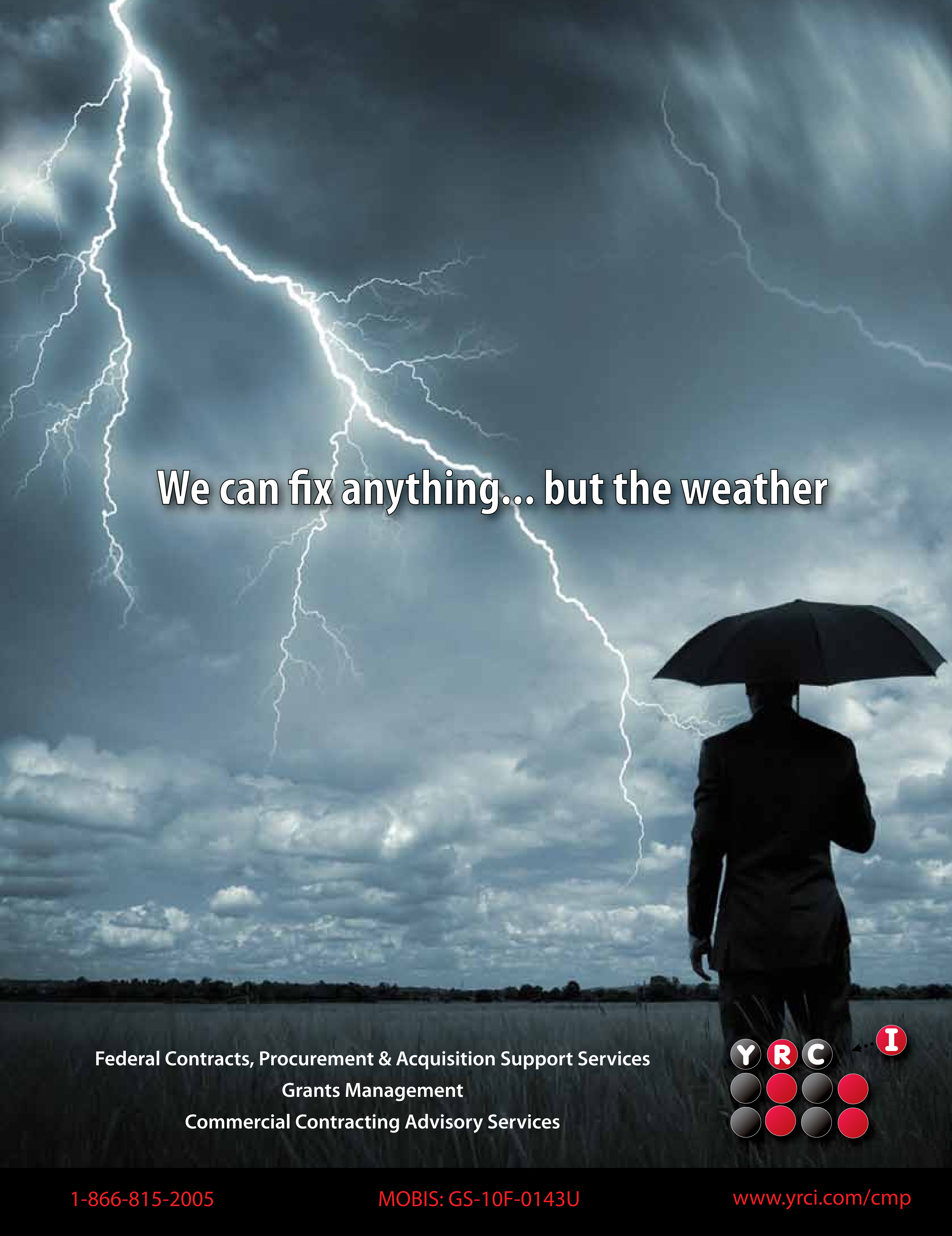
In particular, best value supply chains maximize total value added by developing "the three A's":

- *Agility*: the ability to react quickly to surprises;
- *Adaptability*: a willingness to change when needed, without concern for history and legacy issues; and
- The *alignment* of interests across the members of a supply chain.[8]

A narrow emphasis on cost can end up costing more in the long run. To the extent that this description is accurate, shifting the focus away from cost alone and toward total value added via "the three A's" has the potential to benefit many organizations.

4. Retain Key People in Relationships

Key people, especially those with strong knowledge, skills, and abilities, are critical to an organization's performance.[9] Organizations that are able to identify and retain their best people are much more likely to be efficient and effective than those that do not. Turnover has the potential to create major performance problems within buyer-supplier relationships. Thus, we recommend that organizations take action to reduce future turnover. Such actions might include creating new pathways for recognizing,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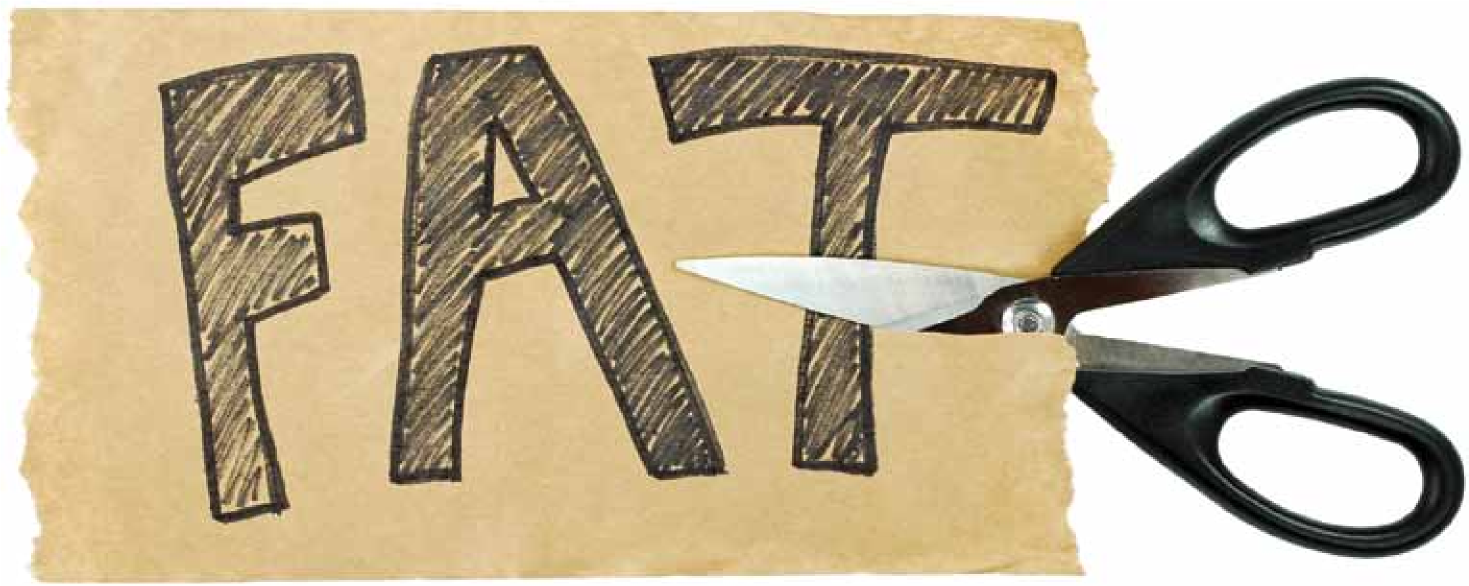

rewarding, and promoting excellent performers. In addition, efforts to reacquire valuable former employees could be worthwhile.

A summary of our recommendations appears in **FIGURE 1** on page 20.

Conclusion

Based on our analysis of the relevant literature and interviews with executives working in key government suppliers, we identified four important drivers of transaction costs and four recommendations for reducing these costs. Given that so much of what the government spends on supplies is tied up in transaction costs, we believe that managers can save big bucks by following these recommendations. The result will be cutting more fat without cutting substance. **CM**

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Send comments about this article to cm@ncmahq.org.

ENDNOTES

1. *See* O.E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).
2. These costs were in the context of working with government. It is possible—even likely—that these percentages would change if we gathered input in other contexts.
3. *See, e.g.*, J.H. Dyer and H. Singh, "The Relational View: Cooperative Strategy and Sources of Interorganizational Competitive Advantage," *Academy of Management Review* (1998): 660–679.
4. *See* L. Weber and K. Mayer, "Designing Effective Contracts: Exploring the Influence of Framing and Expectations," *Academy of Management Review*, 36(1) (2011): 53–75.
5. *See* K. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review*, 14 (1989): 57–74.
6. *See* T.R. Crook and J.G. Combs, "Sources and Consequences of Bargaining Power in Supply Chains," *Journal of Operations Management*, 25(2) (2007): 546–555.
7. *See* D.J. Ketchen, W. Rebarick, G.T. Hult, and D. Meyer; "Best Value Supply Chains: A Key Competitive Weapon for the 21st Century"; *Business Horizons*; 51 (2008): 235–243.
8. *See* D.J. Ketchen and G.T. Hult, "Bridging Organization Theory and Supply Chain Management: The Case of Best Value Supply Chains," *Journal of Operations Management*, 25 (2007): 573–580.
9. *See* T.R. Crook, S.Y. Todd, J.G. Combs, D.J. Woehr, and D.J. Ketchen; "Does Human Capital Matter? A Meta-Analysis of the Relationship Between Human Capital and Firm Performance"; *Journal of Applied Psychology*; 96 (2011): 443–456.