Hogan Lovells

Securing Supply in Disruptive Times – Ways to Set Up and Adapt Strategic Sourcing Agreements

SOAR Compass

Strategic Operations, Agreements and Regulation

Introduction

Driven by transformation trends and geopolitical volatilities, companies must reshape their sourcing strategies. Across all manufacturing sectors the focus is shifting towards securing access to vital technologies and scarce materials amid competitive pressures. Recent global disruptions have exposed weaknesses in existing supply chains, prompting efforts to make sourcing arrangements more resilient and adaptive. The complexity of navigating global product regulations presents additional challenges. Sourcing has become a strategic function, balancing security of supply, flexibility, and regulatory compliance to maintain competitiveness in a rapidly changing market. This article examines current supply chain risks and describes practical approaches and new concepts to make strategic sourcing agreements more robust.

How Industry Transformation Trends and Global Supply Chain Risks Are Impacting Sourcing Strategies

All relevant industries in today's economic landscape are facing disruptive transformation trends, driven by digitalization and artificial intelligence (AI), energy transition and sustainability, as well as increasing volatilities of the political and economic world order following decades of globalization of commerce. With a view to the manufacturing sectors (e.g. automotive, aerospace, defense, pharma, consumer goods sectors) these transformation trends and the related challenges are triggering significant shifts in sourcing strategies, affecting both the product manufacturers (OEMs) and the various players in their supply chains. Three main developments can be identified:

(1) New Sourcing Priorities

- **Evolving Technologies:** Priorities are shifting to new sourcing areas, where continuing access to evolving technologies and to critical production material will be key for being able to offer competitive products in the future. As an example, electrification and energy transition trends will result in ever increasing demand for battery capacities, leading to a competitive race for improved battery technologies and access to the raw materials required for production.

- **Cross-Industry Competition:** Precisely those sourcing areas that are critically linked to industry transformation themes will see increasing overall demand and thus tougher competition among purchasers. Different from the activities on the sales side, this competition on the purchasing side often involves players from different industries. For example, during the global semiconductor chip shortage (so-called "chip crisis") in 2020 and following years, automotive OEMs were competing with purchasers from other industries for the available semiconductor supply capacities which were not sufficient to cover the overall short-term demand. Interestingly, automotive purchasers – who typically were used to act from a strong negotiation position towards its supply chain – were in this situation sometimes faced with superior purchasing power from competing purchasers in the consumer sectors.

(2) Long-Term Security of Supply

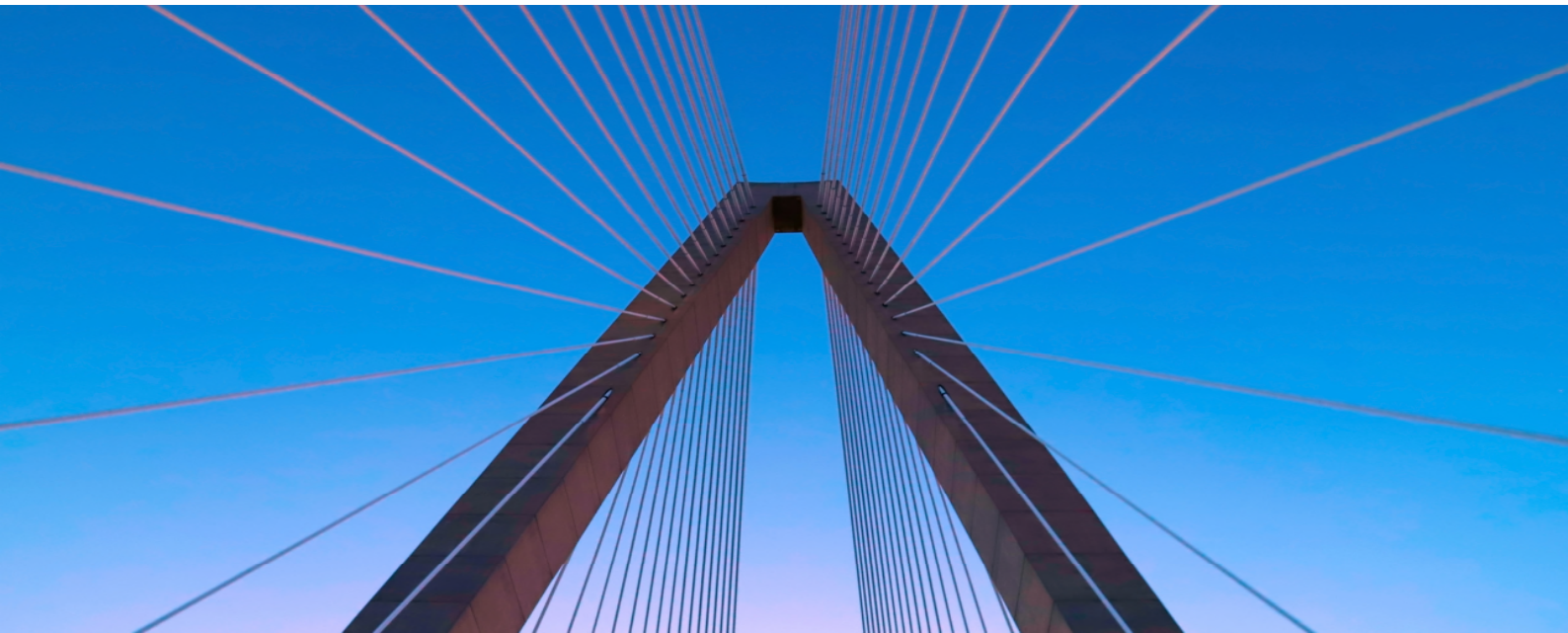
- **Securing Future Capacities:** Sourcing strategies have become more focused on implementing mechanisms and arrangements that aim at longer-term security of supply. This is particularly relevant with a view to securing future manufacturing and supply capacities against possible scarcities and supply chain disruptions.

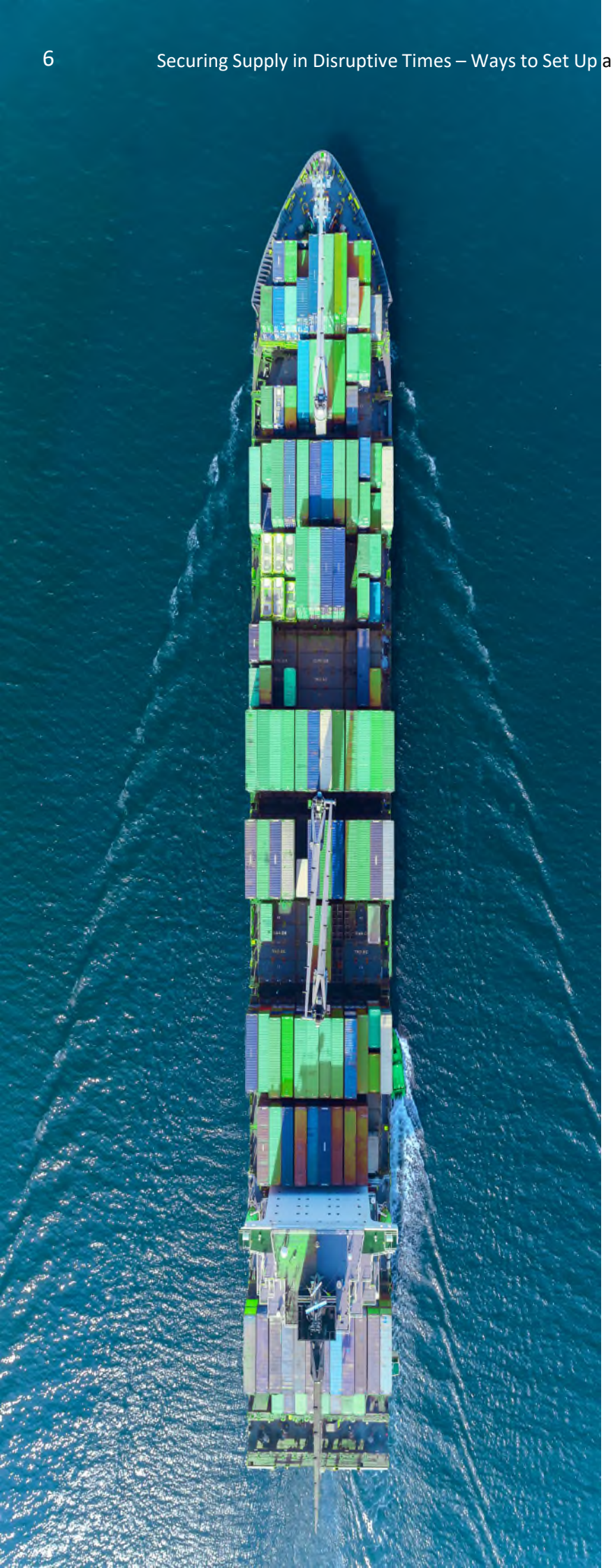
- **Geopolitical Uncertainties and Other Supply Chain Risks:** Recent experience and lessons learned from the COVID-19 pandemic and the war in Ukraine underscore the need for robust sourcing strategies which in turn need to be implemented through effective and enforceable contract arrangements with the relevant suppliers. Many critical supply chains have been set up on a global or cross-regional scale, and strategic suppliers or resources are often located in potential risk countries or regions. It is therefore quite obvious that current geopolitical uncertainties entail significant risks for many supply chains (e.g. in relation to tariffs and trade wars, armed conflicts, sanctions and other export restrictions). Similarly, other disruptive events such as epidemics/pandemics or extreme weather incidents pose a latent risk of destabilizing individual supply chains – and experience from recent years might suggest that such events could occur rather more often in the future.

(3) Structural Changes in Supply Chains

- **Traditional Supply Chain Model:** A general trend can be observed that the shift of sourcing strategies also implies structural changes of how manufacturers set up and manage their supply chains. Under the traditional supply chain model OEMs typically entered into formal agreements only with their direct suppliers (tier-1), while leaving it to these tier-1 suppliers to manage and secure the procurement of the pre-components and materials that they require for their production from their suppliers (tier-2, tier-3 etc.).

- **“Deep Sourcing” Model:** Different from that, in an effort to more directly manage and control security of supply aspects along the supply chain, OEMs now more and more also engage directly with tier-2 (or tier-3 etc.) suppliers. This kind of supply chain integration by the OEM is sometimes called "deep sourcing". It usually involves direct agreements between the OEM and the tier-2 (or tier-3 etc.), including directly enforceable contractual obligations in this relationship (e.g. capacity reservation and supply commitments). Basically, the OEM to some extent "interferes" with the supply chain which, on the one hand, may be an effective instrument to increase security of supply with strategically important suppliers, but which on the other hand may result in a good deal of additional complexity regarding the interrelation of the various contractual relationships in a triangle situation (OEM / tier-1 / tier-2) or even square situation (add tier-3). In this respect it is particularly important to set up consistent and aligned agreements with the various supply parties.





Sourcing Strategies in Light of Product Regulations

Diverging Regulation Approaches

Beyond geopolitical risks and structural changes in supply chain models, an increasingly decisive factor for modern sourcing strategies lies in the growing global complexity of product regulations. The United States are leaning towards deregulation and market-based flexibility. In contrast, the European Union continues to pursue a "regulation to drive growth" approach, fostering change through framework policies and binding regulations (e.g. the Green Deal, the EU Battery Regulation, the AI Act) to promote innovation, sustainability, and resilience. At the same time, the European Commission has recently signalled its intention to simplify product regulations.

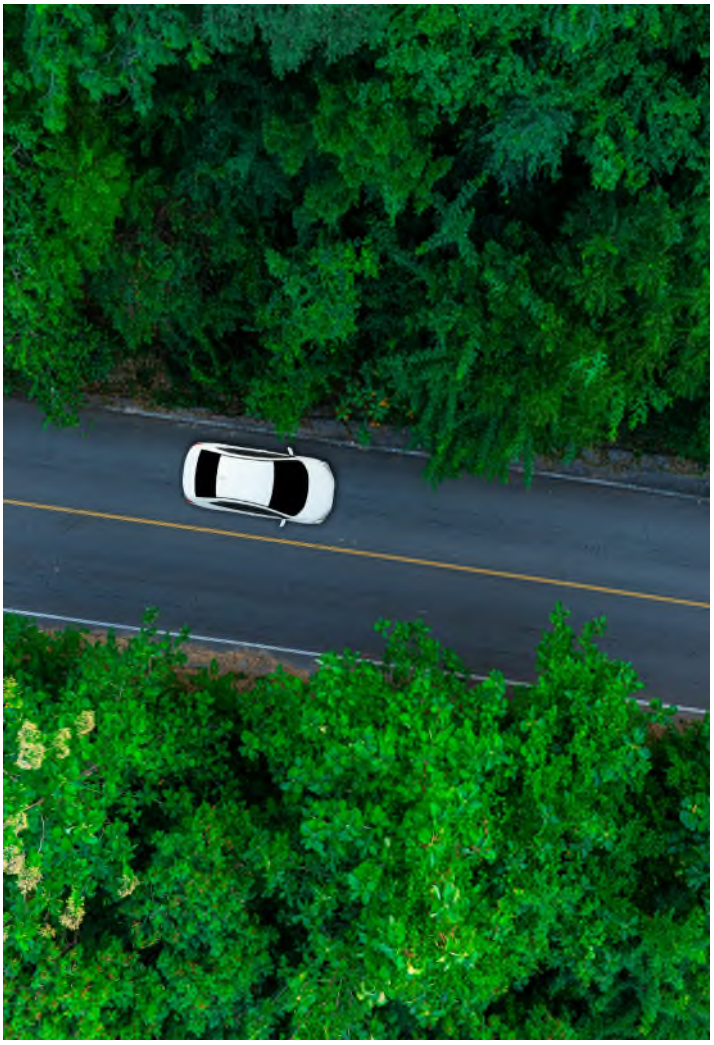
Navigating Global Complexity

This global divergence further elevates the strategic importance of sourcing decisions, as businesses must not only ensure access to technology and critical materials but also navigate overlapping and at times conflicting regulatory requirements across jurisdictions. These dynamics become particularly visible in areas and industries closely tied to technological innovation and sustainability goals. Two illustrative examples are battery systems and autonomous driving technology – both of which demonstrate how regulation, sustainability targets, and technological transformation intersect in sourcing decisions.

(1) Battery Systems

- **Regulatory Impact:** The EU Battery Regulation (EU) 2023/1542, in force since 28 July 2023 with phased-in application from 18 February 2024, has introduced a significantly more stringent compliance framework for all economic operators involved in the battery supply chain. It imposes new obligations related to raw material sourcing, minimum levels of recycled content, battery performance and durability, carbon footprint tracking and declarations, and supply chain due diligence.

- **Clear Allocation:** As the development and production of battery systems typically involves multiple stakeholders – e.g. raw material suppliers, cell manufactures, pack assemblers and OEMs – sourcing agreements must clearly allocate roles and respective responsibilities along the supply chain, particularly in complex constellations like contract manufacturing or dual-branding scenarios. It is therefore crucial that sourcing agreements define technical specifications, include supplier documentation and reporting obligations, and address further downstream compliance, liability and indemnification mechanisms.



(2) Autonomous Driving Technology

- **Technological Innovation and Evolving Frameworks**: Similarly, in the field of connected mobility and autonomous driving, rapid technological innovation is accompanied by evolving regulatory requirements. With increasing investments and progress in AI, sensor technology and vehicle and systems integration, the path towards the deployment of autonomous vehicles is shaped not only by technical readiness, but also by homologation frameworks for these systems and vehicles across international (UNECE), EU as well as national regimes.

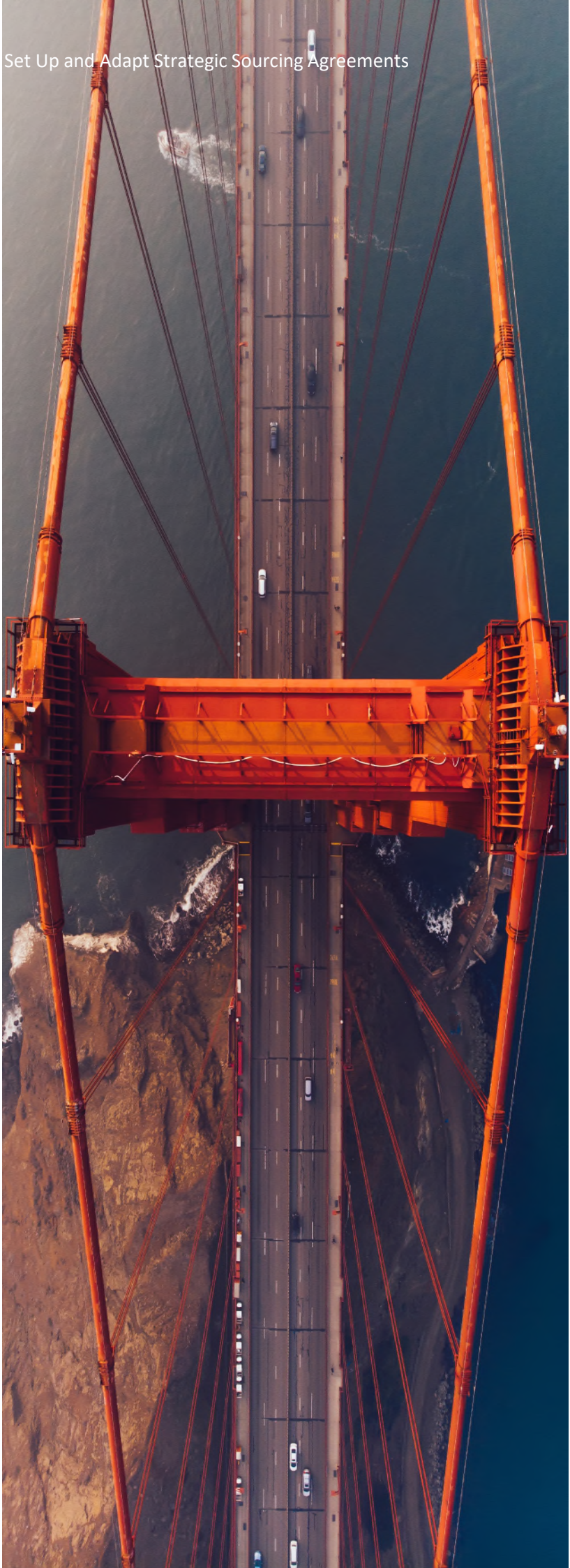
- **Collaboration:** The necessary systems are typically developed and enabled through multi-party collaboration, often involving OEMs, software companies, hardware suppliers and system developers. As a result, the traditional model, where OEMs centrally control and integrate vehicle systems, is increasingly complemented by more complex partnership-based set-ups in which technology developers take on greater responsibility for regulatory compliance. This shift is not only technology-driven, as automated driving systems (ADS) function as the “heart and brain” of autonomous vehicles but also reflect the evolving regulatory expectations.

- **Agile Agreements:** Sourcing agreements must therefore be tailored to reflect shared or shifting regulatory responsibilities and ensure that all parties, including traditional OEMs and ADS developers, are aligned in terms of compliance and regulatory responsibility (safety concepts and validation, including test results), liability, specifications (particularly interoperability and integration) as well as IP ownership and licensing frameworks. Given the pace in both technological and regulatory change, sourcing agreements must be designed with flexibility in mind, allowing for iteration and amendments and realignment as part of an overall agile contractual framework.

(3) Broader Trends

- **Strategic Interface:** These examples underline a broader trend that extends across all sectors: sourcing has evolved from a primarily commercial function to a critical strategic interface between technological innovation, sustainability goals and regulatory developments. As technologies become more complex and advanced and regulations more interconnected and far-reaching, the importance of well-structured sourcing agreements increases accordingly.

- **Futureproofing:** While the key focus was once at securing availability and price, future-proof sourcing now also increasingly requires careful allocation of regulatory responsibilities, integration of technical standards, sustainability and transparency specifications (e.g. supply chain due diligence), and mechanisms to manage regulatory risks and obligations as well as flexibility to adapt to ongoing regulatory and technological changes, rather than reacting to it.



Long-Term Security versus Sourcing Flexibility

Enforceable Supply Obligations

From a legal perspective, the first and main foundation for achieving security of supply is to set up binding agreements that impose legally enforceable supply obligations on the suppliers. As obvious and easy as this sounds, there are a number of contractual implications and challenges.

Challenges in Long-Term Commitments

- **Supplier Opposition**: Suppliers are often reluctant to enter into binding supply commitments beyond the short-term range, or at most mid-term range. This is because exactly those uncertainties regarding future supply capacities and possible disruptions that cause purchasers to seek more robust supply arrangements, mean a risk for the suppliers of not being able to fulfil future supply obligations and incurring liabilities as a result.

- **Request for Purchasing Commitments:** Directly related to the above, the natural supplier response to the purchaser's request for long-term supply commitments will usually be to in turn request purchase commitments from the purchasing side. That said, mutuality in terms of supply and purchase commitments may ultimately mean that the purchaser will have to lower its request for supply commitments to a level the purchaser feels comfortable to commit to corresponding purchase obligations. Alternatively, the purchaser may have to commit to extensive purchase obligations, with the risk that this will exceed its actual future demand.

- **Limiting Sourcing Flexibility:** Long-term supply agreements can have the downside of limiting the purchaser's future sourcing flexibilities. In areas of dynamic technological progress, long-term commitments may require making a bet on the "right" technology that will ultimately prevail and prove competitive. In particular if purchase commitments are made, there may be less flexibility to switch to different technologies or alternative suppliers in the future.

Asymmetric Purchasing Interests

In an attempt to overcome these challenges, the ideal purchaser contract world would be asymmetric – with a binding long-term commitment by the supplier to supply whatever demand the purchaser may have in future, but with no or at most very limited purchase commitments and the flexibility for the purchaser to adapt sourcing strategies. It is hardly surprising that this is challenged by suppliers in contract negotiations, in particular for competitive products and where suppliers are aware of their strategic importance for the purchasing side. It is thus important to carefully consider and balance the conflicting interests when setting up and negotiating strategic supply agreements.

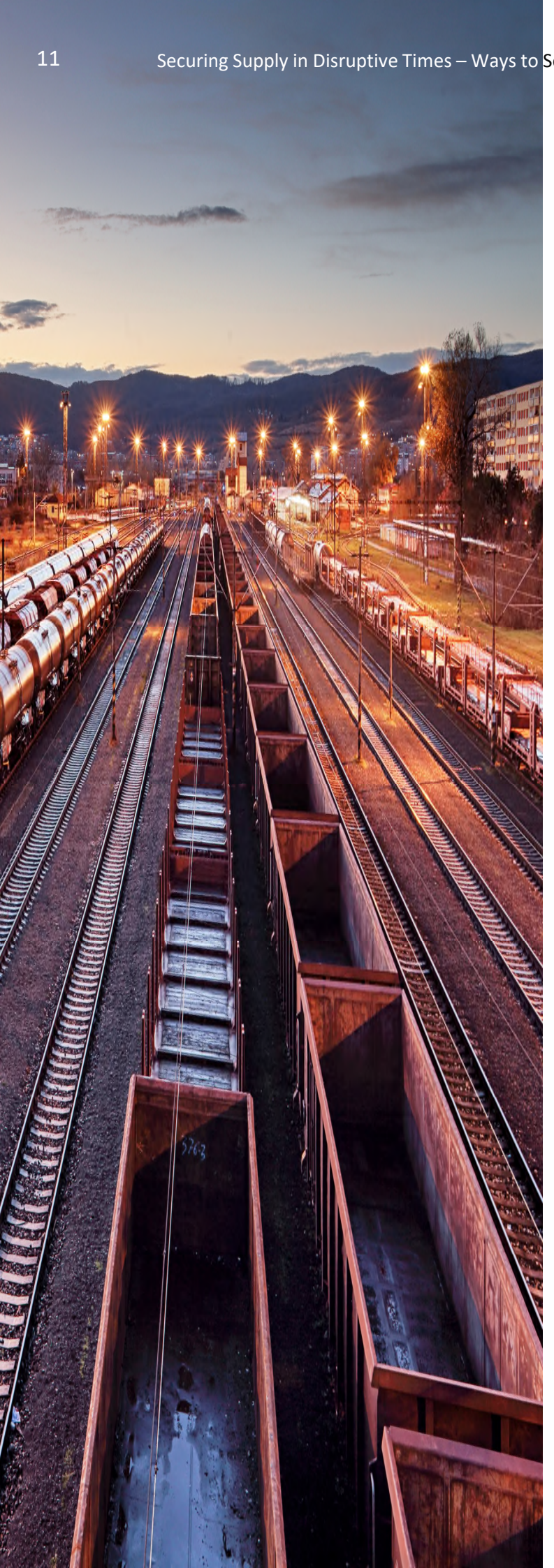
Negotiating Practical Solutions

There are a number of concepts and mechanisms which help to come to practical and negotiable solutions, such as:

- **Balanced Forecast and Order Processes:** Well-structured and reasonably balanced rolling forecast and order processes may help to mitigate the conflict between a (long-term) supply commitment and purchasing flexibility in terms of volume planning. Even if such process is overall still driven by the purchaser's demand (and as such is still somewhat asymmetric), it may be acceptable for the supplier if the supplier's required planning lead times are reasonably taken into account. Additionally, stockkeeping obligations may help to level out short- or mid-term fluctuations in purchasing demand or supply capacity.

- **Commercial Arrangements:** Other commercial arrangements may make it acceptable for the supplier to commit to supply obligations without requesting a symmetric purchase commitment. Examples are price adjustments in the case that certain planning volumes are not achieved or exceeded, or separate fee payments by the purchaser to the supplier as specific consideration for the long-term supply commitment, e.g. capacity reservation fees.

- **Change and Termination Rights:** As a trade-off when accepting purchase commitments, the purchaser may try to negotiate certain change and termination rights to retain future sourcing flexibility. As an example, the parties could agree on special change or termination rights for the purchaser which specifically address and are limited to defined cases where future circumstances reasonably require the purchaser to adapt its sourcing strategy.



New Concepts to Protect against Supply Chain Disruption Risks

Securing Actual Access to Supply

When we look at strategically important and potentially high-risk sourcing areas – be it due to strong competition for limited resources or geopolitical supply chain risks – the purchaser's ultimate goal is to secure actual access to supply. The existence of enforceable contractual supply commitments is a basic requirement, but may alone not be sufficient for this purpose. If the supply commitment is not fulfilled, the purchaser may in the end be left with monetary claims in the form of penalties or damages. This may bring partial compensation for losses, but the actual damage to the purchaser's business resulting from interrupted or reduced production for lack of required pre-components or materials may be much higher and entail irreversible detriments, such as loss of business and reputation. In simple terms: the purchaser primarily needs the material, not the money to buy it elsewhere (if that were possible at all).

New Approaches and Innovative Concepts

So the question is how OEMs and other purchasing stakeholders can make their sourcing arrangements more robust not only with a view to securing contractual rights to supply, but also to more effectively secure actual access to supply. Following the experience from recent disruptive events such as the COVID-19 pandemic, the war in Ukraine and the "chip crisis", some new approaches and innovative concepts have been considered to make strategic sourcing agreements more protective against supply chain risks.

Examples include:

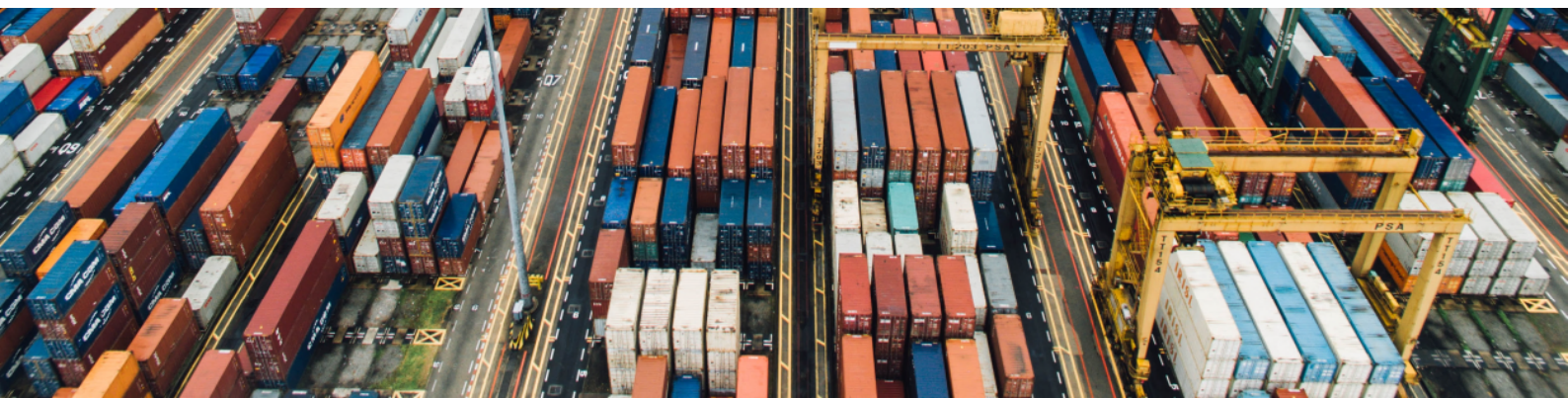
- **(Early) Product Customization:** Purchaser-specific product customization as early as possible in the supplier's production process may ensure that in the case of shortages the remaining available supplier capacities are actually allocated to the purchaser rather than elsewhere. Where the supplier's product is customized for the purchaser in terms of technical specifications or qualities, such product may not be suitable for other customers anyway. That said, for off-the-shelf products or where technical customization takes place only late in the supplier's production process, another option to achieve (early) customization may be to have the supplier implement purchaser-specific product markings (e.g. by adding in a permanent way the name or brand of the purchaser on the product and/or its pre-materials early in the manufacturing process).

- **Order and Logistics Optimization:** Similarly, efforts to optimize and – to some extent customize – the order and logistic processes can help to make the supply arrangement more robust and improve the purchaser's position in the case that the supplier is forced to allocate limited supply capacities. For this purpose, purchaser-specific part numbers may serve to allocate and track volumes destined for the purchaser from the very beginning of the order process throughout the entire logistic and delivery process. Appropriate reporting and monitoring procedures may additionally support an effective volume and allocation management.

- **Early Ownership**: Arrangements that aim at a transfer of title to critical pre-components or materials to the purchaser as early as possible in the supplier's production process may serve to further secure available supplier capacities in the case of shortages. If the pre-materials that the supplier needs for manufacturing are formally owned by the purchaser, this may effectively deter the supplier from using such pre-material for supplies to other customers.

- **Exclusivity and Preferential Rights:** Supplementary to other protection measures, purchasers often seek to impose contractual commitments on their suppliers to grant specific exclusivity or preferential rights to the purchaser. Such (mere contractual) commitment will ultimately not guarantee actual access to available supply and is often difficult to be specifically enforced in practice. However, it may still serve to improve the purchaser's contractual position and to increase the chances that the purchaser will effectively benefit from some sort of preferential treatment when it comes to allocating limited supply capacities.

- **Strategic Assessment of Suppliers and their Locations:** Obviously, any strategic sourcing approach that aims at minimizing supply chain risks must begin with a careful risk assessment and selection of suppliers and their locations, in particular factory locations as well as delivery routes. In this context, if technically and commercially feasible, purchasers may want to seek flexible arrangements that ensure alternative sourcing options in terms of the "geographies of supply". For example, where a specific supplier has the capacities to manufacture the same product at different locations, the purchaser may negotiate a contractual right to request a switch of manufacturing locations and delivery routes if necessary to ensure sufficient supply. Similarly, arrangements that allow for a switch to an alternative supplier may provide the necessary flexibility for the purchaser to adapt its supply setup to future developments. To be effective such arrangements need to be based on robust contractual terms, in particular regarding the termination of supply contracts with the existing supplier and the transfer of production basics to another supplier.



We Can Help

The Hogan Lovells team has deep experience and industry insight in sourcing and supply arrangements, including complex supply chain structures, drafting and negotiating commercial agreements as well as developing innovative concepts for more robust contracts. We can help you navigate through sourcing challenges in disruptive times. Do not hesitate to reach out to the authors or your usual contact at Hogan Lovells.

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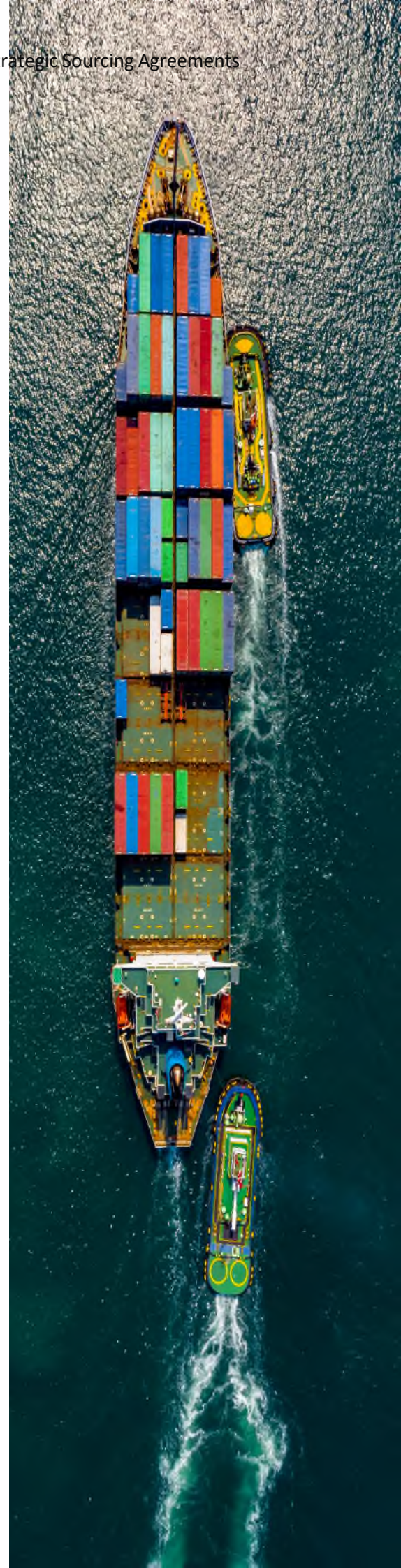

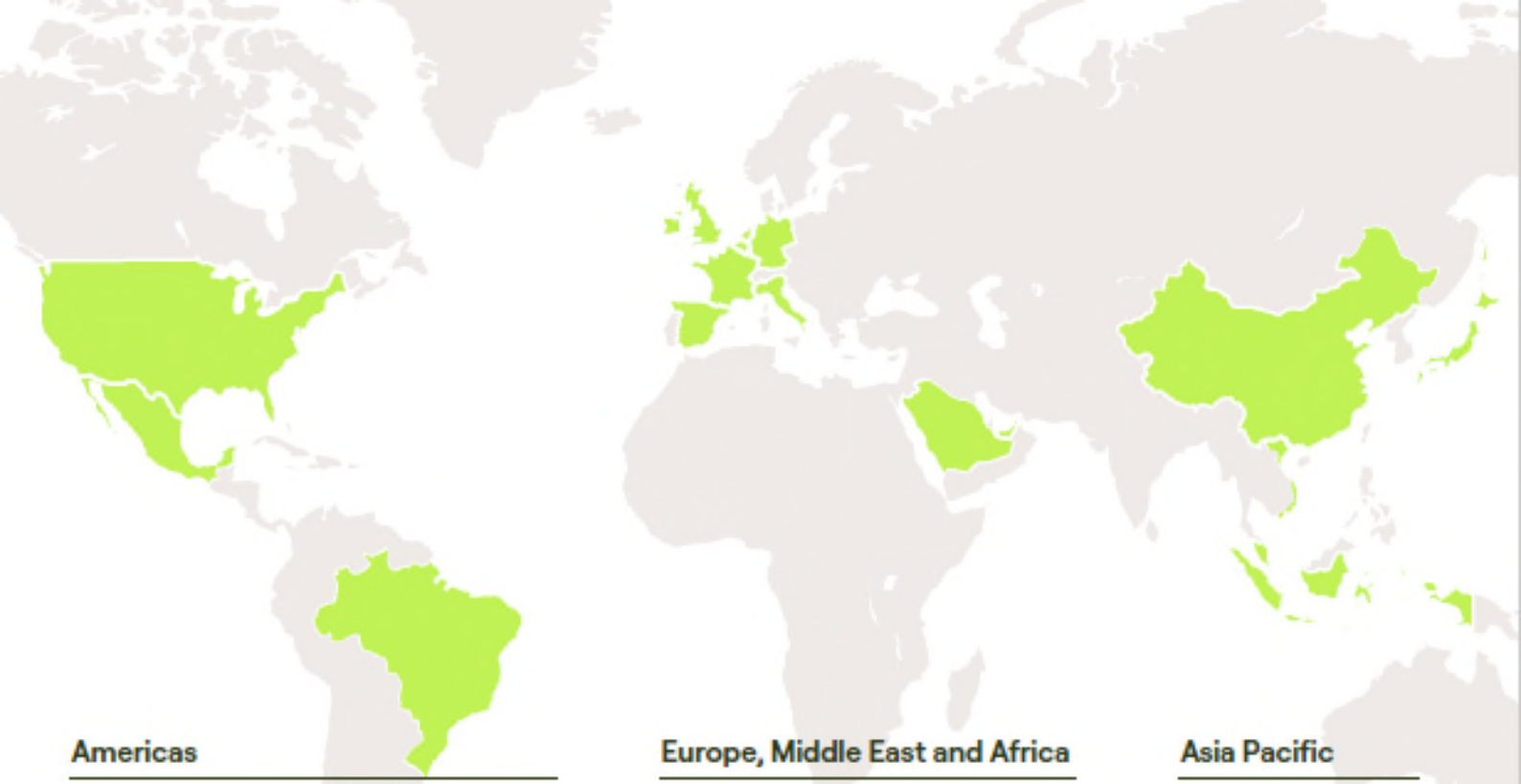

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