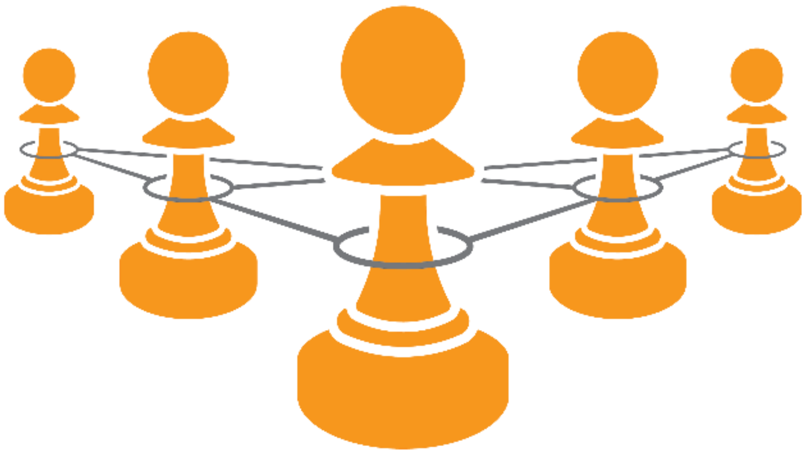
STRATEGIC SOURCING IN THE NEW ECONOMY

Harnessing the Potential of Sourcing Business Models for Modern Procurement



Bonnie Keith • Kate Vitasek • Karl Manrodt • Jeanne Kling

ADDITIONAL PRAISE FOR *STRATEGIC SOURCING IN THE NEW ECONOMY*

"Trust me when I tell you that after reading this book, you will be able to empty much of your bookshelf. This is truly the only sourcing book you need (until they write the next one)."

—Dawn Tiura, President and CEO, Sourcing Industry Group

"This book creates the new 'gold standard' for helping Procurement and IT get on the same page with regards to how to contract for complex services."

—Tony Greenberg, CEO, RampRate

"*Strategic Sourcing in the New Economy* does a great job in linking sourcing theory to practice. A must-read for all sourcing professionals seeking to co-create value with their suppliers."

—Frank Rozemeijer, NEVI Professor of Purchasing and Supply Chain Management, Maastricht University, The Netherlands

"Since no single sourcing model works in all situations, it has become vital to understand your options and architect the optimal relationship that gives you the best shot at meeting your desired business outcomes. That's exactly what makes this book indispensable; it provides the foundation necessary to succeed on the job today and in the decades to come. In fact, *Strategic Sourcing in the New Economy* is one of the most comprehensive, best-written, and valuable books available for sourcing and procurement professionals. I wholeheartedly and unreservedly recommend it."

—Lawrence Kane, International Association for Outsourcing Professionals COP-GOV, Senior Leader, ITI Strategy and Sourcing

"With the rapid evolution and globalization of commerce, strategic sourcing has never been more critical to sustainable value creation. If you are a supply chain professional or supercharged sourcing is key to your organization's success, *Strategic Sourcing in the New Economy* is a pragmatic, enjoyable must-read!"

—Terry Haas, CEO, The Harvard Drug Group

"Modern procurement leaders need to build a new mindset and capability to co-create value with their suppliers in order to survive and then thrive. This book welcomes us into this new reality of the 'collaborative economy' and shows us how to take advantage of the exciting opportunities it offers."

—Mark Perera, Founder, Procurement
Leaders and & Old St

"Lowest price is not the same as lowest cost or even value; companies that buy on best value are more profitable than companies that do not. *Strategic Sourcing in the New Economy* lays a fantastic framework for how buyers and suppliers can unlock hidden value."

—Alrik Danielson, President and CEO, SKF Labs

"Procurement's true value is its fundamental role in strategic sourcing which is inextricable from the business of helping leadership achieve the organization's strategic goals and objectives."

—Robert Gleason, Commonwealth of Virginia,
Department of General Services, Division of
Purchases and Supply

"This book is a must-read for procurement officials who want to take their practice far beyond the way things always have been done. It is chock full of actionable ideas, information, and insights drawn from extensive research. Yet, as I read the book, I felt as if I were sitting around a table having a stimulating conversation with the authors."

—Stephen B. Gordon, PhD, FNIGP, CPPO, Professor of
Practice, Strome College of Business,
Old Dominion University

"This book heralds the new era of procurement as a creator of enterprise value and provides a roadmap for traveling this transformation journey. The authors provide a compelling history of how and why we have arrived at this point, discuss how the time is ripe for change, and how it is finally time for procurement executives to seize a seat at the table!"

—Rob Handfield, PhD, Bank of America Professor of
Supply Chain Management, NC State University

"This book is, literally, a game changer. Brilliantly, it shows why and how we must choose different games to play than the traditional ones with our suppliers, customers, and business partners if we want to realize the enormous value potential residing in the new, networked economy."

—David Frydlinger, Attorney at Law, Partner, Lindahl Law Firm

"We all understand that collaboration delivers better results. The problem is how and when to do it. This book offers a practical roadmap…So read it and get started on a journey that is critical to your business and your career."

—Tim Cummins, President, International Association for Contract and Commercial Management

"This book is a very interesting read for practitioners of the outsourcing industry. I sincerely wish this book will spur more 'out-of-the-box' thinking on integrating Vested principles on contracts, leading to many more 'win-win' relationships."

—Bala Pandalangat, President and CEO, Centre for Outsourcing Research and Education (CORE)

"This book offers tremendous value to all sourcing professionals, from the analyst to the CPO. It guides you through the journey and proves that sustainable relationships based on outcomes will create the value we all so desire."

—Tim Cronin, Vice President and Chief Procurement Officer, GuideWell

"In this newest book, Kate and her team continue to push the envelope on changing the way we've historically done business in the public sector. Their studies and conclusions are an inspirational guidepost for professionals who are passionate about changing the supplier relationship model."

—Rick Grimm, CPPO, CPPB, FCIPS, CEO, National Institute of Governmental Purchasing

"Relationships remain paramount to successful procurement outcomes. The examples in *Strategic Sourcing in the New Economy* hit home, make you think, and suggest behaviors to increase the probability of success!"

—Rick Blasgen, President and CEO, Council of Supply Chain Management Professionals

"This book provides a meaningful 'how-to' for procurement managers—and their corporate-level bosses—to understand and implement a new model for engaging key suppliers and deriving the maximum value from strategic relationships."

—Ted Stank, PhD, Bruce Chair of Excellence at Global Supply Chain Institute, University of Tennessee

"This excellent book paves the way to modern sourcing for the new century. *Strategic Sourcing in the New Economy*'s groundbreaking Sourcing Business Models will become a standard for all mature sourcing organizations in the future."

—Andreas Takacs, Silf, Swedish National Association of Purchasing and Logistics

"*Strategic Sourcing in the New Economy* points the way to the future of modern procurement."

—Anna Bjärkerud, Founder and Managing Director, e-business guide

"This sixth book by Vitasek and her colleagues provides strategic sourcing with a much-needed and well-deserved revitalization that will allow organizations to continue meeting executive team expectations and seizing the opportunities presented by changing dynamics in the market."

—Kelly Barner, Managing Editor, Buyers Meeting Point

"*Strategic Sourcing in the New Economy* is a must-read for every procurement specialist. Ideas are new, fresh, inspiring. It is an extremely valuable practical guide on building a collaborative environment, critical in unlocking value for both client and supplier."

—Piotr Polak, CEO, Chartered Institute of Cooperation

"Since form follows function, the intent of the deal should determine how agreements are structured. Selecting the appropriate Sourcing Business Model produces agreements that are much better aligned with business intent, relationships that generate sustainable value, and transition more smoothly to steady-state governance."

—Mike Beals, Founder, Governance Academy,
Vice President, Governance at HfS Research

"There are many books on the market which talk about supply chain or procurement transformation. All good... but all theoretical. This guide moves the supply chain practitioner into the realm of 'how to' and 'can do' with each of the transformation steps broken down into easy-to-comprehend phases of work, with plenty of practical examples and best practices from leading organizations."

—Philip Molnar, Chief Supply Chain Officer,
Findis Group

"As *Strategic Sourcing in the New Economy* correctly points out, the overuse of power in managing the continuum of buyer/supplier relationships diminishes the effectiveness of many of these relationships and results in the destruction of potential value. Moving to a 'best-value' orientation represents the future of procurement."

—Kenneth J. Petersen, PhD, Dean, College of Business and
Economics, Professor of Supply Chain Management,
Boise State University

"*Strategic Sourcing in the New Economy* foretells the future of strategic sourcing business models for today's fast-paced and unpredictable economy. It should be mandatory reading for chief procurement officers and C-level executives who want to thrive and not perish in the new economy."

—Steve Symmes, Consultant and Advisor (Vested
Certified Deal Architect)

Strategic Sourcing in the New Economy

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Harnessing the Potential of Sourcing Business Models for Modern Procurement

Bonnie Keith, Kate Vitasek, Karl Manrodt, and Jeanne Kling

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We would like to dedicate this book
to all of the individuals and organizations that have the courage
to embrace strategic sourcing in the new economy.

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FOREWORD

As a seasoned professional who has been deeply committed to the sourcing industry for the last 20 years, I was skeptical that another sourcing book could say anything that hadn't already been said. However, knowing Kate quite well and recently getting to know Bonnie made me curious and optimistic at the same time. From the very beginning, *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement* drew me in... deeper and deeper. It reads like a novel, so full of case studies, points in history, and real-life examples that I couldn't put it down. And then I read it again.

I thought I was an expert in sourcing until I read this book. After all, I managed large-scale strategic sourcing projects for 15 years, ran a niche supply chain consultancy, have been the CEO of SIG for the last eight years, and am constantly exposed to the best and brightest minds in sourcing. Surely that gave me as much insight as some of the most experienced professionals in the industry. And yet I learned so many things when I first read this book that I read it again, picking up a few more nuances I'd missed the first time. While I intuitively knew how to create Vested relationships, I had never connected all the dots to meld that concept with sourcing methodology as well as to articulate the subtle differences in the Sourcing Business Models. People who know me well know that I am fairly opinionated and passionate about sourcing. I have shared my views widely that the Office of the CPO should have a seat *equal* to that of the CFO and COO.

During the 2008 recession, companies turned to procurement as a place to hunker down and lead the company in shaving costs. Now things have shifted. No longer is procurement seen as tactical—it is a strategic part of the company that not only has cost-cutting goals but also has revenue-generating expectations. Who else in a company besides the CEO has relationships and insights into every line of business? I can answer that in two words… *no one.* I recently read something on a LinkedIn profile of a colleague in the industry that summed it up rather succinctly: "I am not a roadblock. I am your partner. I am a strategic asset. I minimize your risk. I save you money. I think creatively. I source tactfully. I love the art of the deal. I drive value and success. I am a Procurement Professional." This book helps showcase this very well…it creates a mindset shift that will help many people understand the incredible strategic impact that we as procurement professionals have on our organizations.

Trust me when I tell you that after reading this book, you will be able to empty much of your bookshelf. This is truly the only sourcing book you need (until the authors write the next one). It is so compelling that it is a required book for SIG University certification at the Executive/CPO level. *Strategic Sourcing in the New Economy* so skillfully references the application of the process to the various business situations you will encounter and offers such great tools you can download and use right away that you will want to make this required reading for all your staff. This book provides you with everything you need to demonstrate the complex strategic advantage that sourcing can bring to your company. Truly.

I am humbled to write the foreword for this book. Kate, Bonnie, Jeanne, and Karl have done the industry proud and set the bar very high. I hope you enjoy this book as much as I have…and utilize it as a professional reference for years to come.

Humbly,
DAWN TIURA
President and CEO
SIG, the Original Executive Sourcing Network

INTRODUCTION

The metaphor of dwarfs standing on the shoulders of giants expresses the meaning of discovering truth by building on previous discoveries. Although it is originally attributed to Bernard of Chartres in the twelfth century, Isaac Newton popularized the concept in 1676.

The concept is as relevant for us today as it was for Newton in the seventeenth century. Since the early 1980s, pioneering individuals and companies such as Peter Kraljic, Michael Porter, and A.T. Kearney have pushed procurement professionals to think more strategically about the art and science of strategic sourcing. Thankfully, thousands of individuals and organizations around the world have responded, embracing concepts such as the Kraljic Matrix, Porter's Five Forces model, and A.T. Kearney's popular seven-step framework for strategic sourcing. Procurement organizations would not be where they are now without the insight (and tools) from these big thinkers. The procurement profession slowly evolved from one of a clerical buy desk to a full-fledged function that more and more has a seat at the C-suite table.

No one would debate that these pioneers have led an evolution in procurement that made a lasting impact.

But times have changed. Today's environment is more dynamic and is filled with greater uncertainty. The tried and true tools and tactics adopted over the last 30 years as the "gold standard" are not as effective as they once were. Organizations that historically have won by leveraging their power or by strategically maneuvering to shift power in their favor find those strategies are losing effectiveness.

Many academics and practitioners refer to the subtle shifts that have taken place since the turn of the century as the "new economy." The authors have borrowed the acronym *VUCA* from the military to describe the business environment of today. VUCA stands for *v*olatility, *u*ncertainty, *c*omplexity, and *a*mbiguity. Those adjectives resonate with the day-to-day experiences of many business leaders. Whatever you call it, the shift is clear. Today's business environment is driven by the following:

- Globalization that is accelerating market interconnectedness. Globalization includes the increased mobility of human resources, creating a marketplace made up of a network of highly integrated organizations
- A business environment challenged with increasing volatility and risk, including international terrorism, sovereign debt defaults, natural disasters, and port slowdowns caused by labor disputes and inadequate transportation infrastructure
- An increasingly fast consumer-driven society that demands more agile and flexible supply chains
- The continued evolution of a service economy that is shifting to strategic, not just tactical, outsourcing
- A shift in purchasing skills and processes to create value, not simply procure goods and services
- The expansion and introduction of capabilities of cloud computing in procurement activities

These shifts demand businesses view procurement through a different lens. Studies have shown and continue to validate the power of collaborative partnership. The path to this type of power is different from the road now traveled.

A clear message emerges. The business battles of this century will be won by harnessing the power of your suppliers. Tomorrow's winners will no longer play yesterday's competitive win-at-all costs game with their key suppliers. The playing field is no longer one of lowest cost or best value but one of highly collaborative relationships with suppliers that can help drive transformation and innovation in your organization. After all, if organizations are going to compete supply chain to supply chain, shouldn't supply chain partners work together?

OUR VISION FOR THIS BOOK

Our vision for this book is simple: lay the foundation for procurement professionals to successfully navigate sourcing initiatives in the new economy. We have two specific goals. First, we hope to build awareness that reliance on conventional power and leverage approaches in sourcing relationships is limited. We invite procurement professionals (and their chief executives) to better understand the benefits of using a relational contracting approach. Second, we want to build awareness and encourage the use of Sourcing Business Models. We show how sourcing professionals can apply each of the seven models we present in real-life situations to improve sourcing effectiveness. For these reasons, we include dozens of powerful examples that will help practitioners make the leap from theory to reality.

We provide three simple yet powerful resources that any sourcing professional can adopt immediately. The first is the Business Model Mapping Toolkit, which we explain in detail in chapter 8. Learning how to identify the most appropriate Sourcing Business Model for your situation is one of the most powerful skills buyers and suppliers can master. Selecting the right model increases your ability to reach and surpass your organization's business goals—not just the typical procurement goal of reducing costs. Second, we compliment the Business Model Mapping Toolkit with Sourcing Considerations Guidelines, an easy-to-follow checklist that points practitioners to the proper way to link the appropriate procurement approaches to the appropriate Sourcing Business Model.

The third resource is the Four Cornerstones Framework, which provides a fresh and updated view of tried-and-true multistep strategic sourcing processes. We have carefully mapped 20 Sourcing Considerations across the four essential Cornerstones of a sourcing cycle.

Fortunately, Peter Kraljic and Michael Porter made their models freely available; we humbly follow the example they set. We offer the Business Model Mapping Toolkit and Sourcing Considerations Guidelines as open source (free), downloadable resources at www.vestedway.com/tools. Our hope is this will provide buyers, suppliers, consultants, lawyers, students, and others an easy way to understand the concept of Sourcing Business Models. Several universities have incorporated the concepts into their courses, and the Sourcing Industry Group is launching its SIG University using these frameworks.

EVOLUTION OF THE SOURCING BUSINESS MODEL CONCEPT

Many wonder how we came to think in terms of Sourcing Business Models. We can't attribute the concept to any one individual; rather, it has evolved from the ideas of many.

In 2003, the University of Tennessee (UT) began what would become over a decade of research to study strategic relationships, usually formed with performance-based agreements. Kate Vitasek led a small team of researchers. Dr. Karl Manrodt was one of the original researchers. The initial research was conducted over several phases between 2003 and 2009, and the study is ongoing. Research included in-depth case reviews from some of the world's most successful buyer–supplier relationships.

A few clear patterns emerged. First, buyers' procurement approaches were evolving. There was a clear shift from "buying" goods and services from suppliers to one of strategically *partnering* with suppliers. For these organizations, smart procurement was not about getting the most value for the dollar. Nor was it about leveraging power to extract value from suppliers. It was not even about how to out-strategize suppliers to shift power to buyers' favor. Rather, the most successful companies worked in a highly collaborative manner to purposefully build relationships with selected suppliers to *create* value with them.

Vitasek and her research team were on to something. They codified their research into a methodology and sourcing model that they called Vested®. Vested is a Sourcing Business Model in which buyers and suppliers carefully craft highly collaborative relationships supported by true win-win economics. A win for buyers is a win for suppliers. Buyers and suppliers are vested in each other's success. Their work led to five books in fewer than five years.

Codification of the Vested methodology led to further research regarding the various sourcing alternatives organizations use to procure goods and services. This research laid the foundation for four more years of much deeper work around what the UT researchers would refer to as Sourcing Business Models.[1] Sourcing Business Model theory suggests that sourcing should be thought of a *business model* between two parties with the goal of optimizing the exchange. Each of the seven Sourcing Business Models creates a system to optimize for the business situation.

Bonnie Keith, a procurement professional, was attracted to the concept of Sourcing Business Models. Keith held corporate executive and chief procurement officer positions for two Fortune 100 and two Fortune 500 companies spanning five different industries. She was also an adjunct professor at UT, working closely with Dr. Karl Manrodt on a customized strategic sourcing course for the U.S. Air Force.

Together, Vitasek and Keith drilled down on the concept of Sourcing Business Models. Each purchasing situation is different and requires a different approach. Some relationships are transactional. Others demand highly collaborative relationships with suppliers. Vitasek and Keith's early work was a collaborative effort with the Sourcing Industry Group, the Center for Outsource Research and Education, and the International Association for Contract and Commercial Management. The collaboration led to the publication of a white paper, "Unpacking Sourcing Business Models: 21st Century Solutions for Procuring Services."[2]

But Vitasek and Keith were still curious. Could the concept of Sourcing Business Models be embedded into existing procurement processes? David Frydlinger, a Swedish attorney and partner at Stockholm's Lindahl Law Firm, also was curious. He felt strongly that far too many procurement professionals and lawyers were not operating from a common playbook and that most playbooks were too adversarial. How could you call a supplier "strategic" and then turn around and write a heavy-handed, one-sided contract designed to shift all risk to the supplier? Frydlinger liked the work UT was doing and helped the team connect the dots on how to better structure supplier agreements.

Four collaborators came together to create this book: Kate Vitasek, Bonnie Keith, Karl Manrodt, and Jeanne Kling.[3] This book is a result of four years of curiosity and a lot of hard work to come up with a powerful yet simple way to help organizations understand and apply the concept of Sourcing Business Models. We also offer guidelines to help professionals understand and make better decisions as they put Sourcing Business Model theory into practice with their favorite strategic sourcing framework.

OVERVIEW OF THE BOOK'S STRUCTURE

Most people quickly understand the idea of Sourcing Business Models, but many are stuck when trying to apply the concept. This easy-to-digest book combines the why, what, and how of Sourcing Business Models for procurement professionals.

This book is divided into four sections.

Part I explains how a changed definition of power commands the need to change. Chapter 1 provides readers with a better understanding of why companies' power-based procurement practices are incomplete. We also challenge some of today's tools and approaches for procurement, such as the Kraljic Matrix, Porter's Five Forces model, A.T. Kearney's Purchasing Chessboard®, and well-known and loved multistep strategic sourcing processes. Of course, we recognize that people don't like change, however the new economy *requires* change. For that reason, we share some compelling reasons why procurement professionals need to challenge what many have come to think of conventional wisdom.

In Part II, we introduce the theory of Sourcing Business Models and dive deeply into each of the seven models. Chapter 3 introduces Dr. Oliver's Williamson's Nobel Prize–winning views that sourcing should be viewed as a continuum. We explain the three fundamentally different types of relationship models, ranging from highly competitive marketplaces to establishing corporate hierarchies through insourcing.

Chapters 4 to 7 provide an in-depth view of each Sourcing Business Model. For each model, we provide a clear definition and share why and how it is used. We also provide examples of the models in action. We then provide guidelines for how to properly structure a supplier relationship agreement. We believe it's essential for today's savvy procurement professionals to know how to structure sourcing solutions properly, not just simply buy goods or services. We conclude Part II with chapter 8, which introduces the Business Model Mapping Toolkit and provides step-by-step instructions for determining which Sourcing Business Model is most appropriate for your situation.

It is important to understand no one Sourcing Business Model is perfect for all relationships. Rather, buyers should evaluate which model most effectively meets their unique situational requirements. Using the most appropriate Sourcing Business Model for your situation will help you best achieve your desired objectives.

Part III is dedicated to chapter 9, which provides strategic direction on how to incorporate Sourcing Business Models into day-to-day procurement practice. The chapter introduces the Four Cornerstones

Framework and shares how to apply 20 key Sourcing Considerations to a well-thought-out sourcing solution.

Part IV lays the foundation for you to get started. In chapter 10, we discuss how an organization's maturity can hold buyers back from adopting more collaborative and progressive Sourcing Business Models. We offer two clear paths on how to overcome organizational maturity gaps. Chapter 11 helps you understand the importance of trust in a relationship and provides some easy-to-practice steps that you can apply immediately to build trust with a supplier. We end Part IV by sharing a proven five-step "Getting to We" process to help you improve negotiations for a more collaborative relationship with strategic suppliers.

A NOTE ON TERMINOLOGY

As you read this book, it will be helpful to understand a few key terms we use throughout. We use the term *buyers* or *procurement professionals* to refer to the individuals in an organization who are chartered to lead procurement initiatives. We refer to an *organization* as the entity that is buying goods and services. We understand that buyers work on behalf of for profit companies and/or non-profit/ government organizations. We strategically chose to use the term *organizations* because it is a more generic term.

We primarily use the term *suppliers* but occasionally use the term *providers* or *service providers.*

Throughout, we use the term *business* or *business requirements* interchangeably; typically we are referring to the needs of business groups, business units, or even the stakeholders who consume the goods or services that are procured. Business stakeholders are individuals who have a vested interest in the business requirements. These stakeholders can be users or anyone involved in or affected by the sourcing solution.

We use the terms *procure, source, purchase, buy,* and *acquisition* interchangeably. In all cases, we use these terms in the context of an organization that is buying goods and services.

We use several terms to refer to the coming together of a buyer and supplier. Although we primarily use the term *relationship,* we also use *partnership, agreement, arrangement, deal,* and *contract* to reduce redundancy.

Last, we use the term *relational contract* as a combination of written contract(s), interface protocols, and distinct social norms that enable a continuously efficient and effective commercial relationship. The relationship is efficient when the parties cooperate to minimize friction toward the commercial goals (i.e., when the transaction costs before and after the contract award are optimized). The secret to make this happen is continuous alignment of interests. Relational contracts are a key requirement for strategic sourcing in the new economy and are an important concept addressed throughout this book.

The glossary provides definitions for many of the essential terms used in the book. We also provide a comprehensive glossary as a free resource at http://www.vestedway.com/tools/.

GETTING READY FOR A SHIFT IN THINKING

Why read this book?

The key to Sourcing Business Models lies in understanding and architecting supplier relationships using the most appropriate model for your situation. Why? As there are seven distinct models, you must pair the right model with the right situation and relationship to achieve desired results. If you seek a standard item at the lowest price, the basic provider model is the best choice. As you seek more collaboration and innovation, you must move to a relational contracting model.

Strategic sourcing in the new economy demands sourcing solutions be architected using systems thinking, not by simply buying or negotiating with suppliers. Successful sourcing strategies no longer rely on simplistic two-by-two matrixes to segment suppliers or strategically try to outsmart their suppliers at a game of chess. Today's winners are those who redefine winning in business relationships, seeking to change the game by co-creating a competitive advantage with their suppliers.

Using the wrong Sourcing Business Model will cause friction in your relationship. The only way to reduce this friction with suppliers is to go to the cause of the problems. All too often, friction is not the result of a poor supplier but is caused by applying the wrong Sourcing Business Model.

Regardless of your background, you will find great value as you read this book and begin to reconsider the conventional power-based approaches your organization might be using. You may find that your organization already applies at least some of the concepts we share. However, the power of understanding and applying Sourcing Business Models is not in cherry-picking tactics, but rather in truly learning how to architect the appropriate sourcing solution for your organization's needs.

Maybe the best question to ask is whether you are ready for this book. Are you ready to reconsider how you work with your suppliers? Are you willing to consider sharing more—and expecting more—from your suppliers? Are you willing to win and allow your partners to win at the same time? And are you willing to challenge your conventional procurement processes and contract structures to embrace relational contracting for more strategic supplier agreements? If not, put the book back and save your money.

To understand the power of a paradigm shift in procurement, you must start with an open mind. Keep it open, and you will surely see new opportunities around you.

We wish you well as you learn how to harness your power.

PART I

There is an old saying that the first one to know Thanksgiving is getting close is the turkey.* Unfortunately for the turkey, it's usually too late.

Part I is designed to help you pause and take an aerial view of what procurement professionals are facing at the dawn of new era of procurement. Those who do not recognize the need to change may indeed find themselves not having a seat at the dinner table —or, worse, may realize they are the turkey about to be cooked.

Part I is by far the shortest part of the book. We limit this section to two chapters. Some will think chapter 1 is controversial, as we openly challenge some of the most popular procurement tools and processes, suggesting they are incomplete for strategic sourcing in the new economy. We examine four specific procurement tools: the Kraljic Matrix, Porter's Five Forces framework, A.T. Kearney's Purchasing Chessboard®, and well-known and loved "multistep" strategic sourcing processes. Chapter 2 stresses the fact that the time to change is now and reminds us that organizations that don't evolve often find themselves in a state of decay.

You might be saying "Of course I'm ready for change. That is why I bought this book!" If that is the case, feel free to skip to Part II, the foundation of the book—Sourcing Business Models. In part II, you will discover the powerful potential of thinking of strategic sourcing not just as an operating function but rather as a way to purposely build value for your organization.

* Thanksgiving Day is a national holiday celebrated primarily in the United States and Canada. On this day, it is customary to have a large meal featuring turkey as the main course.

CHAPTER 1

THE 800-POUND GORILLA HAS LEFT THE BUILDING

Julie—not her real name—came from humble beginnings in London. She put herself through vocational college and received a one-year criminal justice specialist certificate. The degree came in handy when she landed a security job at a Fortune 100 company. Julie was excited when she was promoted to work in procurement—managing contract compliance for the firm's security contracts. This was a big deal when you consider the firm had hundreds of locations throughout the world and virtually all security functions were outsourced to third-party security companies, such as Securitas, Brinks, and many smaller local firms.

Julie earned the nickname "Ice Queen" soon after she was promoted to the role of senior buyer for the firm. Her colleagues came up with the name because it aptly depicted her approach when negotiating with suppliers. One supplier joked, "There is definitely no breaking the ice with Julie." Julie's style was successful at winning concessions from suppliers. She was known as the Ice Queen well before the popular Disney movie *Frozen* was a hit.

Julie's repeated successes at garnering year-over-year cost savings with suppliers resulted in her multiple promotions. She eventually worked herself up the career ladder to become the director of sourcing and supply chain management. "I didn't really know what to think about the Ice Queen nickname," Julie shared. "I just came to accept it as who I was when it was time to put on my poker face at the negotiations table."

What Julie did like were the results she was able to rack up for her firm. Time after time, with Julie at the helm of negotiations, the firm found ways to save money. At first it was through tough negotiating. Then it was by bundling: getting significant volume rebates from suppliers as the firm reduced its supplier base. More recently, savings came by pitting suppliers against each other in a highly competitive bid process and switching suppliers if a "preferred supplier" didn't cave to demands. Julie devised a three-by-three sourcing strategy where the firm actively worked with three preferred suppliers in each of the three regions where the firm had a presence: the Americas, Europe/Middle East, and Asia.

One supplier described Julie's approach as bid and transition hell. "We are a global supplier, and, any point in time, we were going through a bid process as the firm sought to pit suppliers against one other. Once they realized none of the suppliers was making much money, they began to shift risk through contract terms and conditions to get concessions. We were told 'your competitors are all accepting 90-day payment terms and unlimited liability terms.' When you are looking at losing a €20 million contract, you somehow can stomach accepting a bad deal or else face transitioning your work to your competitor."

Julie's successes translated to Roberto's pain. Roberto—the firm's vice president of operations—was fed up with the hassle of switching suppliers every year or two. As suppliers' margins eroded, Roberto saw firsthand how suppliers struggled to keep their scorecards green with reduced profitability. And anytime Roberto needed something from the supplier, it was now "out of scope." He was getting literally hundreds of unforeseen invoices to get anything "extra" done. The suppliers weren't making any money on the base contract, but they were certainly taking advantage of all of the extra "out of scope" work. The Ice Queen's reign was having unintended consequences.

Roberto's and Julie's running argument came to a head when Roberto complained to the new chief operating officer (COO) about the risks associated with switching security suppliers. Julie was incensed. How dare Roberto accuse her of not knowing about security suppliers? After all, she was the one who had studied criminal justice.

Julie didn't know what to think when the COO asked her to rethink her approach to working with the firm's most strategic suppliers, including the security suppliers. "We need to build more trusting relationships with our most strategic suppliers," the COO declared. In fact, the COO asked Julie to do what she thought was impossible: work to create the firm's first ever highly strategic global relationship with the firm's best security supplier, a company that had a proven track record for performance.

When Julie dragged her feet, the COO assigned Julie a mentor from outside of the firm to help her with some "fresh thinking."[1] Julie was a smart woman; she took being assigned a mentor as a sign the COO was not playing around. Julie's mentor assigned her reading that would help her understand how a new era of procurement was emerging. Julie thought, "Maybe there are some new approaches out there." She took the COO's assignment seriously.

Julie made good progress; she was never scared of hard work and challenges. She worked with Roberto to put together an A+ team of operations, procurement, and contracting people to be on the negotiating team to help craft the commercial agreement with the supplier. This was the firm's first truly strategic and global deal, and Julie worked the initiative personally. All seemed to be going well until Roberto called her out one day, telling her to let go of her Ice Queen persona. "The supplier can see right through you, Julie. You are saying 'strategic supplier' on the outside, but your actions don't line up. You are sending mixed messages. How do you expect us to build a trusting relationship with the supplier when you don't trust them and they can't trust you?"

Julie, stumped, called her mentor for advice. "I seriously thought, how can you really *trust* a supplier? After all, I studied criminal justice. I have been formally taught to not trust *anybody*." The mentor's answer was simple and to the point.

Pretend.

Pretend? thought Julie. Really? What was the rationale for pretending? Her mentor challenged her to think of someone she *did* trust. What did a trusting relationship look like? Julie answered, "Open. Transparent. Credible." The mentor challenged Julie from that day forward to choose to trust the supplier. Purposely being open, transparent, and credible in every discussion with the supplier. Julie wrote six words on top of her red leather Moleskin® journal:

Choose to Trust. Open. Transparent. Credible.

Julie went back to the office to a team meeting between the firm and the supplier. Choose to trust. Be open, transparent, and credible, she reminded herself. She stopped dictating how things must be done and began acting in a more collaborative and trusting manner. She "let go," as Roberto had suggested, and began to pretend to trust the supplier.

The thaw had begun.

Much to Julie's surprise, the more open, transparent, and credible she was, the more open, transparent, and credible the supplier began to be. "I literally could see the change happening. Our discussions became highly productive. I quit assuming the supplier was trying to screw us over, and, as a result, we started to really come up with solutions. We had breakthroughs that I had never witnessed in my entire career. I saw firsthand the power of how working in a trusting and collaborative manner can and does create a power of its own that I never realized was possible."

Julie was surprised to see how her actions had such an impact on the supplier's actions. "I began to test out my 'new Julie' during other supplier negotiations. What I found was amazing. Rather than painful negotiations geared at extracting value, I was now having productive conversations with suppliers about how we could create value together by leveraging each other's core competencies. What started out as a weird challenge for me to 'pretend' has had long-lasting impact that truly transformed the way I work with suppliers."

Julie's lesson is clear. "What I learned was very impactful. I created a persona that epitomized a hardball negotiator. While we are a Fortune 100 firm that wields a lot of power at the negotiating table, I found that relying on our firm's inherent power is shortsighted. Yes, when I dictated terms with our suppliers and pitted them against each other, I did get supplier concessions. But for every concession, suppliers were thinking of ways to get back what they left on the table. As I purposely created trusting relationships with the most strategic suppliers, I found a whole new world of thinking. I began to realize that, for all these years, I was simply *extracting* value from our suppliers and not really spending quality time figuring out a way to *create* value with our suppliers."

Fourteen months after her first interaction with her mentor, Julie received a big promotion. She was proud to report that the strategic global supplier relationship with the security supplier was one of the very best supplier relationships across the entire firm. The former Ice Queen smiled. "I guess you could say I had meltdown of the very best kind."

RELIANCE ON POWER IS NOTHING NEW

Sun Tzu wrote his classic treatise *The Art of War* more than 2,000 years ago. Meant to be an examination of military maneuvers in ancient China, the book offers observations about politics, psychology, and economics that remain relevant and part of today's lexicon. Sun Tzu suggests that winning comes from power-based behaviors—ruthless, manipulative, and determined to win at any cost.

The problem with power is that people abuse it. History books are littered with examples of royals claiming the rights of absolute monarchy. Their unrestricted power over their kingdoms meant total power over the land and its citizens. Many rulers felt no accountability to the people of their kingdoms but believed their power derived directly from God. Whether the aim was land, riches, debauchery, status, or retribution, royals grabbed the reins of power and used their power to get what they wanted.

In today's society, absolute monarchies are, literally, a dying breed. Today, monarchs tend to reign (govern as heads of state with limited actual power) rather than rule. For example, Queen Elizabeth of Great Britain has learned that positional power is best applied with a sculpting tool rather than a chain saw.

Unfortunately, private enterprise has been slow to show the same restraint. The 1980s ushered in a boost for power as organizations' strategy of choice. Sun Tzu's power-based principles remained firmly embedded in modern boardrooms. The movie *Wall Street* referred to *The Art of War* as the contemporary corporate raider's Bible. And management guru Michael Porter referenced Sun Tzu in his best-selling book *Competitive Strategy: Techniques for Analyzing Industries and Competitors.*[2]

Unfortunately, not much has changed since the 1980s. Power-based tactics remain a mainstay of far too many organizations—especially big businesses.

Yet there has to be a better way.

PROCUREMENT POWER PLAYS

The history of business—like politics—shows that businesses tend to gravitate to the use (and abuse) of power. The authors have worked with Fortune 500 companies that are not shy about declaring "We have the clout. Our suppliers should feel lucky to be working for us."

For decades, procurement organizations have tailored conditions to their advantage in order to create benefit for their organizations. A common tactic is to develop sourcing strategies that increase their leverage over suppliers.

When a slow economy reduced wealth accumulation opportunities, many organizations increased their emphasis on cost reduction and leveraging market power. Achieving the lowest cost possible and "value extraction" became the mantra of procurement organizations. Technologies such as electronic auctions (e-auctions) and automated requests for proposals (RFPs) further enabled the organizations to bid and replace suppliers rapidly. Consultants have become experts in developing requests for prices/requests for proposals to commoditize suppliers and pit them against one another.

As suppliers began to balk about their inability to lower prices, organizations found other ways to use their power. One popular technique that emerged was to use contractual terms to push risk onto suppliers. For example, chief financial officers (CFOs) dictated that suppliers accept new 60-, 75-, or even 90-day payment terms.[3] Many buyers who didn't get their way negotiating payment terms simply strung out payments to suppliers.

In Europe, the late-pay problem was so rampant, the European Union stepped in, with a directive that imposed statutory maximum periods of 60 days for business-to-business contracts and 30 days for business-to-public authority buyers.[4] The U.S. government jumped in as well, launching a SupplierPay initiative aimed at getting private sector companies to pledge to pay their small suppliers faster and/or enable a financing solution that helps suppliers access working capital at a lower cost.[5]

THE HIGH COST OF COST CUTTING

U.S. automobile companies have long been known for using their power. Susan Helper and Rebecca Henderson's National Bureau of Economic Research paper describes General Motors as having adversarial and arms'-length supplier relationships dating back to the 1950s.[6] In 1990, GM decided to step it up further when it promoted Dr. Ignacio Lopez to director of worldwide purchasing operations.

Lopez suddenly was in control of a $57 billion global budget. A fan of Peter Kraljic's Matrix that emphasizes using "leverage" strategies, Lopez instituted aggressive competitive bidding strategies.[7]

Lopez didn't stop with purchase requirements in the leverage category. He amped up the pressure on suppliers across the board, radically changing the established pricing principles. Prices would no longer be set by a supplier's production costs. Rather, GM would set the price, and suppliers' production costs had to be managed to support the price. Writer John Eisenhammer described the new Lopez pricing protocols in a newspaper article: "Having established such a price, he [Lopez] would then take a margin for the supplier—'since obviously they must make a profit'—and whatever is left is production costs plus the car company's own profit. This did not imply a drop of 5 or 10 per cent, but 20 to 30 per cent or more."[8] Lopez was known for saying "I do not want to hear any more that prices are already down too far and you are making no profits. We have to change our attitudes. No more excuses."

No one can debate that heavy-handed cost cutting works in the short term. GM saved a whopping $1.1 billion in 1991 and $2.4 billion in 1992—just two short years after Lopez took the helm of GM's procurement organization. The company called the boost in profitability the Lopez effect. Little did GM C-suite executives know that the Lopez effect also caused long-term negative impact that would last into the next two decades.

In 1993, Lopez left GM to take a position with Volkswagen. GM suppliers were glad to see the proverbial pit bull of procurement move on.

Although Lopez is credited with bringing progressive procurement practices to GM, most would argue that his muscular approach for executing his plans resulted in profound damage to GM's supply chain.[9] A National Bureau of Economic Research report titled

"Management Practices, Relational Contracts, and the Decline of General Motors" shows a direct connection between GM's treatment of its suppliers and its demise.[10] A second study by Jeffrey Dyer, professor of strategy at Brigham Young University's Marriott School, shows that GM's power-based approaches generated costs twice as high as those of Chrysler and six times as high as those of Toyota's trust-based processes.[11]

Simply put, in a changing marketplace that counted on suppliers to bring new ideas and add value, GM was the suppliers' least preferred customer. Suppliers shared innovative products and technologies with every other customer before going to GM. Many argue the lack of supplier contribution contributed to GM's declining finances and ultimate bankruptcy.

It has been over two decades since Lopez reigned over GM's supply chain. New directors implemented policies more favorable to suppliers, but the stigma remains.

In a 2014 survey conducted by Planning Perspectives Inc., U.S. suppliers ranked GM as the worst automaker to deal with.[12] Tier 1 suppliers rate GM as their least favorite big customer. GM also received low marks for key measures such as overall trustworthiness, communication, and protection of intellectual property. Fifty-five percent of suppliers rated their relationship with GM as poor to very poor.

The lesson is profound. Power may work for a season, but seasons always change.

A MUSCULAR APPROACH IS MYOPIC AND INEFFICIENT

The days of ruling your world with muscle are over. As the new economy redefines *power*, the proverbial 800-pound gorillas find their power greatly diminished.

One of most revered big thinkers is 2009 Nobel Prize winner Oliver Williamson, an American economist who is one of the pioneering thinkers in transaction cost economics (TCE).[13] TCE is the study of the cost incurred in making an economic exchange (the cost of participating in a market). According to Williamson, organizations can use three styles when procuring goods and services: muscular, benign, and credible. In the "muscular approach," Williamson speaks directly to our assertions about the imperfect role of power in negotiation. "Muscular buyers not only use their suppliers, but they often 'use up' their suppliers and discard them," he states. "The muscular buyer simply tells suppliers 'These are the specifications for the good or service to be provided. Give me your best price.'" However, this approach is less effective for services that require high levels of expertise. According to Williamson, "Power is a trap" that is "myopic and inefficient."

Williamson's Nobel Prize winning economic theory makes our point: Power is incomplete when making business sourcing decisions. Power is one of many elements that must be considered.

Harnessing a New View of Power

The days of one-size-fits-all-I've got-the power-you-don't are rapidly disappearing. Why? Because power works best when you control the environment. And unexpected circumstances can destroy reliance on power tactics. Unless you find yourself living in a parallel universe, protected from any outside influence and technological advancement, today's business environment demands supplier agreements that provide flexibility to meet emerging trends, technologies, problems, and risks.

Simply put, just because you have "power" doesn't mean using it is the best strategy.

Let's look at how "power" is evolving. Dr. Robert Handfield and Gerard Chick, authors of *The Procurement Value Proposition*, suggest that raw power will be replaced with collaboration. "Collaboration is the new way," they state. "The old adversarial posture of procurement is as outmoded as it is inappropriate."[14] Handfield and Chick call for a clear and definitive break between older or past-generation procurement practices and those of today. In short, they argue that everything that has been done and learned in the past will not be useful in the dawn of procurement's new value proposition.

Handfield and Chick are not alone in their conclusion.

Academic research on collaboration has exploded over the last 20 years. Sociologists, psychologists, and political scientists are proving that collaboration is the best way to solve complicated problems and achieve extraordinary results. This is true whether individuals are working to solve complex social issues or simply trying to reduce cost structures and/or drive innovation with a strategic supplier.

For example, Professor Leslie Willcocks of the London School of Economics distinguished between power-based and trust-based outsourcing contracts. In a study involving 1,200 organizations, Willcocks found that trust-based relationships made an astounding 40 percent difference in cost savings.[15] In a research project funded by the United States Air Force, University of Tennessee researchers found that the most successful relationships were based on what researchers called a "what's-in-it-for-we" (WIIFWe) highly collaborative mindset.[16] Big thinkers such as Elinor Ostrom (collaboration for sustainable resources), Robert Ellickson (collaboration in settling disputes among neighbors), Robert Axelrod (collaboration in game theory), Robert Putnam (collaboration for economic growth), and Brian Uzzi (collaboration for creativity) are all coming to similar conclusions.[17] Individuals and organizations create better results by harnessing power through collaboration.

The lessons of this book build on the work of these and other progressive thought leaders. All are proving that competitive advantage will be harnessed by creating powerful cooperative alliances rather than by using an organization's power at the expense of suppliers.

Challenging the Conventional Approaches

Psychologists and economists study the phenomenon of being stuck in past successes. This inertia is often referred to as the curse of knowledge.[18] Harvard Business School's management guru Clayton Christensen brought a new dimension to challenging businesses to reinvent themselves with his pioneering work on disruptive innovation in his best-selling book *The Innovator's Dilemma*.[19] In it, he describes a dilemma that companies face: Do you continue to do what you are doing today, or do you invest in what may cannibalize what you are doing tomorrow?

Sourcing professionals are stuck in their own innovator's dilemma, using classic procurement tools that promote power and leverage while at the same time hoping there is a better way to manage significant supplier relationships. They work on building collaborative relationships but still hold onto the power they've relied on for so long. Power and collaboration just don't mix.

While the sourcing profession has made a great deal of progress with literally hundreds of new tools and models, many of yesterday's approaches still dominate how today's practitioners think and work.

Porter's Five Forces and the Kraljic Matrix are two such models. Both teach how to leverage an organization's power and position in the marketplace. The A.T. Kearney Purchasing Chessboard is a newer approach that offers an extensive set of discrete influencing options (64), but it is incomplete as well. It too relies on picking strategies that best help organizations leverage (or shift) purchasing power to their favor.

Next we discuss each of these once-pioneering approaches. Although these popular sourcing strategies still have value, their time is rapidly passing as they are incomplete answers in today's more complex and interdependent sourcing environment.

MARKET ANALYSIS: PORTER'S FIVE FORCES

Power, in the form of control over your relationships, got a big lift in 1979 when a young Harvard Business School professor wrote a modern interpretation of the forces within a competitive marketplace. Michael Porter's Five Forces model was well received, and Porter became a respected authority on international competitiveness.

Porter suggested that industry faces four influential elements in addition to competitive rivalry: customers, suppliers, potential entrants, and substitute products. Competition within an industry is determined by how a firm decides to compete, given its capabilities relative to the market and to potential customers. Specifically, Porter focuses on these five forces:

1. Bargaining power of your customers
2. Bargaining power of suppliers
3. Threat of substitute products or services
4. Rivalry among existing firms
5. Threat of new entrants in your field

Porter breaks down the power quotient for each potential source and provides practical advice regarding how an organization can increase its power. For example, suppliers' power lies in areas like the level of supplier concentration, impact of volume and different inputs, and ability to substitute participants or products in the market. Buyers exert power through volume, cost sensitivity, and demand. Strong brand identity, steep learning and/or investment requirements, and access to distribution are examples of exit/entry barriers.

Porter attempts to provide strategies that control customers and suppliers in ways that help organizations reach their strategic objectives. In *Competitive Strategy: Techniques for Analyzing Industries and Competitors,* Porter takes a page out of Sun Tzu's writings as he compares competition to war: "Assuming that competitors will retaliate to the moves a firm initiates, its strategic agenda is selecting the best battleground for fighting it out with its competitors. The ideal is to find a strategy in which competitors are frozen from reacting to given their present circumstances."[20] Porter contends that an organization must complete a thorough market analysis to recognize elements of risk and position itself within the marketplace. The risk analysis helps gain the flexibility and ability to move nimbly to withstand surprises.

Although Porter's Five Forces model is an excellent guide to analyze supply market influences and risks, it is incomplete. Specifically, the approach is steeped too narrowly in the concept of using leverage to gain advantage. Energy is put into maintaining a competitive advantage through defensive maneuvering. Spending your energy in that way takes away energy that you could use to build strategic relationships with suppliers that drive innovation as a source of competitive advantage.

Simply put, trying to outmaneuver your suppliers in a win-lose philosophy is shortsighted. Pioneering research documented by Robert Axelrod (in *The Evolution of Cooperation*), John Nash (Nobel Prize–winning essays on game theory, and the University of Tennessee (*Vested Outsourcing*) has found that it is possible to shift from zero-sum games to non-zero-sum (win-win) games.[21] Organizations find cooperative efforts drive innovation and create value for everyone.

Organizations themselves present a major problem; they are stuck in an outdated approach to value creation that has emerged over the past few decades. They continue to view value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success.

THE KRALJIC MATRIX

In September 1983, Peter Kraljic published a pioneering *Harvard Business Review* article that challenged organizations to take a fresh look at purchasing departments. “Purchasing was seen as a second-class function, a service, and certainly not strategic,” said Kraljic.[22]

Kraljic saw that most organizations treated purchasing as a clerical function, and, most certainly, procurement departments did not rise to the strategic level. Additionally, he felt purchasing was at a crossroads. The first paragraph of his game-changing *HBR* article reads like this:

> In many companies, purchasing, perhaps more than any other business function, is wedded to routine. Ignoring or accepting countless economic and political disruptions to their supply of materials, companies continue to negotiate annually with their established networks of suppliers or sources. But many purchasing managers’ skills and outlooks were formed 20 years ago in an era of relative stability, and the skills and outlooks haven’t changed. Now, however, no company can allow purchasing to lag behind other departments in acknowledging and adjusting to worldwide environmental and economic changes. Such an attitude is not only obsolete but also costly.[23]

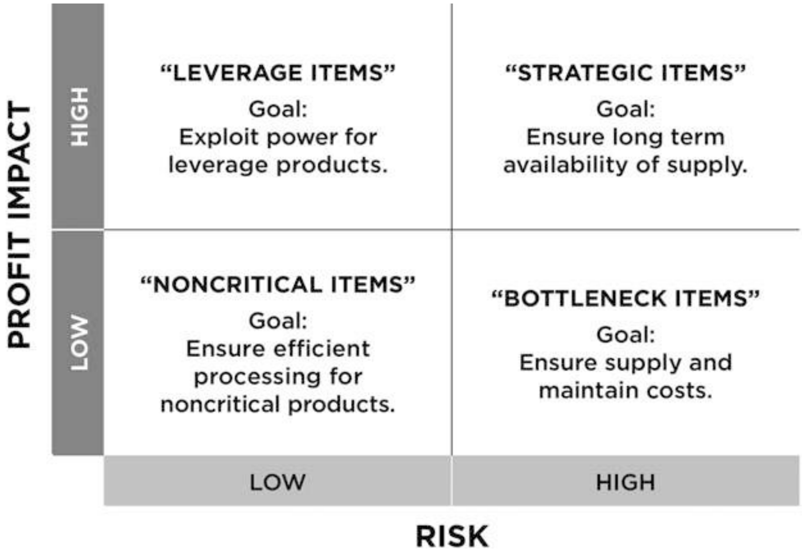
Kraljic suggested buyers categorize what they buy across two dimensions: profit impact and risk. Once spend categories are classified, the organization’s next step is to “weigh the bargaining power of its suppliers against its own strength as a customer.” Based on an organization’s power relative to its supplier, Kraljic asserted there are three primary purchasing strategies: exploit (in case of buyer dominance), balance (in case of a balanced relationship), and diversify (in case of supplier dominance).

To help organizations simplify the approach, Kraljic devised a simple two-by-two matrix.

Figure 1.1 illustrates each of the classifications and Kraljic’s suggested strategy for each spend category.

The “exploit” approach is particularly interesting to us, because it continues to reinforce the time-honored standard of using power to one’s own advantage. The concept means just what you think: Reduce supply risk and get the best price by using your power, whether it’s by consolidating volumes or simply because you are the industry heavyweight. Kraljic viewed the exploit tactic as the most desirable and warned the only thing to be wary of is being excessively aggressive—if circumstances change, you could get bitten.

Figure 1.1 Adaptation of the Kraljic Matrix



Source: Based on Peter Kraljic, "Purchasing Must Become Management," *Harvard Business Review* (September 1983); https://hbr.org/1983/09/purchasing-must-become-supply-management.

The second available tactic is diversify. Kraljic suggested that organizations should not rely on just one supplier; instead, they should "go on the defensive" and proactively seek alternative suppliers and/or products in order to improve their buying power. Kraljic advised buyers to search for alternative suppliers or materials, even going to the point of considering insourcing items in the "strategic" category.

The third alternative is balance, a middle ground between exploiting and diversifying.

Kraljic's advice sends a clear signal for buyers to use their power when at all possible to gain the advantage. Kraljic wrote, "When it [an organization] can bargain from a position of strength, it should press for preferential treatment. Bargaining from weakness, the company may have to offer inducements—longer-term contract obligations for example, or higher prices—in order to ensure an adequate supply." He suggested that it is optimal to use balance and diversification *only* until you are able to move a spend category into a grouping where you can use an exploit strategy. For example, Kraljic recommended that buyers should actively seek alternative suppliers and consider insourcing strategic items when an organization lacks the upper hand at the bargaining table.

Kraljic brought credibility to the procurement profession with his logic and left a substantial mark on the profession. The simplicity of the Kraljic Matrix made it an instant hit. Books and papers on the theory abound. Consulting firms created formal processes and tools to teach and implement the matrix. And software has been developed to make the matrix even easier to use. Even today, the European Institute of Purchasing Management offers a Kraljic Award to organizations that demonstrate strategic application of the Kraljic model.

Scholars and practitioners tinkered and modified Kraljic's concept over the years, but the basic premise stayed the same: If you have power, use it. If you lack sufficient power, find out how to manipulate your environment and the market to gain more.

Kraljic's Matrix—Where's the Win-Win?

Today, the Kraljic Matrix is considered "the standard in the field of purchasing portfolio management models," and it has "become the dominant approach to what procurement organizations regard as 'operational professionalism.'"[24] However, in recent years, many have criticized the model, including Cees J. Gelderman, an associate professor at the Open University of the Netherlands, and Arjan J. van Weel, chair of purchasing and supply development at Eindhoven University of Technology in the Netherlands. Their 2005 *Journal of Supply Chain Management* article cites a number of scholars who question the efficacy of the Kraljic Matrix.[25] We also believe that the Kraljic Matrix is incomplete for today's complex sourcing initiatives.

Like Porter's Five Forces, Kraljic's exploit strategy leads organizations to solutions based on gaining and using power over suppliers. Most organizations find these tactics successful in the short term, but they realize that exploitative strategies cannot produce the innovation and investment needed for long-term success. University of Tennessee research refers to this result as a "watermelon scorecard" because suppliers meet required specifications but are not proactively collaborating to drive innovative value over the long term for the buyer.[26] Like a watermelon, it's green on the outside, but red on the inside.

Next, Kraljic's model does not address emerging thinking around the desire to outsource noncore activities. The model focuses primarily on leveraging direct spend items rather than complex indirect spend items, such as outsourced services or contract manufacturing. Robert Handfield and Gerard Chick have voiced concerns that the Kraljic Matrix is too limited for today's dynamic business environment and that it does not consider the shift to more strategic and service-oriented spending, such as global outsourcing. They write: "Kraljic's Matrix was developed in the 1980s, before the shift in the global center of economic gravity from West to East...While this approach [the Kraljic Matrix] was fine in the context of procurement in the 1980s—when there was greater degree of certainty in markets, and the impacts of offshoring and a globalized market were much less impactful—the commodity-led approach that this tool drives does not address some of today's big issues."[27]

Another criticism is that the Kraljic approach emphasizes simplifying and standardizing categories to drive all sourcing into a transactional, competitively bid model. The problem is that many outsourced requirements have high impact, are very complex, and may require customized solutions and deeper degrees of collaboration for solving business problems. The matrix does not easily apply to more strategic and complex spend categories.

Using the market inappropriately is like trying to put a square peg in a round hole; it results in less than desirable outcomes. The Kraljic Matrix does not recognize the need for a hybrid approach, which Oliver Williamson and other progressive economists suggest is necessary when dealing with complex sourcing initiatives.[28]

The Achilles' heel of the Kraljic Matrix is that it does not recognize a new form of power—the power of highly strategic and collaborative supplier relationships. Kraljic himself identified the problem in 2008 in an interview with Philip Usherwood and Dick Russill. When asked if he would like to add anything to his model, "with the benefit of 25 years' hindsight," Kraljic replied, "the importance of trust in long-term relationships with suppliers. You need [trust] to create win-win."[29]

Power, by itself, is incomplete.

Contracts can be written. Agreements can be solidified. Terms can be defined. But no matter how much success and power an entity enjoys, organizations that depend on legal clauses to define a supplier contract are frustrated when contractual terms interfere with effective trusted supplier relationships demanded by today's dynamic business environment. Without trustworthy, committed relationships, organizations are vulnerable to things going terribly wrong in the ordinary course of business.

The Kraljic Matrix was conceived during a time when purchasing was a clerical buying activity. We applaud Dr. Kraljic for his pioneering work and admire how he elevated purchasing to a more respected and multifaceted strategic planning and decision-making process. Yet does it make sense to make strategic sourcing decisions that rely on a process developed for the 1980s marketplace? How could it, with today's unprecedented speed of change?

A.T. KEARNEY AND THE PURCHASING CHESSBOARD

One of the newest procurement frameworks is the A.T. Kearney Purchasing Chessboard. In 2008, A.T. Kearney (ATK), a leading global management consultant company, published a paper that suggested the procurement profession needed a new framework. The rationale was "consolidating supplier markets, rising energy prices and the growing demand for raw materials in emerging markets have fundamentally changed the purchasing framework." The report offered advice on "buying in a seller's market" and explained that because "suppliers are more powerful than ever . . . buyers must adjust quickly to a new playing field."[30] The result was a chess game concept that was put into a framework known as the Purchasing Chessboard.

ATK's Chessboard attempted to provide companies with a toolkit that addressed every possible supply and demand market condition. The Purchasing Chessboard created a matrix of 64 procurement strategies organizations can use to help them win the procurement game.

Each strategy represents "a stand-alone, differentiating way to work with suppliers to reduce costs and increase value. These methods are derived from 16 approaches and four purchasing strategies."[31] The four major purchasing strategies outlined by ATK are listed below. They are very similar to Kraljic's four categories.

1. Leverage competition among suppliers.
2. Seek joint advantage with suppliers.

3. Change the nature of demand.
4. Manage spend.

Like the work of Porter and Kraljic, the ATK Chessboard is rooted in a classical competitive mindset. Three of the four quadrants are based on reasserting market power and seizing the transactional advantage, while the fourth—seeking joint advantage with suppliers—occurs only when buyers and suppliers in a transaction have equal market power. The message is clear: Be collaborative only when you don't have the muscle to win outright. We believe that this kind of grudging and forced cooperation may work in the short term, but rarely can it be sustained for the long haul.

Power, by itself, is incomplete.

We also want to challenge the incremental thinking presented by ATK. A key argument for using the Chessboard, according to ATK, is that businesses have difficulty incorporating large changes as they navigate day-to-day challenges. The Chessboard provides a variety of smaller change actions that can be applied and digested more easily.

ATK's 64 possible strategies act as levers for procurement professionals. According to ATK, having a toolkit of individual steps allows organizations to implement "smaller elements of change." While the idea of providing bite-size tactics is easy to swallow, it does not keep up with the dynamic pace of business. Incremental change does not address the foundational need of organizations that enable transformation, innovation, or solutions that achieve BHAGs (Big Hairy Audacious Goals).[32] Incremental thinking surely would not have delivered the success of Procter & Gamble, McDonald's, and Microsoft as discussed in *Vested: How P&G, McDonald's and Microsoft Are Redefining Winning in Business Relationships.*

Playing on ATK's Purchasing Chessboard may create more confusion, less efficiency, and much less effectiveness than taking a more holistic view of your entire sourcing spend. Playing chess may get you to checkmate but not to a collaborative partnership built on trust. Playing the power game diminishes trust; it's really just a shell game grounded in old-school thinking where everyone works for his or her own best interest. Why play a game where there is one winner and one loser?

IF NOT POWER, WHAT?

While Porter, Kraljic, and A.T. Kearney have contributed substantially to the sourcing profession, their models do little to foster an environment that inspires suppliers to want to help buyers win their own business game.

More and more savvy C-suite executives are turning to collaboration as a key strategy, enabling them to leverage core competencies of their business partners and suppliers to create a competitive, sustainable advantage. Unfortunately, often these same executives find their organizations are stuck in the past, using conventional power-based approaches for procurement.

Simply put, working together should not be an ad hoc admission that you don't have enough power to control the market. Even Kraljic and Porter are now recognizing their approaches are incomplete.

Kraljic pointed the way forward in 2005 when he recognized that trust in relationships with suppliers is essential to create win-win solutions. And Michael Porter now asserts creating shared value goes beyond being a "good corporate citizen." It's about "being a better capitalist—it's a win-win."[33] Porter is definitely on the right track to encourage a shared-value approach based on shifting the view of capitalism to one of win-win instead of power-based win-lose approaches.

The underlying problem lies with the approach businesses have taken to build long-term relationships. How can you expect your employees to smile and call your supplier "strategic" or "partner" while they're being asked to act (and often rewarded for acting) with old-school what's-in-it-for-me (WIIFMe) tactics? A goal to get the best possible deal and a win at the negotiating table may actually become lose-lose for all.

Consider the following.

Procurement professionals aren't rewarded for the value their suppliers create but for lowering costs or minimizing all forms of risk. CFOs consider extended payment terms to be a best practice in payables management, all the while burying their corporate heads in the sand and thinking that moving from 30- to 90-day payments terms won't harm their supply chain and business partners. It is myopic to think your supplier isn't doing pricing calisthenics to figure out how to make back the loss and make sure it never happens again.

Just how committed do you think your supplier is when your "partnership" is backed by a contract clause with a 30-day termination of convenience? How excited will a supplier's CFO and CEO be to invest in innovation for you when your legal department asks the supplier to forfeit all legal rights and assign all ownership of intellectual property and derivative works to your organization?

Perhaps Charles Darwin offers a solution in regard to the next logical step in the evolution of the procurement profession. Darwin's premise is that it is not the strongest of the species that survive. Nor the most intelligent. But rather the most adaptable. Just as our world evolved from cavemen to royal rule to a society that thrives economically with modern-day governments and corporations, the procurement function needs to challenge its traditional ways.

Power has had its day. Now it is time to adapt.

Procurement leaders need to seek ways that optimize supplier relationships and encourage innovation—to help both buyers and suppliers adapt to the dynamic nature of business. They also need to recognize that power shared is power leveraged. In short, today's procurement challenge is to shift from a base of power to a coalition of collaboration. Suppliers are no longer viewed as a necessary evil that have to be controlled but as sustainable sources of mutual competitive advantage.

Unfortunately for some people, this presents a conundrum. For those who have been the 800-pound gorilla in the room, behaving any other way may seem strange and uncomfortable. For us mere humans, voluntarily relinquishing power does not come naturally. It also feels highly risky.

In the future, the pure power approach will be abandoned for situationally effective agreements. Certainly power will continue to be a point of leverage. But power will come in the form of harnessing the potential of suppliers and business partners. Tomorrow's winners will be those that creatively innovate and maximize profits by creating value, not by simply exchanging value or extracting value. Today's most strategic sourcing decisions will be architected, not negotiated.

It's time for ice queens to melt away, pit bulls of procurement to be tamed, and 800-pound gorillas to leave the building.

RETHINKING MULTISTEP STRATEGIC SOURCING PROCESSES

Nature abhors a vacuum.

If, as we have suggested, Porter's Five Forces model and Kraljic's Matrix are not sufficient to harness the power of suppliers, what should you do? How do you incorporate more modern thinking into your procurement practices? The answer is to rethink your strategic sourcing processes to actively promote more modern approaches. Doing this will be a challenge, since most procurement organizations have worked very hard to create and embed formalized strategic sourcing processes into their DNA, with formal step-by-step strategic sourcing protocols.

In 1994, Toshihiro Nishiguchi introduced a theory of adopting a formal step-by-step sourcing process methodology.[34] His eight-step process resonated worldwide, and countless organizations and consulting firms created their own variations. Many organizations live and die by these multistep models to help them create a more standardized approach for buying goods and services. Exhibit A1 in the appendix provides a high-level overview of 12 of the most popular multistep processes we studied as part of our research.

Almost all of the models stand on the shoulders of the Kraljic and Porter models. For example, most incorporate an opportunity assessment or spend analysis or category profile that promotes the use of some version of the Kraljic Matrix. Most also incorporate some kind of supply market assessment or some form of market research that uses Porter's Five Forces model.

No one can debate the impact of multistep strategic sourcing processes. But, the processes are incomplete. We believe that four primary weaknesses prevent procurement professionals from effectively meeting the challenge of sourcing more strategically in the new economy:

1. Thinking in terms of finite projects
2. Best-practice versus best-fit mentality
3. Limited emphasis on end-to-end category management philosophies
4. Failure to incorporate the concept of Sourcing Business Models

Each weakness is discussed next.

Thinking in Terms of Finite Projects

Most multistep processes approach strategic sourcing as a finite project or initiative. Get the deal done and you are done. This approach is no surprise when you consider that most sourcing organizations have to match supply and demand for hundreds, if not thousands, of goods and services spanning hundreds to thousands of suppliers. Although some sourcing efforts do require a "project" mentality, the vast majority should be thought of as a nonstop process – or a cycle that repeats itself.

Most models also fail to properly incorporate post-contract governance and supplier relationship management (SRM) elements. The good news is that many organizations recognize this need and are starting to adopt formal supplier relationship management processes that emphasize managing supplier performance and the relationship after the deal is done. New models are starting to incorporate SRM. And the International Organization for Standardization (ISO), among others, is suggesting that governance be incorporated into complex outsourcing relationships. Many organizations are adopting sophisticated SRM practices to close gaps in managing the supplier relationship after contracts have been signed. They are also bolstering compliance programs both before and after contract signing. The bad news is that, all too often, organizations view SRM as a separate process rather than a concept that should be incorporated into an end-to-end strategic sourcing cycle. We also encourage organizations to ensure a best-fit, not just a best-practice, view when it comes to governance and SRM practices.

Best-Practice versus Best-Fit Mentality

Not all sourcing initiatives are worth the effort. Let's face it: There is only so much time and resource to manage sourcing initiatives. Some buyers using a multistep strategic sourcing process spend too much effort on their procurement efforts, and others spend too little time. Unfortunately, most multistep models teach the best practices of each step rather than how to apply that step most appropriately to your specific situation. One Fortune 100 company openly stated that it was abandoning seven-step models "for commonsense methods." The chief procurement officer said, "We were spending so much time developing extensive category management plans in pretty vinyl binders, we forgot we had business customers out there who could care less about our perfect plan. When it came time for implementation, the customers would say 'Who cares? I love my supplier—I don't care what your binder says.' Or worse—'It's about time you've finished your homework; we have been dying trying to get what we needed.'"

Limited Emphasis on End-to-End Category Management Philosophies

Existing multistep models don't emphasize end-to-end *category management* philosophies. Most do not stress early procurement involvement for requirements design and business objectives (integrating buyers' efforts with the business stakeholders to give buyers a clear line of sight on how a sourcing strategy supports business objectives). It is imperative for a strategic sourcing process to adopt a cradle-to-grave mentality.

Research shows that as much as 70 percent of the cost impact of a category is determined at the product and service design stage.[35] Think about it: If a buyer is asked to meet cost reduction targets when purchasing a category after design has been completed, that buyer can address only 30 percent of the cost.

Many multistep models also fall short in incorporating the concept of value. The models do an excellent job helping buyers complete a step-by-step process to buy, but traditionally are weak in offering tools that lead buyers to think in terms of value. Handfield and Chick make this point loud and clear: "As supply management moves away from being a cost-reducer (only), it will play a much more important role in value-adding activity and influencing business strategy."[36]

Failure to Incorporate the Concept of Sourcing Business Models

Since the concept of Sourcing Business Models is relatively new, no existing multistep processes consider it. A Sourcing Business Model is a type of business model that is applied specifically to sourcing.

Let's start by first understanding what a business model is. Mutaz M. Al-Debei (associate professor of information systems and computing at the University of Jordan) and David Avison (distinguished professor of information systems, decision sciences, and statistics, at ESSEC Business School near Paris) describe a business model as the rationale for how an organization creates, delivers, and captures value.[37] According to these authors, organizations should build their business model as part of their business strategy. A business model includes an organization's value proposition, value architecture, value finance, and value network.[38]

The Sourcing Business Model theory grew out of a collaborative research project led by the University of Tennessee. The concept was first shared in *The Vested Outsourcing Manual: The Guide for Creating Successful Business and Outsourcing Relationships*. The theory was later refined in collaboration with the Sourcing Industry Group, the International Association for Contract and Commercial Management, and the Center for Outsourcing Research and Education in a white paper first published in 2012, then revised in 2015.[39]

A Sourcing Business Model is the combination of two critical concepts: the contractual relationship framework you use to work with your supplier (transactional, relational, investment based) and what economic model you use (transactional, output, or outcome based). There are seven Sourcing Business Models. Part II of this book helps you understand the why, what, and how of these models.

STRATEGIC SOURCING IN THE NEW ECONOMY

In this chapter we challenged procurement professionals (and their CEOs) to shift their thinking from conventional two-by-two or even eight-by-eight checkerboard approaches. This book is devoted to helping you ask (and answer) two questions: What is the best Sourcing Business Model for my specific business need? And how can I apply Sourcing Business Models to my strategic sourcing process?

Each Sourcing Business Model has its own benefits and limitations. Learning how to navigate through the choices increases your ability to reach and surpass your business goals—not just meet the procurement goal of reducing costs and meeting performance specifications.

That said, changing your organization's perspective is easier said than done. "That's what we have always done" is *not* a mantra for achieving innovative advancement.

CHAPTER 2

THE ONLY PERSON WHO LIKES CHANGE IS A WET BABY

According to the old saying, the only person who likes change is a wet baby. It's likely you have people in your organization who are averse to change. Worse, your entire organization may not be open to change. The goal of this chapter is to provide a compelling argument about why it's essential to change—or risk decay.

General Electric's former CEO, and management guru, Jack Welch believes that inertia is one of the worst traits an organization falls victim to. "When I try to summarize what I've learned since 1981, one of the big lessons is that change has no constituency. People like the status quo. They like the way it was. When you start changing things, the good old days look better and better. You've got to be prepared for massive resistance."[1]

Wine corks demonstrate a classic example of inertia. In the 1600s, Dom Pérignon, a French monk and vintner, regularly used rags wrapped around wooden blocks to seal his bottles—an ineffective practice at best. Legend has it that he switched to cork stoppers after seeing Spanish travelers using tree bark to plug their water gourds.[2]

The first cork stopper factory opened in Anguine, Spain, in 1750. Portugal soon picked up on the idea and remains the world leader in cork production to this day. Cork became accepted as the primary and safest way to preserve wine in bottles for over two centuries. There was no reason to think the cork wine stopper would ever lose its prominence.

In the 1990s, chemists became concerned about an adverse chemical reaction between natural cork stoppers and alcohol that occasionally tainted the wine. Established cork manufacturers, taking for granted their dominant market position, were slow to respond.

Other competitors took the cork taint concern seriously, and, *surprise,* things changed dramatically. New, cost-effective substitutes sprang up: screw caps, plastic stoppers, and even wine boxes using airtight inner bags to preserve the wine's freshness. The stopper war was on.

This was not a good thing for the cork stopper industry. Several Portuguese cork companies, including the second largest, went bankrupt. Hundreds of workers lost their jobs.[3] The Portuguese government, recognizing that the cork industry as too big to fail, declared its survival "a national cause."

Circumstances beyond the control of Portuguese cork manufacturers required a new approach to business. After pouring in resources to improve cork tree forests and recoup market position, sales of cork stoppers slowly made a comeback. However, the hope that the cork industry reclaim its formal monopoly had been erased due to two centuries of inertia.

THE INNOVATOR'S DILEMMA IS BRUTAL FOR BUSINESS AS USUAL

Clayton Christensen, considered one of the world's top thinkers, challenges organizations in his best-selling book, *The Innovator's Dilemma.* Christenen states:

> The reason [for why great companies failed] is that good management itself was the root cause. Managers played the game the way it's supposed to be played. The very decision-making and resource allocation processes that are key to the success of established companies are the very processes that reject disruptive technologies: listening to customers; tracking competitors actions carefully; and investing resources to design and build higher-performance, higher-quality products that will yield greater profit. These are the reasons why great firms stumbled or failed when confronted with disruptive technology change.
>
> Successful companies want their resources to be focused on activities that address customers' needs that promise higher profits, that are technologically feasible, and that help them play in substantial markets. Yet, to

> expect the processes that accomplish those things also to do something like nurturing disruptive technologies—to focus resources on proposals that customers reject, that offer lower profit, that underperform existing technologies and can only be sold in insignificant markets—is akin to flapping one's arms with wings strapped to them in an attempt to fly. Such expectations involve fighting some fundamental tendencies about the way successful organizations work and about how their performance is evaluated.[4]

The history of Swanson's popular TV dinners offers insight into just how easy it is for an organization to fall into the innovator's dilemma. Swanson began to manufacture frozen oven-ready chicken and turkey meals in aluminum trays in 1949. In 1953, the Swanson brothers branded these frozen meals as TV dinners. With over 50 percent of American households owning televisions during the 1950s, this proved an intelligent marketing scheme. The original aluminum Swanson TV Dinner tray was so embedded in American culture the Smithsonian Institute inducted it into a permanent place of honor.[5] The tray even earned a star on the Hollywood Walk of Fame.

The world began to change for Swanson in the 1970s. By 1975, millions of households throughout the world owned microwave ovens. Millions more were sold during the next decade. Yet it was not until 1986 that the Campbell Soup Company, parent company of Swanson's, announced it was replacing old aluminum-foil dinner trays with new microwave-friendly trays. The quick dinners could finally be heated in microwave ovens.

We can't help ponder Swanson's decade-plus of missed opportunity and, the millions of dollars in missed sales. Did higher-priority changes create more significant revenue potential than an aluminum tray change-out? Did Campbell's have a long-term investment in aluminum? Did leaders have blinders on? Were they reluctant and/or unable to invest in the necessary equipment change? Or did inertia simply settle in, spawned by a desire to maintain the status quo or refusal to recognize the obvious, prevent progress? Was there a lack of communication between the marketing and the research and development departments?

We may never know. Progress, like a flowing river, continues. It is hard to halt or hinder. Just ask the railroads. In the 1700s, U.S. commerce moved primarily by boat on a canal system and/or by wagons on regular roads. This was a workable solution for moving goods, but it was painfully slow.

Canals were great for business if you had access to a waterway. However, Baltimore, the third largest city in the United States in the early 1800s, did not have a canal system. Because Baltimore was 200 miles closer to the western frontier than New York City and the Erie Canal, city leaders realized that building a railway would provide a keen competitive edge. On July 4, 1828, construction crews turned over the first shovelful of earth on the Baltimore and Orleans Railroad.

Not surprisingly, railroads faced objections and obstacles. Opposition mounted by businesses of the old order: wagon drivers, toll road operators, and companies that owned stagecoaches and canals. Restaurants and taverns located by existing canals felt threatened with loss of customer traffic. Farmers and landowners wanted no part of the noisy, intrusive encroachment by trains. "Some of the public was wary of railroads at first... claiming them to be a 'device of the devil' as one school board in Ohio put it or that travel by train would cause a 'concussion of the brain.'"[6]

Skeptics often find a champion to help them make their point. In the case of the railroad, many historians point to a letter purportedly written by Martin Van Buren to President Andrew Jackson in 1829 that sought to preserve canals from railway development. The letter reads: "Railroad carriages are pulled at the enormous speed of fifteen miles per hour by engines which, in addition to endangering life and limb of passengers, roar and snort their way through the countryside, setting fire to crops, scaring the livestock, and frightening the women and children."[7]

CHANGE CAN BE GOOD FOR BUSINESS

Although it took nearly 100 years for the railroad to connect the East and West Coasts of the United States, progress prevailed. Railway access expanded trade to previously inaccessible markets, stimulated new business, enabled easy relocation, and brought travel opportunities for people of all ages and cultures. The resulting societal changes were profound. Change phased in as miles of rails and spikes were laid.

The good news is that as a society, we are learning not only to accept change but to embrace it. Contrast the railroad's speed of change with the now-ubiquitous cell phone. Once as weighty as a brick, it is presently a slick, light device capable of much more than just making or receiving telephone calls.

Each year, we get better and better at embracing change. Let's look at Facebook. The idea, born on a college campus, became a global force worth $135 billion a mere ten years later.[8] No one can debate that, as a society, we are getting better at accepting change. And no one can debate whether market speed begets the need for the procurement profession to change.

Progress is the building block for the future. Being open and ready to change course in response to challenges the marketplace throws at you makes all the difference. Results are usually positive for those who see and seize an opportunity. As we learn from Clay Christensen's pioneering work, those who don't openly seek out and invest in disruptive approaches to business may find themselves and their organizations falling victim to the innovator's dilemma.

Progress comes in the form of change. While it may be a new invention or breakthrough technology, more often progress comes in the form of challenging the status quo with process changes. Luke G. Williams, executive director of innovation and entrepreneurship and professor of marketing at the New York University Stern School of Business, wrote a book called *Disrupt: Think the Unthinkable to Spark Transformation in Your Business.*[9] Williams states: "Disruptive innovation is not just about following a process. It represents a mindset—a rebellious instinct to discard old business clichés and remake the market landscape. An eagerness to deliberately target situations where the competition is complacent and the customer has been consistently overlooked or underserved." He instructs organizations to think the unthinkable in order to spark business transformation.[10]

Of course, progress can also come from adopting insightful new business models.

Becoming Change Savvy

The Institute for Supply Management (www.instituteforsupplymanagement.org) has been working to build the skills for procurement professionals since 1915, when it was first formed. The procurement profession's sphere of influence and responsibility has been growing ever since.

Today, there is no doubt that sourcing is much more strategic in nature than it was in the past. No one debates the tremendous progress of the procurement profession, but today's dynamic business environment demands not a continued evolution but a *revolution*. In their 1996 book, *Revolution in Purchasing*, Professors Arjan J. van Weele and Frank Rozenmeijer argueed that an evolution would not be enough; a revolution in purchasing is well overdue.[11] They pointed to four trends that would turn procurement on its head.

1. Radical changes in the business environment, such as globalization, the rise of an information society, and more demanding consumers, will make conventional approaches obsolete.
2. The service industry will evolve as organizations that outsource look to strategic, not just tactical, outsourcing. This will create the need for strong collaborations, with suppliers becoming "networked partners."
3. There will be a shift in purchasing skills and processes to create value, not simply procure goods and services.
4. Successful procurement organizations will adopt a cross functional end-to-end perspective linking internal processes with the needs and capabilities of both suppliers and customers.

Almost two decades later, the professors told us, in personal conversations, that they believe these trends are no longer trends; they are a reality.

Robert Handfield of North Carolina State University and Gerard Chick agree. In their book, *The Procurement Value Proposition*, they write, "This book is about change."[12] The wonderfully written book challenges procurement professionals to embrace the "new vantage point on modern procurement." The authors challenge short-term, cost-focused approaches to procurement and write that value-based approaches to procurement will be "the Holy Grail for Procurement" in the new economy. They argue the time for procurement professionals to embrace change is *now* because the procurement landscape is "shifting around us, often more radically and quickly than we might first realize" and go so far as to state that "existing procurement models may have reached their 'use by' date."[13]

Procurement professionals who fail to see the need for a purchasing revolution will be their own worst enemies.

ARE PROCUREMENT PROFESSIONALS THEIR OWN WORST ENEMIES?

Today's procurement professionals have a tougher job than ever, adapting to and making the best of the inevitable ebbs and flow of today's marketplace. Unfortunately, industry research and benchmarking reports suggest that procurement professionals create their own obstacles when it comes to achieving the success they desire.

Professor John Henke is one such pioneer who is pushing procurement professionals to drive profound change in how organizations work with suppliers. Henke's work represents over 20 years of research studying the impact of supplier trust in the automobile manufacturing industry. Henke and his coauthors have been collecting comprehensive data in the industry since 1992. They have created a series of standardized econometric models for the overall industry and for each of the original equipment manufacturers. As a result, they were able to identify a statistically significant relationship between supplier trust and automobile manufacturer financial performance. Their findings? More trusting supplier relationships directly impact a firm's profitability.

Their work is gaining popularity and recognition, especially after their *Supply Chain Management Review* article titled "Lost Supplier Trust…How Chrysler Missed Out on $24 Billion in Profits Over the Past 12 Years," openly criticized the automaker. In the article, Henke and his coauthors write: "Chrysler's plans should not be considered complete. Conspicuously absent is any mention of Chrysler's suppliers and how they will be viewed going forward."[14] They suggest that Chrysler not making supplier relationships a top priority is a mistake because company suppliers provide goods and services valued at approximately 70 percent of revenue.

The message is clear. Henke and his fellow researchers conclude:

> Building trusting supplier relations is more than a company feel good exercise. It is a prudent company activity that can contribute substantially to a company's profits.…Chrysler's history provides direct evidence of two incredibly important managerial lessons. One is that a company's actions toward its suppliers' contribute to the company's profitability. The other is that it is folly for a company to take an adversarial approach when pressuring suppliers for price concessions.[15]

Another study suggesting procurement professionals are their own worst enemy comes from IBM. The company surveyed 1,351 sourcing decision makers worldwide to understand trends in the procurement profession. According to the study, the top-performing companies are "establishing an inherently different type of relationship. To accomplish their business objectives, they recognize the need to alter the way they structure and manage their long-term alliances. The greatest differences among partnering strategies largely revolved around: business-oriented metrics aimed at strategic outcomes, contract scope designed to drive transformation, and an integrated approach to governance that provides the coordinated decision making necessary to achieve targeted results."[16]

The contradiction? Although a more progressive partnership approach clearly demonstrated higher performance, it comprised a mere 19 percent of all respondents.

A Consero Benchmark Study reinforces IBM's findings that chief procurement officers hold themselves back. The study asked, "Which of the following best describes how your company's procurement strategies are evolving?" The vast majority of respondents (65 percent) remained focused on using competitive pressure to extract value from suppliers.[17]

Whichever study, research, or survey you look at, the theme seems universal. Procurement professionals know there is a better way, but they seem stuck in an old mindset. They find it difficult to take steps that embrace new concepts as rapidly as the world around them is changing.

What Is Your Mindset When It Comes to Change?

Management guru Peter Drucker famously said, "The entrepreneur always searches for change, responds to it, and exploits it as an opportunity."[18] A wise step is to authentically question your own practices and consider alternative viewpoints. When new information comes into existence and circumstances change, thinking differently becomes a requirement rather than an option. And you cannot form new solutions unless you consider new information.

Tim Cummins, CEO of the International Association for Contract and Commercial Management (IACCM), thinks change starts with getting a "License to Act Differently."[19] IACCM created a program (in conjunction with the Center for Entrepreneurship at Aalto University in Espoo, Finland) to encourage a spirit of leadership at all levels. According to the IACCM Web site (www.iaccm.com): "The critical ingredient is getting out of your chair and doing something. It's as simple as that. A lot of people have ideas, but there are few who decide to do something about them now. Not tomorrow. Not next week. Today. The true change-agent is a doer, not a dreamer."

The new economy demands us to seek, respond, and adapt. This can't be accomplished alone, especially when you consider suppliers provide goods and services that often represent up to 80 percent of an organization's revenue. But tapping into a supplier's talent requires new frameworks and skills that are more sophisticated than simply "buying" and "negotiating."

The good news is that these frameworks are available and that specific skills that can be learned and practiced.

ARE YOU READY FOR STRATEGIC SOURCING IN THE NEW ECONOMY?

This chapter invites you to get comfortable with change.[20] Why? The new economy is fast paced and demands change. No longer can you rely solely on raw power to create a competitive advantage. The formerly tried-and-true frameworks practiced for 30 years are now incomplete. Sourcing decisions are no longer as simple as a two-by-two matrix or even an eight-by-eight matrix (chessboard) with 64 unique approaches, no matter how revolutionary those approaches were in their time.

But if today's procurement best practices are incomplete, what is the answer to strategic sourcing in the new economy?

Sourcing is a continuum spanning seven Sourcing Business Models. It is not a task or even a function. Rather, you should view sourcing as a business. That's right—a business. A business where you use the most appropriate business model with suppliers to *maximize* value, not simply to extract it. Sourcing of the future will use the seven Sourcing Business Models with each one designed to help procurement professionals tap into the most appropriate relationships with suppliers and business stakeholders.

In some cases, this means using highly competitive bid situations where you can leverage your scale and power. But in many others situations, it means using Sourcing Business Models designed specifically to foster a highly collaborative environment where suppliers are truly motivated to drive a competitive advantage...*for your organization.*

It's time to adapt. Or decay.

Change starts with building a greater awareness and appreciation of each of the seven Sourcing Business Models. Chapter 3 provides a high-level overview of the models. Chapters 4 to 7 provide an in-depth understanding of each model. And chapter 8 provides a simple yet powerful tool to help you assess your environment and determine which Sourcing Business Model is most appropriate for your situation.

PART II

Part II provides an in-depth view into the art, science, and practice of Sourcing Business Models. It starts with a high-level introduction of Sourcing Business Model theory. The lion's share of Part II puts the theory into practice. Chapters 4 to 7 provide an in-depth look at each of the seven Sourcing Business Models. We also provide examples to show each of the models in action. These relevant, real-world examples are key to understanding how each model works. We then offer guidelines for how to properly structure a supplier relationship agreement for each of the Sourcing Business Models.

It is important to understand no one Sourcing Business Model is perfect for all relationships. The key is for buyers to know which Sourcing Business Model is the most appropriate for their sourcing situation. Chapter 8 shares a step-by-step process and toolkit designed to help procurement professionals determine when to use which Sourcing Business Model.

CHAPTER 3

SOURCING IS A CONTINUUM

Sourcing has its roots in our collective past in commerce and trade. As individuals formed family clans, tribes, communities, and complex societies, individual members began to specialize. That led to a division of labor, improved skill and knowledge, and better workmanship. People with specialized skills traded with each other for goods and services they needed to survive. They did not try to be totally self-sufficient; they relied on each other's talents and productivity and, as a result, lived better.

By 1776, Adam Smith, an eccentric Scottish academician at Glasgow University, observed the human propensity for self-interest and formulated the *invisible hand theory* of modern economics with his publication of *An Enquiry into the Nature and Causes of the Wealth of Nations*.[1] According to Smith's theory, society as a whole benefits from a multiplicity of trading transactions as competition drives fairness and honesty.

As demand for repeat transactions emerged, trading preferences evolved and modern transaction-based models were born. For the most part, transaction-based approaches served business well through the twentieth century.

SOURCING IN THE TWENTY-FIRST CENTURY

Although much has changed over the years, much has stayed the same. Today virtually all organizations use transaction-based economic models for procuring goods and services, much as they have for centuries: “I’ll give you a $1 if you give me a widget” or “I’ll give you $20 if you give me an hour of your time.” Simply put, the cash register rings for every transaction, whether it is a unit of labor (day or hour rate) worked by your information technology (IT) supplier, the number of widgets produced by a component supplier, the number of calls answered by your outsourced customer care center, or the number of pallets stored by your warehouse provider.

Many business professionals wrongly assume that a transaction-based model is their only choice for procuring goods or services. For simple transactions with abundant supply and low complexity, a transaction-based business model is likely the most efficient model and the best choice.

The real weakness of a transaction-based approach emerges when any level of complexity, variability, mutual dependency, or customized assets or processes is involved. A transactional approach cannot produce perfect market-based price equilibrium in variable or multidimensional business agreements. In many instances, alternative sourcing approaches offer more potential.

Sourcing Is Not a Destination

Another incorrect assumption is that sourcing is an activity with an end. Companies generally go through a rigorous make versus buy decision process before deciding to procure a good or service. Many assume that the decision to insource (make) versus outsource (buy) results in one of two approaches: (1) use the market to identify qualified sources to perform the work, or (2) retain or develop the capabilities in-house.

But aren’t there other possibilities between making and buying?

Oliver E. Williamson challenged the traditional make-buy decision process with his work in the area of transaction costs economics.[2] One of his key lessons was that companies should view sourcing as a continuum rather than a simple make versus buy decision.

Perhaps the best way to think of Williamson’s work is to consider free market forces on one side as “the market” and what Williamson refers to as “corporate hierarchies” on the other. In the middle, Williamson advocates organizations should use a hybrid approach for complex contracts.

Developing a Corporate Hierarchy (Make or Insource)

Organizations that use a corporate hierarchy approach to secure goods and services invest to develop capabilities themselves (make or insource). Williamson defines a corporate hierarchy structure as a legal system with high administrative control.

A key factor in the decision to make rather than buy typically revolves around whether the capability is a core competency, meaning that performing the work provides a competitive differentiation. Unfortunately, it is virtually impossible for an organization to be good at everything. When an organization performs work that is not a core competency, inefficiencies drive up cost structures. For this reason, visionary Peter Drucker encouraged CEOs to "Sell the Mailroom" in his 1989 *Wall Street Journal* article of the same name.[3] Others, such as Peters and Waterman and Prahald and Hamel, encourage companies to outsource activities that are not core competencies.[4]

According to Williamson, there are many hidden transaction costs associated with performing work that is noncore to the organization. One reason is that when work is insourced, there is not any competition. Limited competition provides little incentive to drive improvements in cost and/or quality. As a consequence, innovations that might come from the market or third parties are not shared or developed as rapidly as management typically likes—if at all. He adds that corporate hierarchies are "deferential to the management." These additional inefficiencies lead to bureaucratic costs. Williamson states that "the internal organization is usually thought of as the organization of last resort."[5] In other words, organizations should outsource noncore services whenever possible.

Using the Market (Buy)

Organizations that choose to procure goods or services rather than insource typically use "the market" for buying goods and services. The market uses the conventional free market economy to determine how organizations do business, including establishing a price. The market mode assumes that free market forces incentivize suppliers to compete on characteristics important to buyers, such as cost, quality, and service.

The market approach also assumes an absence of dependency; if buyers are not satisfied, they can switch suppliers at any time with little or no switching costs. Buyers typically govern the supply base by switching suppliers (or suppliers switch customers) if a better opportunity comes along. As a result, the market approach relies on classical contract law and requires little administrative control.[6]

The biggest advantage to using the market when sourcing goods or services is that the competitive process enables organizations to obtain good transaction prices. The downside to the market mode is that it often assumes that the good or service acquired is somewhat standardized and therefore available from a variety of suppliers.

Unfortunately, the standard supplier offering is not always the most appropriate. Many times buyers need suppliers to invest in asset-specific or value-added solutions. Luckily, suppliers often are eager to make specialized investments to support specific client requirements. However, to protect themselves in such cases, suppliers raise their prices or negotiate heavily for contractual safeguards that reflect their increased level of risk. This is especially true if there is any type of uncertainty in the buyer–supplier relationship. This give-and-take is a normal part of market-based negotiations.

Hybrid Relationships

Deciding whether to make or buy is rarely a yes-or-no decision. The market doesn't always work as efficiently as theory would lead us to believe. And buyers may find they don't have skills or money to invest in certain competencies. This can put buyers in Catch-22 situations. The term, which is taken from the classic Joseph Heller novel of the same name, refers to no-win situations that use contradictory, circular logic.[7] For instance, you need a pass to enter a particular building, but in order to get a pass, you must visit an office in the same building.

A Catch-22 emerges when organizations want to drive innovation and create a unique competitive advantage, yet decide to use the "market" to buy a particular good or service. For starters, suppliers develop innovations based on generic market trends rather than unique needs that could create a competitive advantage for the buyer's organization. Likewise, organizations miss opportunities by not initiating more strategic and transparent discussions with their suppliers. The result is a lack of a common definition about how client-specific investments and innovations can create value for both the buyer's and supplier's organizations. Buyers then find their suppliers meet contractual obligations and service levels but do not drive innovations and efficiencies at the pace the buyers desire.

You can sense the frustration as buyers and suppliers go through a virtual tug of war. Organizations want solutions to close the gaps when they lack core competencies. Yet suppliers argue that investing in unique customer requirements or innovations is risky because buyers will simply take their ideas and competitively bid the work. The result is that the industry is at a crossroads, with both buyers and suppliers wanting innovation but neither willing to make the investment due to the conventional transaction-based commercial structure of how buyers and suppliers work together.

SEVEN SOURCING BUSINESS MODELS

A University of Tennessee (UT) research team began studying successful supplier relationships in 2003 as part of a large research project funded by the United States Air Force. As part of their work, the researchers codified a business model they called "Vested Outsourcing" or "Vested" for short. Lead researcher Kate Vitasek headed a collaboration with the Sourcing Interests Group, the International Association for Contract and Commercial Management, and the Center for Outsourcing Research and Education to author a white paper titled *Unpacking Sourcing Business Models*.[8] The paper helps procurement professionals rethink the foundational tenets of the business models that underpin their supply agreements.

The white paper outlines seven Sourcing Business Models that fall into the three categories on a sourcing continuum.

1. Transactional models (Williamson's "market" category)
   - Basic provider model
   - Approved provider model
2. Relational models (Williamson's "hybrid" category)
   - Preferred provider model
   - Performance-based/managed services model
   - Vested business model

3. Investment-based models (Williamson's "hierarchy" category)
    - Shared service model
    - Equity partnerships (e.g., joint ventures)

This chapter provides a brief overview of each model. Later chapters go into greater detail. Figure 3.1 shows where the Sourcing Business Models fall along the sourcing continuum.

Basic Provider Model

A basic provider model uses a transaction-based model, meaning that it typically has a set price for individual products and services for which there are a wide range of standard market options. Typically these products or services are readily available, with little differentiation in what is offered.

A basic provider model is used to buy low-cost, standardized goods and services in a market where there are many suppliers and switching suppliers has little or no impact on the business. Buyers typically use frequent competitive bidding (often with preestablished electronic auction calendar events). Often a purchase requisition triggers transactions that signal that the buying company agrees to buy preset quantities of goods or tasks (e.g., widgets or hours). Some organizations even use corporate purchase cards for these types of simple purchases.

The buyer–supplier relationship is based largely on a review of performance against basic criteria. For example, did the supplier work the hours claimed? Did the goods received meet the agreed to quantity, cost, and delivery times?

Approved Provider Model

An approved provider model uses a transaction-based model where goods and services are purchased from prequalified suppliers that

Figure 3.1 Sourcing Continuum

meet certain performance or other selection criteria. Frequently an organization has a limited number of preapproved suppliers for various spend categories from which buyers or business units can choose.

In order to create a seamless and readily accessible supply chain, many organizations develop lists of approved providers. The advantages are many. A key reason to consolidate an organization's supply base into fewer approved providers is to improve a buyer's leverage—a key strategy promoted by Peter Kraljic and Michael Porter. Buyers often create catalogs to drive demand to a narrow range of standardized products and services, with the primary goal to consolidate buying volume. When this is done, buyers and individual users have limited choices when conducting bidding or spot buying. For example, think of a business travel policy where the organization limits flight options to two approved airline carriers.

An organization typically selects multiple approved providers in any given spend category. Using multiple suppliers ensures costs remain competitive. Buyers can also easily switch suppliers if one approved provider fails to meet performance standards. A key reason for using a preapproved supplier list is to save time; the buyer has already "shopped," and the best suppliers are on an approved supplier list.

Goods and services with known and relatively low risk are a good fit for an approved provider model. An approved provider is identified by the buyer as a prequalified option from the pool of basic providers. To reach approved status, suppliers frequently offer some level of differentiation from other transactional suppliers and provide cost or efficiency advantages. In many cases, the advantage is simply a lower price. In other cases, differentiation comes in the form of geographical location or a quality advantage. In some cases, a supplier differentiates itself as a certified minority-owned business, which helps an organization meet its supplier diversity targets.

An approved provider may/may not operate under a master agreement—an overarching contract with the buying organization. Approved providers may or may not also have volume thresholds, that is, minimum purchase expectations, to be in an approved status. In addition, approved providers may or may not participate in supplier management reviews.

Companies like Cooper Industries find great value by consolidating their supply base with a few approved providers. Cooper Industries, a division of the electrical sector of Eaton and a leader in power management solutions, shares its philosophy on why it chooses to narrow the number of suppliers with which it works.

> Cooper follows a Strategic Sourcing process to optimize our supply chain activities by coordinating and leveraging the purchasing and procurement of commodities from a select group of suppliers. Through the creation of distinct commodity groupings, we can identify and manage pertinent market trends and economic drivers that affect cost and availability. This also allows us to better manage our purchasing processes to accommodate regional sourcing, capacity management and other variables. Cooper Strategic Sourcing utilizes technology solutions to consolidate material and service spending across the company into one database. The technology helps us consolidate and leverage our buying power.[9]

Cooper Industries also strives to work with diverse suppliers. The company believes a supplier diversity program grows the pool of "innovative ideas and high quality goods and services, while providing economic development opportunities for small, diverse business enterprises, which include, but are not limited to, small enterprises, minority, women and disabled veteran-owned suppliers."

Preferred Provider Model

Like the basic and approved provider models, a preferred provider model uses a transaction-based economic model. A key difference between a preferred provider and the other transaction-based models is that the buyer has made the choice to move to a more strategic relational model. As such, contracts with specifically chosen supplier(s) assume a more collaborative relationship. Repeat business and longer-term and/or renewable contracts are the norm.

Similar to an approved provider model, buyers seek to do business with preferred providers to streamline their buying processes. Buying organizations typically enter into multiyear contracts using master agreements that allow them to conduct repeat business efficiently. Preferred providers are still engaged in transaction-based economic models. However, the nature and efficiencies in how the organizations work together go beyond a simple purchase order and start to consider how a supplier can provide value-added services.

A preferred provider is a prequalified supplier. Preferred providers often have unique differentiators—offering value-added services and/or demonstrating acceptable levels of performance. For example, a preferred provider may have a superior software system that interfaces with an organization's own system. Sometimes a preferred provider is chosen because of its high-quality workforce and difficult-to-duplicate expertise. Typical conditions for supplier down-selection of a preferred provider are:

- Previous experience
- Supplier performance rating (if the buying organization has a rating system)
- Previous contract compliance performance
- Evidence of an external certification (e.g., such as ISO certification)
- Additional contributions to control costs, such as inventory management, training resources, and aligned geographical positioning

It is common for preferred providers to work under blanket purchase orders (POs) and rate cards that make conducting repeat business easy. For example, a labor-staffing firm may have a rate card that lists the hourly rate set for various types of staffing needs. The buying organization can easily request staffing support from the preferred provider using the predetermined blanket purchase orders and rate cards. Another example would be a facilities management firm that has a preagreed price per square foot to manage a company's multiple buildings across New York City. A third example is a fulfillment center that creates a monthly invoice based on the number of units shipped and the number of pallets of product in storage.

Often preferred providers agree to put value-added solutions in place for buyers. Value-added solutions can take many forms. As an example, medical clinics in the United States often use Labcore to perform lab tests. Labcore sets up an on-site resource in doctors' offices—a significant value-add as well as a competitive advantage.

As suppliers hone their unique differentiating advantages, they become willing to invest their own resources to create more codependency, which makes it harder for buyers to switch them out. Why would a restaurant supply and food distributor be willing to put in a test kitchen at no cost for a customer? Because the distributor sees the investment as an enabling value builder that may make it an indispensible supplier.

Strategic sourcing thought leaders are challenging organizations to think of procurement as an enabler of value.[10] This change in thinking means taking suppliers, such as SKF, a leading worldwide manufacturer and supplier of bearings, linear motion products, spindles, seals and lubricants, seriously when they ask you to rethink price versus value. You are skeptical, of course. After all, SKF is just a manufacturer of bearing and lubricants. You think, "A part is a part is a part; there is no way you can get value out of a $5 bearing." In addition, your organization receives volume discounts because your annual spend is a significant $55 million in bearings and lubricants in the United States alone. You definitely have buying power.

But then you hear Todd Snelgrove, SKF's Global Manager Value, give a talk at the International Association for Contract and Commercial Management conference. He captures your imagination as he eloquently explains how paying $15 for an SKF bearing instead of buying a competitor's $5 part will save you $58 per part over five years. You're still skeptical, but you invite Todd to bring in one of his industry team experts to do a client needs analysis. The experts prove that you are not optimizing your plant equipment. You are surprised to learn you can save $20 million in cost reduction improvement opportunities by switching to a $15 bearing that increases machine reliability.[11]

Eventually, you determine that cost does *not* equal value. So you enter into a collaborative three-year preferred provider contract with your SKF distributor, elevating the distributor from a supplier of "parts" to a supplier that creates value with its Documented Solution Program.

Performance-Based/Managed Services Model

A performance-based model is generally a formal, longer-term supplier agreement that combines a relational contracting model with an output-based economic model. A performance-based model seeks to drive supplier accountability for output-based service-level agreements

(SLAs) and/or cost reduction targets. A performance-based agreement typically creates incentives (or penalties) for hitting (or missing) performance targets.

Sourcing decisions are based not only on a supplier's ability to provide a good or service at a competitive cost but also on its ability to drive improvements based on its core competencies. Performance-based agreements shift thinking away from activities to predefined *outputs* or events. Some organizations call the results outcomes. However, it is important to understand that a performance-based agreement should hold a supplier accountable only for what is under its control. For that reason, in performance-based models, the word *outcome* typically means a supplier's "output." An output is a well-defined and easily measured event or a deliverable that is typically finite in nature.

Performance-based agreements require a higher level of collaboration than preferred provider contracts because typically there is a higher degree of integration between a supplier and a buying organization. In addition, buyers need to apply more formalized supplier relationship management efforts to review performance against objectives and specify the incentive or service credit (also referred to a malice payment or penalty) payments that are embedded in the contracts.

UNDERSTANDING TRANSACTION, OUTPUT, AND OUTCOME METRICS

This example of a facilities management/maintenance contract illustrates how transaction, output, and outcome-based metrics differ. A key lesson is that it is essential to align to the appropriate metric to a supplier's workscope span of control. For example, you cannot expect a supplier to deliver on output metrics if you have dictated a narrow workscope of inputs and activities.

Transaction-Based (Activity Level or Input) Metrics

A transaction-based metric typically measures an activity, input, or level of effort. Activities or inputs are often defined as resources, tasks, or capabilities the supplier must do.

Example: Preventive maintenance actions performed on time. The workscope defines that the supplier should conduct preventive maintenance (PM) tasks on key machines. The buyer specifies all aspects of PM, including defining skill levels of resources, the PM schedule, and how each of the key machines should be serviced and dictating which replacement parts to use.

Output-Based Metrics

An output is a well-defined and easily measured event or a deliverable that is typically finite in nature. Outputs relate to the purpose/functionality of the good or service instead of the activities or inputs needed to create the good or service. An output typically focuses on resources and capabilities of the supplier or the processes needed to produce the service.

Example: Unplanned machine downtime. The workscope requires that a supplier is accountable for preventive maintenance (PM). The buyer provides a list of machines under scope and the manuals that came with the machines. The buyer does not define the PM schedule or a prescriptive statement of work defining how to complete PM. The supplier is responsible for maintaining a PM scheme so that unplanned machine downtime's target is not exceeded. The functionality of the service (minimized downtime) is emphasized versus the actual activities (monitoring that PM activities were completed).

Outcome-Based Metrics

An outcome is the result or consequence of actions taken. Outcomes typically focus on the economic or strategic value generated by the good or service. Typically an outcome relies on an end-to-end perspective, not just the workscope under control of the supplier. As such, outcomes are typically only achieved when suppliers and buyers work collaboratively.

Example: Machine reliability, spare parts, and consumables inventory optimization. The workscope is the same as that for output-based metrics in that the supplier is accountable for preventive maintenance (PM). However, the supplier is challenged to work cross-organizationally to look for ways the buyer can increase the effectiveness of the machines used. The supplier invests in analytical equipment and processes to baseline current success measures across multiple dimensions. For example, the supplier implemented inventory parts planning and worked with a regional parts distributor to put in a vendor-managed inventory program for maintenance, repair, and operations (MRO) suppliers, reducing working capital by 20 percent on MRO supplies. The supplier also implemented a condition monitoring program that would prevent machine downtime by fixing problems before they happened. The program reduced unplanned downtime by 7 percent. Last, the supplier shifted some key bearings and lubricants from a cheaper solution to more expensive options; however, the added costs were well justified because the more expensive bearings and lubricants resulted in a 28 percent improvement in the number of hours a machine could operate between PM actions. As a result, the buying company was able to improve manufacturing throughput, which positioned it to gain market share.

Adapted from Bjorn Axelsson and Finn Wynstra, *Buying Business Services* (Hoboken, NJ: John Wiley & Sons, 2002)

Some service industries are seeing an evolution in managed services agreements where a supplier guarantees a fixed fee with a preagreed price reduction target (e.g., a 3 percent year-over-year price decrease). The assumption is that the supplier will deliver on productivity targets. These guaranteed savings are often referred to as a glidepath because there is an annual price reduction over time. Managed services agreements are a form of a performance-based Sourcing Business Model.

Vested Business Model

A Vested model is a hybrid relationship that combines an outcome-based economic model with a relational contracting model incorporating the Nobel Prize–winning concepts of behavioral economics and the principle of shared value.[12] Using these concepts, companies enter into highly collaborative arrangements designed to create and share value for buyers and suppliers above and beyond the conventional buy-sell economics of a transaction-based agreement. In short, the parties are equally committed (Vested) to each other's success.

UT researchers coined the term *Vested* after studying highly successful buyer–supplier relationships. A Vested model creates a relationship where both buyer and supplier have an economic interest in each other success. Buyers and suppliers develop a common solution based on mutual advantage to achieve strategic business outcomes. A good example is Microsoft and Accenture's seven-year, $185 million contract in which Microsoft challenged Accenture to transform Microsoft's back-office finance operation processes. The agreement is structured so that the more successful Accenture is at achieving Microsoft's goals, the more successful Accenture itself becomes.[13]

A Vested business model is best used when a company has transformational or innovation objectives that it cannot achieve itself or by using conventional transactional Sourcing Business Models (basic provider, approved provider, preferred provider) or through a performance-based agreement. These transformational or innovation objectives are referred to as Desired Outcomes. A Desired Outcome is a strategic business objective that focuses on what will be achieved as a result of the work performed. These outcomes typically span boundaries and generally are categorized as improvements to cost structure (not just a supplier's price), schedule, market share, revenue, customer service levels/customer loyalty, or overall business performance. It is important to note that Desired Outcomes go beyond activity-oriented SLAs, such as those typically outlined in preferred provider business models, or even output-based SLAs, such as those found in performance-based Sourcing Business Models.

Desired Outcomes can be achieved only with a high degree of collaboration between a buyer and supplier and/or with investment by the supplier. The supplier is rewarded for helping the buyer achieve mutually defined Desired Outcomes—even when the supplier shares some of the accountability and risk with buying organization. The rationale is that the buyer cannot achieve the Desired Outcome without the supplier; likewise, suppliers cannot achieve the Desired Outcome without the buying organization.

Shared Services Model

Organizations that struggle to meet complex business requirements with a supplier can always invest to develop capabilities themselves (make or insource). One approach is to develop an internal shared service organization (SSO) with the goal of centralizing and standardizing operations that improve operational efficiencies. A shared services model is typically an internal organization based on an arm's-length outsourcing arrangement.[14] Using this approach, processes are often centralized into an SSO that charges business units or users for the services they use.[15] In some instances, SSOs are formed externally to the company (such as a subsidiary).

The authors' experiences indicate that SSOs typically act like outsourced suppliers, performing services and then "charging" their internal customers on a per-transaction or actual cost basis. SSOs generally mirror conventional preferred provider models. The main difference is that the SOO is an internal supplier rather than an external supplier.

Organizations can use a shared services model for a variety of functional services, such as human resources (HR), finance operations, or administrative services (such as claims processing in health care). For example, large organizations may centralize HR administration into an SSO to provide benefits management to their own employees and even external clients. Small enterprises can benefit from a shared services model by joining forces to create specialized service centers that economically provide a functional service to each of the smaller firms.

Equity Partnerships

An equity partnership creates a legally binding entity. Equity partnerships take different legal forms, from buying a supplier (an acquisition), to creating a subsidiary, to equity-sharing joint ventures or entering into co-op arrangements. Equity partnerships are best used when an organization does not have adequate internal capabilities and does not want to purchase goods or services.

Some companies decide they do not have internal capabilities and a shared services model is not an appropriate solution. In these cases, organizations may opt to develop an equity partnership, such as a joint venture or other legal form, in an effort to acquire mission-critical goods and services. Equity partnerships, by default, bring costs in house and create a fixed cost burden. As a result, equity partnerships often conflict with the desires of many organizations to create more variable and flexible cost structures on their balance sheets.

SOURCING BUSINESS MODELS: A CONSCIOUS CHOICE

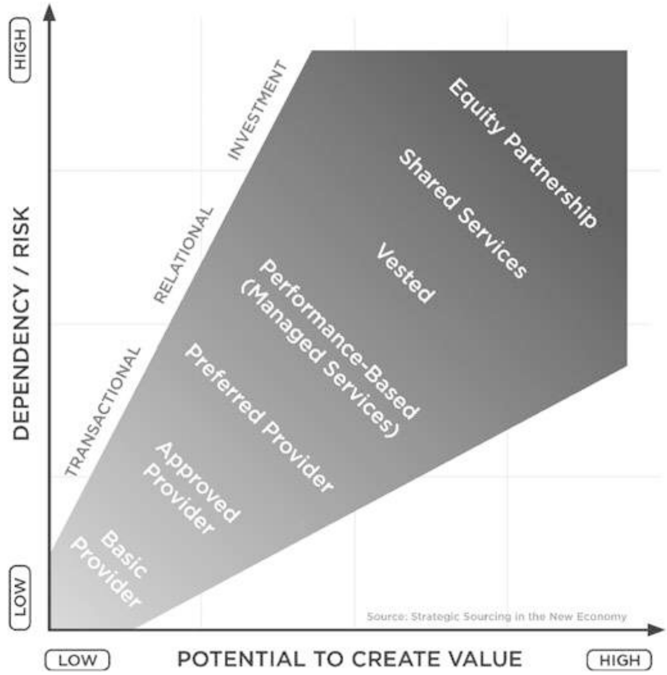
As a buyer decides which Sourcing Business Model to use, the challenge becomes how to purposefully design supplier relationships to motivate the supplier to invest in value-added service, cost reduction efforts, innovation, and transformation. Not all suppliers will be able to rise to the occasion, and that is okay. However, if you have incorporated the concept of Sourcing Business Models into your supplier selection process (addressed in chapter 9), you will find you are well equipped to evaluate suppliers on their value and overall strategic fit with your organization.

Many procurement professionals challenge the concept of creating more strategic and codependent supplier relationships. In fact, Kraljic's and Porter's conventional approaches teach buyers to *avoid* dependency. The last three decades have stressed leverage, power, and competitive tension. However, Williamson's research, along with our own, proves that dependency is not necessarily a bad thing. Rather, the power of highly collaborative relationships can be harnessed using the right Sourcing Business Model, enabling buyers and suppliers to build a trusted relationship. Increased trust, in turn, enables the parties to feel comfortable investing in the relationship and making longer-term investments designed to shift focus away from simply exchanging value to mutually creating value.

Figure 3.2 graphically illustrates an overly simplified sourcing continuum framework illustrating how dependency and value are interrelated. The complete Sourcing Business Model Mapping framework has 25 attributes and is profiled in detail in chapter 8.

As Figure 3.2 suggests, an organization's ability to create value increases as it shifts along the sourcing continuum. In the graphic, the arrow starts in the lower left corner and moves to the upper right quadrant, showing the correlation between dependency and value. This makes sense when you think about it; a properly structured longer-term supplier relationship encourages suppliers to invest in processes

Figure 3.2 Sourcing Continuum Framework



Source: Adapted from Kate Vitasek, Bonnie Keith, Jim Eckler, and Dawn Evans in collaboration with Jacqui Crawford, Karl Manrodt, Katherine Kawamoto, and Srinivas Krishna, "Unpacking Sourcing Business Models: 21st-Century Solutions for Sourcing Services"; www.vestedway.com/vested-library/.

and training to guarantee service levels and/or make commitments to drive efficiencies.

However, longer-term contracts also have a downside. As a buyer moves along the sourcing continuum, it further increases its dependency on the supplier. Although risk increases due to supplier dependency, a well-structured relational agreement can be designed to reward the supplier for mitigating and reducing risk, making the relationship a much more palatable option and mitigating the risk associated with what is commonly referred as "lock-in" associated with a high degree of supplier dependency.

Figure 3.2 also suggests that as organizations move along the sourcing continuum, they create the most value by using investment-based models. With this logic in mind, you might ask why your organization shouldn't just invest and insource everything if such an option creates the most value without a supplier. That is a great question that has been studied for decades, dating back to Ronald Coase's Nobel Prize–winning work in the 1930s.[16] Prahalad and Hamel further examined this question about what is "core" and what is "noncore" in the early 1990s.[17] Simply put, although insourcing everything might sound good, it's not smart. Rarely does an organization have the focus and capital to invest in so many things. Peter Drucker emphatically agreed with this sage advice in his controversial *Wall Street Journal* article titled "Sell the Mailroom."[18]

As you comprehend and apply the concept of Sourcing Business Models, it is important to recognize that there is no single "right" model. Likely you will need to use most, if not all, of the Sourcing Business Models for your organization's sourcing needs. Think of your organization as a baseball team that needs different skills for each position: catcher, pitcher, outfielder, and so on. Your job as a procurement professional is to pick the right model that gets the job done for your specific and unique situation. The key is to know when to use which Sourcing Business Model.

MAKING THE BEST CHOICE IN THE TWENTY-FIRST CENTURY

Successful sourcing in the new economy demands shifting from a "best practice" mentality to a "best fit" mindset. Far too many procurement professionals think merely adopting a best practice tactic will fix all problems. But often it doesn't. Although many organizations find that applying rigorous best practice processes sounds great, the better approach is to adopt the best-fit tactic that gets the job done most efficiently. Chick and Handfield believe that "there is no such thing as a best practice. Best must be judged in context; it is relative to needs and circumstances. Another way of looking at it is to ask: What is right for your organization? What is right for your own needs, and crucially, for your own needs at a particular point in time in a particular market situation?"[19]

In addition, many of the conventional frameworks, such as Kraljic's two-by-two matrix, Porter's Five Forces, and A.T. Kearney's eight-by-eight matrix (64-square Chessboard), are outdated. These models work well to inform an organization's buying position. However, they fall short because they do not address how to architect a supplier relationship that is purposefully designed to optimize value for both buyer and supplier. *Value optimization requires a paradigm shift where procurement professionals and suppliers begin building relationships based on the concept of Sourcing Business Models.*

As buyers work to apply the Sourcing Business Model theory, they must understand the key to success is architecting buyer–supplier alignment between the overall relationship and how the commercial agreement is structured. And that architecture is different depending on which Sourcing Business Model is most appropriate for the specific situation.

There are ten contractual elements that map to five foundational areas. Combined, they form the basis of a successful buyer/supplier relationship. These areas include: business model, scope of work, performance management, pricing model, and governance. Figure 3.3 shows how each of the five foundational areas are expanded into ten elements. It also provides guidelines for how buyers should think about each of the elements across each of the Sourcing Business Models. A brief description of each of the foundational areas is provided next.

1. *Business model.* The foundational relationship and economic constructs of how a buyer and supplier will work together
2. Statement of Work, Outline of how the buyer should direct the work of the supplier
3. *Performance management.* Process of how a buyer measures a supplier's success
4. *Pricing model.* Nature of how a buyer should design payment mechanisms for the supplier
5. *Governance.* How a buyer with suppliers on an ongoing basis after the contract is signed. This includes the buyer's approach to relationship, transformation and exit management and how the buyer will address compliance and special concerns

As Figure 3.3 shows, a buyer must build supplier relationships differently for each of the Sourcing Business Models.

The first four foundational areas are based on the business environment in which you are working. They help you craft a fair and balanced supplier agreement that optimizes and balances the buyer–supplier relationship. The fifth area—governance—is designed to maintain your supplier relationship in the face of a dynamic business

Figure 3.3 Five Foundational Areas of Each Sourcing Business Model

	TRANSACTIONAL (MARKET)		RELATIONAL (HYBRID)			INVESTMENT (HIERARCHY)
	BASIC PROVIDER	APPROVED PROVIDER	PREFERRED PROVIDER	PERFORMANCE-BASED/MANAGED SERVICES	VESTED	INVESTMENT (EQUITY PARTNER/ SHARED SERVICES)
BUSINESS MODEL						
Economic Model	Transaction Based (per Transaction, Hour or Unit)	Transaction Based (per Transaction, Hour or Unit)	Transaction Based (per activity, hour or unit)	Output Based	Outcome Based	Transactional, Output or Outcome Based
Relationship Model	Transactional/ no relationship	Transactional/ Supplier Vetted on "Approved" List	Relational Contract—Emerging Collaboration	Relational Contract—Collaborative	Relational Contract—Highly Collaborative	Investment Based
Vision & Intent	Supply at Lowest Cost	Recurring Commodities at Fair or Lowest Costs	Value Added Capabilities at Best Value	Performance to SLA—Process Efficiencies	Shared Vision, Desired Outcomes & Value Creation	Sustainable Value
SCOPE OF WORK						
Statement of Work & Objectives	"Who" and/or "How"	"Who" and/or "How"	"Who" and/or "How" with Jointly Defined "How"	"What" Limited Emphasis on "How"	"What"	"What if", "What for" and "When"
PERFORMANCE MANAGEMENT						
Performance Focus	Simple Three Way Accounting Match	PO Requirements	Activity Based Service Level Agreements	Output Based Service Level Agreements	Strategic Desired Outcomes	P&L Based Measures
Performance Measures	Right Quantity, Right Price, Damage Free	Basic Provider Metrics + Increased Quality Emphasis	Operational + Customer Satisfaction	Operational + Relational (Values & Behaviors)	Operational + Transformational + Relational System Wide KPIs	Joint Measures of Success
PRICING						
Pricing Model & Incentives	Fixed Price/Typically No Incentives/Volume Rebates	Fixed Price/Low No Incentives/Volume Rebates	Fixed Price/Low Incentives/Volume Rebates	Price with Incentives and/or Penalties	Pricing Model with Value Based Incentives	P&L Based Equity Sharing
GOVERNANCE						
Relationship Management	Delivery & Pricing Validation (Three Way PO Match)	Some Performance & Pricing Oversight	Limited Supplier Relationship Management	Oversight Emphasis: Supplier Relationship Management	Insight Emphasis: Strategic Relationship Management	Shared Control and Management
Improve, Transform, & Innovate	None/Market Driven	Limited/Market Driven	Beginning to Focus on Incremental Improvement	Supplier Driven to Meet SLAs/Price Glide Path	Joint & Proactive Transformation Management	Core Innovation Capabilities
Exit Management	One Way/Limited Commitment to Buy	One Way/Termination for Cause & Convenience	One Way/Termination for Cause & Convenience	Perf Based Termination for Cause w/Safeguards	Joint Exit Management Plan	Divestiture
Compliance & Special Concerns	Compliance Driven/ Survey Based	Typically Compliance Driven/ Survey Based	Typically Market Based/Minimum Audit Requirements	Corporate Based Audit Requirements	Outcome Based Joint Requirements	Investment Based Joint Requirements

environment. As you become familiar with how Sourcing Business Models work, you will see that each model is specifically built to form a "system" that helps buyers and suppliers work in harmony based on the nature of their circumstances. Combined, chapters 4 to 7 provide a detailed overview of each Sourcing Business Model as well as provide insight on how to create a supplier agreement for each.

Think about it this way. If you don't properly architect a supplier agreement, a frustrating business model mismatch can develop because your system is not working in harmony. And your system must stay in balance as the world around you changes. After all, business is dynamic. If you are not thinking in terms of creating a self-correcting system, your supplier relationship can easily get out of whack. Case in point: How many times have you seen a good deal go bad because "business happens"? Getting your sourcing system right becomes increasingly important as you shift along the sourcing continuum to Sourcing Business Models that incur more risk, uncertainty, and supplier dependency.

Chris Holmes, head of procurement strategy and transformation for a Fortune 200 pharmaceutical company, offers the following advice: "It is critical for procurement organizations to realize the continuum of what's available and what's appropriate for the whole situation. If you don't understand the basics of the relationship and what drives the behaviors and motivations, you can easily over-invest or under-invest in a supplier. Any mismatch leads to conflict within other contract terms, whether pricing or total cost."[20]

As you embrace the concept of Sourcing Business Models, your job is to ensure your organization has the skills needed to create and maintain supplier relationships. In some cases, procurement professionals will be responsible for managing each of the five foundational focus areas. This is especially true for spend categories that fall under a basic or approved provider model. In other cases, the skills will reside outside of the procurement function. For example, in some cases, performance management falls under the purview of business units that are using the goods or services. In other cases, you work closely with your finance function to develop a pricing model that aligns supplier incentives to a business unit's Desired Outcomes. Or you work closely with business stakeholders who "manage" the supplier.

Probably one of the most overlooked roles is that of who will manage the supplier relationship after the contract is signed. As supplier relationship management practices gain traction, organizations are figuring out how to best incorporate these roles. The important thing is not who performs each role but rather that you incorporate the appropriate approach and level of diligence for each of the ten elements across supplier relationships.

The IT spend category is a good example of how your role will change from “buyer” to “architect.” In most cases, most if not all of the five focus areas fall under the purview of the chief information officer. The role of the procurement professional is to help educate the IT function about the various Sourcing Business Models. Let’s say you collectively decide a performance-based Sourcing Business Model (often referred to as managed services in the IT sector) is most appropriate. Your job is to ensure the right people are on the team not only to *craft* the most appropriate supplier agreement, but to put in place the right mechanisms to *manage* the supplier relationship after the contract is signed.

As you start to build a particular sourcing solution, work collaboratively with various stakeholders and functional groups that have a stake in the supplier agreement. For example, you will need to work with your organization’s legal department to help it think differently about standard terms and conditions, especially if the supplier is taking on risk. It also means helping the IT organization select and define the right measures as well as craft a statement of work that outlines the appropriate level of detail. Be sure to give the supplier enough flexibility to drive the improvements it is signing up to deliver. For example, you should push back on the IT subject matter experts when they try to hold the supplier accountable without giving the supplier the span of control and authority to achieve the output-based SLAs.

The next four chapters will help you understand the Sourcing Business Model continuum in order to select the most appropriate model for your various business needs. Without full knowledge of each option, you likely will make poor decisions.

CHAPTER 4

TREKKING THROUGH TRANSACTIONS

For centuries, businesses have chosen transaction-based Sourcing Business Models as the primary way to buy goods and services. The heart of the transaction-based model is a simple exchange of goods/services for a set price driven by market competition. Successfully completed transactions trigger payment. Transaction-based approaches are usually highly efficient. As strategic management guru Gary Hamel observes, an efficient transaction-based system allows companies to stamp out the zillions of widgets and process the billions of transactions they need to keep businesses running.[1]

Today, most companies make their "buy" decisions within a transaction-based process, which generally uses prices instead of a pricing model. The supplier charges a price for each transaction, or unit of service. The more transactions, the more revenue for the supplier. The most common pricing for transaction-based suppliers is a fixed price per transaction (e.g., $1.23 per unit) or an hourly labor rate for staff augmentation. However, the price can also be cost reimbursement (also referred to as cost-plus), where the supplier charges for its costs and adds a margin, or profit. Common examples are:

- A call center supplier gets paid a price per call or a price per minute.
- A cell phone service supplier gets paid by the amount of data/kilobytes used.
- An electronic data warehouse gets paid by the amount of storage consumed.

- A temporary staffing agency gets paid a set price per hour for a human resource.
- A utility company gets paid for each kilowatt-hour used
- A third-party logistics warehouse provider gets paid a set price per shipment and per pallet storage space

Two transaction-based Sourcing Business Models have evolved over time: basic provider and approved provider. In both cases, the relationship and economic models are transactional, which makes accounting and payment for goods and services easy to manage. Because the relationship is completely transactional in nature, the buyer does not need to develop a partnership per se with the suppliers. As such, transactional models are often referred to as arm's-length relationships.

This chapter helps procurement professionals understand each of the two transaction-based models. For each model we share:

- Why and how it works
- An example in action
- When to use
- How to structure a supplier agreement

BASIC PROVIDER MODEL

A basic provider is a supplier that operates under a simple buy–sell arrangement where buyers pay a set "transaction" price for products or services. Typically there are a number of standard market options for the product or service. (See Figure 4.1.)

Why and How It Works

Large companies can have thousands of purchasing requirements spanning as many suppliers. A good example is Procter & Gamble

Figure 4.1 Sourcing Continuum: Basic Provider Model

(P&G), which has over 80,000 suppliers. That may sound like a lot until you realize that P&G operates in 80 countries and sells over 100 brands to 180 countries.[2] As a result, P&G's procurement organization needs to be as efficient as possible at procuring goods and services across its supply base. Whether your company is worth $1 million or $10 billion, a basic provider model is a great choice when procuring standardized products that are readily available from a large number of suppliers.

One of the great things about using transactional models is that the prework and administrative efforts are minimal compared to other Sourcing Business Models. Depending on the risk involved, buyers may (or may not) take the time to obtain references or check the financial health of some suppliers. The decision often comes down to price and availability. A buyer can trigger the buy process with a purchase order (PO) or even a purchasing card (P-card) program rather than a formal contract.

For example, let's say you are the buyer for a large oil and gas company. You have a small exploration project in a remote region of the world. A key piece of equipment goes down and needs a bearing. The part is an SKF 7322 BEGAM. A team member jots down the manufacturer and part number and calls suppliers to see if they can expedite the replacement part. None of your company's current suppliers are in region, so it will take five days to get the part to the team. You go online to find an authorized SKF distributor near the exploration site. You're in luck. You can get the part delivered within 24 hours. You make the purchase online with the corporate P-card.

The beauty of transactional models lies in simplicity. The models work best when significant numbers of capable sources provide market competition to keep prices low.

A key reason for buyers to use transactional models is to ensure they get the best market price. More and more businesses are adopting highly automated procurement platforms that ensure they leverage their buying power for the best price among willing suppliers. For example, SAP's Ariba platform provides a shared applications structure where individuals can access global supplier pools and catalogs through a cloud-based service. Ariba likens its service to an "Amazon for business."[3] Many networks like Ariba are excellent for procuring standardized goods and services. Another good example is Transplace's Transportation Management System. The Transplace automated and dynamic bidding system, called the Freight Allocation Module, allows shippers and carriers to connect in a real-time, online marketplace for efficient spot bidding. The Web-based system automating the bidding process enables transportation managers to efficiently broadcast their specific freight needs to all carriers.[4]

Example in Action

A hospitality company owned several properties that purchased a variety of basic food items, such as salt, condiments, snack items, and pasta. Each property did its own purchasing. Because all items were low cost, standard, and readily available from multiple suppliers, the company required no specifications. However, when the company investigated the procurement process, the number of so-called basic food items exceeded 16,000. Many were duplications resulting from disaggregated purchasing procedures. The disparate approach represented millions of dollars in annual spend that could be managed more efficiently.

The company realized it needed a better way to manage these basic food items. Without adding management resources, the company put in place a process to obtain more detailed information across all properties. The process required all properties to utilize a standard electronic auction (e-auction) tool that continuously solicited the supply market to obtain the lowest market price. The buyers simply entered item requirements into the online e-auction tool. Suppliers placed their bids, and the lowest-priced supplier won the order. Negotiation was unnecessary. The system generated a PO using standard terms and conditions.

The company improved its procurement practices without adding complications and resources. The quick turnaround essential for basic food items remained intact. Because the properties had to exert limited efforts to efficiently manage millions of dollars in spend, the procurement team could focus on higher-cost and specialty items and more strategic suppliers.

The company gained additional advantage with a central collection point for information that provided detailed category analysis and spend profiles. Now it could easily identify purchases by type, typical volumes, and demand patterns. The buyer uses this information to drive standardization across all properties.

When to Use

As a general rule of thumb, a basic provider model is best suited for low-value items with abundant supply, little complexity, and minimum asset specificity. Stated differently, if a good or service falls in Kraljic's "noncritical" category, it is likely a good candidate for a basic provider model. Because supplier relationships generally are at arm's length, if problems arise, the buyer simply changes suppliers with little cost impact. Chapter 8 will help you determine if this model is the best one for your situation.

Structuring a Basic Provider Model

All Sourcing Business Models require an organization to think about how it will structure a supplier relationship. This is even true for basic providers, where organizations likely will spend little effort interfacing with suppliers. There are five key focus areas for structuring a supplier relationship: business model, scope of work, performance management, pricing model, and overall governance. This section provides guidelines for how to structure a supplier agreement under a basic provider model. Figure 4.2 summarizes how to structure such a model.

Business Model and Purpose

A basic provider model is a transaction-based economic model and a transactional relationship model. In the model, buyers typically have a competitive mindset, not a more relationship-oriented collaborative mindset. The primary purpose of a basic provider model is to gain access to a supplier's goods or services at the lowest cost. Goods and services that fall under a basic provider model are generic in nature. Many suppliers are willing and able to provide a competitive price in order to win an organization's business.

Workscope

Because a basic provider model uses a transactional economic model, the organizations likely will dictate detailed requirements, such as "who" and/or "how." Let's look at two examples.

1. A product design engineer needs a specific size screw with very low tolerances that will be part of a hip replacement unit

Figure 4.2 Summary Structure: Basic Provider Model

		BASIC PROVIDER
BUSINESS MODEL		
Business Model	Economic Model	Transaction Based (per Transaction, Hour or Unit)
	Relationship Model	Transactional/ no relationship
Vision & Intent		Supply at Lowest Cost
SCOPE OF WORK		
Statement of Work & Objectives		"Who" and/or "How"
PERFORMANCE MANAGEMENT		
Performance Focus		Simple Three Way Accounting Match
Performance Measures		Right Quantity, Right Price, Damage Free
PRICING		
Pricing Model & Incentives		Fixed Price/Typically No Incentives/Volume Rebates
GOVERNANCE		
Relationship Management		Delivery & Pricing Validation (Three Way PO Match)
Improve, Transform, & Innovate		None/Market Driven
Exit Management		One Way/Limited Commitment to Buy
Compliance & Special Concerns		Compliance Driven/ Survey Based

his firm sells to surgeons. The screw will be custom manufactured to the engineer's computer-aided design (CAD) specifications. The buyer shares the CAD defining *how* to fabricate the screw.

2. A retail company ships thousands of products to consumers each year with standard packaging. The retailer provides exact specification for size and durability requirements.

Performance Management

Organizations typically have hundreds if not thousands of basic providers. Due to the large number of providers, it is not feasible to apply a comprehensive performance management program for them. Rather, performance typically is managed on a reactive ad hoc basis if a good or service is faulty or not delivered to the user. For example, a captain of a fire station wants to install some storage units in the station to better organize supplies. The captain shares what he wants with the city's procurement lead, who proceeds to order the storage units for the fire station. The procurement lead needs to be involved further only if the captain reports the storage unit is not delivered properly or is damaged.

Pricing Model

Buyers typically use a PO or a company authorized P-card to purchase goods and service under a basic provider model. In some cases the buyer may set up a blanket PO.

A basic provider model typically has a fixed price per transaction. In many cases, the price is tied to a variable, such as price per mile for shipping a truckload of the company's products from Berlin, Germany, to Rome, Italy.

Governance

Governance of a basic provider typically is limited to validation of any special requirements during the bid process and oversight regarding delivery and pricing. All organizations should have a three-way match process where the PO is compared against the supplier's invoice and the receiving report. A good three-way match compares quantities, price, and terms appearing on the supplier's invoice to the information on the PO and to the quantities actually received. The same process should be followed for service purchases—for example, a comparative matching of hours logged against hours invoiced.

In the basic provider model, a buyer should not be afraid to change suppliers if a supplier is not meeting the organization's needs or keeping prices competitive. If a supplier is classified correctly as a basic provider, switching suppliers should be relatively easy and low risk.

APPROVED PROVIDER

An approved provider is a supplier that meets a predefined set of qualification characteristics, quality standards, previous proven performance, or other selection criteria. Frequently organizations have a limited number of preapproved suppliers that units can choose from. (See Figure 4.3.)

It is common for a buying organization to create a formal approved provider list and encourage purchasing agents and business units to use only suppliers on the list. An approved list of suppliers typically speeds up the procurement process because the buyer simply picks a supplier from the list and negotiates the specifics of the transaction (volume, price, scope). In theory, the procurement department has already shopped around and knows the listed suppliers are capable of providing common goods and services the company needs. Procurement professionals simply need to turn to the approved provider list when bidding is conducted.

To become an approved provider, a supplier must agree to preconditions for the specified product or service it offers. Some organizations require approved providers to meet volume thresholds to gain approved status. Others have supplier qualification programs that include an expectation that the suppliers acquire industry certifications.

Figure 4.3 Sourcing Continuum: Approved Provider

The prequalification process allows suppliers to highlight unique services or benefits they offer. The differentiation could come in the form of geographical location advantage, a cost or quality advantage, or being designated as a MWBE (Minority/Women Business Enterprise) certified supplier. An approved provider may or may not operate under a master agreement (also known as a requirements agreement)—an overarching contract with the buying company. For example, suppliers on Microsoft's Approved Supplier List must sign a master supplier services agreement (MSSA) and comply with Microsoft Supplier Guidelines.[5] Suppliers working under the MSSA agree to several standard terms and conditions, including standard PO and payment terms and Tier X reporting, which helps Microsoft ensure that all vendors/suppliers at all levels are doing everything they can to ensure as much diversity as possible within the supply chain.

Suppliers must also follow the Microsoft Supplier Guidelines for:

- Microsoft's travel policy
- Supplier Code of Conduct
- Preplacement policy required of all contingent staffing agencies and other vendors with employees access Microsoft facilities or networks
- Statement of work (SOW) parameters to ensure that expectations are understood and agreed upon by all parties up front. Each SOW includes price, delivery dates, and specifications for the work.

The MSSA and supplier guidelines are publicly available on Microsoft's Web site by searching on "Contract with Microsoft."[6]

Suppliers on an approved provider list still participate in a competitive bidding process. As with the basic provider model, pricing is driven by market conditions. The main difference is buyers prequalify fewer suppliers. The smaller number of suppliers means that a buyer can consolidate its volume and get preferred pricing. Suppliers bidding to become approved providers understand the benefit of a prominent position in the marketplace with the buyer and become motivated to provide more competitive pricing because of the increased potential for winning the business.

Example in Action—Intel's Supplier Development Program

Intel uses approved providers as part of its Supplier Development Program (SDP), which identifies and confirms that all bidding suppliers are at parity. For that reason, Intel feels confident its identified field of competitors can provide the goods and services needed. When it is time for the bid process, Intel can select the lowest-cost supplier without concern about the supplier's capabilities. Intel knows the supplier can meet its needs. In essence, Intel works very hard to commoditize what it is buying to drive pricing competition in the market.

Take Intel's transportation category. First, Intel rates the capabilities of suppliers that serve the transportation category (e.g., DHL, UPS, Expeditors, etc.). Next, Intel works with suppliers to ensure they close any identified capabilities gaps. Intel then rates the suppliers again to confirm that they meet capability standards. Finally, when Intel is ready to seek a supplier, there are typically three capable, preapproved vendors from which to choose. All offer a "standard" service offering.

Intel's SDP is a solid strategy for commoditized requirements where there are multiple, interchangeable sources of supply. By ensuring adequate competition, Intel is assured it uses the market to get the lowest possible price.[7]

Example in Action—Computer Servers for FinanceCo

A second example is from a financial service organization we will call FinanceCo. FinanceCo is a financial services firm that has heavily invested in information technology (IT) as part of its core product offerings. The IT function completes frequent hardware refreshes to align with product requirements. The goods and services to support these requirements fall into what procurement has classified as the computer servers category.

FinanceCo's procurement group decided to use a formal strategic sourcing process to create a category management plan for the computer services category. Procurement worked closely with the IT business functions to develop the sourcing strategy. Market analysis revealed that many suppliers were available to fulfill this critical category.

The joint team ultimately decided to use multiple approved suppliers in order to mitigate risk associated with supplier shortages.

The team developed down-select criteria to assist in narrowing the field. Then the team chose a small group of qualified suppliers. The firm's engineers and solution product engineers conducted extensive lab tests with the down-selected suppliers and created a ranked list. The top suppliers signed a master agreement and agreed to perform to preagreed service-level agreements. After this, the suppliers were put on FinanceCo's approved provider list.

When to Use

An approved provider model works well when purchases are standardized or where unique specifications can be obtained and easily sourced from a variety of suppliers. As a general rule, an organization uses an approved provider model when it wants to work with fewer suppliers with proven levels of performance. A company that uses the Kraljic Matrix to segment its suppliers will find that goods and services that fall under the noncritical and leverage categories are good candidates for an approved provider Sourcing Business Model.

Chapter 8 will help you determine if an approved provider model is the best Sourcing Business Model for your particular situation.

Structuring an Approved Provider Model

As you move along the sourcing continuum, it is important to make sure you structure an approved provider relationship correctly. Although both basic and approved provider models have the same underlying constructs, an approved provider agreement does have some significant differences. Figure 4.4 summarizes how to structure an approved provider model.

Business Model and Purpose

The primary purpose of an approved provider Sourcing Business Model is to gain access to capable suppliers at a fair cost and enable easy repeat business. Goods and services that fall under an approved provider model have the same or very similar attributes to goods and services falling under a basic transaction model in that there are

Figure 4.4 Summary Structure: Approved Provider Model

	APPROVED PROVIDER
BUSINESS MODEL	
Business Model: Economic Model	Transaction Based (per Transaction, Hour or Unit)
Business Model: Relationship Model	Transactional/ Supplier Vetted on "Approved" List
Vision & Intent	Recurring Commodities at Fair or Lowest Costs
SCOPE OF WORK	
Statement of Work & Objectives	"Who" and/or "How"
PERFORMANCE MANAGEMENT	
Performance Focus	PO Requirements
Performance Measures	Basic Provider Metrics + Increased Quality Emphasis
PRICING	
Pricing Model & Incentives	Fixed Price/Low No Incentives/Volume Rebates
GOVERNANCE	
Relationship Management	Some Performance & Pricing Oversight
Improve, Transform, & Innovate	Limited/Market Driven
Exit Management	One Way/Termination for Cause & Convenience
Compliance & Special Concerns	Typically Compliance Driven/ Survey Based

multiple suppliers capable to meet demand. Often the goods and services are generic in nature.

A key reason for buyers to shift from a basic provider to an approved provider model is to gain more leverage. For example, instead of using the spot market to buy goods and services, buyers entice suppliers to provide pricing discounts and other concessions in exchange for approved provider status. A buyer's competitive bidding goal is to have potential suppliers agree to a set of prequalification standards based on the buyer's unique preferences. In the Microsoft example mentioned earlier, approved providers must comply with prequalified requirements of 2% 10/Net 60 payment terms. Another example is a firm that allows employees to purchase travel from only two airline carriers because the firm has negotiated volume rebates.

A key difference between a basic provider and an approved provider is that most approved providers sign a master agreement that makes it easy for the buyer to conduct repeat future business. The master agreement outlines the basic terms, such as payment terms, conditions, and compliance-related requirements. Although a master agreement may be signed, typically there is no formal commitment to future work.

Workscope

The approved provider model still uses a transactional economic model, and the workscope should clearly outline the requirements, such as who and/or how. For instance:

- The marketing department wants to hire a temporary worker to fill in for an employee who is going on parental leave. The department manager provides a clear description of the type of resource and that are sought and gives it to the staffing services supplier. The staffing services supplier provides qualified candidates, but the department manager likely will interview candidates to make sure they are a good fit for the job.
- A maintenance engineer needs to order a replacement part for a particular machine. The organization has set up three approved providers in the procurement system. The maintenance engineer picks a supplier with which she is most comfortable because the supplier has provided reliable delivery against product specifications in the past. After deciding on the

supplier, the maintenance engineer places the order. It is easy to do because the supplier is already designated an approved provider and has the product specifications on file.

Performance Management

Organizations typically have hundreds if not thousands of approved providers. Although some organizations may find it helpful to use a supplier scorecard, most do not put the time and effort into scorecarding approved providers. Rather, performance management is limited to performance against a PO three-way match and any additional quality requirements. For example, an electronics manufacturer includes printed material in the product box. The receiving department is flagged to perform an acceptance test upon receipt of goods that will ensure the product meets specified quality levels. In this case, the acceptance test indicated a simple visual inspection to check for smudged ink and proper paper size.

Pricing Model

In both basic and approved Sourcing Business Models, a supplier's price is typically fixed unless there are other pertinent variables (such as fuel prices surcharges) that impact the final price. Approved provider models also use volume discounts or rebates. *Volume discounts* are when a supplier reduces its price based on how much volume an organization uses. The more volume, the steeper the discount. A *rebate* is when a supplier provides a discount at the end of a quarter or year based on the volume of work it received.

Typically, an organization does not commit volumes to an approved provider. For that reason, supplier discounts need to be tied to actual volumes, not estimated ones. It is inappropriate for an organization to ask a supplier to establish a discounted price based on a set volume if the volume never materializes. Doing so certainly erodes trust and is unfair to the supplier.

Governance

Because the economic model is transactional in nature, an organization's supplier relationship management philosophy is limited to oversight of delivery performance, pricing, and compliance against key risk exposure areas that are of special concern to the buyer or dictated by government regulations.

The importance of compliance monitoring should not be overlooked. Working with an approved provider does not absolve the buyer from risks. A good example is Target's massive data breach that put the personal data of up to 70 million shoppers at risk. Two months after the breach, an investigation revealed that hackers had gained access to the retailer's systems using credentials stolen from a supplier—Fazio Mechanical Services.[8]

Fazio Mechanical Services is a refrigeration and heating, ventilating, and air-conditioning systems maker. Owner and president Ross E. Fazio explained to the media that his firm was "a victim of a sophisticated cyber attack operation." Target had set up data interfaces for electronic billing, contract submission, and project management with Fazio Mechanical Services, allowing access to the Target network.[9]

Companies that have approved providers under contract can require them to adhere to compliance monitoring. One such system, Hiperos, offers a solution that monitors a supplier's performance against a variety of compliance risk factors. Systems like this one can be used to gather and track supplier performance data across sites, business units, and/or regions. Good monitoring helps buyers make better-informed sourcing decisions as well as identify and address systemic supplier performance problems.

As mentioned previously, buyers typically do not commit a minimum volume level with approved providers. Commitments are limited to what is purchased on an individual PO. In some cases, buyers do put in place blanket POs for approved providers in order to better track and capture volumes that may lead to a rebate. If this is done, buyers should be clear up front that blanket POs should be tied to agreed pricing tiers. The standardized nature of the good or service means buyers can easily replace an approved provider. Master agreements should have clear text regarding termination for cause and termination for convenience.

INHERENT INCENTIVES / PERVERSE INCENTIVES

A key inherent incentive of both basic provider and approved provider Sourcing Business Models is simplicity. These highly competitive transaction-based models drive market leverage to ensure the best price for the good or service being purchased. The buyer's objective is an unapologetic desire to guarantee a constant supply of materials and/or services while taking advantage of the benefits of market competition. Unfortunately, the highly competitive nature of the market sometimes creates negative side effects.

One such negative side effect of a transactional economic model is that a supplier's revenue is directly tied to the volume of transactions. The more transactions, the more revenue the supplier earns. Similarly, the more revenue, the more profit the supplier accrues. For this reason, suppliers have an inherent perverse incentive to refrain from making ongoing improvements to reduce non-value-added transactions. Transactional economic models can also lead to what University of Tennessee researchers call the "activity trap" in which suppliers are motivated to perform more transactions than necessary since their compensation is tied to the number of transactions.[10] The activity trap is especially common in services contracts, where the volume needed (e.g., the hours a temporary worker needs to complete a task or the number of janitors needed to clean a building daily) is somewhat subjective. To fight supplier complacency, procurement professionals use competition and commoditization to reduce their dependency on suppliers. The ultimate goal is to increase the buyer's leverage and thus reduce the price it pays for a good or service.

Another negative effect of the transactional economic model is that highly competitive market forces do not always produce the best long-term solutions. Unfortunately, suppliers sometimes are willing to "buy the business" to get a foot in the door and get on a buyer's short list of approved providers. This action is appropriate when suppliers have underutilized assets and/or are willing to accept smaller margins. For example, sometimes suppliers take on work at low or negative profit margins to help cover fixed costs. However, suppliers that operate on thin margins are often unsustainable.

A third critique stems from the use of technology associated with frequent bid cycles under basic or approved provider Sourcing Business Models. Organizations often use automated solicitation of pricing bids through e-auctions. Over time, savvy suppliers identify patterns of price competition and game the bidding process, leading to price creep. The impact of this behavior actually creates a perverse outcome in that the prices bid are not necessarily the lowest the supplier is willing to offer to their most loyal and trusted customers.

A good example is from a software gaming company that conducted a reverse auction for compact disks (CDs). An historical analysis showed the company was purchasing from seven suppliers; all seven sought to become one of three approved providers. The buyer got a great price for high-volume production runs of CDs associated with the launch of new game titles that sold millions of units on launch day. However, analysis revealed that, after the initial launch volumes, the company paid up to five times more for a CD based on lower post-launch volumes.

The buyer set up a reverse auction where suppliers were to quote a 12-month firm, fixed price across five volume bands. The hope was that the suppliers would provide a steep discount across all volume bands, not just the high-volume production runs. The buyer let the bidders know that the three winning suppliers would be selected based on how well they priced the entire category, not just the high-volume band. The buyer created contracts with three winning suppliers. Unfortunately, the problem persisted.

The issue? In the approved provider model, none of the suppliers had a contractual obligation to fulfill an order. Suppliers gamed the bid process by setting low prices for the lower-volumes bands, knowing they would never accept any order at the quoted price. This ultimately left the buyer in a bind, as none of the approved providers would provide CDs for low-volume orders.

The last criticism lies in the very nature of the simplicity of these models. Because what is being procured is often standardized and low risk in nature, buyers typically spend minimal time with suppliers. Although this is generally a good thing, in some cases it is also a weakness.

Think about it this way. The world our grandparents lived in had transactional relationships; Papa Ed could count on the neighborhood grocer to let him know when that rare shipment of sardines came in. He got his car serviced by the trusty mechanic down the street who knew just how keep his carburetor from stalling. And he visited his favorite corner bakery every Saturday where Virginia would add extra maple glaze to his granddaughter's doughnut as a special treat. Even though each trade was transactional, these suppliers knew tons about Papa Ed. And that familiarity, in turn, provided value.

Fast-forward to today. Our transactional relationships are very shallow, if they exist at all. We deal with faceless voices and machines. We have increased communication, but not with each other. We connect, but the connection is superficial. Business is done but lacks one-on-one connection. Technology cannot replace the unique contributions of real live people with whom we have relationships. Technology is not trust. Being connected is not being committed.

To combat these inherent perverse incentives, procurement organizations should turn to what Oliver Williamson calls a hybrid model that encourages buyers and suppliers to work more strategically in "relational" contracts for more strategic goods and services. We profile the two most common models—preferred providers and performance-based agreements—in chapter 5.

CHAPTER 5

EMBRACING CODEPENDENCY: ENHANCING SUCCESS

As mentioned in chapter 4, transaction-based models are great for driving competition and ensuring low prices. Unfortunately, the highly competitive processes that enable an organization to get the best price do not always bring out the best from suppliers. Buyers can unlock value by moving along the sourcing continuum to hybrid or relational contract models. Properly structured relational contracting models—preferred provider, performance-based, and Vested business models—lead to organizations viewing suppliers as sources of competitive advantage, not as operating at arm's length. As an organization moves to collaborative, relational Sourcing Business Models, it needs to apply different methods. Most importantly, it also needs a different mindset to unlock potential.

Remember Oliver Williamson and transaction cost economics discussed in chapter 1? In his work, Williamson advocates not only for more relational hybrid contracts but also that buyers consider the style in which they work with suppliers. Williamson describes three types of contracting styles: muscular, credible, and benign. According to Williamson, "Power is a trap," and "a muscular approach to outsourcing goods and services is myopic and inefficient."[1] Williamson is not alone in this belief. A growing number of researchers suggest that procurement organizations should not depend on power as their primary tactic.[2]

Clive Heal, team leader and value creation agent at the Supplier Relationship Center (SRC) for Roche/Genentech Pharmaceuticals, provides an insider's perspective on how building more collaborative relationships with suppliers can pay off. Prior to leading Roche's SRC, Heal worked in procurement. He explains:

> Every month we had to write down what money we saved, and what value we brought to the business. Beyond that, we had to write down how we actually did it. This was put into a global procurement database. After a couple of years, I was given the job of analyzing the data. What the data showed is, in the short term up to a year, the biggest driver of value creation was derived from creating competition in the marketplace (i.e., getting suppliers to compete for business and then moving the business around from time to time from one supplier to another). However, the data also showed that in the long term (i.e., over a year), more value came from picking a partner, collaborating very closely with them, and working with the partner to create a win/win scenario. The lesson learned was that suppliers are more willing to do business with you and give you more if they feel there is something in it for them. You will open more doors and get more value from collaboration as opposed to creating competition.[3]

RELATIONAL CONTRACTING MODELS

As companies face higher supply risks, or as the spend categories they purchase become more specialized or complex, there is a need to shift the procurement lens from price to value. Just as we distinguished between standard transaction-based models (basic provider and approved provider), here we cover varying requirements to support movement across the sourcing continuum to relational Sourcing Business Models. Three types of relational Sourcing Business Models enable organizations create more value with their suppliers:

1. Preferred provider model
2. Performance-based model
3. Vested model

This chapter provides a practical way for procurement professionals to understand the first two models. Vested is addressed in chapter 6. For each model we share:

- Why and how it works
- An example in action

- When to use
- How to structure a supplier agreement

PREFERRED PROVIDER MODEL

A key difference between a preferred provider model and the transaction-based models profiled in chapter 4 is that with the preferred provider model, the buyer has made the choice to move to a more strategic relational model with specifically chosen supplier(s) to increase access to value-added capabilities. A longer-term contract and/or repeat business is the norm. (See Figure 5.1.)

Why and How It Works

A key differentiator for a preferred provider model is the conscious decision for buyers and suppliers to move toward a contracting model that characterizes contracts as relationships rather than as purely discrete transactions. As a side benefit, buyers find that using a relational contracting approach streamlines buying processes because a master agreement allows the companies to do repeat business efficiently.

A preferred supplier is still engaged in a transactional economic business model.[4] Think of a preferred supplier model as having one foot in the transactional camp and one foot in the relational camp.

Often organizations select a limited number of preferred providers for each of their spend categories. In some cases, a preferred provider may have an exclusive arrangement, but most often a small number of preferred providers provide goods and services in their spend categories. As buyers seek to identify and down-select preferred providers, they typically consider factors such as:

- Previous experience as a supplier with a threshold minimum performance rating

Figure 5.1 Sourcing Continuum: Preferred Provider Model

- Evidence of an external (such as International Organization for Standardization) certification
- Minimum amount of revenue the organization spends with the supplier
- Ability to provide value-added service offerings for the buyer
- Confidence in assured supply
- History of successful collaboration with supplier
- Other strategic aspects of the relationship
- Desire/need to do efficient repeat business

Organizations choose to work closely with preferred providers for a variety of reasons. One is to lower the price paid for goods or services. For example, an organization may get pricing benefits through tiered volume discounts as it increases its spend with a supplier. In other cases, an organization negotiates value-added or specialized services as part of the bid process. But how do organizations choose suppliers that offer differentiators and measure the benefits received? Ask Mark Avery, former director of International Supply Chain, DineEquity, Inc., parent company for the Applebee's and IHOP brands.

Avery told us about the implications of an American restaurant chain operating in Canada.[5] Often restaurant chains require local franchisees to purchase their food directly from the parent organization. This can be a problem across borders because sourcing becomes expensive, there may be import restrictions or limits, and freight deliveries may require extra considerations. For example, why not source lettuce from a local supplier, instead of having to go through customs? Added import costs caused the chain further headaches. To complicate the situation even more, many Canadians along the U.S. border saw television advertisements touting great menu offerings at prices that could not be matched in Canada. There had to be a better way.

Avery decided to look for a supplier partner that could advance Applebee's business objectives specifically within the Canadian market and not just provide meat and potatoes. He sent a request for proposal to multiple distributors with the intention of finding a preferred provider. A number of suppliers were qualified, but one distributor stood at the head of the line. Because the supplier dealt in large volumes, it was able to offer competitive pricing—a very important advantage.

But the supplier offered more than good pricing. It offered the capability to provide services Applebee's distinctly needed. One of the most critical value-adds was a fully equipped test kitchen that could be used to support Applebee's menu development and suppliers' product qualification. Finding space and time in a busy Applebee's restaurant kitchen to test new food items is nearly impossible. Avery explained how the supplier shared the burden of operation and provided added value to Applebee's.

> Periodically, Applebee's gathered a team to review menu offerings. We would identify a handful of categories, such as meat, soup, and sauces. Then we identified individual dishes within those categories.
>
> At that point the supplier stepped in. A qualified team gathered the data, organized the kitchen, set up comparisons of alternate products, and prepared worksheets to capture ratings and comments. Working alongside Applebee's food quality resources, the supplier basically facilitated a full day of examination and tasting in a single location. This allowed the Applebee's team to do pricing analysis, determine whether the items met Applebee's standards, and select new or alternative menu items. Because the supplier seamlessly provided the organizational details, we could concentrate on our priorities.

The arrangement was good for the supplier as well. Of course, becoming a preferred provider for Applebee's meant the stability of a longer-term contract. In addition, the supplier gained a new market for its private label food brands or brands with which it had an established supply relationship. When Applebee's agreed to use a supplier-branded product, the supplier's profit margins increased. Being Applebee's distributor of choice also made for great bragging rights.

All in all, Applebee's and its preferred provider created a relationship that benefited both parties. The Sourcing Business Model proved to be a win-win situation you could really sink your teeth into.

It is common for preferred providers to work under blanket purchase orders (POs) with predefined pricing for their work. For example, a labor-staffing firm may have a rate card that establishes the hourly rate for various types of staffing needs. Business units or individuals within the buying organization can request staffing support from the preferred provider using the predetermined blanket PO and rate card. There is no need to research the supplier's capabilities or shop around to get the rate.

Often companies work with preferred providers under a supplier relationship management program in which the buyer and supplier agree to formal performance assessments. In many cases, as in the Applebee's example, both companies agree on improvement opportunities as part of value-added efforts.

Some companies have different levels of preferred providers. For example, Microsoft has two levels, which are profiled next.

Example in Action: Microsoft

In the Microsoft Preferred Supplier Program (MPSP), suppliers are divided into two distinct levels: premier and preferred. These suppliers are a small subset of Microsoft's overall Approved Supplier List (ASL). Premier suppliers have the distinction of being recommended by Microsoft's procurement organization, meaning that when an employee seeks to buy goods or services, the supplier is flagged to signal employees to use the premier supplier if at all possible. Suppliers receive substantial revenue increases when business units or employees buy products or services using the procurement group's recommendation.

Microsoft's preferred and premier suppliers also enjoy added benefits. They are invited to special events where Microsoft executives share insights and strategies. Premier suppliers also have access to Microsoft executive briefings.

It is not easy to become a preferred or premier supplier at Microsoft. The company publicly shares the details of its procurement program on its Web site, including the requirements suppliers must meet.[6] (See Table 5.1.)

Microsoft's Web site shares a video showing employee testimonials on how working with preferred providers makes life easier for them.[7]

Microsoft also publicly recognizes the best preferred and premier suppliers for service excellence as part of the MSSP program. In 2014, Microsoft issued six supplier awards, with Infosys LTD winning the Market Agility Award. Microsoft's press release and case study praised the success of Infosys:

> Infosys has been a long-term global supplier of business consulting, technology, engineering, outsourcing, product and platform services for Microsoft. Its ability to remain agile in an ever-changing market has made it a leader in Microsoft's Preferred Supplier Program. Most recently Infosys was recognized for its extremely efficient market agility through its work on the Next Generation Volume Licensing (NGVL) project. Working with very short timelines and high expectations, Infosys

Table 5.1 Microsoft Comparisons of Approved Preferred and Approved Premier Supplier Requirements

Requirements	*Sourcing Business Model Preferred*	*Approved Premier*
Vendor privacy assurance program compliance	X	X
Anticorruption compliance	X	X
Nominated by a category manager, procurement business partner, vendor account manager, or business owner	X	X
Master contract compliance	X	X
Nondisclosure agreement compliance	X	X
Credit rating compliance	X	X
Approved supplier list (ASL) compliance—approved on minimum of one ASL	X	X
Category director/field appropriate approval		X
> $ 10 million for U.S. > $ 1 million for non-U.S.		X
MPSP Advisory Board Review and acceptance		X
Microsoft global relationship owner and/or executive sponsor		X
Annual scorecard or annual business review		X
Global reach, active in multiple tier 1 countries		X

Source: Compiled from Microsoft Web site: http://www.microsoft.com/about/companyinformation/procurement/msvendor/en/us/criteria.aspx

> ramped up over 150 consultants and wrote over 2.4 million lines of code to deliver 10 NGVL releases on time. Its solutions dramatically decreased agreement-processing time from an average of 672 minutes to less than five. And, through the use of its Rapid Agile Delivery Model, it delivered a key Accessibility Release three weeks ahead of schedule and thoroughly demonstrated its excellence in driving market agility.[8]

Publicly recognizing preferred suppliers is a great way to motivate them. The cost to Microsoft for providing this kind of recognition is minimal; however, the company's positive and public endorsement is a tremendously valuable incentive for suppliers.

This example in action shows the power of consciously choosing to build more strategic relationships with suppliers. The objective of Microsoft's Preferred Supplier Program is straightforward: "To enable new efficiencies for both Microsoft and suppliers, bringing new value to the relationship that we are building together."[9] With success stories like Infosys, Microsoft is clearly achieving its goal.

When to Use

As a general rule of thumb, a preferred provider model is best suited for spend categories where there is an increased opportunity for meeting business objectives (e.g., Kraljic's strategic or leverage categories). Some organizations also use preferred suppliers to manage some spend categories that fall under Kraljic bottleneck segment.

Many people assume that a preferred supplier model is not well suited for spend categories that have a relatively low value or where there are multiple supply options. This is a wrong assumption. Buyers often are surprised that consciously choosing to build a closer relationship with a noncritical or leverage supplier can deliver significant value. Just because a spend category historically has been labeled noncritical does not mean that a supplier cannot add value if given the opportunity to engage in a more sophisticated relational Sourcing Business Model. For example, in chapter 6 we share how Procter & Gamble found significant benefit in viewing facilities management from a vantage point of value.

Next are guidelines for structuring a preferred provider model. Chapter 8 will help you determine if a preferred supplier model is most appropriate for your situation.

Structuring a Preferred Supplier Relationship

As you move along the sourcing continuum to preferred provider, you will have made a decision to create a relational contract. This means you need to focus on the relationship in addition to writing a contract to simply buy goods or services. This section provides guidelines for how to structure a relationship for a preferred provider across five dimensions. (See Figure 5.2.)

Figure 5.2 Summary Structure: Preferred Provider Model

		PREFERRED PROVIDER
BUSINESS MODEL		
Business Model	Economic Model	Transaction Based (per activity, hour or unit)
Business Model	Relationship Model	Relational Contract—Emerging Collaboration
Vision & Intent		Value Added Capabilities at Best Value
SCOPE OF WORK		
Statement of Work & Objectives		"Who" and/or "How" with Jointly Defined "How"
PERFORMANCE MANAGEMENT		
Performance Focus		Activity Based Service Level Agreements
Performance Measures		Operational + Customer Satisfaction
PRICING		
Pricing Model & Incentives		Fixed Price/Low Incentives/Volume Rebates
GOVERNANCE		
Relationship Management		Limited Supplier Relationship Management
Improve, Transform, & Innovate		Beginning to Focus on Incremental Improvement
Exit Management		One Way/Termination for Cause & Convenience
Compliance & Special Concerns		Typically Market Based/Minimum Audit Requirements

Business Model and Purpose

The primary purpose of a preferred provider model is to gain access to value-added capabilities. It is important for the buyer to move beyond the competitive bidding process and base supplier selection on a more balanced "best value" perspective that quantifies the value-added services the supplier will provide. In doing so, buyers and suppliers start to shift from a win-lose opportunistic mindset to a win-win mindset. If a supplier is not willing to adopt a win-win mindset, the buyer should keep the relationship with that supplier within an approved provider model.

Under the right conditions, suppliers can add tremendous value to the supply chain, but the value-added services likely come with added costs. The good news is that streamlined contracting processes that enable efficient repeat purchases can help buyers mitigate the cost impact. In addition, bundling workscope and committing to consolidate volume to allow for volume pricing discounts also can help buyers mitigate the added costs.

A preferred provider model is structured using a transaction-based economic model, paying a supplier a transaction fee (per activity, unit, per hour). This allows buyers and suppliers to create a relatively easy payment process.

A key difference is a preferred provider model embraces relational contracting methods. For starters, an organization uses a master agreement that creates a flexible contracting framework for conducting future business. For example, let's say you enter into a preferred supplier contract with a consulting firm to provide consulting services across multiple business units and functions. You don't know what projects you will need in the future, and you certainly don't know the scope of each project. Thus, it is impossible for the consulting firm to give you a price.

You start by setting up a master agreement that outlines the legal terms and conditions that will be used across each of the various future needs. You then create a template (often referred to as statement of work [SOW]) that allows business units and the consulting firm to document the scope, price, and other requirements (such as time commitments or deliverables). The master agreement should reference the fact that future SOWs will be created on an as-needed basis. These future SOWs become an appendix or schedule to the contract. For less complex tasks, the document can be as short as one page. A more complex workscope may split the SOW into multiple schedules (e.g., one schedule defining requirements, one schedule defining pricing, one schedule defining performance metrics/management).

In addition to relational flexible contracting framework, both buyer and supplier need to shift from an arm's-length competitive mindset to a collaborative mindset. Moving to a relational Sourcing Business Model requires buyers to shift from a what's-in-it-for-me (WIIFMe) to a what's-in-it-for-we (WIIFWe) approach. Unfortunately, doing this is often hard for buyers because they have been trained in classic negotiating techniques.

Once a preferred provider has been selected, we recommend that buyers and suppliers follow the five-step process outlined in the book *Getting to We: Negotiating Agreements for Highly Collaborative Relationship* to lay a strong foundation for a much more collaborative relationship.[10] (See chapter 12 of this book for a high-level summary of the five-step process.)

Workscope

It's one thing to create a flexible contract framework and adopt a collaborative mindset. You also need to adapt relational contract techniques in each of the other four key focus areas of your relationship. This means changing the way you define a supplier's workscope in the SOW. Because a preferred provider model still uses a transactional economic model, the workscope should clearly outline the requirements, such as "who" and/or "how." However, a key difference is that in preferred provider models, buyer and supplier typically define the "how" jointly.

For example, it is common for a buyer outsourcing its outbound call center to outline the type of expected resources and to provide call scripts. In many cases, the buyer may even provide the job descriptions and mandate minimum employee qualifications. However, as buyer and supplier build trust in their relationship, they may opt to move to a more flexible SOW and reduce the need to be prescriptive about workscope. There is also an increased expectation that the supplier will begin to challenge the "how" and introduce continuous improvement suggestions in how the work is done.

Buyers should also consider bundling workscope with preferred suppliers. For example, buyers might add inbound *and* outbound calling to a call center's responsibilities. This is done for two reasons. First, it allows suppliers to create economies of scale with overhead costs. When inbound calls are slow, suppliers can perform outbound calls to optimize labor costs. Second, it allows for suppliers to justify further price breaks by leveraging overhead associated with additional workscope. For example, a supplier that has twice the call volume likely won't need twice the number of training rooms and training equipment.

Performance Management

A preferred provider model typically uses an operational scorecard that measures transactional service-level agreements (SLAs) defined by buyers. In addition, buyers often include some form of customer satisfaction measures. A master agreement with a supplier creates an opportunity for buyers to include additional considerations around performance. Suppliers should be held responsible only for achieving performance as related to the transactions they perform. Holding suppliers accountable for something that is out of their control unfairly shifts risk to them. It might be tempting to ask suppliers to take risk that is not within their control; however, suppliers then simply raise their prices to account for the uncontrollable risks.

Pricing Model

As with basic and approved models, a preferred provider's price is typically a fixed price per transaction unless there is a high degree of variability in the requirements or unless market drivers impact commodities. Buyers should negotiate a rate card that provides both scalability and flexibility.

A preferred provider model should also use volume banding. Volume banding is when prices remain constant within a pre-specified band of purchasing commitment. If volumes increase above the band, so can the discount. If volumes decrease, the buyer agrees to pay a higher price for each unit/transaction. It is important to avoid negotiated price breaks without considering volume commitments. Supplier discounts need to be tied to actual volumes, not estimated ones. Simply put, organizations should not ask suppliers to establish a price based on a set amount of volume if the volume never materializes. Doing so is unfair.

Volume banding is an especially important concept when there is a great deal of volume variability. For example, mergers and acquisitions are common practices in the pharmaceutical industry. Preferred providers of a pharmaceutical company's supply chain or facilities management could easily see volumes shift with the onboarding or exiting of product divisions. Volume banding is used in such cases to maintain fair profits for suppliers in the event of volume changes.

Some organizations incorporate incentives in their preferred provider models. However, because many buyers do not want to invest the additional time in governance to warrant, establish, and manage an incentive program, they rely on inherent incentives. Microsoft offers an example of how to think creatively about incentives for preferred providers; the company's Web site outlines several benefits provided, such as supplier executives' access to an executive briefing breakout session, discounts on software, and a supplier showcase on Microsoft's intranet and extranet sites.[11]

Some organizations also find it helpful to ask a preferred provider to become more transparent with an *open book* approach in which buyer and supplier discuss the supplier's actual cost structures. The primary benefit of an open book approach is that it enables the organizations to understand and discuss true costs. Looking at true costs allows buyers to shift focus from sitting across the table negotiating price to probing how both parties can work collaboratively to eliminate non-value-added activities, duplicative efforts, and risks that drive up costs. Buyers should note that many suppliers will be hesitant to shift to a transparent open book approach if they sense that buyers will be opportunistic and use the transparency against them in negotiations. This is a key reason why buyers need to shift to a WIIFWe mindset when moving to a more strategic relational contract.

Governance

Buyers operating under a preferred provider model should have appropriately scaled governance protocols for how buyers and suppliers work across four dimensions: relationship management, continuous improvement, exit management, and compliance/special concerns.

Because the economic model is transactional in nature, a buyer's supplier relationship management (SRM) philosophy typically is limited to monitoring performance and pricing. However, unlike the approved provider model, with preferred providers, buyers create a relationship management framework where buyer and supplier regularly review performance. For example, buyer and supplier typically commit to quarterly business reviews and put in place formal protocols for managing business issues (e.g., poor scorecard results) or future requirements.

A key difference in a preferred provider model is that buyers may ask suppliers to add value by identifying continuous improvement efforts that improve service levels or reduce costs. Remember the Applebee's example of the test kitchen?

Buyers also need to include exit management provisions in their master agreements. Typically, exit management includes a one-way termination for cause and termination for convenience. These clauses allow buyers not only to end a supplier relationship due to poor performance but also to change as business requires. Simply put, while buyers commit to build a closer relationship with suppliers, buyers may or may not actually commit to continued business.

Most buyers think of exit clauses as a way to protect their own organizations. Let's go back to the pharmaceutical company that does frequent mergers and acquisitions. If the company spins off one of its product lines, the buyer needs to trigger an exit clause for the third-party logistics service warehousing provider for that product line. It is important to realize that suppliers may begin to ask for contractual safeguards to protect themselves. Exit clauses in contracts should protect suppliers as well as buyers. In the case of the pharmaceutical company, the buyer needs to compensate the supplier fairly as it winds down its work for the pharmaceutical firm. Doing this would include compensating the supplier for asset-specific investments, such as secure storage, special labeling, or temperature-controlled equipment the supplier purchased on behalf of the pharmaceutical firm that cannot be reused by other customers in the event the supplier's contract is terminated early.

Last, as with an approved provider model, buyers put in place processes and protocols to audit compliance and external requirements that are unique to a supplier's workscope. For example,

- A clothing manufacturer using a contract manufacturer in Malaysia should establish auditing protocols to ensure compliance against corporate social responsibility goals, such as not hiring underage employees.
- A high-tech manufacturer that buys electronic components for

its handheld devices needs to make sure the supplier adheres to Universal Laboratories (UL) standards.

- A retailer that outsources warehousing to a third-party logistics service supplier ensures the supplier meets Occupational Safety and Health Administration (OSHA) standards.
- An insurance company audits its suppliers' ability to meet regulations for handling patient records.

PERFORMANCE-BASED MODELS

A performance-based model combines a relational contracting model with an output-based economic model. A key difference between a preferred provider and a performance-based agreement is that in the latter, the buyer and supplier shift the economic model from transactions to outputs, which normally are measured by process-based SLAs or cost savings targets. In addition, performance-based models shift risk for achieving the output to the supplier. Although performance-based models focus on outputs, many still use transaction-based pricing triggers for the base book of work. For example, an organization outsourcing call center services still pays a cost per transaction (most often a cost per call or minute). However, the agreement includes incentives and/or penalties (also referred to as service credits or malice payments) if the supplier does not achieve performance targets.[12] (See Figure 5.3.)

A performance-based model gets its name because a buyer consciously chooses to create a formal, longer-term contract with the intent that the supplier invest in improvements designed to meet the predefined service-level and/or savings targets. These contracts are also called pay for performance or painshare/gainshare because incentives and/or penalties are tied to specific SLAs outlined in them. Buyers typically set the level of performance and competitively bid the work to determine which suppliers can best meet the requirements.

Figure 5.3 Sourcing Continuum: Performance-Based Model

Performance-based models are popular in the aerospace and defense industries. Rolls-Royce PLC was the first known organization to explore performance-based models in the 1960s. The U.S. Department of Defense (DoD) popularized performance-based models in the logistics and maintenance sector with what it called performance-based logistics (PBL) contracts because the agreements coupled maintenance and logistics support in procurement. The DoD believes that PBL agreements improve a supplier's accountability to deliver against desired performance levels. PBLs gained traction in 2003 when the DoD issued Directive 5000.1 E1.1117 requiring program managers to "develop and implement performance-based logistics strategies that optimize total system availability while minimizing cost and logistics footprint."[13]

The Defense Acquisition University developed its first PBL course in 2004 and then asked the University of Tennessee to create a course to teach government contractors how to properly apply the concepts to governance bids that required a performance-based approach.[14]

Some service industries are seeing an evolution in managed services agreements. Under such an agreement, a supplier typically guarantees a fixed fee with a preagreed price reduction target (e.g., a 3 percent year-over-year price decrease). Managed services agreements assume that suppliers will deliver on productivity targets. These guaranteed savings are often referred to as a savings glidepath because there is an annual price reduction over time. Managed services agreements use a performance-based model.

The well-structured performance-based agreement is a win-win because buyers win with guaranteed performance and pricing. Suppliers win when they are able to beat their proposed price, since improvement beyond their price commitment adds to their bottom line. Lawrence Kane, a certified outsourcing professional and senior leader of IT Infrastructure (ITI) Strategy and Sourcing for Boeing, explains why performance-based agreements can be a win-win.

> One of the biggest value points that motivates a supplier to sign up for added risk to meet the service and cost savings guarantees is that a supplier gains scope, scale, and ownership where they can actually affect needed changes. For a performance-based model to work, the supplier has to have sufficient control of processes and tools to drive continuous improvement so that they can reduce pricing while still making a profit. It is essential that a buyer contracts for outputs and doesn't *overspecify* the

how by being overly restrictive with requirements that specify detailed for processes and tools.[15]

Most performance-based models have three to five year terms, which allows suppliers to recover their investment and improve margins after making an investment. However, contract length must be commensurate with the supplier's investment and risk. The more supplier investment needed, the longer the contract should be.

Think Like an Economist

Many organizations hesitate to move to a performance-based Sourcing Business Model because they fear the lock-in associated with longer-term contracts and increased supplier dependency. This is a false concern because buyers create performance-based models by choice, not out of necessity. Buyers who adopt a performance-based model typically find at least a small number of qualified suppliers that can serve their needs. A well-structured agreement helps them exit a supplier relationship with minimal risk. In some spend categories, very few suppliers can work effectively under a performance-based model (e.g., DoD engine maintenance and logistics support contracts). However, in other spend categories, such as construction and facilities management, many suppliers have reputations for successfully operating under performance-based models.

Suppliers are also wary of using performance-based models. While almost any supplier will say that creating a stronger, longer-term relationship with a client is good thing, many suppliers complain buyers adopt a muscular "all risk, no reward" mindset; suppliers are thus cautious to enter performance-based agreements. This is a well-justified concern because many buyers do not know how to properly structure these models.

The fear should not be entering into a performance-based model, but rather entering into one that is not well structured. A well-structured performance-based model creates tremendous value not just for the buyer but for the supplier who takes on additional risk and achieves excellent results.

It is important to remember that a performance-based Sourcing Business Model is a relational contract. Ed Hansen, a partner/leader of McCarter & English's Business Technology and Complex Sourcing

Practice, insists that the right mindset for a performance-based agreement is key. "All too often buyers approach performance-based agreements with the wrong mindset. Shifting too much risk to a supplier can actually backfire and cause the relationship to be strained—especially if a supplier is forced to accept noncontrollable risks." Hansen offers sage advice:

> Buyers need to think like economists when it comes to performance-based agreements. If the economics of the relationship get out of alignment, one party may no longer feel it is getting a good deal or receiving benefits that exceed its effort and costs. For a sourcing effort to be economically rational, risks and rewards must be allocated appropriately. You need to determine who bears the risk and the appropriate premium for a supplier that accepts additional risk. Simply shifting risk is myopic. While a supplier might feel inclined to agree to take on the risk, it can actually backfire if the economics of the relationship get out of alignment and the supplier's margins slip too far below market margins.

Phil Coughlin, president of global geographies and operations at Expeditors International, agrees and offers a supplier's insight. "Over the last several years in the logistics space," he said, "buyers have become much more aggressive at shifting risk." Coughlin shared an example of a customer that required a consequential damages clause with liability terms of $500 million, which equated to 500 years' worth of the annual cash value of the commercial contract. "I believe in taking calculated risk, but it is important to do the calculation, and the math has to make sense from a benefit versus risk ratio," he added. Unfortunately, many organizations seem to be hiring negotiators who don't get the math or simply don't care. "More often than not," Coughlin adds, "the response we are getting when we try to share the logic behind why price has to be commensurate with risk is simply 'All your competitors have said they will accept our terms and conditions and make these guarantees.' It's a gut-wrenching decision. As president of Expeditors, do I sign the contract and hope like heck a risk does not come to fruition? Or do I walk away from a $20 million account?"[16]

Lawrence Kane agrees that buyers often don't get the math right. He adds:

> The way most IT performance-based deals are structured, suppliers make significant investments in streamlining, automating or offshoring work. Let's say you have a five-year IT outsourcing agreement. Suppliers

> typically lose money in the first year or two of the agreement because they are betting that they'll be able to make improvements that will allow let them earn profits on the last three years of the contract. If a buyer does not understand the economics and negotiates too aggressively, it risks driving the supplier's margins too thin. This can backfire for the buyer because suppliers either won't invest or they wind up nickel and diming you to death with change orders, send in the B-team, or do whatever it takes to get back to a profitable state.

Piotr Polak, chief executive of Poland's Chartered Institute of Cooperation, encourages organizations to challenge conventional mindsets and procurement processes when adopting more sophisticated relational contracts. "Procurement professionals need to invest in critical collaborative contracting and best-value analysis skills to help them truly understand and evaluate deal economics when they are using a more sophisticated performance-based model. Many suppliers are staunchly against transparency. This is unfortunate because a lack of transparency is a real hindrance to getting the math right in a performance-based deal."[17]

Use a Collaborative Contracting Process

Buyers should use collaborative contracting processes when using a performance-based Sourcing Business Model. We recommend using a request for solution (RFS) process versus a request for proposal process (both are outlined in chapter 9). Piotr Polak likes using an RFS process because it takes a problem-solving approach to selecting and contracting with potential suppliers. As he explains:

> A traditional request for proposal process is analogous to putting suppliers in a box. The goal of a performance-based agreement is to allow the supplier to think outside of the box on how they can make investments that will meet your performance and savings glidepath targets. I highly recommend buyers use a bidding process that allows them to test potential supplier's solutioning capabilities. Using a collaborative contracting process will enable you to constitute a high-performing team both internally and with your potential partner during the bid process. It will allow you to get off to a good working relationship.

When buyers shift to comparing solutions instead of activities, their jobs become harder because now they are comparing apples to oranges. Buyers need to hone their skills in using best-value and total cost of ownership analysis techniques to evaluate suppliers' solutions (also addressed in chapter 9).

Why and How It Works

A well-structured performance-based model uses an output-based economic model that pays suppliers for the realization of a defined set of business outputs, such as achievement of mutually agreed-on SLAs. A good example of an output-based economic model is when an airline pays its outsourced ground crew an incentive for achieving (or a penalty for missing) a 20-minute turnaround time after the plane parks at the gate. Suppliers can earn incentives for achieving performance/savings targets and can suffer penalties for missing those targets. We believe the incentive-based structure is more effective than penalty-based agreements.

A properly structured performance-based agreement gives the supplier a broad enough span of control so it can be accountable for making changes that will drive increased performance levels or cost savings targets. Good suppliers like performance-based agreements because their workscope/span of control increases and they get longer-term contracts. They become inherently motivated to make investments that drive the increased performance or efficiency gains. Poor-performing suppliers typically shy away from performance-based agreements because they do not want to be held accountable for performance.

Example in Action: United States Navy and Raytheon

The 2003 contract between the U.S. Navy and Raytheon is a classic example of a well-structured performance-based model. The Navy's program objective was to improve the performance of the H-60 forward-looking infrared (FLIR) system, which enables an H-60 helicopter to detect, track, classify, identify, and attack fast-moving patrol boats, mine-laying craft, and similar targets.

The FLIR system is made up of three components: a turret unit (TU), an electronic unit (EU), and a hand-control unit (HCU). The FLIR was originally expected to operate at least 500 hours before failure. Unfortunately, actual availability averaged fewer than 100 hours.

Supply availability was dismal across each of the components with only 41 percent TU availability, 17 percent EU availability, and 80 percent HCU availability. Unacceptable, to say the least.

The Navy and Raytheon implemented a ten-year public–private partnership contract valued at $123 million where Raytheon would be paid a fixed price per flight-hour plus incentives. The output-based fixed price per flight-hour created inherent incentives for Raytheon to improve reliability across all three components, thereby reducing maintenance on them. Rather than measuring the percentage of times a replacement unit was shipped on time, the Navy shifted to an output-based economic model based on Raytheon's ability to keep H-60 helicopters in the air. The agreed-on output was flight-hour availability. The more hours a helicopter was mission ready, the better. Using an output metric tied Raytheon's performance to achieving what really mattered, not just success of an activity level metric. Under the performance-based model, the Navy negotiated a price per flight-hour with incentives tied to increasing the overall availability across all three units, not just fill rate. If Raytheon beat the negotiated price per flight-hour, its profitability would increase.

Inherent and expressed incentives motivated the Raytheon Depot team to invest in best processes that streamlined FLIR repair processes, improved material utilization, and reduced logistics cycle time. It also institutionalized proactive deployment of training and troubleshooting teams to reduce Depot-level repairs. In addition, Raytheon agreed to implement additional value-added services, such as an online maintenance management information system that allows for real-time data collection by the Naval Aviation Depot in Jacksonville, Florida; an online manual eliminated the need to make and distribute printed copies.

Results far surpassed the original $31 million cost savings projection. In the first three years of the contract, the H-60 FLIR components experienced a 100 percent availability rate and achieved a 40 percent growth in system reliability improvement. By the end of year three, the mean time between failures exceeded 490 hours for the TU and 1,900 for the EU. The effort reduced inventory by 25 percent, and repair response time improved 65 percent.[18] All in all, the innovative, cost-effective approach (which, by the way, stayed within existing budget constraints) was recognized in 2006 by the Secretary of Defense Performance-Based Logistics Awards Program for Excellence in Performance-Based Logistics, proving that a well-structured performance-based model is very powerful.[19]

PUBLIC MEETS PRIVATE

A public–private partnership (also referred to as PPP, P3 or P^3) is a partnership between government and one or more private sector companies. PPPs are created for the purpose of completing a project (or getting a service performed) that will serve the public. PPPs typically are used when a government entity wants to harness the expertise and efficiencies of the private sector or when the government needs to perform a service and does not want to borrow to complete a project. PPPs are common in construction and health care. For example, in India, PPPs have been extremely successful in developing infrastructure, particularly road assets under the National Highways Authority of India and Midday Meal Scheme with Akshaya Patra Foundation.

Many PPPs (like the Navy-Raytheon PPP) are structured as performance-based agreements. Often suppliers take financial, technical, and operational risk as part of the contract, much the way Raytheon took on risk to achieve negotiated services levels at a fixed price per flight-hour. Often PPPs involve the government transfer of resources and/or assets to the private sector supplier much the way an organization would transfer resources to a supplier when outsourcing. PPP's may also be structured as Vested agreements.

Example in Action: Early Learning Coalition and CMIT

Many believe that performance-based models are only for large and complex supplier relationships. The nonprofit Early Learning Coalition of Brevard County, Florida, shows that such models can work for small supplier relationships too. The Early Learning Coalition signed a managed services agreement with CMIT Solutions in July 2011. The entire contract is 12 pages.[20]

CMIT Solutions is a leading provider of managed services and computer consulting services specializing in serving small businesses with round-the-clock technical support. The Early Learning Coalition signed a one-year evergreen contract for CMIT's Ultra Marathon Managed Services Program. Under the program, CMIT provides maintenance, repair, installation, and general network and computer support for the coalition. The agreement holds CMIT accountable to ensure uptime at a fixed monthly price.

The coalition and CMIT followed performance-based guidelines for documenting workscope. The SOW clearly outlines which work is in scope and which is out of scope. In addition, the parties carefully outlined key inputs that the coalition must follow. For example, the contract states: "Customer will provide Service Provider with access to all information, passwords, and facilities requested by the Service Provider that is necessary for Service Provider to perform services." The coalition retains the right to withhold information and access but agreed not to hold CMIT accountable for missed service levels if the CMIT could not access critical inputs.

The SOW also does a good job of outlining the "what" and not the "how." For example, one of the services CMIT provides is server and workstation preventive maintenance. The SOW reads:

> This service allows us [CMIT] to provide preventive maintenance activities on your servers, workstations and laptops to help prevent problems before they escalate into downtime, data loss, or expensive repair issues. We include the following preventive maintenance services on an ongoing basis:
>
> - Patch management (white-listed Critical Security patches for Microsoft operating systems and applications)
> - Temporary file and internet debris removal
> - Hard drive integrity checks (SMART-enabled computers only)
> - Service pack installation.

The parties use monthly reporting not just to track operational activities but also to provide a scorecard that examines "the overall health" of the Early Learning Coalition's technology.

The pricing is fair and flexible. The fixed monthly fee ensures the coalition has predictable pricing and creates an expected budget for IT support. It also outlines volumes; if the Early Learning Coalition goes over the volume (e.g., more than 72 workstations and 4 servers), CMIT can increase its fees. The pricing model also ensures that CMIT is not accountable for uncontrollable costs. For example, it is unfair to expect CMIT to predict what software employees will need. For that reason, the coalition agrees to pay software costs.

It is important to note that even small managed services agreements need to incorporate at least some level of formal governance. Although CMIT and the Early Learning Coalition do not have a contractual supplier relationship management program, in the agreement they identify key resources that maintain the relationship as they work together. They also use both monthly and quarterly business reviews and participate in joint technology planning where both parties outline anticipated technology needs that may impact either the coalition or CMIT relationship management program, the contract includes a clause that formally recognizes that business is dynamic and that both parties must be fair in allocating risk if business needs change.

When to Use

Performance-based agreements are great options for any spend category where the buying organization is not an expert and does not want to or cannot keep up with necessary investments or skills necessary to sustain competitive service levels or cost structures. Recall the example where the Navy turned to Raytheon to make the investments needed to improve reliability. Performance-based agreements are also a good fit when an organization wants to measure outputs versus activities. Shifting to an output-based economic model creates a more holistic view tied to business objectives, not just activities. Typically, the supplier takes on a broader scope and puts skin in the game by placing some of its profit at risk if it does not achieve performance guarantees.

A performance-based model is also good option when an organization is risk-averse and wants to ensure price consistency or have a supplier assume risk to meet predefined service levels. This is what the Early Learning Coalition did in its agreement with CMIT.

Performance-based agreements are excellent choices when changing suppliers would lead to high switching costs. One chief procurement officer for an insurance company who wishes to remain anonymous told us, “We define a ‘strategic’ supplier as a supplier that will take more than one year to switch and cost more than $1 million. We consider these a sweet spot for considering either performance-based or Vested relationships. We often decide to use a performance-based agreement as a stepping-stone to a more strategic and longer-term Vested relationship. This allows us to build trust with a supplier as we learn to work together more collaboratively."

Last, a performance-based agreement is a good fit when buyers need price/budget stability. With such an agreement, suppliers may "guarantee" a price reduction—known as a savings glide path.

Chapter 8 will help you determine if a preferred provider model is most appropriate for your situation.

Structuring a Performance-Based Model

As you move across the sourcing continuum to a performance-based model, both the buyer and the supplier increase their codependency on each other. Getting the structure of a performance-based model is not easily accomplished, and, unfortunately, many buyers get it wrong, which almost always leads to tensions with suppliers.

David Frydlinger, partner at the Lindhal Law Firm, lists some common mistakes buyers make when structuring performance-based agreements.

- Use of a power-based what's-in-it-for-me mindset rather than a collaborative what's-in-it-for-we mindset. The WIIFWe approach fosters an environment for a fair and balanced relational contract.
- Unclear workscope roles and responsibilities.
- Inability to allow a supplier to have a broad enough workscope and flexibility to make improvements, reducing the supplier's margin potential.
- Inadequate skills; buyers need to shift from doing/managing the activity to effectively managing a strategic supplier relationship.
- The agreement creates a rigid price for a set scope, yet the business requirements change and the agreement does not allow suppliers to optimize due to these changes. This is especially true where the spend category relies on technology investment.
- Failure to plan for a proper transition of workscope to a supplier; don't simply throw the work over the fence, as doing so often gets the relationship off to a rocky start.[21]

There is definitely an art *and* a science to structuring a good performance-based model. Failure to allow suppliers to do proper due diligence or limiting their due diligence of existing processes results in suppliers underestimating (or overestimating) their prices. The problem is exacerbated when there is a "scope sweep" clause in the contract. A scope sweep clause in essence forces a supplier to sweep extra work into an existing SOW without allowing the supplier to make pricing adjustments.

Figure 5.4 summarizes performance-based Sourcing Business Models across five key dimensions.

Business Model and Purpose

The purpose of a performance-based model is to structure a relationship that creates an environment that increases value for both buyer and supplier. Buyers receive value through reduced risk with guaranteed performance against predefined outputs. Suppliers receive value when they are rewarded fairly for achieving outputs. Because suppliers take on risk under performance-based models, buyers and suppliers need to ensure negotiations are fair and balanced.

A performance-based model should fully embrace relational contracting tactics. The negotiation process must end in a fair and balanced win-win scenario. Unfortunately, many buyers find it hard to break the habit of hard-nosed negotiating tactics. Other buyers often *think* they have a win-win mindset, but, despite their best intentions, they don't put a fair and balanced solution in place. Likewise, account executives or sales executives should try not to oversell or game negotiations. When in doubt, consider hiring a consultant skilled in collaborative contracting or a Certified Deal Architect (CDA) who provides neutral third-party facilitation during the negotiations.[22] Also, be cautious about using consulting firms that get paid based on negotiated savings. Last, exclude any team members with muscular negotiating styles who are unwilling to adopt a collaborative contracting approach. Simply put, don't let the Ice Queen be part of your negotiating team.

As you structure a performance-based model, remember that the agreement uses an output-based economic model: It pays a supplier for performance against outputs rather than triggering payments for performing an activity or completing a transaction. It is essential to properly define the outputs, how they will be measured, and how suppliers

Figure 5.4 Summary Structure: Performance-Based Model

		PERFORMANCE-BASED/MANAGED SERVICES
BUSINESS MODEL		
Business Model	Economic Model	Output Based
Business Model	Relationship Model	Relational Contract—Collaborative
Vision & Intent		Performance to SLA—Process Efficiencies
SCOPE OF WORK		
Statement of Work & Objectives		"What" Limited Emphasis on "How"
PERFORMANCE MANAGEMENT		
Performance Focus		Output Based Service Level Agreements
Performance Measures		Operational + Relational (Values & Behaviors)
PRICING		
Pricing Model & Incentives		Price with Incentives and/or Penalties
GOVERNANCE		
Relationship Management		Oversight Emphasis: Supplier Relationship Management
Improve, Transform, & Innovate		Supplier Driven to Meet SLAs/Price Glide Path
Exit Management		Perf Based Termination for Cause w/Safeguards
Compliance & Special Concerns		Corporate Based Audit Requirements

will be compensated. The box in chapter 3 titled "Understanding Transaction, Output, and Outcome Metrics" explains the difference.

Workscope

As in a preferred provider model, in performance-based models, a buyer should consider bundling workscope. The U.S. Navy did this for the FLIR program, giving Raytheon responsibility for all three of the component units within the FLIR system. This was essential because the only way Raytheon could achieve the flight-hour availability metric would be if its control spanned the entire subsystem.

The workscope must be clearly defined to ensure that the supplier is not penalized for a lack of performance due to a failure on the customer side. Roles and responsibilities must be spelled out very clearly.

Clarity of workscope does not mean being overly prescriptive. Remember, buyers use performance-based models when they want, need, and value suppliers' expertise and ability to create value through improved service and reduced costs. Entering into a performance-based model must send a strong signal to a buyer's internal organization: "We hired the expert; we need to let them be the expert." A foundational change of philosophy must take place within the buyer's organization to give the supplier the control to make changes in existing processes. As such, a well-structured performance-based model shifts workscope definition from "who" and "how" to "what" and greatly reduces or altogether eliminates references to the "how." After all, you hired the expert, right?

Letting go does not mean losing control. There is still a documented "how." The key difference is that the supplier defines the "how" in a performance work statement (PWS). Think of a PWS as a supplier's defined SOW. The supplier defines the "how" because it is the one that is accountable for delivering the "how"—including driving continuous improvement opportunities that help it meet performance guarantees.

Last, many buyers believe that performance-based agreements are risky because their organizations will lose control over compliance and regulatory concerns. Andrew Downard, a Certified Deal Architect (CDA), explains: "Performance-based agreements definitely shift to a less prescriptive statements of work, and this makes folks in charge of quality nervous; however, a well-structured agreement adds governance protocols that allow the supplier to make suggestions for changing the 'how' if it leads to performance enhancements or cost savings. It is important for a buyer to ensure the appropriate business owners and/or quality leads are in a front-row seat on governance teams for any scope change, since they are the experts."[23]

ADVICE FROM A PRO

As a buyer, you need to ensure your performance-based agreement creates economies of scale and flexibility for a supplier to take ownership/accountability to drive improvements against targeted service levels and cost targets. Buyers should specify "what" is in the SOW and how you'll measure success in the SLAs but then let the supplier figure out the "how." The only "how" you'll want to define are minimal requirements for interoperability (such as common incident/problem management systems, especially in a multisourced environment) and security, regulatory compliance, and the like. It's very important to make sure that all bidders (especially nonincumbents) deeply understand the size, scope, complexity, maturity, and regulatory environment of the work that they're getting into.

Lawrence Kane, a certified outsourcing professional and senior leader, ITI Strategy and Sourcing, Boeing.

Performance Management

A performance-based agreement measures both operational and relational success. There are two key differences between a performance-based and a preferred provider model. The most obvious difference is, in a preferred provider model, both buyers and suppliers measure the overall health of the relationship. Because buyers and suppliers become more codependent under a performance-based model, it is essential for the parties to actively monitor the health of the relationship. Simple performance-based agreements tend to use customer satisfaction as the most critical measurement. More complex relationships create more advanced mechanisms for measuring overall relationship health.

The second key difference is the lens through which buyers and suppliers view operational performance. A performance-based model has a broader view on performance management than does a preferred supplier model. While both use SLAs, a performance-based model shifts to output-based SLAs instead of transactional ones.[24]

Output-based SLAs shift thinking from measuring a functional activity to measuring the results of a process, such as how the Navy measured Raytheon's ability to meet flight-hour availability. Often buyers have inputs (such as information, timely approvals, subcomponents, activities, etc.) to the supplier that are essential for success; thus, it is important to ensure that buyers measure the inputs for optimal success. The IT sector stresses using operational-level agreements (OLAs), which are internal back-to-back agreements that define how buyers and suppliers will work together. Working together is important because it helps to prevent buyers and suppliers from acting in silos.

Buyers and suppliers must mutually define and agree on the operational scorecard and associated metrics. Why? Because suppliers earn incentives (or penalties) based on their ability to achieve success against the scorecard.

Pricing Model

A performance-based model uses a price with incentives and/or penalties (also referred to as service credits or malice payments). The price usually includes guarantees for performance and/or a cost savings glidepath. The price can take many forms but typically revolves around one of two compensation methods: fixed price or cost reimbursement.

In a fixed-price compensation method, buyers and suppliers agree in advance to a price. The fixed price may relate to an individual transaction (e.g., price per call, per minute, per full-time equivalent, per hour, per unit, per shipment, per square foot, etc.) or to a set of transactions bundled together (e.g., fixed monthly management fee, such as in the Early Learning Coalition agreement).

A cost-reimbursement compensation method pays suppliers their actual costs in performing a service plus a markup. The markup can be a percentage (e.g., cost plus) or a fixed fee. By definition, cost reimbursement is a variable price agreement, with fees dependent on the amount of service provided over a given time period.

One of the key advantages of moving to a cost-reimbursement method is to achieve increased transparency on underlying cost structures. Transparency brings many benefits, including creating a more fair and accurate way to measure cost savings. Transparency also makes it much easier to identify opportunities for cost reduction because the underlying cost drivers are fully visible.

A performance-based agreement typically splits pricing between "base" service fees (e.g., monthly fee to manage the workscope) and event fees tied to outputs. The monthly fee typically covers all the basic costs necessary to set up and perform the service, whereas the event fee is for achieving the outputs. This method protects suppliers' base cost/profitability while letting buyers see savings over time from baked-in price reductions and tying suppliers' fees to outputs.

Performance-based models should have either inherent or expressed incentives. Some organizations choose to include penalties, which the authors believe are less effective than incentives. An expressed incentive is typically a formalized reward for suppliers but can also be a reward for buyers. When considering incentives, most people think of tangible ones given to suppliers for a job well done. However, some of the most powerful incentives are inherent, meaning they are embedded into the overall framework of a buyer–supplier relationship. Inherent incentives are created as a result of the combination of the Sourcing Business Model and chosen compensation method.

Inherent incentives are by-product of a well-structured (or poorly structured) agreement. They are powerful because they naturally drive behaviors between buyers and suppliers, often creating very positive or negative results. Unfortunately, many buyers do recognize inherent perverse incentives in supplier agreements that can lead to negative and even fatal mistakes. A perverse incentive is a direct negative or unconscious behavior that drives unintended consequences. A poorly structured performance-based agreement causes friction between buyers and suppliers. See Exhibit A2 in the appendix for a list of the most common perverse incentives.

Chapter 9 provides additional insight into pricing models and incentives.

A well-structured performance-based agreement includes an incentive framework, which is a mechanism to measure performance and trigger incentive awards or payments. Using a clearly defined incentive framework with mutually defined terms is critical for both suppliers and customers. Unfortunately, in far too many performance-based agreements, buyers tend to unilaterally make the reward determination for incentives or penalties without input from suppliers or key user stakeholders. If this determination is not done properly and fairly, a more adversarial buyer–supplier relationship may result.

Buyers also need to work with their finance function to ensure the organization has mechanisms in place to pay supplier incentives. One buyer who wishes to remain anonymous admitted, “We knew our performance-based agreement was successful when we needed to pay out the incentive bonus. However, when it came time to cut the check, we realized our finance function didn’t have a mechanism in place to physically cut a check to the supplier. It took us two months develop the appropriate process to pay out incentives. The next time I structure a deal with incentives, I will make sure finance is in the loop.”

Governance

As a supplier relationship shifts along the sourcing continuum, so too does the need for additional governance. Organizations need to adopt SRM practices to handle the more strategic nature of a performance-based relationship. As part of the SRM process, buyers and suppliers conduct periodic reviews with senior management participation from both parties. Typically the business owner(s)/service user(s) participate in the reviews. For example, in an IT managed services agreement, the buyer, the supplier relationship manager, and the director of IT attend formal quarterly business reviews with the supplier.

Next we provide high-level guidance for designing a governance structure for a performance-based model across four governance dimensions: relationship management, transformation management, exit management, and compliance/special concerns.

Supplier Relationship Management A well-structured performance-based model applies formal SRM processes and protocols. Many formal SRM frameworks are available that are quite good. Most large consulting firms, such as EY, Accenture, PricewaterhouseCoopers, and ISG, include SRM frameworks as part of their consulting efforts. Smaller organizations, such as Vantage Partners, the Forefront Group, the Governance Academy, and Old St. Labs, are also well known for their efforts to teach companies SRM practices. The important thing is to pick an SRM framework and use it for suppliers that fall under a performance-based model.

Although each SRM framework is unique, several best practice themes apply to a performance-based model.[25] These include:

- *The business owns the relationship.* Procurement plays a key role in facilitating the SRM process and establishing a cross-functional team so that the interests of all relevant stakeholders are served. However, the business owns the relationship and directly collaborates with the supplier so that business objectives are achieved.
- *Executive sponsorship and involvement.* The importance of partnerships is emphasized and the right priorities are set.
- *Dedicated governance structure.* Buyers and suppliers have key roles in how they work together. The structure is essential because supplier relationships are often not established in a structured way so that reporting lines, roles and responsibilities, and communication are clear. Fuzzy communication is exacerbated by the fact that often employees are involved in partnerships part time only, which results in a lack of focus.

Contracts for performance-based models should include a formal schedule or appendix that outlines how buyers and suppliers will proactively manage the relationship.

Transformation (Continuous Improvement/Innovation Management) A performance-based model is designed so that the supplier takes risks to achieve performance and/or cost savings targets for workscope under its control. This means that the buyer has already identified and contracted for the desired level of improvements and burden of continuous improvement lies within the supplier. Within a performance-based agreement, the supplier has the flexibility and freedom necessary to drive essential changes in order to meet SLAs and cost reduction targets. Although the supplier is ultimately accountable and contractually obligated for improvements, an organization must ensure that the buyer and business stakeholders help the supplier drive process changes. In particular, the governance processes should include mechanisms for recording ideas and projects, tracking their progress, and ensuring both parties are aligned on improvement areas. Having the buying organization provide senior-level sponsors for the suppliers' project teams further assists in breaking down any barriers and helps deliver the performance both parties are looking for.

Exit Management A third aspect of governance is exit management. Performance-based models are used when the environment demands higher levels of codependency. Codependency happens in two ways.

First, performance-based models—by design—have longer terms. There is no "right" answer to contract length. However, more complex workscopes requiring supplier investment are at least three years and sometimes span five or more years. Longer-term contracts are needed because they allow suppliers to recover their investments and improve margins after making those investments. The more supplier investment needed, the longer the contract length. It is not uncommon for performance-based models to include options to extend the contract one year at a time for up to five to seven years. We have even seen ten-year contracts and one 25-year performance-based model contract. In cases where the workscope may be simpler or fairly stable in nature (such as the Early Learning Coalition case), it is possible to have one-year contracts that include automatic renewal if suppliers meet certain standards.

Performance-based models are designed to give suppliers the freedom and flexibility to make changes to the workscope—the "how." Typically buyers bundle workscope to provide more flexibility for suppliers to make improvements. For example, by bundling dining and cleaning services into an "integrated" facilities management contract, suppliers can drive cost reduction through economies of scale in overhead and staffing management.

Combined, larger and longer-term contracts increase the risks for both buyers and suppliers by making exiting a performance-based relationship much more complex. With added risk comes added responsibility to put more time and energy into exit management planning. Performance-based agreements, by design, focus on termination for performance failures. Many organizations wonder how to deal with standard termination for convenience and termination for cause clauses. Buyers can start with the organization's standard clauses; however, it is likely that suppliers will push back on standard clauses. This is not only expected, it is appropriate because suppliers are making investments in the organization's business solutions. The more asset-specific the investment, the more buyers need to look at these two termination clauses through different lenses. A key differentiator is not the clauses themselves but the amount of time and protocols for how buyer and supplier will unwind. For example, ask: "What is the appropriate amount of time to safely shift work to a new supplier?"

A second key differentiator is that termination clauses consider the costs associated with early termination, especially terminating for convenience. If suppliers make asset-specific investments that have not been amortized, buyers need to make the suppliers whole if buyers terminate early for convenience.

Compliance and Special Concerns Last, as with a preferred provider model, buyers put in place processes and protocols to audit compliance and external requirements that are unique to the suppliers' workscope. Because of increased codependency, buyers often have more advanced corporate audit requirements for these suppliers.

In some industries, performance-based models have more compliance and external requirements than preferred provider models due to the level of codependency. The focus includes topics such as how the firms will handle intellectual property (IP), data rights, compliance, or other government requirements. For example, CMIT had preexisting IP when it signed the contract with the Early Learning Coalition. As part of the agreement, CMIT agreed to provide the coalition with a perpetual, worldwide, royalty-free nonexclusive license to use the CMIT IP for its internal business uses. This ensured that the Early Learning Coalition would not have service disruption in the event that it switched suppliers at the end of the contract.

INHERENT INCENTIVES/PERVERSE INCENTIVES

This chapter profiled the most commonly used relational contract models: preferred provider and performance-based models. These two models are a great step in the right direction to build more strategic relationships with suppliers.

One of the beautiful things about shifting along the sourcing continuum is that a properly structured relational contracting model creates inherent positive incentives for both buyers and suppliers to make investments that create value. Suppliers are incentivized to add value and reduce prices in exchange for longer-term, closer relationships. The performance-based model pushes suppliers to do things better at lower prices to preserve their profit margins.

Although relational contracting models bring solid advantages, they are not a panacea and should not be used for all of an organization's sourcing needs. One reason is that not all suppliers are strategic. It does not make sense to put time and effort to make all of your suppliers preferred, and it certainly does not make sense to have a large number of performance-based relationships. As mentioned, chapter 8 will help you decide if either of these Sourcing Business Models is a good fit for your situation.

Knowing when to use preferred provider or performance-based models is only half of the battle. Getting relational contracts right starts with embracing a what's-in-it-for-we (WIIFWe) mindset. Learning how to architect a commercial agreement and ground rules that keep the relationship fair and balanced is the next step, especially when the sourcing environment demands a supply solution that requires codependency with a supplier.

Get it right, and you'll get real results, much like the Navy did with Raytheon.

Get it wrong, and you will quickly find your good deal going bad.

Good Deal Gone Bad

One example of a strategic deal gone bad is a five-year deal Apple and GT Advanced Technologies signed in October 2013 for GT to produce sapphire glass in unprecedented quantities, sizes, and quality. The strategic alliance stated:

> GT will own and operate ASF® furnaces and related equipment to produce the material at an Apple facility in Arizona where GT expects to employ over 700 people. Apple will provide GT with a prepayment of approximately $578 million. GT will reimburse Apple for the prepayment over five years, starting in 2015.
>
> Although the agreement does not guarantee volumes, it does require GT to maintain a minimum level of capacity. GT will be subject to certain exclusivity terms during the duration of the agreement. GT expects this arrangement to be cash positive and accretive to earnings starting in 2014. Gross margins from this new materials business are expected to be substantially lower than GT's historical equipment margins. However,

> the company believes the strategic nature of this agreement and the benefits associated with building a recurring revenue stream are important to its continued diversification.[26]

Unfortunately, it didn't take long for GT Advanced's chief operating officer, Daniel Squiller, to find out that he was in a sea of red ink. The company's strategic deal with Apple soon became its least profitable one: not just bad news for GT Advanced, but catastrophic. On October 28, 2014, just over a year after the initial deal was signed, Squiller called the relationship "unsustainable," citing his company's "liquidity crisis," and filed for Chapter 11 bankruptcy. The publicly released bankruptcy declaration revealed that Apple's strategic contract did not allow GT Advanced to negotiate changes to the pricing regime. GT Advanced found itself selling sapphire material at a substantial loss.

Obviously, the situation was a losing one for GT Advanced. But what about Apple? It lost its quest to have a "strategic" contract that guaranteed pricing, and disappointed consumers because it was unable to meet new product deadlines for durable sapphire glass in the iPhone 6 and iWatch. Plus, the hefty $578 million prepayment for a deal gone bad was no small issue.

One could say that the companies negotiated a deal for getting to yes but failed to lay the foundation for a truly strategic and collaborative supplier relationship designed for Getting to We. The bottom line is that Apple and GT Advanced's hearts and minds went in one direction, but their pocketbooks and processes created a countermovement.

Stuck in a Virtual Catch-22

Unfortunately, many organizations find themselves caught in virtual Catch-22s when trying to create more strategic supplier relationships. The problem lies in how companies think about, and execute, sourcing and contracting for their strategic suppliers. This disconnect happens when an organization says it wants a strategic partner but fails to use relational contracting practices. Often buyers approach their sourcing initiative with the wrong mindset, using a competitive WIIFMe approach instead of a collaborative WIIFWe mindset. In other cases, buyers apply conventional procurement processes and tools designed to commoditize a good or service rather than encourage suppliers to invest in value-added services.

Here are a few Catch-22 examples in action.

First, many organizations have procurement policies that are designed to promote competitive tension. Many organizations have “must-bid” policies and rules that limit contracts to be no longer than three years. This can work well in preferred provider models but is not so good for larger, more complex performance-based models that require suppliers to make investments (especially asset-specific ones) designed to promote process efficiencies and enhanced performance. One Fortune 100 company even had an “every dollar, every year” mantra that required buyers to bid every contract every year, regardless of whether doing so made sense or not.

Arjan J. van Weele, who holds the NEVI chair in purchasing and supply management at Eindhoven University of Technology in the Netherlands, warns procurement professionals that continuous and relentless competitive bidding leads to “ritual dances between purchaser and supplier [that] usually deliver limited results.” He adds, “Moreover, this process consumes valuable time. Second, when applied among a small group of suppliers, it promotes silent agreements among them and the forming of cartels.”[27]

Emmanuel Cambresy, global supplier performance and innovation manager for one of the world’s largest pharmaceutical companies, shares his insight about what he calls “compulsive” competitive bidding. “The compulsive approach to competitive bidding reflects the failure of many procurement professionals to own and execute the ‘R’ in supplier relationship management. In more strategic spend categories—especially where business continuity is paramount—switching suppliers should ultimately remain the very last resort to consider, only when all existing supplier relationship levers have been truly exhausted on both sides.”[28]

Buyers make the situation worse by using a power-based muscular style that pits supplier finalists against each other as they negotiate to get greater concessions. Many buyers, such as the Ice Queen highlighted in chapter 1, feel the need to win at all costs. One firm’s procurement group got the reputation as the pit bulls of procurement. One pit bull, who prefers to remain anonymous, openly admitted, “I used to know I was doing a good job when I had the vendor naked, bleeding, and crying at the table.” How can you expect to play a win-

win game (or at least promote a positive relationship) when you use trust-busting tactics?

Lawyers are not helping matters. Lawyers, by design, are required to protect their firms. To do so, they try to avoid risk for the buying organization and push suppliers to adopt standard contract templates. On one hand, buyers are looking for long-term strategic relationships, but, on the other hand, the legal department is mandating a 30-day term of convenience clause that contradicts the organization's very intent. To a supplier's chief financial officer, this translates to a 30-day contract instead of the intended long-term relationship.

Suppliers also argue that far too few organizations have lawyers who understand IP rights. Buyers expect strategic suppliers to bring them their best innovations. But suppliers are no longer interested in investing when the buyer's lawyer insists that the buyer owns the IP and all future derivatives.

Another vexing problem is that preferred provider and performance-based models typically do not promote pricing transparency. Buyers expect suppliers to have value-added services but fail to recognize that these hidden costs are baked into the suppliers' price. Buyers have no way of knowing if a supplier operating with a fixed-price structure under a performance-based agreement has "fair" prices over the life of the agreement. This is especially problematic in IT managed services deals where costs of technology have decreased. Many buyers entered into long-term agreements thinking a 25 percent price savings guarantee was a fantastic bargain. However, they didn't realize that suppliers were going to offshore most of the work at drastically reduced costs. Nor did buyers factor in hardware costs declining at the rate they have or the trend to shift to cloud-based services. Many savvy consulting firms do bake in benchmarking terms to require regular price checks, but pricing opaqueness creates friction that could be avoided with transparent pricing and proper incentives to drive down cost structures, not just the price.

Emmanuel Cambresy explains price transparency:

> I have seen a number of supplier agreements which have been structured to promote improvements and process efficiencies, while simultaneously being supported by totally opaque/transactional cost structures. This is one of the most common inherent flaws in traditional performance-based relationships. How can you and your supplier expect to agree on cost baselines, improvement targets, and performance measurements

> against process outputs when the end-to-end costs of such processes are not shared? Simply put, a buyer's need to improve is best served by a transparent cost structure that enables a focus on true total costs.[29]

Suppliers are not innocent either.

In the rush to get the deal done, supplier sales reps don't push back and demand due diligence. This situation is exacerbated by little or no pricing transparency, and suppliers often wind up not fully understanding the true costs of value-added services or the risk they have agreed to. The result? Suppliers often overcommit. When they realize the true costs of being a preferred partner, they face internal pressures to cut costs and, perhaps, even cut corners.

When suppliers face margin compression, or the possibility of making a smaller profit, they often:

- Forgo needed investments. For example, a facilities management provider may skip preventive maintenance on all but the most critical items if they feel the risk of downtime is low.
- Switch out the A team for the C team.
- Fight back with an aggressive approach to manage scope creep, nickel and diming the buyer for any out-of-scope items.
- Consciously take the SLA penalty rather than invest in what it takes to keep the SLA in place.

Each of these actions creates a lose-lose for both buyers and suppliers.

Gresham's Law in Action

Probably one of the most troubling Catch-22s is that many spend categories and, in some cases, entire service industries are suffering from gross overcommoditization (a compelling drive to standardization and treating all providers the same). There is a real Gresham's law at play across many spend categories. Gresham's law is an economic principle that states, in essence, "Bad money drives out good."[30]

Phil Coughlin of Expeditors International explains how Gresham's law impacts the third-party logistics sector. "We've seen a significant increase in buyers commoditizing our services and shifting risk. As margins erode, there is a real risk of driving away good third-party logistics service providers (3PLs). We like to think of ourselves as one of the most progressive and service-oriented suppliers in the 3PL service sector. However, it is demotivating to invest in value-added solutions for our clients when we know at the end of the year we'll just be back at the negotiating table facing aggressive price pressures again."[31]

Logistics expert/analyst Adrian Gonzalez agrees that procurement departments are overcommoditizing 3PL services. "I know of a company that actually performed a reverse auction to select a 3PL to manage its nine-figure transportation spend and daily operations. In other words, this company was turning over several hundred million dollars of transportation management responsibility to the lowest bidder over a computer. It's a sad case of overcommoditization that—if not stopped—creates a perverse incentive where the leading suppliers stop investing and innovating."[32]

We believe this overcommoditization can result in a death spiral. The logic behind the death spiral is simple. Although it seems counterintuitive, an organization's commitment to become more strategic actually can have a negative perverse incentive.

Here is why. If an organization chooses to buy competencies from a strategic supplier, why should it continue to invest in the relationship? After all, a longer-term strategic agreement encourages *suppliers* to invest. But what if the buyer has not done a good job at structuring the agreement? For example, if a buyer and supplier are unclear on workscope definition, the supplier may find itself doing more work than anticipated, which erodes its profit potential, and the losses begin. When the supplier's chief financial officer realizes that the deal is contributing to a sea of red ink, the supplier becomes more rigid and less willing to proactively invest in the relationship. Service slips, and the buyer gets frustrated. The buyer bids out the work, and unless the cycle is corrected, it repeats. And the cycle speeds up the more a buyer thinks of a good or service as a commodity that can and should be bid out frequently.[33]

Todd Shire, former logistics global sourcing strategy manager for Intel, told us how easy it is to fall in the trap. "Our strategy had been to frequently rebid and transition our business from supplier to supplier, always chasing the lowest transaction costs. We could feel comfortable that we were paying the lowest market price for a specific service, but we weren't creating value through the relationship with our service providers. We were stepping over a dollar to pick up a dime."[34]

In situations like this, Gresham's law begins to kick in. The more commodization, the less willing a supplier is to invest. The less the supplier invests, the more its product or service turns into a commodity.

In some cases, organizations become so frustrated they are tempted to throw in the towel and bring the work back in house. In other cases, buyers give up their quest for a strategic supplier and return to multiple sources, shifting back down the sourcing continuum. Why bother to have a strategic relationship if it is not delivering on the promise?

But the most savvy procurement professionals seek to escape the Catch-22. For some, doing this starts by embracing relational contracting approaches and applying the lessons offered in this chapter on how to properly structure preferred provider and performance-based Sourcing Business Models. For others, it means taking the plunge into a brave new world that unlocks the hidden potential of a truly collaborative Vested Sourcing Business Model. We encourage you to stop spinning your wheels.

CHAPTER 6

VESTED: A BRAVE NEW WORLD

When we think of the great innovations that come our way, we might instinctively think of them as the product of a sudden brainstorm from an individual—a light bulb moment, if you will. But, in reality, good ideas can come from anywhere. Leading companies find that innovation is often produced over time with a lot of collective sweat equity. And that includes perspiring suppliers.

Most organizations say they want suppliers to be innovative and collaborative. But they approach these concepts as separate efforts or skill sets. Or worse, they simply say collaboration and innovation and do not actually do anything differently.

Research at the University of Tennessee (UT) has found that innovation and collaboration are not mutually exclusive; they feed and build on each other. It's not either/or. Innovation happens *through* collaboration. And the best organizations not only *say* they want innovation and collaboration; they *contract* for it.[1]

PROCTER &GAMBLE'S COLLABORATIVE INNOVATION IN ACTION

Using a highly collaborative approach to drive innovation is exactly the approach P&G began using in 2000 when A. G. Lafley took the helm as chief executive. Lafley took a huge leap forward and made a strategic bet by turning to a collaborative approach to drive innovation. This concept came to be known as "Connect and Develop," and his goal was that "half of our new products [would] come from our own labs, and half would come through them."[2]

Lafley's "Connect & Develop" paid off and spurred a huge wave of innovations that emanated from collaborations with "outsiders." A good example was the Swiffer, a highly successful brand of cleaning supplies. Looking for opportunities to expand the line, the P&G team had worked on a handheld dusting tool, but without much success. On a trip to Japan, the research and development leader for home care found the answer in the cubicle of a P&G employee: a sleek, user-friendly handheld duster that was better than the products P&G was testing. Its curly fiber captured dust, dirt, and hair far better than anything P&G had come up with, but it was owned by Japan's UniCharm. The problem turned into a collaborative opportunity when P&G bought the rights to UniCharm's duster outside of Japan. A win for P&G and a win for UniCharm. The Swiffer Duster was an instant success: In the first four months, it cleaned up $100 million in sales.[3]

P&G took collaboration to a new dimension when it developed a highly collaborative outsourcing relationship for facilities management with Jones Lang LaSalle (JLL) in 2003. The companies established a precedent-setting commercial agreement that flipped conventional outsourcing on its head by contracting for mutually defined Desired Outcomes instead of transactional, day-to-day work. A key objective was to drive innovation in facilities and real estate management to unprecedented levels.

Why outsource? After all, benchmarking had shown that P&G's facilities and real estate management processes were already world class. Making such a big bet could be risky, but it could also pay big dividends. William Reeves, P&G's director of global workplace services at the time, commented when he signed the deal with JLL, "We know that you [JLL] and the other suppliers we evaluated have never done this before; and neither have we," he said. "But JLL has the culture that is much like P&G's. We think we have the best chance of being successful with you because you are so much like us."

Larry Bridge, the P&G leader in charge of contract governance for JLL, reflected on the success of the JLL relationship. "As much as we give credit to relationships, we have a really good contract. It is simple and drives the right behaviors. The transparency, cost pass through, and incentive features allow us to be aligned versus being on opposites sides of the table negotiating." The P&G/JLL relationship is discussed as an example in action later in this chapter.

HOW DO YOU WIN AT TUG-OF-WAR? HINT: YOU DON'T

If companies like P&G and JLL are proving that collaboration can and does drive significant value for buyers and suppliers, what is preventing others from moving along the sourcing continuum to more collaborative sourcing relationships? The answer is found in the mindset and economics of how buyers and suppliers work. To use an analogy, all of the Sourcing Business Models we have discussed so far put the buyer and the supplier on opposite ends of a virtual tug-of-war with misaligned goals and economics. Here is why.

Most suppliers have a universal goal: Sell as much as you can with the highest possible profit margin. This goal is no different at Stream International, which sells outsourced support solutions to technology companies and e-businesses.[4] Stream was fortunate to have several large, strategic clients. In most cases Stream was considered a preferred provider. The company had a few performance-based agreements as well.

Stream had a small number of contracts valued at over $50 million in revenue, with most contracts ranging from one to three years. It was common practice for clients to require highly competitive bid processes when contracts expired.

In all cases, Stream's business development team and lawyers would hunker down to negotiate the contract, hoping to preserve its price point and prevent taking on additional risks without compensation.

A common example of a buyer shifting risk was the adoption of best-practice accounting to shift from 30-day payment terms to 60-day payment terms. Other risks Stream tried to avoid were unlimited liability for a breach of customer confidential data. If pushed, Stream would accept a performance-based agreement where it agreed to pay a penalty for missing service-level agreements (SLAs). In some cases, it would agree to year-over-year price reductions as part of a guaranteed savings commitment—but, typically, only if the contract length was three or more years.[5]

Going through this process was a natural part of buying and selling, and Stream's business development and legal teams were very good at protecting their business and profits. In fact, most went through formal negotiations training to learn the best tricks and techniques to ensure they negotiated the best possible deal. After all, as Charles

Karrass, a worldwide leading negotiating expert, says, "You don't get what you deserve, you get what you negotiate."[6]

The procurement process became a virtual tug-of-war, and Stream was acutely aware that the organization with the most power tended to win. The larger and more powerful the client, the more concessions Stream would expect to make. However, when Stream dealt with smaller clients, it tended to "win" more.

As part of the negotiations, the buying organization and Stream International would almost always negotiate a price for each activity performed, a practice that was customary for the industry. For example, there was a cost for every call that provided technical support for clients' customers. There was a cost per "touch" to manufacture the customer's product. There was a price per pallet to store the customer's product. In short, the more activities that were performed, the more money Stream earned. Since the sales reps were on a commission plan, the more revenue they booked, the more they got paid. If a customer pressed for lower prices in one area, it was the sales rep's job to shift the pricing around to keep Stream's profit margin whole. Thus, sales reps gave their all to maximize revenue and profitability for Stream because when the company won, they personally won.

Once a contract was signed, Stream designated a business manager to own profit and loss (P&L) responsibility for that account. The goal was simple: Meet contractual customer service levels and P&L targets. Business managers had to live with the clients for daily interactions, so for the most part, they pulled out all the stops to make the clients happy; as a result, Stream was a customer service–oriented firm.

Stream was a considered a strategic supplier for many of its clients. As such, clients expected Stream's business managers to provide proactive ideas to make the business better. After all, Stream's clients had outsourced to an expert! One of two interesting dynamics would occur.

The first dynamic had to do with the types of ideas that were generated. If the business manager found ways to bring efficiency to the client, Stream's management often frowned at the idea because it reduced revenue. When fewer activities were performed, revenue decreased. If Stream was on a cost-reimbursement agreement, its profit decreased when its costs decreased. Being efficient was simply bad business.

Over time, a culture developed where business managers focused their improvement ideas on areas that would generate more revenue for Stream. These revenue-generating ideas were termed *value-added activities*. For example, a business manager worked to deliver same-day service (for orders received by the client, to meet last-minute changes to an order, etc.) Or he or she offered to develop a solution for physical destruction and disposal of the client's inventory when the client eliminated certain stock-keeping units. Although these ideas solved a customer's problem, a charge was almost always associated with the activity.

A good business manager at Stream was very clever at identifying ways to perform an activity that would solve a client's problem. Stream solved the problem and, in return, was rewarded with billable activity. More activity meant more revenue.

The second dynamic between Stream and its clients evolved over time. When a business manager developed an idea that would have a positive impact for clients, clients often discounted the idea or chose not to approve the improvement initiative. They had two reasons for doing this.

First, clients often said, "That is not the way we did the work before. We want you to keep doing it the same way as we have outlined in our standard operating procedures." In essence, the clients had outsourced to the experts, but they were not open to changing the way the work was done.

The second reason clients gave for not wanting to approve improvement initiatives was because they would have to involve another group that controlled part of the process. For example, one Stream business manager pointed out that the client's bill of materials, which outlined the manufacturing guidelines, was often wrong—as much as 80 percent of the time. The situation was so problematic that the business management team fell into the habit of creating new bills of materials in order to produce the client's product correctly. This work was not in scope. The client's supplier account manager had tried, to no avail, to get the client's program manager to improve the internal process and correct the issues with bills of materials. The supplier account manager finally solved the problem by allowing Stream to charge a value-added service to redo the bills of materials rather than work with the marketing operations people within the client organization to create a proper Bill of Materials. This meant bills of materials were produced twice, once incorrectly by the client and then again by Stream. But the good news is the product ended up being produced correctly. The bad news is that outsourcing a bad process is costly.

THE WHACK-A-MOLE PROBLEM

If everyone gives their all, what is the problem?

The same tug-of-war occurred for most of Stream's "strategic" clients. Clients wanted the best service at the lowest cost per activity. Stream wanted the highest margin and lots of activities in order to maximize revenue and profits. If buyers pushed Stream to reduce its margin, clever people worked to sell more activities.

Once the work was implemented, the focus was on maintaining the P&L. It was capitalism and free market economics at its best. Stream's clients won if they were able to reduce the work's price. Stream won if it could maximize revenue and profits. The problem is that while each party gave its all individually, the overall solution was far from optimized.

The reason for these seemingly paradoxical solutions is that often it is much easier to fix symptoms than underlying causes. The buying organization and the supplier sit across the table from each other, putting bandages on symptoms rather than fixing the root causes of problems. Decisions are made in a vacuum to optimize the individual firm's goals rather than considering the total picture.

Kate Vitasek shared her observations in *Vested Outsourcing: Five Rules that Will Transform Outsourcing*:

> I came to call my observation the "mole theory" because the effects were similar to the Whack-a-Mole game children play. When a child whacks the mole in the game, it disappears from that hole but simply pops up in another hole. The mole is never really eliminated but is chased somewhere else. The problem was simple: everyone was working to achieve what was in their own best interest rather to work together for a much broader definition of success.[7]

Today's organizations do not have the patience to play incremental functional silo games. They need a better way.

IN SEARCH OF A BETTER WAY

What exactly is the better way? That is the question that the University of Tennessee (UT) researchers asked when they formed a small team to study complex sourcing relationships.

The UT research team studied organizations that were exploring more innovative approaches of working with their most strategic suppliers and business partners. The goal was to find the secret sauce for developing highly collaborative supplier relationships aimed at creating broad, true win-win solutions. UT looked at both the procurement process and examined actual contracts. It studied both public and private sector buyer–supplier relationships, such as the successful relationship between the U.S. Department of Energy, the Environmental Protection Agency, the Colorado Department of Public Health, and Kaiser-Hill Company, LLC to safely clean up and close the Rocky Flats Nuclear Production Site. The U.S. General Accountability Office touts this as one of the most successful government procurement efforts in modern times.[8] On the commercial side, UT researchers studied Jaguar and Unipart (logistics), Procter & Gamble and Jones Lang LaSalle (facilities and real estate management), Microsoft and Accenture (outsourced financial business process outsourcing), and McDonald's (direct spend categories spanning from beef and poultry to baked goods and special sauces). UT researchers examined more than 50 buyer–supplier relationships.

The research validated what Vitasek observed while at Stream: Although buyers and suppliers have good intentions to create highly collaborative win-win relationships, the relationships and economic model used in preferred provider and performance-based agreements often have fundamental flaws that result in direct negative or unconscious behaviors that drive unintended consequences, as profiled in the Stream example.

Researchers distilled their lessons into a systematic model they refer to as Vested Outsourcing®—or Vested for short. They chose the term *Vested* because the most successful organizations create a hybrid relationship and economic model where buyers and suppliers are literally vested in each other's success. A win for the buyer translates into a direct win for the supplier, and vice versa.

THE PREMISE OF VESTED RELATIONSHIPS

A Vested model is a hybrid relationship that combines an outcome-based economic model with a relational contracting model. Vested incorporates the Nobel Prize–winning concept of behavioral economics and the principle of shared value.[9] Using these concepts, companies enter into highly collaborative arrangements designed to create and share value for buyers and suppliers above and beyond conventional buy–sell economics of transaction-based agreements. In short, the parties are equally committed to—Vested in—each other's success.

Buyers and suppliers have the same goal: Make a profit. However, they approach this goal from opposite viewpoints. Cost to the buyer is revenue to the supplier.

The premise of Vested is simple: *Create a business model where both buyers and suppliers are able to maximize their profits together.* Doing this means creating a culture where the parties work together to make the end-to-end process efficient regardless of which party is performing the activities. *The approach also highly rewards suppliers for reducing cost structures (not prices) if workscope stays the same.*

To be successful, buyers and suppliers have to change the lens through which they look at problems; they need to adopt a boundary-spanning view, working cross-organizationally to make improvements in complete solutions that achieve real business outcomes regardless of who performs an activity. In short, the more efficient and effective the business outcomes, the more profit the supplier (or suppliers, if more than one is involved) makes.

Vested gets to the heart of the negotiations tug-of-war because it puts buyers and suppliers on the same side of the rope—they virtually pull together to create value that can be shared by both parties. Companies and individuals are no longer rewarded for giving their all to solve immediate problems and improve their individual positions; rather, they win when everyone works together toward an optimized solution. This means not just saying that the companies collaborate but truly creating a Sourcing Business Model where buyers and suppliers both benefit. The rest of this chapter helps procurement professionals understand the Vested Sourcing Business Model in more detail by profiling:

- Why and how it works
- An example in action

- When to use Vested
- How to structure a supplier agreement

THE VESTED SOURCING BUSINESS MODEL

Vested is a business model, methodology, mindset, and movement for creating highly collaborative business relationships that enable true win-win relationships in which both buyers and suppliers are equally committed to each other's success. As shown in Figure 6.1, Vested is the Sourcing Business Model that is closest to an investment-based model.

The Vested model is the farthest right "buy" model on the sourcing continuum, falling just left of the insourced solutions. The Vested methodology follows Five Rules:

1. Outcome-based vs. transaction-based business model
2. Focus on the WHAT, not the HOW
3. Clearly defined and measurable Desired Outcomes
4. Pricing model with incentives to optimize the business
5. Insight vs. oversight governance structure

When each and every one of these rules is applied, the result is a flexible relationship framework that creates a harmonized system where buyers and suppliers foster an environment that sparks innovation. A Vested relationship results in improved service, reduced costs, and creates value that didn't exist before—for both buyers and suppliers.

Each of the rules is explored in more detail in both the "Example in Action" and "Structuring a Vested Sourcing Business Model" sections of this chapter.

Figure 6.1 Sourcing Continuum: Vested Model

Why and How Vested Works

A Vested model achieves the benefits of an investment-based business model—but without the investments—by creating a relationship and economic model that promotes investment yet allows buyers and suppliers to remain separate entities. A Vested agreement uses a relational contract model and an outcome-based economic model that leverages Nobel Prize–winning concepts of behavioral and relational economics and the principles of shared value. Suppliers are incentivized to make investments to help buyers achieve strategic business outcomes, not simply to be accountable for outputs under their control or to be paid to perform tasks or accomplish a transaction. Sound science is why Vested works.

Behavioral Economics

Behavioral economics is the study and practice of how economics (monetary and nonmonetary) impact the behavior of individuals or decision makers within an organization. The study of behavioral economics evolves more broadly into the concept of relational economics, which proposes that economic value can be expanded through positive relationships with mutual advantage (win-win) thinking rather than adversarial relationships (win-lose or lose-lose).

Behavioral economics has been studied since the 1940s, when John von Neumann and Oskar Morgenstern applied mathematical analysis for modeling competition and cooperation in living things. Behavioral Economics has been applied to study simple organisms and the complex interactions of human beings. Game theory is a subset of behavioral economics in that it attempts to model human behaviors, especially when there is an incentive at stake. Specifically, game theory models how an individual's success in making a strategic decision depends on the choices of others.[10]

According to economists, there are two types of games that can be played: zero-sum games and non-zero-sum games. In zero-sum games, the size of the pie is fixed. For one participant to get more, other participants must get less. In non-zero-sum games, the size of the pie is not fixed; therefore, everyone can do better, or much worse.

Deeply rooted in mathematics, game theory began to attract attention when John Nash received the Nobel Prize in economics (along with John Harsanyi and Reinhard Selton) for the Nash equilibrium in 1994. One of the core principles of game theory that Nash made famous—and the one that's of particular interest to the Vested Sourcing Business Model—is the concept of equilibrium. Equilibrium is also referred to a *solution concept.* One of the key philosophies of game theory is to develop the strategy that will optimize the payout (results).

The Nash equilibrium teaches us to devise a strategy to play to win *relative to the other player's strategy.* This means that a player's optimized payout can be, and often is, constrained based on a competitive player's strategy. The Nash equilibrium assumes the other player is playing against you. Later research has shown that an organization or individual can improve the payout beyond that of a Nash equilibrium. The key lies in players working together toward a mutually beneficial strategy that optimizes for the cumulative payout. In other words, the power of partnerships and collaboration is not to optimize for the status quo (e.g., the Nash equilibrium) but to look for ways to change the game to create an overall larger payout. In short, the size of the pie is not fixed, and organizations can and should work together to find ways to grow the pie. This is counter to conventional procurement practices that promote using power to grow one's benefits. In reality, the more buyers and suppliers fight over their share of the pie, the more they limit the size of the pie.

A zero-sum-game attitude is typical in conventional buy–sell negotiations. This is a key reason many of today's more strategic supplier relationships fail to deliver the benefits that could be realized. Recall the Stream International example. A zero-sum game attitude is what drove Stream sales reps and business managers to react as they did. Each was optimizing for his or her personal position.

Cooperative (Win-Win) Games Win More

A win-win game is designed in such a way that all participants benefit. In economics, this is called a non-zero-sum game. Robert Axelrod's book, *The Evolution of Cooperation,* helped put the concept of win-win game theory on the map. In it, Axelrod describes computer games with participants from around the world, focusing on how individuals in groups are likely to interact with others in a competitive situation. These computer game simulations statistically prove that when individuals cooperate, they come out better than when they do not.[11]

The lessons are simple yet profound. Playing a game together to achieve a mutual interest is always better than playing it with self-interest in mind. Ergo the idea that working together toward a win-win strategy is always better than competing in a win-lose strategy that promotes self-interest.[12]

Shared Value Thinking

Shared value thinking involves entities working together on innovations that benefit everyone—with a conscious effort that the successful parties share the rewards. As discussed in chapter 1, Michael Porter encouraged the use of his Five Forces analysis to identify how a firm can create competitive advantage by levering its power and manage risk where it does not have power. Porter now promotes a twenty-first-century view for creating a competitive advantage, one that includes *creating shared value for the benefit of all.* Porter and Mark Kramer profiled their "big idea" of shared value in a 2011 *Harvard Business Review* article. In it they assert that shared value thinking will drive the next wave of innovation and productivity growth in the global economy.[13]

A Vested business model drives organizations to innovate collaboratively to find the best solutions by working in an integrated and mutually beneficial manner where the parties have a vested interest in each other's success. At its heart, Vested is about partners in a business arrangement unlocking the most efficient and effective solutions with the goal to mutually share the rewards.

Using these concepts of behavioral economics and shared value, organizations enter into a highly collaborative relational contract with strategic benefits for the business objectives of both parties. Vested's outcome-based business model is designed to create and share value for both buyer and supplier when the parties achieve mutually defined strategic business outcomes that create value.

Example in Action: P&G and JLL

In 2003, P&G signed a contract with JLL, spanning 60 countries and including facility management, project management, and strategic occupancy services.[14] P&G wanted an outsourcing relationship that challenged JLL not just to take care of its buildings but to take *charge* of its buildings.

Rule #1: Focus on Outcomes, Not Transactions
P&G made it clear the real reason it outsourced was to drive transformation and achieve "the power of AND." Its contracting approach motivated JLL to bring new ideas and determine the best way to get results. P&G shifted the economics of outsourcing to an outcome-based approach whereby it bought Desired Outcomes, not individual transactions or service levels. P&G paid JLL based on its ability to achieve mutually defined Desired Outcomes. Under this approach, both P&G and JLL shared an interest in achieving P&G's strategic goals.

Rule #2: Focus on the WHAT, Not the HOW
When P&G decided it was serious about trusting and delegating responsibility to JLL, contract negotiation was considerably simplified. P&G didn't have to create exhaustive lists of potential tasks/details because it turned over the entire facilities management responsibility to JLL. It was JLL's job to figure out what was needed and how to get it done.

Rule #3: Agree on Clearly Defined and Measurable Outcomes
Both P&G and JLL understood that measurement drives behavior. Instead of focusing on time and tasks, the companies focus on measuring success against P&G's business priorities. For example, when JLL began the relationship in 2003, the focus was on a successful transition. Then, in 2005, the focus switched to the successful integration of the Gillette and Wella businesses into the facilities management portfolio. More recently. JLL and P&G have focused on sustainability and energy management. Formal governance mechanisms allow P&G and JLL to refocus priorities as needed.

Rule #4: Pricing Model with Incentives to Optimize the Business
The P&G/JLL global team developed a pricing model that is fair yet drives accountability and transformation. Key components include:

- *Cost pass-through.* JLL is responsible for managing the budget and the costs, but P&G retains responsibility for the bills.
- *Base scope of work management fee at risk.* Under this arrangement, JLL places a portion of its management fee at risk pending its ability to achieve results. P&G pays the "at-risk" portion only

after JLL achieves mutually agreed upon predefined success factors.

- *Above-base scope work (additional fee).* P&G created a structured approach for JLL to charge it an additional management fee for any work above the base scope of work.
- *Shared savings.* There is a shared savings incentive for JLL when it helps P&G reduce cost structure.

Rule #5: Governance Structure Provides Insight, Not Merely Oversight

One of the most important aspects of the P&G/JLL governance structure is that the companies live (and manage) the business following Vested's what's-in-it-for-we (WIIFWe) mindset. One way they do this with the two-in-a-box approach that identifies both a P&G and a JLL person as joint owners of a core process. There are teams of two overseeing multiple core functions—all aligned with mutually defined Desired Outcomes. Doing this ensures that business plans and action plans are aligned between P&G and JLL. Inspired to achieve a true win-win, the two-in-a-box approach has the potential to be functionally lose-lose. That is, if one partner in the box fails, so does the other. Shared function, shared win or shared disappointment. The common fate motivates folks to do everything possible to enable their box mate to succeed.

VESTED FOR SUCCESS

JLL went from being a new supplier to P&G to winning "Supplier of the Year" three of the past eleven years in a field of 80,000 suppliers. P&G is on record saying that its Global Business Services group has reduced cost as a percentage of sales by 33 percent for its outsourced operations. These savings were not achieved at the expense of customer satisfaction. P&G's "customers"—the employees who use the facilities—are the real customers of JLL. JLL exceeded the satisfaction target for six consecutive years. JLL was a winner too, expanding its capabilities, profitability, and earning additional workscope during contract renewal.

When to Use

Vested relationships are appropriate when there is a high degree of potential risk that can be minimized by working in a highly collaborative manner with a supplier. This risk can come from being dependent on a supplier or from uncertainties in the business environment. Vested is ideal when a buyer wants to ensure it is getting the absolute best value through a transparent relationship aimed at driving innovation. Companies also see great benefit from using a Vested model when there is an opportunity to grow market share through increased products, better geographical coverage, or expanded clients through joint capabilities.

The Vested methodology requires both buyer and supplier to embed a WIIFWe mindset as part of the highly collaborative implementation process. Although Vested can be applied to both large and small supplier relationships, most organizations consider Vested approaches only for their most strategic supplier relationships that have the highest potential to create value.

Chapter 8 will help you determine if a Vested model is the best Sourcing Business Model for your particular situation.

Structuring a Vested Relationship

Vested is founded on the philosophy of win-win principles and shared value creation. If a supplier helps create value, the buyer must share this value with the supplier. Shared risk, shared reward. Getting the structure of a Vested relationship right is critical. There is definitely an art and science behind structuring a good Vested relationship.

Figure 6.2 summarizes the Vested Sourcing Business Models across five key dimensions. The guidelines in the text provide insight into how a structure a Vested agreement.

Business Model and Purpose

The primary purpose of a Vested relationship is to create a highly collaborative environment that drives innovation. A key differentiator in a Vested relationship is, first and foremost, the mindset of how an organization approaches the relationship. A Vested relationship fully embraces a relational contracting mindset—the WIIFWe mindset. An organization attains the WIIFWe mindset when it begins to pull on the same end of the rope with its suppliers.

A second key differentiator in a Vested relationship is the economic model. Rule #1 of Vested covers the need to focus on outcomes, not transactions. A Vested relationship is the only "buy" Sourcing

Figure 6.2 Summary Structure: Vested Model

		VESTED
BUSINESS MODEL		
Business Model	Economic Model	Outcome Based
	Relationship Model	Relational Contract—Highly Collaborative
Vision & Intent		Shared Vision, Desired Outcomes & Value Creation
SCOPE OF WORK		
Statement of Work & Objectives		"What"
PERFORMANCE MANAGEMENT		
Performance Focus		Strategic Desired Outcomes
Performance Measures		Operational + Transformational + Relational System Wide KPIs
PRICING		
Pricing Model & Incentives		Pricing Model with Value Based Incentives
GOVERNANCE		
Relationship Management		Insight Emphasis: Strategic Relationship Management
Improve, Transform, & Innovate		Joint & Proactive Transformation Management
Exit Management		Joint Exit Management Plan
Compliance & Special Concerns		Outcome Based Joint Requirements

Business Models that uses an outcome-based economic model. Desired Outcomes must be clearly defined and measured when the agreement is structured. Guidelines for how to structure the performance management and pricing model dimensions of an agreement are provided later in this chapter.

Is it possible to use a competitive bid situation when selecting a Vested supplier? Yes. This is the approach used by P&G and Microsoft. However, most buyers choose to work with existing suppliers and restructure an existing preferred provider or performance-based agreement rather than bid out the work. A good example is Dell, which decided to restructure a preferred provider agreement to a Vested relationship with GENCO for reverse logistics and repair operations.[15]

Workscope

As in performance-based agreements, in Vested agreements, buyers should consider bundling workscope. P&G did this when it outsourced to JLL. P&G selected JLL as the best partner to manage the transformation of offices and technical centers, including maintenance and security, in more than 60 countries. Under the agreement, JLL consolidated regional suppliers spanning all aspects of facilities management under one global contract with P&G. In 2007, P&G extended the contract and added real estate management to further drive synergies.

A critical enabler to a Vested relationship is Rule #2: Focus on the WHAT, not the HOW. Entering into a Vested relationship should send a strong signal to a buyer's internal organization: "We hired the expert; we need to let them be the expert." A foundational philosophy change must take place within the buyer's organization to give the supplier the control to make changes in existing processes.

A good example of how P&G defined workscope comes from a quick review of the P&G contract. Descriptions of major areas of responsibility are concise. For example, under 4.0 ENERGY MANAGEMENT, the contract states: "The Supplier's responsibilities shall include operating an energy efficiency program at all P&G Facilities in accordance with P&G's policies and guidelines."[16] Simple. Direct. And unequivocal in the expectation that JLL can and will comply.

One way to tell if you are thinking about workscope properly is to look at the statements of work. If your SOW is prescriptive, then it likely is prescribing the "how."

Many organizations fear that a supplier will not have strong process controls if the contract doesn't state a documented "how." We agree, and this is why we stress that the "how" should be documented in a performance work statement. The difference is that in a Vested relationship, the *supplier* documents the "how," not the buyer. Since the supplier is the expert, the "how" becomes the supplier's processes and responsibility.

Many organizations fear they will lose control in a Vested relationship. This is faulty thinking. What does change is an organization gains visibility and control in the form of a well-managed governance structure (discussed in detail later) rather than through an overly prescriptive SOW.

Performance Management

Rule #3 of Vested states that it is necessary to "agree on clearly defined and measurable outcomes." A well-structured Vested relationship focuses on delivering success against true business outcomes, not simply performance to a set of SLAs. For example, the original P&G-JLL contract outlined these five Desired Outcomes:

1. Provide services of equal or better quality at a lower cost.
2. Enjoy world-class supplier support, dedicated account management.
3. Build a global relationship to support P&G business objectives.
4. Have a supplier that guarantees the availability of resources.
5. Allow JLL to satisfy the facilities management needs of a world-class global corporation.

These outcomes were supported by just ten outcome-level measures that included three critical success factors and seven operationally focused key performance indicators. Similarly, when Dell restructured its relationship with GENCO, it reduced the number of metrics from over 100 SLAs to just six Desired Outcomes.

It is essential that the buyer and the supplier mutually define and agree on Desired Outcomes and how they will be measured. A Vested relationship has not only an operational scorecard but also a relationship and transformation scorecard that measures how effective the parties are at ensuring the overall success of the relationship and driving innovation.

Pricing Model

If a performance-based agreement is designed to shift risk to a supplier, a Vested relationship is designed to share risk and reward. Many wonder why a firm would share risk and reward when it can simply push risk on the supplier. This is a good question and one that should not be taken lightly.

A primary reason to share risk and reward with a supplier is to structure a relationship in which the goals of both buyer and supplier are tightly tied to mutually defined Desired Outcomes. Many describe the relationship as the buyer and the supplier being in the same boat. Linking incentives to common goals is very powerful because it naturally drives highly collaborative behaviors.

A second key reason to share risk and reward is because shared value creation is highly motivating for the most innovative suppliers. As discussed in chapter 5, why should a supplier invest if there is no hope of a future return on investment? It is crucial to develop supplier relationships where the economics work for all parties involved.

With that in mind, the Vested pricing model is a joint solution conceived through an open and transparent process. A buyer's pricing team sits on the same side of the negotiation table as the supplier. Together, they develop a pricing model that creates an effective, fair economic exchange between an organization and the supplier.

The idea of jointly creating a pricing model may appear counterintuitive. By doing so, however, buyers and suppliers can see the complete big picture of costs and explore hidden costs. Candid and transparent discussions allow both parties to determine the true total cost of ownership and apply best value techniques that justify the cost of business requirements. These more fact-based and frank conversations enable buyer and supplier to reach a pricing model that is fair and motivating for both organizations.

It is important to remember that a Vested pricing model always includes incentives. No matter the type of incentives used, we recommend keeping them as simple as possible.

Governance

Rule #5 of Vested is "governance structure provides insight, not merely oversight." A key difference between Vested and a performance-based governance structure is that the latter typically uses supplier relationship management (SRM) with an oversight mindset while a Vested model uses joint governance with an insight mindset that is heavily dependent on transparency. This section provides high level guidance how to design a governance structure for a Vested relationship across the four governance dimensions: relationship management, transformation management, exit management, and special concerns/ requirements.

Relationship Management

A key theme in a Vested governance structure is managing the business with the supplier, not just managing the supplier. As such, a well-structured Vested relationship goes beyond the formal SRM processes and protocols. Rather, think of SRM as *strategic* relationship management.

A well-structured Vested relationship applies a concept known as systems thinking. A system is an interconnected set of elements, sub-elements, and components that are structured in a way that achieves a defined purpose. A well-designed system with the right motivation has the structural ability to manage itself, much as the Slinky® Toy's helical springs creates a self-contained system that enables the toy to move down stairs unimpeded. A properly structured system keeps the relationship in alignment throughout its duration. McDonald's "system first" thinking for working with its most strategic suppliers is why many of its supplier relationships have lasted for decades.

A Slinky is a self-managing system, but we've all seen what happens when the toy runs into a bend in the stairs or reaches the bottom of the stairs. This is why a Vested governance structure applies processes and protocols based on insight, not just oversight. A buyer and supplier constantly scan the environment and performance against Desired Outcomes and make adjustments to ensure their Vested relationship continues to drive a competitive advantage for both partners. Simply put, a well-defined governance structure can redirect the relationship as business happens.

A Vested relationship uses an appropriately scaled SRM framework that defines and documents the following mechanisms in the contract:

- Tiered structure with clear and separate roles for relationship management, operation management, commercial/contract management, and transformation/innovation management
- Dedicated resource(s) focused on relationship management using a two-in-a-box buyer–supplier interface structure for key roles
- Formal decision-making process/rights clearly assigned
- Formal communications protocol and plan
- Change management/commercial management mechanisms
- Formal escalation process
- Formal continuity of resource plan to ensure consistent relationship interface (including *key man* provisions as appropriate)

Buyers and suppliers operating under a Vested model should jointly develop a relationship management scorecard to monitor the relationship's effectiveness.

Last, we highly recommend that a Vested relationship contract include a formal schedule or appendix that reflects the relationship management framework. This puts teeth in relationship management by making each partner contractually liable to maintain a healthy relationship.

Transformation (Continuous Improvement/Innovation Management) A key reason to enter into a Vested agreement is to proactively drive innovation/and or transformation in the spend category. For this reason, buyers and suppliers should develop a joint transformation management framework.

It is important to remember a Vested relationship is designed to share risk and reward. This means buyers and sellers mutually commit to staffing a transformation management lead for the relationship. For perspective, the Microsoft agreement with Accenture was designed with six full-time transformation managers—three from Microsoft and three from Accenture. The six were paired into three two-in-a-box teams, with each joint team being accountable for transforming processes under their area of expertise. These two-in-a-box pairs work together closely to drive proactive change against the Microsoft's desired transformation management goals.

Having a joint buyer–supplier team is important because each team member plays a critical role. Both buyer and supplier develop business cases to justify changes. The buyer plays a critical role by driving awareness, approval, and buy-in of the process or product improvements. The supplier plays the lead role in implementing the approved changes. Together, they achieve far greater success than when the supplier drives the changes under a performance-based agreement.

A good transformation management framework includes four areas:

1. Processes and protocols for driving overall transformation initiatives through a continuous innovation management process for "big ideas."
2. Processes and protocols for driving smaller day-to-day continuous improvement efforts or solving business problems that arise.
3. A formal process for updating and managing any changes to the actual commercial agreement or contract.
4. A common understanding on how any workscope transition will be managed. This is essential for new relationships but can also apply to existing relationships where workscope may flex to accommodate to new situations. For example, companies that outsource information technology work often have a project focus where transitions can become important.

A Vested relationship should have a formal appendix or schedule in the contract that outlines the responsibilities of the transformation managers and provides guidelines for each of the four areas just listed.

Exit Management A third aspect of governance is exit management. A Vested relationship, by design, creates supplier codependency. A supplier's commitment to make strategic investments creates a competitive advantage and helps the buyer attain its Desired Outcomes.

Codependency happens in three ways. First, Vested relationships are longer term in nature, typically a minimum of five years and often much longer. Many Vested agreements include an incentive where the supplier earns a contract extension at the end of each year. For example, at the end of year 1, the supplier can earn a sixth year. At the end of year 2, the supplier can earn a seventh year. This in essence creates an evergreen contract with a rolling five-year contract duration that highly motivates suppliers to keep making investments in order to earn contract extensions.

Second, Vested Relationships are designed to give a supplier the freedom and flexibility to make changes to the workscope—the "how." Suppliers make conscious investments in process improvements and technologies that help them achieve mutually defined Desired Outcomes.

Last, a supplier often chooses to bundle workscope. Combined, these decisions increase the stakes for both buyers and suppliers. With added risk comes added responsibility to spend more time and energy in exit management planning as firms develop a physical agreement or contract that supports the Vested relationship.

Buyers and suppliers must be fair and balanced in terms of how they plan to exit the relationship. The intent of a Vested relationship is that neither party should be harmed if an exit is necessary. As buyers and suppliers work through exit management, they should seek to understand and appreciate each other's perspective. Rather than negotiate standard termination clauses that are common in typical buy-sell agreements, they should instead seek to reach a fair and balanced approach for how the parties will unwind if necessary.

Special Concerns/Requirements Often organizations use Vested models because they are operating in an environment with significant risk. In such environments, compliance is a key driver of success. As with the other relational sourcing models, buyers should put in place processes and protocols to ensure that special concerns and requirements are met. A key difference in Vested arrangements is that, in many cases, suppliers have a significant role in ensuring that standards are met. For example, Accenture is accountable for ensuring that Microsoft complies with all Sarbanes-Oxley regulations. It is Accenture's responsibility to know when regulations change and stay in compliance without interruption, not Microsoft's.[17]

Vested models are also used to create highly motivating environments for suppliers to invest in developing competitive advantages for buyers. Most Vested agreements also have a fair and balanced way to manage intellectual property and are designed to motivate suppliers to invest in innovation. However, often that innovation is customized for buyers. Buyers and suppliers need to think though the ramifications of intellectual property. Many find creative ways to jointly manage and reward innovation through licensing agreements.

INHERENT INCENTIVES/PERVERSE INCENTIVES

A Vested model creates a competitive advantage through a highly collaborative win-win relationship. This is essential in today's networked and dynamic economy where innovation is needed in order to stay ahead of the competition.

Although the Vested methodology can help organizations structure (or restructure) supplier relationships to eliminate inherent perverse incentives found in preferred provider or performance-based agreements, is Vested a panacea? Absolutely not. Vested is not for every supplier relationship.

First, not every environment is ideal for establishing a Vested relationship. Completing a Business Model Mapping exercise (outlined in chapter 8) can help you determine if a Vested relationship is the best Sourcing Business Model for your situation. If your sourcing environment has low risk, fairly stable demand and operational requirements, and little opportunity to create value through innovation, likely a transactional model or a preferred or performance-based agreement is a better supplier relationship for you.

Next, and a point that is not to be taken lightly, is that buyers and suppliers should not enter into long-term, highly collaborative Vested relationships if they do not have a minimum amount of compatibility and trust. A Vested relationship demands a high degree of transparency and compatible cultures in order to create an environment with a high level of collaborative communications skills and teaming capabilities. The organizations must be comfortable working together in a dynamic environment that embraces innovation and desires to drive proactive changes. Chapter 10 addresses how to close gaps in buyer and supplier trust levels.

Going through the Vested methodology takes time and investment to institutionalize the new workscope allocations, pricing model, and governance mechanisms that are essential to keep the relationship in equilibrium when business needs change. If either the buyer or supplier is unwilling to invest in both the mindset shift and the physical changes that are needed, it should not pursue a Vested relationship.

Finally, organizations that have a core competency and the ability to create a competitive advantage by keeping the work in-house should consider using their time, energy, and money in investment-based business models. Chapter 7 profiles these types of Sourcing Business Models: shared services and equity partnerships.

CHAPTER 7

INVESTMENT-BASED SOURCING MODELS

In chapters 4 to 6, we discussed five different Sourcing Business Models, all relying on suppliers to ensure availability of particular products or services. This chapter is devoted to investment-based models that organizations can use when they want to "make" versus "buy." According to Oliver Williamson, organizations that select a make or insource strategy select a structure that, by default, creates a hierarchy. We think of insource decisions in terms of investment-based models because organizations consciously open their wallets to invest in the capabilities needed for securing supply sources for goods and services.

Investment-based models fall in two categories: shared services and equity partnerships. A shared services model is typically constructed as an internal organization based on an arm's-length outsourcing arrangement. Processes are generally centralized into a shared services organization (SSO) that charges business units and users for the services they use. Some organizations decide they do not have internal capabilities to invest in an SSO. These organizations may opt to invest in an equity partnership to acquire mission-critical goods and services. Equity partnerships take different legal forms ranging from acquiring a supplier, creating a subsidiary, joining a co-op, or even investing in an equity-sharing joint venture (JV).

WHY MAKE VERSUS BUY?

There are a variety of reasons why organizations choose to make rather than to buy. A primary reason for organizations to make is because a certain activity or scope of work is a core competency. A core competency is a capability or advantage that distinguishes an enterprise from its competitors. In their classic *Harvard Business Review* article, C. K. Prahalad and Gary Hamel shared three tests that identify whether an activity is core or not.[1]

First, a core competency provides potential access to a wide variety of markets. Prahalad and Hamel use the example of an electronics company needing to have a core competency in display systems. Second, a core competency should make a significant contribution to perceived customer benefits of end products. It is easy to see how a display screen can impact end users' perceptions of electronic items, such as cell phones. Third, a core competency should be difficult for competitors to imitate. Display screens might have once been difficult to imitate, but, as the market evolved, suppliers began to manufacturer display screens. This is likely why Apple chose to work with Corning, which has competencies in advanced glass technologies like the Gorilla Glass® used in the iPhone 6™.

Sometimes organizations decide to keep noncore functions in-house. Organizations often insource when they can't find suppliers that meet complex business requirements. Or suppliers lack the ability to provide unique or highly integrated services. Other organizations desire to maintain control, worrying they might lose control of proprietary information or trade secrets if they work with suppliers. Still others believe their organization's culture prevents them from working with suppliers strategically, especially if the work will be outsourced.

In some cases, an organization's economic or legal circumstances limit the use of suppliers. A good example would be a manufacturer with five years left on an iron-clad union contract. That manufacturer has few options. In other cases, a firm may have stipulations in corporate bylaws that limit the use of property and allocation of resources.

And, of course, some organizations are simply risk-averse or are unwilling to change.

Lawrence Kane, a certified outsourcing professional and senior leader of IT Infrastructure (ITI) Strategy and Sourcing for Boeing, explains why Boeing chooses to keep some of its information technology (IT) work insourced.

> Boeing is large, complex, and multinational. Depending on what day it is, we rank somewhere in the top five global targets for hackers. Our environment dictates that Boeing maintains core process knowledge that we cannot buy "off the street." In addition, Boeing has chosen to use

> a multisourced IT infrastructure so you can imagine that we are faced with the challenge of managing what could potentially be a rather chaotic environment if we don't do our jobs just right. For this reason we retain architecture, integration and oversight necessary to make the multitude of parts and pieces move together in synchronicity. This enables us to leverage suppliers for what they are best at while retaining strategic knowledge and activities necessary to move Boeing forward effectively.[2]

Unique barriers like Boeing's can inspire an organization to think creatively about investment-based options. Chapter 8 will help you determine if an investment-based model is a good fit for your particular situation. As you think through a make versus buy decision, it is important to recognize that most organizations do not take investing lightly. For this reason, most investment-based sourcing solutions include decisions typically driven by an organization's overall management and finance functions, not necessarily by a buyer (or even the chief procurement officer) in a procurement function.

TYPES OF INVESTMENT-BASED MODELS

As mentioned, there are two primary types of investment-based models: shared services and equity partnerships. However, within these two categories, investment-based models take on many unique forms. This chapter profiles these types of investment-based models:

- Shared services (a private corporation example and a government example)
- Equity partnerships
  - Acquisition
  - Joint venture
  - Subsidiary
  - Co-op

This chapter also provides a practical approach to help procurement professionals understand each of these investment-based models. For each model we share:

- Why and how it works
- An example in action
- When to use

Because there is a wide variety of investment-based models, there is no one right way to structure such a model. For starters, investment-based models can use any of the three economic models: transactional, output, or outcome based. Because the stakes typically are high due to an organization's financial nature, most investment-based models benefit when they follow a highly collaborative what's-in-it-for-we (WIIFWe) approach coupled with an outcome-based economic model (similar to how a Vested model is structured). However, every situation is different. We provide insights into how one SSO is structured; however, we do not endorse it as an official format. Because of the myriad of equity partnership structures, we do not provide an example as we do not want to endorse any one particular structure.

Shared Services Model

A shared services model creates an internal functional business unit or a stand-alone entity that provides goods or services to the overall organization. Think of a shared services model as an organization creating its own internal supplier and then outsourcing to itself. An SSO consolidates services across an organization from headquarters, individual business units, regions, or countries and puts them into a distinct entity designed to be competitive with buy solutions.

Figure 7.1 illustrates how a shared services model fits into the sourcing continuum.

A core purpose of a shared services model is to centralize internal processes to drive economies of scale. Centralization builds efficiencies across multiple business units, and that reduces operational costs, usually reduces head count, and often streamlines processes to improve control and service. It often gives improved visibility to leverage buy opportunities. Centralization can come from physically

Figure 7.1 Sourcing Continuum: Shared Services Model

aggregating resources into one location or through a "center-led" organization design using centralized processes across decentralized locations.

Organizations use a shared services model to provide a variety of goods and services. Some of the most popular SSO services are human resources (HR), finance operations, administrative services (such as claims processing in health care), logistics, IT, and even procurement. For example, large organizations centralize HR administration into a shared services group to provide benefits management to their employees. The SSO provides the activity on behalf of all the internal "customers."

In most cases, an SSO becomes a stand-alone business unit within the context of the broader firm. In some cases, an organization even creates a subsidiary for its SSO, which operates as a stand-alone business entity.

A shared services model does not simply centralize functional work into one group; an SSO is structured to act more like an external supplier where the business groups become customers. The SSO must become market responsive and accountable to internal customers, agreeing on cost, quality, and service levels. Key features of an SSO include:

- A governing board that sets policies and directions
- Accountability to business groups/users through service-level agreements
- Tailored services to address business unit requirements, including relying on business groups/users to set priorities on quantity and quality of services
- Flexibility to source key work scope from external suppliers
- Revenue based on charges to businesses groups/users for actual usage of service
- Location wherever it makes sense, not just in an organization's headquarters or in business group locations[3]

According to an Accenture study, the use of SSOs is steadily rising; more than 75 percent of Fortune 500 companies have implemented shared services models. The report also indicates that shared services programs are evolving. Historically SSOs provided just one function, primarily administrative.[4]

There is a trend for SSOs to provide more advanced skills and services, referred to as integrated business services. Some organizations are well known for pushing the envelope in shared services innovation. Global Business Services (GBS) at Procter & Gamble (P&G) spans 170 business services including IT, finance, facilities, purchasing, and employee services. P&G's GBS is one of the largest and most progressive SSOs in the world. In 2003, P&G drove efficiencies in its shared services model by carefully selecting outsourcing partners that helped the company execute many of its day-to-day tasks. One of these outsourcing initiatives is the highly acclaimed Vested relationship with Jones Lang LaSalle we examined in chapter 6.[5]

One critique of SSOs is that they often operate in a nonprofit basis, as cost centers for the overarching organization. This often causes what is known as a free rider problem, which occurs when those who benefit from resources, goods, or services do not pay fair market value for them.[6]

Not recognizing the "value" in using a good or service typically results in either inferior provision of the goods or services or overuse of them. Both lead to a degradation of quality. Many shared services models charge internal customers a transaction fee to help mitigate the free rider problem. In these cases, the SSO acts like an outsourced supplier, performing services and then charging its internal customers, most often on a per-transaction or headcount basis. This approach very much mirrors a conventional preferred provider model.

Sometimes SSOs are self-funded, meaning they charge their internal customers (business units or other functions) an add-on fee in addition to the actual cost of the service they perform. This add-on fee turns into a profit for the SSO that generates additional income above the base cost of operation. Because SSOs generally are nonprofit, they typically either pay a credit/dividend to users or reinvest the profit back into operations within the organization to drive further efficiencies.

In some cases, separate enterprises create solutions that mirror a shared services model. For example, Wright State University in Dayton, Ohio, worked with the Ohio Department of Transportation and nearby municipalities of Beavercreek and Fairborn to create a shared services model for a solution to the problem of storing the salt used to de-ice roads in the winter.[7]

Why and How a Shared Services Model Works

To put a shared services model in context of an organization's overarching supply base strategy, an organization creates an SSO to standardize a spend category and the associated processes. The hope is to drive significant cost savings or other internal benefits that are at parity or better than using a supplier. Organizations find shared services appealing for a variety of reasons, including:

- *Cost transparency.* The SSO has a "price" for each service it offers, and users can determine how much service they want for that price.
- *Business management.* The SSO is managed like a business. Its own profit and loss drives accountability. Some SSOs even serve external customers.
- *Market responsiveness.* The SSO provides the service levels business groups want, not what the SSO thinks they need.
- *Best practice proliferation.* The centralized nature of SSOs makes identifying and deploying best practices quickly and globally easier.
- *Process standardization.* The centralized nature of SSOs makes streamlining and maintaining processes easier.
- *Service culture.* SSOs are designed to treat business groups like customers, offering services that customers value and pay for.[8]

Properly executed shared services models offer many benefits. First and foremost, these models capture economies of scale for functions that can be decentralized. This decentralization reduces duplication of effort and allows for simplification that demands less management time as well as fewer administrators and staff. Standardization also lays the groundwork for work that can be potentially automated. The centralized nature of SSOs also enables them to leverage expertise across the entire organization, which increases quality levels. Metrics and reports also become standardized and easier to access, enabling SSOs to make better business decisions.

SSOs offer an excellent way to ensure supply. This finding makes sense when you consider that an internal SSO will always put its own internal customers first. However, capacity is a double-edged sword. Having too much capacity means added costs, but if demand peaks above internal capacity, the SSO may not be able to meet that demand. For this reason, many people think that SSOs are inflexible.

Many customers must go outside of the SSO when they have a requirement that the model cannot meet. A good example is a university that has a centralized shared services printing center. Faculty members are highly encouraged to use the university's print center because of its low costs. When they do so, they are charged a price, but the cost per page is far less than at the local print shop.

The print center is a great option for the university, as it achieves economies of scale across the campus. However, let's say an absent-minded professor does not allow for the 48-hour turnaround time the print center requires. In such cases, professors either use the more expensive departmental equipment or pay a premium to send a graduate student to the local FedEx Office Print & Ship Center.

Example in Action: Gary Keisler's Experience

Gary Kiesler, a wise veteran of the corporate world, believes reinvention is one of his keys to success. Throughout his career, Kiesler managed different sourcing models, including a shared services model.

Kiesler told the authors about a time when a shared services model was the right solution.[9] As a technology company entered the global market, it gained consumers by the thousands—consumers who were confused by the company's technology and by how to use its products.

The company chose to outsource customer support to local suppliers in various countries. Although there was a plethora of suppliers, the corporation was not happy with the capabilities of most local suppliers. Those local suppliers could answer basic consumer questions but faltered when faced with more complex queries regarding technology and product use. New consumers often became frustrated. The lack of customer service quality was particularly vexing for this tech company, which prided itself in its record of total customer satisfaction.

Kiesler was attracted to a shared service model for many reasons. He liked that the functional customer service activities could be centralized. Operation of local services centers was cost prohibitive when the function was decentralized across various countries.

Kiesler and his team identified a potential obstacle—a centralized solution would not offer support in various languages. The team solved this by assigning unique call-in numbers for the each language and hiring customer service representatives (CSRs) with matching language skills.

The shared services center offered other advantages. Centralization allowed it to improve hiring and training practices. The new centralized SSO committed to hire individuals with both technical skills and customer service skills. And because the CSRs were in a centralized location, they could learn from each other and provide rapid escalation if needed.

Example in Action: Health Shared Services British Columbia

Health Shared Services British Columbia (HSSBC) was formed to provide nonclinical support services to British Columbia's six health authorities with the vision of "Shared Services, Better Value."[10] For organizational purposes, HSSBC operates within a division of one of the six health authorities, the Provincial Health Services Authority. HSSBC is chartered to perform accounts receivable, employee records and benefits, payroll services, supply chain management (including accounts payable), and technology services.

As a nonprofit government organization, HSSBC receives funding from the six BC health authorities that perform these services, and any savings realized by HSSBC are distributed back to the health authorities for reinvestment in patient care. As such, the BC health authorities are not only customers of HSSBC's services but also shareholders in HSSBC's success.

The HSSBC mission is to "enhance value to the health system through the effective and efficient delivery of support services." To achieve the mission, HSSBC identified three primary goals:

1. Maximize value to the Health Authority system by generating expense savings and increasing productivity.
2. Build trust in HSSBC as a provider of reliable services.
3. Create an organization that has the corporate capacity and capability to be flexible, innovative, and entrepreneurial stewards of taxpayer's dollars.

In its first four years of operation, HSSBC had implemented dozens of initiatives generating over $230 million in savings.

When to Use

A shared services model is well suited for larger organizations with multiple locations or business units where there is a significant opportunity for the organization to consolidate and standardize the workscope. The cost savings can be significant.

Although many focus on cost savings, some SSOs are set up to improve access to a particular competency. A centralized SSO brings together an organization's limited number of experts within in a given skill set, allowing them to collaborate and build on their skills.

A shared services model is also a good option when an organization wants to combine its volume and scale with other organizations, such as the way Wright State University did for salt storage. Shared services models are especially good options for uniting smaller enterprises that do not have the volume and scale to create their own SSOs.

How to Structure a Shared Services Model

Setting up a shared services model, whether for one function or many, is not just about physically moving various functional resources to one centralized location. Here we provide guidelines for structuring a shared services model.

Figure 7.2 provides a high-level summary of how an investment services model (equity partner/shared services) works across five key dimensions.

Business Model and Purpose

A primary purpose of a shared services model is to provide a centralized function that creates sustainable value to the broader organization by streamlining operations, lowering costs, and improving service. When an organization creates an SSO, it makes a strategic decision to invest in building functional skills rather than buying the skills of a supplier. Because the buyer (the business units) and the supplier (the SSO) are under the control of one firm, by nature the economics are a win-win as long as the costs and services from the SSO are competitive with the marketplace. When an SSO lowers its cost, the internal customers win. And the more business units use the SSO, the more the firm drives economies of scale.

Figure 7.2 Summary Structure: Investment Services Model

	INVESTMENT (EQUITY PARTNER/ SHARED SERVICES)
BUSINESS MODEL	
Business Model – Economic Model	Transactional, Output or Outcome Based
Business Model – Relationship Model	Investment Based
Vision & Intent	Sustainable Value
SCOPE OF WORK	
Statement of Work & Objectives	"What if", "What for" and "When"
PERFORMANCE MANAGEMENT	
Performance Focus	P&L Based Measures
Performance Measures	Joint Measures of Success
PRICING	
Pricing Model & Incentives	P&L Based Equity Sharing
GOVERNANCE	
Relationship Management	Shared Control and Management
Improve, Transform, & Innovate	Core Innovation Capabilities
Exit Management	Divestiture
Compliance & Special Concerns	Investment Based Joint Requirements

A shared services model can be structured using a transaction-based economic model (charging internal customers a per-use/per-transaction fee), an output-based model, or an outcome-based model. Because users pay a fee, by default, buyers think of the SSO as an internal preferred provider. That is, the SSO is nice to do business with but not an organization vital to their success. Often internal buyers view their shared service supplier as an arm's-length supplier and do not fully value the benefits the SSO provides. For this reason, we encourage SSOs to consider using an outcome-based economic model that follows the Vested Five Rules.

Although a written agreement is not legally required, an SSO should create some form of written document to use with its internal clients. The agreement documents how the parties will work together. This is like a master agreement between buyers and suppliers that outlines the overall intentions of the relationship. The agreement also specifies how the SSO will manage workscope, performance metrics, pricing, and governance.

Workscope

A key reason for moving to a shared services model is to centralize and standardize workscope. For maximum effectiveness, the SSO should ask its internal customers these questions: What if? What for? and When? To create process efficiencies, the SSO should have complete authority regarding how the work is done. After all, why bother to centralize the work to drive changes if the internal business units/customers won't allow change?

Unfortunately, sometimes business units become frustrated when they feel they lose control over how the work is done. For this reason, SSOs should strive to work with business unit stakeholders, viewing them as customers that have a voice in the establishment of requirements and service levels. And business units should view their SSO as a highly collaborative partner, much the way a Vested relationship is viewed.

Performance Management

The SSO performs a service on behalf of the organization's business groups. An SSO should consider performance management just as rigorously as a supplier does. Unfortunately, many SSOs focus on costs and transactional activity level measures, not measures based on more strategic outcomes.[15] This cost-driven mentality can cause friction between the SSO and internal business stakeholders, who say that the SSO just doesn't understand the business. When this happens, internal customers circumvent the SSO, as the absentminded professor mentioned earlier did. Circumventing the SSO weakens the raison d'être for establishing a shared services model. This inherent, perverse incentive is another reason we encourage organizations to consider structuring their SSO based on the Vested rules that focus on joint outcome–based measures.

Pricing Model

SSOs typically use a transactional economic model, charging internal customers for use of their services based on a per-transaction fee. As with HSSBC, many SSOs pay credits/dividends to their internal customers, thereby lowering user costs for the service.

Charging internal customers for using services does reduce the free rider problem; however, it does not give the SSO a profit. And, without operating profit, the SSO does not have capital to invest and keep competitive. For this reason, we believe SSOs should be structured as profit centers, charging an add-on fee to the actual cost of the service they perform. Structuring a pricing model where the SSO uses a profit-focused P&L with equity sharing to business stakeholders offers several benefits. First, using a profit-focused P&L allows the SSO to charge add-on fees that generate additional income above the base cost of operation. The add-on fee becomes profit, which can be reinvested back into the SSO for improvements or can be distributed back to business stakeholders in the form of a dividend. Having SSOs operate as profit centers facilitates a longer-term view that forces continuous evaluation of their overall viability relative to competitive external suppliers.

Jim Eckler, retired chief operating officer for HSSBC, shares his observations about how having a nonprofit shared service model can create friction within the broader context of an organization. According to Eckler:

> A shared services organization needs access to capital—otherwise they cannot invest in maintaining competitive services for their internal customers. Unfortunately, many SSOs operate as a nonprofit center under the purview of senior executives of the broader firm. This can create a great deal of friction because the shared services operation is always seeking capital to invest to improve the function and better serve internal customers. But chief executive officers can sometimes fall victim to internal company politics or focus on other priorities for tactical reasons.
>
> A good example is an SSO that proposed a new IT application that would dramatically improve service quality and reduce costs. The project budget was about $2 million with a payback in less than two years—not a major investment for the multibillion-dollar organization. The CEO agreed it was a smart investment. However, the request for funding was denied as the CEO was worried that approval of the investment in a critical but “nonstrategic” SSO would convey the wrong message to the broader organization due to financial challenges in “more strategic” business units.

The message of this story is that SSOs need to have their own independent treasury with borrowing power where funding can be raised on a project's own merit or outsource if the work is truly not a core competency.

Eckler also provides astute advice for setting up an SSO:

> I like to go to the essence of what drives behaviors. Does the SSO—through its governance processes—have authority to reinvest to make needed improvements? If not, I would highly recommend a firm "buy" versus "make." Saying you want to have a core competency but then not investing in keeping the function competitive is myopic. If an SSO cannot make strategic investments that keep the SSO at pace with external suppliers providing the same services, they will find customer satisfaction wanes over time. When that happens, internal customers will find ways to go around the SSO, which defeats the purpose of even having a SSO.

Governance

Governance is critical to SSOs. For HSSBC, a management board comprised of the CEOs of the province's six Health Authorities, a representative of the Ministry of Health, and two external directors governs the organization. The services HSSBC provides are outlined in a formal master agreement between HSSBC and the six Health Authorities.

SSOs also act as strategic suppliers to internal customers. As such, they set up a relationship management function and relationship managers with each business unit to ensure that the SSOs clearly understand and respond to the dynamic needs of internal customers. As you structure your shared services model, ask yourself these questions:

- How will the SSO work with the various internal clients?
- What are the processes and protocols around decision rights for investments?
- How will conflicts of interest be managed?

SSOs must outline how they will work with business units to make decisions that impact the business.

Internal customer management is important. HSSBC is accountable for the provision of supplies and equipment that doctors and other clinicians use as part of their clinical practices. One of the HSSBC's goals is the development of a standardized list of approved suppliers and products to use across the entire BC health care system. Standardization drives procurement and supply chain efficiencies. However, physicians often worry when they hear the term "standardization." This is one reason HSSBC includes physicians and clinicians as they work to standard suppliers and products. Having a representative user on the evaluation committee is vital to get buy-in. Physician involvement is also essential for identifying which products are appropriate for standardization within the health care system. It ensures that items selected for the product list not only meet standardization goals but also adhere to physician requirements for clinical quality and safety.

Last, a well-structured shared services model proactively determines factors that enable organizations to recognize when the SSO is no longer a viable option. For example, will the SSO be spun off or disbanded if the organization is not achieving a minimum performance threshold or benchmark cost targets? There is no need to continue developing an internal capability if the market provides a competitive cost and service advantage.

EQUITY PARTNERSHIP

Some organizations decide they do not have internal capabilities and a shared services model is not an appropriate solution to fulfill their requirements. In these cases, organizations may opt to develop an equity partnership such as a joint venture (JV) or other legal form in an effort to acquire mission-critical goods and services. Figure 7.3 shows that equity partnerships are on the far right in the sourcing continuum because an organization makes a direct investment in building capabilities with a formalized entity.

Legally, equity partnerships bind potential business partners through formal structures. Typically, these partnerships are asset-

Figure 7.3 Sourcing Continuum: Equity Partnership

based with a formal and comprehensive governance framework. They come in many forms, such as acquiring a supplier, creating a JV, establishing a subsidiary, and joining a cooperative (co-op). This section provides a glimpse into each of the various options.

It is essential to structure equity partnerships properly. Setting up an equity partnership can be a costly and complicated process. In addition, many countries have unique laws that must be understood and complied with. For this reason, we cannot offer general guidelines for structuring equity partnerships. Rather, we suggest you check with a local consultant and attorney in the countries where you will do business.

Acquisitions

An acquisition is the act of gaining possession of anything valued by the buyer. In the context of a supply-based strategy, an acquisition typically means purchasing a supplier or a competitor that has certain capabilities or resources, such as physical assets, employees and know-how, patents, intellectual property (IP), or even brand trademarks and/or goodwill.

Acquisitions allow an organization to expand its reach and capability through the purchase of an organization or IP (e.g., patents, copyrights.) Acquisition targets are often suppliers or competitors that have a desired capability. An organization can buy some or all of another organization's assets. For example, an organization may choose to acquire just certain patents or copyrights or even a select business unit, facility, or function.

Why and How Acquisitions Work

The premise behind an acquisition is straightforward. An organization seeks out another organization that has a competency that it needs. Need a specialty that you don't have? Find an organization that has mastered the needed competency and buy it. Growing a technological niche market offering? Keep your eyes open for breakthrough technologies by small companies, then buy them.

Buying the assets you need keeps your own proprietary information within your organization; there is no need to work with an external supplier that might accidentally leak your trade secrets. Acquisitions allow an organization to continuously grow its own unique capabilities and thus be more skilled to thrive in today's changing environments.

Example in Action

Let's look at Lexmark International Inc. for an example to understand when an acquisition is appropriate. In 1991, as part of strategic downsizing, IBM spun off its printer manufacturing to a private investment firm, and Lexmark (Lex for "lexicon"; mark for "marks on paper") was born. With a start-up debt of more than $1 billion, surviving and thriving required savvy and courageous management.[11]

Innovation lies within the DNA of Lexmark's business practice—from products to partnerships, the company strives to think differently.

Lexmark decided to approach niche markets holistically by offering complete technology solutions. Software became an important enabler to its future. Lexmark kept its eyes open for companies that specialized in software that furthered its new strategic objectives. When one was found, Lexmark bought it, bringing the expertise under the Lexmark umbrella. As part of the acquisition, Lexmark bought not only the technology but also acquired the researchers and designers. Targeting niche software suppliers allowed Lexmark to grow its competencies while preserving proprietary secrets and prevented its competitors from using these same competencies.

When to Use

An acquisition is a great option if an organization already has a core competency it wants to expand. An acquisition is also a good fit when an organization wants to gain access to a capability and does not want to share proprietary information with a supplier or wants to keep the information from a competitor. Amazon's acquisition of Kiva Systems, an automated distribution firm, for $775 million is such an example. Amazon acquired Kiva's innovative warehouse robotic technology to ensure that competitors would not have access to the new technology.[12]

Joint Venture

The term "joint venture" covers a wide range of collaborative arrangements in which two or more businesses decide to share costs, management, and profits with a common goal. A JV is a legally binding business arrangement where each party contributes capital, IP, personnel, and other resources to design and implement a new business.

In today's market, JVs are becoming more and more prevalent. A recent survey by McKinsey found that 68 percent of CEO and senior executive respondents expect JV activity to increase over the next five years.[13]

Successful JVs can offer tremendous rewards to entrepreneurs, but those that fail cost a significant amount of time, money, and frustration. There are no formal statistics on the success rate of JVs, but experts surmise that between 40 to 70 percent of JVs fail.[14] According to a PricewaterhouseCoopers report, "Failure to identify and consider the variety of risks in these arrangements can have a significant impact on the likelihood of success in any JV or business alliance, and on its value to the overall enterprise."[15] Many JVs fail because the partners are accustomed to having control over their companies. Organizations entering into a JV need to understand they won't have control the same way they would if they were doing an acquisition and must consider cultural differences with potential partners.

JVs are popular in industries where there is a high degree of risk and uncertainty but also high potential for significant upside. These industries include pharmaceuticals, high tech, entertainment, oil and gas, and aerospace.

Many people believe that JVs are permanent entities. In fact, JVs can be created for a specific project (e.g., construction projects) or to achieve a specific goal. As we discuss in the next Example in Action, Samsung and Sony created a JV for the design and production of liquid crystal displays for flat-panel televisions.

Why and How Joint Ventures Work

A JV is a good solution for ensuring continuity of supply and is a good option when a project offers extremely high risk or high reward. The joint investment provides inherent safeguards that motivate each party not to fail because a failure for one party is a failure for both. A JV is a good choice when an organization wants to reduce the amount of investment because partners pool their money, personnel, and other resources to enhance their chances of success.

JVs can gain access to new markets, especially international ones, where entering without local knowledge may be extremely risky or too complex. JVs provide an environment that is conducive for research and development. Sharing Intellectual Property (IP) is much easier because both parties own IP held under the JV. Parties are motivated to make investments because the outcome of the JV can lead to greater innovation than each partner could obtain by itself.

Example in Action: Samsung and Sony[16]

In 2004, the consumer electronics giants Samsung Electronics and Sony established a 50/50 JV for the production of liquid crystal displays for flat-panel televisions. The companies formed a new company, the S-LCD Corporation, near Seoul, South Korea, with an initial capital budget of nearly $2 billion.

The two tech giants—and fierce industry rivals—structured the venture so that South Korea's Samsung held S-LCD stocks at 50 percent plus one share of stock. Japan's Sony held 50 percent minus one. "The two companies will invest evenly, but Samsung has the ultimate initiative," said a Sony spokeswoman.[17]

The joint collaboration offered advantages for both companies. In 2003, Samsung had committed to a decade-long large capital investment to construct an LCD production facility, a relatively new technology and market. Sony had no production base for large LCD panels.

Bloomberg Business Week described the JV as a win-win: "[The companies] have pulled off one of the most interesting and fruitful collaborations in global high-tech by jointly producing liquid-crystal display (LCD) panels. And it's an alliance that is reshaping the industry."[18]

The JV enjoyed success on multiple levels:

- It was instrumental in Sony's introduction of the hugely successful Bravia line of LCD-TVs.
- It established Samsung's LCD-TV business as a trendsetter.
- Sony technology ensured high-quality, sharp TV pictures.
- The alliance impacted the TV market for large-screen sets industry wide.

In 2006, Lee Sang Wan, president of Samsung's LCD unit, declared that "the Sony-Samsung alliance is certainly a win-win. . . . If there had been no S-LCD venture, Sony's LCD business would not be what it is today."[19] In December 2011, however, Sony made the corporate decision to discontinue manufacturing flat-screen TVs and sold its share of the S-LCD venture to Samsung for 1.08 trillion Korean won ($1.002 billion).[20] Sony's investment had indeed paid off even though it ultimately decided to exit the business.

Samsung's dominance in the newest flat-screen TVs continues. In 2013, Samsung ranked first in TV sales for the fourteenth year in a row. It achieved the industry's top global market share for eight years in a row. Along with sales, Samsung's profitability for the flat-screen market was also number one.[21]

The JV was unusual and remarkable in terms of its scope and duration. Two fierce competitors put their rivalry aside to achieve a win-win in an emerging market.

When to Use

Organizations use JVs in many situations. One big reason to enter into a JV is to allow an organization to expand into new markets or new products areas. For example, many organizations use JVs when doing business in China. The advantage of a local partner, familiar with local regulations and culture, can be significant. Cutting through red tape and connecting through established local contacts shortens start-up schedules and informs effective operation.

One example is a restaurant chain that developed a JV with a local Chinese food service distributor. The goal was for the restaurant chain and the distributor to jointly invest in food distribution capabilities to manage the restaurant chain's temperature-controlled supply chain. The restaurant chain had 49 percent ownership, and the local Chinese distributor had a 51 percent stake in the JV.

Other organizations use JVs to share costs and/or risks on expensive projects, especially those that involve investment in uncertain IP development. A JV allows an organization to spread costs and risk by sharing investment with a partner. This is one reason why JVs are common in pharmaceutical, high tech, entertainment, and aerospace industries. A well-nurtured JV creates an environment where the parties are excited about combining their best talent on a big project, with the aim of closing crucial gaps in resources and expertise in order ultimately to reduce risks.

Last, some organizations use JVs to work more strategically with key suppliers. In some cases, this means investing with a supplier for co-creation of a new product or capability or establishing a vehicle for slowly transferring the buyer's noncore resources to a strategic supplier.

Subsidiaries

A subsidiary is a company that is partly or completely owned by another company (the parent or holding company). Companies in a parent-subsidiary relationship are separate legal entities. The parent company must hold a controlling interest in the subsidiary of at least 50 percent of the voting stock.

It is very common for global companies to use subsidiaries to establish and grow market presence. Subsidiaries also address legal nuances in countries where a business wants to operate. In some cases, such as our example of Sony and Samsung, a subsidiary is a Sourcing Business Model whose time has come. When Sony and Samsung created its groundbreaking S-LCD JV, benefits to both parties were actualized. With time and corporate strategies moving in different directions, need for the JV waned. Samsung bought out Sony's share, and the S-LCD organization became a wholly owned Samsung subsidiary.

A good analogy of a subsidiary is to think of a starfish. If the subsidiary does not work out, the parent organization can simply dissolve or sell the subsidiary with very low risk to the broader firm—much like a starfish can lose an arm without dying. Boeing, for example, has 282 subsidiaries in countries across the globe.[22] Microsoft has 116 subsidiaries, one for each country where the organization operates.[23]

On the surface, creating a subsidiary often sounds like a smart option. However, maintaining a subsidiary is costly. It is important to scrutinize total costs associated with establishing a subsidiary before creating one. The tax advantages and other benefits need to outweigh the costs of creating and managing the subsidiary. Even a subsidiary that is not active costs a significant amount of money. Brian J. Chartier of the RBC Financial Group suggests that organizations calculate the total cost of a subsidiary by consideration of the following:

- Systems Costs—GL [general ledger], Finance, & Accounting
- Legal and Regulatory
- Records and Administration—Articles, Resolutions, Minute Book
- Governance (Operating Subsidiaries—Board Meetings, Material Costs, Time)
- Audit—Internal and External
- Financial Reporting—Must roll up somewhere
- Risk—Assess a dollar figure based on contribution or purpose
- Staff Costs—Somebody has to deal with this entity[24]

Why and How Subsidiaries Work

Organizations often create subsidiaries to provide access to new markets and to avoid financial risk. A key difference between a JV and a subsidiary is that the subsidiary's financial losses do not automatically transfer to a parent organization, which helps the parent mitigate financial risks. In order to qualify for subsidiary tax advantages, the organization must meet stringent criteria. The subsidiary must be part of an affiliated group, and ownership must meet preset regulations. Frequently, a corporation forms multiple subsidiaries to isolate itself from tax and business risk liabilities.

Example in Action: Progistix Solutions, Inc.

In 1995, Bell Canada's distribution operations functioned at service levels 10 to 15 percent below industry average within a cost base of $100 million.[25] Bell Canada (the largest telecom services company in Canada) decided to spin off the assets and the staff of the distribution business. It created a stand-alone, wholly owned subsidiary known as Progistix Solutions Inc. (PSI).

At its inception, PSI had an estimated revenue stream (benchmarked by Deloitte) of $55 million against its cost base of $100 million. Bell Canada believed making PSI a subsidiary with its own P&L would provide an inherent profit incentive that would highly motivate PSI to dramatically reduce costs.

As part of the transition, Bell Canada turned over its order management and inventory management functional processes and infrastructure to PSI. As a stand-alone entity, PSI had a mandate to achieve a financial break-even state and offer industry average service levels to Bell Canada. In essence, creating a subsidiary allowed Bell Canada to hand over its noncritical functions to PSI and establish an environment where PSI would be responsible for making these same services a core competency. In short, PSI needed to make a profit if it was going to survive financially. Transactional services contracts were negotiated and executed between PSI and Bell Canada; Bell Canada would become a paying customer for PSI.

A new CEO was brought in to turn around PSI. The new CEO judiciously blended new talent with experienced managers. This combination ensured that the valuable historical learnings remained while new managers were highly encouraged to introduce new best practices.

PSI carefully reviewed its own P&L statement to determine needed investments in business processes and technology in order to become a profitable business unit and raise service levels to its Bell counterparts. Priorities fell into three key areas:

1. Replacement of aged technology infrastructure and outdated applications
2. Renegotiation of four collective agreements to align wage rates and work rules with the logistics services market
3. Commitment to culture change from an entitlement-based telecom services company to a market-focused logistics services competitor

Within the first three years, PSI reduced its costs by $45 million, yielding a break-even position. In addition, systematic improvements raised service levels to industry standards. Over 95 percent of daily orders were picked, packed, shipped, and delivered to customers by the end of the next day. During the next two years, PSI generated industry-standard profits and grew revenues by 15 percent.

By the end of 2000, Bell Canada shareholders decided that they no longer needed to own the PSI subsidiary to benefit from its services. Bell Canada sold Progistix for $40 million to Canada Post Corporation in June 2001. Canada Post Corporation continues to provide services to Bell Canada as well as many other customers.

When to Use

Subsidiaries are great for organizations when they want to pursue new markets or lower costs. Teaming with local entities familiar with local customs and regulations can substantially reduce headaches and avoid missteps. In some cases, countries require commerce to come through a domestic, incorporated business. For example, organizations wanting to do business in the United Arab Emirates (UAE) must comply with Article 23(1) of the UAE Commercial Code, which requires non-UAE nationals engaging in "commercial business" in the UAE to partner with a UAE national who owns 51 percent of the capital of the company.[26]

Organizations also use subsidiaries to mitigate risks and protect the parent organization. If there is a significant issue with the subsidiary, the organization's liability will be limited to the exposure of the subsidiary versus exposing the entire organization.

Last, turning a function or business unit into a subsidiary is a great way to drive accountability. If the subsidiary suffers losses, the losses do not flow back to the parent organization.

Purchasing Cooperatives

A purchasing cooperative (co-op) is a jointly owned business enterprise that is operated by members or user-owners for their mutual benefit. The co-op supplies members with goods and services. It is largely focused on aggregating demand to get lower prices from selected suppliers.

Purchasing co-ops have grown in utilization and popularity over the last 60 years. Co-ops actually have been around for centuries. In 1761, a group of 15 Scottish weavers established the first known consumer co-op. (A consumer co-op is a cooperative business venture that is owned by its customers for mutual benefit.) The Fenwick Weavers' group pledged to "make good and sufficient work and exact neither higher nor lower prices than are accustomed."[27]

Co-ops traditionally have been used in various industries by independent retailers. For this reason, they are often also referred to as retail cooperatives. Co-ops are also popular among franchised entities such as restaurants. Today there are a variety of co-ops used by groups including banking, agricultural, housing, and consumers.

Purchasing co-ops are often formally established by independent owners who cannot gain competitive purchase prices by themselves. One of the world's largest retail co-ops, established in France in 1949 by E. Leclerc, is a multicountry hypermarket chain comprised of semi-independent stores that operate under the Leclerc brand. Leclerc has grown steadily over the years; its reported annual sales volume (net of all discounts and sales taxes) in 2013 was €10.6 billion.[28]

Co-ops also can be a leverage point of growth for small independent businesses. Perhaps one of the best co-op success stories is that of U.S.-based Ace Hardware.[29] What was once a handful of corner stores in small communities has grown to 4,794 Ace Hardware stores that comprise the country's largest retail cooperative outside the grocery sector. Every Ace store owner initially buys $5,000 in co-op shares. With this purchase the owners become shareholders with rights to purchase any of the 80,000-plus products from the co-op's warehouses. Owners receive dividends based on purchases rather than equity.

All stakeholders contribute to activities that benefit the co-op as a whole, such as advertising and marketing. The red-and-white logo and motto, "The Helpful Place," are available for each store's use. Joint branding and marketing initiatives have worked well for Ace Hardware stores, even as the landscape became crowded with big box stores that are in direct competition.

Jerry Venhuizen, a 22-year company veteran of Ace Hardware and current CEO, explains why. Ace doesn't sell lumber; but Ace seems like they have every kind of light bulb in production. It's easier to get a new light bulb from "your local Ace than navigate the labyrinthine aisles of a big box or wait in the dark for an Amazon delivery. 'If you want to remodel your house, you'll go to them,' Venhuizen says. 'We're making our money $20, $25 at a time.'"

And $20 at a time works just fine. The Ace Hardware Co-op expected a year-on-year revenue increase of 13 percent to about $4.7 billion and a profit boost of 35 percent when it released its 2014 annual report, following eight consecutive quarters of record sales. That's a lot of light bulbs.

Why and How to Use Co-ops

A purchasing co-op is a business whose owner-members have joined forces to increase the performance and competitiveness of their organizations. By banding together, members gain economic power, purchasing strength, valuable goods and services, and marketing opportunities.

Co-ops are legally established businesses, and most are incorporated. They operate like any business does, with policies and practices that support their objectives. A key difference, however, is that member owners set the direction of the business. The members receive regular information on the operation and are included in decision making through voting. Co-ops have a formal governance structure that includes a board of directors. Board members represent all owners, which helps protects individual owners.

There are also many benefits to a co-op. From a procurement and supply chain perspective, the owner-operators gain the advantage of large buying scale and other administrative support services, which allow them to compete effectively with larger chains. The centralized co-op structure enables members to channel their efforts to create core competencies that provide consistent practices, core category knowledge, and increased strategy development expertise that would not otherwise be easily obtained or managed in a scattered ownership approach.

Co-ops also offer financial benefits for the members. Profits and earning generated by the co-op typically are distributed among the members. In addition, there are taxation advantages on surplus earnings and the increased opportunity for investment funding, such as improved systems or online training offerings for members.

In addition, many members appreciate the peer-to-peer networking opportunities associated with being involved with a larger group of business owners with similar interests.

Example in Action: Yum! Brands, Inc.

Some of the best-known restaurant brands use co-ops to supply goods and services. For example, three top consumer brands—Taco Bell®, Pizza Hut®, and KFC®—commerce together as one company under the name Yum! Brands, Inc., headquartered in Louisville, Kentucky. The world's largest purchasing co-op in the quick-service restaurant industry, Restaurant Supply Chain Solutions (RSCS) is the exclusive supply chain management organization for the three food giants.[30]

RSCS provides core services of sourcing food, packaging, and equipment. It also provides ancillary services that offer discounts on everything from cell phones to safety shoes. But RSCS is not just a middleman for goods. Customers can access strategic services, such as packaging design, logistics, and distribution support. RSCS also offers commodity risk management for several key supply categories, such as poultry, beef, and dairy products.

The RSCS co-op offers many member benefits. The primary benefit is competitive pricing for individual restaurant owner operators who would surely pay higher costs without the benefit of RSCS's buying power. From the franchisee viewpoint, small restaurant owners have an equal say; nobody gets the incremental benefit unless all of the franchisees get them.[31]

Co-ops are structured so that there is an overarching democratic governance system that keeps things fair and honest. To participate in RSCS, restaurants are required to become members and own stock in RSCS for the "concept co-op" based on the brand they represent. The stock requirements for operators who own a store is a $10 membership fee plus $400 per store.[32] As member owners, they have a voice in the leadership selection of RSCS. Members in good standing also qualify for an annual patronage dividend (if one is paid). Each concept co-op generally pays patronage dividends annually out of net income. Patronage is based on eligible food, packaging, and equipment purchases, which have a volume incentive benefit tied to the supplier pricing. The dividend amount is tied to the amount a member spends through the concept co-op, RSCS suppliers, or participating distributors.

RSCS also provides services for A&W and Long John Silver's restaurants through specific purchasing agreements.[33] Ben Butler, former president of Long John Silver's, provides a firsthand perspective of what being supported by the RSCS co-op was like.

> Long John Silver's gained advantages right away after joining the co-op in several category items, such as oil and packaging. The people who were responsible for the sourcing on the core fish items were also really good, so the franchisees easily recognized RSCS as the category experts. Also, the people that worked in the co-op had access to purchasing colleagues with a larger breadth and depth of experience than that could be afforded by a smaller sole/one brand sourcing team.
>
> The top-level board has representation that looks across the brands. Then there are individual brand councils, each having a board member(s). Most representation came from franchisees versus the brand company. Decisions were partially influenced by the number of representatives by brand, resulting in some brands having more voting rights than others. This did not impact quality because quality was controlled by each brand. However, it did impact decisions that were not always beneficial to the Long John Silver's brand. For example, supply decisions were sometimes based on short-term cost benefits for the bigger brands versus longer-term or strategic decisions for the Long John Silver's brand.[34]

When to Use

Purchasing co-ops can be beneficial in positioning small businesses for success. Co-ops are best used when a combination of independently owned businesses can gain a cost advantage through investing in a support organization that can serve all units. A smaller cash investment in a co-op could provide benefits typically enjoyed by larger organizations. Potential investing members must pay careful attention to develop a common need and vision and determine a plan for how to achieve this. Members should investigate and benchmark the potential return on investment.

Co-ops are helpful in franchise systems to gain inputs and insights across the system for the benefit of the system. Ed Medlock, senior vice president of distribution, logistics, and program management for Quality Supply Chain Co-op, Inc., suggests that there are three primary reasons for choosing the co-op model.[35]

1. *Efficiency.* When a company sources product through a co-op, it doesn't have to find separate suppliers for products.
2. *Stable supply chain.* Co-ops provide a shared service model for product sourcing and supply.
3. *Cost effective.* Co-ops provide volume for suppliers, which, in turn, provides better pricing for co-op members.

In addition, Medlock explains one of the big benefits of Wendy's moving to a co-op:

> When Arby's and Wendy's merged in 2008, Arby's was part of a buying co-op. Wendy's was a publicly traded company. As such, federal regulation required Wendy's Arby's Group (WAG) to report 100 percent of any risk management positions on their books, even though they only owned and operated 20 percent of the restaurants. It is a challenge to show Wall Street earnings on all the gains and losses when you only get 20 percent of gain…but are required by law to show 100 percent of risk. Moving these positions off the WAG balance sheet allowed the co-op to be more active in commodity risk management as it's s a more appropriate representation of the risk sharing between franchisor and franchisee, given the relative ownership levels/purchasing activities.

Butler shares an essential tip to help drive the success of a co-op model: "Developing an effectively structured board is important for fair representation across the brand membership and developing a governance process that provides the brands with control over strategic objectives and decisions is key."

INHERENT INCENTIVES/PERVERSE INCENTIVES

One of the biggest advantages of investment-based models is that they allow an organization to maintain maximum control and to reap the fullest extent of the reward when they create value. High risk, high reward. For many organizations, this is attractive. Ownership, after all, is a strong profit motivator. Why dilute the value if you can invest and claim all of it yourself? Although this is a good question, perhaps the better question is: Why invest just because you can? While ownership has its perks, much research supports the general rule that an organization should invest only when something truly is a core competency and the organization can reap a return on investment far greater than if it used the market.

According to C. K. Prahalad and Gary Hamel, organizations likely do not have more than five or six fundamental core competencies. A core competency does *not* mean "shared costs, as when two or more SBUs [strategic business units] use a common facility—a plant, service facility, or sales force—or share a common component. The gains of sharing may be substantial, but the search for shared costs is typically a post hoc effort to rationalize production across existing businesses, not a premeditated effort to build the competencies out of which the businesses themselves grow."[36]

This may be why some insource models, such as shared services or even co-ops, have come under criticism in recent years. For example, the Shared Services Outsourcing Network (SSON) reports that SSOs are not getting the full benefits because business groups are going around SSOs. In fact, more than half of SSOs service less than 50 percent of their customer base. And some SSOs report that only a fraction (15 percent) of their customers fully use the SSO's service.[37]

In a co-op environment, there is also potential for negative impact because often the franchisees are not knowledgeable about strategic sourcing practices, yet they are members of the board that makes business decisions. In addition, franchisees commonly seek short-term financial gain and increased transparency. They see the profit a co-op makes and all too often believe profits should be channeled back to franchisees in the form of year-end bonuses. This creates an inherent perverse incentive. The short-term gain and occasional bonus are welcome. However, when franchisees take too much financial upside, there is not enough money to invest in increased capabilities to drive longer-term benefits or innovation. Ben Butler gives an example of a difficulty he had with the co-op Long John Silver's used. "Long John Silver's wanted to pay a premium to get engaged directly with aquaculture—the breeding, rearing, and harvesting of plants and animals in all types of water environments—for the long term, but this was not allowed under the structure."

Another negative of a co-op model occurs when a larger member (e.g., a brand) wields more power than smaller members. Butler explains: "Decision making doesn't always translate into the best advantage for the smaller brand player. For example, we had less than 5 percent of the total media spend budget dollars and, as a result, didn't always get the benefits provided by the media contract. The smaller brand may get the efficiency (lower cost/media unit) from a larger buy group but may not get the effectiveness of value-added sponsorships or PR [public relations] offerings that a smaller advertising agency working only for your account can achieve."

Perhaps Butler was experiencing the frustration that Oliver Williamson points to in his research on transaction cost economics. Williamson argues that a corporate hierarchy provides low incentives, high administrative costs, and a legal system that is "deferential to the management." Because of these bureaucratic costs, Williamson says that "the internal organization is usually thought of as the organization of last resort."[38] In other words, if at all possible, companies should outsource noncore services.

So, if you should outsource noncore competencies, we have come full circle. Is there a Sourcing Business Model that best fits your situation? The answer is yes. Chapter 8 shares a powerful yet easy-to-use tool to help you determine which model is best for your unique situation.

CHAPTER 8

SELECTING THE RIGHT SOURCING BUSINESS MODEL FOR YOUR SITUATION

In chapters 4 to 7, we profiled seven distinct Sourcing Business Models. Which one is right for your situation? The answer is: "It depends." You don't need a sophisticated relationship to source paper clips. A straightforward transactional deal works just fine. Likewise, as Adrian Gonzalez points out in chapter 5, an organization shouldn't rely on an electronic auction to find a third-party logistics service provider to provide $100 million of logistics support.

Most organizations can and should use multiple Sourcing Business Models. The problem is knowing when to use which model. This chapter provides an easy-to-use tool to help sourcing professionals find the right answers.

INTRODUCTION TO BUSINESS MODEL MAPPING

To help organizations determine the best Sourcing Business Model for their situation, the authors led a collaborative effort with academic and industry experts to develop a Business Model Mapping process.[1] As part of the process, stakeholders assess a spend category across seven dimensions by asking these questions:

1. What is the overall level of dependency associated with each spend category?

2. What is the strategic impact of the spend category? Does this spend category provide your organization with a core competency or competitive advantage?
3. What is the degree of risk associated with this spend category?
4. How much potential is there to create mutual advantage by collaborating with a supplier?
5. What is the nature of the workscope?
6. What is the criticality of the work?
7. What are your risk tolerance preferences?

These seven dimensions are broken down into 25 key attributes. Using the Business Model Mapping template, a buyer "maps" the 25 attributes of a specific spend category across a continuum: For example, overall cost to switch suppliers ranges from low to high. (See www.vestedway.com/tools to access the free online Business Model Mapping Toolkit.)

A cross-functional group of subject matter experts and business users should make up the stakeholder group conducting the Business Model Mapping process. Invite key suppliers to participate. Including a broader group of stakeholders widens the perspective about how each of the 25 attributes affects the spend category. It also helps you create a more accurate assessment of which Sourcing Business Model is most appropriate for your situation.

Determining the optimal model is a factor of two components: the most appropriate relationship model and the most appropriate economic model. The concept of relationship models stems from Oliver Williamson's work that classifies an organization's sourcing needs into three categories: market (transactional models), hybrid (relational/hybrid models), and hierarchical (investment-based models).[2] The concept of economic models has evolved over time as modern businesses shifted their thinking away from transactional economic models (you pay 218 yuan to print more business cards at your Shanghai hotel) to output- and outcome-based approaches (you pay the supplier for achieving a certain output or strategic business objective).

The final output of the Business Model Mapping process is a consensus view among stakeholders determining which of the seven Sourcing Business Models best meets your needs.

FOUR-STEP BUSINESS MODEL MAPPING

Buyers and suppliers follow a four-step Business Model Mapping process to determine the most appropriate Sourcing Business Model for their situation.[3]

Step 1. Select the defined spend category/categories you are sourcing/potentially sourcing.
Step 2. Use the Business Model Mapping template to determine the best relationship model for what you are sourcing. (Map the first 14 attributes on page 1 of the template.)
Step 3. Use the Business Model Mapping template to determine the best economic model for what you are sourcing. (Map the 11 attributes on page 2 of the template.)
Step 4. Use the Business Model Mapping matrix to develop a consensus view of the right Sourcing Business Model for you. The best model is a combination of your chosen relationship model and economic model.

Each step is outlined in detail in this chapter. The Business Model Mapping template and Business Model Mapping matrix are part of the Business Model Mapping Toolkit.

As you conduct this exercise, keep in mind that no one model is "better" than another. For example, it might be tempting to think a Vested model sounds good because it motivates suppliers to invest in innovation and transformation. But if the exercise indicates that a preferred provider model is more appropriate for your situation, selecting a Vested model likely would cause you to overengineer your efforts and not realize the value you hoped for. Likewise, you may be frustrated with a supplier if you are expecting transformational results or innovation associated with a Vested model but are treating the supplier as a preferred provider.

Step 1: Select the Defined Spend Categories You Are Sourcing

The first step is to define the spend categories of products/services your organization needs to either make or buy. This review includes products/services that are currently insourced, currently outsourced, and new products or services you need to decide to make or buy.

When most organizations think of spend categories, they typically think in terms of "direct" or "indirect" spend.[4] For example, a major hospital system with 63 hospitals has direct spend responsibility for its pharmaceuticals category. This spend category can be further segmented into three subcategories:

1. Prescription drugs (generic)
2. Prescription drugs (name brand)
3. Nonprescription drugs

In this case, the hospital has to determine whether it should group these three subcategories into a single category or to treat them as three different categories.

Facilities management is an example of indirect spend. TD Bank maintains 2,500 bank branches in addition to its corporate offices. Maintaining all of the bank branches to keep up with TD's brand image as the world's most convenient bank keeps TD Bank's facilities and real estate management team on their toes. For example, after Hurricane Sandy, TD Bank branches were some of the first businesses open in affected communities. When TD Bank thinks about "category management" for its facilities management category, there are three broad "buckets," including:

1. Facilities management (cleaning and day-to-day maintenance)
2. Energy management
3. Project management (e.g., building a new bank branch, remodeling an office, or managing employee relocations)[5]

A third example comes from Microsoft. When Microsoft decided to rethink how it approached back-office finance operations, it looked at the following categories:[6]

- Accounting transactions
    - Accounts payable
    - Accounts receivable
    - Purchase order administration
- Statutory compliance
- Review and approval process
- Management reporting

- Payroll
- Tax
- Mergers and acquisitions

We recommend that buyers have a basic understanding of a spend category before they complete a Business Model Mapping exercise. To do so, they must look both internally and externally to understand the overall spend category and market characteristics. For example, they will want to work with stakeholders to understand how the spend category links to business objectives as well as the overall requirements. They should also have a good understanding of external market factors, basic costs structures, and potential suppliers' capabilities and positioning. Chapter 9 provides guidance for assessing a spend category.

We recommend completing a Business Model Mapping exercise for each spend category in scope. For example, TD Bank maps facilities management, energy management, and project management separately. Then the exercise is repeated (as we encourage all buyers to do) with a broader perspective, asking: What if spend categories were bundled into a broader, more holistic category? How would bundling the separate spend categories affect supplier dependency and risk? Would bundling give a supplier an opportunity to create more value than managing each spend category separately? If you decide to bundle, which categories can be bundled and still be managed effectively by potential suppliers?

This is exactly what Microsoft did when it outsourced its finance operations to Accenture. Bundling several of the smaller finance spend categories allowed Accenture to have an end-to-end perspective of Microsoft's overall finance operations. Bundling provided a unique vantage point on how Acccenture worked with Microsoft to transform back-office finance operations. It also allowed Accenture to create significant synergies that could not be realized if the spend categories remained unbundled. Bottom line: Bundling can easily impact how you view a spend category and shift your perspective from that of a "commodity" to a "strategic" enabler.

Step 2: Determine the Best Relationship Model

The second step is to begin the actual mapping part of the process. Step 2 focuses on the relationship model while Step 3 focuses on the economic model. To complete Step 2, use the Business Model Mapping template to map each attribute that will impact your relationship model. This exercise helps you answer the following questions about your business environment:

- What is the overall level of dependency associated with each spend category?
- What is the strategic impact of the spend category? Does this spend category provide your organization with a core competency or competitive advantage?
- What is the degree of risk associated with this spend category?

Many procurement professionals will recognize the links between these mapping attributes and the logic behind the Kraljic Matrix. In fact, the Business Model Mapping template directly leverages the concept of business risk and profit impact from the Kraljic model. However, the Business Model Mapping template includes 23 additional attributes from the best thinking in the areas of transaction cost economics, agency theory, understanding a firm's core competency, and relational contract theory.

Table 8.1 provides an example of how to map one of the attributes: level of supplier integration/interface.

As you complete the exercise, you will map your response on the template by noting which is the most appropriate column or answer box. As the table illustrates, there are six possible answer boxes with responses ranging on a scale from none to critical. In some cases, such

Table 8.1 Business Model Mapping Attributes: Level of Supplier Integration/ Interface

Attributes to Determine Best Relationship Model	*Transactional Contract*		*Relational Contract*			*Investment*
	A	*B*	*C*	*D*	*E*	*F*
Level of supplier Integration/ interface required (systems, support processes)	None	None	Medium	High	Very High	Critical

as the example in Table 8.1, there may not be a single right answer; answers may appear in more more than one answer box. For example, notice that both columns A and B have "none" in the answer box. As you work through each attribute you will eventually have a map that profiles you spend category.

Let's say you work for an insurance company and your chief operating officer wants to find a business process outsourcing partner to transform the back-office procure-to-pay processes. You know your existing processes are woefully inadequate, and a significant amount of automation and interfaces with your existing claims systems are needed. In this case, the supplier would likely need to invest in highly customized business process, workflows, and specialized skills that may require a large investment. The stakeholder group cannot determine how much integration will be needed, but its members know it is significant. You mark the answer box with columns D (high) and E (very high). It is acceptable for your answer to appear in more than one column because your final decision for which Sourcing Business Model is most appropriate will be based on your complete map, not just on one attribute.

As you work through each of the attributes on the template, stakeholders should openly debate their perspective. For example:

- A procurement professional new to the spend category might underestimate the level of integration required with the claims process to support the necessary procure-to-pay processes to meet the organization's requirements.
- The director of operations is a 30-year veteran and has personally run the claims processing group. He is adamantly against outsourcing the procure-to-pay process because of its interdependence with the claims process and views the work as so critical that it must be deemed a "core competency" to the organization.

You invite two potential suppliers to participate in the mapping exercise. Both recognize that a high level of integration is needed with the claims process but state that other insurance companies have successful procure-to-pay processing. Both also are uncertain how much integration is needed without understanding your requirements better, but they believe either high or very high integration will be needed.

Getting a cross-functional consensus helps ensure that you are looking at the spend category holistically. Consideration of viewpoints other than your own helps you make the most appropriate and educated selection for each mapping attribute.

Once you have mapped all of the relational attributes, you will begin to see a pattern emerge. At this point, your map may indicate an overall preference for a transactional, relational, or investment-based model. This is okay; you will use this information in Step 4.

Table 8.2 provides an example of the completed Business Model Mapping template for a pharmaceutical company that outsources clinical trials. The map clearly shows that the sourcing environment suggests the use of a relational contract. (**Note**: The downloadable Business Model Mapping Toolkit defines each attribute.)

Some organizations find it helpful to prioritize or do a weighted ranking for each attribute. While you can modify the template to allow weighted ranking, most organizations however, find the generic Business Model Mapping template meets their needs.

Step 3: Determine the Best Economic Model

Step 3 completes the Business Model Mapping template by helping you map attributes that point you to the most appropriate economic model for your situation. An economic model determines how you will manage the economics of the relationship (e.g., pay the supplier). There are three economic models.

The most prevalent economic model in businesses today is a transactional model. Transactional economic models are the easiest to administer; a supplier typically is paid per activity. This can be a price per unit, per hour, per mile, per kilometer, per kilogram, or per call answered. Record the number of transactions, multiply by the price per transaction, and you easily determine how much to pay.

A transactional economic model can be limiting, especially for more complex spend categories that require a supplier to invest in value-added, asset-specific, or innovation opportunities. Because of the limited nature of transactional models, organizations tend to shift to economic models that drive business results rather than simply pay for a task. Two types of results-oriented economic models have emerged: output-based models and outcome-based models. In

Table 8.2 Completed Business Model Map: Relationship Model (Contract Research Organization Example)

Attributes to Determine Best Relationship Model	*Transactional Contract*			*Relational Contract*		*Investment*
	A	*B*	*C*	*D*	*E*	*F*
Dependency						
Overall cost to switch suppliers[1,4]	Low	Low	Medium	Medium to High	Medium to High	High
Physical asset specificity (location, machinery, processes)[1]	Low	Low	Medium	Medium to High	Medium to High	High
Skill level needed for predominant personnel[4]	Unskilled	Semiskilled	Skilled	Professional	Professional	Expert
Level of supplier Integration/interface required (systems, support processes)	None	Low	Medium	High	Very High	Critical
Overall availability of service/ product in marketplace[4]	Widely Available	Widely Available	Wide to Moderate Availability	Limited number of capable suppliers	Limited number of capable suppliers	Scarcely Available
Availability of human resources[4]	High	High	Medium	Low	Low	Low
Availability of required technology[4]	Universal	Limited	Restricted	Restricted to Scarce	Scarce	Unique
Access to buyer's critical systems and processes[4]	None	Low	Medium	High	Very High	Critical
Strategic Impact/Core Competency for Buyer[3]	No	No	No	Maybe	Maybe	Yes
Degree of Business Risk[1,4,5]						

Continued

Table 8.2 Continued

Attributes to Determine Best Relationship Model	*Transactional Contract*			*Relational Contract*		*Investment*
	A	*B*	*C*	*D*	*E*	*F*
Profit Impact (volume purchased, % of total purchased costs, impact on business growth)[5]	None	Low	Medium	High	Very High	Critical
Service failure impact on end customer/brand experience	None	Low	Medium	High	Very High	Critical
Service failure impact on internal customer experience	None	Low	Medium	High	Very High	Critical
Regulatory compliance policy	Meet Standard	Meet Standard	Meet Standard or Higher	Meet Standard or Higher	Meet Standard or Higher	Meet Standard or Higher
Uncertainty of demand[1]	N/A	Manage unanticipated demand spikes with multiple sources	Provider response to unanticipated volume spikes limited	Contractual ability for supplier to respond to spikes	Contractual flexibility for supplier and client to respond to spikes to optimize the business	Capacity is set based on captive assets plus using market if not asset specific

Source of key of research supporting the attribute: [1]*Williamson,* [2]*Eisenhart,* [3]*Prahalad and Hamel,* [4]*University of Tennessee,* [5]*Kraljic.*

output-based models, a supplier's payment typically is tied to achievement of predefined measures, such as process-based service-level agreements. Performance-based (managed services) agreements use output-based economic models where a buyer negotiates predefined efficiency or performance targets. For example, a buyer may negotiate for a supplier to decrease the price by 3 percent year over year. Or it may negotiate a penalty or incentive for a supplier to achieve a certain performance target (e.g., the Navy-Raytheon flight-hour availability metric discussed in chapter 5).

An outcome-based economic model is more sophisticated than an output-based one because it typically ties the supplier's payment to mutually agreed, boundary-spanning business outcomes, not just process or functionally focused performance outputs. To achieve true business outcomes, buyers and suppliers must work together in a highly integrated and collaborative fashion. There is shared risk and shared reward when business outcomes are reached.

ADVICE FROM A PRO

Arjan J. van Weele, NEVI professor of purchasing and supply management at Eindhoven University of Technology in the Netherlands, offers the following advice for thinking about outputs and outcomes.

> Preferably the buyer should always strive for an output or outcome specification. The reason for this is that it allows the supplier more degrees of freedom to select the work methods that suit them best and organize the work in the best possible way. All of this should work out positively in terms of pricing, but also in terms of quality and flexibility. Moreover, the supplier is requested to put down a certain performance, which is relevant when the buying organizations seek a performance-based contract. In general, performance-based contracts are largely preferred over contracts in which the supplier only commits to perform certain activities.
>
> This, however, is too easy a statement. From a purchasing point of view, it is always very important to check whether a service provider is capable of delivering the required output or outcome.

> And more generally—the more difficult to specify the outcome and output—the more difficult to arrange performance-based contract.
>
> ---
>
> Arjan J. van Weele and Frank A. Rozemeijer, "Revolution in Purchasing: Building Competitive Power through Proactive Purchasing," *European Journal of Purchasing and Supply Management* 2, no. 4 (1996): 153–160; http://repository.tue.nl/611717; accessed June 4, 2015.

The life sciences industry actively seeks to embrace output- and outcomes-based models. John Orloff, M.D., global head of research and development at Baxter BioSciences, offers insight into emerging trends. "The clinical trial enterprise is endangered because the model is antiquated and has not kept pace with advances in technology. Contract research organizations (CROs) of the future will rely on different business models, becoming stronger strategic partners with sponsors. They will be fully integrated into team structures and will have accountability for delivering on a program with objectives and rewards similar to sponsor team members (i.e., much less transactional and much more strategic and program-oriented)."[7]

CROs offer a great example of how outcome-based economic models differ from transactional economic models. Traditionally, life sciences companies engage a CRO as a staff augmentation resource to manage clinical research trials. Most often CRO relationships fall under a preferred provider Sourcing Business Model and use a transactional economic model.

Often a CRO firm provides services that span several phases of investigation. The goal is to provide quantifiable and undeniable statistical data to validate effectiveness and safety of potential new drug therapies. The life science company specifies very detailed protocols, such as determining viable unit dose, formulas, and types of formats (oral, liquid, pill). The CRO conducts the trials according to the client's specifications and oversees various principal investigators (physicians at clinical site locations where testing occurs) at multiple geographic sites to assess the quality of data received and aggregate the findings.

CRO relationships are often plagued with poor communications and misalignment of economic interests. Life sciences organizations want high-quality data in order to get a new drug approved. CROs are economically incented to spend more time and perform more tasks under transactional economic models.

More recently, life sciences firms have moved to adopt electronic recording requirements. Unfortunately, often there is a lack of systems compatibility. There is a running debate as to which party will invest in systems integration. These misaligned interests often produce delays and strained relationships between life sciences firms and CROs.

When a life sciences firm and its CRO move to an outcome-based economic model, they agree to work collaboratively and share risks and rewards associated with the ultimate desired outcome: gaining government approval for a new drug and successfully launching a new drug. As such, the parties enter into a contractual agreement that shifts thinking away from price per hour or activity to a pricing model with incentives for the supplier to drive success toward ultimate outcomes. As the relationship changes, it is important to recognize that suppliers have purposefully taken on more risk. Thus, buyers must purposefully create mechanisms that reward suppliers for this added risk when and if outputs and outcomes are achieved.

The Business Model Mapping template includes 11 attributes across four dimensions focused on helping you understand which economic model is best for your situation. The mapping exercise helps you answer these questions:

- How much potential is there to create mutual advantage by collaborating with a supplier?
- What is the nature of the workscope?
- What is the criticality of the work?
- What are your risk tolerance preferences?

Based on the nature of your stakeholders' requirements, you will select one of the three economic models.

Table 8.3 provides an example of how to map one of the attributes—potential efficiency gains. As you map this attribute, you will determine to what extent there will be an opportunity to drive efficiency. For example, let's return to the insurance company that was looking to potentially outsource a legacy claims processing function.

Table 8.3 Business Model Mapping Attribute: Potential Efficiency Gains

Attributes to Determine Best Economic Model	*Transaction-Based Economic Model*			*Output-Based Economic Model*	*Outcome-Based Economic Model*	
	1	*2*	*3*	*4*	*5*	*6*
Potential efficiency gains	None	Low	Medium	High	Very High	Significant

As you complete the exercise, you will map your response on the template. As table 8.3 illustrates, there are six possible answer boxes with responses ranging on a scale from none to significant.

All of the stakeholders you've invited to the Business Model Mapping workshop believe the firm will save money by outsourcing. As you have not done a formal business case yet, you are simply estimating the potential at this time, which is okay. The stakeholder group agrees that efficiencies are likely to be high to very high. You mark the answer box for column 4 "high" and for column 5 "very high". It is okay for your answer to span more than one column because your final decision for which Sourcing Business Model is most appropriate is based on your complete map, not just one attribute.

As with the relationship model template, stakeholders should openly debate their perspective for each attribute. If they are uncertain, stakeholders should brainstorm potential ideas for efficiency gains to gain common understanding of the opportunity. Potential suppliers also should share some benchmarks of what they have seen.

Once you have mapped all of the economic model attributes, a pattern will emerge. At this point, it is normal if your map simply indicates an overall preference for a transactional or output- or outcome-based economic model. This is okay because you will use this information in Step 4.

Table 8.4 provides an example from the CRO spend category of how one organization completed a Business Model Map for the economic model attributes. (Note: The downloadable Business Model Mapping Toolkit defines each attribute.)

Some organizations find it helpful to prioritize or do a weighted ranking for each attribute. As mentioned previously, you can modify the template to allow for weighted rankings.

Table 8.4 Completed Business Model Map: Economic Model (Contract Research Organization Example)

Attributes to Determine Best Economic Model	*Transaction- Based Economic Model*			*Output-Based Economic Model*	*Outcome-Based Economic Model*	
	1	*2*	*3*	*4*	*5*	*6*
Potential to Create Value/Mutual Advantage*						
Potential efficiency gains[4]	None	Low	Medium	High	Very High	Significant
Potential for revenue increase[4]	None	Low	Medium	High	Very High	Constant
Potential for innovation[4]	None	Low	Medium	High	Very High	Critical
Size of investments needed in to achieve outcomes (buyer or supplier)*	Low	Medium	High	High to Invest	Invest	Invest
Nature of Workscope/Tasks[2]						
Degree of supplier control over outcome[2]	Low	Low	Low	High	Medium–High	N/A
Type of success measure desired/Required[2,4]	Transactional Activity Metrics	Transactional Activity Metrics	Transactional Activity Metrics	Output SLA Metrics	Strategic KPI† or Business Outcomes	Strategic KPI or Business Outcomes

Continued

Table 8.4 Continued

Attributes to Determine Best Economic Model	*Transaction- Based Economic Model*			*Output-Based Economic Model*	*Outcome-Based Economic Model*	
	1	*2*	*3*	*4*	*5*	*6*
Ease with which task/workscope can be specified[2]	High	High	Medium	Medium	Can Vary	Very Difficult or Impossible
Criticality of Work[4]						
Risk related to operational safety[4]	Minimal	Low	Medium	High	High	Critical
Risk related to operational reliability[4]	Minimal	Low	Medium	High	High	Critical
Commercial Preferences						
Financial risk Tolerance for buyer[2]	High Risk	High Risk	Medium Risk	Medium-Low Risk	Shared Risk	N/A
Financial risk Tolerance for supplier[2]	Low Risk	Low Risk	Low Risk	Medium Risk	Shared Risk	N/A

Source key of research supporting the attribute: [1]*Williamson,* [2]*Eisenhart,* [3]*Prahalad and Hamel* [4]*University of Tennessee,* [5]*Kraljic*

*These attributes are used to determine both the relationship and the economic model.

†Key performance indicator.

Step 4: Determine the Best Sourcing Business Model

Steps 2 and 3 helped you identify the most appropriate relationship model and economic model. In Step 4, you use this information to identify which of the seven Sourcing Business Models is most appropriate for your situation. The answer stems from a combined view of both the relationship model and the economic model.

To complete the exercise, use the Sourcing Business Model Matrix (see Figure 8.1) provided in the Business Model Mapping Toolkit. The simple three-by-three matrix has the three relationship models on the vertical axis and the three economic Models on the horizontal axis. Take your answers from Steps 2 and 3 and plot them into the matrix. For example, if the majority of responses for the relationship model fall into the C column, your ideal contracting model would be relational. And if your predominant answers were in columns 2 or 3, you ideal economic model is transactional. Plotting these lead you to a preferred provider Sourcing Business Model.

Determining the best Sourcing Business Model is simply a factor of plotting your relationship model and economic model onto the matrix. Let's use the CRO example. The mapping template indicates that the most appropriate relationship model is a relational contract and the most appropriate economic model is outcome-based. When you plot these onto the Business Model Map matrix, you find that a Vested model is your most appropriate choice.

It is important to note than investment-based models (equity partnerships and shared services) can be developed using *any* of the three

Figure 8.1 Sourcing Business Model Matrix

		RELATIONSHIP/CONTRACT MODEL		
		TRANSACTIONAL CONTRACT (MARKET)	RELATIONAL CONTRACT (HYBRID)	INVESTMENT (VERTICAL INTEGRATION/ HIERARCHY)
ECONOMIC MODEL	OUTCOME BASED Economics tied to boundary spanning/business outcomes	Mismatch— not a viable strategy N/A	Vested (E - 5,6)	Equity Partnership Vested Shared Services (F - 5,6)
	OUTPUT BASED PERFORMANCE BASED/ MANAGED SERVICES Economics tied to supplier output	Mismatch— not a viable strategy N/A	Performance Based (Managed Services) Agreement (D - 4)	Equity Partnership Shared Services (Performance Based Shared Services) (F - 4)
	TRANSACTION BASED Economics tied to activities (e.g., per unit, per hour)	Basic Provider Approved Provider (A,B - 1,2,3)	Preferred Provider (C - 1,2,3)	Equity Partnerships Transaction Based Shared Services (F - 1,2,3)

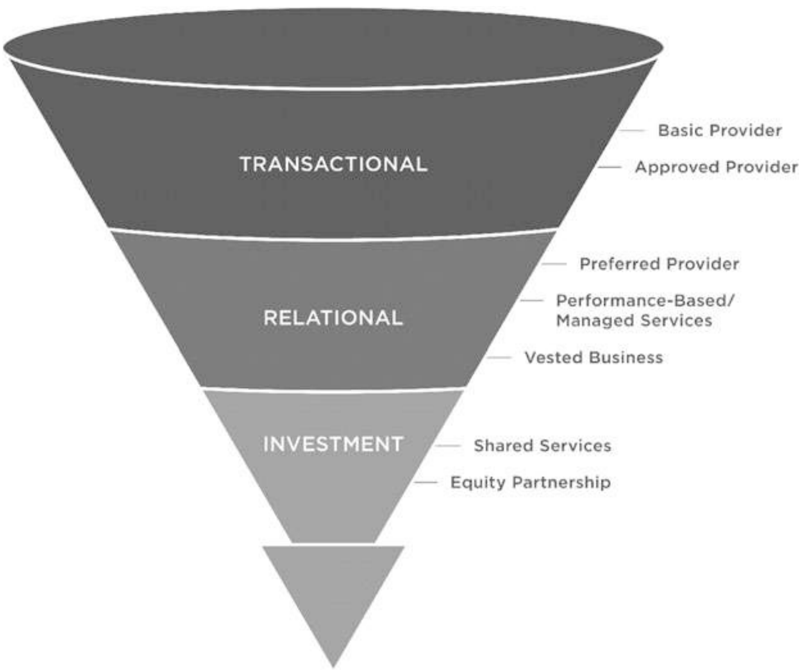
economic models. The key point is that the entity or venture is structured differently based on the desired economic model.

SOURCING BUSINESS MODELS IN CONTEXT

As you review your organization's spend categories, you will find that the majority of sourcing decisions fall under transactional models (basic and approved providers). A smaller number of spend categories are likely a good fit for performance-based or Vested models. In practice, the actual application of the various Sourcing Business Models looks much like the funnel depicted in Figure 8.2.

As you use the Business Model Mapping Toolkit, remember that no one Sourcing Business Model is better than another. The important thing is to understand the attributes of your business environment and use them to help you select the most appropriate Sourcing Business Model. We wholeheartedly agree with Oliver Williamson's observation that "no comprehensive commitment to one approach

Figure 8.2 Sourcing Business Models in Context



rather than another needs to be made. What is involved, rather, is the selection of the approach best suited to deal with the problems at hand."[8]

It is also important to put the concept of Sourcing Business Models in the context of the broader view of strategic sourcing. While Business Model Mapping is an excellent resource, it, like the Kraljic Matrix and Porter's Five Forces, is incomplete if it is not taken in the context of a holistic sourcing strategy and category management plan. Although selecting an appropriate Sourcing Business Models is a critical step, it is only one factor in developing an overall sourcing strategy and category management plan. In chapter 9, we share a fresh approach to sourcing that not only embraces the concept of Sourcing Business Models but embeds it into how to develop a sourcing strategy.

CHANGING SOURCING BUSINESS MODELS AS BUSINESS NEEDS EVOLVE

In chapter 2, we wrote about the dynamic nature of business. As the old saying goes, the only thing in life that is constant is change. Sourcing professionals must know when it's time to at least be open to looking at potential new ways to create value with suppliers.

Let's look at procuring basic office supplies. Your organization's office supplies have pretty much remained the same for the last 25 years. Pens. Paper. Staples. Yes, the actual products have changed. Now employees in your office have an affinity for brightly colored pens. And because your firm has grown, you now buy 100 times the volume you used to buy. But office supplies are office supplies, and they clearly map onto the Kraljic Matrix as "noncritical" items.

How much could things have changed?

Any firm that has already adopted a category management plan for office supplies will respond "A lot," especially if it has become a large organization that buys a significant quantity of office supplies for employees in multiple locations.

Your procurement organization is progressive and adopted a formal seven-step strategic sourcing process almost ten years ago. As part of the seven-step process, you formally bid out the office supplies spend category every two years. The rationale is to create competitive tension and make sure you get the best prices. As part of your strategic sourcing initiative, you ask each of your firm's business groups to order supplies only from suppliers on your approved provider list.

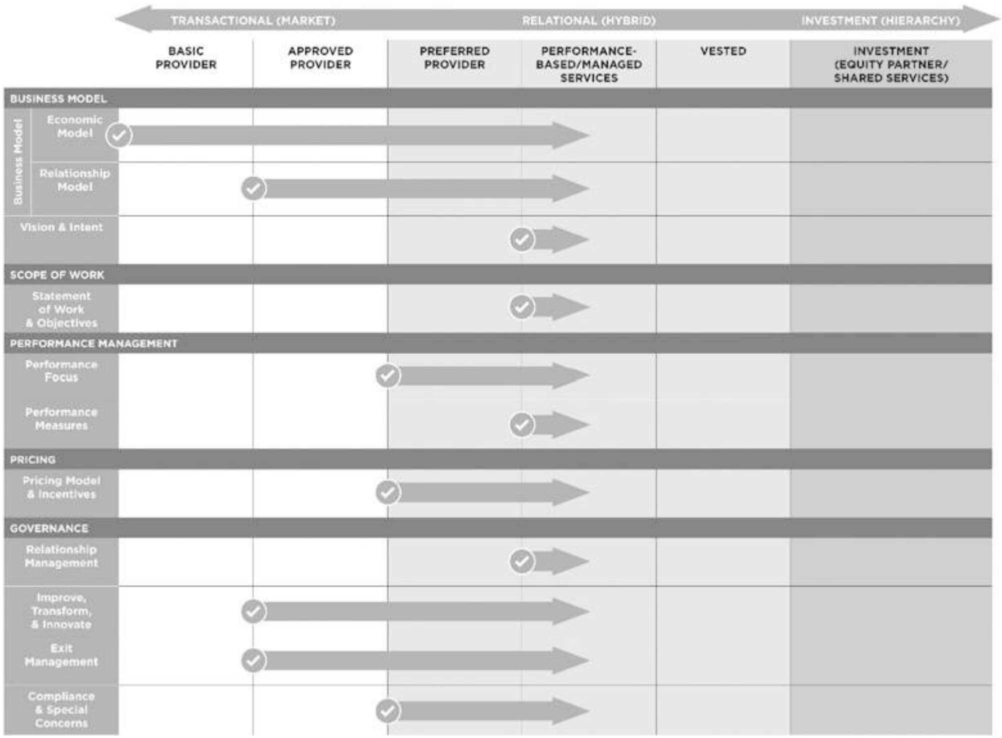
Six years ago, you made the strategic decision to consolidate over 50 local suppliers into 14 regional suppliers. As part of the consolidation effort, all suppliers provide mandatory monthly detailed reporting so you can monitor demand usage of individual departments, a key to driving cost savings across the spend category. Your U.S.-based supplier and one of your European suppliers have exceptional performance records for on-time delivery and complete and accurate reporting. For that reason, two years ago, you promoted these two suppliers to preferred status in your ordering system. As part of the negotiation process, you successfully negotiated with both suppliers to provide value-added services—a Web-based ordering process that allows subsidiaries and departments to streamline the ordering process for office supplies.

How much could things have changed?

Your U.S. preferred provider has asked you to consider pursuing a Vested relationship. You are skeptical but open-minded. How could the office supply spend category—clearly a noncritical spend category for fairly low-cost commodity items—be a candidate for a Vested model? As you listen to the supplier's account executive, she shows you an end-to-end supply chain map. It reveals a cost structure associated not only with the actual products you buy but also with the benchmarks for end-to-end supply chain costs. She proposes a vendor-managed inventory program coupled with a direct-to-department delivery program that would enable office suppliers to directly deliver goods rather than going through your centralized mailroom. Her company is prepared to shift to open-book pricing and put skin in the game based on her firm's confidence that it can reduce your overall total costs. You realize that a tremendous amount of value can be unlocked if your firm has a fully integrated solution for office supplies. Perhaps a Vested relationship has merit.

Bottom line—it's easy to see how the organization just discussed migrated from a basic transactional model to consideration of a Vested model with a trusted supplier. The lesson is simple: Business is dynamic. Just as in the office supplies example, a Sourcing Business Model that worked well for a category ten years ago might not be the most appropriate now. Organizations need to adapt to a continuously morphing marketplace. As your situation changes, you need to proactively reevaluate your existing Sourcing Business Model to ensure you do not have a Sourcing Business Model mismatch.

Figure 8.3 Business Model Diagnostic Resource Example



BUSINESS MODEL MISMATCHES: THE SQUARE PEG/ROUND HOLE SYNDROME

Many organizations find that what they *should* be doing doesn't match what they *are* doing. A business model mismatch is analogous to trying to put a square peg in a round hole; something needs to change for your intent and your actions to fit together.

One of the best ways to determine if you have Sourcing Business Model mismatch with an existing supplier relationship is to review the overall structure of the relationship and compare the as-is structure with the should-be structure you identified during your Business Model Mapping exercise. In chapters 4 to 7, we shared how to structure each of the models, providing guidelines for each of the ten structural elements. Figure 8.3 illustrates how to use the business model diagnostic resource to help you determine if you have structural mismatches in an existing relationship. The resource is part of the Business Model Mapping Toolkit.

A good way to describe a business model mismatch is to use the example of an Audi car commercial that ran during Superbowl XLIV. The commercial featured a couple who wanted a new dog but could not decide on which breed to get. The girlfriend wanted a Doberman Pinscher and the boyfriend wanted a Chihuahua. They decided to breed the dogs, and the result was a "Doberhauhau" that terrorized New York City.[9]

On the surface, it seems logical and harmless to cherry pick the best attributes of each breed. However, the undertone of the commercial is that it is dangerous to choose among competing ideas that on the surface look good but in reality don't work well together. The same is true with Sourcing Business Models. Each model forms a "system" that works in harmony with the business environment. Mix the elements, and you end up with an animal that simply doesn't behave the way you are expecting.

Here are a couple of simple examples of business model mismatches.

SYSTEMS THINKING IS IMPORTANT IN REGARD TO SOURCING BUSINESS MODELS

A system is an interconnected set of elements, subelements, and components that are coherently structured in a way that achieves a defined purpose. The interconnectivity between the elements forms a feedback loop from which information is derived. The purpose or function of the system is to perpetuate or replicate a chosen result.

Donella Meadows, a pioneering environmental scientist, author, teacher, and farmer, was an influential writer on systems thinking. Her book *Thinking in Systems* provides a simple guide that shows business leaders how to address complexity through systems thinking. Meadows illustrated her philosophy with an analogy of a Slinky toy, which appears to magically walk downstairs by itself. All that is needed is to take it out of the box, put it in the right place, and let it go with a gentle push. That gentle push releases energy latent within the toy's structure to keep it moving. That latent behavior makes it possible for the Slinky to "walk" downstairs by itself. It's quite simple.

Much like the Slinky, with the right motivation, a well-designed system has the structural ability to manage itself. Think of a thermostat in your house. After you set the temperature, it is self-correcting system that keeps your home the same temperature inside regardless of how cold or hot it gets outside. Latent powers in supplier relationships can be unlocked when the relationships are intentionally structured to do so. *But they must be designed properly*, just as the Slinky developer designed it to have latent powers to operate on its own. The toy goes downstairs without falling, stopping, getting tangled, or, worse, falling off the stairs altogether.

What does a Slinky have to do with Sourcing Business Models? Business relationships, in essence, form their own systems. For that reason, mechanisms must be in place to keep their unique systems running at peak performance. What happens when the well-designed system hits a roadblock? Looking back at the Slinky, it can move by itself so long as the stairs are straight. A bend in the stairs poses a problem for it. An attentive child must redirect and point the toy in the right direction. Similarly, a robust strategic sourcing process redirects buyer–supplier relationships when business happens that requires a change in approach.

Source: Donella H. Meadows, *Thinking in Systems: A Primer Paperback* (White River Junction, VT: Chelsea Green, 2008), p. 1.

Let's say you have completed your Sourcing Business Model map, and the most appropriate approach is a Vested model. You want your supplier to invest in innovation to drive business outcomes. You carefully put in place an outcome-based economic model with clearly defined and measurable Desired Outcomes. However, your finance team does not want to put incentives into the pricing model to reward the supplier for its added risk. The result? Even though you might be clear about the outcomes you want, your supplier resists investing in innovation and transformation. Why? There is no hope of a future return on investment for the supplier.

Or let's say you created a great pricing model with significant incentives for your supplier. However, your operations team cannot bear the thought of losing control and creating a more flexible statement of work (SOW) that focuses on the "what" and not the "how." In addition, the operations team does not feel comfortable managing the supplier with a high degree of insight rather than oversight. In short, the team doesn't trust the supplier. The result? The supplier eventually will stop trying to bring innovations because it's likely the organization suffers from the Junkyard Dog Syndrome and Measurement Minutia.[10]

Cherry-picking the best part of something can lead to a scary mishmash when it comes to Sourcing Business Models. Simply put, when a procurement professional poorly structures a supplier agreement they often unleash an unwieldy Doberhauahu. Rather, think of each Sourcing Business Model as having its own set of rules, just as the games of football, rugby, cricket, and baseball do. You wouldn't bring a baseball to a rugby match.

Bottom line: A properly structured buyer–supplier relationship creates a system that works in harmony to keep buyers and suppliers aligned with the dynamic nature of the business environment, irrespective of the spend category.

ARE YOU READY?

You've completed your Business Model Map. You know what you should be doing. You've even identified mismatches in how your existing relationship is structured and have a clear idea of what needs to change. However, just because you should be applying a certain Sourcing Business Model does not mean that you can apply it effectively or that employees will embrace it. There are two primary reasons why an organization fails to shift across the sourcing continuum effectively: One reason is due to the buyer, and the other is due to the supplier.

The first reason is that a buyer isn't ready or willing to change. For example, a buyer may find the organization simply does not have the skills or organizational maturity to tackle more advanced Sourcing Business Models. Or perhaps a buyer feels that a supplier lacks sufficient skills to provide value-added capabilities. In many cases, key stakeholders simply lack confidence in the supplier's ability to create a more transparent and trusting relationship demanded by more complex Sourcing Business Models.

The second reason is that the supplier isn't ready or willing to change. Suppliers often are hesitant to invest in more advanced Sourcing Business Models because they don't trust buyers' intentions. Many suppliers complain, "When I hear the words 'collaborate' or 'partner,' it often means 'open up your checkbook.'" Others simply don't know how to start the discussion to build a more collaborative relationship. Suppliers become frustrated when buyers don't listen to their ideas on how they can create value or, worse, take their ideas and share them with their competitors.

These reasons are discussed in more detail next.

IS THE BUYER READY?

In many cases, the very nature of existing commercial agreements with suppliers discourages suppliers from either making proactive suggestions or making physical investments to drive innovation.

A good example comes from ISS, a leading provider of facilities management based in Denmark. One of ISS's contracts was with a client that sole-sourced all its facilities management activities under a "strategic" contract to reduce costs, holding ISS to an aggressive cost savings glidepath under a performance-based agreement. The SOW was 800 pages and included 550 detailed, task-oriented metrics. As part of the contract, the SOW required janitors to clean the restrooms every hour using preestablished best practices. After cleaning the restrooms, the janitors signed a form posted on the restroom entrance wall with their name and the time of service. Once a day, the ISS manager in each location removed the form and put up a new one. Once a week, the account manager created a detailed scorecard with all of the metrics.

ISS argued that the buyer suffered from the Activity Trap and Measurement Minutia.[11] On several occasions, the ISS account manager brought these inefficiencies to the attention of the client supplier relationship manager. Although that manager, who prefers to remain anonymous, was sympathetic, she consistently offered up the same reason why the process could not be changed: "The facilities management stakeholders wrote the SOW. We have asked them if there is flexibility to change the SOW, but they have insisted they worked with a consultant who has written best practices into the SOW and that they do not want to change the process."

The business model mismatch was clear. The telecommunications company liked the idea of a performance-based agreement but was not ready to let go and provide the workscope flexibility that ISS needed to drive cost structure improvements.

Chapter 9 provides guidance to ensure your strategic sourcing processes align with your Sourcing Business Model and don't create a Doberhauhau.

In some cases, buyers may recognize the need for a more sophisticated Sourcing Business Model but find that the organization is not mature enough to drive the physical changes needed to support the appropriate model.

In other cases, organizations simply may not have the capabilities or skill set to use a more strategic or collaborative Sourcing Business Model. A good example comes from a company that outsourced its information technology. The chief information officer (CIO) was very happy with the supplier's performance and wanted to push to new levels of innovation and performance. After completing a Business Model Mapping exercise, the CIO proposed moving to a performance-based model. However, the procurement department dragged its feet.

The CIO argued that the procurement department simply did not "get it "and felt frustrated that the procurement staff did not see the value in establishing a more formal governance structure required by a performance-based model. The procurement person on the team—a virtual Ice Queen—went so far as to argue that governance was "free" if suppliers kept a green scorecard. The CIO was also annoyed that existing procurement processes seemed to go directly against processes that a performance-based model needed.

If you find yourself with a Sourcing Business Model mismatch due a lack of organizational maturity, you must decide either to close the gaps in your maturity or to accept that you need to use a Sourcing Business Model that will lead to suboptimal results.

Chapter 10 will help you understand your organizational maturity. It provides guidance on how to address each of your options.

IS THE SUPPLIER READY?

You may be willing and ready to adopt a more sophisticated Sourcing Business Model, but your supplier may not have the same viewpoint. One example is a midsize regional bank that outsourced its back-office procure-to-pay operations. The supplier had read the Microsoft-Accenture OneFinance case study and loved how Microsoft used a Vested model to "transform" its back-office procure to pay.[12]

During the supplier selection process, the bank felt strongly that Accenture offered the best capabilities to meet its needs. As part of the bidding process, the bank gave Accenture and the other suppliers' time to review existing processes and develop solutions to help the bank achieve the transformation it wanted. Once again, Accenture made a strong showing.

A disconnect emerged when the bank and Accenture began to discuss the pricing model. Accenture felt strongly that it wanted to use a managed services (performance-based) agreement. The bank wanted to use a more flexible and transparent Vested Sourcing Business Model in which Accenture would accept a below-market fee to perform the "base" book of work with high incentives tied to achieving "transformation" outcomes.

When the bank asked Accenture why it was unwilling to pursue a Vested model, Accenture stated that since the bank was a smaller organization than Microsoft, there would not be enough of a transformational opportunity (referred to as a pony in Vested terminology) to make its investments worthwhile. Accenture also did not believe the bank was properly valuing Accenture's risk. Bottom line, Accenture did not feel comfortable the bank would fairly structure a Vested model.

A sales executive of a large business process outsourcing service supplier (who prefers to remain anonymous) shared his perspective on why organizations like his are sometimes hesitant to pursue Vested models. “I personally like the idea of a Vested model and see the merits. However, our CFO has been clear that he prefers the economics of a managed services deal. Once we sell a deal, we know how to do labor arbitrage and automation. If we are good, we can take a 15 percent margin account upward to 50 percent with the right investment.” He continued: “A Vested relationship preaches transparency and shared risk/shared reward. Quite frankly, a Vested model scares the hell out of our CFO and CEO. It would mean we would have to trust our clients, and I am not sure that is something we are culturally prepared to do.”

Sadly, some organizations have a deep lack of trust with their business partners. Chapter 11 addresses how to close gaps in buyer and supplier compatibility and trust to get over fears such as those above.

SUCCESSFULLY SHIFTING ALONG THE CONTINUUM

A buyer and supplier worked together for eight years using a classic preferred provider model under a three-year contract using a cost reimbursement compensation method with an 8 percent markup. At the end of three years, the buyer was fairly happy with the supplier’s basic ability to perform the work but felt that a cost-plus pricing scheme created a perverse incentive that prevented the supplier from wanting to proactively drive its cost structure down. In addition, the buyer felt the supplier had slowly replaced its A team with a C team.

The buyer also realized it was locked in with the supplier due to the high degree of asset specificity associated with the work and infrastructure provided by the supplier. The cost of switching to a new supplier would be extremely expensive. The buyer approached the supplier about a three-year no-bid contract extension in exchange for the supplier’s commitment to a 3 percent annual year-over-year cost savings glidepath. Under the performance-based agreement, the supplier assumed the risk and potential profit loss if costs did not go down.

Unfortunately, the buyer did not understand Sourcing Business Models and created a Doberhauhau that caused a great deal of friction. The supplier felt the buyer was “randomizing” it. Every time the supplier did additional work, it worried that it increased the cost structure, which the supplier now was accountable for decreasing. To help it control scope creep, the supplier put in a new process that required the buyer to follow a rigid process and complete a form whenever it wanted to add out-of-scope work. The buyer became frustrated with the new process, claiming the supplier was not being flexible and that it was nickel and diming him.

With one year left on the contract, the buyer decided to go through a strategic sourcing initiative to determine the best way forward. As part of the process, the buyer did a Business Model Mapping exercise and determined that a performance-based model was most appropriate. However, the existing deal was poorly structured. The buyer also realized it had been applying a power-based adversarial mindset that would need to change if the relationship was to be successful. Thus, the firms were suffering from a business model mismatch.

A market analysis revealed there was a potential opportunity to drive value by implementing new integrated technologies that the existing supplier did not have. The buyer concluded that it should open competitive bidding with the goal of switching to a supplier that had the new technologies. However, this meant the firm would need to work with a new supplier. The buyer realized that it would have to create a collaborative what's-in-it-for-we (WIIFWe) mindset and wondered how to lay the foundation for a more collaborative performance-based relationship when working with a new supplier.

Chapter 12 helps you understand the basics for Getting to We, which outlines how to lay a strong foundation with a new (or existing) supplier.

The remaining chapters in this book help you address many scenarios and get you and your supplier more comfortable shifting along the sourcing continuum to a more advanced Sourcing Business Model.

PART III

CHAPTER 9

CONSIDERATIONS FOR CROSSING THE CONTINUUM

You've done your homework. You've used the Business Model Mapping Toolkit and now have a preliminary understanding of which Sourcing Business Model is the most appropriate for your situation. But how do you take this information and turn it into action? In the past, you would have used a formal multistep strategic sourcing process. (Exhibit A1 in the appendix presents the most popular models.) But as we noted in chapter 1, existing models have many weaknesses, resulting in lower-than-expected performance.

There has to be a better way.

This question nagged Bonnie Keith. As a procurement professional, Keith held corporate executive and chief procurement officer positions for two Fortune 100 and two Fortune 500 companies spanning five different industries. In 2001, she left the corporate world and founded a successful boutique consulting firm.

Keith was frustrated that the natural tendency of procurement professionals was to think in terms of "buying" versus "managing" a spend category. Go through the steps and you are done. Keith believed procurement departments' reactive and "project" mentalities fostered a disconnected culture between procurement and the "business" they serve. Procurement "bought" goods/services, and the business "managed" a spend category and the supplier relationship. When Keith went to a new firm, she frequently witnessed a very deep chasm between procurement organizations and business units. Although Keith had adopted category management practices to close some of the gaps, she felt there must be a better approach to address the weaknesses discussed in chapter 1.

EVOLUTION OF THE FOUR CORNERSTONES FRAMEWORK

Keith knew that a good strategic sourcing process should include a clear link to business objectives, a solid analysis of value, and a "manage and refresh" plan to monitor the effectiveness well after the purchase is made or the contract is signed. Ultimately she developed a new framework, which she called the Four Cornerstones. The Four Cornerstones Framework is best demonstrated by four key terms in a continuous sourcing cycle: Assess, Analyze and Select, Plan and Execute, Manage and Refresh.

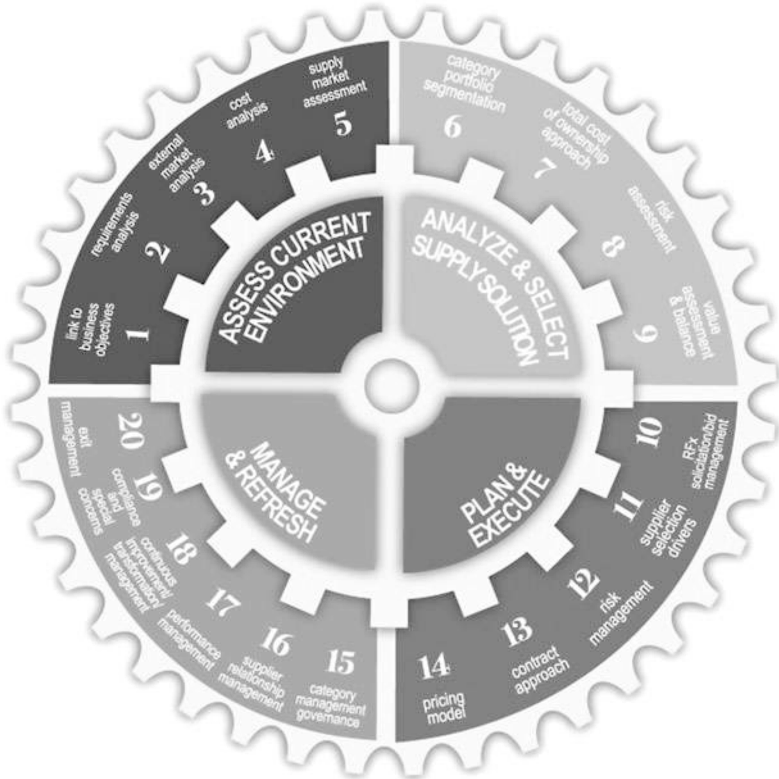
The framework encourages procurement professionals to shift from a step-by-step strategic sourcing process aimed at buying goods or services to a sourcing solution that addresses many of the gaps identified in chapter 1. Viewing sourcing as a continuous cycle that embeds end-to-end category management practices ensures that the solution remains in harmony with both changing business requirements and the dynamic nature of supply markets.

The framework addresses 20 key, or decision points, that procurement professionals need to make as they work their way through the sourcing cycle.[1] It is essential for procurement professionals to optimize their sourcing solution based on the most appropriate Sourcing Business Model. The 20 considerations should be addressed for any Business Sourcing Model.

Figure 9.1 shows how each of the 20 sourcing considerations link to the Four Cornerstones sourcing cycle.

If you already use a formal multistep strategic sourcing process, you can simply map the 20 sourcing considerations into your existing process. Most multistep strategic sourcing processes address at least half of the 20 considerations. Others skip whole sections, and most omit the critical Manage and Refresh Cornerstone altogether. No matter which strategic sourcing process you use, the key is to pause, reflect, and make good decisions for each of the 20 considerations. In some cases, you may have more considerations. This is fine. The framework includes supplementary decision points that provide additional refinement for complex requirements. At a minimum, we believe any sourcing initiative needs to work through these 20 considerations.

Figure 9.1 Four Cornerstones Framework/20 Sourcing Considerations



EVOLUTION OF SOURCING CONSIDERATIONS

In 2009, Bonnie Keith became an adjunct faculty member for the University of Tennessee's Graduate and Executive Education program, where she collaborated with Karl Manrodt and Kate Vitasek, who were pioneering research on the Vested Sourcing Business Model.

A key part of the collaboration was to link Sourcing Business Model theory to the Four Cornerstones Framework, by identifying decision points necessary for effective sourcing solutions. The goal was to create of a set of guidelines procurement professionals could use as they reviewed each of the 20 sourcing considerations. The end result was the Sourcing Considerations Guidelines that connected each consideration to the seven Sourcing Business Models. Keith and Vitasek designed the guidelines to help procurement professionals understand the most appropriate tools, required resources, and actions they should take as they work through the sourcing cycle of whatever Sourcing Business Model they use. For example, what is the typical contract duration for each Sourcing Business Model? What type of RFx is most appropriate for each Sourcing Business Model?[2] Spend categories falling into more sophisticated Sourcing Business Models logically use more complex approaches, require more effort and time, and emphasize a deeper inclusion of business and supplier stakeholders during their design, construction, and management.

Simply put, the Sourcing Considerations Guidelines help you build and manage the most appropriate sourcing solution for a given relationship. Procurement professionals shift from being buyers or category managers to being architects of a sourcing solution.

Game-Changing Approach

The Four Cornerstones Framework and the Sourcing Considerations Guidelines inspire a game-changing approach. Combined, the two resources become a highly flexible tool for procurement professionals to work as architects to blueprint, build, and maintain the most appropriate sourcing solution for their situations. Strategic sourcing is no longer about following a rigorous six-, seven-, or eight-step strategic sourcing process with the goal to "buy" a good or service. Nor is it about adopting the latest best practices. It's not even about creating detailed category management plans that may or not get used by business owners who view procurement professionals as outsiders.

Rather, through the lens of strategic sourcing, procurement professionals have integrated, holistic, and flexible mindsets to create the *best-fit* sourcing solution. Using the guidelines, buyers align the appropriate resources, time, tools, stakeholder engagement, and mechanisms to craft the best possible sourcing solution.

Many organizations find the concept of having strategic sourcing architects rather than buyers or category managers appealing. One chief procurement officer, who prefers to remain anonymous, shared her insight:

> We consider ourselves to be progressive when it comes to our procurement strategy. We adopted category management practices and rigorously followed a seven-step strategic sourcing model for several years. We even bolted on a formal supplier relationship management process

> as well. But we were totally missing the logic underpinning Sourcing Business Models. We would create "vinyl binders" with a ream of paper for each of our spend categories and, in many cases, go through overkill with rigorous requests for proposals with suppliers.
>
> It didn't make a lot of sense. We were stretched way too thin trying to keep up with all of the latest best practices. The Four Cornerstones Framework and the Sourcing Considerations Guidelines work because they offer a framework that inspires our procurement professionals to think differently. Like architects, our procurement associates look through their toolkits and apply the right tools for the right job to develop a purpose-built solution to that meet specific business requirements.

Dawn Tiura, President and CEO of SIG (Sourcing Industry Group), provides enthusiastic support for the Four Cornerstones and Sourcing Considerations Guidelines. "The Four Cornerstones framework and Sourcing Considerations Guidelines help procurement professionals make smart decisions for their organizations. It is such a powerful—yet flexible—framework that we have incorporated it into our online SIG University training curriculum."[3]

The rest of this chapter profiles each of the Four Cornerstones and shares insights into each of the 20 sourcing considerations. We could write an entire book about each sourcing consideration. In fact, others have. Many excellent books, white papers, and courses provide detail about each sourcing consideration. Because this book is about Sourcing Business Models and applying them to a strategic sourcing process, we supply only a high-level overview of each sourcing consideration. We realize many readers may be experts and an overview of this type will be a good refresher. For others who are new to strategic sourcing, we provide lists of recommended resources for each sourcing consideration.

An essential component of this chapter is the Sourcing Considerations Guidelines, which can be found in the appendix as Exhibits A3 to A9. These exhibits show how we map the sourcing considerations to each of the seven Sourcing Business Models. With your Sourcing Business Model in mind, use the guidelines to help you think through each of the 20 decision points you need to make. The results will be a sourcing solution built on the collective decisions you make during the sourcing cycle. We believe the guidelines are such a critical asset that we provide them as a downloadable resource as part of the open source Business Model Mapping Toolkit, which can be downloaded at www.vestedway.com/tools.

GETTING GROUNDED: KEY TERMS USED IN THIS CHAPTER

Before you dig into each sourcing consideration, it is important to understand some key terms that we use throughout the remainder of this book. You may want to put a Post-it© note on this page as you likely will come back to this glossary list often.

Business or ***business requirements.*** We use these terms interchangeably. We typically refer to needs of business groups, business units, or even stakeholders who consume the goods or services that are procured.

Category management plan. A formal plan that outlines how an organization will deploy its sourcing strategy for a specific spend category.

Category management. The process of overseeing a sourcing strategy for a specific spend category throughout the sourcing cycle.

Requirement. A specific need and want of business groups, business units, or users who consume the goods or services that are procured. Requirements may cover such areas as discrete specifications, quality conditions, regulatory compliance, special handling, shelf life, volumes, or any other attributes that define business needs and wants.

Sourcing cycle. A continuous process for evaluating and managing a spend category requirement. We use the Four Cornerstones Framework to think about a four-phased sourcing cycle. Although all spend categories go through all four phases, the cadence of the cycle itself varies by spend category and is highly influenced by product life cycle, technical factors or complexity of the requirement.

Sourcing solution. The final approach selected to fulfill a spend category requirement; a sourcing solution is structured around the most appropriate Sourcing Business Model and addresses each of the 20 sourcing considerations.

Sourcing strategy. The approach an organization uses to buy and manage goods and services in a spend category. Typically, a sourcing strategy focuses on the highest spend categories an organization purchases and consumes. A good sourcing strategy includes reviewing and making appropriate decisions regarding each of the 20 sourcing considerations outlined in this book. A deployed sourcing strategy results in a sourcing solution.

Spend category. Goods or services with similar characteristics that are grouped together for planning and management purposes and are bought and sold in any marketplace. For instance, "furniture" can be a spend category and have subcategories consisting of the desks, chairs, tables, and cabinets.

Stakeholders. Individuals in either the buyer's or the supplier's organization who are involved in or affected by the sourcing solution. As you move across the sourcing continuum to relational contracts, both buyer and supplier stakeholder engagement increases.

Supply base strategy. A systematic and analytical approach for identifying the proper mix of suppliers in a specific spend category. A supply base strategy is one component of an organization's overall sourcing strategy.

Supply base. The designated suppliers that provide goods or services for a given spend category and/or sourcing solution.

CORNERSTONE 1: ASSESS THE CURRENT ENVIRONMENT

The first Cornerstone in the sourcing cycle is: *Assess the Current Environment.* Assessing the current environment means investigating both internal and external influences across a variety of sourcing considerations. The purpose of this Cornerstone is to gain a clear understanding of the history, current state, and future aspects of the requirement.

While navigating this Cornerstone, you gather facts to help you select your sourcing solution and validate that you have selected the most appropriate Sourcing Business Model. Examination of the facts helps you answer these questions, among others:

- How valuable is the spend category in meeting business objectives?
- How are the spend category requirements being managed?
- What plans are in place for continued usage of the spend category?

- Are any changes in design, use, or demand anticipated?
- What is happening in the market that could impact future access to or availability of future supply?
- Are consumer or end user preferences or needs changing?
- How are suppliers being managed?
- Are existing supplier performance and pricing adequate?

There are five primary sourcing considerations in the Assess Cornerstone:

1. Understanding of the link to business objectives
2. Requirements analysis
3. External market analysis
4. Cost analysis
5. Supply market analysis

We highly recommend that buyers go through the entire Assess Cornerstone before finalizing your Sourcing Business Model. Why? By doing so, you will undoubtedly uncover insights that will influence how you map each of the 25 attributes on the Business Model Mapping template. For example, as you work with stakeholders during the first two considerations, you will learn if they seek a sourcing solution that will be best serviced by a transactional or output- or outcome-based economic model. You may uncover information that will cause you to revise your choice of the most appropriate Sourcing Business Model.

1. Linking to Business Objectives

All sourcing initiatives start by determining if the goods or services in a spend category have a link to business objectives. According to Professor Robert Handfield, a sourcing strategy needs to start from the view of business stakeholders. “It is imperative that category team leaders establish their direction for building strategies directly based on business requirements. Supply management, in general, needs to build strategies that enable businesses to be more successful in developing new solutions that provide the *best value* to customers, and meet corporate objectives for cost savings, revenue and shareholder value.

When in doubt, view every decision from the point of view of the customer (stakeholder)."[4]

Understanding a spend category's link to business objectives is not always obvious. Depending on your organization, business stakeholders will view spend categories differently. Simply put, the more integral a product or service is to your organization, the more important it is for the buyer to create a direct link between the spend category and the business objectives.

Think about it. What would Starbucks be without a stable coffee source? One of Starbucks' goals is to support a healthy coffee farming community that ensures supply and combats the threat of supply disruptions. Starbucks makes a direct link between its coffee spend to its business objective. Starbucks explains:

> The Cornerstone of our approach is Coffee and Farmer Equity (C.A.F.E.) Practices, our comprehensive coffee-buying program that ensures coffee quality while promoting social, economic and environmental standards. C.A.F.E. Practices, which we developed in collaboration with Conservation International (CI) more than a decade ago, has impacted more than a million workers employed by thousands of participating farms. We are committed to not only increasing our own C.A.F.E. Practices purchases, but also to making the program available to the entire coffee-growing industry—even competitors.[5]

It is easy to see how coffee directly links to Starbucks' business objectives. But many organizations find that supplier failures even for standardized noncritical items, such as common screws, cleaning supplies, or desktop software updates, can interrupt business plans and objectives. For this reason, buyers should determine how much time they want to spend with business stakeholders to define any linkages between what they are procuring against changing business objectives.

Handfield encourages buyers to work proactively with business stakeholders to become trusted advisors. "The ability to build relationships and understand that value relates to levels of satisfaction points to how important it is to identify stakeholder (customer) feedback in procurement. The awareness of and ability to use methods such as face-to-face discussions, surveys and cross-functional meetings can help the category leader to ensure that the voice of the stakeholder is heard."[6]

The amount of time you spend reviewing business objectives with business stakeholders will vary based on which Sourcing Business Model you use. In a basic provider model, you will not need to spend much time, as there is little or possibly no link to business objectives. Think of buying pens and pencils. An architecture firm might care which pencils are bought, but most organizations don't. As you move along the sourcing continuum, you need to spend more time understanding how the spend category supports the buyer's business objectives.

Vancouver Coastal Health (VCH) is a good example of how to align business objectives to a sourcing solution. Although a clean building is important to everyone, it is much more important for hospitals such as VCH, which serves one of the largest health regions in Canada. VCH works with Compass Group to provide contract Environmental Services (housekeeping) across 34 VCH sites. Compass's services are directly aligned with VCH's business objective of reducing hospital-acquired infections, which can cost lives and millions of dollars. VCH's Business Initiatives and Support Services (BISS) and Compass collaboratively worked with business stakeholders to understand VCH's mutual business objectives. VCH's (BISS) and Compass jointly engaged hospital and residential care stakeholders, spending time in stakeholder workshops to determine how cleaning impacted VCH's goal to decrease infection rates. The parties ultimately took the information and developed a contract that directly linked Compass's performance measures to stakeholders' business objectives.[7]

RECOMMENDED READING FOR LINKING PROCUREMENT TO BUSINESS OBJECTIVES

Chartered Institute of Procurement and Supply (CIPS). *Linking Strategy and Purchasing;* http://www.cips.org/documents/linking_strategy.pdf

Gerard Chick and Robert Handfield. *The Procurement Value Proposition.* London: Kogan Page, 2012.

Jonathan O'Brien, *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

2. Requirements Analysis

The second sourcing consideration helps you gain a full understanding of the requirements for the goods and services you will be sourcing. A key part of requirements analysis is to identify general spend category characteristics as well as detailed specifications or additional requirements that are essential to business stakeholders. In addition, buyers should develop a summary profile of the current state of the spend category.

Category characteristics describe the nature of goods and services being procured. This is important because the overall characteristics of the category itself play a role in how much time and effort you need to spend on the category and the depth of the category management solution. For example, goods or services that have a low level of asset specificity and are widely available are generic in nature. These items will fall under a basic or approved provider model. Review the attributes on the Business Model Mapping template as you think through the overall characteristics of your spend category. The information you glean from researching the overall category characteristics will help you identify the right Sourcing Business Model.

As mentioned in chapter 8, when you are conducting a Business Model Mapping exercise, you should look at both the broad spend category (e.g., facilities and real estate management) and the subcategories (cleaning services, plant maintenance, dining services, environmental services, etc.).

Buyers should also develop a current-state snapshot to understand existing requirements as well as potential future ones. For example, buyers should work with business stakeholders to determine if there will be any design changes or anticipated changes in the demand.

Buyers' level of effort will vary dramatically based on which Sourcing Business Model is used. For example, buyers who manage spend categories falling under the basic provider model simply have to respond to requisitions. In many cases, this is an automated process, and buyers spend little or no effort developing requirements for an individual sourcing initiative. Think about the example from chapter 4 where a buyer received an urgent request from an oil and gas expedition crew for a replacement part for an SKF bearing. There is no need to define product specifications or have a detailed statement of work because the requirement is defined by the supplier part number.

Let's look at how a buyer at an original equipment manufacturer (OEM) of home office printers approached requirements analysis for the printer display category. The firm had a single-source preferred provider relationship with the supplier to provide printer displays. The OEM faced competitive cost challenges and looked to procurement to find ways to cut costs. The buyer was actively developing a sourcing strategy to reduce costs for printer displays that included a competitive bid process to see if other suppliers could meet the requirements at a lower price. The buyer knew it was important to collaborate with the OEM's product development and marketing group to review existing requirements and understand any potential new requirements. Stakeholder discussions revealed that consumer preferences for the displays had changed dramatically; an engineering design change was in process. The buyer recognized that the current supplier was not capable of meeting the technical sophistication of the new design. Early awareness enabled the buyer to begin searching for suppliers for the new display design. The buyer also facilitated discussions with the OEM's planning team and existing supplier to develop a transition plan to the new design to ensure the discontinued model inventory and scrap was kept to a minimum.

Another key part of requirements analysis is to review supplier performance to determine if the existing supply sources are adequate to meet the business stakeholder objectives identified in Consideration 1 (Link to Business Objectives). Doing this helps buyers understand gaps in the current sourcing solution versus the desired objectives and specific requirements.

Many buyers find that identifying business requirements is one of the hardest tasks in a strategic sourcing initiative. Some business stakeholders simply have difficulty expressing and/or documenting their requirements. This is especially true when buying complex services. Many buyers fall victim to what Arjan J. van Weele refers to as over-specification. "The disadvantages of over-specification are obvious," he says. "Products may become unnecessarily expensive. Supplier knowledge for improving or simplifying product design is not used."[8] The University of Tennessee's Requirements Roadmap helps buyers document requirements with stakeholders. (Go to www.vestedway.com/tools to see all resources available in the toolkit.)

As buyers move through the sourcing cycle, they may uncover additional information that may influence or potentially change how they think about requirements for the spend categories. For example, buyers going through a competitive bid process to pick an information technology (IT) supplier to provide managed services for network maintenance can easily learn additional information as they go through the request for solution or competitive dialogue process.

RECOMMENDED READING FOR REQUIREMENTS ANALYSIS

Bryan Ball, *Best-in-Class Strategic Sourcing: Value of Internal Collaboration*. Aberdeen Group, March 2015. http://www.aberdeen.com/research/10253/10253-KB-strategic-sourcing-bestinclass.aspx/content.aspx

Gerard Chick and Robert Handfield. *The Procurement Value Proposition*. London: Kogan Page, 2012.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

University of Tennessee's Requirements Roadmap open source template (available at www.vestedway.com/tools)

3. External Market Analysis

Once the internal assessment has been completed, look outward to conduct an external analysis to assess and benchmark the marketplace. Experts refer to the insights gained from doing an external market analysis as market intelligence. You want to identify any influences that may affect supply of goods or services. For example, review for consumer trends, changes in the global business environment that shift supply and demand, technology platforms that impact design or communications, new products that replace old ones in some segments of the market, and even the role of geopolitical actions impacting delivery of supply requirements. You will answer questions like these:

- What is the current competitive environment for raw materials or finished goods and services?

- Are providers under cost, competitive, or technology pressures, or are customers changing their preferences?
- What trends are occurring that will shift the current balance of supply and demand?
- Which suppliers can best meet your requirements, and is there an adequate number of suppliers?
- Are new suppliers entering the market with new innovative capabilities?
- What insights can you gain into supplier cost structures of the overall value chain?

Even something that seems as incidental as a marketing campaigns or promotions can potentially disrupt the marketplace supply and demand balance; a severe weather event definitely will. External market analysis may not allow you to pinpoint a severe weather event, but understanding the flow of supply can help you weather a storm to assure supply. When you carefully consider where you or your suppliers are located and how they operate to manage upstream supply flows for raw materials and semi-finished and finished products, you are better prepared to understand the external market.

Just as in the previous sourcing consideration, the level of effort expended in completing an external market analysis scales to the Sourcing Business Model selected. For example, if you are procuring goods or services under a basic provider model, you will not expend much effort reviewing the marketplace. There are many suppliers, all of which can provide standard offerings. You simply need to search existing supply catalogs and do some competitive spot market testing for price to choose your supplier. In many industries, suppliers provide catalogs of basic standard items.

For example, Graybar and Newark Electronics publish catalogs for the electronics industry. McMaster Carr produces a catalog for industrial supplies and hardware. In the music industry, American Music Supply is the catalog of choice for almost any equipment, software, or supply need. In the U.S. Government sector, the General Services Administration produces a catalog that allows government agencies to select from a wide offering of categories at competitive prices. Thomas Register of American Manufacturers, now ThomasNet, provides a comprehensive listing of suppliers in the United States and Canada by product or service category. Today, all these catalogs are available online, as are a myriad of other specialty and supplier-specific catalogs.

More sophisticated and complex Sourcing Business Models require a more formal external market analysis using analytical tools such as Porter's Five Forces or a strengths, weaknesses, opportunities, threats (SWOT) assessment. A SWOT analysis is a commonly used tool that increases knowledge of the business environment from a strategic management perspective. These macro views of the commodity will give you a good understanding of the overall market factors impacting your spend category and how those factors can impact overall business objectives.

A good example of a company that uses rigorous external market assessment to understand changes that may affect its business strategy or its supply strategy is Starbucks, which goes through a SWOT analysis every year. Starbucks' 2013 SWOT analysis revealed that a significant threat to the coffee bean spend category was the rising prices of coffee beans. The company also was worried about supply disruptions in some regions because of drought. Coffee bean price is the major influencing factor over Starbucks' profitability.[9] A 10 percent rise in the cost of coffee beans will result in a direct reduction in profit unless Starbucks passes the price onto its customers. It's important for buyers to understand the context of the impact of coffee bean price increases. The SWOT analysis helped the buyer understand that Starbucks was experiencing increased competition from local cafés and specialization of other coffeehouse chains that put pressure on it to hold consumer coffee prices level. For a coffee buyer at Starbucks, this means coming up with creative sourcing solutions that help mitigate these issues.

Kelly Barner, managing editor of Buyers Meeting Point (an online knowledge and professional development resource for supply management and procurement professionals), suggests that buyers take a broad perspective when assessing the supply market. "Without a solid understanding of the markets in question, procurement professionals are confined by the boundaries of their company's historical purchasing habits. Researching the materials and services required by the organization in a more general sense identifies types and sources of supply that otherwise would not have been considered for inclusion. This expanded view of how to meet requirements creates value beyond negotiating lower prices for the same goods and services."[10]

Many organizations find value in constant reviews of external market factors for some spend categories where changes can have a big impact. In Kraljic terms, these would be strategic or bottleneck spend categories. Let's take a company that relies on oil. Consumer electronic products use plastic resin. It's in televisions, coffeepots, computers and printers. One of the biggest raw materials in plastic resins is oil or an oil-based ingredient. The consumer electronic producer is plagued not only with the typically higher variable cost of oil but also with increased consumption and potential shortages in the global oil market. For example, if the oil production is interrupted or volumes are capped to keep prices higher, the larger oil consumers are likely to have better access to the oil; consider automotive manufacturers, which use a large amount of plastic, oil-based parts on cars. Steel manufacturers also use oil to fuel their furnaces to make steel beams, which are in turn used in the construction industry. If steel beam prices are adversely affected by oil availability or cost, construction projects could become too expensive, resulting in project cost overruns or even delayed or cancelled projects. Each of these different industries must conduct an external market analysis to learn how to build the best sourcing strategy and ultimately the best supply solution to meet its requirements.

Barner comments on the importance of market analysis: "Understanding the regulations, volatility of raw materials/inputs, or the likelihood of a competitive threat from another vertical might change the sourcing strategy chosen as well as the award allocation, risk assessment, and contract type or exit plan."

We all recognize companies that missed analyzing changing market conditions and were impacted negatively. Kodak, the leader in imaging patents, did not anticipate the growth of digital photography, which eliminated the need for printed photographs. This single missed market change brought Kodak to its financial knees.

Once again, it is important to note that as buyers move through the sourcing cycle, they may uncover additional information that will influence or potentially change which Sourcing Business Model is their best choice.

RECOMMENDED READING FOR EXTERNAL MARKET ASSESSMENTS

Jeanette Jones and Kelly Barner. *Supply Market Intelligence for Procurement Professionals: Research, Process, and Resources.* Plantation, FL: J. Ross Publishing, 2015.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Michael Porter. "The Five Competitive Forces that Shape Strategy." *Harvard Business Review* (January 2008).

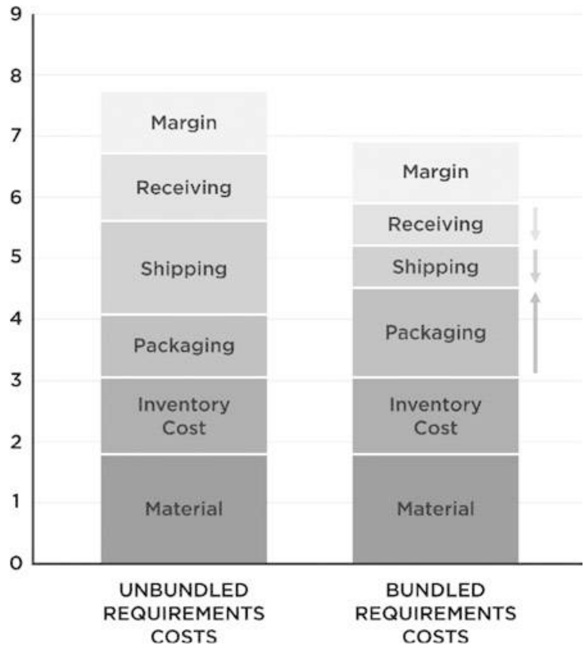
4. Cost Analysis

The fourth sourcing consideration is cost analysis. A cost analysis is the accumulation, examination, and manipulation of cost data. It is essential to understand cost drivers that may impact the price of the spend category you are procuring. A cost analysis is a component of the total cost of ownership (TCO; discussed later).

A cost analysis starts by breaking down the cost of the good or service into its individual cost elements. The individual elements can then be visually displayed, reflecting the estimated percentage to the total cost. Cost drivers are easily identified. The cost breakdown is often referred to as a cost bar. Suppose you currently have a contract with a supplier to provide safety supplies to your 22 manufacturing plants across Europe and North America. The supplier factors many costs into the price. For example, direct costs include material costs, packaging, and inventory costs. The supplier also has a profit margin. The buyer may have to pay for shipping and receiving. Adding these costs together provides the buyer's net landed cost.

Once a baseline cost bar is completed, the buyer needs to do a cost analysis to identify improvements, opportunities, and actions that might be taken to reduce specific elements of costs. For example, can suppliers provide a lower price if, instead of placing pairs of safety glasses in individual plastic bags and cardboard boxes, they put a dozen pairs of glasses in a single box? Logic says less handling and material costs should result in some cost savings. Perhaps packages of earplugs can be included in the same box. Further savings may be gained if the supplier agrees to consolidate orders for each plant and deliver

Figure 9.2 Example of High-Level Cost Bar



on a weekly basis. Again, this results in fewer labor and transportation costs. A thorough costs analysis will show that these two initiatives drive down costs for both buyer and supplier. Figure 9.2 provides an example of a high-level cost bar.

Tailor your level of diligence for cost analysis to whichever Sourcing Business Model you choose. You should expend much less effort for goods and services falling under a basic provider model. Your cost analysis will may mean simply understanding administrative costs. However, for complex Sourcing Business Models you will need to apply more effort. Effort is used for more complex Sourcing Business Models.

For example, an insurance company relied primarily on internal resources for processing claims. The external market analysis showed a significant trend to outsource claims processing. The insurance company hired a top consulting firm to help create the detailed make versus buy analysis it needed in order to justify outsourcing. Knowledge of the business case was essential, as the numbers would be reviewed at every layer of management all the way to the organization's board of directors. Just doing the cost analysis to justify outsourcing took almost four months.

Once again, as buyers move through the sourcing cycle, they may uncover additional information that will influence or potentially change which Sourcing Business Model they choose.

RECOMMENDED READING FOR COST ANALYSIS

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Michael. E. Smith, Lee Buddress, and Alan Raedels. *The Strategic Use of Supplier Cost Analysis.* Paper presented at the 91st Annual International Supply Management Conference, May 2006; https://www.ism.ws/files/pubs/proceedings/jfsmith.pdf

Special Education Team, Wisconsin Department of Public Instruction. "Contract Cost and Price." Last updated November 8, 2011; http://sped.dpi.wi.gov/sites/default/files/imce/sped/pdf/grt-disc-procurement-guide-cost-price.pdf

Kate Vitasek, Todd Snelgrove, Dawn Tiura, Wendy Tate, Bonnie Keith, and Sarah Holliman. *Unpacking Best Value*: *Understanding and Embracing Value Based Approaches for Procurement.* University of Tennessee College of Business Administration, Sourcing Industry Group. Download at www.vestedway.com/vested-library/.

Patrick S. Woods, *Purchasing at All Costs? Understanding Your Supplier's Cost Structure.* Paper presented at the 84th Annual International Supply Management Conference, 1999; http://www.ism.ws/pubs/proceedings/confproceedingsdetail.cfm?ItemNumber=11212

5. Supply Market Assessment

The last sourcing consideration in Cornerstone 1 is to assess the overall supply market.

While you may have identified some potential suppliers in the overall external market assessment, this part of the sourcing cycle is a deeper dive and focuses on how particular suppliers are positioned to meet your requirements. A key part of conducting a supply market assessment is to ensure that suppliers can meet the requirements you identified previously in Consideration 2, Requirements Analysis. A good supply market assessment also enables a buyer to understand the current state of suppliers in the marketplace. Also, you will be able to forecast potential changes in each supplier's market position to ensure you consider suppliers that can meet your needs not only today but also in the future. You will include your findings in your overall sourcing strategy.

It is important to remember that supply markets are dynamic. According to Kelly Barner, even experienced category experts should strive for a fresh perspective. "You cannot assume a supply market will have the same characteristics and behaviors that existed five or even two years ago. It is common for suppliers to invest in new capabilities, expand their locations, or even acquire competitors. As such, there are adjustments you will have to make to meet the requirements and the overall category management expectations for your business."

Barner adds, "A good supply market analysis considers how much control each supplier has over these market forces and how innovative they are likely to be in response to market-wide challenges. Understanding the landscape suppliers play in could be the difference between picking a winner or picking a loser."[11]

As you complete a supply market assessment, you will likely discover there are all types of suppliers: large ones, small ones, and suppliers that provide unique skills or operate in specialized environments. Some even might be candidates for acquisition by other companies. There are market leaders both in size and in innovation. There are market followers that can provide long-term competitive solutions. There are suppliers that meet sustainability criteria and others that can help you achieve small/minority-owned business targets. And then there are suppliers that have the scalability and ability to forward integrate and eventually compete with your company.

You will need to evaluate the best mix of suppliers to effectively deliver the spend category requirements you identified in the second sourcing consideration. As you work through your supply market assessment, you consider the number of available suppliers, looking at both existing suppliers and potential new ones. You also review each supplier's potential market positions and ability to react successfully to market impacts or influence them and the risks associated with conducting business with each supplier.

A global pharmaceutical company provides a good example of a warehouse and distribution spend category supply market assessment. During the external market assessment consideration, the buyer reviewed over 100 potential logistics suppliers. He ultimately decided that 24 potential suppliers would be a good fit for the company. No one supplier could meet all of the company's requirements on a global basis. In addition, no one company could perform all of the services required on a competitive basis. The buyer ultimately classified the 24 potential suppliers into three types he called global end-to-end integrators, regional freight forwarders, and local third-party logistics health care experts. He used these classifications as he continued to develop his sourcing strategy for the warehouse and distribution spend category.

As you move along the sourcing continuum, you will want to put more effort into your supply market assessment. For example, existing suppliers may prepare briefings on their overall capabilities as part of their quarterly business reviews. Or you may conduct a formal request for information where you ask potential suppliers about their capabilities, such as their locations and the services they offer in which locations.

As you shift to more complex Sourcing Business Models, you also want to place an increasing emphasis on the financial viability and sustainability of suppliers because the impact and effort to change suppliers increases as relationships become more dependent and complex. Doing so is especially important if you are working under a performance-based or Vested model where you have codependent supplier relationships.

Let's say you are the procurement liaison to your firm's director of fleet operations. Fleet operations is a big deal for your firm because you rely on a large fleet of small trucks that operate all across North America. You conducted a SWOT analysis as part of the external market analysis and found there were mergers and acquisitions among major automobile manufacturers. Although your existing supplier has not been part of any mergers or acquisitions, you need to consider how a merger or acquisition would impact the spend category.

There are plenty of examples of why this is important for buyers to consider. First Mercedes purchased Chrysler and Jeep; now Fiat owns those vehicle brands. What if your firm had a major government contract that required the use of only U.S.-built products? Could that have an impact? You must understand the potential impact as you seek to either bid out or renew the contract with your current supplier.

RECOMMENDED READING FOR EXTERNAL MARKET ASSESSMENTS

Jeanette Jones and Kelly Barner. *Supply Market Intelligence for Procurement Professionals: Research, Process, and Resources*. Plantation City, FL: J. Ross Publishing, 2015.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Michael Porter. "The Five Competitive Forces that Shape Strategy." *Harvard Business Review* (January 2008).

CORNERSTONE 2: ANALYZE AND SELECT THE SUPPLY SOLUTION

You've done your homework. During the Assess Cornerstone, you learned many insights that will influence how you approach developing a sourcing strategy. Cornerstone 2 in the sourcing cycle is *Analyze and Select the Supply Solution*. You will use the information you generated and the decisions you made in Cornerstone 1 as you work through the sourcing considerations here.

There are five sourcing considerations in this Cornerstone. The first is to determine where the category requirement fits in the overall category portfolio segmentation approach you will use for the spend category. You will also determine to what extent you will incorporate TCO evaluation for your category. Buyers need to assess the level of risk associated with the sourcing initiative and determine how to balance value between the business and suppliers' organizations. Combined, these considerations help buyers analyze and select the most appropriate supply solution.

As you work through each of these sourcing considerations, you will make decisions based on the type of Sourcing Business Model that is most appropriate for your situation. Use the guidelines (found in Exhibits A3 to A9 in the appendix) to help you make these decisions. Consider these guidelines to be checklists that will help you build an effective sourcing strategy based on your chosen Sourcing Business Model.

6. Category Portfolio Segmentation

After you have completed the Assess Cornerstone, you must complete an overall category portfolio segmentation for your spend category.

Spend category portfolio segmentation (also referred to as commodity segmentation) is the process of classifying spend categories into logical groups as you think through the most appropriate tactics that will improve purchasing efficacy and efficiency. Most organizations think of portfolio segmentation through the lens of the Kraljic Matrix. In fact, the Institute for Supply Management (ISM) defines category portfolio segmentation as grouping spend categories into the four Kraljic matrix quadrants. The Institute for Supply Management definition of portfolio segmentation is: "Dividing an organization's total spend into categories of goods and services in order to leverage spending and increase purchasing efficiency. Common practice involves using a matrix to divide the commodities into four quadrants: acquisition or non-critical (low-risk, low-value items); critical or bottleneck (high-risk, low-value); leverage (low-risk, high-value); and strategic (high-risk, high-value items)."[12]

Based on the Kraljic quadrant, buyers devise category management tactics (typically around Kraljic's exploit, diversify, or balance strategies) to shape the overall category management strategy and eventual sourcing solution. A good example of using this conventional approach comes from A.T. Kearney (ATK), which uses a Kraljic assessment in step 2 of its seven-step strategic sourcing process. ATK shares how to approach category portfolio segmentation for IT services spend in an article in *Information Outlook* magazine.[13]

> For information products or services that fall within the "Non-Critical" or "Leverage" categories, the most appropriate sourcing strategies are "Volume Concentration" (combining your organization's total spend to gain leverage with the supplier) and "Best Price Evaluation" (negotiating on price.) Global Sourcing refers to opportunities to develop new vendors and extend the geographic vendor base, for example through low cost country sourcing or outsourcing opportunities.
>
> For information products or services that fall within the "Bottleneck" or "Strategic" categories, the most appropriate sourcing strategies are "Product Specification Improvement" (can the supplier tailor the product more specifically to your organization's needs?), "Joint Process Improvement" (can you and your supplier work together to provide better value and more usage?) and "Relationship Restructuring" (establish long-term partnerships with key suppliers in return for preferred pricing).
>
> Another strategy to consider in your equation is demand management. Does your organization really need all the seat licenses that you currently

have? Do some users require access to only a certain part of the product, rather than the whole thing?

As outlined in chapter 1, the Kraljic Matrix is an excellent framework to begin thinking about spend category segmentation and initial category management approaches, but it is an incomplete, overly simplistic approach.

In chapters 3 to 8, we offered an alternative approach for segmenting a spend category, one based on Sourcing Business Model theory. Our premise is that by using Sourcing Business Models to segment a spend category, users can make a much more comprehensive set of decisions, which leads them to the best approach for designing a strategy and managing a spend category. Chapter 8 presented 25 attributes to help you evaluate spend category environmental and business factors. The Business Model Mapping Toolkit includes all of the attributes Peter Kraljic outlined in his 1983 Harvard Business Review article as well as many other business and relational attributes identified by thought leaders and researchers around the world.[14] The template guides you in segmenting your spend category into seven Sourcing Business Models rather than Kraljic's four classifications. Before you proceed further into the sourcing cycle, validate your Sourcing Business Model choice by applying the insights you gained through the considerations in the Assess Cornerstone. It is essential that you have a good understanding of the characteristics of the Sourcing Business Model identified through the mapping exercise. The Sourcing Business Model you pick will result in very different sourcing solutions that will be further developed over the next three Cornerstones. For example, the model you choose will determine how you will use competitive bidding, which type of contracting vehicle you use, and to what extent you will design supplier relationship management into your sourcing solution. Simply put, from here on out, your selected Sourcing Business Model will shape your sourcing strategy.

You will have other chances to change which Sourcing Business Model you choose, but this is an excellent time to validate that you are moving in the right direction as you build the details of your sourcing solution. You will use additional insights gained in this Cornerstone to confirm your Sourcing Business Model selection.

As you refine your portfolio segmentation, do not feel obligated to use a single Sourcing Business Model for an entire spend category, or even for subcategories. A good example is how Microsoft approached managing the broader category of back-office financial operations. A supply market assessment and TCO analysis showed that Microsoft could easily outsource some of these functions and improve costs. Microsoft had already outsourced payroll services in many regions, but the additional insights the company gained from the assessment showed that the current Sourcing Business Model could be changed. Microsoft took the key learnings and developed an overarching strategy for the entire back-office finance category that included:

- Centralizing finance operations under a shared services model
- Outsourcing some of the less strategic functions (accounts payable, accounts receivable, and the administrative buy desk function) under a highly strategic and collaborative Vested model with a goal to incentivize their supplier to transform back-office finance operations
- Outsourcing payroll services under a less strategic preferred provider model

With a more comprehensive category portfolio segmentation in hand and insights gained from additional considerations and analysis, Microsoft validated its approach as it competitively bid out the workscope to be outsourced.[15]

The Microsoft example shows why it is essential to refine your category portfolio segmentation and perhaps adjust the Sourcing Business Models used. As a result of additional insights gained in the remaining considerations, you may uncover new information that impacts your strategy. New insight becomes increasingly more important if your Sourcing Business Model map leads you to more complex, relational contracting models. If your goal is to create a performance-based or Vested model, the information you glean as you work through each of the next considerations will help you to build a best-fit sourcing solution for your situation.

Remember the midsize bank we discussed in chapter 8? The bank fully intended to use a Vested model, but during Consideration 14 (pricing approach), it realized that Accenture did not want to explore a Vested model. For that reason, the bank ended up with a performance-based model. Although it is acceptable to change courses as you gain new information through each consideration, the correct approach would have been for the bank to have specified its intentions to architect a Vested model during the solicitation process.

RECOMMENDED READING FOR PORTFOLIO SEGMENTATION

- Download the Business Model Mapping Toolkit (www.vestedway.com/tools/) if you have not already done so, and validate your responses with key stakeholders.
- Share the "Unpacking Sourcing Business Model: *Unpacking Sourcing Models: 21st-Century Solutions for Sourcing Services*" white paper (from vestedway.com/vested-library/) with key stakeholders so a broader audience will understand the concept of Sourcing Business Models.

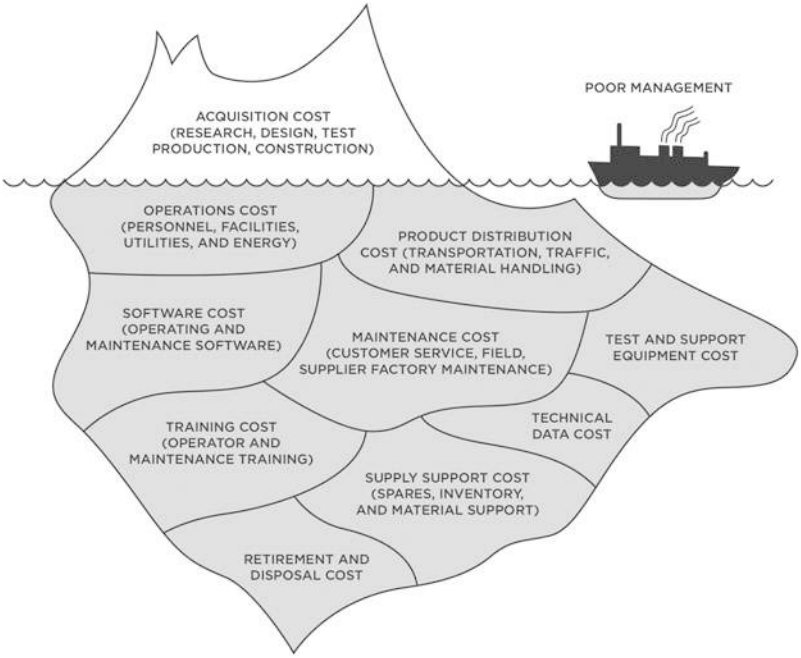
7. Total Cost of Ownership Approach

As you work through this Cornerstone, it is important to determine to what extent a TCO evaluation should be used. Most buyers focus on price or net landed price (also referred to as net delivered price for services) as a key element for selecting the supplier. A price is how much you pay for something. For example, you can order an injection-molded part from China for a price of $1.23 per unit. Net landed price is the basic price inclusive of taxes, levies, transportation, all material and labor charges, plus government or vendor service taxes as applicable. You realize that, when you add these other costs to the part, it actually costs $3.72 per unit. Using a net landed price is more complicated than simply buying on price, but it helps you make a smarter choices. TCO is the most progressive (and complex) approach to understanding total costs.

A TCO analysis includes determination of both the direct and indirect costs of using a product or service. A good TCO analysis takes the net landed price and includes all other hidden costs, such as administrative transaction costs, training, maintenance, testing, and disposal costs. Thus, TCO provides a much broader perspective of how costs are incurred before, during, and after the purchase.

The best and most accurate approach is to document total costs from an end-to-end perspective—capturing the costs from both the supplier and the buying organization. Figure 9.3 illustrates the concept of TCO by showing the hidden costs are of buying a large industrial asset—in this case an airplane engine.

Figure 9.3 Total Cost of Ownership



Source: University of Tennessee Performance-Based Logistics courseware

RECOMMENDED READING FOR TOTAL COST OF OWNERSHIP

American Productivity and Quality Center and KPMG. “Supplier Category Management—Driving Value through the Procurement Organization,” 2012; http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/supplier-category-management.pdf.

Jonathan O’Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Solution Matrix Ltd. "Total Cost of Ownership TCO Explained: Definitions, Meaning, and Example Calculations," *Business Encyclopedia*; updated March 29, 2015; https://www.business-case-analysis.com/total-cost-of-ownership.html.

Kate Vitasek, Todd Snelgrove, Dawn Tiura, Wendy Tate, Bonnie Keith, and Sarah Holliman. *Unpacking Best Value: Understanding and Embracing Value Based Approaches for Procurement.* University of Tennessee College of Business Administration, Sourcing Interests Group. Download at www.vestedway.com/vested-library/.

8. Risk Assessment

Risk assessment takes place during this Cornerstone. (Risk management occurs in the next Cornerstone.) As Benjamin Franklin pointed out, "An ounce of prevention is worth a pound of cure."

The Business Model Map clearly indicates that an organization should use more sophisticated Sourcing Business Models as risk levels increase. This is because an organization can greatly decrease its risk by working with smaller numbers of trusted suppliers that know its operations well and share a stake in its success. However, many argue that working with fewer suppliers increases codependency, which is perceived as an increased risk. This is a true statement. Therefore, buyers must use the proper level of diligence in conducting a formal risk assessment and understand how to allocate risk with a good value-balancing approach (Consideration 9) and risk management (Consideration 13). The more collaborative structures of performance-based and Vested models mitigate a buyer's risk. This is especially true when working under a Vested model that promotes a high degree of transparency.

Linda Tuck Chapman, president of ONTALA Performance Solutions Ltd., a widely respected subject matter expert in third-party supplier management, shares, "This type of codependency (relying on a small set of suppliers) is commonly known as concentration risk. Concentration risk occurs if there is a single supplier delivering many services across the organization or in one line of business. It may also occur if critical suppliers and their subcontractors are in the same geographic region, particularly if they are using the same infrastructure. While there can be tremendous benefits, it is important for buyers make sure they put in higher levels of risk assessment and mitigation associated with concentration risk."[16]

Regardless of which Sourcing Business Model you use, you should conduct a risk assessment. The larger and more complex your sourcing initiative, the more diligent your risk assessment must be. The first step is to identify the risks. Murphy's law is a good guide here, as anything that can go wrong probably will go wrong. Well-known outsourcing lawyer George Kimball notes five types of risks, which we summarize next:[17]

1. *Operational risks.* These risks relate to workscope and workload allocation. For example, poor service from the service provider or poor forecasting from the company creates operational risks.
2. *Financial risks.* These risks relate to overconsumption of services (poor assumptions) or inaccurate baselines impacting pricing and margins and/or suppliers' financial instability.
3. *Scope.* These risks result from the actual implementation of the workscope, such as unmanageable workload allocation and unforeseeable project overruns ("business happens").
4. *Compliance and security.* These risks impact highly regulated industries and pose significant legal liability issues and potentially regulatory impact for both companies. Your company's lawyers are especially eager to document these issues properly.
5. *Extraordinary risks.* These risks are your worst-case scenarios. Although they have little likelihood of occurring, when they do occur, they can result in financial ruin or, worse, loss of life.

The authors add more to Kimball's list:

- *Business/Programmatic risk.* These risks include scheduling issues that may impact success.
- *Technical risk.* These risks include maturity of technology and processes reliant on technology.
- *Funding risk.* Are funds identified for which availability is reliant on pending events or approvals? Have adequate funds been identified?

- *Process risk.* Are new processes required to be implemented?
- *Stakeholder risk.* Stakeholders change, or needs change over time.
- *Acts of stupidity risk.* You know what we're talking about.

Once you have identified the risks, you need to categorize them according to likelihood and severity, as shown in the descriptions in Tables 9.1 and 9.2.

As you conduct your risk assessment (see Figure 9.4), you start to generate options that could address how you can mitigate or manage

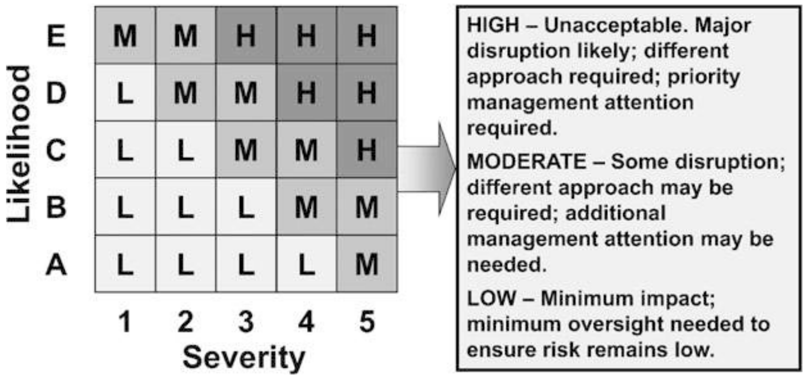
Table 9.1 Risk Likelihood

Level	*What is the likelihood that the event will occur?*
A	Remote
B	Unlikely
C	Likely
D	Highly Likely
E	Near Certainty

Table 9.2 Severity of Risk

Level	*Technical Performance... and/or*	*Schedule... and/or*	*Cost... and/or*	*Impact on Other Teams*
1	Minimal or no impact	Minimal or no impact	Minimal or no impact	None
2	Acceptable, with some reduction in margin	Additional resources required; able to meet needed dates	<5%	Some impact
3	Acceptable, with significant reduction in margin	Minor slip in key milestones; not able to meet all needed dates	5%–7%	Moderate impact
4	Acceptable; no remaining margin	Major slip in key milestone or critical path impacted	7%–10%	Major impact
5	Unacceptable	Cannot achieve key team or major milestone	>10%	Unacceptable

Figure 9.4 Risk Assessment



each of the risks. Capture these ideas for possible inclusion later when you consider how to allocate risk (Consideration 9) and risk management (Consideration 13, where you will build a risk management plan).

As business environments in the new economy continue to be driven by increased technology solutions, even the smallest business with the most basic requirements can be disrupted by the risk to data security. This risk likely will be identified in many risk assessments. Think about companies with customer credit card information breaches. Target, for example, estimates that its 2014 breach will cost it in excess of $148 million.[18] Risk assessment has become more complicated as more and more organizations face what is referred to as a VUCA (*v*olatility, *u*ncertainty, *c*omplexity, and *a*mbiguity) environment.

RECOMMENDED READING FOR RISK ASSESSMENT

Customs-Trade Partnership against Terrorism. "CTPAT 5 Step Risk Assessment Process Guide," March 2010, http://www.cbp.gov/sites/default/files/documents/supply_chain_assess_guide_3.pdf.

Free project management templates at Project Management Docs: http://www.projectmanagementdocs.com/project-planning-templates/risk-management-plan.html

Jonathan O'Brien. *Category Management in Purchasing: A Strategic*

Approach to Maximize Business Profitability, 2nd ed. London: Kogan Page, 2012.
PriceWaterhouseCoopers. "A Practical Guide to Risk Assessment: How Principles-Based Risk Assessment Enables Organizations to Take the Right Risks," http://www.pwc.com/en_us/us/issues/enterprise-risk-management/assets/risk_assessment_guide.pdf.
Risk Assessment Worksheet and Management Plan, http://acqnotes.com/Attachments/Risk%20Assessment%20Worksheet%20and%20Management%20Plan.pdf.

9. Value Assessment and Allocation

Buyers are always being challenged to get the best deal. But what does getting the best deal mean? And how do you know when you have a good deal? The answer to both questions is: "It depends." Value comes in many forms. It can be a supplier's capability to perform unique tasks, geographic positioning, and unique differentiators in systems, such as robust reporting capabilities or equipment or process excellence.

Many buyers use a best value analysis to compare value between suppliers' solutions. Best value analysis can be thought of as an equation that balances the decision criteria when choosing from alternatives. Buyers often calculate the optimum benefit (adding up all the value criteria as defined by buyers) less buyers' total cost. The State of Minnesota Department of Transportation (MnDOT) applied what it referred to as a best value formula when it sought a supplier to replace the collapsed I-35 Bridge.[19] MnDOT's formula included three factors: a technical score, price, and days to complete the bridge. MnDOT divided nine technical evaluation criteria into four categories with the listed weighted rankings:

1. 50%—Quality
   - Experience and authority of key individuals (10%)
   - Extent of quality control/quality assurance (10%)
   - Safety (10%)
   - Measures to evaluate performance in construction (10%)
2. 20%—Aesthetics
   - Enhancements to the request for proposal (10%)
   - Approach to involve stakeholders (10%)

3. 15%—Enhancements
    - Geometric enhancements (10%)
    - Structural enhancements (5%)
4. 15%—Public Relations

The winning supplier was chosen based on this best value formula:

A + (B × $200,000) / Technical Proposal Average Score = Adjusted Bid

where

A = Contract bid price.
B = Number of days to complete project. Days are multiplied by $200,000 per day, the weight assigned to the economic impact of not having the bridge in place. The longer the bridge took to complete, the higher the adjusted bid price.

Although best value analysis is a great approach, it is incomplete and one-sided, as there is no mention of the value benefit to the supplier. A true view of value must be two-way and consider both the buyer's *and* the supplier's perspectives. Buyers and suppliers should have a fair and balanced approach for allocating value. If value is not balanced, one (or both) parties will get cranky when they realize that the economic assumptions are not a reality. Unbalanced value is unfair and leads to an unbalanced system. And unbalanced systems lead to perverse incentives, such as when suppliers nickel and dime clients over small-scope issues.

Types of Value Exchanges

Buyers and suppliers exchange value in four ways: through increased benefits, decreased costs, increased opportunities, and decreased risk. Each of these represents how companies can exchange value in a fair manner.[20]

Increased Benefits There are numerous ways to create benefits. A supplier creates benefits for a buying organization by providing more services or services of better quality, by improving the company's brand, by increasing the company's turnover of goods, and so on. A buyer, in turn, creates benefits by paying more to the supplier for its services, by awarding the supplier extended contract terms, by increasing the scope of work, and so on. For example, a large bank wanted to improve its JD Powers consumer loyalty ranking for its credit card services. A key component of the JD Powers assessment is how consumers interact with the bank on administrative items, such as credit card application processing and responding to consumer questions. The bank wanted to develop a pilot program with one of its strategic call center suppliers. The goal was to increase consumer loyalty and positively impact part of the scoring components for the JD Power rankings.

Decreased Costs Value is also created when an organization decreases costs for another party. This doesn't mean that the supplier has to reduce its price. In some cases, the buyer has to determine the cost of the constraints it places on the supplier. By reducing or eliminating non-value-added tasks, the supplier saves money and then reduces costs to the buyer.

Let's continue with our bank example. In the external market assessment, the bank learned that there are some fabulous new technologies designed to optimize call center staffing. A more detailed supply market assessment (Consideration 5) revealed that two of the bank's four current suppliers had invested in the technology. Discussions with these suppliers revealed the buyer's business stakeholders currently dictate staffing levels for the suppliers, but the suppliers can manage this activity more efficiently. Shifting the staffing workscope to the suppliers enabled the bank to decrease costs.

Increased Opportunities Value is also created when an organization generates increased opportunities for another party. For example, a buyer can increase a supplier's workscope or increase volumes if the supplier hits certain predefined targets or outcomes. Suppliers also receive value from a specific client relationship if that client serves as a reference for the suppliers. This is especially valuable when the buyer is viewed as a leader in industry.

In the call center example, the supplier gained an increased opportunity to expand its workscope by taking on the additional responsibility for managing staffing levels. This added workscope resulted in increased revenue for the supplier but at a lower TCO for the buyer.

Decreased Risk Finally, value is created when an organization decreases risks for another party. Organizations can control some risks but not others. Risks that are out of the parties' control include increased prices for raw materials, foreign currency exchange risks, and decreased demand for the product or service. Risks that are within the parties' control include predictable delays from organizational misalignment, inaccuracies in reporting, and poor talent management.

Let's dig deeper into the call center example. One of the four call center suppliers has demonstrated excellent performance, and the bank especially values its flexibility in ramping up quickly around marketing campaigns. The bank is considering shifting to a performance-based agreement. At least one of the suppliers is willing to guarantee service levels at a fixed cost per call if it is allowed to use its own staffing technology. The guaranteed service levels are attractive, as is a fixed price, because the bank struggles with meeting peak demand times during large-scale marketing campaigns.

Creating Balanced Exchanges

Value must be fair and balanced for all parties. One organization may decrease costs while the other party may receive increased benefits or decreased risks. Figure 9.5 illustrates this concept.

It is not correct to look at creating value from the buyer's perspective alone. For example, if a buyer unilaterally forces a supplier to accept increased payment terms from 30 days to 60 days, value is created for the buyer's organization but not for the supplier. The

Figure 9.5 Balanced Exchange

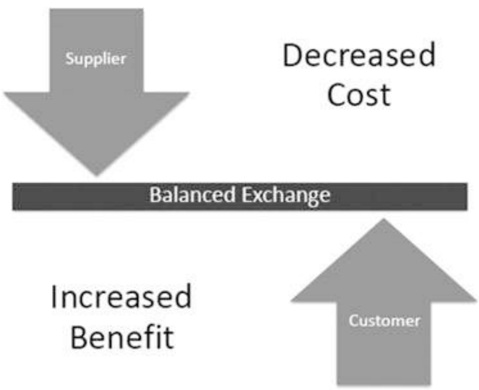
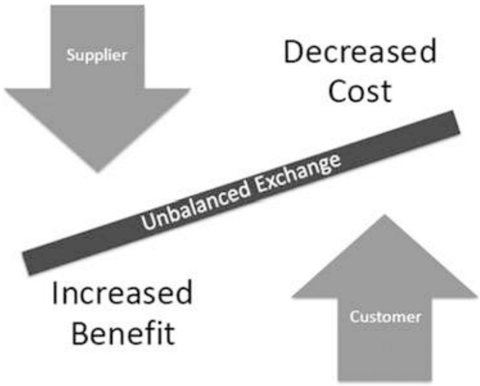


Figure 9.6 Unbalanced Exchange



increased opportunity of improved working capital is not offset with a value exchange. A fair value exchange occurs only if the supplier gets something of value in return, such as a longer contract term, commitment for more volume, or an increase in price to compensate the supplier for increased cost of capital. Figure 9.6 demonstrates this unbalanced exchange.

In the process of identifying and allocating value, buyers and suppliers need to hold candid conversations about what they want and what they can provide in return. As they discuss the ways to meet each other's needs, buyers and suppliers look for opportunities to exchange one type of value for another, always aiming for a fair allocation of value. Buyers must realize that when more sophisticated Sourcing Business Models are used, attention to fair and balanced value allocation becomes even more important.

Value allocation relies on people's perception of the relative value of what is being exchanged. Buyer and supplier give something each perceives as being less valuable and, in return, get something each perceives to be of equal or more value. So long as both buyer and supplier are genuinely satisfied with the exchange, the relationship stays in balance.

A good example comes from Procter & Gamble and Cisco. In 2007, Cisco had 200 TelePresence systems deployed in its own offices worldwide. The multimedia technology provided an impressive conference capability, but its high price tag was a hard sell. P&G was skeptical and did not see the value. Traditional video conferencing technology was not popular within P&G, and the Cisco TelePresence system, while full of bells and whistles, was very, very expensive.

Cisco, a longtime strategic partner of P&G, wanted to prove the value of TelePresence and approached P&G's Global Business Services group about a potential pilot. Cisco would conduct the pilot on P&G's network at Cisco's own cost. "Cisco believed in the solution and didn't blink an eye when we asked them to prove their technology would work on our network," Laurie Heltsley, director of strategic initiatives for P&G, explained in a press release on the success of TelePresence.[21]

If the pilot was successful, P&G agreed to expand the program to more than 40 Cisco CTS3000 TelePresence studios throughout the company. TelePresence was a home run. "Once it [TelePresence] was in the door and people saw how it affected their business process, the technology sold itself," says Heltsley. "We had early successes, and from that point on, it's been like rolling a stainless steel ball down a marble surface." By September 2008, P&G had deployed Cisco's TelePresence across 40 of its key sites globally. P&G estimated that using TelePresence had enabled the firm to eliminate about 1,000 business trips per month, at a cost savings of several million dollars per month.

This example shows creative value allocation at its finest. Cisco agreed to take on the risk for the pilot; in exchange, P&G committed to install TelePresence if the results were successful.

RECOMMENDED READING FOR VALUE ASSESSMENT AND VALUE

American Productivity and Quality Center and KPMG. *Supplier Category Management-Driving Value through the Procurement Organization*, 2012, http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/supplier-category-management.pdf.

Jeanette Nyden, Kate Vitasek, and David Frydlinger. *Getting to We: Negotiating Agreements for Highly Collaborative Relationships.* New York: Palgrave Macmillan, 2013, chapter 5 for a more detailed explanation of "Creative Value Allocation" through reciprocity.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Kate Vitasek, Todd Snelgrove, Dawn Tiura, Wendy Tate, Bonnie Keith, and Sarah Holliman. *Unpacking Best Value: Understanding and Embracing Value Based Approaches for Procurement.* University of Tennessee College of Business Administration, Sourcing Interests Group. Download at www.vestedway.com/vested-library/.

CORNERSTONE 3: EXECUTION PLANNING

The first two Cornerstones enable you to thoroughly understand your spend category. The *Execution Planning* Cornerstone focuses on five sourcing considerations you need as you shift your focus to delivering a sound sourcing solution. Cornerstone 3 includes:

1. Developing your solicitation plan.
2. Identifying and finalizing supplier selection criteria.
3. Establishing the approach and actions you will use to manage and mitigate risk.
4. Selecting your preferred contract type.
5. Determining your preferred pricing model.

Again, we provide an overview of each consideration as well as suggested guidelines that assist you to make decisions depending on the Sourcing Business Model you have selected. (See Exhibits A3 to A9 in the appendix for the Sourcing Considerations Guidelines for each Sourcing Business Model.)

10. RFx/Solicitation Plan

Buying organizations typically use a competitive bidding process to solicit proposals from suppliers. As you manage your solicitation process and develop your solicitation plan, there are several factors to consider.

The first factor is how frequently you should bid out the spend category. As a general rule, you bid out a spend category less frequently as you move along the sourcing continuum to more sophisticated Sourcing Business Models. This makes sense as it takes more time and diligence to conduct a solicitation for a more complex and higher-risk spend category.

The second factor is to decide what you will emphasize in the solicitation. For example, will you seek lowest price or best value? Will you seek for value-added services? Perhaps you are looking to shift risk and want a performance-based agreement. Your solicitation must align with the Sourcing Business Model you use; if not, you risk creating a Sourcing Business Model mismatch, such as those described in chapter 8.

Next, you need to determine the most appropriate solicitation process, resources, and tools to use. Buyers have a plethora of options to work through a competitive bid process. One of the biggest decisions regarding your approach to the solicitation process, often referred to as an RFx process (or a solicitation). The most common techniques are defined next.

Electronic auction (e-auction)—A process in which a purchaser prequalifies multiple suppliers and invites them to participate in a fixed-duration Web-based bidding or sourcing event. A buyer-driven e-auction is an online, price-centric auction where purchasers specify what they are interested in buying and prospective suppliers respond by entering competing bids. A *reverse auction* is a type of e-auction where a single buyer uses a fixed-duration bidding event in which multiple prequalified and invited suppliers compete for business. Potential suppliers review the requirements, choose to bid, and enter their selling prices. Suppliers' prices are visible to competitors, often resulting in successively lower prices. A seller-driven e-auction is an electronic, online auction where suppliers post items for sale and buyers bid on the items

Request for information (*RFI;* also referred to as an *invitation to bid, a request for quotation, or a tender*)—Used to obtain general information about products, services, or suppliers. An RFI is sometimes used to gather benchmark information and general market data from the marketplace. Buyers rarely, if ever, pick a supplier based on RFI information but use the information to help them further refine the RFx approach. As such, an RFI typically precedes other RFx processes and often is used to help a buyer down-select the number of potential suppliers it will evaluate. An RFI can be used with any of the RFx processes, but it is almost always used with a request for proposed solution and a request for partner process. Note that an RFI is not binding for either buyer or supplier.

Request for price (RFP; also referred to as a *request for quote*)—Used to obtain price offers for a specified product or service. Buyers using an RFP must be sure to properly define the requirements so there is no ambiguity for the supplier. An RFP is often a follow-up to an earlier request for information (RFI). The law may or may not treat a quotation as a binding offer.

Request for proposal (also referred to as an *invitation for proposal [IFP] or request for tender*)—Used to obtain pricing as well as detailed descriptions of services, methodologies, program management, cost, and other support provided by the supplier. A request for proposal allows a buyer to specify requirements but allows suppliers to begin to define some of the "how." For example, a buyer may ask a supplier to outline how it proposes to manage quality.

Request for solution (RPS; also known as *request for proposed solution*)—A collaborative process used where an organization has a dialogue with potential down-selected suppliers. A request for solution is different from a request for proposal because the buyer does not know the solution; rather it is asking suppliers to propose the most appropriate solution.[22] In the EU, a competitive dialogue process is a tool used in a request for solution.

Request for partner (also referred to as a mutual value solution)—A highly collaborative process used when a buyer is actively seeking not just a solution from a supplier but also compatibility across multiple providers' cultures, mindsets, and willingness to engage in a collaborative relational contract. A key part of this process is a request for proposed solution, which is used when selecting a supplier for a Vested Sourcing Business Model.

The main difference in each of these solicitation processes is between the level of effort and the level of business stakeholder/supplier involvement. As you shift across the sourcing continuum, you will use a more sophisticated RFx process and spend more time in preparation and evaluation of the proposals. The business stakeholders will be heavily involved in determining the specific final selection criteria and will participate in determining the weight factor assigned to each criterion based on its importance to the business.

The last factor a buyer needs to consider is the level of effort necessary to put into the solicitation and how long the process should take. For example, how much detail do you need to capture from suppliers to feel comfortable making your final supply base decision?

This factor also includes identifying the most appropriate internal resources that must be involved in the preparation and review process. As you move along the sourcing continuum, you should involve more stakeholders and take more time for the solicitation process. Highly complex relational Sourcing Business Model solicitations can take up to six months and involve a dozen or more people.

RECOMMENDED READING FOR RFX SOLICITATION/BID

European Commission, Directorate General Internal Market and Services. Public Procurement Policy, "Explanatory Note—Competitive Dialogue—Classic Directive," http://ec.europa.eu/internal_market/publicprocurement/docs/explan-notes/classic-dir-dialogue_en.pdf.

Kate Vitasek, Bonnie Keith, Karl Manrodt, and Jeanne Kling. "Unpacking Competitive Bidding Processes: The ABCs of RFx Processes." University of Tennessee, 2015. Download at www.vestedway.com/library.

11. Supplier Selection Drivers

After buyers have determined the best means of communicating needs to the supplier, it's time to decide how to select which supplier(s) to work with. The information garnered from Cornerstones 1 and 2 (Assess; Analyze and Select) should influence your supplier selection drivers.

Responsibility for developing supplier selection criteria to support the category requirement often falls on the buyer's shoulders. As spend category requirements move along the sourcing continuum, there is increasingly more stakeholder involvement. In some organizations, the responsibility shifts to the business owner.

For basic providers, a buyer may simply pick a supplier based on price and product availability. As you move along the sourcing continuum, your selection criteria become more sophisticated and important because the drivers for success are more critical. Ideally, buyers should link the supplier selection drivers to the business objectives and requirements outlined in the first two sourcing considerations. In a preferred provider model, buyers begin to place increased emphasis on a supplier's past performance or other value criteria that best meet business objectives and/or specific requirements. For example, you may include criteria such as unique capabilities, geographic coverage, additional value-added services, ease of systems integration, and the ability to meet supplier prequalification conditions. Price is still important, but the supplier's ability to positively impact cost management becomes a higher-priority supplier selection driver.

The International Organization for Standardization (ISO,) the world's largest developer and publisher of internal standards, suggests that organizations analyze and rank proposals based on an evaluation matrix that clearly establishes supplier selection criteria in their ISO 37500 Standards.[23] Key success factors include: transparent, clear, and consistent selection criteria; balance between quantitative and qualitative criteria; the use of weighting rankings; and a solid understanding of management values and culture. As you choose more relational Sourcing Business Models, cultural fit becomes increasingly important. We agree that using an evaluation matrix is a very sound practice.

Minnesota Department of Transportation (MnDOT) provides a good example of how to think about the supplier selection process and drivers. MnDOT started with six criteria as it sought to down-select potential suppliers to rebuild the I-35 Bridge.[24]

1. Proposer's experience as a constructor, designer, or design-builder
2. Key personnel
3. Technical competence
4. Past performance on similar projects
5. Safety record
6. Availability to and familiarity with the project locale

MnDOT short-listed four potential suppliers. John Chiglo, MnDOT project manager in charge of the bridge replacement, led a team to clearly define and measure how MnDOT would use best overall value to pick the final supplier. There were three parts to the bidding proposals: Equal Employment Opportunities (EEO) and Disadvantaged Business Enterprise (DBE) proposals, technical proposal, and pricing proposal. The EEO and DBE proposals were the easiest part, as they just affirmed that potential suppliers complied with state and federal laws and policies. Firms that failed to conform to standards were eliminated from consideration.

The more difficult part was the pricing component. Although the bid price is usually considered the price of the project, Chiglo and his team wanted to factor in a critical element: the cost of time, as time was a significant factor. The goal was to have the bridge open by Christmas Eve 2008, fewer than 18 months after the collapse. (Normally, it takes longer than that just for the proposal process.) For this reason, the evaluation criteria included the number of days to complete the project as a critical element of the formula. A "cost" of $200,000 was assigned for each day it would take a contractor to complete the project. This amount was based on the estimated 50 percent of the cost to road users. In this way, time was given a value that could be used in the analysis of the bids.

The final, and hardest, component was evaluating the technical score. Chiglo and his team created multiple committees and advisory groups to assist in bid evaluation and ensure complete transparency and fairness. Because the technical component of the proposal was somewhat subjective in nature, Chiglo's team had to establish formal grading criteria, evaluation criteria, and an evaluation process. Within the contract evaluation, transparency became evident from beginning to end. The technical proposals included narratives that described each of the categories and weightings as shared in previous best value considerations.

The entire evaluation process ensured maximum security. Each person with access to the bid proposals signed a nondisclosure agreement. The technical review committee chair had to sign off on any disclosures made to parties outside the committee structures. The technical review committee and technical subcommittee even met in separate rooms. Subcommittee members had to be invited to enter the technical review committee meeting room. If a nonmember appeared for any reason in the technical review committee meeting room, all discussions ceased and paperwork was stored until the person(s) left the room.

Rating the technical proposal was the trickiest part of the process. The technical review committee reviewed the proposals, along with recommendations and comments from the technical subcommittee, and awarded a qualitative rating for each criterion.

The proposal evaluation plan summarized the four assessment levels:

1. Excellent (91–100%). The Proposal demonstrates an approach with unique or innovative methods of approaching the

proposed work. The Proposal is considered to significantly exceed stated requirements/objectives in a beneficial way (providing advantages, benefits, or added value to the project) and provides a consistently outstanding level of quality.
2. Very Good (76–90%). The Proposal demonstrates an approach offering unique or innovative methods of approaching the proposed work. The Proposal exceeds the stated requirements.
3. Good (61–75%). The Proposal demonstrates an approach that is considered to adequately meet the RFP requirements/objectives and offers an acceptable level of quality.
4. Fair (50–60%). The Proposal demonstrates an approach that is marginally meets the RFP requirements/objectives.
5. Fails (0–49%). The Proposal is considered to Not Meet the RFP requirements or is Nonresponsive.

Each technical review committee member assigned a percentage based on the qualitative assessment rankings just shown. Then the committee multiplied the percentages by the maximum number of points in each category. The product became the final value of technical score.[25]

RECOMMENDED READING FOR SUPPLIER SELECTION

Gerard Chick and Robert Handfield. *The Procurement Value Proposition.* London: Kogan Page, 2012.

New Zealand Government, Procurement—Driving Better Value for Money, "Guide 3 to Sustainable Procurement Evaluate and Select Suppliers," July 2010, https://www.business.govt.nz/procurement/pdf-library/agencies/Guide3.pdf.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability,* 2nd ed. London: Kogan Page, 2012.

Arjan J. Van Weele and Frank A. Rozemeijer. "Revolution in Purchasing: Building Competitive Power through Proactive Purchasing." *European Journal of Purchasing & Supply Management* 2, no. 4 (1996): 153–160; http://arjanvanweele.com/42/records/14/Revolution%20in%20purchasing%201996%20JPSM.pdf.

Kate Vitasek, Todd Snelgrove, Dawn Tiura, Wendy Tate, Bonnie Keith, and Sarah Holliman. *Unpacking Best Value: Understanding and Embracing Value Based Approaches for Procurement.* University of Tennessee College of Business Administration, Sourcing Industry Group. Download at www.vestedway.com/vested-library/.

12. Risk Management Plan

In the Risk Assessment consideration, the buyer assessed the overall spend category environment to determine potential risks. The sourcing strategy decisions made previously likely have addressed and mitigated some of the identified risks. In the Execution Planning phase of Cornerstone 3, buyers must finalize a comprehensive risk management plan as part of their sourcing solution. The more critical or complex the spend category requirement*s*, the more comprehensive the risk mitigation plan likely will be. The level of effort applied to building out the risk management plan is commensurate with increasing levels of effort and diligence as an organization shifts along the sourcing continuum.

The purpose of a risk management plan is to identify actions and deploy tactics that enable buyers and/or suppliers to better manage risk. Let's look at how a major restaurant serving chicken as the primary menu item approaches risk management for the poultry spend category. An external market assessment forecasts that long-term poultry prices will increase due to consumer pressure to reduce the use of antibiotics in chicken. The risk assessment, conducted previously, revealed that the in-country supply of chicken is constrained by the capacity of poultry producers. An interrupted supply could be disastrous for the restaurant company. Being out of stock on chicken would clearly be a high risk. The buyer developed a risk management plan that included:

- Acquiring a special import license and permissions from the government to support volume shortfalls from in-country suppliers by importing frozen chicken breasts and thighs from outside the country.
- Working with the restaurant's distribution supplier to jointly develop standard operating procedures for import processes.

- Ensuring the company's forecasting team and the distribution supplier were aligned on appropriate reorder points and inventory levels that factored in longer lead times

A risk management plan should include strategies and a plan of action for managing any identified risks in the sourcing solution. The plan should build on your risk assessment (Consideration 8). The University of Tennessee offers an open source risk assessment management tool that can be downloaded at http://www.vestedway.com/tools/.

For each risk, it is important to say what is to be done (the mitigation plan) and who is responsible and to set a target date for review. As mentioned earlier, risk mitigation is an ongoing process. The list of risks will change, with some risks being resolved and new ones being added.

One key risk area that often is not properly mitigated is ramping up a new supplier. This process includes transitioning workscope to a supplier, either from one supplier to another or from an internal organization to a supplier for a first-time outsourcing event. For generic goods falling under basic and approved provider models, there is limited or no risk to switching suppliers or ramping up a new supplier. However, as you shift along the sourcing continuum, risk increases significantly. This is especially true when an organization is outsourcing services for the first time or where a supplier's solution is embedded in the operation or business process.

ISO offers advice for procuring outsourced services using a pilot approach to mitigate risk, especially for workscope transitions involving more complex outsourced services. ISO's 22301 standards (Business Continuity Management) suggest creating a formal transition plan with active participation between buyer stakeholders and the supplier. Collaborative planning is essential for a smooth transition. Transition managers from both the buying organization and the supplier create a common objective and common project plan, including a formal communication plan to ensure that internal and external stakeholders are up to date on what is changing when and why. A transition should not be considered complete until key stakeholders have reviewed and signed off on the pilot results, highlighting their confidence in the supplier's ability to deliver and to accept the residual risk.

Pilots are not just for large, complex sourcing initiatives. For example, recall the example of FinanceCo from chapter 4. FinanceCo's engineers and solution product engineers used a pilot to conduct extensive lab tests for hardware falling under the computer services spend category. The test results helped the company down-select suppliers as approved providers.

Sourcing initiatives that require a pilot should not be considered final until the pilot results are incorporated and the sourcing strategy is adjusted to include critical information gained from the pilot. Why? Simply put, both buyer and supplier will learn valuable information as they do their due diligence. In some cases, buyers will need to reevaluate the business case as cost estimates prove to be higher or lower. A good example of this dynamic approach is how Microsoft and Accenture managed the transition of workscope under the OneFinance program. Microsoft knew it could not develop an accurate baseline alone. Its chance of getting it right would have been slim to none, given that Microsoft had 140 systems spanning 95 countries. Microsoft and Accenture agreed to a fair and flexible pricing model that enabled them to jointly develop the performance baseline as Microsoft shifted workscope to Accenture's control. The agreement also had a rollout plan that migrated each workscope performed under each subsidiary over the course of 18 months.[26]

RECOMMENDED READING FOR RISK MANAGEMENT

Linda Tuck Chapman. "Vendor Third Party Management: Third Party Management: What Boards of Directors and C-Suite Executives Need to Know," Hiperos; http://promotions.hiperos.com/Third-Party-Management-What-Boards-of-Directors-Need-to-Know.

FFIEC. IT Examination HandBook InfoBase. Appendix J: Strengthening the Resilience of Outsourcing Technology Services; http://ithandbook.ffiec.gov/it-booklets/business-continuity-planning/appendix-j-strengthening-the-resilience-of-outsourced-technology-services.aspx.

Free risk management templates at Project Management Docs: http://www.projectmanagementdocs.com/project-planning-templates/risk-management-plan.html.

ISO 22301 2012. "Societal Security—Business Continuity Management Systems—Requirements," May 15, 2012, http://www.iso.org/iso/catalogue_detail?csnumber=50038.
"Risk Assessment Worksheet and Management Work Plan." http://acqnotes.com/Attachments/Risk%20Assessment%20Worksheet%20and%20Management%20Plan.pdf.

13. Contract Approach

A key sourcing consideration is to determine what type of contract you will use. A contract is a legally enforceable written or oral agreement between two or more parties to provide specific goods or services. Although the term "contract" is often used interchangeably with "agreement," the legal definitions of the two terms are different.

Formal written contracts are used infrequently for basic provider solutions, because a purchase order or a p-card serves as a form of contract between the buyer and supplier. As a general rule of thumb, organizations tend to rely on more formal contracts as they move along the sourcing continuum. Often suppliers are required to sign the buyer's unique corporation standard contract template with predefined terms and conditions. As mentioned in chapter 4, Microsoft requires approved providers to sign its master services and supply agreement and agree to several standard terms and conditions as well as corporate policies. Organizations often use blanket purchase orders as they work with approved providers to facilitate easy repeat business.[27]

The farther along the sourcing continuum an organization moves, the higher the degree of codependency. In such cases, organizations typically seek to use even more formal contracts. Although such contracts are not mandatory, most businesses prefer to use them. We believe that organizations can greatly benefit from documenting their intentions and overall structural components of their relationships into formal contracts.

As you move across the sourcing continuum, it becomes increasingly important to frame contract terms flexibly. Relational Sourcing Business Models require relational contract elements that provide for more flexible contract structures, including more formal governance mechanisms designed to keep your sourcing solution aligned with changes in business requirements and market forces. We provided examples of how to structure agreements for each Sourcing Business Model in chapters 4 through 7. A well-structured Sourcing Business Model includes ten elements across five dimension areas. Those chapters profiled the five focus areas included in a well-structured Sourcing Business Model. As you move along the sourcing continuum, these elements become more and more formalized and are even embedded in the contracts you employ with business partners and/or suppliers. By working through the remaining sourcing considerations, you will be able to determine what to include in your contracts.

It is tempting to think that the more complex the contract, the more likely it is to be longer, include a more detailed statement of work, and embed an increased number of service-level agreements (SLAs). It sounds logical, but it is often wrong. Oliver Williamson offers prudent advice for organizations as they structure their physical agreements, especially more complex agreements with higher codependency. Williamson believes that business agreements should be structured as flexible frameworks and include a process for understanding the parties' relationship. Structuring agreements with flexibility prevents what he calls "maladaptations," or aspects of an agreement that can become more harmful than helpful.[28]

A good example of a preferred provider contract is the United States Air Force five-year indefinite delivery/indefinite quantity (IDIQ) contract with the University of Tennessee, which enabled the Air Force to create a research contract for the support of a variety of research projects. At the time of contract signing, only a small number of research projects were known.[29] IDIQ contracts provide for an indefinite quantity of supplies or services during a fixed period of time. Such contracts are used most often for service contracts when the organization cannot predetermine the precise nature and quantity of supplies or services that it will require during the contract period. Like a master agreement, an IDIQ contract allows for a certain amount of contract process streamlining. The Air Force didn't have to write a new contract; rather it simply needed to write a new task order that would fall under the same prenegotiated terms and conditions outlined in the IDIQ contract.

Contracts for performance-based models typically become complex because they incorporate additional value-added components. For that reason, performance-based agreements typically are for a longer periods of time than transaction-based agreements. Performance-based models often span three to five years and often contain options to renew for additional years based on performance. Performance-based agreements typically include expected objectives, performance metrics, business continuity plans, and relationship management expectations because there is a heightened sense of risk due to increased supplier dependency. However, they should not over-specify requirements and mandate "how" work should be performed; doing so reduces the supplier's ability to drive processes changes—a key reason for using a performance-based agreements.

As organizations shift to investment-based models, the contracting approach changes yet again. Many organizations do not see the need to create formal contracts for their internal shared services organizations (SSOs). However, because the shared services group is, in essence, a "supplier" to internal business groups, there should be some form of documented operational agreement. In organizations that formally structure agreements for their shared services models, the agreements should be based on the selected economic model.

Remember, shared services agreements can be structured with transactional or output- or outcome-based economic models. In most cases, the internal "contract" includes risk mitigation and management obligations and a formal governance structure that outlines how the SSO works with internal business groups. For a good refresher, review how Health Shared Services British Columbia set up its formal agreement with the health authorities, discussed in chapter 7.

Equity partnerships require a very formal contract approach due to the ownership structure aspects of the business relationship. A key focus of an equity partnership contract is how the partners will meet the business objectives and how success will be measured within the ownership structure. It is also critical to detail management and governance. Risk mitigation and management plans are required (Consideration 13) but typically are delivered as part of the overall business planning process rather than as part of a contract.

RECOMMENDED READING FOR THE CONTRACT APPROACH

Andy Akrouche. *Relationships First.* N.p.: Author, November 24, 2013. Available at International Association for Contract and Commercial Management, www.iaccm.com.

Jeanette Nyden, Kate Vitasek, and David Frydlinger. *Getting to We: Negotiating Agreements for Highly Collaborative Relationships.* New York: Palgrave Macmillan, 2013.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements.* New York: Palgrave Macmillan, 2011.

14. Pricing Approach

Perhaps no other topic creates as much apprehension between buyers and suppliers than negotiating a fair price for a product or service. Buyers must first and foremost understand the differences between a price and a pricing model and then must understand when to use each.

A price is how much you pay for something. You can order a printer cartridge replacement for $27.50. A customer care service provider charges a price per call to provide technical support to your customers.

A pricing model is fundamentally different from a price because it includes mechanisms to determine the optimum monetary exchange between a buyer and a supplier. A good pricing model is dynamic and enables the parties to adjust the underlying pricing assumptions as business happens. This flexibility allows the parties to "model" the outputs relative to the input components to determine a fair way to pay for goods and services. A good pricing model equitably allocates risks and rewards with the goal of realizing mutual gains for the duration of the agreement.

Most pricing models are expressed in a simple spreadsheet; however, some can resemble a small, customized software package or a macro-based Excel spreadsheet. The best pricing models allow buyers to align a supplier's payment with value received—in essence, validating that the company is getting what it pays for. Common factors affecting a pricing model include:

- *Contract duration.* This term refers to the number of years in a buyer–supplier agreement. Contract length is an essential element of a pricing model because achieving step-level improvements can take time and a significant investment on the part of the service provider. Longer-term agreements may be needed to achieve the Desired Outcomes. The length of the contract affects how some costs are amortized over the life of the agreement.

- *Desired compensation method.* A compensation method is the mechanism that a buyer uses to trigger payment to the supplier. Most organizations rely on one of two compensation methods for their business arrangements: fixed price or cost reimbursement.
- *Incentives.* Coupling incentives to business agreements is certainly not new, but neither is it common. Getting incentives right is also easier said than done. The key is to design the right mix of incentives that align interests. Organizations should incorporate incentives that are mutually beneficial to both parties in order to offset the flaws of using conventional compensation methods.
- *Margin matching* (used in Vested agreements). Margin matching is a mechanism that allows companies to address market events and fluctuations as business happens. It enables organizations to fairly adjust prices based on movements in the defined underlying pricing model assumptions and prevents having one party win at the other party's expense.
- *Risk allocation.* Rather than shifting the risk, a pricing model seeks to jointly identify risks, understand potential risk costs, and allocate risk to the party best suited to manage and mitigate it.
- *Underlying financial and operational assumptions.* Common financial assumptions include unit costs, costs of raw materials, market share estimates, currency assumptions, and base exchange rates. Common operational assumptions include inventory targets and workload mix.

Four big questions arise when the buyer and sellers try to determine the most appropriate pricing approach.

The first big question is: When should a company shift from using a price to using a pricing model? The simple answer: Companies should use a price when the business exchange is simple and predictable; there is no opportunity to create value beyond simply acquiring the good or service. Basic and approved providers almost always use price due to the simplicity of transaction-based models. As an organization moves along the sourcing continuum, it should consider using pricing models. Although they can be used for any Sourcing Business Model, pricing models typically require a significant amount of administrative burden and therefore are not used in transaction-based models.

Organizations should look to a pricing model when the work is complex and variable in nature, and there is a higher likelihood of creating value by working more collaboratively (e.g., reducing costs, innovating). A Vested model always uses a pricing model, not a price.

The second big question is: Which type of compensation method should the company use? There is much debate on merits of cost reimbursement compared to the fixed-price compensation model. And, really, there is no one "right" answer. There are, however, some very sound rules of thumb that can guide you. A cost reimbursement approach typically favors an environment where there is uncertainty, and the buyer wants flexibility. A fixed-price approach typically favors an environment that is more stable and the buyer seeks pricing stability. Table 9.3 outlines the attributes that impact your choice of compensation method.

Many buyers believe that time and materials contracts use a cost reimbursement compensation method because these contracts are variable by nature. Although such contracts can be cost reimbursement, more often they are fixed-price compensation methods because suppliers are charging fixed prices (often negotiated rate cards) for their time (e.g., an hourly rate). The general guideline is that transactional models—basic, approved, and preferred provider models—use fixed-price compensation methods. As you move along the sourcing continuum, the business environment tends to favor cost reimbursement approaches.

The third question is: What, if any, incentives should be used? Typically the more complex the Sourcing Business Model, the greater need to use incentives. Buyers typically receive volume discounts and rebates when operating under basic and preferred provider models, but typically there are limited or no supplier incentives for these models. Performance-based and Vested models rely heavily on incentives. Performance-based models typically tie incentives to performance guarantees (in the form of SLAs) while Vested models rely on more value-based incentives tied to achieving transformation and innovation goals tied to mutually defined Desired Outcomes.

Table 9.3 Attributes that Impact Fixed-Price versus Cost Reimbursement Decision

Criteria	*Favors Firm Fixed Price When…*	*Favors Cost Reimbursement When…*
Level of understanding of work to be performed	Work is clearly defined	Flexibility to adjust the work tasks is required
Ability to influence supplier behavior	Low level of need to influence supplier behavior	High level of need to influence supplier behavior
Flexibility to adjust work tasks	Regulations or policies do not allow flexibility in tasks	Opportunity to adjust the tasks to gain efficiencies
Level of inefficiency in the operations being outsourced	Current processes are well defined and efficient	High degree of inefficiency in current processes
Budget predictability	Need for predictable budget	Ability to tolerate budget fluctuations to achieve performance goals
Level of understanding of price/high level of competition	Strong competition/high certainty of price	Weak competition/low certainty of price
Need for visibility of cost data	Visibility to cost data is not required	Visibility to cost data is required or desired
Administrative burden	Low tolerance for administrative burden	Ability to handle administrative burden
Tolerance for risk	High outsource supplier risk Low organization risk	High organization risk Low outsource supplier risk

COMMON INCENTIVES

Award fee. A fee paid at the conclusion of a fixed-duration agreement for achieving a desired goal. Award fees can be fixed or variable and typically are used when the supplier's performance is not objectively measurable as it occurs or when the nature of the work makes it difficult to devise objective predetermined performance incentives tied to cost or other performance indicators. To be effective, the value of the award fee must exceed the supplier's cost of achieving the result.

Award term (contract extension). An incentive in the form of a contract extension. When a supplier meets specified goals, the contract is extended for an additional length of time. More business is a great incentive for a supplier (provided it is profitable business). In some cases, award terms are used to create long-term evergreen contracts in which the buyer extends the contract when a supplier achieves agreed-on performance targets. If a supplier relationship is distressed, an award term is an excellent incentive for the supplier to complete a get-well plan aimed at correcting the dysfunctional relationship.

Gainshare/Cost savings incentive. A monetary incentive where buyer and supplier share in costs savings. The focus is on driving out costs that are of limited value and sharing the costs savings. The concept provides an incentive to both buying and supplier organizations when the focus is on continually reevaluating, reenergizing, and enhancing their business relationship. The principle is to drive out cost inefficiencies and still protect profit margins.

Nonmonetary incentives. Incentives, such as public recognition, endorsements in the form of public case studies, willingness to provide references, sharing processes and techniques, sharing knowledge, and other goodwill gestures. Nonmonetary incentives can be powerful, intangible awards that increase visibility and market worth of the supplier. However, buyers and suppliers must be realistic in evaluating the true worth of such incentives. A poorly positioned customer may not be able to provide valuable nonmonetary incentives to a well-positioned supplier. However, a customer that is relatively small but well regarded in its industry may be able to provide valuable incentives, particularly if its industry is one that the supplier considers strategic.

Pay for performance incentive. An incentive that is tied to specific performance requirements. The desired performance typically is stated in terms of quantitative SLAs. The incentive fee can be fixed or variable, but it always corresponds to specific, agreed-on targets. A performance incentive can be an effective way to encourage performance, provided that the incentive is worth more than the effort to achieve it.

Rebate/Volume discount. A financial reward a supplier gives a buyer for purchasing its goods or services.

The fourth big question: Should an open-book or a closed-book approach be used? In a closed-book approach, suppliers and buyers do not share their costs and margin—in essence, each party's profit margin is hidden. An open-book approach is transparent. Buyers and suppliers see each other's costs and profit margins.

A common misconception is that a cost-reimbursement compensation method is an open-book approach. This is not necessarily true. The actual costs may be passed through, but the management fee markup may not reveal actual suppliers' costs to perform the management services. Open-book approaches allow buyers and suppliers to build a fact-based discussion around actual costs.

The primary benefit of an open-book approach is that transparency enables both buyers and suppliers to understand true costs. Looking at true costs allows organizations to shift their focus from sitting across the table negotiating price to probing into how both parties can work collaboratively to eliminate non-value-added activities, duplicative efforts, and risks that drive up costs. Typically, transactional models use closed-book approaches; Vested models almost always use open-book approaches. Preferred or performance-based agreements can use either; however, most use a closed-book approach. We suggest that buyers and suppliers challenge tradition and shift to an open-book approach for performance-based agreements, as doing so will increase transparency, which is important when buyers and suppliers are operating in a more dynamic and/or risky environment.

When there is a situation in which the supplier can't disclose open costs because of proprietary client reasons, a faux open book cost model is developed and agreed to by both buyer and supplier. Based on the buyer's specific requirements and business environment, this agreed-to cost model baseline enables measurement of cost changes and total cost improvements.

RECOMMENDED READING FOR PRICING MODELS

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Arjan J. Van Weele, and Frank A. Rozemeijer. "Revolution in Purchasing: Building Competitive Power through Proactive Purchasing." *European Journal of Purchasing & Supply Management* 2, no. 4 (1996): 153–160, http://arjanvanweele.com/42/records/14/Revolution%20in%20purchasing%201996%20JPSM.pdf.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating*

Successful Business and Outsourcing Agreements. New York: Palgrave Macmillan, 2011, chapter 6: Rule # 4: Optimizing the Pricing Model

Kate Vitasek, Jeanette Nyden, Ed Hansen, and Astrid Uka. *Unpacking Pricing Models: Make "You Get What You Pay For" Real for Business Relationships.* University of Tennessee Center for Business Education and SIG, 2013; www.vestedway.com/wp-content/uploads/2014/05/Unpacking_Pricing_Models_v8.pdf

CORNERSTONE 4: MANAGE AND REFRESH

As you work through the six elements of the *Manage and Refresh* Cornerstone, you need to consider how to best manage the overall spend category after contracts have been signed. A key purpose of this Cornerstone is to determine the most appropriate supplier interface that allows buyers and suppliers to respond dynamically to changing business requirements and market fluctuations as they occur. Many organizations wait to think about how they will manage a spend category and the supplier until after a supplier contract is signed. This is a miss, especially for supplier relationships falling under a performance-based or Vested model. When using a performance-based or Vested model, it is imperative to jointly agree and formally embed these concepts into supplier agreements. Doing so ensures the buyer, supplier and stakeholder groups are aligned on how they will work to successfully manage the spend category.

In this Cornerstone, you will answer these questions:

- What is the most appropriate approach to overall governance of the spend category?
- What role will formal supplier relationship management mechanisms play in how you work with the supply base?
- What are the best-fit performance management protocols? What are the required resource levels to support a sustainable sourcing solution?
- What is the expected focus on continuous improvement and/or innovation for the spend category, and how will ideas and implementation be managed?
- How do you ensure contract, policy, and regulatory compliance?

- How will you manage the physical and commercial aspect of transitioning from one supply solution to the next (managing onboarding and off-ramps) from both buyers' and suppliers' perspectives?

Collectively, the answers to these questions help you frame how to manage and refresh the spend category on an ongoing basis. Each of these considerations is discussed next.

15. Category Management Governance

Governance and governance structures matter. The more complex, risky, or strategic the spend category, the more buyers need either to facilitate or to play a support role in a formal governance structure for managing the category. As you shift along the sourcing continuum, the level of effort and formality required in category management governance increases.

Good governance requires an organizational framework that provides consistent management and cohesive policies, processes, and decision protocols that enable parties to work together effectively to manage a spend category. Figure 9.7 is an example of a governance framework from the Governance Academy.

Figure 9.7 Governance Framework

Source: The Governance Academy. Used with permission. https://governance-academy.com/.

In short, governance involves the development of processes that bring together the appropriate people, processes, and technology to keep your sourcing solution performing as a well-run system.

As far back as 1979, Oliver Williamson wrote that a governance structure is "the framework within which the integrity of a transaction is decided."[30] For this reason, there is no one-size-fits-all governance structure. As Williamson points out, "Because contracts are varied and complex, governance structures vary with the nature of the transaction."

As you design and execute your category management governance, you should consider these factors:

- Sourcing Business Model
- Complexity of sourcing solution
- Geographical coverage
- Corporate management structure (e.g., divisions, business units, regions)
- Culture and behaviors

According to the Governance Academy, good governance includes five key roles that serve to coordinate key stakeholders involved directly or indirectly in executing the sourcing solution. These roles are: contract compliance, financial management, managing issues and risks, managing performance, and managing relationships. We have already expanded on risk management (Consideration 12).

We address supplier relationships management (Consideration 16) and performance management (Consideration 17) in more detail later in this chapter. Table 9.4 is high-level overview of each of the key roles.

Some complex sourcing solutions may require a significant transition plan to implement your governance structure. This is especially true when the sourcing solution involves any outsourced services. The ISO 37500 standards for outsourcing suggest setting up seven formal governance committees for large, complex outsourcing initiatives:[31]

1. Strategy and relationships review
2. Service review
3. Commercial review
4. Financial review
5. Security and compliance review
6. Quality and risk review
7. Change control committee

Table 9.4 High-Level Overview of Governance Roles

Contract Management	• *Maintain solid understanding of the agreement* • *Administer the agreement and all amendments as change occurs* • *Manage contract change control and ensure appropriate documentation* • *Advise on contractual implications of commercial issues and potential changes* • *Lead, or support, negotiations with providers*
Finance/ Commercial	• *Monitor and report on financial performance* • *Verify and approve provider invoices including penalties* • *Advise on financial impact of commercial issues* • *Calculate and report chargebacks or allocations* • *Assist in business case development* • *Monitor market pricing and compare against fees/costs* • *Track and communicate value* • *Monitor asset tracking and life cycle management*
Issue/Risks Management	• *Monitor and report on financial performance* • *Verify and approve provider invoices including penalties* • *Advise on financial impact of commercial issues* • *Calculate and report chargebacks or allocations* • *Assist in business case development* • *Monitor market pricing and compare against fees/costs* • *Track and communicate value* • *Monitor asset tracking and life cycle management*
Performance Management	• *Monitor and report on service and project performance* • *Ensure accurate and timely performance reporting* • *Consolidate and redistribute performance reports* • *Perform proximate and/or root cause analysis* • *Facilitate performance reviews* • *Monitor consumption against base case assumptions* • *Monitor and change service levels and penalties*
Relationship Management	• *Develop and update communication plans* • *Ensure timely and accurate reporting to all constituents* • *Establish and maintain expectation alignment* • *Internal* • *External* • *Administer stakeholder satisfaction process* • *Facilitate joint planning and innovation* • *Facilitate change management*

Source: Based on the Governance Academy's online Governance Design Course. Used with permission by Mike Beals, Founder Governance Academy.

RECOMMENDED READING FOR CATEGORY MANAGEMENT GOVERNANCE

Corporate Executive Board, IACCM, and the University of Tennessee Center for Business Education. *Unpacking Outsourcing Governance: How to Build a Sound Governance Structure to Drive Insight Versus Oversight*, © 2011.

Governance Academy Governance Design Course. https://governance-academy.com/.

ISO 37500 2014. "Guidance on Outsourcing," November 11, 2014, http://www.iso.org/iso/catalogue_detail?csnumber=56269.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements.* New York: Palgrave Macmillan, 2011, chapter 7, Rule #5: A Governance Structure that Provides Insight, Not Merely Oversight.

16. Supplier Relationship Management

The Corporate Executive Board found that companies can erode up to 90 percent of anticipated value due to poor governance of supplier relationships.[32] This value loss, which is often called value erosion or savings leakage, is a pressing problem for companies.

Many organizations are developing formalized supplier relationship management (SRM) programs as a best practice. SRM is a welcome discipline because far too many organizations have done poor jobs managing relationships with suppliers. It is important to make sure that activities and processes designed to support SRM are appropriately aligned with the Sourcing Business Model you select. Basic transaction and approved provider models use limited SRM mechanisms; performance-based and Vested agreements have sophisticated mechanisms. As you shift along the sourcing continuum, you begin to incorporate SRM practices into your supplier relationships. For example, preferred provider relationships usually do not include a formal continuity of resources plan; performance-based and Vested relationships do include a formal, documented plan with a "key man" provision embedded into the overall contract, which outlines provisions and protocols for how key individuals in the relationship will transfer into and out of a strategic supplier relationship roles.

In an interview, Mike Beals, founder of the Governance Academy, shared his insights on SRM.[33] "There is definitely a trend for organizations to begin to incorporate formal SRM protocols into supplier contracts. This is a good thing because it helps the buyer and supplier create a mutual understanding of how they will work together during the buying and negotiating process and allow for a supplier to properly staff their account teams as necessary. This is especially important on more complex supplier relationships and should be considered essential in any sourcing initiative that involves outsourced services." It's important that SRM processes align with the intent of the deal and the Sourcing Business Model you are using; if not, you will find yourself with management mechanisms that do not support the deal structure."

Many organizations offer guidance on SRM frameworks. Next we list SRM mechanisms you should consider incorporating into your supplier relationships as you design and build the most appropriate sourcing solution. Again, these concepts need to be scaled for the appropriate Sourcing Business Model. (Exhibits A3 to A9 in the appendix suggest guidelines for scaling SRM to each model.)

Interface Structure with Supplier

Who is the primary interface for the supplier relationship? As you move along the sourcing continuum, the role of the business stakeholder increases. ISO 37500 standards outline guidance for SRM in outsourcing relationships. The standards suggest that a joint buyer–supplier management team should install a "manage relationships" process that is embedded with the overarching governance model (Consideration 15.) This makes sense because tighter integration of buyer's and supplier's organizations is needed when services are outsourced.

According to ISO 37500, the main activities in managing the relationship process are:

- Build confidence and trust with all stakeholders.
- Ensure the buyer and the supplier are clear on the behaviors expected of each other, in particular ensuring openness, transparency, and honest communications at all times. Processes should also cover the onboarding of new team members.
- Monitor the strength and quality of the relationship with a method of regular relationship assessment.

- Ensure performance expectations align with agreed requirements through regular stakeholder interactions and expectation setting.
- Review and implement improvements with a process agreed to by the joint management team. Designate an individual who is responsible for managing the relationship and ensuring client satisfaction. Typically, this will be the relationship manager or account/provider manager. Both the client and provider do this.[34]

The ISO standards offer excellent advice when you are working in a performance-based or Vested agreement.

Formal Escalation Process

How will you manage issues that arise? The level of formality will vary greatly based on your Sourcing Business Model. As you move along the sourcing continuum, the emphasis shifts from reactive (the captain did not get one of the storage cabinets ordered for the fire station) to formal processes embedded in the contract. The ISO 37500 standards for outsourcing suggest that buyers and suppliers clearly define an issue resolution process in the event of issues and problems. This is especially important in relational contracts and should be considered mandatory for performance-based and Vested models. According to ISO Standards 37500, an issue resolution process should include:

- Resolution of issues and problems while taking into account the established joint goals of the relationship.
- A documented process for logging, classifying, escalating, and communicating issues and problems based on their severity.
- An agreed process for the escalation of issues and/or problems that cannot be resolved at the point of origin within a set time frame.
- An issues register/log including actions, taken, to be maintained, and reviewed within the appropriate joint governance committee. Client and provider should work together to correct issues and problems and agree on the appropriate response.

- Issues log and resolution log that are fed back into the knowledge management systems to ensure that future transactions are conducted accurately.[35]

Resource Continuity

How will the parties work to keep overall business continuity? Continuity is not an issue when dealing with goods and services that fall under basic or approved provider models because the market provides continuity and keeps the overall systems in check. However, as organizations become more dependent on suppliers, they need to ensure business continuity. According to ISO 37500 standards, a good SRM program outlines how buyer and supplier allocate management resources, especially during critical transition phases of the sourcing cycle.[36]

Change Management/Commercial Management

Sourcing Business Models using longer-term contracts with a documented statement of work (preferred, performance-based, and Vested models) require buyers to develop mechanisms that embrace the dynamic needs of business stakeholders or react to changing market conditions. Thus, a good SRM program establishes and implements procedures to modify the goods/services provided according to the agreed-on changes.

RECOMMENDED READING FOR SUPPLIER RELATIONSHIP MANAGEMENT

Corporate Executive Board, IACCM, and the University of Tennessee Center for Business Education. *Unpacking Outsourcing Governance: How to Build a Sound Governance Structure to Drive Insight Versus Oversight*, © 2011.

Governance Academy Governance Design Course, www.governance-academy.com.

ISO 37500 2014. "Guidance on Outsourcing," November 1, 2014, http://www.iso.org/iso/catalogue_detail?csnumber=56269.

PriceWaterhouseCoopers. "A Practical Guide to Risk Assessment: How Principles-Based Risk

Assessment Enables Organizations to Take the Right Risks," 2013.

http://www.pwc.com/en_us/us/issues/enterprise-risk-management/

assets/risk_assessment_guide.pdf
Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements.* New York: Palgrave Macmillan, 2011, chapter 7. Rule #5: Agree on Clearly Defined

17. Performance Management

Buyers should also consider how the organization needs to manage performance against the sourcing solution. To do so, they should determine how overall performance and results will be monitored; in essence, this step involves validating whether your sourcing solution meets business requirements. Think through how to scale performance management mechanisms and processes. As the old saying goes, "You don't need a sledge hammer to tap a thumbtack into a corkboard." Likewise, you don't want to fall victim to what University of Tennessee researchers refer to as Driving Blind Disease, a situation in which the organization does not capture detailed information to properly manage the activity or process.

The good news is that many organizations have formal quality and performance management programs. If your organization has a documented performance management program, ensure that your sourcing solution complies with organization-wide standards. Although corporate-wide programs may be sufficient, they also may not be sufficient or appropriately tailored to a specific sourcing solution. Evaluate any existing programs to ensure your sourcing solution incorporates the four factors outlined in the next paragraphs.

First, as you define your performance management approach, you must determine how much effort and resources to apply based on the risk and the return on your investment. You need to work with business stakeholders and suppliers to ensure that you properly identify and facilitate the implementation of the best-fit performance management solution. Having a rigid and highly detailed performance management program for a low-risk basic provider is likely overkill.

Many organizations fail to design and implement proper performance management approach for complex performance-based or Vested relationships. Use the Sourcing Considerations Guidelines outlined in Exhibits A3 to A9 in the appendix to help you determine the appropriate level of effort/resources for performance management for each Sourcing Business Model. For example, ISO 37500 suggests that for complex sourcing initiatives for outsourced services, buyers should incorporate ongoing formal performance monitoring as part of their governance processes. ISO suggests: "The purpose of the 'monitor and review service performance' process is to verify that the agreed-upon service commitments are being met, to take appropriate action when commitments are not met or at risk of being missed and to provide appropriate information to enable continual improvement of the management of the relationship and its performance."[37]

The second factor is to decide how to embed performance management processes in your overall category management governance. As you recall from Table 9.4, a good category management governance structure incorporates performance management into the broader governance perspective. When you are working with a supplier, it means that performance management will naturally extend to include your supplier(s).

Many organizations embed a performance management plan in a formal SRM framework. Unfortunately, not all organizations use SRM programs. In addition, overall performance of the spend category is not always simply a factor of a supplier's performance in delivering a unit of something on time. What is often missing in the plan is the overall alignment with the broader category of management governance. Disconnecting supplier performance from category management governance leads to what University of Tennessee researchers call a watermelon scorecard (green metrics on the outside, but red faces on the inside) because suppliers could be meeting all of their performance targets but business stakeholders still may not be happy as the performance of the overall spend category is not meeting their business objectives.

The third factor to consider for performance management is to agree on the overall cadence and physical reporting requirements. Buyers should facilitate alignment across business stakeholders, and suppliers should focus on the defined reports and physical reporting mechanisms used to assess performance. In some cases, suppliers themselves may provide advanced performance management reporting. A good example is how Procter & Gamble relies on the Jones Lange LaSalle IntelliCommand® system to help monitor overall building maintenance.

Many buyers are hesitant to use a supplier's performance management process because they don't trust their supplier or the supplier's data. This is often shortsighted. After all, why should an organization invest in advanced performance monitoring if a supplier such as JLL already has? A better approach? Trust but verify.

As you shift along the sourcing continuum, a series of scheduled meetings (e.g., quarterly business reviews) will be set up to review performance. Both formality and frequency increase. In addition, the emphasis on performance management evolves as you enter into relational contracts. Incorporate a formal operational scorecard for preferred providers, an operational and relational scorecard for performance-based providers, and an operational, relational, and transformation management scorecard for Vested providers.

The fourth factor to consider for performance management is whether to use technology as a key component to manage the category. Use of sophisticated software tools to monitor a supplier's performance is increasing. In many cases, the overarching procurement function or business unit decides whether to use technology or not; you use what the company has adopted, or you don't have technology. If you are using software tools, review their functionality and ensure they can meet your specific category requirements. For example, most existing software typically focuses on operational performance and rarely incorporates relational aspects of performance (required for performance-based and Vested models) and transformational aspects of performance associated with Vested agreements. Also, more sophisticated supplier relationships often require comprehensive and sometimes customized performance reporting.

RECOMMENDED READING FOR PERFORMANCE MANAGEMENT

Bryan Ball. "Best-in-Class Strategic Sourcing: Profile and Approach." Aberdeen Group, March 18, 2015. http://www.aberdeen.com/research/10155/10155-RR-strategic-sourcing-bestinclass.aspx/content.aspx.

Robert S. Kaplan. *Conceptual Foundations of the Balanced Scorecard.* Harvard Business School Working Paper10–074, 2010.

Jason Minghini. "Measuring What Matters: Creating Key Performance Indicators Will Help You Monitor the Vital Signs for Your

Business." *Material Handling & Logistics* (January 2015). http://www.highbeam.com/doc/1G1-401505964.html

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

Oak Ridge Associated Universities. *The Performance-Based Management Handbook*. Section 1: Development Management Processes, Performance Measurement Process. http://www.orau.gov/pbm/handbook/1-1.pdf.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements*. New York: Palgrave Macmillan, 2011, chapter 5, Rule # 3: Agree on Clearly Defined and Measurable Outcomes, and chapter 7, Rule # 5: A Government Structure that Provides Insight, Not Oversight.

18. Continuous Improvement/Transformation/Innovation

Continual improvement is essential to ensure an organization's competitiveness. As you shift along the sourcing continuum, continuous improvement, transformation, and innovation become increasingly important. A Vested model is purposely built to incentivize suppliers to invest in transformation and innovation. By design, a shared services model streamlines redundant operations. In most cases, equity partnerships are created to drive innovation and solve problems that undoubtedly require investment in intellectual property or a specific core competency.

It is important to set everyone's expectations of what level of continuous improvement/transformation/innovation is needed to support the various aspects of the spend category requirement. Buyers need to remember that improvement initiatives come in all shapes and sizes. Continuous improvement projects tend to focus on managing improvement in day-to-day operations and processes while transformation management or innovation management projects focus on larger projects that require significant supplier investment or effort.

For less sophisticated Sourcing Business Models, most of the continuous improvement is focused on administrative cost management, such as streamlining the order-to-pay process. For example, Dell worked with existing suppliers to integrate them into the Ariba Buyer™ procure-to-pay platform and reduced cycle time and administrative costs of working with all suppliers, even small suppliers with one-time buys.[38]

As they move to relational Sourcing Business Models, organizations integrate suppliers into their business processes with the conscious purpose to create value. A preferred provider model typically focuses on at least some level of incremental improvement through the inclusion of value-added service offerings. Performance-based models have a higher expectation of year-over-year cost reductions and/or performance guarantees. In a Vested relationship, both buyer and supplier develop formal processes and guidelines for managing transformation and picking ideas and innovations to implement. Equity partnerships often have a single purpose: to drive innovation of a core capability or to complement or introduce capabilities in certain functions or geographies (e.g., an organization needs to ramp up capabilities with a subsidiary in a new market).

Organizations operating with relational or investment-based models should establish formal mechanisms to manage and deliver improvement opportunities. Doing this includes providing strategic direction, supervision, and monitoring of all innovation-related activities. You should consider what processes and mechanisms you will use to:

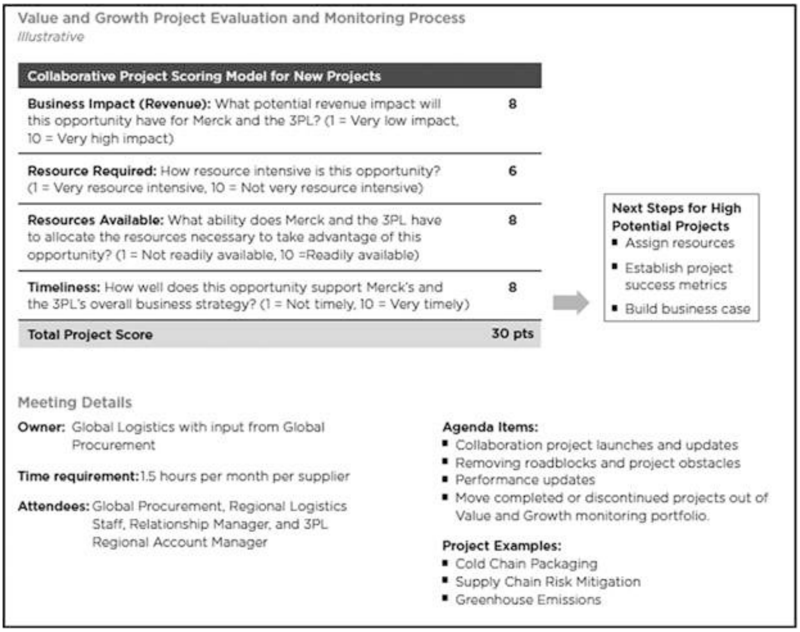
- Capture innovation ideas
- Qualify and select innovation candidates to pursue
- Develop business case requirements and protocols for approving potential projects
- Determine how projects will be sponsored and governed as part of either the overall category management governance or the SRM program
- Request formal transformation approval from the appropriate governance committee

Last, buyers need to consider the role of intellectual property (IP) with regard to improvement opportunities. As an organization shifts along the sourcing continuum, it will likely foster an environment where there are joint investments. It is essential for buyers to outline clear ownership of IP.

Merck offers a good example for how to work with suppliers on continuous improvement.[39] The company developed a decision framework to help both it and its suppliers understand the nature of the continuous improvement projects it wanted to implement. The Merck scoring model has four criteria with a 1 to 10 scale:

1. *Business impact (revenue).* What potential revenue impact will this opportunity have for Merck and the supplier?
2. *Resource required.* How resource intensive is this opportunity?
3. *Resource available.* What ability does Merck and the suppliers have to allocate the resources necessary to take advantage of this opportunity?
4. *Timeliness.* How well does this opportunity support Merck's and the supplier's overall business strategy?

Figure 9.8 Merck Collaborative Scoring Model for New Projects



Source: Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing*, 2nd ed. (New York: Palgrave Macmillan, 2013). Used with permission.

Figure 9.8 provides an overview of the Merck collaborative scoring model for new projects.

The framework from Merck demonstrates an effective way to identify good continuous innovations by scoring the projects for value. Merck's framework helps the parties prioritize their ideas through a formal scoring process. It also differentiates between long-term projects requiring significant supplier collaboration and/or investment and shorter-term quick wins. The framework ensures Merck and its suppliers are using fact-based assessments. The process also ensures visibility and escalation of ideas to the governance team for approval.

RECOMMENDED READING FOR CONTINUOUS IMPROVEMENT/INNOVATION

Deborah Doughtery. *Supplier Innovation Management Process* [Video]. http://blog.oldstlabs.com/top-videos-inspire-your-supplier-innovation-management-process/.

John H. Henke Jr. and Chun Zhang. "Increasing Supplier-Driven Innovation." *MIT Sloan Management Review* (January 2012). http://sloanreview.mit.edu/article/increasing-supplier-driven-innovation/.

International Association for Outsource Professionals. GEO Award for Innovation. http://www.iaop.org/content/19/165/3005/.

Robert M. Monczka, Thomas V. Scannell, Phillip L. Carter, and Joseph R. Carter. *Accelerating Innovation through Effective Supplier Collaboration.* Paper presented at the 95th Institute for Supply Management Conference, April 2010. https://www.ism.ws/files/Pubs/Proceedings/2010ProcEA-Monczka.pdf.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability,* 2nd ed. London: Kogan Page, 2012.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements.* New York: Palgrave Macmillan, 2011.

Kate Vitasek, Karl Manrodt, and Jeanne Kling. *Vested: How P&G, McDonald's, and Microsoft Are Redefining Winning in Business Relationships.* New York: Palgrave Macmillan, 2012.

19. Compliance and Special Concerns

Companies like Apple are seeing firsthand the impact of third-party compliance issues. According to its 2015 Supplier Responsibility

Report, Apple audited 633 supplier facilities in 2014.[40] Fifteen percent had compliance issues related to involuntary labor policies, five percent did not comply with underage labor laws, and 8 percent were not meeting Apple's working hours' policy. In all, Apple wound up terminating 18 suppliers in 2014 for noncompliance issues and paying $3.96 million for restitution. For example, Apple paid $900,000 to workers for unpaid overtime. Jeff Williams, senior vice president of operations at Apple, said: "Around the globe, Apple employees are united in bringing equality, respect for human rights and protection of the environment to the deepest levels of our supply chain. While we have made significant progress, gaps still exist, and there is more work to do. We know that workers are counting on us. We will not stop until every person in our supply chain is treated with the respect and dignity they deserve."[41]

As you develop your sourcing solution, it is essential to understand required compliance and special concerns for your spend category and/or specific supplier relationship. Many of these issues were captured in Consideration 2, Requirements Analysis. In other cases, your risk assessment would have uncovered risks that needed to be addressed through compliance and/or policies and procedures that address special concerns. In yet other cases, compliance and special concerns requirements are not determined until after you have detailed dialogs and solutioning sessions with suppliers or business partners. And it is common to have government regulations that you will need to manage after contract signing. Thus, compliance and special concerns should be viewed as continual and dynamic components of your sourcing solution.

Some of the most common compliance and special concern focus areas are listed next.

- *Security.* How will you manage specific security concerns (e.g., in remote or developing locations for a contracting manufacturing agreement or services delivered at international border control points?)
- *Hazardous materials.* How do you manage chemical and hazardous materials with special handling, packaging, security, and transportation challenges? When do specific local government regulations become an integral part of the governance framework?

- *Intellectual property.* How you manage IP is particularly important in transformational relationships. It concerns how the parties will handle background, emerging, and current IP, ownership, and rights of use.
- *Special tax issues.* Do international and cross-continental deals have special tax provisions and laws that require expert guidance?
- *Import and export and transportation.* How do the parties deal with transfer of goods and services across national and international boundaries? Who takes care of insurance for goods in transit? What standard transport is used—road, rail, ship, or air—and who pays for the freight and the charges?
- *Information management.* Are the parties aware of any special data management considerations, security of data, location of servers, and other matters pertinent to information security?
- *Law and jurisdiction.* How will the parties make informed decisions about the legal framework that underpins the agreement? Agreements across international boundaries with parties in different countries require careful consideration, as laws and jurisdictions may vary.
- *Care of documents.* Do the parties have all the relevant safety records and validated insurance certificates, training records, and other such documents that confirm the capability of the parties to deliver the work safely? Always keep these documents with the agreement and propose an annual review so that, in the future, anyone accessing the agreement file has everything needed Doing so is a special consideration to colleagues who may come after you. Keeping a clean and tidy file hardly bears mentioning—but such a file is worth its weight in gold to contract managers waiting for the auditor to visit.
- *Local labor law.* Does the contract accommodate ratios and laws that govern the hiring of local people at the asset or work level? Does the governance structure require a diversity balance? Are there rules about hiring via local agencies? Are there any regulations around transferring of activities and personnel from an existing partner to a new partner? Are the terms and conditions of employment different from other locations? Determine if these considerations need to be included in the pricing model.

- *Ethics and compliance issues.* Do the parties support fair trade or other similar causes related to sustainable operations, clean working conditions, and environmental safety and compliance? How do the parties ensure joint social and corporate ethics in trading practices, and are there joint rules and processes?
- *Publicity and marketing.* Have the parties coordinated public relations activities and promotional marketing messages around the agreement? Even though the parties are separate entities, the public and the media will likely be interested in the new relationship between the parties.
- *External regulatory issues.* Do special local laws and regulations exist in the work location? Decide if international or local convention applies, for example, in health and safety matters.
- *Special safety issues.* Most important of all, how will the parties ensure continuous safe and reliable service? How will they comply with specific regulations and any special local practices pertaining to the particular location or operating environment? How will the parties coordinate and manage any rectification action in the event of a safety incident or event requiring major action to resolve? Do the parties have a mutually agreed business continuity plan pertaining to the loss of function or service, such as major loss of power, of mission-critical capability, or of confidential data? How will the parties work together to resume normal working conditions?
- *Environmental regulations.* Must the parties comply with certain laws and regulations, sometimes specific to an industry or geography, that focus on meeting specific environmental conditions or protections?

We could go on and on about the myriad of compliance and special concerns we have seen. The point is, it is wise to slow down and think about them now. Buyers must clearly understand and vet compliance and special concerns, both within their organizations and with their suppliers. As you consider the various compliance and special concerns, you must determine how to best incorporate them into actual contracts. In some cases, compliance and special concerns may impact *all* supplier agreements. For example, Microsoft's overarching master agreement requires all of its approved suppliers adhere to a Microsoft travel policy. Performance-based and Vested agreements typically have entire schedules devoted to compliance and special concerns that are included as part of their master agreements.

We offer three suggestions for incorporating compliance and special concerns into your contracts. First, consider pointing to a Web page or specific regulation rather than physically incorporating the requirement into a supplier contract. Microsoft pointed suppliers to the travel policy rather than incorporating the policy into its master services agreement. One way to ensure that Occupational Safety and Health Act (OSHA) requirements are followed is to include in the service agreement a simple statement saying: "The service provider will abide by all OSHA regulations. The service provider is responsible for monitoring changes and updates in OSHA regulations." This is a much more effective way to manage the issue than baking the details into the agreement itself and updating the agreement each time there is a change to OSHA regulations.

Second, there is a definite trend to use third-party compliance monitoring software and third-party auditors to monitor essential compliance requirements. Hiperos is a good example of a company that provides compliance and performance management monitoring. In an interview, Greg Dickenson, the company's chief executive, explained the criticality of putting in sound compliance infrastructure with supplier and equity partners.[42]

> For the last 20 years, businesses have been moving more and more of their processes to suppliers and business partners. For example, it's now common for an insurance company to work with a business process outsourcing service provider to process all of their claims. This puts pressure on organizations to put in more robust compliance infrastructure that is designed to provide proper controls that can protect organizations from reputation risk and potential revenue losses associated with third-party compliance failures.
>
> Unfortunately, far too many companies are trying to manage compliance fundamentals on an Excel spreadsheet. Or they assume an equity partner such as a subsidiary or a joint venture will have the same level of diligence your own firm has. All too often, organizations simply lack the needed infrastructure that ensures their third-party supply network is meeting basic compliance requirements. You can't just put one person in charge of 10,000 suppliers using a spreadsheet and think you will be successful.

ISO 31000, ISO/IEC 27001, and ISO 19011 are standards for risk, audits, and compliance. ISO also suggests embedding "quality, risk, audit and compliance" processes directly into governance and SRM frameworks. According to ISO, the main activities of a good-quality risk, audit, and compliance process are to:

- Provide work environment and assign roles to resources.
- Set up audit criteria (e.g., company standards, relevant external standards, legal requirements).
- Implement mechanism for getting information from both buyer's and supplier's performance and quality management teams.
- Implement risk management framework including reporting.
- Implement audit and compliance framework and reporting.
- Implement performance framework including reporting.[43]

Third, we see a definite trend for organizations to focus on compliance as a key driver for more strategic outsourcing relationships. Microsoft thought about compliance when it outsourced back-office financial operations to Accenture under the OneFinance agreement. The companies entered into a seven-year Vested agreement where one of the key Desired Outcomes was to improve controls and compliance. In fact, Accenture's operational and transformation scorecard (and ultimately its profitability) is directly linked to its ability to achieve Microsoft's compliance goals.

One of these goals is Sarbanes-Oxley (SOX) compliance. One of the keys to SOX compliance is an improved control environment. Accenture increased coverage of SOX compliance from just 15 "large" countries to 100 percent compliance regardless of size or complexity. With Accenture's expertise, Microsoft achieved its goal of zero unremediated SOX 404/302 and audit control deficiencies in less than three years after embarking on the strategic Vested relationship.[44]

RECOMMENDED READING FOR COMPLIANCE AND SPECIAL CONCERNS

Linda Tuck Chapman. "Vendor Third Party Management: Third Party Management: What Boards of Directors and C-Suite

Executives Need to Know," Hiperos. http://hiperos.com/Third-Party-Management-What-Boards-of-Directors-Need-to-Know.

ISO 19011 2011. "Guidelines for Auditing Management Systems." http://www.iso.org/iso/iso_catalogue/catalogue_ics/catalogue_detail_ics.htm?csnumber=31169.

ISO 31000. "Risk Management." http://www.iso.org/iso/home/standards/iso31000.htm.

ISO/IEC 27001. "Information Security Management." http://www.iso.org/iso/home/standards/management-standards/iso27001.htm.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability*, 2nd ed. London: Kogan Page, 2012.

SAI Global. "2014 Compliance Benchmarking Survey Report," August 28, 2014. http://compliance.saiglobal.com/community/resources/whitepapers/item/5875-2014-compliance-benchmarking-survey-report.

20. Exit Management

The final consideration is exit management. An exit management plan facilitates a smooth, effective transition of services, should the need arise. Almost no one will disagree with the fact that it is far easier to work through an exit management plan at the beginning of a relationship than when the parties are in a heated debate and separation is imminent. Traditionally, an off-ramp or exit management provision in a contract is the right to terminate an agreement; however, any right to renegotiate or reevaluate is actually an off-ramp. Off-ramps often address what happens at the end of the agreement purely from a liability point of view. The goal of exit management is to ensure business continuity, even if that means proper wind-down of project-based sourcing initiatives, such as construction projects.

There is no need to complete a formal exit management plan for goods and services falling under a basic provider model; there is typically no contract. Suppliers can be switched easily with little or no impact to the business. However, as you move across the sourcing continuum, dependency and codependency increases, and the need to develop a formal exit management plan grows.

Your exit management plan may or may not be a formal part of the contract.

The most common off-ramps are “termination for cause” and “termination for convenience” clauses. These clauses typically address the notice period and financial obligations. They are incomplete, however, because they do little to describe how to unwind the business relationship. More advanced Sourcing Business Models demand more sophisticated exit management planning and include agreed-to protocols for exiting a supplier, such as termination process and formal transition commitments from a supplier.

Many assume exit is the result of a supplier’s poor performance. This is a mistake. Organizations may need to exit supplier relationships for a variety of reasons. For example, volume may decline or there may be a shift in strategy. A good example is a Consumer Packaged Good Company that conducted a distribution network design project which resulted in existing warehouse locations closing. For this reason, buyers need to think through the various aspects of supplier terminations. For example, will the contract contain a provision that waives early termination fees if the supplier is acquired?

In more sophisticated performance-based and Vested models, suppliers often invest in assets specific to the buyer. There is often a considerable amount of shared IP, some of which may have been co-created. For these reasons, it is important that buyers and suppliers are fair and balanced regarding how they exit the relationship. Exit management plans can include a termination notice, transition period/timing, a high-level transition plan (including requirements for transfer of resources), and even outlines defining exit team roles, including exit governance and reporting. According to ISO 35700 for outsourced services relationships, exit management should include these areas:

- Fair division of IP rights
- Fair allocation of assets and investments
- Business continuity for stakeholders
- Contract satisfaction and completion
- Record of lessons learned[45]

Remember, this planning is best done at the beginning of the contracting process.

RECOMMENDED READING FOR EXIT MANAGEMENT

National Outsourcing Organization. "Exit Management and Transition Checklist." http://www.noa.co.uk/files/162.pdf.

Jonathan O'Brien. *Category Management in Purchasing: A Strategic Approach to Maximize Business Profitability,* 2nd ed. London: Kogan Page, 2012.

Scottish Government. "Exit Strategy." http://www.gov.scot/Topics/Government/Procurement/buyer-information/spdlowlevel/routetwotoolkit/contractsuppliermanageme/exitstrategy.

Kate Vitasek, Jacqui Crawford, Jeanette Nyden, and Katherine Kawamoto. *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements.* New York: Palgrave Macmillan, 2011. Chapter 5, Rule # 3: Agree on Clearly Defined and Measurable Outcomes; chapter 7, Rule # 5: Governance that Provides Insight, Not Merely Oversight.

ARCHITECTING YOUR SOURCING SOLUTION

You will need to go through each of the 20 sourcing considerations as you architect your sourcing solution. You may find there are other considerations you need to include as well.

Your sourcing solution will vary based on which Sourcing Business Model you believe is most appropriate. If you are building a basic or approved Sourcing Business Model, your path will be somewhat straightforward. You will not have much stakeholder or supplier involvement; you will tend to move smoothly and likely quickly from one consideration to another.

However, as you navigate to more sophisticated Sourcing Business Models you are likely to take a circuitous path as you sort through each sourcing consideration. It is safe to assume you will find yourself gaining valuable information as you progress through the sourcing cycle. As you learn from new information, you will find yourself revisiting earlier assumptions.

Let's assume you are a buyer for a large public university and are reviewing how you might traverse through each of the 20 sourcing considerations for a facilities management sourcing initiative. The university has 72 different facilities management suppliers; it currently uses a combination of insourced and outsourced models. In some subcategories, there is a single-source provider. In other subcategories, you use multisource solutions. A fairly large internal staff manages not only the 72 suppliers but also performs some of the work.

The vice chancellor has mandated a 15 percent cost reduction and sees facilities management as a key area to cut costs. You facilitated a small group of internal stakeholders through a Business Model Mapping exercise and believe a performance-based model will be a good fit. You use the Sourcing Considerations Guidelines to gauge your approach for your sourcing strategy. As you work through the Assess Cornerstone, you complete a comprehensive assessment since the university is leaning toward a performance-based model.

You also learn there is little appetite to outsource additional workscope. Insourced workscope is excluded from your initiative. However, you are pleased your benchmarking and cost analyses indicate that bundling much of the facilities management workscope under an integrated facilities management solution would achieve the vice chancellor's cost savings target. The supply market assessment clearly shows that capable suppliers can operate as integrated facilities management providers under either a performance-based or a Vested model.

A key part of finalizing the Assess phase of the sourcing cycle is to validate your findings within a larger stakeholder community. The majority of the Business Model Mapping attributes fall into an outcome-based economic model, but some fall into an output-based model. Business stakeholders definitely like shifting to an outcome-based approach. However, some members of the management team that currently manage the supply base are nervous and afraid they will lose control. They do not believe suppliers are capable of a Vested model.

The team works through the Analyze and Select Cornerstone and decides to use a request for information to validate the assumption that a performance-based model is most appropriate. Stakeholders provide input to develop down-select criteria and invite 12 suppliers to participate in the RFI. Five suppliers are clearly good candidates for a performance-based model. Three of the five have indicated they have experience with Vested Sourcing Business Models. The buyer compares the supplier responses to the down-select criteria. The university decides to move forward with five suppliers using a request for partner process for the next phase of the RFx process. A two-pronged approach is used to help down-select even further. The university also will use a comprehensive best value analysis to compare each supplier's proposed solutions.

As you facilitate the stakeholder community through the request for partner process, uncertainty remains about whether the ultimate choice structure is a performance-based or a Vested agreement. A key part of the down-select criterion is to review suppliers' solutions under a formal request for solution. You will use a comprehensive best value analysis, coupled with competitive dialogue, to help you gain significant insights about potential suppliers. For example, you learn that two potential suppliers are willing to be fully transparent. Three have suggested completing an end-to-end baseline assessment to capture the true total cost of ownership snapshot—something the team has not been able to accomplish due to lack of skills and spotty supplier data. While insourced work is not under scope for this initiative, a robust TCO baseline would be valuable to help develop a business case for how to view the insourced functions in the future—something that is not currently under scope but would be a good fit to potentially outsource in the future. Further, one supplier's approach to performance and compliance is very impressive. Your best value analysis accomplishes your goal to down-select to two finalists.

The second phase of the supplier selection process is to begin more advanced solutioning with each potential supplier. The university continues with a robust competitive dialogue through development of a pricing model, governance, and performance management portions of the agreement with the two supplier finalists. One of the suppliers is willing to make significant investments under a Vested model.

The university completes the solutioning process, and the team makes its final scoring and best value determination. The chosen supplier has proposed both a performance-based and a Vested model. Now the decision is which model you want to move forward. The internal stakeholders have been highly engaged and are feeling more comfortable with the chosen supplier, but do they have the skill set to operate under a Vested model? The stakeholders complete maturity self-assessments and find, as a whole, that the university's overall category management maturity is not sufficiently robust to tackle a Vested agreement. Internal stakeholder interviews reveal that a few of the key leaders feel overwhelmed with all of the change.

During a gate review meeting (a periodic progress session) with the vice chancellor, your team discusses options and decides the best-fit solution is to move forward with a three-year performance-based agreement with an option to extend the contract duration based on the supplier's performance. The option includes the ability to renegotiate the agreement to a Vested model after the first year pending a comprehensive TCO analysis, evaluation of supplier trust levels, and assessment of the internal organization's ability to close gaps in maturity levels.

The university's final sourcing solution consolidates workscope from 56 of the 72 suppliers under the chosen finalist. For example, 12 cleaning suppliers and four dining suppliers will be consolidated under one supplier as part of what the chosen supplier proposed as a bundled soft services subcontract. Workscope for procurement of supplies and maintenance, repair, and operating supplies also shifts to the chosen integrated facilities management supplier.

Finally, the university completes the contracting process by negotiating the specifics with the chosen supplier. You are pleased to have negotiated a guaranteed savings target of 15 percent. You are also pleased to have negotiated for the supplier to increase diverse supplier spend from seven percent to 20 percent under the performance-based agreement. As part of the negotiations, the university developed a detailed transition plan that ramps up the governance structure and begins to implement formalized SRM, performance management, and compliance processes.

LOOKING BACK...LOOKING AHEAD

In chapter 8, you learned how to identify the most appropriate Sourcing Business Model for your situation. In this chapter, we introduced 20 essential sourcing considerations you need to work through as you develop a sourcing solution. We shared the importance of viewing strategic sourcing as a continuous cycle and architecting a best-fit sourcing solution rather than simply going through a multistep process to "buy" a good or service or "manage" a spend category.

As you develop your sourcing solution, understand that just because you want to use more progressive approaches, they may not be the right choice, given your environment or organizational constraints. Your organization may lack the mindset or skills to lay the foundation for a more collaborative relational contract. The Business Model Mapping exercise points you in the right direction to the Sourcing Business Model that may be optimal for your needs. Simply put, if you don't have the right skills to manage that model, you are likely to be unsuccessful. Part IV of this book will help you lay the foundation to improve your skills for more collaborative and trusting relationships. Chapter 10 helps you understand the role that organizational maturity has in enabling your success.

PART IV

Part IV lays a strong foundation that will help you shift along the sourcing continuum to more strategic supplier relationships.

In Chapter 10, we discuss how an organization's maturity can hold back a buying organization from adopting more collaborative and progressive Sourcing Business Models. An easy-to-understand assessment will help you identify gaps in your procurement practices that may be impeding your progress. We offer two clear paths on how to overcome those gaps.

Chapter 11 focuses on what some believe is the secret sauce of any successful relationship: trust. This chapter helps you understand the importance of building a trust in a relationship. But, more importantly, the chapter provides some easy steps that you can apply immediately to build trust with a supplier. We end Part IV with a proven five-step Getting to We process that lays a foundation for strategic supplier relationships.

CHAPTER 10

MATURITY MEETS MODALITY

Think of children, and the various levels of maturity they go through as they develop. Physical maturity allows children to crawl, then walk, then run. Mental maturity develops as children begin to process problems. Children start by figuring out how to get dressed and tie their shoes. As they develop, they learn to handle more complex problems, such as algebra and learning how to drive so they can get themselves to school. Cognitive maturity is the ability to relate cause and effect, understand societal rules, and see the potential consequences of your actions. Emotional maturity helps children deal with siblings and difficult peer group dynamics with grace.

Just as children grow into the ability to handle more complex situations and relate cause and effect, the procurement function must grow into the ability to handle complex spend requirements and supplier relationships. Sound procurement practices are essential to execute your sourcing strategy effectively. This is why organizational maturity matters. Unless an organization has the skills and enabling processes to execute effectively, it is destined to cause angst for everyone who works with it.

One source of frustration comes when an organization attempts to have more strategic and collaborative relationships with suppliers but applies the wrong Sourcing Business Model. Unfortunately, stating you want to use a certain model with suppliers is only half the battle. Why ask a supplier to become "strategic" and invest in value added, cost structure reductions, or even transformation with your company, only to turn around and develop a transactional nonstrategic commercial agreement? As discussed in chapter 8, getting the alignment wrong creates a business model mismatch—a real-life

Doberhauhau that is dysfunctional and causes unnecessary tension and frustration not only within your own organization but with your suppliers as well.

Getting it right means being able to execute your chosen Sourcing Business Model effectively. If your procurement organization or the responsible buyer has not reached certain levels of competence, executing more sophisticated supplier relationships like performance-based or Vested models will be frustrating. This is why maturity matters.

EVOLUTION OF MATURITY MODELS

Much of the original focus on maturity assessments stemmed from the quality movement, evolving from Philip B. Crosby's concept of a Quality Management Maturity Grid.[1] Early maturity models were developed to ensure success where success really matters—at the U.S. National Aeronautics and Space Administration (NASA) and in the military, where lives are on the line and success equals survival.[2] Carnegie Mellon University put the concept of maturity models on steroids when it developed a model to improve government contractors' ability to deliver software projects. Carnegie Mellon led a collaborative effort that ultimately created what is known as the Capability Maturity Model and has been revised to the Capability Maturity Model Integrated (CMMI). The U.S. military requires that all its software contractors (and their subcontractors) be rated at least CMMI Level 3 of the possible five levels.

The CMMI model has expanded outside of the military. Today, it is widely adopted by private companies and has even reached the People's Republic of China, where CMMI assessment is widely used. Official Chinese policy aggressively advocates for its use, even requiring CMMI maturity levels for government-funded software projects and offering a 50 percent subsidy for the cost of CMMI certification.[3]

The concept of maturity models has definitely gained traction within the procurement profession. Many academics and organizations have created maturity models. For example, the Corporate Executive Board developed a Procurement Portfolio Maturity Diagnostic. This tool was designed specifically to collect information on a procurement function across seven managed processes:

1. Procure to pay
2. Strategic sourcing

3. Supplier/Vendor management
4. Consumption/Demand management
5. Function management (leadership)
6. Administrative support (to support all preceding actions)
7. Value-added activities (described as market intelligence, spend analysis and reporting, process improvement, and other analysis)

Questions were built to identify the level of capability and therefore maturity in five areas:

1. Strategically managed categories
2. View (use) of procurement by the business
3. Level of strategies applied for future impact
4. Category management techniques ranging from basic/reactive to multiyear approaches that build value
5. Level/approach to supplier management[4]

Ever since Peter Kraljic first challenged the procurement profession to become more strategic over 30 years ago, individuals and organizations have applied some level of procurement best practices and technology to help them mature in their core procurement processes. According to all maturity models, managing your processes more prudently will have a positive impact the bottom line.

WHAT EXACTLY ARE MATURE BUSINESS PROCESSES?

Procurement maturity can be described as the ability to strategically manage a company's spend requirements from cradle to grave. Three primary aspects of maturity are important to enable a procurement team to generate optimum value:

1. *Organizational maturity*. How is the function structured, and how effectively does the organization perform the work?
2. *Category management maturity*. How effectively does an organization incorporate category management concepts that help it make sound business decisions and best manage day-to-day work to meet business requirements?

3. *Supplier management maturity*. How effectively does the organization work with suppliers?

Each aspect is discussed in detail next.

Organizational Maturity

There are many components to organizational maturity. One factor to think about is how an organization is structured. Historically, decision making follows a hierarchy of command. If the business is structured in a traditional hierarchal format, it has several levels between top management, middle management, and front line workers. Good organization design models, such as the STAR Model™, provide the appropriate connections among the overall business objectives, technical work that needs to be done, role definitions that provide clarity, skills required to do the work, decision-making protocols that are most effective, resource management, and development considerations that fit the business needs, and continuous improvement protocols.[5]

Another factor to consider is how well work gets completed within the defined structure. Processes are defined that enable workflows to match the structure so that work can be executed consistently. A mature organization is adaptable and flexible and demonstrates a philosophy of continuous improvement. All resources understand their contribution to the business at large. If the organization is not mature, processes will not be applied consistently, if at all. This will greatly impact the procurement organization's effectiveness. If the organization is relatively flat, consistent application of policies to processes is less of a problem.[6]

Another part of organizational maturity is how well the procurement function is integrated into the overall business. Procurement organizations exist to serve the overall business. As such, mature organizations view their procurement function as an enabler, not simply as an order taker or buyer. This makes sense when you consider that the many industrial organizations spend from 60 to 80 percent of their revenue with suppliers.[7] As an organization matures, procurement professionals need to be proactively included in the development of business objectives and play an active role in contributing to the broader strategies of the business.

Category Management Maturity

Category management is the process of overseeing a sourcing strategy for a specific spend category throughout the sourcing cycle. The objective is to maximize profit and customer satisfaction. Successful category management requires vigilance of industry trends, available data, and best-in-class technologies. As management of spend matures, its ability to impact the business and drive sustainable value grows as well.

The increased integration of the sourcing organization into the overall business process transforms how an organization manages spend. The first evidence of maturing category management is a repeatable process that develops an overall spend management strategy. As we have mentioned, tools such as the Kraljic Matrix enable organizations to segment their total spend (both direct and indirect categories) into four different groupings, each with a prescribed management approach. Although this method helps organizations prioritize categories in terms of business impact and determine the best allocation of resources, it lacks the ability to advance a sourcing organization's maturity.

An important characteristic of category management maturity is the need for sourcing to identify and build category plans with a direct correlation to a specific business objective. In this regard, sourcing is closely integrated in the overall business strategy planning process. Sourcing actively monitors and adjusts supply solutions to the changing marketplace. The focus shifts to understanding total cost impact and developing supplier relationships that enable achievement of both financial and long-term sustainability.

Innovation beyond continuous improvement becomes an underlying pillar of sourcing strategy. Sourcing resources become general managers of the category as if the category being managed is a standalone business unit. Organizations that have achieved category management maturity have formal cross-functional teams. They possess deep market analysis capability with strong market knowledge and create solutions based on data and facts. A decision-making protocol empowers the sourcing resources to take timely actions on behalf of the organization. An overall governance process includes the engagement of key stakeholders.

Supplier Management Maturity

Organizations with a mature procurement function build an environment where buyers create more collaborative and trusting relationships with their organizations' most strategic suppliers. They do this by establishing supplier relationship management (SRM) approaches with the appropriate level of effort aligned to the proper Sourcing Business Model. In addition, SRM protocols are well defined, often including internal cross-functional resources. The most complex supply solutions are supported by formal governance that maintains a positive relationship with the supplier and creates an intellectual exchange that promotes contract management and execution excellence. Formal communication protocols are established to support supplier performance management. The protocols include a defined supplier interface cadence and a disciplined approach.

Mature procurement functions also understand the value of continuous improvement and innovation. They work to incorporate governance mechanisms designed to emphasize the supplier's role in driving value.

UNDERSTANDING YOUR GAPS

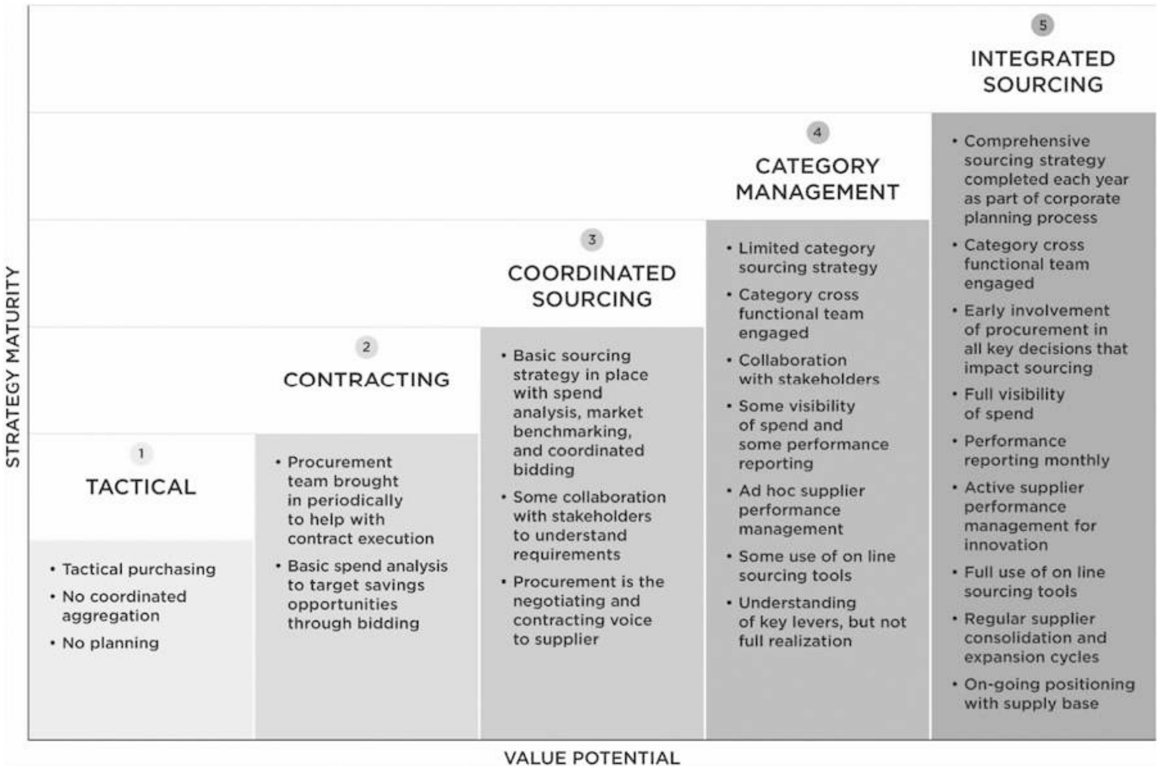
Most maturity models encompass three to six levels of maturity. Each level denotes a higher level of maturity, typically ranging from working ad hoc in a reactive environment through increasing levels of applied best practices. A good maturity model will help an organization seek opportunities for continuous improvement and innovation. This can be accomplished by using the maturity model to first identify an organization's current level of maturity. Once the as-is state is identified, an organization can then plan for the desired to-be state.

We believe that five levels of procurement maturity are appropriate to prepare a procurement organization to manage across the sourcing continuum. The University of Michigan offers excellent definitions for evaluating maturity.[8] We have modified these definitions to be applicable to strategic sourcing. Figure 10.1 illustrates how increased maturity has a positive impact on a firm's ability to create value across each of the five levels.

Level 1: Tactical

Level 1's purchasing processes and activities tend to be tactical and reactive in nature. No explicit purchasing strategy is in place. The processes are driven by internal users or events, with little or no

Figure 10.1 Strategic Sourcing Maturity Levels



coordinated aggregation or planning. This results in a chaotic and unpredictable environment. There is very little knowledge of total spend for the entire organization, and purchasing systems and processes are very much administratively focused, with more emphasis on office processes than on overall strategy.

Organizational structures are not well defined and are likely to be decentralized, often reporting to production or logistics managers. There is little to no supplier communication, planning, or consultation. Success likely depends on individual efforts and is not considered to be repeatable because processes are not sufficiently defined and documented to allow replication.

Level 2: Contracting

At Level 2 maturity, a procurement function increases focus around basic contracting skills. The procurement team is brought in periodically to help with contract execution, perhaps in the form of purchase orders. Some of the processes are repeatable, possibly with consistent results. Process discipline is unlikely to be rigorous, but where it exists, it may help maintain existing processes during times of stress. There is basic analysis to target savings opportunities through competitive bidding and leveraging spend. The focus tends to be on negotiating lower prices with suppliers.

There is increased definition of the organizational structure. The purchasing function emerges as a specialist function that allows some interface with internal users and some limited interface with suppliers.

Level 3: Coordinated Sourcing

Level 3 maturity is depicted by an environment of coordinated sourcing efforts. The procurement function emerges as a strong central purchasing function that aims at implementing uniform buying policies and systems. A centralized or center-led procurement function begins to create procurement policies and procedures and strives to reduce unauthorized or unexpected spending. This emphasis is reinforced by an organizational structure with clearly defined roles and standardized processes. Purchasing staff is encouraged to have specialized purchasing backgrounds and training. Buyers begin to develop basic sourcing strategies with increased use of analysis tools, such as market analysis, market benchmarking, and some cost analysis.

Buyers also have a clear intention to foster collaboration with business stakeholders to gain a deeper understanding of user requirements. Procurement professionals begin to emphasize developing cross-business unit coordination to consolidate spend and negotiate national or global contracts that drive cost savings. Standardized processes drive consistency with an expectation that improvements will occur over time. Procurement clearly represents the voice of the supplier in negotiations, contracting, and supplier performance tracking.

Level 4: Category Management

At Level 4, organizations adopt formal category management practices. Until this level, the purchasing has been very much functionally oriented and has tried to organize the company around itself. At Level 4, purchasing becomes more process focused; work processes are also well defined and measured. The processes provide for sustainable, repeatable performance. Procurement at this level generally has category management plans or strategies that can be managed and measured. Execution of work is heavily supported by deep analysis to include consideration of market behaviors, supply market trends, total cost analysis, and validated estimates of value benefits beyond cost. Buyers begin to incorporate formal benchmarking.

The organizational structure is clearly defined, and the purchasing function may be designed around internal customers, utilizing formal cross-functional resources to develop solutions that meet well-defined business objectives. Procurement is viewed as an integral part of the business operation, and collaboration with stakeholders to engage early in the business process is characteristic. Formal purchasing training is critical, and teaming/collaboration skills are required.

Procurement organizations also begin to invest heavily in technology and other support tools and process such as supplier relationship management (SRM) practices. SRM typically is not comprehensive or well planned.

Level 5: Integrated Sourcing

Procurement processes at Level 5 change from "leverage" to "value" as procurement professionals shift to integrated sourcing to drive value for business units and users. Processes are streamlined and automated, with the majority of goods and services falling under corporate contracts. Users order goods and services they need themselves through advanced, Web-enabled catalog systems.

At this level, the organization invests in skills and tools and aligns resources with the purposeful intent to better support business objectives. Buyers have full visibility into the overall spend and reports. Procurement professionals possess advanced skills to make good business decisions based on total cost of ownership and best value. Procurement is seen as an integral part of the business strategy and execution and often facilitates cross-functional teams, especially for larger and more complex sourcing initiatives. Organizations shift to more strategic outsourcing and strategic supplier partnerships; strategic direct spend suppliers are integrated in new product development to help speed time to market and drive innovation. Supplier management is engaging and rigorous and provides differentiated value in the marketplace. There is a conscious shift of focus to one of continuous improvement, supplier integration, and innovation.

YOUR MATURITY IMPACTS YOUR CHOICES

An organization's maturity in managing a specific spend category influences its ability to adopt and implement the various Sourcing Business Models effectively. As an organization's maturity level increases, so does its ability to use more sophisticated Sourcing Business Models. Organizations with a low level of organizational maturity usually focus on executing day-to-day purchase orders. For this reason, if a business falls in Levels 1 (tactical) and Level 2 (contracting maturity) levels, it should consider basic provider or approved provider models that are easy to adopt and manage.

Organizations that reach Levels 3 (coordinated sourcing) and 4 (category management) maturity levels are able to support the higher expectations of preferred supplier and performance-based models more effectively. Businesses ideally meet Level 5 (integrated sourcing) before considering a Vested model. However, they can consciously choose to close specific maturity gaps as part of ramping up a Vested supplier relationship.

What do you do if the business model mapping exercise points to a relational Sourcing Business Model, yet your maturity self-assessment reveals a low score on category maturity?

Organizations typically choose one of the following two approaches.

Option 1: View Your Lack of Capability as a Constraint and Do Only What You Are Capable of Doing Well Now

General Electric chief executive officer Jack Welch observes that "when you start changing things, you've got to be prepared for massive resistance."[9]

Unfortunately, no matter what your Business Model Mapping exercise indicates, some individuals and organizations will not find value in adopting more progressive relational contracting models. As a 2005–2006 University of Michigan study that is still quoted widely revealed, "People with strong beliefs about something don't necessarily change their minds just because contrary facts are presented to them."[10]

If your organization holds this perspective, our advice is to use only those Sourcing Business Models that it can best manage at this time. Although you may understand that a more sophisticated Sourcing Business Model can drive value, if your organization is not willing to invest time and resources to close gaps in your maturity, don't fool yourself into believing all will be good if you proceed.

Ian R. McNeil, a foremost academic in the field of contract law, summarizes:

> In business, we are restricted to sourcing models that we have capacity to engage. The factors that inhibit sourcing, or restrict or preclude certain options, are known as constraints. Every company has its own set of constraints, and it is important to deal with them upfront rather than doom sourcing decisions to failure. Culture, organizational structures, personnel policies, politics, regulatory or legal issues, and risk tolerance are constraints that affect the scope and types of sourcing decisions. Many seemingly insurmountable constraints, if within a company's control, can be overcome with time, allowing more work to become eligible for sourcing, increasing the

> pool of options, and broadening the benefits. Other constraints are a permanent part of the sourcing landscape, and companies will either have to live with them (in the case of laws or regulations) or find workarounds.[11]

Let's look at how an organization recognized its constraints effectively. A chief financial officer of a Fortune 100 firm had read about Microsoft and Accenture's very successful OneFinance Vested relationship. He felt there would be tremendous value for his firm in bundling several smaller contracts into a more strategic and holistic back-office procure-to-pay agreement that focused on transformation, not just transactions. The procurement organization was onboard with the concept, and the Business Model Mapping exercise indicated that a Vested agreement was the most appropriate Sourcing Business Model. However, the firm's corporate counsel was adamant about not wanting to have a long-term contract and would only approve smaller, "less risky" contracts with two-year durations. In this case, the CFO and the procurement director realized that internal constraints prevented them from pursuing a Vested relationship, so they chose a less complex preferred provider model.

If you find yourself in this situation, try to work with suppliers that are comfortable working with the Sourcing Business Model you have selected. For example, in the case just mentioned, the CFO realized that while Accenture could perform all of the unbundled activities, its real value proposition was in managing the end-to-end procure-to-pay process. The CFO and procurement organization wound up doing a request for proposal that eventually included five different suppliers, each having a smaller workscope. Each supplier was happy to work under a shorter-term, transaction-based model.

Option 2: Use the Best Sourcing Business Model and Consciously Close Your Gaps in Maturity

Option 2 is to select the most appropriate Sourcing Business Model identified as part of the Business Model Mapping exercise and consciously invest the time and resources to increase your organization's maturity level so you can operate effectively under that model. This approach requires a strong commitment and resources to close the gaps and increase a firm's capabilities and, ultimately, its maturity.

This approach can work well because it is possible to develop an organization's maturity at the category level rather than across the entire procurement organization. Although some find this approach risky, others find it provides an easy stepping-stone to Sourcing Business Models that offer increased value and innovation. It allows them to make the right strategic choice for a particular spend category/supplier without feeling obligated to increase overall maturity across the entire procurement function. Organizations frequently find they can close gaps in maturity much more quickly than they thought.

Many progressive procurement professionals find this approach is attractive because it spurs action. The logic is "Well, I have to get this contract signed, so I might as well do it right and close the gaps now." In essence, an organization has an inherent motivation to respond because the challenge is on it *now*. It's analogous to a climbing a mountain. If you are at the base of the mountain, you might as well start taking one step at a time. After all, according to the old saying, the hardest step is always the first one. By forcing your organization to take the first step, you in essence are at the forefront to drive change and improve process maturity in real time.

This is just what Novartis did. Novartis—one of the world's leading pharmaceutical companies—operates in a highly dynamic environment that demands innovation, flexibility, and an ability to manage and mitigate risk. Novartis felt the best approach for understanding and implementing a Vested model would be to try applying it in one category in one country first; in essence, it would take the first step up the mountain.

The good news is that many resources and consultants are available to help close the gaps in your sourcing strategy maturity. Checklists and category management guides can grow maturity one step at a time. The work may require coaching help and training, but the path to close your gaps in operational maturity is clear if you have the desire and the commitment.

SHOULD YOU TAKE THE LEAP?

Organizations that decide to take the leap and proceed with Option 2 (selecting the appropriate Sourcing Business Model and committing to close maturity gaps) should ask themselves (and answer) three key questions as they proceed:

1. Am I ready?
2. What resources do I need to close the gaps?
3. Is my supplier the right fit?

Am I Ready?

The Forefront Group, a boutique consulting firm specializing in strategic sourcing, has designed a free Maturity Model Self-Assessment tool. (The link to this free resource is www.theforefrontgroup.com.) The tool, composed of 20 critical questions, helps organizations determine if they have the fundamental capabilities and culture they need to execute more sophisticated Sourcing Business Models.

Buyers plot the answers to the questions to a corresponding maturity level and the Sourcing Business Models that their organization is most likely to execute effectively. Unlike other maturity models, the Forefront Group model places the maturity of a procurement function in the context of the Sourcing Business Models. The results help users identify the current level of maturity and the types of business models they are capable of managing. An organization can then compare these results to the best-fit Sourcing Business Model identified from the Business Model Mapping exercise. If there are any gaps, an organization can put a plan together to close them. A maturity assessment provides information about how the organization needs to change to travel up the maturity ladder.

Table 10.1 provides two example questions from the self-assessment tool. The answer closest to your own response indicates your level of maturity, which corresponds directly to your ability to manage the various types of Sourcing Business Models.

What Resources Are Needed to Close the Gaps?

Each Sourcing Business Model has requirements that must be met. Logically, there are fewer steps and considerations in a basic provider model than in more involved models, such as performance-based or Vested models.

Understanding the level of maturity needed to manage your sourcing initiative helps you determine what gaps you need to close. Let's say the Business Model Mapping exercise suggests you should be using a performance-based model. If your maturity self-assessment indicates you are at the Level 3 (coordinated sourcing) maturity level, you will

Table 10.1 Sample Maturity Model Assessment Questions

Best-Fit Sourcing Model	*Basic Provider*	*Approval Provider*	*Preferred Provider*	*Performance Based*	*Vested*
For each question, select the answer that describes your organization most closely:	**Level 1: Tactical**	**Level 2: Contracting**	**Level 3: Coordinated Sourcing**	**Level 4: Category Management**	**Level 5: Integrated Sourcing**
Does the sourcing organization measure employee skill set competency against a required level for each role?	Skill requirements are listed and maintained in job descriptions; owned by human resources.	Skill requirements are listed and maintained in the job description; but sourcing helps define these by role.	Skill requirements are defined by role, and training plans are in place to support development. However, these plans are not centrally managed or tracked.	Skill requirements are defined by role, and each manager determines training and development plans for their team. Development metrics are included in employee performance plans.	Skill requirements are specific to each role, and managed in a sourcing owned knowledge program. Knowledge program has associated training plans, targeted development goals, and development metrics.
Does your organization use a measure or metric to link the category strategy to the overall corporate business objectives?	No category strategies or measures/metrics.	Category strategies do not have metrics that are tracked outside of sourcing.	Category strategy metrics are not tied to corporate business objectives.	Business objectives influence the metrics included in category strategies.	Business objectives determine all metrics in the category strategy, and progress is tracked and reported on a regular (quarterly, etc.) basis.

need to close only a few gaps in maturity in order to move to Level 4 (category management).

Understanding the gaps you need to close in physical process capabilities is critical, but it's only part of the equation. One of the largest roadblocks in an organization's success in moving to more sophisticated Sourcing Business Models is that a mind shift is also required. This-is-how-we've-always-done-it thinking simply does not allow progression to new sourcing strategies. Sourcing Business Models that fall into relational contracting models (preferred provider, performance-based, and Vested relationships) require a more collaborative what's-in-it-for-we (WIIFWe) mindset than transactional models.

We elaborate on this concept in chapter 12, where we share a five-step process to help you shift your mindset.

Are My Suppliers the Right Fit? Are They Ready?

Some suppliers may be ill-equipped to offer innovative thinking. Others may have profoundly different cultures from your organization, or lack capabilities necessary to manage a complex relationship. Or some suppliers may be too risk-averse to enter into an output-based or outcome-based economic model required by performance-based and Vested models. Relationships, existing or emerging, with suppliers do not exist in vacuums. Perhaps a supplier has had bad experiences with performance-based or Vested contracts with other clients, or even your own organization. Buyers and suppliers must be aware of each other's ability (or lack thereof) to operate under more relational strategic sourcing models.

When your Business Model Map points to a relational contract model (preferred provider, performance-based agreement, or Vested relationship), buyers and suppliers must begin to think beyond capabilities and price. The relationship itself becomes an important factor in the overall success of a sourcing initiative. More strategic performance-based and Vested models require buyers and suppliers to have at least a minimum level of compatibility and trust for a good relationship. An analysis that includes evaluating workplace culture, collaboration skills, and behaviors that support collaborative relationship is necessary.

Chapters 11 and 12 discuss some essential concepts and resources that will help you close the gaps in supplier compatibility and trust that will help you adopt a WIIFWe mindset as you embark on a journey to create more strategic relationships with your suppliers.

CHAPTER 11

THERE'S NO SUCH THING AS HALF TRUST

Life is hard without trust.

Trust is everywhere. Not only do we want it, we need to create an environment that lives it. We trust our bank will keep our money safe. We trust the hotel elevator will take us to the right floor. When we order a steak in a restaurant, we expect to get a steak.

Trust simplifies the process of buying and selling goods and services, minimizing transaction costs. When you buy pickled herring, you don't wonder if it is really something else. You trust the label, and this lowers costs. Otherwise, we would all have to verify what we buy, every time we buy. By working with a trusted supplier, you can dramatically lower your transaction costs and use your energies in other, more productive areas.

The need for trust is everywhere. Business guru Stephen Covey, author of *The Speed of Trust*, says:

> When there is a high level of trust between parties in a business transaction, deals can be made in minutes with a handshake, yet many organizations are dysfunctional and inefficient because of low-trust cultures. In a high-trust situation, you can fumble your words and people will still stay with you, follow your true meaning. In a low-trust relationship, you can be incredibly precise and others will find a way to twist your words against you, misinterpret your meaning, find or invent hidden threats, distort your intent.[1]

Intuitively, everyone understands the importance of trust in commercial relationships. But what are the benefits?

A HARD LOOK AT THE SOFT SIDE OF TRUSTING

A trusting relationship brings many benefits. First, trust establishes the conditions for productive collaboration. Companies with high degrees of trust can spend their energy leveraging each other's core strengths and creating value. Adam Smith, author of *The Wealth of Nations*, wrote that the division of labor was the number one factor behind growth and progress in society.[2] Smith believed that two individuals working together are more productive if they split the work, letting each do what that person does best—that is, choose to cooperate and focus on his or her own core competencies. Smith recognized that the division of labor requires trust—trust that the other person will actually do what he or she says will be done. Although Smith's observations concerned the division of labor in a nail factory, his hypothesis applies to just about every kind of commerce. Focusing on your core competencies is something a number of advocates have espoused in thought-leading research and articles since the early 1990s.[3]

Trust also unleashes the extraordinary power of human innovation and creativity. As levels of trust increase, parties are relieved of the burden of having to constantly look over their shoulders. Once partners are less cautious, they can spend their time and energy in the pursuit of more creative solutions. Thus, trust allows companies to invest in the future because they are confident that their counterparts will support their strategic objectives. This is one reason why, as you move across the sourcing continuum, it is important to shift thinking to focus on the what, not the how.

Can you actually quantify the value of having a trusting supplier relationship? The answer is yes. According to Nobel laureate economist Kenneth Arrow, "Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time."[4] Without a fair degree of trust, organizations won't be able to unlock the full potential of more sophisticated relational Sourcing Business Models. The next section explores how supplier trust can quantitatively be linked to an organization's profitability.

THE QUANTIFIABLE ECONOMIC BENEFITS OF TRUST

Trust = Profit

That's the message emanating from a recurring study done about the automotive industry for over a decade.[5] Professor John Henke's pioneering research linking supplier trust to profitability suggests that Chrysler alone may have missed as much as $24 billion of profit from 2000 to 2014. Henke challenges organizations to take a hard look at how trust can improve an organization's bottom line, suggesting that "the majority of CEOs, CFOs, and heads of purchasing grossly underestimate the importance of allocating the resources and supporting the effort needed to create and maintain a working environment that will increase suppliers' trust and the subsequent supplier contribution to their company's profits."

The study offers two lessons for all of us. "First, working to build and maintain trusting supplier working relations is a prudent, financially responsible activity for every company to undertake. Second, by working to build and maintain trusting supplier working relations, the opportunity for purchasing to achieve meaningful and substantial supplier price concessions and other supplier-provided benefits is maximized."

ASSESSING YOUR OWN TRUSTWORTHINESS

Trust starts with you.

In his 1987 megahit "Man in the Mirror," pop singer Michael Jackson encouraged people to start by changing the person in the mirror. That is where the process of creating trust must start—with the woman or man in the mirror. A buyer must first and foremost ask, "Do I, based on how I have acted in the past, deserve to be trusted by my supplier?" And the trust must extend beyond just the buyer to the entire organization that has the power to impact the supplier negatively with its actions.

We also need to recognize that it is natural to measure ourselves by our intent and others by their actions. This brings us back to the earlier point about trust. Although we might have every intention of completing a certain action, our partner will be watching to see if we actually do so. As with anything to do with trust, it is important to communicate and delve into why we might be seen as untrustworthy. The actions you take to correct a perception of lack of intent are very different from those that you take to correct a perception of lack of capability.

It makes sense to link behavior to trust. For example, you might wonder how you can trust a certain supplier, as every time you've shared valuable information or made a concession of some sort, the supplier takes advantage and abuses your trust. Interestingly, your partner probably thinks the same thing about you. Living in that vicious circle, people look for reasons not to trust each other. Both buyers and suppliers expect that others will fail to be trustworthy.

The only way to break out of this vicious circle is to start with you. Trust requires a degree of faith that others will act in the best interest of the partnership. In an article, C. F. Sabel linked vulnerability to trust, explaining that "trust is the mutual confidence that no party to an exchange will exploit another's vulnerability. If a party chooses a course of action that involves no vulnerability then the firm has simply made a rational decision."[6]

It is impossible to force others to be trustworthy. It is possible only to affect their trustworthiness by being trustworthy in your own communications and actions. Research into game theory teaches us that most individuals utilize tit-for-tat behaviors.[7] Simply put, if you act distrustful, your supplier will likely act distrustful. If you act in a trusting manner, your supplier will likely act in a trusting manner. Therefore, establishing trust starts by asking these questions:

- How trustworthy am I?
- How trustworthy is my organization?
- How trustworthy is my supplier?

But what if you answer these questions and really believe the issue is with "them," not you? How can you break the vicious cycle and begin the process of having what could likely be a very difficult conversation with your supplier?

BREAKING THE CYCLE

The best way to break the cycle is to face it head-on. Proactively discuss the topic of trust with your supplier. Many buyers say, "I know trust is a discussion I should be having with my supplier, but I don't even know where to start." Our advice is simple. Just do it.

A discussion about trust does not have to start with an adversarial mindset. It is much easier to start by seeking to have a candid discussion and not being accusatory. Consider framing the discussion this way:

"We have been thinking and reading a lot about the power of trust in business relationships. We feel it is important that we have a relationship based on mutual trust with your organization. We think it would help build trust if we could talk about it. You may have some doubts about our trustworthiness, and if you do, we would like you to tell us. And we would like to discuss with you some issues that affect our trust in you. Would that be okay?"

You are inviting your supplier to discuss the foundational issue of trust. Completing a Compatibility and Trust (CaT) Assessment® is a great second step once a buyer and supplier agree they want to improve their trust levels.

THE COMPATIBILITY AND TRUST ASSESSMENT

Accurately assessing trust is not easy. The assessment often is a one-sided affair. In other words, a buying organization evaluates a supplier's trustworthiness without understanding the supplier's perceptions of the buying organization's trustworthiness. This is why many organizations find it helpful to have a professional, anonymous assessment to gauge the level of trust between their organization and key suppliers.

Several organizations and consulting firms talk about trust. Stephen Covey goes into great detail about the importance of trust in *The Speed of Trust*, mentioned earlier. A small handful of organizations actually measure trust. Yet how do you really measure trust and compatibility?

This is a question Dr. Karl Manrodt and Dr. Gerald "Jerry" Ledlow explored. Although trust assessments were available, they tended to be one-dimensional. Most also were not designed to measure trust specifically for buyer–supplier relationships. Manrodt and Ledlow's research led to the development of the Compatibility and Trust (CaT) Assessment. Ledlow, a thought leader in organizational culture, leadership, and health care practice, had a track record of developing rigorous assessments. Together, Manrodt and Ledlow were the perfect fit to develop what would become known as the CaT.

The goal was simple: Develop an easy-to-use assessment that creates a 360-degree feedback mechanism around the most important constructs defining trust and compatibility in buyer–supplier relationships. Why focus on compatibility and trust rather than trust alone? Simply put, cultural fit matters. Ledlow and Manrodt found that "style" is really a reflection of certain organizational behaviors (culture), which they condensed into four of the five dimensions of the CaT Assessment. The more compatible a buyer and supplier, the more likely they are to build trust and be successful.

And trust is certainly needed, especially in large agreements like the one between Procter & Gamble and Jones Lang LaSalle (JLL). William Reeves was the individual responsible to lead the outsourcing of P&G facilities management. Although P&G did not have the CaT when it selected JLL as its long-term supplier of choice, Reeves certainly had the gut instinct to know that cultural compatibility matters. Reeves summed it up when he met with JLL global account executive Bill Thummel to let him know that P&G had decided to go with JLL as the supplier of choice. Reeves shook hands with Thummel to symbolically seal the deal, stating "We know that you [JLL] and the other suppliers we evaluated have never done this before; and neither have we. But JLL has a culture that is much like P&G's. We think we have the best chance of being successful with you because you are so much like us."[8]

Cultural compatibility alone does not suffice. Just because you are culturally compatible does not mean you inherently have a trusting relationship. For this reason, measuring trust is also important.

The Five Dimensions of Trust According to CaT

The CaT Assessment is designed to measure a buyer's and a supplier's compatibility and trust across five dimensions:

1. *Trust.* Performance to promise and meeting commitments is the foundation of trust. Without performance, trust cannot exist.
2. *Innovation.* Strong and trusting relationships allow the parties to share risks and rewards, investing in each other's capabilities and collaborating to achieve common goals.
3. *Communication.* The open and timely sharing of all information is relevant to a partner's decision-making ability.
4. *Team orientation.* Both sides believe in the relationship. Efforts are made to view decisions from the partner's perspective to mitigate opportunism and promote collaboration.
5. *Focus.* There is common purpose and direction.

The CaT asks questions that provide a 360-degree view of the relationship. Buyers assess their own trustworthiness and their perceptions of the supplier's trustworthiness. Likewise, the supplier assesses its trustworthiness and its perceptions of the buyer's trustworthiness. Buyers' responses are mapped and compared to suppliers' perceptions of the same questions, and vice versa. The scores reveal the degree of alignment between the companies. If one side perceives itself as trustworthy but the other does not, there is an issue that needs to be addressed.

In Figure 11.1, the buyer is portrayed based on how it sees itself and how it is seen by the supplier according to five variables. In this particular case, buyer and supplier see the buyer in a similar way. Interestingly, the supplier sees the buyer as being slightly better in all five areas than the buyer sees itself. The two areas that show the biggest gaps—trust and communication—are ones the teams could work to improve as the relationship continues. This same analysis is also done showing how buyer and supplier see the supplier. This then provides a complete and detailed view of the current state of the relationship, existing gaps, and areas for improvement. All of these five

Figure 11.1 CaT Buyer View of Self and Supplier View of Buyer: Compatible

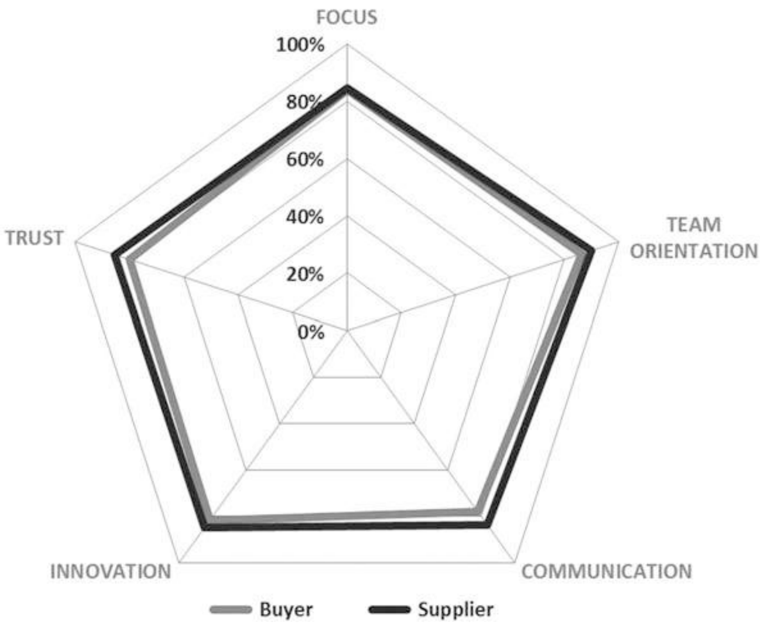
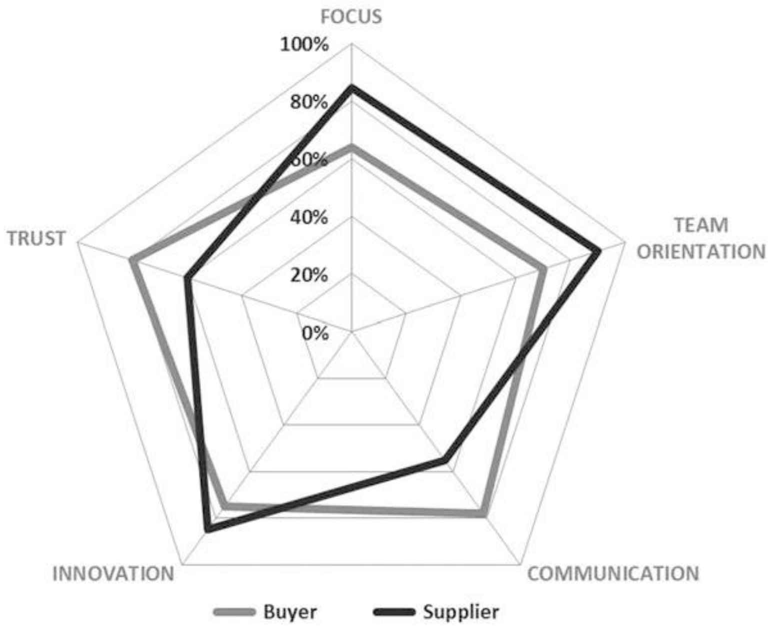


Figure 11.2 CaT Buyer View of Self and Supplier View of Buyer: Identification of Gaps



variables are then used as inputs to create an overall raw score of compatibility and trust. This score serves as a benchmark to determine what remedial work should be done to build a healthier relationship.

Compatibility is not always easy. Consider Figure 11.2; again, the buyer is portrayed based on how it sees itself and how it is seen by the supplier. Buyer and supplier agree that the buyer is innovative, but there are issues. According to the supplier, the buyer is not a good communicator, is not team oriented, and lacks focus, all of which impact the level of trust in the relationship.

Organizations can use a CaT Assessment to improve trust between a buyer and a supplier in several ways. Next we present a few of the examples we have seen work.

- Organizations can use CaT Assessments to understand their compatibility and trust by providing an overall raw score of compatibility and trust (known as the CaT Index). The assessments also highlight perception gaps between buyers and suppliers. Understanding and closing both real and perceived gaps across each of the five dimensions of compatibility and trust is essential to developing a successful long-term, mutually beneficial relationship. Once companies know where they have gaps, they can use the information to help them consciously close the gaps and thus proactively work to build a stronger relationship.

- The CaT Assessment helps a buyer assess its cultural fit with a potential new supplier. For example, buyers can use the CaT at the end of an RFx process/supplier selection to help them gauge overall cultural fit. The assessment reveals which suppliers have similar approaches across the five dimensions of compatibility and trust.
- Suppliers use the CaT Assessment to rank their clients by having account team members share their perceptions of client behaviors across each CaT dimension. Doing this helps suppliers decide which clients might be a good fit for highly collaborative relationships (or help them justify not investing in clients that demonstrate repetitive untrustworthy behavior).

The CaT Assessment is one of the best resources for strategic buyer–supplier relationships. However, it is not the only tool to be used in all scenarios, such as mergers and acquisitions. Equity partnership models require a deeper analysis of the culture, organizational climate, communication environment, and conflict styles of both firms. Analysis of the equity partnership model appropriately uses tools developed and based on the dynamic leadership model, an approach that accepts change as a constant and fosters flexibility and agility that ensures the relationship easily adapts to change.[9]

CLOSING GAPS, BUILDING TRUST

Knowing your gaps in compatibility and trust can be a discussion starter, but the real benefit comes when buyers and suppliers take action by consciously changing behaviors to purposefully improve the relationship.

The key to finding and establishing trust in any partnership is to discover the right strategy. Many think the way to build trust develops over time. Our experience is that buyers and suppliers can create a high degree of trust rather quickly by using seven proven and powerful actions in business relationships.

1. Choose Trust

First and foremost, recognize that to trust or not to trust *is a choice.* Let us repeat. Trust is a choice. Parties choose to trust each other and act in a trustworthy manner, or they don't. It is that simple. It is also a choice to expect that others will act only in their own self-interest without regard for another's interests. Likewise, it is a choice to expect that your supplier will act in the best interests of the relationship. A supplier may provide a reason not to trust, but it is imperative that an organization purposely set the tone that trust is a key factor to the mutual success of their relationship. Remember our earlier discussion on how to start a discussion about trust?

Trust is the result of actions, and since actions are a result of human thought and willpower, individuals and organizations can make a choice to take actions that increase trust and avoid actions that decrease trust. Trust goes to the heart of the collaborative partnership. And it must be established; trust does not increase or decrease by coincidence.

Dell and GENCO are good examples of business partners that chose to pursue a path of trust to help them transform their relationship. Dell and GENCO, Dell's repair and returns service supplier, had worked together since 2005. Although GENCO's performance was good, the relationship was strained. Laboring under Dell's "every dollar every year" procurement mantra meant that GENCO felt it could no longer reduce costs while maintaining a high service level and profitability. Rather than keep pushing on costs, in 2011 Dell and GENCO modified how they viewed the business, seeking to shift from a what's-in-it-for-me (WIIFMe) mindset to a what's-in-it-for-we (WIIFWe) mindset. They decided to transition the relationship using the Vested methodology.

The parties met on neutral ground at the Texas Motor Speedway during a hot August summer day to discuss the future of their relationship. The negotiations were so tense at times that attendees from each company went to separate rooms to cool off. Tom Perry, GENCO's president of reverse logistics, later recalled, "There was a moment of truth in that meeting. I did not want to proceed because I didn't have enough trust [in Dell] to move forward." But during those cooling-off periods, his peers at GENCO convinced Perry to stay the course and negotiate a collaborative partnership agreement with Dell. Perry later said: "I had an epiphany. If you can't get past the absence of trust, you can't ever make it work. I can't say enough about how that's changed everything."[10]

The parties took a leap of faith to trust and went on to establish a collaborative Vested relationship. "There was a recognition for the importance of the relationship and most important for the power of trust," Perry explained. He proudly added, "Today, the atmosphere at our meetings is 180 degrees different from the past."

Trust has the power to transform relationships. Within nine months of signing the new Vested agreement, the companies achieved record-setting results, including reducing scrap by 62 percent. "The results have been beyond my wildest dreams," said Stephen McPherson, Dell's global operations senior leader. "It has simply been amazing to see how we could literally turn around the culture and see such drastic results in such a short time frame." Perry made the decision to trust without Dell first earning his trust. And Dell committed to more trustworthy behaviors. Perry's decision to trust changed everything for Dell and GENCO.

2. Declare Your Intent to Build a Trusting Relationship

Nothing builds trustworthiness better and faster than when words and actions coincide. Expressing an intention to trust your supplier is an important element in building trust. For example, host a workshop to discuss trust with your supplier. Start by saying things such as "We would like to create a more trusting relationship with your organization," then work together to outline what a trusting relationship looks like. Identify specific examples of how each of your organizations can improve trust. Then write it down in a formal statement of intent document.

Declaring your intentions to build trust is especially important when buyers and suppliers are about to enter into actual negotiations. We recommend telling your supplier that you intend to trust it until it does something that is not trustworthy. For example, an organization could say at the initial stage of a negotiation: "We want to tell you that we place great value in trust. We know and feel that trust is perhaps the most important thing for us as we embark on our strategic relationship. Therefore, we will be trustworthy in our negotiation process, and we will trust you and treat you as worthy of our trust. We expect you not to take advantage of the trust we give you." The next example demonstrates this concept.

An artist contacted a record company to inquire about the company's interest in releasing his new album. The record company recognized this as a good opportunity and wanted to enter into negotiations with the artist. The company did not want to spend time and resources negotiating an agreement only to find out later that the artist preferred to work with another company that offered a better deal. When initiating the contract negotiations, the record company said to the artist: "We want to release your record, and we are willing to negotiate a contract with you. However, we want to be clear that we do not want to waste our time negotiating just to find you will go to someone else. We will provide you with a good and fair offer that is mutually beneficial. In return, we trust that you will not negotiate with another record company. If we can't come to a fair agreement, then we'll shake hands and you can pursue a deal with our competitor." The artist agreed and the contract was closed in a matter of days. The record was a big hit, making a lot of money for the record company and the artist.

A key to success here was that the record company expressed its intent to trust the artist and at the same time also expressed its expectation that the artist would not violate the trust. Expressing trusting expectations and intentions often has important psychological consequences. Simply put: No one wants to be caught being untrustworthy.

3. Do What It Takes to Not Lose Trust

Once formed, trust can quickly fade. Trust is fragile and is easily damaged or destroyed. And, once destroyed, often it is harder to rebuild trust than it was to establish it in the first place. The path to trust can be long. The path from trust to mistrust is always short.

McDonald's has long been known for building long-term and trusting relationships with its suppliers. Unfortunately, sometimes suppliers do things that lose trust. When Devin Cole, group vice president of the food service division of Tyson Foods, was tapped for the lead role in managing the McDonald's account, Tyson Foods was not in a favored status. Cole explained how Tyson's management lost McDonald's trust for a time.[11]

> Trust is the basic building block of McDonald's supplier relationships and is a fragile thing that can be eroded through the actions of a single individual if not relentlessly protected. Tyson has been a longtime supplier of McDonald's, but new leadership in our company managed—or, more appropriately, mismanaged—the McDonald's account. Tyson started to treat McDonald's like every other customer, and the magic dissipated, as the fundamentals of trust and collaboration were lost with Tyson's management turnover. Tyson got complacent as a supplier, and our performance slipped.[12]

Reflecting on how Tyson lost McDonald's trust for a time, Cole explained, "It was us that had gotten off track. McDonald's consistently adhered to their values and rewards. They held themselves accountable and remained open to talking with us, even when we weren't holding up our end. McDonald's always had a willingness to meet with me and coach me on how Tyson could get back on a path to mutual success."

4. Create a Shadow of the Future for the Relationship

Robert Axelrod, professor of political science and public policy at the University of Michigan, has conducted research on the science of collaboration. Axelrod advocates using a concept he calls "the shadow of the future." The term means "that the importance of the next encounter between the same two individuals must be great enough to make defection unprofitable."[13] If the shadow of the future looms large enough and organizations believe that they will meet again, they are more likely to build trusting relationships. The future starts to influence the behavior of how parties behave in the present, and organizations will promote building trust as a way to establish stability and harmony in a relationship that must be functional in the future. Simply put, most people and organizations will act with integrity and trust if they know they have to work together the next day.

Dr. Mary Lacity of the University of Missouri–St. Louis and Dr. Leslie Willcocks of the London School of Economics identified "focus on the future" as their number one attribute for effective leadership in a buyer–supplier relationship.[14] A good example in action is how McDonald's works with its strategic supply chain suppliers. McDonald's key suppliers and franchise owner/operators have a "seat at the table" on McDonald's proverbial "three-legged stool." All of the parties work collectively to create a plan to win that provides visibility to goals for the future. This future-forward view of the business, coupled with McDonald's no-bid strategy, creates trust and confidence that the suppliers will remain a key part of McDonald's future.[15]

A shadow of the future is one reason why relational Sourcing Business Models are so powerful. Relational models create a credible commitment to continue to do business with a supplier. The more an organization shifts along the sourcing continuum, the more it is able to create an even larger shadow of the future for its suppliers. This is especially true when an organization uses a performance-based or Vested model. Properly structured, relational Sourcing Business Models provide suppliers with the hope of future returns on investment that exceed what they would achieve if buyers used the "market."

5. Develop a Culture of Accountability

A basic rule for building trust is to state intentions and then follow through with action. This is, however, not enough. If a culture of accountability becomes opportunistic and one party violates the other's trust, it is imperative that the nonviolating partner discuss the untrustworthy behavior. This means creating an environment where it is not only socially acceptable but it is desirable to call forth bad behaviors that undermine trust.[16] Breaches of trust cannot be water cooler gossip. Buyers and suppliers owe it to the other party to hold themselves (and each other) accountable in a timely manner.

A good example of this in action is TD Bank and Brookfield Johnson Controls Canada (BJCC). The two organizations came up with a creative and fun way to help individuals working within the relationship to tactfully call out improper behaviors. Employees were given small Angry Bird® toys, and each conference room was equipped with additional ones, just in case employees forgot their toys. When a TD Bank or BJCC employee felt someone was not living up to the desired behaviors, he or she was encouraged to give that person "the bird."[17]

6. Leave Money on the Table

Oliver Williamson promotes the concept of leaving money on the table as a way to build trust. Williamson notes, "Always leaving money on the table can...be interpreted as a signal of constructive intent to work cooperatively, thereby to assuage concerns over relentlessly calculative strategic behavior."[18] On one hand, a buyer leaving the money shows that it is trustworthy by acknowledging that the supplier should make a fair profit. On the other hand, the buyer shows that it trusts the other party not to take the money and run. When a supplier does not take money off the table, that party is being trustworthy.

7. Use a Credible Negotiating Style

Williamson also urges individuals and organizations to use what he calls a credible style—one that is "hardheaded and wise." First, buyers should not be mean-spirited. They should strive for clear results and accountability. Second, buyers need to be wise, recognizing that business is dynamic and that more complex contracts are "incomplete and thus pose cooperative adaptation needs."[19] In other words, credible negotiators are forward thinking (and acting), uncovering potential risks and developing a mechanism to address these factors and factor them into the contract. Most important, credible negotiators do not use a muscular style.

TRUST CHANGES THE GAME

It is not unusual for buyer–supplier relationships to be rife with conflict. Some buyers scrutinize activity to spot contract inconsistencies and potential areas to fine or otherwise penalize suppliers. Some suppliers cagily prepare reports to ensure they squeeze every available dollar from buyers.

In this classic game of tit-for-tat, each side seeks to gain advantage.

To have a trusting supplier relationship, you need to break the cycle and play a different game—a game that seeks to purposefully create trust. It is impossible to harness the power of more collaborative relational Sourcing Business Models without trust.

Trust is not an afterthought that happens after you pick a supplier and negotiate your contract. Rather, trust is the base on which competitive advantage is built, driven by a highly collaborative culture that supports teamwork, open and honest communication, and innovation. Entry into more collaborative Sourcing Business Models is *not*, however, an emotional decision where you blindly disclose business secrets with the hope you have chosen a supplier wisely. High trust levels are the result of careful scrutiny of your relationship that leads your decision-making process. And it is backed up by a commonsense commercial agreement that clearly states your intentions and expected business behavior.

A complete picture of compatibility and trust is essential to establishing a productive and proactive relationship because, as Stephen Covey rightly says:

> "Nothing is as fast as the speed of trust.
>
> Nothing is as profitable as the economics of trust.
>
> Nothing is as relevant as the pervasive impact of trust."[20]

Not only has this chapter shown the importance of trust, but it has given practical and easy-to-follow advice for purposefully building trust in supplier relationships. We've explained that trust is not a one-way street but rather requires buyers and suppliers to behave consistently in trustworthy manners. The next chapter shows a simple yet powerful process for laying the foundation for highly collaborative relationship with your suppliers.

CHAPTER 12

GETTING TO WE

"You don't get what you deserve, you get what you negotiate." If you've worked in a Fortune 1000 company or flown on an airplane in the last ten years, you've likely heard or seen this quote from Charles Karass. He has conducted hundreds of public and in-house trainings across the globe and regularly advertises in in-flight magazines that tout this quote from his popular book, *The Negotiation Game*.[1]

Henry Ford didn't have the benefit of taking one of Karrass's courses when he found himself sitting across the table from the United Auto Workers (UAW) union to negotiate a contract. In fact, Henry Ford wasn't even sitting at the table. In 1936–1937, the fledging UAW had successfully concluded sit-down strikes at General Motors and Chrysler. Now it was time to turn its attention to Ford Motor Company.[2]

Henry Ford was adamantly opposed to unions. He threatened to close plants rather than give in to workers' demands. When union organizers attempted to distribute flyers at one location, he hired thugs and encouraged the use of violence to convince the organizers to leave. Eventually the National Labor Relations Board found Ford to be in violation of federal law and ordered the company to stop interfering with efforts to unionize.

In May 1941, workers voted in favor of unionizing the workforce. Ford was so disgusted he repeated his threat to close plants rather than sign a contract with the union. His associates urged Ford to reconsider. Even Ford's son Edsel and wife Clara pleaded with him to start conversations with the workers. Clara went so far as to announce she would leave Henry if he did not relent. After 53 years of marriage, this was a pretty radical threat.

Edsel took the helm of representing Ford Motor Company in bargaining with the workers. Finally, on June 20, 1941, the UAW signed its first contract with Ford. The company remains unionized to this day.

Henry Ford learned the hard way that power was not enough to get what he thought he deserved. Instead, he got what his son Edsel negotiated.

POWER IS NO LONGER ENOUGH IN THE TWENTY-FIRST CENTURY

Although Henry Ford learned the hard way that sheer power was not enough, most organizations have yet to get the message. One reason is that tools, resources, and training materials of the procurement profession teach that power and leverage are the preferred strategies. After all, if you've got power, why not use it?

Robert Axelrod began to question the prevailing wisdom. Axelrod wanted to explore the power of cooperation. He invited game theorists to compete in a computerized tournament to see who could devise a strategy to win in a classic game known as the Prisoner's Dilemma.[3] The game shows why two individuals might not cooperate even if it appears that it is in their best interests to do so. All purely rational self-interested prisoners could remain silent, but instead often prisoners betray one another ("defect") by implicating the other in the crime. As a result, all prisoners receive stiff sentences. The irony of the Prisoner's Dilemma game is that both prisoners get the best outcome if they both remain silent ("cooperate").

To cooperate or not to cooperate? This is a simple yet profound question.

Axelrod invited game theorists to play four rounds of the game with each player having four opportunities to either cooperate or defect. His findings were seminal: The greatest odds of winning came from a strategy known as tit-for-tat. A tit-for-tat strategy can be defined best by having a player echo (reciprocate) what the other player did in the previous move. For example, if person A cooperates, person B will cooperate. If person A suddenly defects, then person B follows suit and also defects. (A defection is a competitive move that is characterized as non-cooperative and opportunistic in nature.)[4]

Axelrod described his findings in *The Evolution of Cooperation,* which was first published in 1984. Playing "nice"—or cooperating—led to the best results. Axelrod's findings are summarized:

- *Be nice.* Cooperate, never be the first to defect. The best results come when both parties consistently cooperate.
- *Be provocable.* Return defection for defection, cooperation for cooperation.
- *Don't be envious.* Be fair with your partner. Resist the urge to optimize your position at the expense of your partner's position.
- *Don't be too clever.* Don't try to be tricky in the pursuit of trying to game the system for your benefit.[5]

After reading this summary, it's worth asking why buyers and suppliers fall prey to trying to outwit their counterparts at the negotiating table through deceptive practices aimed at winning at the other party's expense. The answer is simple. Many players who negotiate on behalf of their companies have an inherent incentive simply to get the deal done and to get the best deal for their companies. Many organizations even measure buyers for short-term cost reductions rather than ensuring overall success of the sourcing solution. In addition, the larger the deal and the more that is at stake, the more prone companies are to bring in professional negotiators, consultants, and/or lawyers to ensure that the organizations are getting a good deal. Often these outsiders have a personal interest in getting short-term wins rather than long-term wins, especially when the object is to get to a deal rather than establish a successful relationship.

Unfortunately, today's business culture is rife with organizations that justify opportunism. Remember the Ice Queen from chapter 1? Opportunism can be defined as the desire and the ability to take advantage of the person sitting across from you at the negotiating table—or anyone—simply because you can. Far too many organizations have developed (or at least allowed) social norms that encourage opportunism. Sadly, the tendency to take advantage of others has become business as usual in many organizations.

Opportunism takes many forms—and can even occur well after a deal is negotiated. For example, a global retailer sends out a letter to suppliers requesting that they provide a rebate to offset the retailer's losses in other areas. Or a supplier intentionally bids very low to win the business only to recoup the losses with many costly change orders. Maybe an organization's procurement group pressures its suppliers to accept another 5 percent in savings at the midpoint of the life of the agreement.

INFLUENCING COOPERATION

Two factors influence cooperative behavior. The first is Axelrod's "shadow of the future," which embodies the likelihood that the parties will meet again. If the shadow looms large enough—if players believe that they will meet again—they are more likely to cooperate since successive rounds of competitive behavior offer no path out of the dilemma. In long-term collaborative relationships, the future influences the present. Properly structured relational Sourcing Business Models cast a positive shadow of the future and encourage cooperation with a supplier.

The second factor is Axelrod's "additional activities," which have the power to change how the parties behave. One significant additional activity that changes the Prisoner's Dilemma game is staying in the game. If neither party can leave or eliminate the other, players tend to actions that promote increased collaboration. As organizations shift along the sourcing continuum, they should recognize when they are in an environment that demands codependency and not overcompete in a spend category. Embracing value-added activities and investment in the relationship creates opportunities for additional activities, making defection more difficult, and therefore promotes higher levels of credible collaboration. Unfortunately, buyers often do everything in their power to limit dependency. The ironic thing is that buyers often have short-term contracts that go on for many years, one or two years at a time.

A leading consumer packaged goods company (CPGco) realized the importance of Axelrod's two lessons. CPGco was renegotiating a contract with a facilities management supplier. Over the course of months, CPGco was cooperative, fair, and balanced during the negotiation process. But at the eleventh hour, CPGco's chief financial officer demanded a 10 percent across-the-board price cut. CPGco demonstrated classic negotiation tactics, thinking it could defect by demanding a price reduction.

The eleventh-hour demand was a quintessential case of opportunism. When one organization is focused solely on getting to an agreement without regard for the long-term effects on the relationship, the organization blindly justifies opportunistic behavior. When the supplier called CPGco's bluff and suggested it would rather leave the relationship—the ultimate defection—than take a price cut, CPGco retreated. CPGco failed to realize that it and the supplier were both in a relationship. CPGco did not want the supplier to exit; it just wanted a price cut. CPGco wrongfully believed the supplier would comply. Unfortunately, actions like this set precedents in establishing a norm of opportunism in relationships. The good news here is that both parties realized they wanted the same thing—to continue the relationship. They went on to negotiate a fair price both CPGco and the supplier could agree on.

The example poses a very important question: How do parties keep the cycle of cooperative moves going when there is an opportunity for one party to grab short-term gains? How can businesses prevent suppliers from being opportunistic and taking advantage of them? Or prevent CFOs from acting opportunistically at the eleventh hour just because they can?

The answer? Establish clear social norms that discourage and punish opportunism.

CULTURAL NORMS GUIDE THE RELATIONSHIP

Ronald Dworkin, a distinguished professor of law and philosophy at both UCLA and New York University has sought to understand the role social norms play in regulating society and producing fair outcomes in the legal system. He argues: "Often the unwritten (and unspoken) principles partners choose have the power to change the very essence of how they work together. Specifically, principles (or social norms) have the power to drive behaviors. Those behaviors have a cause and effect that can dictate certain outcomes. For example, if partners choose to follow principles that are fair, outcomes will also be fair. If they choose to be short-sighted and opportunistic, the nature of their relationship will be short-sighted and opportunistic."[6]

Putting Axelrod's tit-for-tat concepts next to Dworkin's concepts about social norms driving behaviors, we find that modern businesses have created "negotiation norms" that foster destructive behaviors by setting a tone for opportunism in buyer and supplier relationships. Once these negative cultural norms are established, they create an environment that destroys value rather than promoting value creation through mutual self-interest.

Despite the very real potential that opportunistic behaviors can permanently damage relationships, businesses often encourage such behaviors. The concept of Getting to We was born to combat such behavior. Getting to We is a process that helps buyers and suppliers break the cycle of opportunism caused by damaging unwritten and unspoken social norms. It creates an easy-to-follow process that establishes and documents positive and ethical social norms that promote collaborative behaviors.

The heart of the Getting to We process is a jointly created formal document we refer to as a statement of intent. Buyers and suppliers jointly agree to a statement of intent for the relationship, which includes strictly abiding by six essential principles that become the "new" social norms for the relationship.

Think about it. The intent of a deal between a buyer and a supplier is not the specifics of the deal but the relationship itself.

Consider the implications. Business environments are highly dynamic. A fair negotiation today is likely to not be fair tomorrow when circumstances change—and they will. Buyers and suppliers agree that change is the status quo, and they will treat each other fairly and ethically throughout the life of the relationship. This means checking opportunism at the door. The goal is to be certain each party is committed to and behaves in a fair and, therefore, trustworthy manner.

The Getting to We process helps buyers and suppliers introduce six social norms that have the power to turn a typical tit-for-tat supplier relationship into a highly collaborative and trusting relationship.

SIX NEW NEGOTIATION NORMS

The concept of social norms is not new. Much research has been done on the concept of social norms. What is new is the concept of purposefully agreeing to and embedding positive social norms into a buyer and supplier relationship as part of a statement of intent. Although buyers and suppliers can establish their own social norms, we believe that the six social norms presented here should be considered the universal gold standard. The new norms should be applied to all buyer–supplier relationships that fall under the three relational Sourcing Business Models. After all, why wouldn't you want to ethically create fair and balanced commercial agreements with potential strategic suppliers? And equally important is the fact that failing to agree to proven positive principles designed to build a trusting relationship signals that you can't be trusted. The six norms are listed next, then discussed individually.

1. Reciprocity
2. Autonomy
3. Honesty
4. Equity
5. Loyalty
6. Integrity

Reciprocity

A truly collaborative supplier relationship builds on the strong foundation of reciprocity. Without reciprocity, there is no win-win situation. If one party commits to investing time and money in an important project, the other organization must be prepared to reciprocate.

Procter & Gamble and Jones Lang LaSalle present a great example of how reciprocity works. In the outsourcing agreement the two companies signed, JLL held zero responsibility for the Clairol properties. However, when an emergency at one of the Clairol facilities happened, JLL was on site, creating an action plan to get operations back on track. JLL did what was right for the relationship, even though the work was outside its contract scope. Some may think JLL's actions were imprudent because there was no guarantee P&G would compensate JLL for its actions. However, P&G did reciprocate fairly by compensating JLL for its effort.[7]

Proactive actions, innovative ideas, and fair and balanced economic exchanges are the cornerstones of a mutually beneficial agreement.

Autonomy

Getting to We defines autonomy as the absence of power-based actions between parties. This means that if either partner in the relationship holds the power, it must be checked at the door. The threat of using power to control the relationship undermines collaboration and trust. Freedom from coercion is a base of any effective relationship. Buyers and suppliers must agree that they won't use their power, even though they could do so.

Autonomy also means allowing a supplier to have flexibility to optimize its workscope on behalf of the buyer. Autonomy means enabling a supplier to make its own decisions, decide how the operation can best be accomplished, and function as an equal working partner. This is why it's important in cases where more strategic suppliers will be adding value for buyers to view workscope through a different lens. As you learned in chapters 4 to 6, buyers should shift thinking from the "who" and "how" of the workscope definition to the "what" as a buyer–supplier relationship shifts along the sourcing continuum. This is common sense when you think about it. The farther you go along the sourcing continuum, the more you have consciously decided to rely on a supplier with core competencies you don't have and can't easily get from other suppliers. It's important not to fall victim to the outsourcing paradox of hiring experts and then telling them how to do the work.

Autonomy and the ability to focus on the "what" and not the "how" was a key reason for the success in rebuilding the Minneapolis I-35 Bridge in Minnesota.

On August 1, 2007, the vital traffic corridor I-35 Bridge linking Minneapolis and St. Paul buckled and collapsed. Dozens of cars were submerged in the waters of the Mississippi River, and 100 other vehicles were stranded. The human toll included 13 deaths and 145 injured persons.

Replacement of the collapsed bridge became Minnesota's number one issue. The governor, Tim Pawlenty, challenged the Minnesota Department of Public Transportation (MnDOT) to construct a new bridge within 18 months. It was no small challenge in that normally it takes that long to just define the scope of a project this large, and completion takes years.

To meet the governor's timeline, MnDOT utilized a process based on best value rather than lowest cost. MnDOT and the chosen contractor, Flatiron Manson, followed the Vested Five Rules, which required collaboration and sharing of both risk and reward. MnDOT relocated its offices to work side by side with the contractors, assessing problems and process on a real-time basis.

The Vested's Five Rules delivered an award-winning bridge design, under budget and within the 18-month time line. (Refer to chapter 6 for a review of the Five Rules.)

Vested's Rule 2, "Focus on the WHAT, not the HOW," puts the onus of details on the contractor. MnDOT's objective was to leverage the what-not-how thinking by allowing Flatiron Manson to choose from several bridge and wall types, propose geometric solutions to correct substandard elements, and develop visual quality components for the project. In fact, final contract language set clear expectations:

> 5.1 Control and Construction of Work—Contractor shall be solely responsible for and have control over the construction means, methods, techniques, sequences, procedures, and Site safety, and shall be solely responsible for coordinating all portions of the Work under the Contract Documents, subject, however, to all requirements contained in the Contract Documents.[8]

The final result not only complied with the challenging construction schedule, budget, and safety concerns, it also provided numerous new technology breakthroughs that MnDOT now owns. Ultimately, MnDOT gave the architect and engineer freedom to design what *Popular Mechanics* magazine called "America's Smartest Bridge." A high-tech structural health monitoring system, equipped with 240 sensors, sends real-time data from the bridge to the University of Minnesota. The sensors provide relevant data used by MnDOT to control automated anti-icing systems (remember, we are talking Minnesota winters here), and the Intelligent Transportation System monitors traffic flow, message signs, and the like. Even bridge security and records of structural behavior are monitored.

Permission to act autonomously opened the doors of creativity to achieve a win-win solution for all: MnDOT, contractors, subcontractors, Minnesota business, politicians, and citizens.

Honesty

Although nearly everyone agrees that honesty is the best policy, it doesn't always work that way in business deals. Organizations fear if they tell the facts of a situation, the other party may not be as forthright and might gain a superior position. "If I am honest about my intentions and actions, how can I be sure the other party is as well?" is a common concern.

A relational trust-based Sourcing Business Model is impossible to achieve if honesty is not present. In order to establish trust, each party must be willing to disclose information that the other party potentially could use to its advantage. Following a principle of honesty strengthens trust and transparency.

Honesty counts in the little things too. Consider this example of a candidate for a senior management position in a Fortune 500 company. After the interviewing committee broke for lunch, everyone headed for the company cafeteria. While in the lunch line, the candidate, separated momentarily from committee members and thinking he was not being observed, slid a few containers of butter under his napkin, in an attempt to not pay for them. Too bad a person he had yet to meet observed his petty pilfering. Two pats of butter were never so costly. The candidate lost the job opportunity.

Loyalty

Trust brings loyalty. Loyalty brings extra effort. Extra effort brings innovation and other results to the bottom line. Loyalty joins trust as an important element of a solid partnership.

However, when we say that loyalty is critical to a relationship, we are not suggesting loyalty no matter what. Loyalty in a relational Sourcing Business Model means loyalty to the relationship. Being loyal to a relationship is acting in the best interest of the joint objectives—maximizing revenue and minimizing cost. As you move along the sourcing continuum, your commitment to your suppliers will need to grow more and more. This does not mean you can't ever switch suppliers. Rather, it means you need to be credible in your considerations about impacts on suppliers, especially if a supplier has made investments on your behalf to drive innovations that have not yet been amortized.

Equity

Following the principle of equity requires parties to share rewards in proportion to their contributions, resources invested, and risks taken. Equity means the parties do the right thing, even if the remedy is not featured in the contract.

Equity takes shape in two ways: proportionality and remedies. Dividing things by a rule of 50/50 may sound fair, but it may not be equitable. Sometimes one party receives more than 50 percent because it accepted more risk or made greater investments. In these cases, equity drives trust precisely because the split is not an arbitrary 50/50.

Equity within remedies means defining remedies that may go beyond limitations or silence within the contract. For example, contract language may not fully cover a natural disaster. Nonetheless, the parties move forward to expeditious solutions. Equity also drives trustworthiness and strengthens the relationship.

Dan Keto and Dean Dorcas know the value of equity and sharing value with their most strategic clients.[9] Friends and fellow U.S. Navy midshipmen, the men wished to start a business but had little start-up capital to invest. They decided a staffing agency would be a good fit since they had both managed hundreds of people in the Navy. To differentiate their firm, they came up with the idea to hire "senior" workers—that is, people other staffing agencies may not consider eligible for employment.

Lots of people thought a senior temp workforce was a really bad idea—the seniors might be sickly, slow, and unable to learn new technologies. In order to allay potential customer concerns, the business, Integrated Service Systems (IMS), guaranteed new customers would experience a 5 percent cost savings compared to their previous sourcing agencies.

Turns out the naysayers were totally wrong. The appreciative seniors brought a work ethic and determination that astounded everyone. Not only did clients achieve cost savings, Keto and Dorcas earned more money than they thought possible. In fact, the profitability of the firm caused problems. Keto explained:

> One of the biggest challenges IMS has faced with our approach is that it has been a victim of its own operational success. Customers usually do not realize how inefficient their operations are. IMS sometimes has been able to increase overall productivity by over 300 percent. When it priced the work at 5 percent below previous costs, a 300 percent increase in output created very substantial profit margins. At first, customers were ecstatic with the productivity gains, but then they realized that all of the benefits after the 5 percent guaranteed savings was going into IMS profit. This led to customer resentment or opened the door for competition to undercut the business on price.

Dorcas added: "While IMS was successful, at the end of the day, the results were not really fair and balanced. We won a lot—and they [ISM's clients] only won 5 percent. . . . We realized IMS needed a long-term value model with our customers and began taking a Vested approach with them in regard to sharing efficiency gains and cost savings."[10]

And that is exactly what we strive for in what's-in-it-for-we (WIIFWe) thinking:

> People who know there is enough to share.
> People who earn our trust by acting equitably with business partners and customers.
> People who are happy when everyone wins.

Integrity

Integrity is the final principle in the Getting to We social norms. Integrity references past actions and connotes consistency in decision making or actions. It is natural to desire partners upon whom you can rely to perform and make the same decision or take the same action as in previous similar situations. The consistency builds trust. Integrity means trust and trustworthiness are both present in the negotiation process.

A relationship steeped in integrity will act according to agreed guiding principles. But integrity must be carefully nurtured or, like sand through your fingers, it dissipates with time. When both parties respect the history of the relationship and can count on each other to act with integrity, trust and longevity develop.

WHAT GAME ARE YOU PLAYING?

The problem is, today's procurement professionals are playing the wrong game.

Here lies the systemic problem: Most procurement professionals are hard-wired to negotiate to get the best deal. But classic negotiations tactics are trust busting and set the tone for opportunistic relationships. Conventional negotiations tactics should be allowed only for transaction-based Sourcing Business Models (basic provider and provider). Transactional models are quick, short-term exchanges.

The deals they create are static, and that is perfectly acceptable if you don't need to count on your supplier to reduce risk or create value.

This is an issue as much of the goods and services an organization procures fall into relational Sourcing Business Models (preferred provider, performance-based, and Vested models). The environments in which these models are used are inherently more dynamic in nature and have more risk.

Buyers who negotiate a static deal in a dynamic or risky environment set themselves up for failure. Static deals often lose equilibrium, with one or both parties no longer perceiving the deal as fair. When this happens, parties find themselves back at the negotiating table under new circumstances. What a waste of precious time and money that could be better spent on creating innovation and growth for the parties. And if buyers and suppliers have not set positive social norms, they likely will find themselves in a vicious negative tit-for-tat death spiral.

Negotiating for relational Sourcing Business Models is really about playing a different game. It's about negotiating for a successful business relationship, not the specific deal or discrete transaction. The purpose is to lay down the crucial foundational elements of the relationship itself. Then and only then can you even start to work collaboratively through the specific scope and terms and conditions for the transaction at hand.

Think about that: *The relationship is the focus of the deal.*

The specifics of how the parties will manage the relationship become the basic guidebook for the relationship. A well-structured relational Sourcing Business Model outlines how the business parties will work together in a dynamic business environment of constant change, increasing risk, and uncharted opportunities.

Of course, these words are easy to write. How do you actually do what we're recommending?

That is the question Kate Vitasek asked as she discussed the research she was doing on highly collaborative Vested relationships. She ultimately collaborated with attorneys Jeanette Nyden and David Frydlinger, and the trio developed a new negotiation paradigm to use for highly collaborative relationships.

The result? A five-step negotiating process called Getting to We.

Getting to We: A Five-Step Process for Negotiating Relationships

The Getting to We five-step process changes how individuals and organizations approach negotiations. The focus in Getting to We is the relationship. Simply put, you outline how to Get to We before you Get to Yes on the deal specifics. Any organization can adopt the simple-to-follow five-step process for negotiating relational Sourcing Business Models.

The Getting to We process helps buyers and supplier create a solid foundation for the overall relationship. Following the Getting to We process helps buyers and suppliers jointly change their mindset. The new attitude builds understanding, comfort, and trust so parties can work together effectively in a sustainable relationship. The Getting to We process is designed for buyers and suppliers to complete together. As a team, buyers and suppliers lay the foundation for a more collaborative relationship that has the power to deliver a competitive advantage for both organizations, not just the party with the most power or the one with superior negotiating skills.

Following the Getting to We process helps companies change how they view the relationship and embrace a WIIFWe mindset. WIIFWe is the philosophical mantra that forms the framework for a collaborative and trusting relationship. Once embraced, a WIIFWe mindset has the power to deliver a competitive advantage for buyers and suppliers long after the deal is signed.

The Getting to We process comprises five distinct steps:

1. Get ready for Getting to We.
2. Jointly agree on the shared vision for the relationship.
3. Collaboratively negotiate the guiding principles for the relationship.
4. Negotiate as We.
5. Live as We.

The first four steps lay the foundation for a highly collaborative relationship depicted by a WIIFWe mindset; the fifth step ensures that buyers and suppliers can sustain their relationship by creating a sound governance structure that is properly scaled to their relationship. None of the steps should be skipped. Cutting corners derails efforts as laying the foundation for a collaborative, relational Sourcing Business Model.

GETTING TO WE FIVE STEPS

The Getting to We complete process is discussed in detail in the book *Getting to We: Negotiating Agreements for Highly Collaborative Relationships* by Jeanette Nyden, Kate Vitasek, and David Frydlinger (New York: Palgrave Macmillan, 2013). The University of Tennessee offers an online course to aid buyers and suppliers in following the process, http://www.vestedway.com/getting-to-we-online-course/. The online course includes a detailed Getting to We Toolkit to help buyers and suppliers facilitate each of the five steps.

We recommend using the Getting to We process in all relational Sourcing Business Models. Getting to We is so essential for Vested agreements that the process is physically embedded in the Vested methodology.

STEP 1. GET READY FOR WIIFWE

The first step in the Getting to We process looks at three foundational elements for a successful collaborative relationship: trust, transparency, and compatibility. Chapter 11 addressed the importance of compatibility and trust. This step applies many of the concepts you learned in that chapter. An additional aspect covered in this step is the extent to which buyers and suppliers use transparency as an enabler for the relationship. As shown in the examples in chapters 5 and 6, as buyers and suppliers move across the sourcing continuum, the need for transparency increases. Transparency is essential to enable key concepts such as best value and total cost of ownership. The starting point for a buyer and supplier must be to get on the same page with regard to how transparent they will be in their relationship.

At the completion of this step, buyers and suppliers know whether they have a solid enough foundation to move to the next step. If they don't have enough trust to continue, they will need to develop a roadmap for improving trust. If they have a good foundation, they move on to step 2. Completing this first step enables buyers and suppliers to determine whether a WIIFWe mindset has merit and whether they are willing to explore establishing or renegotiating a collaborative relational sourcing business models.

STEP 2. JOINTLY AGREE ON A SHARED VISION FOR THE PARTNERSHIP

As buyers and suppliers enter into discussions, they talk through their respective organization's visions and goals. A joint buyer–supplier team transforms those separate visions into a shared vision. The shared vision gives the partnership its purpose beyond a series of transactions. Furthermore, it guides buyers and suppliers not only throughout the negotiation process but throughout the entire term of the relationship. Aiming for the same target sets the stage for step 3.

STEP 3. COLLABORATIVELY NEGOTIATE THE GUIDING PRINCIPLES FOR THE PARTNERSHIP

The Getting to We process demands that buyers and suppliers abide by a set of principles to purposefully drive positive behaviors by creating ethical and trusting social norms. This is the critical step that distinguishes highly collaborative relationships from average-functioning relationships. Guiding principles establish new social norms for the relationship and, when followed, prevent the opportunism and competitive tit-for-tat moves that inhibit true collaboration. The principles establish the mindset to support buyers and suppliers on their journey to live a WIIFWe existence.

STEP 4. NEGOTIATE AS WE

Buyers and suppliers following the Getting to We philosophy do not immediately start the actual negotiation process to outline the specifics of their deal. First, they jointly establish the mechanisms they will use as they negotiate the specifics. Doing this includes agreement on the negotiation rules, the strategies and tactics, and an approach that ensures the deal specifics are fair and balanced. Agreement is especially important regarding how the parties deal with risk allocation and creating value. Once buyers and suppliers agree to these mechanisms, they will use them to reach consensus on the specifics of their agreement.

STEP 5. LIVE AS WE

The last step in the Getting to We process is to Live as We. Because relationships are dynamic, buyers and suppliers co-create their supplier relationship management (SRM) framework. The framework will vary based on the size and complexity of the relationship. Use the guidelines for SRM outlined in chapter 9 as you create your relationship management framework. The SRM framework sets cohesive and well-understood processes, policies, and decision-making rights to help buyers and suppliers govern (or manage) their relationship. Proper governance mechanisms ensure buyers and suppliers can maintain (or live into) the guiding principle. By doing so, the relationship runs at peak performance long after the deal is signed.

Your approach to implementing SRM practices will vary based on which Sourcing Business Model you select. For example, a preferred provider model likely has limited SRM mechanisms and is driven primarily by buyers. Organizations using a performance-based model adopt formal SRM processes that typically emphasize oversight. Organizations that adopt Vested models shift their viewpoint to insight rather than oversight—in other words, they shift from *supplier* relationship management to *strategic* relationship management.

A key aspect of Live as We is a radical commitment to adhere to the guiding principles. Remember the TD Bank Angry Bird example? Living your intentions and strictly enforcing the guiding principles are critical to create the daily behaviors that foster a highly collaborative relationship.

IS GETTING TO WE REALLY DIFFERENT?

Although negotiation tactics and contract law have evolved over time, the basic approach has stayed pretty much the same over the years. People enter contracts at arm's length to pursue material ends, and risks are negotiated and assigned at the time the contract is signed. The party with the most power or better negotiating skills usually gets the better deal. Either party has the ability to walk away.

Getting to We is different. It is not focused on getting the best deal today but rather on negotiating the intent and behaviors of the relationship itself. The five-step Getting to We process lays a strong foundation where buyers and suppliers can fluidly adjust to business needs and risks as needed and do so in a harmonious, productive manner. The premise is that by agreeing to the foundational nature of the relationship itself, the organizations can get to a fair and balanced deal not only for the present, but also for any circumstances in the future as well. This foundation is essential for relational Sourcing Business Models because, by design, they create repetitive relationships with suppliers aimed at creating value. Even the simplest of the three relational Sourcing Business Models—a preferred provider—is still a relationship. As you move along the sourcing continuum, each model brings higher levels of codependency. A strong foundation is essential for performance-based and Vested agreements, the most codependent and collaborative of the models.

GETTING TO WE SOUNDS GOOD. BUT WHY NOT JUST GET TO YES?

William L. Fisher and Bruce Ury presented a paradigm known as interest-based bargaining in 1981 in their best-selling book titled *Getting to Yes*.[11] Interest-based bargaining allows people to creatively find ways to achieve their interests. Fisher and Ury give an excellent example about how two parties were negotiating over an orange. One party wanted the pulp while the other party wanted the peel. Interest-based bargaining allows the parties to creatively find ways to achieve their interests. Thus, in Fisher and Ury's analogy, the parties' self-interests are maximized, with each person getting exactly what is wanted. In their example, the parties sought to understand each other's interests, finding out that one wanted the peel and the other the pulp. The result, they said, was a win-win negotiation because both parties could both win when one person got the peel and the other the pulp.

The problem is that Fisher and Ury's approach falls short of achieving real mutual gain. The parties are still negotiating over one orange. Although this interest-based approach is useful, organizations can do better. Why negotiate how to creatively divide one orange when you should be seeing if you can develop a relationship with the intent to grow more oranges?

The Getting to We process helps buyers and suppliers change the question from "How can I optimize how to split this orange?" to "How can we use each other's core competencies to grow more oranges?" In short, Getting to We shifts from optimal *value exchange* (Getting to Yes) to *creating value.* Buyers and suppliers lay the foundation for finding solutions to work together to perhaps plant orange trees that allow both to prosper from increased harvests. Planting those trees requires conducting business in a radical new way.

Breaking the Opportunistic Cycle

Many see a WIIFWe mindset and Sourcing Business Model theory as a shift in the management of procurement. Humans have the power to choose their behaviors and work cooperatively. Breaking the cycle of opportunism means teaching people that making a competitive move triggers a competitive countermove. It is in everyone's best interests to avoid opportunism in long-term business relationships where buyers and suppliers have consciously chosen to work together to create value.

Unfortunately, breaking the cycle of opportunism is not easy. A psychological bias, called partisan perceptions, distorts the impact of a competitive move. Partisan perceptions skew how we judge our actions and those of our partners. For example, if a person tells a lie, he or she offers self-serving justifications for doing so. But if the person's partner tells a lie, the person evaluates the behavior (telling the lie) critically and as being far worse than the lie he or she told.

Partisan perceptions, coupled with a series of competitive behaviors, create downward pressures in the relationship. The "defection" becomes ever-worsening behavior, justifiable in the eyes of the doer and unjustifiable in the eyes of the recipient. Many business relationships live in various stages of this death spiral. The process starts with one person justifying a purely self-serving, noncooperative action.

Negotiating the true nature of the relationship at the outset means that buyers and suppliers move out of competitive and negative tit-for-tat cycles of actions and instead creates a positive environment based on social norms that encourage cooperation.

The Getting to We process alters the natural urge for self-interest and opportunistic behavior in three ways. First, buyers and suppliers turn into partners for success by committing to a longer-term relationship that casts a hopeful shadow of the future. The intent of moving across the sourcing continuum is to create value beyond what the market would deliver as a result of a highly competitive process. Doing this shifts the mentality of buyers and sellers from fighting for their share of the pie to expanding the pie.

Second, buyers and suppliers adhere to a common set of documented social norms (guiding principles) that drive cooperative behavior. Doing so creates an environment that fosters trust and fair decision making.

Finally, the Getting to We process helps buyers and suppliers turn a WIIFWe mindset into daily interactions by institutionalizing a formal governance structure that ensures compliance with cooperative behavior. Combined, buyers and suppliers create a relationship that generates successive rounds of cooperative tit-for-tat thinking to create value that is mutually beneficial to both partners.

TIME TO START?

It's the moment of truth.

You have completed a Business Model Mapping exercise and identified the most appropriate Sourcing Business Model. You've analyzed your organization's maturity. You've talked with your supplier, who is both surprised and willing to complete the Compatibility and Trust Assessment. You are beginning to believe that having more trusting relationships will help everyone be more effective.

It is time to start. It is time to lay the foundation for more trusting relationships and let the power of relational Sourcing Business Models lead you on the path to innovation and WIIFWe thinking. In the virtual race to success, your mantra should be "One . . . two . . . three . . . GO!"

CONCLUSION

Business, like a flowing river, is dynamic and unpredictable. It has the inherent power to bring many opportunities…and many sorrows.

The Yellow River flows through the cradle of Chinese civilization. In ancient times, the Yellow River was believed to flow from heaven as a continuation of the Milky Way.[1]

The Yellow River is powerful indeed. It carries 1.5 billion tons of loess, or sediment, annually from the higher elevations of the Bayan Har Mountains in western China to empty into the Bohai Sea. The sediment causes natural dams to accumulate slowly, undetected. Sometimes the sediment buildup was so great the riverbed was higher than the surrounding land. The soft earth is unstable, and storms can result in breaks in the riverbanks, causing massive flooding. Farmers would look up from their fields to see the masts of vessels sailing by.

At times, the power of the Yellow River cannot be contained. When this happens, the river often is referred to as the River of Sorrows. For example, in 1332–1333, 7 million people perished as the river rampaged nearby communities. In 1887, up to 2 million people lost their lives. The Central China Floods of 1931 were some of the most devastating, with as many as 4 million people dying. After a flood the Yellow River would plot a new course, and bring devastation to the villages and cities along its changed course. Power—unleashed—can have significant negative consequences.

Yet power—harnessed—creates new and different options.

Harnessed properly, the power of the slow-moving waters of the Yellow River can have dramatic benefits. The Chinese government uses sophisticated damming systems that convert the river's raw power into productive power for lights, cars, homes, and factories. Each of seven of the largest dams on the river can produce over 5,600 megawatts of power each year.

Harnessed power. New opportunities. New wealth created.

But what happens when the river cannot be tamed? A key part of the system is advanced warning signals. Risk is mitigated. Lives are saved.

This book has given you options, resources, and tools to help you harness raw power into something new. Something new based on collaboration. Purpose-built collaboration that harnesses the power of highly strategic and collaborative supplier relationships working in harmony to leverage each other's core competencies. Purpose built collaboration that openly shuns distrustful and opportunistic behavior created when buyers and suppliers play a virtual game of chess trying to outsmart each other.

The future of strategic sourcing in the new economy will be built by advocates like yourself who harness the power of Sourcing Business Models and build momentum for change in your organization.

We close with a challenge to change. It's time to make a choice: a choice to embrace change by shifting your thinking from old-school, power-based procurement processes born in the 1980s. Choose not to change and you may find your organization being swept aside by inertia and possibly the innovators' dilemma.

Where do you start? Maybe, like our Ice Queen, you need to start by pretending. Maybe you too have to make a conscious choice to trust, to be open, and to be transparent. It pays to be credible.

Those who are already believers can start by taking the lessons from this book and architecting your own sourcing systems using the seven Sourcing Business Models. Use the fresh approaches and resources we have provided to create your own self-correcting strategic sourcing systems to channel power in new and better ways with your own suppliers.

We wish you well as you harness your own power in new and more productive ways.

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Ed Medlock
Philip Molnar
Mary Morrison
Kevin Nash
David Natoff
Ann Oka
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Mark Perera
Brad Peterson
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IAOP (International Association for Outsource Professionals)
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Greg and Austin Picinich
Susan, Katie, Sarah, and Ben Manrodt
Steve and Stew Kling

APPENDIX

EXHIBIT A1 HIGH-LEVEL OVERVIEW OF POPULAR MULTISTEP STRATEGIC SOURCING PROCESSES

Toshihiro Nishiguchi, *Strategic Industrial Sourcing: The Japanese Advantage* (1994)[1]							
Assess spend	Assess the supply market	Assess supply chain	Total cost analysis	Supplier selection	Develop sourcing strategy	Negotiate with suppliers	Track results and restart
The Procurement Center, "Strategic Sourcing: A Step-by-Step Practical Model" (2004)[2]							
Identify targeted spend area	Create the sourcing team	Develop a team strategy and communicate the plan	Gather market information	Develop a supplier portfolio	Develop a future state	Negotiate, evaluate, commit, and agree	Supplier relationship management
Censeo Consulting Group "Strategic Sourcing and Spend Analysis Briefing" **(2004)[3]**							
Conduct opportunity assessment	Profile commodity	Conduct supply market analysis	Develop commodity strategy	Issue RFx and negotiate	Implement and manage performance		
Rene Rendon, United States Naval Postgraduate School "Commodity Sourcing Strategies. Processes, Best Practices, and Defense Initiatives" (2005) [4]							
Spend analysis	Industry/ Market analysis	Identify cost and performance drivers	Supplier role analysis	Internal process assessment	Savings quantification / justification	Develop implement-ation plan	
A.T. Kearney "7 Steps for Sourcing Information Products" (2005)[5]							
Profile the category	Select the sourcing strategy	Generate the supplier portfolio	Select the implement-ation path	Negotiate and select suppliers	Integrate suppliers	Benchmark supply market	

United States Air Force (2009)[6]						
Opportunity assessment	Review current strategy	Market research	Requirements definition	Sourcing strategy	Execute strategy	Performance management
Joe Payne and William Dorn. ***Managing Indirect Spend: Enhancing Profitability through Strategic Sourcing*** **(2011)**[7]						
Data collection and spend analysis	Market research	RFx process (go to market)	Negotiations	Contracting	Implementation and continuous improvement	
New York State Procurement "Seven Steps New York State Procurement" (2013)[vii]						
Develop sourcing project work plan	Develop category profile	Develop category strategy	Identify minimum requirements and evaluation criteria	Conduct competitive exercise	Negotiate and develop sourcing recommend-ation	Implement new agreement
Supply Management.com "The seven stages of a sourcing strategy" **(from Web site 2015)**[9]						
Spend analysis	Supplier market assessment	Prepare a supplier survey	Build the strategy	RFx process	Supplier selection	Communicate with new supplier(s)
Arjan J. van Weele, *Revolution in Purchasing: Building Competitive Power through Proactive Purchasing* **(from** ***Purchasing and Supply Chain Management*****)**[10]						
Define specification	Select supplier	Contract agreement	Ordering	Expediting	Evaluation	

Chick and Handfield (from *The Procurement Value Proposition* 2014)[11]

Build the team	Market research	Strategy development	Contract negotiation	Supplier relationship management

[1] http://www.amazon.com/Strategic-Industrial-Sourcing-Japanese-Advantage/dp/0195071093
[2] http://www.ism.ws/files/pubs/proceedings/fbengel.pdf
[3] Strategic Sourcing and Spend Analysis Briefing, DOD Procurement Conference, May 27, 2004, Censeco Consulting Group
[4] https://www.ncmahq.org/files/Articles/JCM05_pp7-20.pdf
[5] http://www.atkearneypas.com/knowledge/articles/2005/7steps.pdf
[6] Process developed by the University of Tennessee as part of a research project for the United States Air Force
[7] http://www.wiley.com/WileyCDA/WileyTitle/productCd-0470886889.html
[8] http://purchasingforum.ogs.ny.gov/sites/default/files/A1%20-%20Strategic%20Sourcing_0.pdf
[9] http://www.supplymanagement.com/resources/2011/the-seven-stages-of-a-sourcing-strategy
[10] Arjan J. van Weele and Frank A. Rozemeijer, *Revolution in Purchasing: Building Competitive Power through Proactive Purchasing*, Eindhoven University of Technology, Faculty of Technology Management, Purchasing Education and Research Unit, the Netherlands.
[11] Gerard Chick and Robert Handfield, *The Procurement Value Proposition* (London: Kogan Page, 2012).

EXHIBIT A2 THE TEN AILMENTS

Ailment 1. Penny Wise and Pound Foolish

This ailment occurs when an organization sources based purely on costs. Many organizations may say they have a partnership but then focus instead on beating up their service providers to get the lowest price. This is costly in the long run.

Ailment 2. The Outsourcing Paradox

An organization hires a supplier as the "expert" and then proceeds to tell the provider precisely how to do the work, developing the "perfect" set of tasks, frequencies, and measures, but without input from the service provider it has hired to the implement the perfect system.

Ailment 3. Activity Trap

Traditionally, organizations purchase goods and services using transaction-based model: The service provider is paid for every transaction—whether needed or not. There is no incentive to reduce the number of non-value-added transactions, because doing so results in lower revenue.

Ailment 4. The Junkyard Dog Factor

The decision to "buy" usually means jobs are lost as the work and jobs transition to a supplier. Employees hunker down and stake territorial claims to processes that "absolutely must" stay in house.

Ailment 5. The Honeymoon Effect

Research on the honeymoon effect indicates that attitudes toward a new supplier tend to be positive at the outset but over time satisfaction levels decline, thus creating problems over the long term.

Ailment 6. Sandbagging

Some companies adopt approaches to encourage suppliers to perform better over time by establishing bonus payments for certain levels of performance. A perverse incentive can result: The supplier does just enough to get the incentive.

Ailment 7. The Zero-Sum Game

This occurs when organizations believe that if something is good for the supplier, then it is automatically bad for them.

Ailment 8. Driving Blind Disease

This ailment affects many business relationships. It is the lack of a formal governance process to monitor relationship performance and measure success.

Ailment 9. Measurement Minutiae

The hallmark of this ailment is trying to measure everything: There's a blur of meaningless numbers and little context or insight.

Ailment 10. The Power of Not Doing

Many organizations invest heavily in fancy software and scorecards, but if the metrics are then not used to make adjustments and improvements, don't expect results.[19]

EXHIBIT A3 BASIC PROVIDER: SOURCING CONSIDERATIONS GUIDELINES

Consideration	*Attributes*
Link to Business Objective	• No action—sourcing solution supports primary business objectives limited to expense control or nonexistent
Requirements Analysis	• Limited to no action—requisition(s) details requirements
External Market Analysis	• Search for suppliers by scanning online sources, catalogs, or other supplier directories, such as diversity publications, and spot market testing through competitive bidding
Cost Analysis	• Focus on administration cost only, seeking ease of order to pay (i.e., purchasing cards, preidentified catalogs, or preset electronic-auction events)
Supply Market Assessment	• No action— multiple suppliers are available and can be easily changed
Category Portfolio Segmentation	• Validate portfolio segmentation—indicates requirement is best managed with a basic provider business model • Category management is achieved through competitive bidding for lowest price supported by a purchase order
Total Cost of Ownership Approach	• No action—TCO calculations are not used, and price is the only cost consideration because of low value impact unless delivery or inventory is a significant expense

Consideration	*Attributes*
Risk Assessment	• No action—risk is minimum due to market standards, supplier must meet corporate/compliance policies and standards or buyer will chose alternative supplier
Value Assessment and Balance	• Buyer focus—lowest price • Supplier focus—Receiving the order and predictable payments
RFx Solicitation/Bid Management	• Yearly solicitation cycle is typical; however, can be perpetual based on industry • Spot buys as frequently as daily • Solicitation purpose is to seek best market price • Buyer manages bid and supplier selection with no stakeholder input • Use request for price • Typically 1–2 weeks to select supplier but could be same day
Supplier Selection Drivers	• Supplier selection driven by lowest price standard items or services and administrative ease of ordering/managing
Risk Management	• No action—category does not require active risk management due to low value and is mitigated by switching suppliers
Contract Approach	• Use *procurement card* or *purchase order (PO)* to buy standard market offerings • May use blanket POs if plan on repeat buys from supplier
Pricing Model	• Use price based on a transactional economic model (e.g., price per unit, per call, per hour) • Select the lowest competitive bid
Category Management Governance	• No action—the purchase order provides the administrative and governing approach • Buyer manages all aspects of category governance
Supplier Relationship Management	• No specified SRM plan—"market" governs the relationship; suppliers interchangeable based on lowest price • Buyer owns supplier relationship; any interactions are short term, ad hoc, and reactive based on solving a problem or addressing issues
Performance Management	• Utilize a three-way match accounting process to PO (quantity, price and damage free)

Consideration	*Attributes*
Continuous Improvement/ Transformation/ Innovation	• Identify ways to improve administration or category standards where possible
Compliance and Special Concerns	• Survey supplier to verify compliance with government driven compliance requirements
Exit Management	• No exit strategy required

EXHIBIT A4 APPROVED PROVIDER: SOURCING CONSIDERATIONS GUIDELINES

Consideration	*Attributes*
Link to Business Objective	• Apply some effort in purchase solution to support business objectives such as growth, cost reductions, or unique specifications • Supplier approval and down-selection criteria reflect corporate objectives
Requirements Analysis	• Complete review of historical sourcing solution and forecasted changes in use and demand • Review supplier down-selection criteria and supplier past performance • Define workscope —workscope focuses on WHO and/or HOW
External Market Analysis	• Complete some work effort to understand the supply and demand influences of the market • Assess suppliers to identify any opportunities presented by current market conditions
Cost Analysis	• Complete base product or service cost bar focused on hard costs to include buyer costs (typically does not include visibility of supplier's costs) • Identify cost drivers that affect product or service choice. Estimate supplier's ability to affect buyers and sellers' costs • Develop cost management plan based on cost bar analysis, information from market queries, and inputs from internal stakeholders
Supply Market Assessment	• Complete supplier prequalification process and down-selection using criteria that include a strong focus on supplier's financial stability • Determine the best size of the supplier, small or large, to support delivery of the requirement

Consideration	*Attributes*
	• Down-select suppliers from the broad base of supplier options in the market; typically, there are several approved suppliers to support a single requirement • Investigate supplier's current business state based on its ability to manage market influences and other factors, such as size, geographic advantage
Category Portfolio Segmentation	• Validate portfolio segmentation—indicates requirement is best managed through an approved provider business model
Total Cost of Ownership Approach	• Do not complete a TCO for generic items where you are just leveraging your volume • Do complete a TCO if the category value is high, has unique specifications, or products or services have special conditions or considerations
Risk Assessment	• Conduct risk assessment as part of supplier qualification process (Some risk is mitigated through supplier prequalification) • Complete risk assessment plan for more critical items, to factor in capacity and supply management processes and any unique requirements that are imposed beyond standard product or service offerings
Value Assessment and Balance	• Buyer focus—recurring commodities at fair or lowest price • Supplier focus—increased volumes and client reference
RFx Solicitation/ Bid Management	• 1–2 year solicitation cycle • Solicitation purpose is to seek best market price often with unique quality or specification requirements • Buyer manages bid and supplier selection with some input by stakeholders • Request for price is used • 3–4 weeks to select supplier
Supplier Selection Drivers	• Supplier selection driven by combination of prequalified capabilities, price, and the ability to meet unique requirements (business or specifications)
Risk Management	• Manage risk primarily by switching suppliers (multiple preapproved suppliers) • Use supplier preapproval process to verify supplier's ability to meet requirements including basic compliance directives • Identify alternate supply sources as backup plan

Consideration	*Attributes*
Contract Approach	• Use standard master agreement contract Use blanket POs for ease of reordering • Include defined workscope (workscope focuses on WHO and/or HOW) • 1–2 year contract duration
Pricing Model	• Use price based on a transactional economic model • Typically fixed price per transaction (per unit, per call, per hour) • Negotiate a rate card • Negotiate volume discounts/rebates by bundling workscope/consolidating volumes
Category Management Governance	• Manage governance through periodic supplier meetings with some business stakeholder involvement • Changeover of preapproved suppliers driven by competitive solicitations • Include additional governance requirements as additions to standard contracts • Resource requirements: Buyer with periodic business stakeholder consult and qualification support
Supplier Relationship Management	• Buyer owns supplier relationship once the prequalification process is complete • Supplier meetings are held periodically to include early warnings on shifting performance trends
Performance Management	• Utilize a three-way match accounting process to PO (quantity, price and damage free) with expanded quality/performance criteria based on business requirements • Some oversight of performance and pricing
Continuous Improvement/ Transformation/ Innovation	• Capture and assess improvement opportunities through periodic supplier interfaces and feedback from stakeholders
Compliance and Special Concerns	• May require corporate compliance validation to become a supplier • Develop and use surveys and periodic audits to verify supplier compliance with government and company-driven requirements
Exit Management	• Terminate for convenience and cause • Develop a formal plan for supplier change-out that includes an assessment of impact on business operations with supplier replacement

EXHIBIT A5 PREFERRED PROVIDER: SOURCING CONSIDERATION GUIDELINES

Consideration	*Attributes*
Link to Business Objective	• Define solution to support specific business objectives • Supplier down-selection based on proven track record of performance and ability to meet business objectives
Requirements Analysis	• Complete review of historical sourcing solution and forecasted changes in use and demand • Interface with buyer's business stakeholders to detail requirement objectives • Define workscope to focus on WHO and/or HOW; begin to jointly define HOW with trusted suppliers
External Market Analysis	• Complete industry market analysis yearly at a minimum to ensure understanding of opportunities and threats • Benchmark suppliers impact by market behaviors and influences • Benchmark best practices in the market to identify potential value offerings that could be applied in the final sourcing solution
Cost Analysis	• Complete base product or service cost bar focused on hard costs to include both internal costs and supplier's costs • Identify cost drivers that affect product or service choice • Develop a target cost model with estimated adjustments in cost drivers (based on market pricing queries) to present to the potential suppliers for comment on how suppliers' target cost differs • Develop cost management plan based on cost bar analysis, information from market queries, and inputs from internal stakeholders • May solicit inputs from suppliers
Supply Market Assessment	• Investigate supplier's current business state and position in the market based on its ability to manage market influences and other factors, such as size, geographic advantage, value-added capabilities, etc. • Determine the best size of supplier, small or large, to support delivery of the requirement

Consideration	*Attributes*
	• Complete supplier prequalification and down-selection using criteria that include a strong focus on supplier's financial stability and ability to meet compliance requirements • Identify suppliers with differentiated capabilities to provide value-added services
Category Portfolio Segmentation	• Validate portfolio segmentation—indicates requirement is best managed through a preferred provider business model • Formal category management plan may be developed with input from key stakeholders and will include methods for evaluating additional value benefits to be achieved through a preferred provider model
Total Cost of Ownership Approach	• Complete TCO model to validate supplier value-added pricing against current costs • Prepare plan to monitor net landed or net delivered price and operational costs to measure improvements in TCO
Risk Assessment	• Conduct risk assessment as part of supplier qualification process (some risk is mitigated through supplier prequalification) • Complete formal risk assessment with internal stakeholder involvement (may include supplier input)
Value Assessment and Balance	• What's-in-it-for-we mindset seeking fair and balanced exchange Buyer focus—increase value beyond price and delivery to include quality, efficiency, capacity management with specific link to buying company objectives, volume discounts/rebates • Supplier focus—increase contract duration, client reference, preferred status, revenue growth opportunities to gain larger share of buyer's spend
RFx Solicitation/ Bid Management	• 2–3 year solicitation cycle • Solicitation purpose is to seek value-added capabilities at best value • Utilize cross-functional business stakeholder involvement in bid management and development of supplier selection criteria • Execute periodic request for information to solicit benchmark information or specific supplier information in advance of preparation of formal bid or proposal solicitation request to gain insights on best practices in the market

Consideration	Attributes
	• Use request for proposal for solicitation with possible inclusions of requested information on cost, pricing models, and examples of successful improvements with other customers • 4–8 weeks to select the supplier
Supplier Selection Drivers	• Complete best value evaluation (combinations of price, value-added supplier offerings, geographic benefit, differentiated market position, technology, and prequalified capabilities) as well as identified unique differentiators or value benefit • Review supplier past performance • Verify supplier acceptance of standard contract terms and conditions
Risk Management	• Document risk management expectations from the supplier (i.e., a documented requirement for the supplier to produce a risk management and mitigation plan) • Identify alternate suppliers, review differences in value offerings between suppliers, and determine potential impact on costs to change suppliers • Prepare a supplier change contingency plan should there be a need to change suppliers • Supplier qualification process includes risk management capability and ability to meet specific compliance requirements
Contract Approach	• Use a relational contract approach based on standard master agreement contract for legal terms and conditions with standardized statement of work template for future business requirements Incorporate what's-in-it-for-we mindset with mutually agreed statement of intent Use blanket purchase orders (POs) for ease of reordering • Includes defined workscope to focus on WHO and/or HOW; begin to jointly define HOW with trusted suppliers • Contract duration 2–3 years
Pricing Model	• Use price based on a transactional economic model • Typically fixed price per transaction (per unit, per call, per hour) • Negotiate a rate card with volume discounts/ rebates by bundling workscope/consolidating volumes

Consideration	*Attributes*
	• May use an open book compensation model but typically there is limited use due to higher administrative burden • Establish price adjustment targets using a total cost of ownership model as basis for costs
Category Management Governance	• Include appropriately scaled governance mechanisms for contract compliance, financial management, managing issues and risks, performance management, and relationship management between internal stakeholders • Buyer facilitates governance with key internal stakeholders throughout the sourcing cycle • Develop a plan for formal minimum quarterly business reviews with a preestablished agenda for: strategy and relationships review, service review, commercial review, financial review, security and compliance review, quality and risk review, and change control committee
Supplier Relationship Management	• Buyer typically "owns" supplier relationship management with business stakeholder involvement • Appropriately scaled SRM framework, including mechanisms for buyer–supplier interface, formal escalation management, and change management/commercial management • Identify and document planned opportunities for additional periodic supplier interaction at various levels of buyer and supplier organizations to review supplier expanded value contribution to buyer's business
Performance Management	• Develop activity-based service-level agreements • Develop a formalized cost target tracking process • Develop and use a formal operational scorecard • Create customer satisfaction surveys and develop a management plan
Continuous Improvement/ Transformation/ Innovation	• Develop a plan to capture and assess improvement opportunities through supplier reviews • Include a contracted requirement for the supplier to proactively identify and implement continuous improvement efforts
Compliance and Special Concerns	• Create an audit plan to verify supplier compliance with government and company-driven requirements

Consideration	Attributes
Exit Management	• Terminate for convenience and cause • Develop an exit management plan with longer duration allowance to reduce business interruption because the supplier typically is integrated into the business operation

EXHIBIT A6 PERFORMANCE-BASED MODEL: SOURCING CONSIDERATION GUIDELINES

Performance-Based Model: Sourcing Consideration Checklist

Consideration	*Attributes*
Link to Business Objective	• Define solution to support specific business objectives with active inclusion of business stakeholders • Develop measurable targets with business stakeholders that align to business objectives • Document a clear description of the business objective(s) for eventual provision to supplier
Requirements Analysis	• Complete review of historical sourcing solution with business stakeholder involvement • Complete current state assessment of the requirement to establish ***baseline*** performance target against which the supplier's future performance guarantees will be compared and measured. • Define workscope; workscope focuses on the WHAT and limited HOW of workscope; supplier develops HOW using a Performance Work Statement
External Market Analysis	• Complete formal market analysis to investigate market behaviors, trends and influences on the category requirement • Benchmark best practices to provide basis for evaluating current practices and identifying possible improvements to build into requirements
Cost Analysis	• Develop cost model with hard and soft cost elements included • Identify cost drivers and prioritize improvement targets with business stakeholders • Develop cost management plan with supplier involvement • Establish performance targets for specified cost drivers reduction and year over year price reduction • Develop cost baseline with buyer business and supplier business stakeholders that will serve as the foundation for savings glidepath to validate year over year cost reductions

CONSIDERATION	*ATTRIBUTES*
Supply Market Assessment	• Complete supply market research to identify suppliers which lead in the category and have sound financials that allow them to assume higher levels of risk • Determine the stability of the supplier(s) position in the market based on their ability to manage market influences and other factors such as size, geographic advantages, and assess whether they are candidates for acquisition or divestiture for the term of the support needed • Determine the best size of the supplier, small or large, to support delivery of the requirement • Complete supplier pre-qualification and down-selection using criteria that has a strong focus on financial stability, supplier(s) strength in the industry, as well as other category requirement-specific support criteria developed by business stakeholders • Develop a supply base strategy based on intelligence collected to assure continuous support, strong performance and process stability and improvement
Category Portfolio Segmentation	• Validate Portfolio Segmentation- indicates requirement is best managed with a Performance Based Model • Develop a Formal Category Management Plan with input from business stakeholders establishing goals, objectives and performance targets
Total Cost of Ownership Approach	• Complete TCO model to validate supplier value against current costs • Identify factors in addition to price, such as systems capabilities, full-time resources assignments, training provisions or work design efficiencies, that might be applied by a supplier based on the situation and complexity of the requirement that may be incremental to current TCO • Prepare plan to monitor net landed or net delivered price and operational costs to measure improvements in total cost of ownership
Risk Assessment	• Conduct full risk assessment due to higher dependency on fewer suppliers • Draft contract clauses to transfer appropriate level of risk management to suppliers, requiring supplier contingency plans where applicable to the category requirement being provided • Complete formal risk assessment and risk mitigation plan with involvement of business stakeholders. Solicit input from suppliers. • Formal transition plan for any transfer of workscope

CONSIDERATION	*ATTRIBUTES*
Value Assessment and Balance	• What's-in-it-for we mindset seeking fair and balanced exchange • Buyer focus: replacement of non-core competencies to lower cost, drive performance improvements and gain additional support for other business objectives such as market growth and/or new product introduction • Supplier focus: increase contract duration, opportunity for increased profit with incentives if meet performance targets, revenue growth, reference client, cooperation for improvement
RFx Solicitation/ Bid Management	• 3–5 years solicitation cycle • Solicitation purpose is to seek cost management and year over year cost reductions at a competitive price/ value • Create a cross functional team to represent all business stakeholders and users with responsibility to create a supplier down-selection criteria; down-select criteria should be weighted and include quantitative and qualitative criteria including cultural fit • Participate in proposal review and negotiations preparation and planning • Periodically use a Request for Information (RFI) to gain benchmark information that may be applicable. RFI's are also used to test market pricing throughout the period of the selected supplier performance period to track valid pricing trends • Prepare a Request for Solution (RFS) focused on specific supplier provided benefits such as cost reductions, quality improvements, technology improvements and service scope expansion potential • 2–4 months to select the supplier
Supplier Selection Drivers	• Complete best value evaluation with benchmarked supplier leaders possessing core competency to uniquely support delivery of the requirements and provide cost efficiency • Evaluate suppliers against TCO model to identify the best value supplier approach • Evaluate the ability of the supplier to manage cost and manage or mitigate risks • Down-select supplier based on proven track record of performance and capability to meet business objectives • Complete best value analysis reviewing other factors in addition to price such as systems capabilities, full-time resource application, a geographical capability, training or other work design efficiencies

CONSIDERATION	*ATTRIBUTES*
Risk Management	• Document risk management expectations from the supplier, i.e., a documented requirement for the supplier to produce a risk management and mitigation plan • Develop performance metrics to track risk • Document specific risk penalties, i.e., monetary or termination with exit transition obligations • Prepare a formal risk management contingency plan • Supplier qualification process includes risk management capability and ability to meet specific compliance requirements • Jointly develop formal workscope transition plan
Contract Approach	• Use a relational contract approach designed to be a flexible framework • Modify buyer master agreement to develop contract language inclusions for supplier management of risk and costs • Incorporate what's-in-it-for-we" mindset with mutually agreed Statement of Intent • Include defined workscope; workscope focuses on WHAT, with limited focus on HOW; supplier develop Performance-Work Statement outlining the HOW • Contract duration commensurate with supplier's investment, typically with a 3–5 year base using options to extend one year at a time

Pricing Model	• Use Output-based economic model
	  ❍ Use price with incentive and/or penalties tied to supplier's performance against performance guarantees
	  ❍ Typically fixed price, but can be cost reimbursement
	  ❍ Pricing typically split into a base fee (often transactional in nature) and management fee with incentives
	• Define expected pre-agreed savings glidepath
	• Define incentives and/or penalties tied to performance
	• Define gainsharing for performance above meeting requirements as appropriate if allowed by company policies

Category Management Governance	• Include appropriately scaled governance formally documented in contract • Incorporate mechanisms for contract compliance, financial management, managing issues and risks, performance management, and relationship management between internal stakeholders

CONSIDERATION	*ATTRIBUTES*
	• Business facilitates governance with cross-functional team; buyer plays support role. Appropriately scaled resources support various governance mechanisms with goal to have a high degree of business continuity over the sourcing cycle • Develop a plan for formal governance review meetings with a pre-established agenda for: strategy and relationships review, service review, commercial review, financial review, security and compliance review, quality and risk review, change control committee
Supplier Relationship Management	• "Business" typically owns the supplier relationship with key stakeholder responsibilities coordinated by the buyer • Appropriately scaled SRM framework, including defining and documenting the following mechanisms into the actual contract ❍ Change management/commercial management ❍ "2 in a Box" buyer-supplier interface structure ❍ Formal escalation process ❍ Formal continuity of resource plan to assure consistent relationship interface (including key man provisions as appropriate) ❍ Clear and separate roles for relationship management, operation management, commercial/contract management (for managing scope changes) • Identify and document planned opportunities for additional periodic supplier interaction at various levels of buyer and supplier organizations to review supplier expanded value contribution to business objectives
Continuous Improvement/Transformation/Innovation Compliance and Special Concerns	• Include contractual clause for supplier performance guarantees for continuous cost improvements • Create an audit plan to verify supplier compliance with government and company-driven requirements
Exit Management	• Termination for performance failures • Significant impact with supplier exit; develop a formal Exit Management Plan addressing: ❍ Budget for transition costs and resource allocation ❍ Mutually agree on transition duration for supplier removal and replacement ❍ Fair division of intellectual property rights ❍ Fair allocation of assets and investments ❍ Business continuity for stakeholders ❍ Contract satisfaction and completion ❍ Record of lessons learned

EXHIBIT A7 VESTED MODEL: SOURCING CONSIDERATION GUIDELINES

Consideration	*Attributes*
Link to Business Objective	• Brief down-selected supplier(s) on overall business strategies • Develop measurable targets that align to business objectives jointly with business stakeholders and supplier
Requirements Analysis	• Complete review of historical sourcing solution • Complete current state assessment with business stakeholders to serve as the baseline against which future performance will be measured • Develop desired outcomes and complete the requirements roadmap directly aligned to business objectives with joint team of buyer business stakeholders and supplier representatives Determine and document objectives with joint team of business and supplier stakeholders to drive work effort to meet the desired outcomes • Determine workscope/workload allocation through a process of evaluation with joint team of business and supplier stakeholders workscope as part of the requirements • Define workscope to focus on WHAT, not the HOW; supplier develops performance work statement
External Market Analysis	• Complete market analysis to identify potential Vested partners • Conduct ongoing market analysis with joint team of buyer business and supplier stakeholders to ensure understanding of current trends and potential opportunities for improvement
Cost Analysis	• Develop a cost model with both hard and soft costs with business and supplier stakeholders to serve as the basis against which improvements are made and measured • Develop a protocol for reviewing supplier-provided open book costing with focus on reducing overall cost structure (not just the supplier's price) • Develop a cost management plan to include considerations of efficiency and productivity and on understanding value of potential innovations and transformation with involvement of both parties

Consideration	*Attributes*
Supply Market Assessment	• Identify suppliers through market research with focus on those suppliers that provide demonstrative evidence and record of innovation, transformation, and collaboration • Investigate suppliers' current business state and position in the market based on their ability to manage market influences and other factors, such as size, geographic advantage, etc. • Determine the best size of the supplier, small to large, to support delivery of the requirement • Complete a review of the suppliers' ability to invest in their business to improve productivity and efficiency and drive excellence in management of the category
Category Portfolio Segmentation	• Validate portfolio segmentation—indicates product or service provided is best managed by a Vested business model • Develop a formal category management plan with key internal stakeholders with defined supply solution guardrails
Total Cost of Ownership Approach	• Develop a TCO model with joint buyer/supplier team members • Prepare a TCO monitoring plan with a defined cadence and a refresh time frame with joint buyer/supplier team members
Risk Assessment	• Comprehensive formal risk assessment completed by both business and supplier stakeholders
Value Assessment and Balance	• Define what's-in-it-for-we mindset seeking true win-win/value creation • Conduct value allocation evaluation and best value analysis to ensure balance between the two parties with joint buyer/supplier team members • Define process with joint buyer/supplier team members for measuring and allocating value generation after total cost management and predefined objectives are achieved
RFx Solicitation/ Bid Management	• 5–7 year solicitation cycle • Solicitation purpose is to seek differentiated value add with a competitive pricing model • Buyer utilizes cross-functional business stakeholder involvement in bid management and development/ priority weighting of supplier selection criteria • Periodic use of request for information to solicit benchmark information in advance of preparation of a formal proposal request to gain insights on best practices in the market

Consideration	*Attributes*
	• Prepare a request for proposed solution or request for partner, which may include requested information on cost, pricing models, and examples of successful improvements with other customers • 2–4 months to select the supplier
Supplier Selection Drivers	• 5–7 year solicitation cycle • Solicitation purpose is to seek differentiated value add with a competitive pricing model • Buyer utilizes cross-functional business stakeholder involvement in bid management and development/priority weighting of supplier selection criteria • Periodic use of request for information to solicit benchmark information in advance of preparation of a formal proposal request to gain insights on best practices in the market • Prepare a request for proposed solution or request for partner, which may include requested information on cost, pricing models, and examples of successful improvements with other customers • Evaluate historical supplier performance, benchmarked supplier innovation and transformation experience, and track record of success in the key areas of capability required for successful delivery of the category requirement • Determine the alignment of business objectives between buyer and supplier • Assess the supplier's ability to successfully manage the influences in and impact of the market • Conduct Compatibility and Trust Survey to assess alignment between both parties for ease of relationship interface and management
Risk Management	• Buyer and supplier jointly define and document shared risk and shared reward clause for inclusion in the contract • Buyer and supplier jointly develop formal risk analysis, management and mitigation plan with defined tracking and measurement process • Buyer and supplier jointly develop formal *onboarding* and off-ramp process to ensure knowledge transfer, process continuity, and compliance requirements are met
Contract Approach	• Highly collaborative relational contract approach designed to be a flexible framework; statement of intent formally embedded into contract • Buyer and supply jointly develop master agreement for terms and conditions and explicit guardrails

Consideration	*Attributes*
	• Incorporate What's in it for We mindset with mutually agreed statement of intent • Include defined workscope—workscope focuses on "WHAT," not the "HOW"; supplier develops performance work statement • Contract structure includes all 10 Vested elements, including a comprehensive change management process defined in the contract schedule • Contract duration typically 5–7 years with a minimum of 3 years with an option to extend contract 1 year at a time up to 10+ years • Consider using evergreen provision to extend contract based on supplier's ability to create value against strategic desired outcomes
Pricing Model	• Pricing model with incentives to optimize for business outcomes and motivate supplier to invest in innovation • Supplier fee at risk with incentives for achieving and/or exceeding requirements and outcomes • Open book cost management where supplier provides all cost visibility • Clearly identified financial guardrails for both buyer and supplier • Margin matching mechanisms designed to keep buyer and supplier in financial balance • Win together, lose together
Category Management Governance	• Include appropriately scaled governance formally documented in contract • Incorporate governance mechanisms for contract compliance, financial management/budgeting • Decision protocol with issue escalation and resolution parameters • Performance management • Relationship management between internal stakeholders (typically three-tier structure with assigned budget and three levels of one-to-one interface for operating team; core relationship management team; executive team) • Business facilitates governance with cross-functional team; buyer plays support role • Appropriately scaled resources support various governance mechanisms with goal of having a high degree of business continuity over the sourcing cycle

Consideration	*Attributes*
	• Larger or complex outsourced services have a formal workscope transition and change management teams • Develop a plan for formal governance review meetings with a pre-established agenda for: strategy and relationships review, service review, commercial review, financial review, security and compliance review, quality and risk review, transformation review, and management process • Formal communication process, supported by planned cadence to ensure timeliness of interfaces
Supplier Relationship Management	• Identify and document planned opportunities for additional periodic supplier interaction at various levels of buyer and supplier organizations to review supplier performance • Buyer and supplier "business" own the relationship • Appropriately scaled SRM framework, including defining and documenting the following mechanisms in the actual contract: • Change management/commercial management • Two-in-a-box buyer–supplier interface structure • Formal escalation process • Formal decision-making process/rights clearly assigned • Formal continuity of resource plan to ensure consistent relationship interface (including *key man provisions* as appropriate) • Dedicated resource(s) focused on relationship management • Three-tier structure mirrors overall category management governance with clear and separate roles for relationship management, operation management, commercial/contract management, and transformation/innovation management • Formal communications protocol and plan • Formal continuity of resource plan including key man provisions for both buyer and supplier • Joint relationship management scorecard is defined and used to monitor relationship effectiveness • Yearly Compatibility and Trust Assessments used to monitor potential gaps in the relationship
Performance Management	• Focus on outcome-based strategic business objectives/desired outcomes

Consideration	Attributes
	• Balanced business scorecard jointly managed including operational, relational, and transformational key performance indicators (KPIs) • KPI's are perpetually tracked by both parties • Formal total cost of ownership tracking
Continuous Improvement / Transformation/ Innovation	• Formal transformation/innovation management framework • Defined processes and protocols for driving overall transformation initiatives through a jointly managed continuous innovation management process • Defined processes and protocols for driving day-to-day continuous improvement efforts or business problems that arise • Formal process documented for updating and managing any changes to the actual contract/ pricing model as part of governance
Compliance and Special Concerns	• Compliance with government and jointly developed requirements and practices perpetually monitored
Exit Management	• Termination criteria co-developed by buyer and supplier • Significant impact with supplier exit; develop a formal exit management plan addressing: • Budget for transition costs and resource allocation • Mutually agreed-on transition duration and pre-identified resource allocations estimates for off-ramp activity • Fair division of intellectual property rights • Fair allocation of assets and investments • Business continuity for stakeholders • Contract satisfaction and completion • Record of lessons learned

EXHIBIT A8 SHARED SERVICES: SOURCING CONSIDERATION CHECKLIST

Consideration	Attributes
Link to Business Objective	• Design or select the shared services organization (SSO) to drive cost efficiencies that support business/ user groups

Consideration	*Attributes*
	• Provide economic model descriptions (transactional, output, or outcome) to serve as a guide for the SSO to determine the appropriate link to business objectives based on the economic model used for a specific requirement
Requirements Analysis	• Conduct a review, document the historical solution, and define forecasted changes in use and demand as part of the requirement definition • Define a process and plan for updating requirement information • Define and document category requirement solution objectives and continuous improvement expectations
External Market Analysis	• Participate with the SSO in market analysis and best practices benchmarking continuously to identify opportunities to improve results • Design SSO market analysis reporting process to enable adequate updates to business stakeholders on market influences and impacts
Cost Analysis	• Establish baseline operational and management cost model using input from internal stakeholders against which the SSO cost performance will be measured • Compete a full business case justification for make versus buy decision • Develop a cost management reduction plan with internal stakeholders and SSO • Develop a spend reduction plan based on volume consolidation and leveraging with SSO aggregated volumes
Supply Market Assessment	• Benchmark SSOs in the market to validate the cost benefit and best practices of shared services solutions • Participate with SSO in supply market investigations and source qualification with focus on process efficiency and quality consistency • Investigate supply market periodically to evaluate cost and risk of this supply solution (i.e., could the SSO be spun off into a subsidiary, a candidate for acquisition. or workscope outsourced) • Prepare a supply base strategy based on the attributes identified from the supply market investigation • Investigate suppliers' positioning against market behaviors to ensure requirements can be met

Consideration	Attributes
Category Portfolio Segmentation	• Category portfolio segmentation indicates that the requirement is best managed through a shared services/equity business model; the same segmentation process will be used by the SSO (with possible support by the business unit) to determine the best sourcing business model to use for specific category requirements • Develop a category management plan prepared by the SSO with input from the business unit; SSO follows the appropriate process for managing each of the sourcing business models according to the spend requirement
Total Cost of Ownership Approach	• Build a TCO model to serve as a baseline against which the cost of the SSO to the business unit is measured • Participate with the SSO in developing category requirement specific TCOs • Build a plan that supports focus on overall category management and total supply chain costs using internal cost model; use joint efforts (SSO and business unit) to identify ways to streamline services provided, to improve quality or reduce costs, and to ensure that the business unit can meet objectives
Risk Assessment	• Participate in completion of a formal risk assessment and mitigation plans with the SSO; the SSO is responsible for managing and minimizing risk with periodic reporting requirements • Prepare a contingency plan should there be a need to change the sourcing business model (e.g., change to outsource to a supplier, spin off as a subsidiary) or change in external suppliers managing the SSO
Value Assessment and Balance	• Business unit focus: lower prices and costs; assured supply with captive supplier • SSO focus: increased volumes and the ability to invest in itself to improve capabilities and costs; assured demand with captive buyer
RFx Solicitation/ Bid Management	• 3–5 year solicitation cycle • Solicitation purpose is to seek a competitive fixed fee with improved cost management and cost savings • Define objectives setting and final decision criteria with business stakeholders; business management and business stakeholders participate in final selection of the supplier

Consideration	*Attributes*
	• Request for proposal or request for proposed solution is used if a buyer seeks cost savings commitments and other value drivers using an external shared services source • 4–6 months to select an external shared services provider
Supplier Selection Drivers	• Pre-evaluate core capabilities and cost management efficiency
Risk Management	• Prepare formal risk mitigation and management plans
Contract Approach	• 3–5 year complex services contract (for external shared services providers) with inclusions to mitigate and manage risk and cost efficiency internally • Formal memorandum of understanding or agreement between SSO and business unit • A periodic formally documented determination of measurements and cost objectives (for internal shared services provider)
Pricing Model	• Nonprofit model—Typically transaction fee charged to business unit; may use headcount or overhead allocation charge but not a preferred approach • For-profit model—Transaction fee charged to business units plus add-on fee (profit) • Rebates paid to business unit when transaction fees exceed cost • Annual reset of transaction fee (if internal SSO)
Category Management Governance	• Internal shared services: Organizational policies and procedures supported by organization design decision making and management provide governance • External shared services: Develop and document process for holding formal quarterly reviews supported by additional internal stakeholders
Supplier Relationship Management	• Business unit holds formal meetings with the SSO (minimum quarterly reviews); business unit is included in specific external supplier reviews as appropriate • Internal shared services: ❍ Relationships reflect organizational structure and cross-functional integration behaviors and decision making ❍ Escalation process follows the prescribed company protocols

Consideration	*Attributes*
	• External shared services: ○ Business unit plans regular interactions to ensure effective relationship development and decision making ○ Business unit defines a formal escalation process for service delivery issues • Business unit may be a member on the provider's category team
Performance Management	• Develop operational metrics based on chosen economic model (transactional, output, or outcomes) • SSO and business unit develop and use a formal operational and relational scorecard • Internal SSOs: ○ Use organizationally defined performance objectives ○ Develop cost-focused measures; business unit typically develops a formalized cost target tracking process ○ SSO and business unit create customer satisfaction surveys and develop a management plan • External SSOs typically managed as preferred, performance-based, or Vested
Continuous Improvement/ Transformation/ Innovation	• Business unit develops a formal capture and assessment process for improvement opportunities • Internal shared services: SSO follows the business requirements and objectives for continuous improvements and requires external suppliers to proactively identify and implement continuous improvement opportunities as part of the contracted requirements • External shared services: Contract includes defined guarantees for continuous cost improvements through efficiencies or alternate solutions
Compliance and Special Concerns	• Internal shared services: Follows business compliance protocols perpetually monitored • External shared services: Business unit creates an audit plan to verify supplier compliance with government and company-driven requirements
Exit Management	• High impact to business if internal SSO is outsourced or external SSO is exited • Internal shared services: Exit plans are part of overall business plan • External shared services: ○ Business unit develops a budget for transition costs and resource allocation ○ Business unit develops a formal exit management plan with longer duration transition allowance because of high impact to business operations with supplier removal and replacement

EXHIBIT A9 EQUITY PARTNERSHIPS: SOURCING CONSIDERATION CHECKLIST

Consideration	*Attributes*
Link to Business Objective	• Equity partner is purposely created to enable business strategy execution • Corporate objectives are developed jointly by equity partners; business and supplier stakeholders incorporate them into their specific performance goals
Requirements Analysis	• Requirements are provided as part of the standard business operation and execution process
External Market Analysis	• Use of market analysis and benchmarking to evaluate benefits of using an equity partner model • Use market analysis to determine influences and impact on the equity partner • Use SWOT (strengths, weaknesses, opportunities, threats) analysis to validate equity partner value and to determine appropriate adjustments in the model design • Establish competitive cost solutions with internal equity holding
Cost Analysis	• Build a cost model with hard and soft costs, and conduct an analysis of cost drivers • Assist in building a cost management plan focused on improving profit and loss (cost and revenue) • Cost management objectives are established and driven by the business, are focused on being competitive, and are tested by benchmarking • Focus of the equity partner is on profitability
Supply Market Assessment	• Use benchmarking to search for best practices, cost efficiency, and innovation practices in the supply market to compare to the equity partnership • Investigate the supply market to validate the equity partner position (i.e., leader or follower) and potential risks that could affect requirements delivery
Category Portfolio Segmentation	• Completed portfolio segmentation indicates the requirement is best managed with an equity partner business model • Develop a category management plan jointly with the equity partner

Consideration	*Attributes*
Total Cost of Ownership Approach	• Develop and use a TCO model to monitor cost improvements; the primary focus is on how costs (influenced by the buying unit's behavior as well as operational behavior) impact profit
Risk Assessment	• Prepare a contingency plan to mitigate any identified risks
Value Assessment and Balance	• Business unit: Lower total costs • Equity partners: Increased profitability and potential growth
RFx Solicitation/Bid Management	• 5+-year solicitation cycle seeking mitigation of risk and internal cost management
Supplier Selection Drivers	• Typically no choice: Business unit is directed to use equity partner
Risk Management	• Typically high-risk/high-reward scenario • Formalized use of company standard risk management planning process; associated with investments
Contract Approach	• Internal cross-departmental documented agreement for delivery of specified requirements
Pricing Model	• Shared costs and sometimes shared profits; predetermined markup based on company policies and financial objectives
Category Management Governance	• Formal monthly reporting and business reviews covered by company policies, procedures, and reporting structures • Business unit typically facilitates governance between key operational stakeholders and business management resources
Supplier Relationship Management	• Business unit may have a seat at monthly business reviews—may be part of business strategy planning process • Business unit may be included in business strategy planning process to address specific category requirement influences
Performance Management	• Focus is on TCO and potential profit impact measured against objectives influenced by the category requirement
Compliance and Special Concerns	• Compliance with government and company policies and practices perpetually monitored as part of the business protocol

Consideration	*Attributes*
Exit Management	• May or may not have high impact depending on the rationale for discontinued use of the equity partner • Exit (discontinued use of equity partner) contingency plans are developed by the business as part of the business planning process • Budgets are established and resources are identified and are included in the plan to manage transitions effectively

EXHIBIT A10

Link to the Free, Downloadable Toolkit, including Business Model Mapping Toolkit and Four Cornerstones Framework

www.vestedway.com/tools

NOTES

INTRODUCTION

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   Shared value thinking involves entities working together to bring innovations that benefit the parties—with a conscious effort that the parties gain (or share) in the rewards. Two advocates are Harvard Business School's Michael E. Porter and Mark R. Kramer, who profiled their "big idea" in "Creating Shared Value," *Harvard Business Review* (January–February 2011); https://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1; accessed January 28, 2015. The article states that shared value creation will drive the next wave of innovation and productivity growth in the global economy. Porter is renowned for his Five Forces

model of competitive advantage. Due to his prominence, it is likely that his take on shared value, although focused on society, will cause practitioners to embrace shared value approaches.

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32. All A&W and Long John Silver's franchisees are eligible to join the A&W National Purchasing Co-op, Inc. or the Long John Silver's National Purchasing Co-op, Inc., respectively.
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8 SELECTING THE RIGHT SOURCING BUSINESS MODEL FOR YOUR SITUATION

1. The original concept of Business Model Mapping came from Jacqui Archer. The initial Business Model Mapping template was developed as part of the *Vested Outsourcing Manual: The Guidebook for Creating Successful Business and Outsourcing Agreement* (New York: Palgrave Macmillan,

2011), in conjunction with Kate Vitasek, Jeanette Nyden, and Katherine Kawamoto. UT researcher Kate Vitasek later expanded collaborative efforts, and the concept of Business Model Mapping evolved to what is presented in this book. The authors would like to give special thanks to David Frydlinger, Donna Massari, Angela Easterwood, and Emmanuel Cambresy for their wonderful fieldwork, refinement, and validation of the Business Model Mapping concept.

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9 CONSIDERATIONS FOR CROSSING THE CONTINUUM

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2. According to Sourcing Innovation (http://www.sourcinginnovation.com/glossary/rfx.php), RFx, "one of the most common acronyms in the strategic sourcing and procurement landscape, is a catch-all term that captures all references to" requests for information (RFIs), requests for proposal (RFPs), requests for quote (RFQs), and requests for bid (RFBs). "The RFx process is probably one of the most difficult e-Sourcing processes to define as it can range from a simple one-time RFq to a complex multi-stage RFi/RFp/RFq process, depending on the needs of the project. The complexity of the RFx process is determined by, among other factors, the completeness of the requirements, the number of suppliers that have been qualified, expected competition in the supplier base, inherent risk in the sourcing effort, and projected savings or cost avoidance opportunities."
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5. Starbucks, "Ethical Sourcing: Coffee," http://www.starbucks.com/responsibility/sourcing/coffee.
6. Chick and Handfield, *Procurement Value Proposition*.
7. Conversation among David Handley, VCH vice president of business partnerships—lower mainland business initiatives and support services, Mary Morrison, Compass vice president of strategic markets, Compass Group Canada, and Bonnie Keith, December 2014.
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39. Vitasek et al., *Vested Outsourcing*.
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CONCLUSION

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APPENDIX

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GLOSSARY

This glossary is a condensed version of a comprehensive glossary that is available for download as part of our open source toolkit. The comprehensive glossary can be downloaded for free at www.vestedway.com/tools/.

Activity trap: One of Vested's ten ailments, which refers to outsourcing paradoxes typically found in transaction-based sourcing business models. The supplier is paid for every transaction, whether needed or not. The more transactions made, the more money the supplier makes. There is no incentive for the supplier to reduce the number of non-value-added transactions, because such a reduction would result in lower revenues. Refer to Exhibit A2 in the appendix for a complete list.

Agreement: When two or more parties are in consensus. In contracting terms, an agreement usually refers to a negotiated and typically legally binding oral or written arrangement between parties. Many use the term *agreement* in the same way as *contract*. See also **contract**.

Approved provider model: A transaction-based Sourcing Business Model in which goods and services are purchased from prequalified suppliers that meet certain performance or other selection criteria. Frequently an organization has a limited number of preapproved suppliers for various categories from which buyers or business units can select.

Approved supplier list (ASL): List of the suppliers approved for doing business with. The ASL is usually created by procurement or sourcing and engineering personnel using a variety of criteria, such as technology, functional fit of the product, financial stability, and past performance of the supplier.[a] Synonym: Approved Vendor List (AVL).

Arm's-length agreement: A transaction in which the buyers and sellers of a product act independently and have no relationship to each other. The concept of an arm's length transaction is to ensure that both parties in the deal are acting in their own self-interest and are not subject to any pressure or duress from the other party.[b]

Asset specificity: The use of a capital good for a narrow purpose. Asset specificity applies to capital designed to have a single function or labor trained to perform a single task, and has limited uses because of some inherent restriction on other possible uses.[c]

Attribute: In the Business Model Mapping Toolkit, an attribute is defined as a characteristic that is inherent in an organization's business environment. For example, switching costs range from low to high. The 25 attributes in the Business Model Mapping Toolkit were selected based on research that indicates an organization should consider different management practices based on the nature of each attribute.

Award fees: Fees paid at the conclusion of a fixed-duration agreement for achieving a desired goal.

Award term: An incentive in the form of contract extension. When a supplier meets annual goals, the contract is extended for an additional length of time.[c] Synonym: contract extension.

Balanced exchange: In negotiations, a term used to describe an equitable exchange. When one party takes value from a relationship, the other party must replace it with equal benefit. For example, I give you a $1 and you give me a widget worth $1.

Baseline: A basis for comparison set by monitoring the initial performance of a process. The baseline is used as a reference point to evaluate performance improvement efforts.[a]

Basic provider model: A transaction-based Sourcing Business Model that has a set price for individual products and services for which there are a wide range of standard market options. Typically these products or services are readily available, with little differentiation in what is offered.

Best fit: A sourcing solution that can effectively harmonize dynamic business requirements with evolving market forces.

Best value: An assessment that bases pricing decisions on the value associated with the benefits received, not on the actual prices or cost. It uses decision criteria that go beyond costs and include decisions on work scope and pricing based on intangibles such as market risks, social responsibility, responsiveness, and flexibility.

Blanket purchase order: An order the customer makes with its supplier that contains multiple delivery dates scheduled over a period of time, sometimes at predetermined prices. It is normally used when there is a recurring need for expendable goods. Hence, items are purchased under a single purchase order rather than processing a separate purchase order each time supplies are needed.[a]

Business continuity plan (BCP): A defined operational plan that is designed for implementation in the event of disruption of normal operations. Disruptions may be the result of natural disasters, civil or labor unrest, or other events.

Business happens: A Kate Vitasek colloquialism that refers to circumstances and occur unexpectedly and unplanned for in day-to-day activity. "Business happens" can refer to both good and bad surprises.

Business model: The plan implemented by a company to generate revenue and make a profit from operations. The model includes the components and functions of the business as well as the revenues it generates and the expenses it incurs.[c]

Business model mapping: A tool that is used to map 25 attributes of a specific spend category across a sourcing continuum. This enables users to identify the best Sourcing Business Model.

Business process outsourcing (BPO): The practice of outsourcing noncore internal functions to third parties. Functions typically outsourced include logistics, accounts payable, accounts receivable, payroll, and human resources. Other areas can include information technology (IT) development or complete management of the IT functions of the enterprise.[a]

Business requirements: The needs of business groups, business units, or even stakeholder users who consume the goods or services that are procured.

Business review: Periodic assessment of the commercial context of a business, its mission statement, goals, and strategic plan. The timing of reviews varies, but typically a review is held each quarter of the calendar year and is attended by senior managers of functional areas from both supplier and customer organizations. Often referred to as quarterly business reviews.[a]

Category: Refers to a group of products or services that share a common set of characteristics. A single product could belong to multiple categories; for example, detergents could be included in "Household Cleaning," "Non-Grocery," and "Liquid."

Category management: The process of overseeing a sourcing strategy for a specific spend category throughout the sourcing cycle.

Commodity: Any physical item that is traded in commerce. The term usually implies an undifferentiated product competing primarily on price and availability.[a]

Compatibility and Trust Assessment® (CaT): A diagnostics resource devised by Dr. Karl Manrodt and Dr. Gerald Ludlow that creates a 360-degree feedback mechanism around the most important constructs defining trust and compatibility in buyer–supplier relationships. The CaT is designed to test for buyer–supplier cultural fit across five dimensions. The more compatible a buyer and supplier, the more likely they are to build trust and be successful.

Competitive bidding: A common method of selecting sources for contract awards. Suppliers interested in participating in the process are asked to submit information on prices and/or other specified elements. Major public sector purchases commonly are awarded on a sealed bid basis, with the law requiring that the award be made to the lowest responsive and responsible bidder. In private sector purchasing, competitive bids usually are solicited from several suppliers with the stated intention of selecting those organizations with which negotiations subsequently will be conducted to arrive at a final contract award decision.[d]

Competitive dialogue: A procedure introduced into the European Union public procurement system in 2004 to provide an improved method for awarding complex contracts, such as those for public infrastructure and major information technology systems. The intent is to allow buyers and suppliers to collaborate on solutions.

Competitive differentiator: The ability to communicate what makes the company, product or service unique and to stand out from other companies, products or services within the marketplace.[a]

Contract (see also agreement): A legally enforceable written or oral agreement between two or more parties to provide specific goods or services. Although often used interchangeably with the term *agreement*, legal definitions of the two terms are different. Contract is defined in the Uniform Commercial Code Section 1–201 (11) as "the total legal obligation that results from the parties' agreement as affected by this Act and any other applicable rules of law."

Core competency: Those activities through which an organization achieves sustainable competitive advantage. A core competency is seen as a process that is central to the way an organization works. It fulfills three criteria: (1) It provides consumer benefits. (2) It is not easy for competitors to imitate. (3) It can be leveraged widely to many products and markets. A core competency can take various forms, including technical/subject know-how, a reliable process, and/or close relationships with customers and suppliers. It may also include product development or culture, such as employee dedication.[a]

Corporate hierarchies: A term coined by Oliver Williamson that describes a corporate structure with high administrative control and a legal system that is "deferential to the management."

Cost bar: The start of a cost analysis that breaks down the cost of the good or service into its individual cost drivers.

Cost model: A model that typically is designed to help the buyer do scenario what-if testing with cost drivers.

Cost-plus agreement: See **cost reimbursement.**

Cost reimbursement: A compensation model that fully reimburses a supplier for its actual cost plus an additional markup. The markup can either be variable or a fixed fee. By definition, cost reimbursement is a variable price agreement. A cost reimbursement approach is appropriate when it is too difficult to estimate a fixed price with sufficient accuracy and when the supplier will not agree to assume the risks associated with unknowns. For example, the U.S. government typically uses cost reimbursement compensation models with military defense companies that are developing new technologies for national defense. Synonyms: cost-based pricing, cost-plus agreement, cost reimbursement agreement.

Creative value allocation: A process outlined in the book *Getting to We: Negotiating Agreement for Highly Collaborative Relationships* that uses a systematic process for fairly allocating value.

Critical products/services: Also referred to as *strategic* products/service. Critical products and services fall under one of the four Kraljic Matrix quadrants. In general, these are products or services that are high tech and high volume, which are often supplied to meet customer specifications.

Desired outcomes: A term that defines collaboratively negotiated strategic business outcomes expressed in terms of a limited set—ideally, no more than five—of high-level success measures. Organizations spend the time collaboratively during the strategic sourcing process to establish explicit definitions for how relationship success will be measured. See also **outcome-based economic model.**

Driving blind disease: One of Vested's Ten Ailments. This ailment affects many business relationships: the lack of a formal governance process to monitor relationship performance and measure success. See Exhibit A2 in the appendix for a complete list.

Equity partnerships: A legally binding entity. Equity partnerships take different legal forms, from buying a supplier (an acquisition), to creating a subsidiary, to equity-sharing joint ventures or entering into a co-op arrangement. Equity partnerships are best used when an organization does not have adequate internal capabilities and does not want to outsource.

Evergreen contract: An automatic contract extension. Vested agreements often create such contracts, where the supplier earns a contract extension at the end of each year. For example, at the end of year 1 of a five-year contract, the supplier can earn a sixth year. At the end of year 2, the supplier can earn a seventh year. This in essence creates an evergreen contract with a rolling five-year contract duration that highly motivates the supplier to keep making investments in order to earn the contract extensions.

Exit management plan: A plan that facilitates a smooth, effective transition of service delivery, minimum disruption of ongoing delivery, and efficient completion of all agreement obligations. The plan is invoked with the issuance of a formal termination notice under the agreement, specifying: (1) the portion of services included in the scope of termination, (2) the estimated exit transition period and vendor delivery centers affected, and (3) the period of time following a termination notice that the parties will have to agree on the specific scope of transition services provided by the vendor.

Fixed-price agreement: An approach in which a supplier's price is agreed in advance and typically is not subject to adjustment. The parties agree on the fixed price, which includes the supplier costs and profit. A fixed-price agreement eliminates budgeting variation for the company. Because the total fee for the products and services is fixed, the supplier, not the company, absorbs the peaks and valleys.

Free rider problem: Based on an article written on the effects of unregulated grazing on common land, a free rider problem occurs when those who benefit from resources, goods, or services do not pay for them, which then results in either an underprovision of those goods or services or an overuse or degradation of the service.

Glidepath: A formula that defines the commitment of a supplier to provide continual cost savings over a specific span of time. The term is derived from an aircraft's line of descent to land.

Governance (in buyer–supplier relationships)**:** The management of cohesive policies, processes, and decision rights that enable parties to work together to effectively manage a spend category. In short, governance involves the development of processes that bring together the appropriate people, processes, and technology to keep a sourcing solution running as a well-run system.

Governance structure (in buyer–supplier relationships): The organizational framework by which an organization governs.

Guardrails: Agreement boundaries or structured parameters that provide clearly stated boundaries. Guardrails provide the team that is drafting an agreement with the authority to develop a deal within the clearly stated boundaries.

Innovators Dilemma: From Clayton Christensen's book of the same name. Organizations get attached to existing successful ways of doing business and fail to recognize what seems to be small or insignificant progress that often can "mature enough to make inroads into our playing field and have our lunch."

Investment-based model: An equity-based business structure in which the parties form a single balance sheet entity, also known as a merged in-source solution. This model can take different legal forms, from buying a service provider, to becoming a subsidiary, to equity-sharing joint ventures. Equity-based partnerships often are born out of a company's need to acquire mission-critical goods and services. These partnerships also often require the strategic interweaving of infrastructure and heavy co-investment. Most equity partnerships are in place on a continuing basis and often conflict with the desires of many organizations to create more variable and flexible cost structures on a company's balance sheet.

Joint venture (JV): A wide range of collaborative arrangements in which two or more businesses decide to share costs, management, and profits with a common goal. A JV is a legally binding business arrangement where each party contributes capital, intellectual property, personnel, and other resources to design and implement a new business.

Junkyard dog syndrome: One of Vested's ten ailments describing when the decision to buy usually means jobs are lost as the work and jobs transition to the supplier. See Exhibit A2 in the appendix for a complete list.

Key man provision: A contract clause that spells out requirement for the supplier and/or buyer to name key positions or even individuals in the contract as "key" (or essential) to the success of the relationship. Often such a contract clause states that certain individuals should stay in a role ranging from 18 month to 48 months.

Lock-in: A business situation in which organizations are obliged to deal only with a specific company

Margin matching: A technique used to fairly adjust actual prices to be paid based on movements in the defined underlying pricing model assumptions. This avoids having one party "win" at the other party's expense. Margin matching includes establishing a trigger point that activates to reset prices when the point is met. For example, the inflation rate might be a trigger point for resetting inventory carrying costs charges. The goal of using a margin-matching technique is to establish pricing fairness, which ultimately builds trust and a better working environment.

Market-based pricing: The price of the product is determined on the market and is generated exclusively by market circumstances such as demand, supply, stock positions, and the economic situation and political factors.[c]

Master agreement (MA): A legally binding contract entered into by two or more parties. The agreement goes into great detail regarding all its components. Because the parties intend to enter into future agreements with one another, they document in the MA terms that will govern future agreements. The same terms need not be negotiated again. Thus, the parties are freed up to negotiate deal-specific terms. See also **master services agreement**. Synonyms: requirement agreement, master services agreement.

Maverick spending: A term describing purchases made within an organization that are not in compliance with negotiated contract.

Measurement minutia: One of Vested 10 Ailments that states, "With the intention of ensuring accountability, the contract requires measuring everything—accumulating more data that can be managed or used for improvement purposes." See Exhibit A2 in the appendix for a complete list.

Multistep strategic sourcing process: (1) Recognition of need; (2) specification of need in terms of quality, quantity, and timing; (3) search for potential sources; (4) analysis of suppliers and proposals; (5) negotiation with and selection of supplier; (6) administering the contract; (7) evaluation of performance and feedback to supplier; and (8) disposal of excess, scrap, or surplus.[d] This book expands on the concept and suggests using 20 sourcing considerations instead of a multistep process because multistep processes are incomplete. (See chapter 1 for more details.)

Nash equilibrium: A game theory concept where the optimal outcome of a game is one where no player has an incentive to deviate from the chosen strategy after considering an opponent's choice. Overall, an individual can receive no incremental benefit from changing actions, assuming other players remain constant in their strategies. A game may have multiple Nash equilibriums or none at all.[b]

Net landed cost: The basic price inclusive of taxes, levies, transportation, all material and labor charges plus government or vendor service taxes as applicable.

Noncore competencies: Activities that are conducted within an organization that do not contribute to sustainable competitive advantage.[b]

Off-ramp: A term used to describe exit management clauses in a contract. Off-ramp clauses provide the buyer flexibility. The most common such clauses are termination for convenience and termination for cause. Performance-based and Vested sourcing business models should have more comprehensive exit management plans than these two simple off-ramp clauses.

Offshoring: The practice of moving domestic operations, such as manufacturing, to another country as a way to lower costs, avoid taxes, and the like. May or may not involve transferring employees. In many cases, organizations **outsource** to a supplier that then offshores the work. Offshoring is particularly common in for outsourced information technology and business process outsourcing workscope.

Operational-level agreement (OLA): An **i**nternal "back-to-back" agreement that defines how the buyer and supplier will work together. An OLA often includes hours of operation, responsibilities, authorities, response times, supported systems, and the like. OLAs tend to be more technical than in service-level agreements (SLAs) since they define information technology (IT). Not every SLA requires unique OLAs, and just a few key OLAs can help resolve the silo problem. However, it can be difficult to implement OLAs, especially between departments under different management. Implementing an OLA requires patience and the commitment of all involved as well as the recognition that each silo has its own job to accomplish. Of course, the common relationship all silos share is the provision and maintenance of IT services of all kinds to the business.

Outcome: Achievement of economic or strategic value as the result of doing something. Often an outcome can be achieved only when multiple parties work together collaboratively. As such, outcome-based thinking incorporates an end-to-end perspective, not just the workscope under control of the supplier.

Outcome-based economic model: An economic model in which a supplier is paid for the realization of a defined set of business outcomes, business results, or agreed-on key performance indicators. An outcome-based model typically shifts risk to the supplier for achieving the outcome but requires both buyer and supplier to work together to achieve the outcome. A well-structured agreement compensates a supplier's higher risk with a higher reward. See also o**utcome.**

Output: Achievement of a well-defined and easily measured event or a deliverable that is typically finite in nature. An output typically relates to the purpose/functionality of the good or service instead of the activities or inputs needed to create the good or service. A supplier can achieve outputs without help from a buyer. However, often a buyer has inputs to a supplier. As such, output-based metrics/service-level agreements should be based on only what is in a supplier's control.

Output-based economic model: An economic model in which a supplier is paid for achieving a prespecified output-based metrics. An output-based model shifts risk to the supplier for achieving the output but requires both buyer and supplier to work together to achieve the outcome. A well-structured agreement compensates a supplier's higher risk with a higher reward. See also o**utput.**

Overspecifying: A situation in which technical requirements are imposed that are not necessary for the functionality of the product or the delivery of the service.[b]

Performance-based logistics (PBL): A term used primarily in the aerospace and defense sector to describe the purchase of assets with a complete array of services and support in an integrated, affordable performance package. PBLs typically use a performance-based Sourcing Business Model. They can be structured as Vested models.[a]

Performance-based/Managed services model: A Sourcing Business Model that relies on a formal, longer-term supplier agreement that combines a relational contracting model with an output-based economic model. A performance-based model drives supplier accountability for output-based service-level agreements and/or cost reduction targets. This type of agreement typically creates incentives (or penalties) for hitting (or missing) performance targets.

Performance measure: An indicators of the work performed and the result achieved in an activity, process, or organizational unit. A performance measure can be financial, operational, or relational. Such measures enable periodic comparisons and benchmarking. Performance measures can be measures of activities, outputs, or outcomes.[a]

Performance measurement program: A program that goes beyond just having performance metrics in place. Measuring other important elements, like customer satisfaction and value generation, helps buyers realize the full benefit of their performance metrics..[a]

Performance work statement (PWS): A document that resides between a statement of objectives and a statement of work in terms of specificity. The buyer defines the expected results in the statement of objectives and solicits solutions from suppliers. The supplier then develops a PWS. A PWS directs the supplier to drive continuous improvement/transformation/innovation to fulfill the company's statement of objectives but goes into more detail than a statement of objectives. A PWS allows for input and innovation from the supplier in how it meets the organization's outputs or outcomes associated with the statement of objectives.

Perverse incentive: A direct negative reward or unconscious behavior that drives unintended consequences.

Physical asset specificity: The use of a capital good for a narrow purpose. Asset specificity applies to capital designed to have a single function or labor trained to perform a single task and has limited uses because of some inherent restriction on other possible uses. The more specific an asset, the lower its potential resale value or redeployability. Companies may be reluctant to invest in such assets in a poor or uncertain economy. When a company purchases a highly specific asset, this purchase is considered a sunk cost, as the asset likely will not be salable or usable for purposes other than its intended purchase.[b]

Portfolio segmentation: In strategic sourcing, the overall classification of either spend categories or suppliers. Sourcing Business Model theory classifies spend categories into seven sourcing business models based on 25 attributes.

Preferred provider model: Transaction-based economic model. A key difference between a preferred provider model and the other transaction-based models is that the buyer has made the strategic choice to move to a more strategic relational model. As such, buyers that work with specifically chosen supplier(s) assume a more collaborative relationship. Repeat business and longer-term and/or renewable contracts are the norm.

Price creep: Refers to increased costs associated from changes that occur when a good or service has not been properly specified. It is generally considered harmful. See also **scope creep.**

Pricing model: The mechanism organizations use to establish the price(s) between a buyer and its supplier. A pricing model is different from price as it includes mechanisms to determine the optimum monetary exchange between and buyer and supplier, not just a negotiated price. We use the term *model* because in many cases prices change for various business reasons. In most cases, a pricing model consists of a spreadsheet. A good pricing model

- Is dynamic and enables the parties to adjust underlying pricing assumptions of the various pricing model components. Pricing model factors include the compensation method (e.g., fixed price, cost plus, hybrid), input assumptions, total costs and best value assessment, risk allocations, margin matching, and contract duration.
- Equitably allocates risks and rewards to realize mutual gains for the duration of the agreement.
- Allows buyers to align a supplier's payment with value received, in essence validating that a company gets what it pays for.

Process metric: Measurement of the success of a process. Output-based metrics are typically process metrics.

Relationship management: The practice of establishing joint policies and processes that emphasize the importance of building collaborative working relationships, attitudes, and behaviors. The structure, by necessity, is flexible and provides top-to-bottom insights about what is happening with the desired outcomes and the relationship between the parties. Relationship management is a comprehensive approach to managing an enterprise's interactions with the organizations that supply the goods and services it uses. The goal of relationship management is to streamline and make more effective the processes between an organization and its suppliers. This is most definitely not a whose-throat-to-choke exercise; rather, it is the establishment of processes for communication, reporting, and improvement (also referred to as supplier relationship management).

Relationship model: A concept based on Dr. Oliver Williamson's pioneering work that classifies an organization's sourcing needs into three categories: "market" (transactional Sourcing Business Models), "hybrid" (relational/hybrid Sourcing Business Models), and "hierarchical" (investment-based Sourcing Business Models).

Request for partner: A highly collaborative process used when a buyer is actively seeking not just a solution from a supplier but also the ability to assess multiple providers' cultures, mindsets, and willingness to engage in a collaborative relational contract. A request for proposed solution is a key part of the process and is used when selecting a supplier for a Vested sourcing business model.

Request for proposal: Used to obtain pricing as well as a detailed description of services, methodologies, program management, cost, and other support provided by the supplier. A request for proposal allows a buyer to specify requirements but begins to allow suppliers to define some of the "how." For example, a buyer may ask a supplier to outline how it proposes to manage quality. Synonym: invitation for proposal.

Request for proposed solution: A collaborative process used where an organization has a dialogue with potential down-selected suppliers. It is different from a request for proposal because the buyer does not know the solution; rather it asks suppliers to propose the most appropriate solution.

Requirement: The needs and wants of business groups, business units, or users who consume the goods or services that are procured. Requirements may cover discrete specifications, quality conditions, regulatory compliance, special handling, shelf life, volumes, or any other attributes that define the needs and wants of the business.

RFx: A request to suppliers to make submissions to a purchasing organization. One of the critical documents in the RFx is the specification/statement of work. There are various types of RFxs: IFP, RFP, RFQ, RFS.[d] Synonym: solicitation.

Sarbanes-Oxley (Sarbanes-Oxley Public Accounting and Investor Protection Act; SOX): A U.S. federal law enacted on July 30, 2002, to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. The law is divided into 11 sections ranging from additional corporate board responsibilities to criminal penalties.

Scope creep: Refers to uncontrolled changes or continuous growth with associated workscope. Scope creep is very common when buying services such as construction or software development. It can occur because the buyer adds on additional specifications or when the scope is not properly defined, documented, or controlled. It is generally considered harmful. Synonym: requirements creep.

Scope sweep clause: A contractual clause where a supplier is asked to include (or "sweep") additional services under a defined statement of work document. These additional services usually are intended to be incidental and minor, but all too often the additional scope creates scope creep for a supplier, which creates pressure on the supplier's profit.

Service credit: A mechanism by which an adjustment to pricing is made if actual supplier performance fails to meet the performance standards set in the service levels. Service credits can be defined in terms of a credit that is received rather than an amount deducted. Synonyms: malice payment, penalty provision.

Service-level agreement (SLA): A documented agreement between a buyer and supplier that identifies services and service targets, including prerequisites for service levels and measures for performance.

Shared services model: An internal organization based on an arm's-length outsourcing arrangement. Using this approach, processes typically are centralized into a shared services organization (SSO) that charges business units or users for the services they use. SSOs leverage the company's global corporate resources and contract with outsourcing partners to deliver cost-competitive one-stop services to their entire enterprise. A Shared Services Model is a type of Sourcing Business Model.

Shared value: A mutual commitment to establish economic benefits for all parties. In essence, shared value thinking involves entities working together to bring innovations that benefit them through a conscious effort to gain (or share) in the rewards. This shared value thinking is what the University of Tennessee researchers have named what's in it for we (WIIFWe).

Shared vision statement: The statement that sets forth the larger, guiding principles for the business relationship and the purposes for the relationship. A shared vision statement is an essential element of a Vested Sourcing Business Model.

Sourcing Business Model theory: A theory that suggests sourcing should be thought of a business model between a two parties with the goal to optimize the exchange. Sourcing Business Models are based on two factors: **relationship model**s and **economic models**. The seven Sourcing Business Models are (1) basic provider, (2) approved provider, (3) preferred provider, (4) performance-based model, (5) Vested business model, (6) shared services model, and (7) equity partnership. Each Sourcing Business Model creates a system to optimize for the business situation. An organization uses a Business Model Mapping template and assesses 25 **attribute**s to determine which Sourcing Business Model is best suited for their situation.

Sourcing strategy: The approach an organization uses to buy and manage goods and services in a spend category. Typically a sourcing strategy focuses on the highest spend categories an organization purchases and consumes.

Spend analysis: Analysis of the historical spending patterns in an organization, usually by commodity or category. This analysis provides information about the types of items purchased and their cumulative dollar value, which becomes the substance for future strategic and operational purchase planning.[d]

Spend category: Goods or services with similar characteristics that are grouped together for planning and management purposes. For instance, furniture could be a spend category for an organization and have subcategories consisting of the desks, chairs, tables, and cabinets purchased by the organization during the year.

Statement of intent: Within a relational contract, a formal document between buyers and suppliers that commits them to constructive working relationships, attitudes, and behaviors. The book *Getting to We* outlines how to create a statement of intent.

Statement of work (SOW): A formal document that outlines the workscope between a buyer and a supplier. A SOW is typically a schedule or appendix in a formal contract. The level of detail in a SOW should vary based on the Sourcing Business Model. Performance-based and Vested models focus on the "what," not the "how"; as such, the SOWs should be less prescriptive in nature but should be reinforced with the supplier developing a performance work statement.

Tender: A process where organizations invite bids or proposals for projects.[d]

Termination for cause: Provision in a purchase order or contract that allows for unilateral ending of the contract, either in whole or in part, due to some behavior of the other party, usually breach or default.[d]

Termination for convenience: Provision in a purchase order or contract that allows for unilateral ending of the contract, either in whole or in part, without fault of the other party. Termination for convenience is not provided for by law itself and requires a specific contract provision.[d]

Tiered governance structure: A formal mechanism for decision making (both escalations and approvals). More complex and strategic relationships often use a three-tier approach, with an operational, a management, and an executive level. The process provides an opportunity to assess multiple providers' cultures, mindsets, and willingness to engage in a collaborative performance-based or Vested relationship.

Transaction: A unit of business exchange typically associated with performing an activity: for example, answering a call, working an hour, producing a widget.

Transaction costs: Costs that occur when participating in a market. The level of transaction costs depends on three important factors: (1) transaction frequency, (2) level of transaction-specific investment, and (3) external and internal uncertainty.

Transaction cost economics (TCE): A methodology through which to analyze how the governance of economic organization affects economic value.

Value: The regard that something is held to deserve; the importance, worth, or usefulness of something. Typically there is an estimation of the monetary worth of something.

Value balancing: A process of creating a balanced exchange between a buyer and a supplier with the goal of creating economic equilibrium. Typically, buyers think of value in one direction. However, to create equilibrium, buyers must think in terms of a two-way exchange of value.

Value-based purchasing: Purchasing goods or services based on value received, not tied to the actual costs.

Vested®: Vested is a hybrid business model, movement, and methodology that enables true win-win relationships in which parties are invested in each other's success. Vested combines a relational contract with an outcome-based economic model. When applied, a Vested approach fosters a highly collaborative environment that sparks innovation, resulting in transformation, improved service, and reduced costs.

Vested ten elements: Ten essential "elements" that follow the Vested Five Rules. Buyer and supplier relationships that structure their agreement based on the ten elements were found to have a high degree collaboration and success in driving transformation and innovation.

Volume banding: A technique where a buyer and a supplier agree on a fixed price at various volume thresholds. Prices remain constant within a prespecified band of purchasing commitment. If volumes increase above the band, the price per transaction typically goes down. If volumes decrease, the buyer agrees to pay a higher price for each unit/transaction. Volume banding is an especially important concept when there is a great deal of variability in volume. It is used to maintain fair profits for suppliers in the event of volume changes.

Watermelon scorecard: A term coined by University of Tennessee researchers to explain the concept that a supplier can meet a buyer's required specification while not proactively collaborating to drive innovative value over the long term for the buyer. In essence, the scorecard is green on the outside but red on the inside.

What's in it for me (WIIFMe): A power approach to negotiation that centers on getting the best possible deal for oneself.

What's in it for we (WIIFWe): A collaborative mindset that seeks a true win-win solution, ensuring all parties share risk and benefit.

Workload allocation: A Vested term that describes maximum integration (management and visibility) of the entire business process. The organization and the service provider work together to optimize the end-to-end process rather than focusing on process effectiveness specific to the internal company.

Workscope: A generic term used to define the work that a supplier will perform under a contract. Workscope is often defined as a combination of type of work (activities, output, outcomes) and breadth of work (geography, business units). Organizations typically define workscope in a formal statement of work or a performance work statement.

Zero-sum games: Associated with game theory. A situation in which one person's gain is equivalent to another's loss, so the net change in wealth or benefit is zero. A zero-sum game may have as few as two players, or millions of participants.[b] In contrast, a non-zero sum game is a situation where one person's gain does not impact another person's gain or loss.

Definitions are original or are taken or adapted from these sources:

[a] Council of Supply Chain Management Professionals Glossary of Terms; https://cscmp.org/research/glossary-terms

[b] www.investopedia.com; http://www.investopedia.com/dictionary/.

[c] From Arjan J. van Weele, *Purchasing and Supply Chain Management*, 5th ed. (N.p.: Cengage Learning EMEA, 2009).

[d] Institute of Supply Management Glossary of Terms; https://www.instituteforsupplymanagement.org/glossary/.

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