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SIG

Unpacking Pricing Models

Unpacking Pricing Models:

Make “you get what you pay for” Real for Business Relationships

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EXECUTIVE SUMMARY — YOU GET WHAT YOU PAY FOR

Perhaps no other topic creates as much apprehension between a buyer and a supplier as trying to negotiate a fair price for a product or service. The conventional procurement process puts buyers and sellers on opposite sides of the table until the parties "get to yes." While a buying company and service provider often "get to yes" and go on to establish a business agreement, they will frequently face renegotiations. Buyers especially become frustrated — frequently blaming suppliers for not honoring their original price. Rather than being frustrated, buyers should look in the mirror and say, "Did I get what I paid for? And if not — why?"

We believe the primary reason is that the process for establishing pricing between buyers and suppliers is broken. How so? At the heart of the misalignment is the fact that conventional sourcing business models typically result in the buyer company and their supplier establishing a "price" that reflects the circumstances at a point in time when the business agreement is established. A "price" is not responsive to changes in the scope of work, in the market, or in corporate strategy. In addition, many companies do not take the time to use more advanced sourcing business models and pricing mechanisms that are designed to keep a buyer and supplier relationship in equilibrium as "business happens."

Our premise is that if you are not happy with your "deal," or your business relationship, look closely at your sourcing business model and pricing mechanisms rather than rush out to bid and switch suppliers. This white paper helps companies see that "you get what you pay for" is in direct correlation to how well they match the right tools to the right business needs.

This white paper is divided into three sections:

- **Section I defines and explains the various tools in a business professional's toolkit**, with the goal to help buyers and suppliers understand the nuances of the various approaches available to help craft great deals. We address six common questions with which organizations often struggle.
- **Section II provides an in depth review of aligning the right pricing mechanisms with the right sourcing business model**, a key success factor in eliminating unwanted perverse incentives that often occur when companies use an improper combination of sourcing business model, compensation method and pricing approach.
- **Section III challenges buyers and suppliers to negotiate prices with a different lens**. Transparency and an approach that encourages the parties to have deeper and more meaningful economic discussions will expand their agreement zone with one based on shared risk and shared reward – not simply shifting risk.

We conclude with a call to action for practitioners to evaluate existing pricing models to ensure their appropriateness for the business.

INTRODUCTION

Why do so many companies find themselves back at the negotiation table after they have negotiated a “deal?” We believe it is the nature of the pricing process itself that causes consternation.

There are three significant reasons for discord. First, dissatisfaction is often directly related to the pricing approach used (or more appropriately a lack of a well thought-out and aligned approach). In their rush to “get to yes” parties negotiate and lock-in early on a “price” — only to find that business conditions change, unknowns become discovered and now the price is no longer “fair.” In the logistics and transportation industry “cost creep” is the number one reason why buyers and suppliers are frustrated with their outsourcing deal.[1] Other industries have similar studies. We advocate for companies to understand and know when to use a “price” versus a “pricing model.”

A second reason stems from companies adopting a muscular, lowest-price-possible mindset in which buyers aim to squeeze short-term price concessions from their suppliers. In fact procurement philosophies introduced in the 1980’s, such as the Kraljic Model,[2] encouraged businesses to assert their *buying power* to condition their supply chains and force a change in the demand curve in order to lower dependency on suppliers. This has led to over-commoditization in many industries as companies seek to “bid and transition” as a way to pit supplier against supplier. The more companies apply these dominating I-win-you-lose methods, the more suppliers hunker down to protect margins and use short term tactics to win the business, knowing they will be back at the table with tactics to increase their price once work is transitioned.

Finally — and all too often — companies rely on a conventional transaction-based business model rather than using more appropriate outcome or investment-based sourcing business models that will best meet their business needs. Research conducted by the International Association for Contract and Commercial Management (IACCM) validates that most companies operate in a conventional transaction-based model that is constrained by formal, legally oriented corporate policies.[3] There is growing awareness that this approach is lacking the dynamic nature of today’s business environment and does not always give each party their intended long-term results. Rather, it often creates perverse incentives and missed opportunities to drive investments and innovation.[4]

Bottom line: companies that want to prevent these common traps should start by first understanding — and using — the right tools. They then must proactively align the right pricing mechanisms to the right sourcing business model that best fits their sourcing situation. The next section starts with the basics, providing answers to six common questions we often get about some of the most used, and often misused, tools.

SECTION I: UNDERSTANDING THE BASICS — KNOW YOUR TOOLKIT

A basic understanding of your toolkit is essential for ensuring you are using the right sourcing business model and aligning the right pricing mechanisms for your business needs. Each of the following terms represents key concepts that have evolved over time as business itself has evolved. All too often individual business professionals are not using the right tools. Terms that are defined and used frequently are emphasized in bold italics.

Price vs. Pricing Model — Am I Using the Right Approach?

So what exactly is the difference between a "price" and a "pricing model?" A ***price*** is how much you pay for something. You pay $3.25 for your Starbucks grande two pump vanilla latte. A call center supplier may have a price of $.50 per minute every time an agent picks up the phone and acts as a company's customer service representative.

A ***pricing model*** is fundamentally different because it includes mechanisms to determine the optimum monetary exchange between a buyer and a supplier. We use the term *model* because a good pricing model is often dynamic and enables the parties to adjust the underlying pricing assumptions as "business happens." This 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 purpose of realizing mutual gains for the duration of the agreement.

In some cases a pricing model simply includes actual costs, volume targets, and incentives. 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 a company is "getting what it pays for."

Common factors affecting a pricing model include:

- **The *total cost*** (defined later) **build-up and *best value*** (defined later) **assessment.** While closely related, there are differences between total cost and best value. A total cost of ownership analysis determines all direct and indirect costs so that clear pricing decisions can occur. The best value assessment then goes beyond total costs to include decisions on work scope and pricing based on intangibles such as market risks, social responsibility, responsiveness and flexibility.

- **Underlying financial and operational assumptions.** Common assumptions include unit costs, the costs of raw materials, market share estimates, currency assumptions and base exchange rates, inventory and workload mix.

- **Risk allocation.** Rather than shifting the risk, a pricing model seeks to jointly identify risks, understanding potential risk costs, determining which party is best suited to manage and mitigate risks, and establishing a risk premium for the party who agrees to bear the risk.

- **Desired *compensation method*** (defined later). Setting the correct compensation structure requires an intimate understanding of the operational risk involved in doing the work. There is no "right answer" when it comes to selecting the compensation method for the pricing model; rather the objective is to create a flexible pricing structure that enables companies to use the method – or combination of methods - that best fits the nature of the work performed.

- ***Margin Matching*** (defined later) **triggers and techniques.** Margin matching is a mechanism that allows companies to address market events and fluctuations as "business happens." Margin matching enables companies to fairly adjust prices based on movements in the defined underlying pricing model assumptions and avoids having one party "win" at the other party's expense.

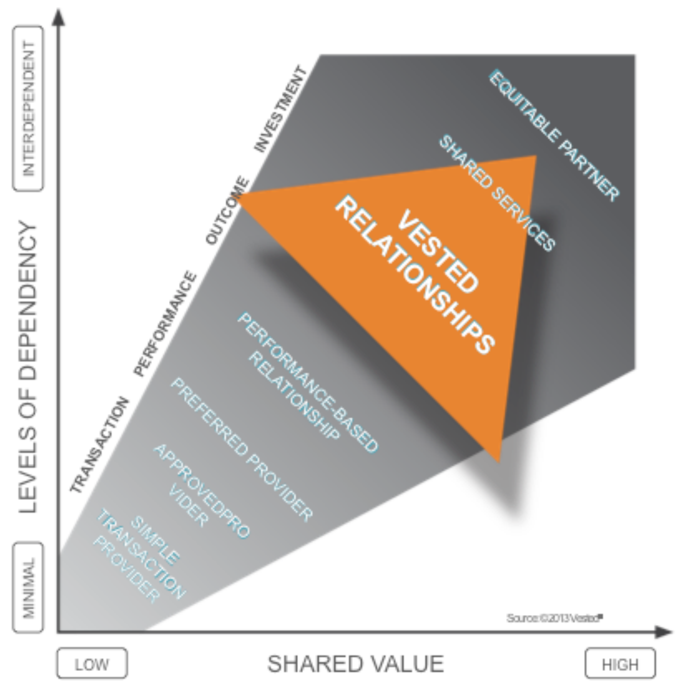
- **Contract duration.** Contract length is an essential element of a pricing model because achieving step-level improvements can take time and a significant investment on the part of the service provider. Longer-term agreements often are needed to achieve the Desired Outcomes and the term can affect how some costs are amortized over the life of the agreement.

- ***Incentives*** (defined later). Coupling incentives to business agreements is certainly not new, but it is not common either. It is also easier said than done. The key is to design the right mix of incentives that align interests. Companies should incorporate incentives that are mutually beneficial to the parties in order to offset the flaws of using conventional compensation methods.

The big question becomes "when should I shift from using a 'price' to a 'pricing model'?" The simple answer: companies should use a "price" when the business exchange is simple, predictable, and there is no opportunity to create value beyond simply acquiring the good or service. Companies should shift to a pricing model when the work is more complex, variable in nature, and there is a higher likelihood of creating value by working more closely with suppliers (e.g. reducing costs, innovating).

Am I Using the Right Sourcing Business Model?

FIGURE 1



Getting a good business deal starts with using the right sourcing business model. The University of Tennessee, Sourcing Interests Group (SIG), the Center for Outsourcing Research and Education, and the International Association for Contract and Commercial Management outlined seven sourcing business models in a joint white paper, "Unpacking Sourcing Business Models; 21st Century Solutions for Sourcing Services" (free download here).

Figure 1 shows the Sourcing Business Model Framework.

The Unpacking Sourcing Business Models white paper emphasizes companies should look to business characteristics to determine the correct sourcing business model for what is purchased or outsourced. The paper also advocates for buyers and suppliers to use more sophisticated outcome-based sourcing business models for more strategic relationships that have the ability to create value and drive innovation.

Figure 2 (following page) maps the seven sourcing business models to the four main categories of sourcing business models.

Figure 2 — Sourcing Models

Sourcing Model	Sourcing Business Model Categories			
	Transaction Based	Outcome Based Models		Investment Based
		Performance Based/ Managed Services	Vested	
Simple Transaction Provider	X			
Approved Provider	X			
Preferred Provider	X			
Performance-Based / Managed Services		X		
Vested Relationship			X	
Shared Services (internal)			X	X
Equitable Partner (external)				X

General Rules of Thumb:

As a general rule of thumb a **transaction-based pricing model** is effective for *simple transactions with abundant supply, low complexity, and little asset specificity (unique or custom requirements).* For example, if a company can buy the same widget from 100 different suppliers, a transaction-model is ideal. Companies that want to strengthen ties with their supply base will often choose to create "approved" or "preferred" supplier categories – often creating master services agreements for suppliers with whom they do ongoing business.

The general rule of thumb for shifting to an **outcome-based model** is to drive a step function change in performance and costs. Performance-based agreements typically shift risk to the supplier and guarantee savings while a **Vested sourcing business model** is better suited for a highly collaborative supplier relationship with the goal to drive innovation and share risk and reward.

Lastly, the general rule of thumb for applying an **investment-based business model** is when the buying companies believes they can create more value by performing work in house – either in a functional group or through direct investment (e.g. a joint venture).

Section II of this white paper goes into more detail on each of the sourcing business models and the appropriate pricing mechanisms to use with each sourcing business model.

What Compensation Method is Best — Fixed Price or Cost Plus?

No matter which is used — a price or a pricing model — companies must determine their compensation method. A ***compensation method*** is the mechanism that a buyer uses to trigger payment to the supplier. Most companies rely on one of two compensation methods for their business arrangements: ***fixed price*** or ***cost reimbursement***. In each case, the buyer is expected to pay the supplier for its costs and an acceptable profit margin. These two compensation methods have ***inherent perverse incentives*** (defined later). Each is discussed below.

A ***cost-reimbursement*** compensation method pays the supplier its actual costs in performing a service plus a markup. By definition, cost-reimbursement is a variable price agreement, with fees dependent on the amount of service provided over a given time period. Cost-reimbursement works well when the actual costs are not completely known in advance and neither party is willing to bear the risks of "guessing" badly at what a "fair" price should be. Suppliers make a profit in one of two ways: either by charging a "markup" based on the actual costs (e.g., costs plus 10%) or passing through the cost with no markup and charging a "management fee."

One downside to a cost reimbursement method is that it may encourage suppliers to be careless in managing costs. Why? Suppliers that overspend, increase the scope and scale of work, or deliver more services than may be needed are unfortunately rewarded with additional profit. Sophisticated benchmarking, cost accounting and productivity tracking can help mitigate this risk.

In a ***fixed-price compensation method*** the buyer and supplier agree in advance to a "price." The fixed price may relate to an individual transaction (e.g., price per call, per minute, per FTE, per unit, per shipment, per square foot, etc.) or to a bundled set of transactions together (e.g., fixed monthly management fee to manage an IT maintenance). Fixed price per transaction compensation methods are popular in many industries — including logistics outsourcing, Information Technology (IT) outsourcing and facilities management outsourcing.

An agreed upon price is typically not subject to adjustment for a set period of time. Because the fee for the transaction is fixed, the supplier absorbs the peaks and valleys rather than the buying company. A supplier's ability to manage costs directly impacts its ability to make a profit. A fixed price method is best used when budget predictability and administrative efficiency is more important than pricing accuracy.

Unfortunately, many risks are uncontrollable or unknown. For example, Cost of Living Adjustments (COLA), Foreign Currency exchange rates, or commodity prices (such as fuel, electricity or sugar) fluctuate. If the supplier is negatively impacted by these fluctuations, it likely will do whatever it takes to mitigate the profit impact. In fact, once a "price" is established, the profit maximization motive inherently encourages a supplier to cut costs and take undeclared risks, delivering products or services at minimally acceptable technical specification levels or reduced safety or reliability. This isn't inherently immoral or evil, it's simply how economics work.

One way a buyer can mitigate this risk is to include key performance metrics or service level agreements (SLAs) that define minimum quantitative levels of quality expected for the price paid. Often buyers levy a "penalty" on the supplier for missing key metrics or SLAs. Some suppliers view penalties as a hammer to punish bad behavior. But in reality metrics or SLAs are simply mechanisms that buyers can employ in an attempt to maintain good economics. After all it makes sense that if performance goes down, the penalty would ensure the price goes down. Unfortunately, penalties for SLAs do not always drive the right behavior. For example, a BPO (Business Process Outsourcing) supplier would review performance mid-month. If it was going to miss an SLA it would determine the cost of hitting the SLA and often decide that it made better economic sense to simply miss the SLA and pay the penalty. Even worse, if SLAs are not properly targeted they can force the supplier to focus on performance that does not drive buyer satisfaction.

Some service industries are seeing an evolution in fixed priced compensation methods to what is known as a ***Managed Service*** model (also known as **performance-based contracts**), where a supplier typically guarantees a fixed fee with a pre-agreed price reduction target (e.g. 3% year over year price decrease) with the assumption that the supplier will deliver on productivity improvements. These guaranteed savings are often referred to as a "glidepath" because the buyer will see an annual price reduction over time.

On the surface it would seem a managed services approach is a "good deal" for the buyer because it pushes the risk to the supplier through the guaranteed savings. Managed services models are in essence a "bet" by the supplier in the beginning of a contract term that if it can drive improvements in excess of the guaranteed savings, that it will reap the benefits — with the potential for surprisingly high margins. The positive is that the buyer enjoys certainty.

Many suppliers who manage highly complex outsourcing deals have mastered "managed services" to their fullest advantage. They happily sign multi-year agreements that lock in future revenue (large IT outsourcing deals can span 10 years and be valued in excess of $1 billion in revenue for the supplier). These suppliers recognize that many of their clients have plenty of improvement potential. Once the work is transitioned to their span of control they often offshore and automate activities to drastically lower their costs and allow efficiency gains that may lead to the supplier "winning" far more than the guaranteed glidepath savings. Let's say a BPO supplier was able to use its system to automate the accounts receivable and accounts payable process for the client and eliminate 70% of the workers. Under typical managed services contract the supplier would only have to share the savings with its client at a rate of 3% a year. This may make sense at the time of the contract signing — after all the supplier took on the risk when by "betting" it could deliver the service at the glidepath savings rate.

As mentioned above, the best suppliers have become very savvy at "winning" in a managed services agreement. In research conducted by the University of Tennessee, we have seen managed services deals where the supplier was earning in excess of 80% margin. Typically when a buyer senses the supplier has "won" at its expense in a managed services relationship one of three things happens: the buyer either seeks to bid out the work to "test the market" at the end of the contract term, the buyer introduces additional suppliers into the mix to help rebalance power through competition, or the buyer seeks to ask the supplier to move to an ***open book*** approach (discussed below) with some form of ***gainsharing*** incentive (also discussed later).

Open or Closed-Book Approach? Is There a Benefit?

A ***closed-book*** approach bundles the supplier's and buyer's costs and margin — in essence hiding each party's profit margin. An ***open book*** approach is transparent and buyers and suppliers see each other's costs and profit margin. A common misconception is that a cost-reimbursement compensation method is an open book approach. This is not necessarily true. While the actual "costs" may be passed through, the "management fee" markup may not reveal the suppliers actual costs to perform the management services. Open book approaches are transparent and allow a buyer and supplier to build a fact-based discussion around actual costs. The primary benefit of an open book approach is that it enables the companies to understand true costs. Looking at true costs allows companies 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.

What Types of Incentives Can I Use?

An ***incentive*** is typically a reward for the supplier, but can also be a reward for a buyer. When speaking of incentives, most people think of ***tangible incentives*** given to a supplier for a job well done. However, it is important to understand that some of the most powerful incentives are ***inherent incentives,*** 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, compensation method and pricing approach (price vs. pricing model).

Inherent incentives are very powerful because they naturally drive behaviors between a buyer and supplier — often creating very positive or negative results. Unfortunately, many companies often do not realize the inherent incentives they create as a result of the combination of a sourcing business model, compensation method, and pricing approach. In fact, many business relationships become strained (or at least stressed) because of inherent perverse incentives. A ***perverse incentive*** is a direct negative or unconscious behavior that drives unintended consequences. (Appendix 1 highlights 10 common perverse incentives found in buyer-supplier relationships.)

No matter the type of incentives used, we recommend keeping incentives as simple as possible. There are several types of incentives; some of the most common are described below.

- ***Gain-share/cost savings incentive*****:** A monetary incentive in which the company and the supplier share cost savings. The purpose of gain-sharing is to encourage the parties to drive out non value-added activities and reduce costs. Some companies also apply a penalty (often referred to as "**painshare**") for companies that do not achieve pre-defined cost saving targets or other performance targets.

- ***Pay for Performance Incentive*****:** An incentive that is typically tied to specific performance requirements. The desired performance is typically stated in terms of a quantitative service target — such as percentage on-time completion, quality/DPPM (defective parts per million), throughput, uptime percentage — and/or qualitative targets (customer satisfaction). A performance incentive is ideally designed to tie the supplier's profit to the achievement of the specific targets. The incentive fee can be fixed or variable, but always corresponds to specific, agreed upon targets. Performance incentives can be an effective way to encourage performance provided that the incentive is worth more than the effort to achieve it.
- ***Award Fee****:* Award fees are paid at the conclusion of a fixed-duration agreement for achieving a desired goal. Award fees can be fixed or variable and are typically 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. Like performance incentives, for award fees to be effective, the value of the award fee must exceed the cost of achieving the result.
- ***Non-Monetary 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 can be powerful, intangible incentives that increase visibility and market worth. 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 non-monetary incentives to a well-positioned supplier. On the other hand, a customer that is relatively small, but well regarded in its industry may be very well positioned, particularly if its industry is one that supplier considers strategic. Non-monetary incentives can play a significant influence in rewarding intangible or hard-to-measure effort.
- ***Award Term (Contract Extension****):* A great incentive for a supplier is more business (provided it is profitable business for the supplier). An Award Term is an automatic renewal/contract extension that is added when a supplier meets agreed targets. In some cases, especially Vested agreements, Award Terms are used to create a long-term "evergreen" contract where the buyer automatically extends the contract. If a deal is distressed, an Award Term is an excellent incentive for a supplier to complete a "get well plan" aimed at correcting the dysfunctional relationship.
- ***Rebate/Volume Discount*****:** A financial reward a supplier gives a buyer for buying goods or services. Typically a rebate is provided when suppliers hit certain volume targets.

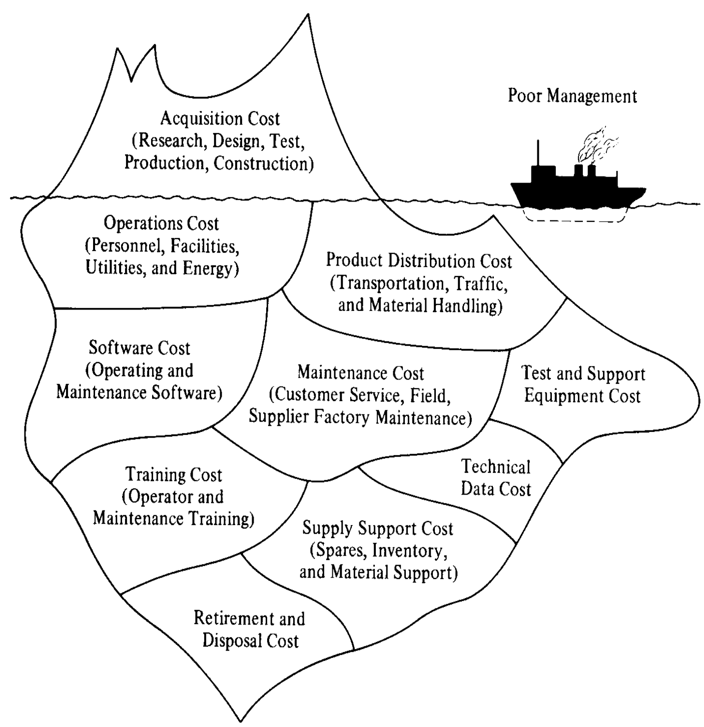
Companies that want to include incentives should develop an ***incentive framework,*** which is a mechanism to measure performance and trigger incentive awards or payments. Using a clearly defined incentive framework will prevent frustration that often occurs between a buyer and supplier.

What's the Difference in TCO, Best Value and Shared Value Creation?

A Total Cost of Ownership (TCO) analysis includes determining the direct and indirect cost of using a product or service. It is very important to consider all costs associated with buying a product or service. In the case of outsourcing, this includes all the usual suspects, but also transaction costs, retained costs, any HR related costs and the like. Understanding only some of the costs will result in a poor decision

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 company*. **Figure 3** (next page) nicely illustrates the importance of understanding total costs, and the "iceberg" nature of not paying attention to what's below the surface. What is out of sight often will cause the greatest damage!

FIGURE 3



Establishing real total costs is not entirely straightforward and often difficult. Most companies establish a baseline business case that is only focused on their vendor procurement spend. Let's take warehousing costs as an example. There are many hidden costs, such as inventory carrying costs, transportation costs between warehouses and from manufacturing sides, insurance costs and other implied costs for governance and risks that, if overlooked, can completely destroy the business case for outsourcing. These costs and their related services should be added to the business case to establish a comprehensive TCO to use as a baseline.

The preferred approach is always *transparency* (discussed in much more detail later), where the total costs to own a product or have a service over time are factored into the business case. Only then will the comparison between the pricing model and the business case (or between alternative pricing models) provide meaningful justification for a decision. Interestingly, a good business case/pricing model analysis will sometimes lead to increasing a supplier's scope to leverage a more complete delivery model. This can raise the supplier's "price," but will lower the TCO against the baseline business case, which is what really counts.

Best Value is closely related to TCO, but is slightly different. TCO is actually a foundational component for any Best Value decisions that need to be made. Best Value bases pricing decisions *on the value associated with the benefits received and not on the actual prices or cost*. A Best Value Assessment uses decision criteria that go beyond costs and includes intangibles such as market risks, social responsibility, responsiveness, and flexibility. The use of Best Value techniques is underdeveloped in the business world. However, organizations such as the non-profit Global Sourcing Council [5] are trying to change that by raising the awareness of the true costs and impact of global sourcing arrangements. Other organizations such as the Sourcing Interests Group (SIG) and the University of Tennessee are also seeking to educate the sourcing community about best value practices. ("Unpacking Best Value — Understanding and Embracing Value Based Approaches for Procurement," a white paper by the University of Tennessee and SIG is a free download here.)

Shared Value Creation/Value-Sharing. ***Shared value creation*** is the act of creating value with two or more parties. A good example occurred when two McDonalds' suppliers joined forces to create the Chicken McNugget, which ultimately brought billions of dollars of value to McDonalds and the suppliers. ***Value-sharing*** is the practice of allocating a share of the *total value that is derived from an improvement or innovation*.[1] The value is based on the measureable benefit to all defined stakeholders, not just the party with the idea or the one that takes action. Value-sharing encourages suppliers to innovate for total overall value. Because some Desired Outcomes are not easily quantifiable, value sharing can use non-monetary incentives to reward the parties.

Margin Matching: Margin matching is an excellent but rarely used technique that adjusts prices predictably (and preferably fairly) based on movements in underlying pricing model assumptions. The pricing adjustment is based on trigger points that, when activated, reset prices. The goal of using this relatively new and innovative technique is to maintain economic alignment in the relationship as the business environment changes, ensuring fairness in prices. Margin Matching is a key element of a Vested pricing model, which is explained in more detail later.

[1] Desired Outcomes describe the results that a company wants to achieve. Desired Outcomes typically include system-wide, high-level results for items such as lowered cost structures, higher service levels, higher market share, faster speed to market, reduced cycle time, more loyal customers or other results.

SECTION II: ALIGNING THE RIGHT PRICING MECHANISMS WITH THE RIGHT SOURCING BUSINESS MODEL

The biggest mistake a company can make when trying to establish fair pricing is to use the wrong sourcing business model. The problem worsens when a company does not align the right pricing mechanisms (compensation method, price vs. pricing model) with the sourcing business model. This section of the white paper provides an overview of the various sourcing business models and seeks to explain the most appropriate pricing approach for each. For each sourcing business model we:

- Explain the nature of the sourcing business model
- Share typical pricing mechanisms used for the business model
- Discuss inherent incentives: pros and cons
- Identify when the sourcing business model is most appropriate

Transaction-Based Models

Nature of Transaction-Based Models

Transaction-based business models have been the cornerstone of business endeavors for centuries and remain the most common of sourcing business models in use today. Among them, staff augmentation and price per transaction are the most frequently used pricing approaches. The main difference is that staff augmentation typically is tied to labor (how many hours/days were worked) while price per transaction is tied to the completion of a product unit/unit of service. As the commitment between a buyer and supplier increases, buyers will often shift their suppliers to an "approved provider" or a "preferred provider" status. Figure 4 summarizes the typical characteristics of staff augmentation and price per transaction approaches.

Figure 4: Summarized Characteristics of Common Transaction-based Approaches

	Two Most Common Transaction Based Pricing Approaches	
Characteristic	**Staff Augmentation**	**Price Per Transaction**
Typical Business Drivers	Overhead reduction and variable staffing	Variable costs (people and infrastructure)
Work Definition	Focus on WHO and HOW	Focus on HOW. Used Statement of Work to define work
Desired Outcomes	Hours of Work Completed	Transactions completed at desirable quality specifications
Economics / Compensation Method	Price vs. Pricing Model Hourly/Daily Rate per FTE Can be *cost reimbursement* or *fixed price* with more tendency to be *fixed price*	Price vs. Pricing Model Per Unit/Activity (cost per call, cost per unit, cost per shipment) Can be *cost reimbursement* or *fixed price* with more tendency to be *fixed price*
Governance Structure	Direct Oversight/Supervision where "Boss" signs off on work	Oversight through quality metrics, volume tracking, Service Level Agreements). Larger "preferred" suppliers may be managed under a Supplier Relationship Management program
Typical Mindset	Zero Sum/Win-Lose	Zero Sum/Win-Lose

Typical Pricing Mechanics Used

Transaction-based models typically use ***prices*** instead of a ***pricing model*** and payment is triggered when transactions are completed. The supplier gets paid by the transaction; therefore, the more transactions, the more revenue for the supplier. The transaction price can be based on labor, product, or unit of service. Some common examples are:

- A third party logistics supplier may get paid monthly for the number of pallets stored, the number of units picked, and the number of orders shipped
- A call center supplier may get paid a price per call or a price per minute
- A temporary staffing agency may get paid a price per hour for a resource
- A widget manufacturer gets paid a price for each widget

While transaction-based agreements can be open book or closed book, it is very common to use a ***closed-book fixed price compensation method*** where the buyer and seller establish a unit price per-transaction for a particular task.

Inherent Incentives — Pros and Cons

The primary disadvantage of a transaction-based model is that the supplier revenue is directly tied to the volume of transactions…the more transactions, the more revenue…the more revenue, the more profit. Suppliers have an ***inherent perverse incentive*** to not make ongoing improvements to reduce non-value added transactions (see Ailment 3 in the Appendix and here). To fight supplier complacency, procurement professionals use competition and commoditization efforts to reduce supplier dependency with the goal to increase the buyer's leverage and thus reduce the price they must pay for a good or service.

Most companies make their "buy" decisions with a transaction-based business model in mind, because of the perception that the transactions are simple, requiring limited to no commitment to continue to work with the supplier after the transaction has been completed.

As a general rule of thumb a transaction-based pricing model is effective for *simple transactions with abundant supply, low complexity, and little asset specificity (unique or custom requirements). If the level of dependency and the shared value is low, transaction-based models are the way to go.* For example, if a company can buy the same widget from 100 different suppliers, a transaction-model is ideal.

In many cases buyers and suppliers face variability (e.g., component costs or volume fluctuations) or multiple-dimensions in their business agreements. In this case, transaction-based business models fall short. Why? Changes in the inputs will cause the ***"price"*** to get out of equilibrium, resulting in either the buyer or the supplier "winning" or "losing" based on the fluctuations. Some buyers seek ***rebates/volume discounts*** to compensate for efficiencies due to volume increases. Likewise, suppliers seek minimum volume guarantees to mitigate for volume decreases. While these types of incentives work to balance the economics of volume variability, they do not work for other types of variability.

Transaction-based approaches also fall short when a supplier is expected to provide asset specific goods or services such as custom assets, training, or processes that the supplier must make on behalf of their client. Again, why? The fixed costs associated with the asset-specific investments can no longer be spread over many customers. The supplier's challenge becomes how to pass through these customer unique costs.

A common mistake is that a buyer over-commoditizes goods or services that require asset specificity. In this case, suppliers will often be left with thin margins and will slow (or sometime stop) making investments and overall improvements in the business in their effort to keep prices as low as possible and win the work. This over-commoditization is what we refer to as "the death spiral" because neither buyer nor supplier is making the appropriate investments in the business. After all, if a buyer has chosen to "buy" vs. "make" why would it make investments? And if a supplier were required to participate in frequent repetitive bidding, why would it risk making asset specific investments that may not allow it to achieve the proper return on investment? For this reason outcome-based approaches, such as Performance-Based and Vested models, are gaining popularity because these sourcing business models provide an incentive for suppliers to drive greater productivity and innovation.

When a Transaction-Based Model Works Best

Transaction-based models work best when what is being procured has stable specifications and delivery criteria and there is little risk in the economics of the buyer-supplier relationship getting out of equilibrium. As commitment increases, buyers will often shift their suppliers to an "approved provider" or a "preferred provider" status. Regardless of the supplier classification, most transaction-based models still rely on either a staff augmentation approach or a price per transaction approach.

Outcome-Based Models

Outcome-based business models pay a supplier for achieving a defined set of business outcomes. Outcomes may be broad-based, such as when Jaguar set a goal to move from worst to first in the JD Power and Associates rankings or more narrowly tied to specific service level like operational uptime.[6]

Outcome-based approaches are used most widely in the aerospace and defense industries where they are often referred to as performance-based logistics because they couple logistics maintenance and support to the procurement of a product. Rolls Royce PLC was the first known organization to formally explore outcome-based approaches in the 1960s while making engines for aircraft clients. In this type of approach, the buyer often increases the scope of work and reduces the level of detail in the Statement of Work – focusing on "outcomes."

Rolls-Royce's outcome-based model is referred to as the "Power-by-the-Hour"[7] program. Under the model, Rolls Royce assumes the risk for operational uptime and gets paid a **fixed fee** per hour of operational uptime. This flexibility allows Rolls Royce to use its expertise efficiently and cost effectively to deliver the Desired Outcome — a well-maintained engine that decreases aircraft downtime for its clients. Rolls Royce benefits by having a steady revenue stream it can use to level load resources and budget for optimized maintenance during the life of the engine. The airline benefits because regularly scheduled, expertly provided maintenance results in fewer planes that require unexpected repairs, increasing the number of hours the planes are operational.

Outcome-based business models have increased in popularity in the last few years. More companies outside of the aerospace industry have adopted the concepts and expanded the thinking to other outsourced service deals.

There are two types of outcome-based models: performance-based agreements and Vested agreements. In the ITO and BPO sector, performance-based agreements are often referred to as "managed services" agreements. Each has attributes that sets it apart from the other as described in Figure 5 below and in more detail in the following section.

FIGURE 5: Summarized Characteristics of Common Outcome-Based Approaches

	Outcome-Based Sourcing Business Models	
Characteristics	**Performance-Based / Managed Services Agreement**	**Vested Business Model**
Typical Business Drivers	Cost Control	Total Cost of Ownership, Best Value, Innovation/Value Creation
Work Definition	HOW/WHAT	WHAT
Outcomes	Deliverables to SLAs and Guaranteed Costs Savings	Innovation, transformation and holistic business outcomes (market share, profit margin, customer loyalty, Total Cost of Ownership, Innovation)
Economics	Varies: Typically Fixed Fee with high margin in base services and small margin in incentives. Often penalties for not meeting SLAs	Hybrid approaches emphasizing transparency. Typically small margin in base services and high margin/large incentives for meeting Desired Outcomes
Governance Structure	Primarily oversight with focus on meeting SLAs. Progressive firms use formal Supplier Relationship Management approach	Insight vs. Oversight. Focus is on managing the business with the supplier, not just managing the supplier. Vested governance structure with strong relationship management, transformation management, and exit management elements
Typical Mindset	Zero-Sum Game/Win-Lose	Non-Zero Sum Game/Win-Win

PERFORMANCE-BASED AGREEMENTS

Nature of a Performance-Based Model

Some business relationships are by their nature "sticky," meaning that there is a high cost of entering and exiting. This can cause one party to exploit the other, knowing that its ability to exit is limited. For this reason companies are beginning to insist or lock on on supplier guarantees around performance levels or cost containment.

Performance-based pricing agreements are sometimes referred to as “pay for performance” because they often have positive and/or negative incentives tied to outcomes (often referred to as ***gain-share/pain-share***). Incentives and penalties help align the parties’ interests by creating a band of performance tied to the supplier’s price. The incentives/penalties help align the economics of the relationship based on the level of service received.

Typical Pricing Mechanics Used

Performance-based agreements are often structured so that the buyer pays a fixed price per transaction rather than using a more comprehensive ***pricing model*** (e.g., the Rolls Royce example stated previously). Performance-based agreements typically take two forms. The most common type is structured so that the buyer still pays a supplier using transaction-based pricing triggers for scope of work. For example, a company outsourcing call center services will still pay a ***fixed fee price*** per transaction (most often a cost per call or minute). The performance-based part of the model in this case will take the form of a negative or positive incentive based on meeting a SLA (e.g., answering 80% of calls within 20 seconds or having a 98% fill rate for product shipments).

Performance-based agreements typically require a higher level of interaction between a supplier and a company in order to review performance against SLAs and determine the ***incentive*** or penalty options that are typically embedded in the contract. These reviews are periodically scheduled and generally include representatives from the supplier and the company.

Companies typically try to make performance-based agreements self-executing, meaning that SLAs are established with clearly determined metrics and measurement methodologies. Determining the actual ***incentive*** payment simply becomes a reporting requirement. A less desirable method is to allow either party (usually the customer) the ability make the reward determination without the input from the supplier. If this is not done properly and fairly, it can cause the buyer-supplier relationship to become more adversarial than necessary.

Inherent Incentives — Pros and Cons

Performance-based agreements can be a very important and powerful means to secure a desired behavior. A well-structured performance-based agreement will align the economics of a deal and will compensate for a supplier's performance as appropriate under the circumstances.

It is tempting to say that performance-based agreements typically shift risk to the supplier for achieving designated performance levels or SLAs. However, from an economic viewpoint, performance-based pricing simply provides behavioral ***incentives*** that are often lacking. Unfortunately, one of the pitfalls of performance-based agreements is that frequently buyers structure the deal around "all risk and no reward." On the surface, penalties may seem like a smart tactic. But in many cases an unbalanced contract will drive ***perverse incentives*** and cause the supplier to hunker down to reduce risk at all costs. For example, a supplier might know the best long term solution for its client is to shut the system down and do a complete maintenance overhaul. However, the ***incentive framework*** could be forcing the supplier to choose between getting a green scorecard (and, therefore, higher fees) and making the right business decision that might temporarily reduce its scorecard rating. Economics would predict that the supplier would choose to pursue the green scorecard.

A good example of this ***inherent perverse incentive*** is a city utility district that operates a large water treatment plant. Under a classic performance-based agreement, the supplier is incentivized to achieve operational SLAs. Focusing on operational SLAs allows the supplier to get a green scorecard every month. While this is great, it would be far more beneficial for the supplier do more proactive maintenance to maximize the performance over the plant's lifetime. Unfortunately, more preventive maintenance would increase the supplier's costs (thus decreasing its margin). Suppliers easily justify that they will forego maintenance in the short term as long as there is not a risk to operational performance (achieving their green scorecard). After all, why invest now when the buyer is likely to bid out the work? And if the supplier made the investments and lost the bid they truly would face a lose-lose scenario.

Unfortunately, many companies like the city utility district above struggle with how to properly apply incentives. Because there is a strong desire for performance-based **incentives** to be self-executing, there is a strong tendency towards over-simplification. Another great example of a bonus system gone awry is the idea that if a supplier outperforms a service level, it should automatically get a bonus. This only works if there is a corresponding business benefit. If a customer needs a system to be available 99.99% of the time, the value of the service may very well be degraded if the system is only available 99% of the time; however, it is unlikely that exceeding 99.99% will provide any additional value, so an offset or bonus is not appropriate. Contrast this with a development project where beating a deadline may mean going to market earlier with a product. The key decision point should be whether incremental value is gained from incremental performance improvements against SLAs.

Companies that want to shift to a performance-based agreement should spend time early on to ensure that the performance requirements, when met, will achieve the business results. They should also ensure contractual mechanisms are built into the service level methodology to allow the parties to adjust service levels once their effects are fully understood, and then to suspend the service levels when business needs require the supplier to focus elsewhere for the good of the customer. For this reason, it is imperative that performance-based agreements include fairly strong governance structures on the buyer and supplier side.

In some cases, buying companies find their suppliers are meeting SLAs, but the buyer perceives the supplier is still failing to meet the company's business objectives. University of Tennessee researchers call this a "Watermelon Scorecard" because the SLAs appear green on the surface, but the customer "feels red" because they are not satisfied with the business result (green on the outside, red on the inside — like a watermelon). This happens frequently when the SLAs are mismatched to the business objective or there are cross-company infrastructure failures that skew measurements. If you are experiencing a Watermelon Scorecard, it may be a signal that your business is better suited for a Vested business model.

Finally, lack of proper governance of a performance-based agreement can lead to ***inherent perverse incentives.*** First, because many performance-based agreements still rely on a ***price*** per transaction, the cost of governance is often baked into the transaction *price*. As suppliers take on the risk to meet SLA targets or guaranteed glidepath price reductions, they may feel margin pressure. When this happens buyers can quickly see the "A team" on their account move off and they are staffed with the "C team." Suppliers also suffer for lack of proper governance. They often will bring ideas that will help them drive efficiencies only to find the buyer does not have the proper mechanisms to drive sound decision-making and support the implementation of their ideas. Or worse, they make investments that are right for the relationship only to find that a “new sheriff” rides into town and does not honor previous decisions thus putting their investments at risk.

When a Performance-Based Model Works Best

Performance-based approaches can be wildly successful or hugely disappointing. The main reason for the difference is because many companies use a performance-based sourcing business model when other approaches would fit better. A performance-based approach works best when the supplier is placed in a static “black box” and asked to optimize productivity and costs in the “box.” It is simply unfair to ask a service provider to sign up for putting its compensation at risk if the nature of the business itself is risky. *If the level of dependency and the shared value is medium, performance-based models are the way to go.*

Before deciding to adopt a performance-based pricing approach, ask the following questions:

- Do you have a sound baseline where the supplier feels comfortable signing up for “guaranteed” performance or cost reductions?
- Is the scope of work very stable and predictable? If is it variable, can you ensure the supplier will not be taking on risk that is not appropriate?. Under a performance-based model the supplier will place a “bet” on the risk and the buyer will have to live with the predictable consequences. (If the risk turns out well for the supplier, they will earn very high margins. If the risk is too much for the supplier to bear, the supplier will have an inherent incentive to marginalize performance or come back and ask for a price increase.)
- Can a discreet scope of work be carved off into a “black box” for the supplier to optimize? Work that requires a significant amount of input from the buyer or external sources probably is not a good fit because it imposes risk that is likely not appropriate.
- Are the cost components controllable? A general rule of thumb is a supplier should not be held accountable for “guaranteeing” a price decrease if there is a large degree of potential risk (e.g., foreign currency exchange, commodity fluctuations).
- Are you prepared to devote proper governance levels to the relationship? This is especially true for the supplier as governance is typically absorbed into the transaction-based price versus part of a more comprehensive *pricing model.*

If the answer is “yes” to each of these, a performance-based agreement is potentially a good fit. If the answer is “no,” the parties are likely going to create friction in their relationship because the supplier will be signing up for risk that is not in its control. In this case, the parties should consider either a transaction-based or a Vested approach.

VESTED AGREEMENT

The Vested approach is a highly collaborative sourcing business model where the company and the supplier share risk ***and*** rewards; in essence a buyer and supplier are Vested in each other’s success. Vested takes buyer-supplier alignment to a new level by structuring a true “win-win” ***pricing model*** by establishing an economic engine that generates value for all parties at a very high level. Procter & Gamble (P&G) uses the analogy of having buyers and suppliers “tug on the same side of the rope" when referring to its Vested agreements because a Vested supplier sits on the same side of the table. The better P&G does, the better the supplier does…and the worse P&G does, the worse the supplier does.[8]

The name "Vested Outsourcing" was originally coined by University of Tennessee researchers to describe the highly successful outcome-based outsourcing agreements the researchers studied as part of a large research project funded by the United Stated Air Force. Their research revealed that Vested agreements combined an outcome-based model with the Nobel award concepts of behavioral economics and the principles of shared value. Using these concepts, companies enter into highly collaborative arrangements designed to create value for all parties involved above and beyond the conventional buy-sell economics of transaction-based or performance-based agreements.

Nature of a Vested Pricing Model

There are five characteristics of a Vested pricing model (see below, Figure 6: Five Principles of Vested Pricing Models).

FIGURE 6 — Five Principles of Vested Pricing Models

First, Vested pricing models often mirror Abraham Maslow's Hierarchy of Needs. Maslow's theory states that it is vital to meet certain lower needs before higher needs can be addressed. In the business world, the basic requirement for a supplier is at least breaking even on a customer's business. A Vested ***pricing model*** usually establishes relatively small margins for the base services. We often see pricing models that strategically guarantee a minimum profit for the supplier in exchange for performing base services at greater levels of efficiencies. This provides everyone peace of mind, knowing the work will be done effectively and efficiently, while also guaranteeing that the supplier's lights will stay on, payroll will be covered, and the equipment or facilities will be properly maintained.

Second, a supplier's minimum fee is coupled with ***incentives*** that enable suppliers to earn very high margins as value is created by achieving their customers' Desired Outcomes and by solving complex business problems. A general rule is that "small" means below-market margins if the work is competitively bid — often as low as 50% of "market" margin. For example, if the work was put to bid and the "market" margin was 10%, a Vested deal might have a 5% margin for the base services. Using the 10% as "market," the Vested ***pricing model*** would allow the supplier to earn 2-3 times the market margin — or up to 20-30% profit margins — if the supplier successfully incorporates transformation and innovation to achieve Desired Outcomes.[9]

A Department of Energy's (DOE) superfund site known as the Rocky Flats Closure Project is a great example of a Vested ***pricing model*** in practice. The supplier — Kaiser-Hill — earned a base management fee of 3.7% (the average margin for DOE contracts was 4.1%) with incentives enabling it to earn up to an 11.7% profit margin when pre-defined outcomes were met (e.g., beating budget, raising safety levels, developing innovations that sped up closure, etc.). With the performance targets and incentives clearly outlined in the contract, Kaiser-Hill earned the maximum bonus payments. Its final incentive payment was $560 million; this may seem excessive until the full story is known: Kaiser-Hill saved U.S. taxpayers $30 billion in costs and closed the site safely 65 years ahead of schedule.[10] Using a ***margin matching*** philosophy allowed the DOE to directly tie Kaiser-Hill's success to the DOE's success. The more benefits for the DOE, the more margin for Kaiser-Hill. Safety levels also hit all-time high levels, and the site eventually was safe enough to become a wildlife refuge.

A third attribute is not having suppliers assume the full risk of uncontrollable events, unless the buyer agrees to pay an appropriate and fair risk premium. For example, a facilities management supplier should never bear the financial risk for increasing energy prices if it does not also control consumption. The rationale here is simple: if a supplier is forced to "guess" at the future of energy prices, it will invariably guess high in order to cover the risk; in other words, it will hedge the bet. The quoted price is always inflated for risk, even though the risk may never materialize. A better way is to accept the fact that the 'cost of electricity' is the 'cost of electricity' and allocate the risk to the party most able to manage the particular risk.

Buyers should develop incentives for the supplier to work with the company to mitigate the risk associated with the rising cost of electricity. For instance, a good incentive would reward a facilities management supplier for designing environmentally sustainable solutions that reduce the kilowatts the company uses per hour. An example of this in action is the highly successful P&G/Jones Lang LaSalle (JLL) facilities and real estate management outsourcing agreement. P&G establishes a cost pass-through with JLL for energy. P&G covers the actual cost of electricity and JLL's incentives are tied to their ability to develop energy efficient buildings and workspaces. Under the agreement, the EPA awarded P&G's Cincinnati corporate headquarters the Energy Star Certification label in February 2007, making it one of the largest of the 650 private sector office properties to gain such distinction. It was a win-win for both parties.[11]

The fourth characteristic of Vested pricing models is that governance is spelled out as a discreet cost in the ***pricing model***. This is very different than most transaction-based and classical performance-based model approaches that "lump" the cost of governance into the supplier's price — or worse — allows muscular buyers to use hard-nose negotiating tactics to insist suppliers provide governance for "free." Bottom line: it costs money to manage the business. Skimping on governance can create perverse incentives such as encouraging the supplier to swap out the "A Team" for the "C Team" after the deal is done in order to maintain a profit margin. The award-winning Microsoft-Accenture OneFinance outsourcing agreement is a good example of this in action. Under the agreement, governance includes the cost of 16 key people from both Microsoft and Accenture who provide the joint leadership to manage Microsoft back financial operations. The 16 people are aligned with peers from both companies ensuring business success in four key areas — service delivery, transformation management, contract and commercial management, and overall relationship success. Under the agreement, Microsoft fully funds governance for both parties to effectively manage the business and the success of the relationship.

Last, Vested ***pricing models*** go well beyond ***pay for performance incentives*** for meeting SLAs, focusing instead on value creation based on ***Total Cost of Ownership*** and ***Best Value*** approaches. In addition, most Vested pricing models include ***non-monetary incentives*** such as early renewal ***award term incentives,*** expanded scope of services, or even the customer's willingness to provide references. Above all else — Vested ***pricing models*** are based on the "What's in it for We" mindset by including a ***margin matching*** component.

Typical Pricing Mechanisms Used

A Vested pricing model almost always uses a transparent, *open book* and *best value* approach, as this builds trust, which is needed in a longer term relationship.

There are no quick or easy answers when it comes to creating a Vested pricing model. But pricing is not a guessing game. *The Vested Outsourcing Manual* lays out a comprehensive 12-step process for developing a pricing model that includes:

Step 1 — Form the Team: the pricing model should be developed in unison, not separately and then negotiated. Typically this includes one person from the buyer and one from the supplier.

Step 2 — Establish Guardrails: Each party shares their guardrails — basically their corporate boundaries or their walk-away positions. In classic negotiations terms this is known as a BATNA (best alternative to no negotiated agreement). The guardrails form the boundaries for the team to develop the pricing model.

Step 3 — Document Input Assumptions: Assumptions include cost drivers and volume metrics to help the team build the model.

Step 4 — Identify *Total Ownership Costs* and Perform *Best Value* Assessment: This enables the parties to make sound workload allocation decisions and to ensure that incentives are tied to the overall total ownership costs — and not just to the cost of the services the supplier is providing. A good example is that a Vested pricing model will reward a supplier for positively impacting inventory levels even when they do not own the cost of the inventory.

Step 5 — Perform Risk Assessment and Allocate Risks: Vested pricing models avoid using contractual terms and conditions in order to shift risk. Instead a Vested pricing model fairly allocates risk and provides a risk premium (or discounts) associated which each risk component.

Step 6 — Agree on *Compensation Method*: Vested pricing models are typically a hybrid between a fixed-price or *cost reimbursement* with multiple "components" that match the best method for various components of the business.

Step 7 — Determine Target Contract Duration: The length of the contract is a significant factor in helping the pricing model team understand how to reward the supplier for making investments — especially asset specific investments that only benefit the specific buyer. Generally speaking, longer contract durations are better because they enable the supplier to make long-term investments and still have a fair return on investment.

Step 8 — Complete *Pricing Model*: With the above steps complete, the pricing model team can create the actual pricing model. Often this is a macro-based spreadsheet. Pricing models are typically "run" each month and use business inputs to derive the "price" that is paid to the supplier for that month.

Step 9 — Test the Model and Agree on Baseline: Once the pricing model team has completed the pricing model they should allow key stakeholders to "test" the model and agree on the baseline for the business. The baseline typically involves a snapshot of the starting point of the business. This can either be a snapshot at a point in time (e.g., at Day 0 of the agreement the nature of the business yielded a $1 million fee for the supplier and 95% service level) or an agreement on a typical month (e.g., in a typical month the supplier earns $1.2 million and achieves 98% service levels).

Step 10 — Define *Margin Matching* Triggers and Techniques: This includes determining the targets and process for how the pricing model will be changed when the business inputs change causing the "price" between a buyer and supplier to get out of equilibrium. For example, a supplier may agree to a fixed fee to cover its fixed costs (e.g., building, insurance). However, if volumes double and it needs to add a new building, this would trigger a review of the pricing model. The rule of thumb for a Vested pricing model is that risk and reward are shared. Think of it as the buyer and supplier being in the same boat, floating and sinking the parties at the same rate.

Step 11 — Agree on *Incentives*: The model should include triggers for both monetary and ***non-monetary incentives***. A typical non-monetary incentive for a Vested agreement is an ***award term*** extension.

Step 12 — Document Deployment Processes: It is wise to assume that at some point the people developing the pricing model will go on to take other roles in the company or eventually even leave the company. For this reason, the pricing model team should carefully document how the pricing model works and how it is deployed. The overriding goal of a pricing model is to ensure the economics between a buyer and supplier stay in equilibrium when "business happens."

Inherent Incentives — Pros and Cons

One might think that moving to a Vested pricing model is a risky venture for a company and its supplier(s). Obviously, anything new and different involving investment in time, effort and resources implies some risk. But thought leaders agree that the rewards can greatly outweigh the evaluated risk.

Outsourcing expert Adrian Gonzalez — a leading analyst who specializes in supply chain management and third-party logistics — offers this advice: "What differentiates Vested Outsourcing are not the risks, which are inherent in any outsourcing relationship, but the potential payoff for both suppliers and customers. In other words, the benefits-to-risk ratio is much greater for Vested Outsourcing and the risk of remaining at the status quo — in terms of lower profits for suppliers and continued diminishing returns for customers — trumps them all."[12]

Gonzalez articulates the concept of relational economics and ***shared value***, which are key to Vested thinking. By working together, the companies can have a "bigger payoff," but this payoff must be shared. The Harvard Business School's Michael Porter and Mark Kramer recently focused on the "big idea" of ***shared value*** in their excellent Harvard Business Review article, "The Big Idea: Creating Shared Value."[13] While the article relates primarily to how companies can work with society to create shared value, the concept of ***shared value*** is crucial to the Vested approach. The ***pricing model*** *must* share any value that is achieved from achieving the Desired Outcomes. This requires a mindset change.

Companies that choose a Vested sourcing business model must resist the urge and corporate pressures to demand the lowest possible ***price*** from suppliers. It also requires an open and transparent approach to developing a ***pricing model***. Organizations must go beyond merely saying and using the term "partnership" to actually creating a commercial pricing model that equitably allocate risks and rewards with the purpose of creating ***shared value*** for the duration of the agreement. If companies cannot do this they should not enter into a Vested approach.

The biggest complaint about a Vested approach is the amount of time it takes. While we have seen some companies adopt a Vested approach in less than three months, most take longer as the Vested methodology is often thought of as a "paradigm shift."

When a Vested Pricing Model Works Best

A Vested ***pricing model*** works best when both parties are prepared to sit on the same side of the table conducting transparent, fact-based discussions about the business and Desired Outcomes. Each party must clearly understand the goals and financial drivers of the relationship. A Vested approach works best when: 1) a company has transformation or innovation objectives that it cannot achieve itself or by using conventional transaction-based or performance-based approaches; and 2) when there is a need to share risks and rewards. *If the level of dependency and the* **shared value** *is high, Vested* **pricing models** *are the way to go.*

Transformational or innovative objectives are referred to as Desired Outcomes and the pricing model should be "win-win" in nature. It is important to remember that a Vested pricing model will only work when a buyer and supplier agree to adopt the Vested business model in totality; a Vested pricing model is one of the Five Rules of the Vested approach, as profiled in *Vested Outsourcing: Five Rules That Will Transform Outsourcing.*[14]

Investment-Based Models

Nature of Investment-Based Models

Companies that struggle to meet complex business requirements using conventional transaction-based or outcome-based approaches typically invest to develop capabilities themselves (or insource). Internal shared services organizations and joint ventures are two such investment-based business models. Shared services are internal organizations typically modeled on an arms-length outsourcing arrangement. Some companies decide they do not have the internal capabilities, yet do not want to outsource for a variety of reasons. In these cases, companies may opt to develop a joint venture or other legal form in an effort to acquire mission-critical goods and services. These equity partnerships can take different legal forms, from buying a supplier, to becoming a subsidiary, to equity-sharing joint ventures.

Investment-based business models often require the strategic interweaving of infrastructure and heavy investment. By default, investment-based models bring costs "in house" and create a fixed cost burden. As a result, investment based models often conflict with the desires of many organizations to create more variable and flexible cost structures on their balance sheets. Figure 7 summarizes the typical characteristics of investment-based approaches.

FIGURE 7: Characteristics of an Investment-Based Approach

Characteristic	Typical Profile
Typical Business Drivers	Acquisition of core competencies
Work Definition	Heavy control with focus on WHO, WHAT and HOW
Desired Outcomes	Service, as investment based deals acquire core competencies
Economics/Compensation Method	Joint P&L: shared results based on agreement
Governance Structure	Formal corporate governance structure equal to companies internal governance
Typical Mindset	Win-Win due to joint P&L — but a culture of complacency and high costs if not a core competency

Typical Pricing Mechanics Used

Investment-based approaches by design do not "buy" goods or services. They use internal resources and assets to perform the work and then use internal accounting to "pay" for the goods or services. In the case of a joint venture, the buyer and the supplier effectively merge into "one" company using joint financials and the joint venture typically acts as an internal supplier or subsidiary. In the case of shared services organizations, the "users" (or "departments," "subsidiaries" or "business units") often "pay" for the services through internal accounting policies. The pricing model can be budget-based or a transaction fee.

Inherent Incentives — Pros and Cons

Insourcing drives what Nobel laureate economist Oliver Williamson referred to as a "corporate hierarchy," which is an ***inherent perverse incentive*** of complacency. According to Williamson, insource solutions create low incentives, high administrative control, and a legal system that is "deferential to the management." As a consequence, innovations that might come from the market or suppliers are not shared or developed because there are additional bureaucratic costs involved in taking a transaction out of the market and organizing it internally. Williamson advises that insourcing should be "the organization of last resort."[15] Williamson, like many other business luminaries, advises that companies should only insource activities that are true core competencies.[16] This theme is consistent with other thought leaders such as Peter Drucker who encouraged companies to "do what you do and outsource the rest."

When an Investment-Based Model Works Best

Investment-based models work best when an activity is truly a buyer's core competency. If a company must explore insourcing for goods or services that are not a core competency, it should only do so if the buyer cannot acquire the goods or services needed from "the market."

SECTION III: A CALL TO ACTION — NEGOTIATE WITH A DIFFFERENT LENS

As we have highlighted, it is easy to get a fair price for purchasing goods and services that have a short — one time — duration where the focus is on "this deal, this time." Buyers and suppliers typically can easily use competition to test the market — often on a one time/purchase order-based deal.

As a buyer's and supplier's scope of work and relationship expand, they will advance to more sophisticated approaches for negotiating pricing. Buyers typically push for ***rebates/volume discounts*** in exchange for "approved" or "preferred" supplier status and longer-term contracts. Typically buyers and suppliers also go through a more formal negotiation and contracting process of tradeoffs and concessions to reach a fair **price.**

Many businesses operate in multi-faceted environments that require buyers and suppliers to interact on an ongoing basis with a variety of complexities (e.g., large scale outsourcing deals) that can easily get out of equilibrium in a transaction-based sourcing business model. In the case of complex business and outsourcing agreements, disconnects over pricing can and do cause frustration, create a lack of trust in the relationship, increase transaction costs, or worse trigger hostilities that wind up in court and severing the commercial agreement between the buyer and supplier.

Companies should strive to negotiate pricing through a different lens — a lens that includes embracing **transparency, cooperation, and smart risk/reward allocation** while encouraging companies to expand their agreement zone. Each concept is discussed in more detail.

A Clear View With Transparency

Transparency is *the open and timely sharing of all information relevant to a party's ability to make wise decisions for itself and the partnership*. Many companies — especially service providers and suppliers — wonder if they should adopt a transparent philosophy in the way they develop pricing for clients. Companies that espouse transparency rely on ***open book*** pricing to understand the true costs of working with business partners. The best don't just seek to understand a supplier's costs — but rather seek to understand the true ***total cost of ownership*** of doing business — together. There are both concerns and benefits, and these must be carefully weighed.

Benefits of Transparency

Research shows that when negotiators fail to reach a well-balanced agreement it is often because they failed to exchange enough information to allow each other to identify options.[17] Further research shows that organizations that embrace a transparent approach are able to creatively solve tough business problems. In fact, effective information flow promotes more balanced agreements — and, more importantly, better solutions. When it comes to solution development, the old adage that information is power reigns. However, to truly develop great solutions requires access to data from *both* buyer and supplier. Trying to optimize with only one party's data will certainly mean a less-than-optimal result.

Too often people succumb to the temptation to share only information that bolsters their position or that undermines their counterpart's position, while concealing information that exposes a weakness. The intentional concealment of some information skews the ability of others to make good decisions. It also reinforces people's beliefs that they cannot trust anyone at the bargaining table.

Complete sharing is powerful because it builds trust. True strategic partnerships tend to be highly transparent — sharing all relevant information to help their partner make an informed decision. One example[18] of a company that chose a more transparent path is Sykes, a global leader in providing customer contact management solutions and services in the business process outsourcing (BPO) arena. Sykes was renegotiating an outsourcing agreement with one of its large clients, a financial institution that relied on Sykes to answer customer calls around the world. Like most traditional negotiations, the negotiations centered on money. Sykes' client wanted to expand its business with Sykes because of Sykes' high-quality service. However the client assumed that Sykes was collecting an unfair profit and wanted Sykes to provide a ***rebate*** because of additional volume commitments.

At one point in the negotiations, Jim Hobby, recently retired executive vice president of global operations for Sykes, came to a significant realization. Both companies were laboring under some serious misconceptions that tainted the conversations and limited their ability to see the larger picture.

For many months, the financial institution expressed concern that it did not want Sykes to take advantage by making more profit from their account than Sykes was making on other accounts. Hobby knew that the typical profit margins in the industry were in the 8–10% range. Sykes was not making that at some of its client's locations. Hobby explained, "Sykes is a public company and has an obligation to its shareholders. The client wanted us to expand in an area, but it was not financially viable for Sykes. Before we made the decision to be transparent, we seemed to be at a crossroads in our discussions."

Hobby explains how moving to a transparent approach changed the nature of the discussions. "We agreed to model the business at various locations that performed the client's work. We looked at Sykes's company-wide financial objectives and how the client's work compared to Sykes's company-wide goals. By addressing our client's concern head-on in a transparent manner it helped us view our business through a new lens."

At first, this level of transparency felt risky. A colleague of Hobby's warned him, "Sharing this financial information is like sharing on Facebook. Once we post on the wall we cannot take it down." Many at Sykes wondered how the client would receive the information and how it would use the information going forward. Nevertheless, Hobby and his team felt that sharing the information would benefit the partnership and trusted their client not to abuse Sykes' trust by using the information against Sykes.

Sykes' willingness to be transparent paid off. The client was receptive to the information and to having a dialogue with Sykes about the operating income percentage points at various locations. By sharing information with the intent to help the client make an informed decision, Sykes showed the client that Sykes was not trying to take advantage of its client. Hobby noted, “Sharing the financial information brought business logic to the conversation. It was a breakthrough point for all of us. Our client realized Sykes was being honest with them.” The client saw in numbers what Hobby had been saying for months and agreed to a price increase at some locations to keep Sykes operating at those locations.

Looking back at the negotiations, Hobby noted, “There was nothing wrong with being more open and sharing some financial information so that we could partner in a more trusting environment. Nothing we did put Sykes at risk. It was all in the spirit of good faith and contributed to an open and honest dialogue with the client…openness made our conversations business discussions. The conversations were more rational.”

Concerns about Transparency

While many companies understand the benefits of transparency, they are still fearful of a transparent ***open book*** approach because they lack trust. Concerns about ***open book*** pricing are real and the parties should address them early in their discussions. We find two primary concerns when it comes to transparently sharing costs.

First, suppliers often feel “naked” or too exposed by sharing costs. Many suppliers believe if they divulge their true costs it is then easy for their client to calculate the supplier’s profit — a sacred cow for many suppliers. Suppliers also fear that the company will find out their actual costs and use that information to whittle away at the supplier margins. Another fear is the buying company will use actual costs to create a bidding war between the supplier and its competitors, which might also lead to the supplier’s competitors inadvertently learning its costs.

One-way to mitigate these fears is to develop a Statement of Intent[19] that outlines each party’s’ expectations of the other. Authors Jeanette Nyden, Kate Vitasek and David Frydlinger advocate for this in their book *Getting to We: Negotiating Agreements for Highly Collaborative Relationships*. Statements of Intent should be developed early on in the negotiation process. For example, the two parties could come to an agreement that clearly states margin targets for the supplier. In addition, the parties agree to formally establish guardrails, which should express such items as profit targets, market share and other key assumptions. A proper job of setting margin targets early in discussions will make sharing costs and margins more comfortable.

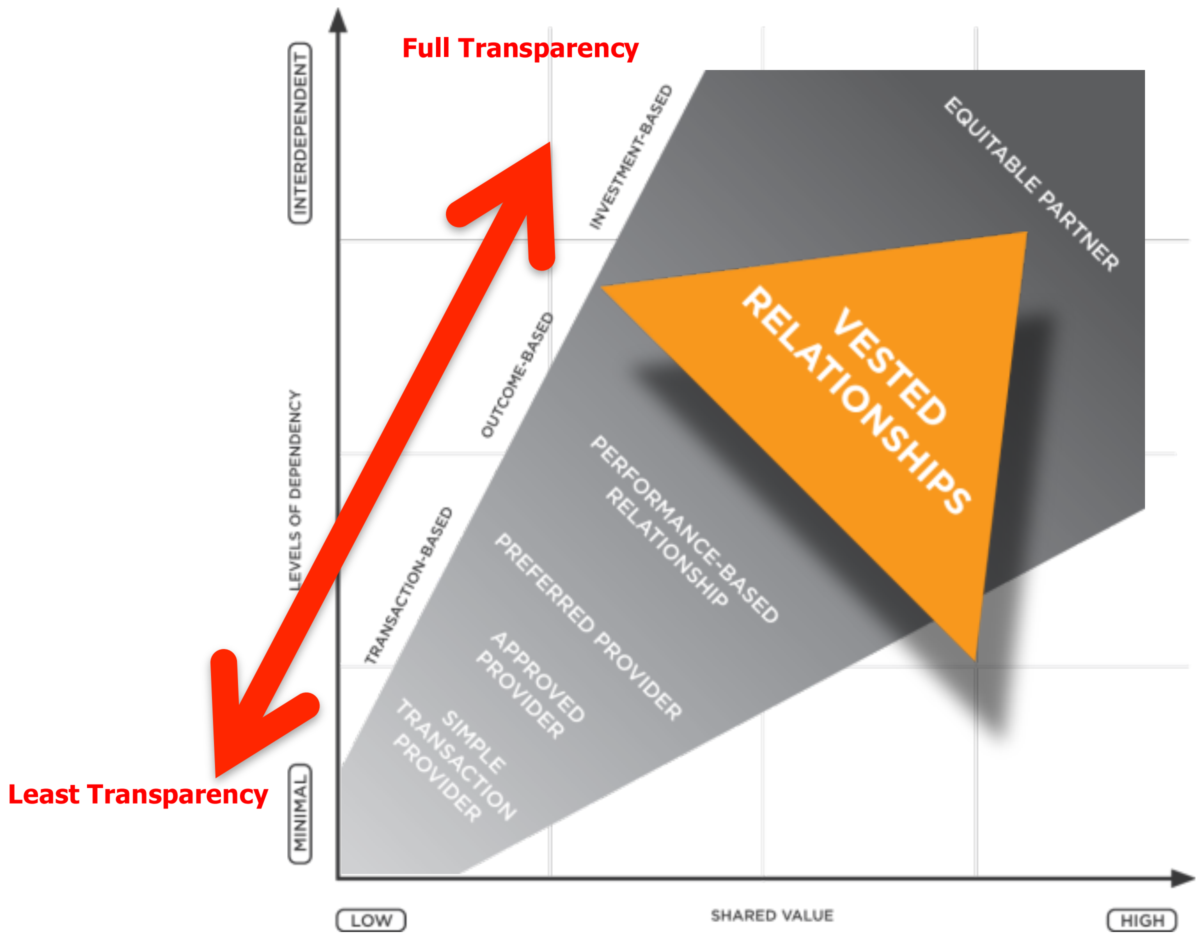
A second criticism about transparency involves the buying company. Often when it comes time to share critical information, the buying company will narrowly define transparency as a one-way street — that is, the supplier is supposed to share but the company doesn’t have to. This is a real criticism and one we often see. To ensure that the spirit of transparency is addressed early, we recommend including the concept of transparency in the Statement of Intent. Then suppliers should explain why they are asking for certain information. When clearly explained why, it helps allay company concerns. For example, in one case a third-party logistics supplier asked its client about a three-year forecast — was it going to stay the same, grow or decline? Once the company realized the supplier needed this to help estimate the maximum building size it would need to secure for the duration of the contract the company felt more at ease.

If total transparency is not possible, it is important to share as much information as feasible. Over time as the companies get more comfortable and trusting with each other, they can revisit and refine the ***price*** or ***pricing model.***

When to use Transparency

There is no black and white answer companies can use to decide on when to use a transparent approach. A general rule is that using a non-transparent ***closed book*** approach is best for less complex sourcing business models, while more complex and dependent relationships seeking value and innovation should use a transparent approach. University of Tennessee researchers say Vested agreements should always follow a transparent ***open book*** approach. Figure 7 below shows the relationship between transparency and pricing approaches as they relate to the various sourcing business models.

FIGURE 7: Relationship between Transparency and Pricing Approaches



Seek Mutual Gain Through Cooperation, Not Competition

Too often business people are opportunistic and focus on self-interest in their approach to pricing. However, progressive companies are challenging this mindset and are establishing highly collaborative buyer-supplier relationships. Nobel Laureate Oliver Williamson advocates avoiding opportunism. In fact, he encourages a concept of "leaving money on the table" as a way to build trust with a business partner, arguing that trust greatly reduces the transaction costs of doing business.

Robert Axelrod, a professor of political science and public policy, is a pioneer in the science behind the power of using cooperative — not competitive approaches for doing business.

To cooperate or not to cooperate? This is a simple yet profound question. Axelrod invited game theorists to play the Prisoner's Dilemma game,[20] which demonstrates why two individuals might not cooperate even if it appears that it is in their best interests to do so.[21] The game gets its name because two players are each charged with committing a crime. When questioned by the police, each has the chance to confess his own involvement, implicate his partner in crime and receive a reduced sentence, or remain silent. The Prisoner's Dilemma scenario is a classic exercise in game theory that illustrates the advantages and disadvantages of cooperation. The irony of the Prisoner's Dilemma game is that both prisoners actually get the best outcome if they remain silent ("cooperate"). His findings were seminal: The greatest odds of winning came from a strategy known as "tit-for-tat." A tit-for-tat strategy can best be defined 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 should follow suit and also defect. A defection is a competitive move that is characterized as non-cooperative and self-serving in nature.

Axelrod's findings were described in *The Evolution of Cooperation.*[22] Playing "nice" — or cooperating — led to the best results and maximized mutual gain for both players. Axelrod summarized his findings as follows:[23]

> 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. This means resisting 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 gaming the system for your benefit.

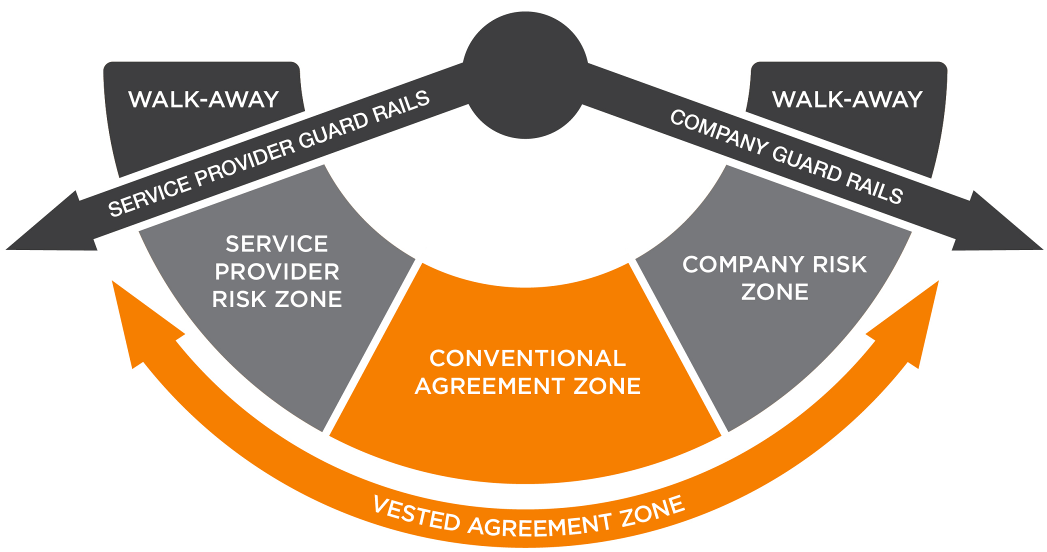
After reading Axelrod's summary, it's worth asking why more companies don't use highly collaborative approaches. Unfortunately, too many companies don't view opportunism as a bad thing. Rather, opportunism is business as usual. We argue this needs to change, and it must change if companies are to evolve and use more advanced sourcing business models and pricing models.

Expand the Agreement Zone with Smart Risk/Reward Allocation

Most companies use conventional negotiating approaches that involve tradeoffs and concessions. After a series of back and forth negotiations trying to shift risk to the other party — the parties get a compromise price. We encourage companies to look at expanding their agreement zone with smart risk/reward allocation. Companies that choose this approach shift the discussion from ***"price"*** to a deeper economic discussion that encourages buyers and suppliers to expand the "agreement zone." Partners move away from sitting across the table — negotiating over a ***price*** — to sitting on the same side of the table in joint problem solving.

An expanded agreement zone encourages the buyer and the supplier to take on risks they would normally push to the other party — as long as they are compensated with incentives if they achieve success against mutually defined Desired Outcomes. For example, buyers are challenged to create longer-term contracts and adopt exit management plans in lieu of termination for convenience clauses. Suppliers are challenged to shift margin out of the base activities into margins associated with transformation efforts based on the mutually defined Desired Outcomes. They are also rewarded with a fair return on investment for making smart decisions that drive innovation and mitigate risk.

Figure 8 illustrates this concept, with the larger circle representing the opportunity for much greater gains through transformative innovation, in essence expanding the pie for both parties. Note also that with the larger pie comes more risk.



Vested ***pricing models*** adopt this approach. What makes a Vested approach a good fit for more complex relationships where value creation is the goal is the fact that the parties mutually agree to a transparent ***pricing model*** that aligns the buyer and supplier to create value as they seek mutual Desired Outcomes. In addition, a properly structured Vested model creates tightly aligned ***inherent incentives*** as a key reward structure. Both parties become highly motivated to work together to achieve Desired Outcomes — creating a true partnership based on real win-win economics.

Because the parties are transparently taking on more risk in hopes for larger than normal returns, the parties jointly identify risk and create a risk mitigation plan. By doing the homework, the parties can feel more confident about taking on additional risks and therefore expanding their zone of agreement, which in turn expands the size of the pie for both parties.

Creating a Vested pricing model drives collaborative behaviors because the parties see the reward of working together efficiently and effectively. Partnership no longer is something that is merely spoken. It is something that is contracted and paid for.

CONCLUSION – YOU GET WHAT YOU PAY FOR

Collectively the authors have been involved in hundreds of buyer-supplier agreements. One thing is certain. The old adage “you get what you pay for” is as true today as when the saying was passed down from Grandparents of all generations.

Pricing is usually one of the first questions that arises in a new business relationship. It is also the thorniest question to answer. We challenge companies to evolve their business relationships to go beyond a “this deal, this time” mindset. Companies must resist the urge to simply get to “yes” on a ***price,*** and challenge themselves to explore more advanced sourcing business models such as performance-based or Vested agreements. They must also take the time to develop flexible ***pricing models*** to ensure the economics of their commercial agreement stay in equilibrium over the life of the agreement — and provide proper ROI when one party smartly takes on investment risk to drive innovation.

A general rule of thumb: the more complex and dependent an organization is on a supplier, the better it is to remove pricing from the center of the discussions and instead shift to the co-creation of a fair, balanced and sustainable pricing model that seeks to align the interest of both the buyer and supplier.

There are no magic potions or easy answers when it comes to creating a pricing model, Vested or otherwise. We have seen many models from many companies covering various types of work scopes and they all differ. There is no generic template or spreadsheet that provides the sole “answer.” The good news is that you do not have to be an accountant, a consultant, or an economist to recognize the benefits of a fair pricing structure that rewards innovation. You should view developing a pricing model as a process that parties go through to reach — and maintain — equilibrium. Putting the time and effort into a pricing model based on mutual transparency, sensible economic and cost assumptions, and proper incentives will go a long way to answering that thorny question by taking the pain, frustration and adversarial mindset out of the pricing negotiation.

If we had a magic wand we would wish that more business people make conscious decisions about their sourcing business models based on the characteristics of their business and actively seek to use pricing mechanisms that prevent perverse incentives. Keep in mind that no one single approach fits all circumstances and that all of them — when chosen correctly — can lead to sustainable and successful relationships. It is time to adapt and adjust procurement and negotiation processes to address the rise of today’s more dynamic and complex environments in order to create much-needed innovation.

We hope that our collective thoughts will help make “you get what you pay for” a reality in your business.

APPENDIX: THE 10 AILMENTS

Ailment 1 — Penny Wise and Pound Foolish [24]
This ailment occurs when a company outsources based purely on costs. Many companies 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
A company hires a service provider 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 actually the implement the perfect system.

Ailment 3 — Activity Trap
Traditionally, companies that purchase outsourced services use a 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 it results in lower revenue.

Ailment 4 — The Junkyard Dog Factor
The decision to outsource usually means jobs are lost as the work and jobs transition to the outsource provider. 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 contract tend to be positive at the outset, but satisfaction levels decline, thus creating problems over the long-term.

Ailment 6 — Sandbagging
Some companies adopt approaches to encourage service providers to perform better over time by establishing bonus payments for certain levels of performance. A perverse incentive can result: the service provider does just enough to get the incentive.

Ailment 7 — The Zero-Sum Game
This occurs when companies believe that if something is good for the service provider, then it is automatically bad for them.

Ailment 8 — Driving Blind Disease
This ailment affects many business relationships: 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 companies invest heavily in fancy software and scorecards, but if the metrics are then not used to make adjustments and improvements, don't expect results.

AUTHORS AND CONTRIBUTORS

Kate Vitasek is an international authority for her award-winning research and Vested® business model for highly collaborative relationships. Vitasek, a Faculty member at the University of Tennessee, has been lauded by *World Trade Magazine* as one of the "Fabulous 50+1" most influential people impacting global commerce. Her pioneering work has led to 5 books, including: ***Vested Outsourcing: Five Rules That Will Transform Outsourcing, Vested: How P&G, McDonald's and Microsoft Are Redefining Winning in Business Relationships*** and ***Getting to We: Negotiating Agreements for Highly Collaborative Relationships***. Vitasek's work also won the Supply Chain Council's Academic Advancement award for it's impact in advancing business practices.

Vitasek is internationally recognized for her practical and research-based advice for driving transformation and innovation through highly collaborative and strategic partnerships. She has appeared on Bloomberg radio multiple times, NPR, and on Fox Business News. Her work has been featured in over 300 articles in publications like *Forbes, Chief Executive Magazine, CIO Magazine, The Wall Street Journal, Journal of Commerce, World Trade Magazine* and *Outsource Magazine.* Contact Kate at kvitasek@utk.edu with any questions about this white paper.

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University of Tennessee researchers have authored five books on the topic of Vested.

Why | What | How | Negotiate the relationship | Tells the real stories of…

For additional information visit the University of Tennessee's website dedicated to the Vested business model at http://www.vestedway.com/ where you can download white papers, watch videos, read articles and subscribe to the Vested blog. You can also learn more about our six Executive Education courses in the Certified Deal Architect program as well as download the many resources and tools to help you understand and begin the Vested journey.

For more information, contact kvitasek@utk.edu

FOR MORE INFORMATION ABOUT SIG

SIG

SIG is a membership organization that provides thought leadership and networking opportunities to executives in sourcing, procurement and outsourcing from Fortune 500 and Global 1000 companies. It has served these professionals and opened dialogues with their counterparts in finance, HR, marketing and other business functions throughout its 22-year history. SIG is acknowledged by many as a world leader in providing "next" practices, innovation and networking opportunities through its: global and regional events, online webinars and teleconferences, member peer connection services, content-rich website and online Resource Center, which was developed by and for professionals in sourcing and outsourcing. The organization is unique in that it blends practitioners, service providers and advisory firms in a non-commercial environment.

For more information, visit http://www.sig.org.

END NOTES

[1] "Contract Negotiations Continue to Undermine Value," International Association of Contracting and Commercial Management 9th Annual Top Ten Terms Report, April 2010.

[2] The Kraljic Model or Matrix from Peter Kraljic was first described in an article in the Harvard Business Review, "Purchasing must become Supply Management," (Sep-Oct 1983). The model can be used to analyze the purchasing portfolio of a company with regard to two factors: profit impact and supply risk. The model distinguishes between four product categories: leverage items, strategic items, non-critical items, and bottleneck items.

[3] "Contract Negotiations Continue to Undermine Value." Ibid.

[4] Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing* (New York: Palgrave Macmillan, 2010). See chapter 3 for a detailed discussion of the 10 Ailments that can disrupt or derail business and outsourcing relationships.

[5] The Global Sourcing Council website is http://gscouncil.org/

[6] Kate Vitasek, Karl Manrodt and Jeanne Kling, *Vested: How P&G, McDonald's and Microsoft Are Redefining Success in Business Relationships* (New York: Palgrave MacMillan 2012).

[7] Power by the Hour is a registered trademark of Rolls-Royce.

[8] *Vested*, Ibid.

[9] We have seen Vested relationships with the margins on the base work as low as zero margin for base work and transformation incentives yielding profit margins for the supplier in excess of 80% profit margins.

[10] *Vested*, Ibid.

[11] ibid

[12] Gonzalez quote available from the Vested Outsourcing website, http://www.vestedoutsourcing.com/rule-4-optimize-pricing-model-incentives/

[13] Michael E. Porter and Mark R. Kramer, "The Big Idea: Creating Shared Value." Harvard Business Review Magazine (January-February 2011), pg. 62-77. Available at http://hbr.org/2011/01/the-big-idea-creating-shared-value/ar/1

[14] The Five Rules are:

Rule# 1 Focus on Outcomes, Not Transactions
Rule# 2 Focus on the What, Not the How
Rule#3 Agree on Clearly Defined and Measurable Outcomes
Rule #4 Optimize Pricing Model Incentives
Rule# 5 Governance Structure Should Provide Insight, not Merely Oversight

[15] Oliver E. Williamson, "Outsourcing: Transaction Cost Economics and Supply Chain Management," *Journal of Supply Chain Management* 44, no. 2 (2008): 5–16.

[16] C.K. Prahalad and Gary Hamel, "The Core Competence of the Corporation," *Harvard Business Review* 68.3 (1990): 79-91.

[17] J. K. Butler, Jr., "Trust, Expectations, Information Sharing, Climate of Trust, and Negotiation Effectiveness and Effeciency," *Group & Organization Management* 24, no. 2 (1999): 217–38.

[18] Jeanette Nyden, Kate Vitasek and Steve Frydlinger, *Getting to We: Negotiating Agreements for Highly Collaborative Relationships* (New York: Palgrave Macmillan, 2013).

[19] See Chapter 2 of *The Vested Outsourcing Manual*.

[20] The Prisoner's Dilemma scenario helps individuals and businesses understand what governs the balance between cooperation and competition in business, in politics, and in social settings. The game demonstrates how two individuals might not cooperate even if it appears that it is in their best interests to do so. It was originally framed by Merrill Flood and Melvin Dresher working at RAND in 1950. Albert W. Tucker formalized the game with prison sentence payoffs and gave it the name Prisoner's Dilemma.

[21] Cooperation would mean remaining silent about one's own involvement and the involvement of the other player in the crime.

[22] Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984).

[23] Ibid, 119.

[24] For a thorough discussion of the 10 Ailments, see Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing* (New York: Palgrave Macmillan, 2010), chapter 3.