Unpacking Oliver

The lessons of
Dr. Oliver Williamson,
Nobel Laureate
and their impact
on outsourcing
and supply chain
relationships

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Ten Lessons to Improve Collaborative Outsourcing

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Executive Summary

We've identified ten key lessons that should be applied when developing strategic business partnerships. Our challenge to the reader is simple: apply these 10 valuable lessons to the outsourcing relationship and see how performance will improve.

The purpose of this white paper is to explain how managers in the supply chain can use Dr. Oliver Williamson's ideas to create better outsourcing agreements.

Dr. Oliver Williamson is not a household name. In fact, it is rare to come across any business person that has heard of him. This is changing as practitioners begin to understand Williamson's award winning contributions to the art of forging "credible" outsourcing business relationships and contracts.

The 10 lessons are:

1. **Outsourcing is a continuum, not a destination.**
Deciding to in-source or outsource is rarely a simple Ôyes or no' decision. Most often the decision encompasses a tradeoff between safeguards and price. In other words, it is a hybrid of what tasks or responsibilities each party will complete. Choosing who does what can be determined by using the other lessons noted below. The goal is to reduce costs, and improve service while maintaining or increasing profit margins for all partners.

2. **Develop Contracts that create "Mutuality of Advantage."**
Dr. Williamson shows that the contract itself can have negative impacts on business if an organization does not think through how to structure the contract properly. In short – don't just say win-win – contract for win-win by committing to a 'What's in it for We' approach.

3. **Understand the Transaction Attributes and their Impact on Risk and Price.** Companies should look to identify all costs, including transaction costs associated with asset specificity, uncertainty, frequency and work to develop solutions that can mitigate these risks and the costs associated with them. It is important to understand the true "Cost to Serve." Don't ignore the risks – but identify them and determine the best way to manage them. Failure to manage the risks will lead to one-sided agreements by pushing risks on to the service provider or the customer. Doing so will simply cause the service provider to raise costs or the customer to want to reduce the price without trying to manage the real issues. Risks and costs need to be addressed from a "holistic" supply chain perspective. Remembering the sum of the local costs does not equal the global cost.

4. **The Greater the Bilateral Dependencies, the Greater the Need for Preserving Continuity.**
Companies that are "promiscuous" frequently bid and transition work to new suppliers that are likely to experience higher overall costs than if they had developed a fair and equitable contract that preserves continuity and eliminated switching costs.

5. Use a Contract as a Framework – Not a Legal Weapon

Creating a detailed contract and associated statement of work puts the outsource provider and customer into a "box." This limits innovation and encourages finger-pointing when there is inevitable scope creep and changes. Instead of trying to "guess" about the future, it is better to indicate an outline of the work to be done, and provide recourse for ultimate appeal. For work yet to be determined, focus on the process and tools to be used, not on the work to be done.

6. Develop Safeguards to Prevent Defection.

It is important to recognize that business relationships may need to change due to changes in the market and for this reason contracts need a well thought out exit management plan. Due to the changing market place, a perfect supplier (or customer) today might not be a perfect match in the future. For this reason, practitioners should clearly identify the costs associated with terminating a contract. Create safeguards in the contract that are fair and equitable in terms of keeping either party "whole" in the event that a contract needs to be terminated prematurely.

7. Predicted Alignments can minimize Transaction Costs.

Predicted alignments or what is sometimes thought of as "shared visions" can and does reduce transaction costs. When at all possible, create a shared vision that will guide how both the company and the service provider will work. Companies should create mutually beneficial outsourcing agreements whereby the service provider is rewarded financially for achieving the desired outcomes for the company that is outsourcing. Develop pricing models that reward and incentivize service providers for achieving the desired outcomes.

8. Your Style of Contracting Matters; Be Credible.

Organizations that use their "muscle" to gain an advantage over suppliers may have a short term win, but they will lose in the long term. Companies will ultimately face higher market costs and transaction costs from switching or transitioning suppliers, or at a minimum from suppliers being forced to use conventional negotiations to put in myopic and costly contractual provisions and behaviors that simply drive up hidden costs.

9. Build Trust; Leave Money on the Table.

Leaving money on the table may sound foolish, but when striking a strong business relationship it can signal a constructive intent to work cooperatively that will build an environment that is credible from start to finish. As the old proverb states "Give and it will come back to you, generosity gives rise to generosity."

10. Keep it simple.

Organizations should strive to keep its relationships and contracts pragmatic, plausible and correct: Those are excellent lessons in life and for a good business relationship and supporting contract.

The Bottom Line

The bottom line on Dr. Williamson's work is that the bottom line is not always apparent at first look. You have to look at the hidden costs of doing business as well as the price of what you are buying. Dr. Williamson focuses on the contracting process itself looking through the "lens of the contract" and how organizations behave when it comes to the contract and how people behave during contract negotiations.

Williamson's thoughts on outsourcing go beyond the numbers and substantiate the value of a collaborative, win-win approach to outsourcing and strategic relationships. In our opinion, it is some of the best academic work we have seen that shows how contract and governance structures need to be addressed in developing these types relationships.

A Nobel Prize is rare, recognizing significant achievement. Dr. Williamson's work is impressive because his work aligns with best practices observed in leading edge companies. It is one thing to have theory; it is quite another to see it in practice. His lessons are simple and profound when you look at their core essence. We hope more people will understand his work afte r reading this "unpacked" translation.

Our Disclaimer

This white paper is an opinion paper. It is the collective writers' best attempt to "translate" the work of Dr. Williamson into key Lessons and to relate them into lessons that can be applied by practitioners.

For those that have the time and desire, we highly encourage you to read of Dr. Williamson's work, particularly his April 2008 article in the Journal of Supply Chain Management entitled "Outsourcing: Transaction Cost Economics and Supply Chain M anagement." We also conclude this white paper with a listing of additional resources that can help you in your journey to improve how you approach contracting for your collaborative outsource business relationships.

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Introduction

The average person hasn't heard of Dr. Oliver Williamson. In fact, it is rare to find a business professional that has heard of him. Outside of academia very few journals on economic theory are generally read and disseminated so it is understandable that Dr. Williamson's work is not widely known in the practitioner community.

Fortunately, this is beginning to change. The award of his Nobel Prize in 2009 for his work on Transaction Cost Economics recognizes his contributions to the field of economics. His research on Transaction Cost Economics (TCE) provides outsourcing and supply chain professionals with lessons to read and practice.

This white paper attempts to summarize the Lessons of Dr. Williamson and put them into terms for the average practitioner. It is our hope that we all can learn from his lifelong efforts and improve how businesses work together. The main body of work that we review in this white paper is Dr. Williamson's 2008 article in the *Journal of Supply Chain Management.*

This paper is divided into four main parts.

1. We begin by presenting a brief background of who is Oliver Williamson and why practitioners should care about his work
2. We then address the essence of the key theme of Dr. Williamson's work, which is that businesses should understand and make business decisions based on a lesson that he popularized, Transaction Cost Economics (TCE).
3. The majority of this paper is devoted to "translating" what we believe are the 10 most important lessons into what we hope is practitioner-friendly advice by providing our opinion on why we believe practitioners should adopt his philosophies. We will also relate his works to "real world" findings from the applied field research the authors have done in the area of Vested Outsourcing, Performance Based Outsourcing, collaborative supply chain management, and collaborative contracting.
4. We end with commentary about what we believe is the "bottom line" or key contribution of the work and share our point of view on why we are challenging business professionals to take notice of Dr. Williamson and his work. We also share additional resources practitioners can use to learn more.

Who is Oliver Williamson?

Oliver Williamson, Professor emeritus of business, economics and law at the University of California, Berkeley, has spent his life devoted to the study of what is known in the world of academia as Transaction Cost Economics or TCE for short. As mentioned earlier, one his most recent articles to the areas of outsourcing and supply chain management appeared in April 2008 article in the *Journal of*

Supply Chain Management entitled "Outsourcing: Transaction Cost Economics and Supply Chain Management." It was based on a keynote address at the "International Conference on Large and Small Business Cooperation" in Seoul, Korea in August 2007, as well as earlier works, some of which can be found in the bibliography.

In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Unfortunately, half a year later (and nearly two years after his JSCM article) it is difficult to find business professionals who have heard of him or his work on TCE. We hope to change this and convince practitioners that they should understand and adopt the essence of his teachings.

What Exactly is Transaction Cost Economics?

Transaction costs are the costs that occur when participating in a market. To use a very simple example, when buying a book, there is not only the purchase price of the book but also the costs you incur in purchasing the book, these could include your energy and effort in selecting the book, the costs of traveling to the store or using the internet, the time waiting, the effort and costs of making the payment. The costs that go beyond the books price are the transaction costs. Transaction costs include actual monetary costs, expertise, flexibility, risk, asset specificity, the cost of managing the relationship, and supplier set up and switching costs to name only a few that must be considered.

Transaction cost economics adopts a contractual approach to the study of economic organizations. Briefly, TCE is best thought of as accounting for all the costs of a deal or contract, both the obvious and hidden costs.

There are also positive and negative transaction costs to factor in. As Dr. Williamson colorfully says, "Upon opening the black box of the firm and the black box of the market, we are confronted with a vast buzzing, blooming profusion of transaction cost possibilities, few of which are easy to quantify."

Dr. Williamson notes there are transaction costs whether a firm decides to make or buy a product or service. That is, whether or not a firm decides to make or buy, they will incur some transactions costs. A company should strive to use TCE as the basic unit of analysis to determine these costs to mak e better, more meaningful decisions. A firm has to decide whether to do the work internally (make) or procure the service (buy) and it should consider all of the transaction costs taking special care to identify hidden transaction costs. If a company does decide to outsource, it should work to reduce transaction costs with regards to how the companies work together including the remaining internal transactions.

It is important to understand that there are costs associated from the simplest one-on-one commodity contract to the costs associated with vertical integration. *There is no such thing as a zero transaction cost: there is a cost for bureaucracy and there is a cost for operating in the market. The goal then becomes to identify and quantify these and optimize for how you do business.*

10 Key Concepts of TCE in Outsourcing – and the Lessons for Today's Practitioner

A key element of Dr. Williamson's work is to help companies understand how their behaviors and approach to the contract itself can drive up transaction costs. This section of the white paper examines 10 key Lessons of Dr. Williamson's work that is directly applicable to outsourcing and supply chain professionals. Each Lesson is discussed, and is followed by advice for practitioners.

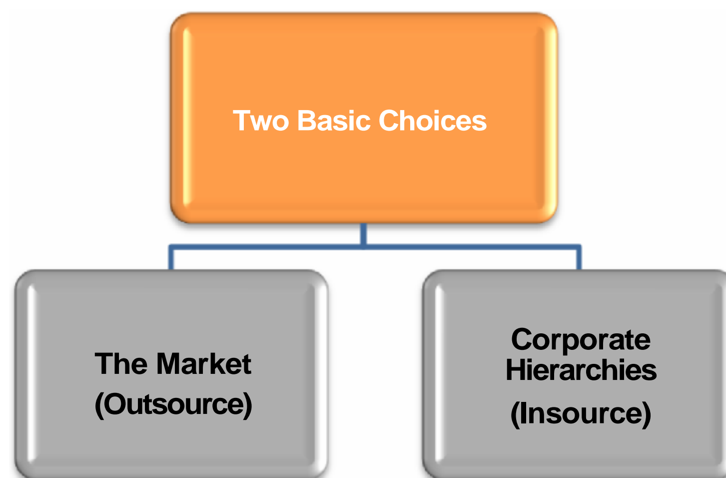
Lesson 1: Outsourcing is a continuum, not a destination.

In 2004, Peter Drucker said, "Do what you do best and outsource the rest!" Most companies jumped on the outsourcing bandwagon and used conventional procurement methods for negotiating often large and complex outsourcing deals. For the most part the conventional approaches meant using contracting philosophies and approaches that were used for buying supplies and commodities.

Under conventional thinking about outsourcing there are basically two approaches for outsourcing. The first is going to "the market" and the other is building a "corporate hierarchies" by bringing the capability within your organization.

Companies have generally made a make vs. buy decision when it comes to outsourcing, and if they outsource they use conventional free market economy and market-based approaches for developing the contract.

Figure 1: Two Basic Approaches to Ensuring Supply



Source: Vitasek, Manrodt, Wilding and Cummins

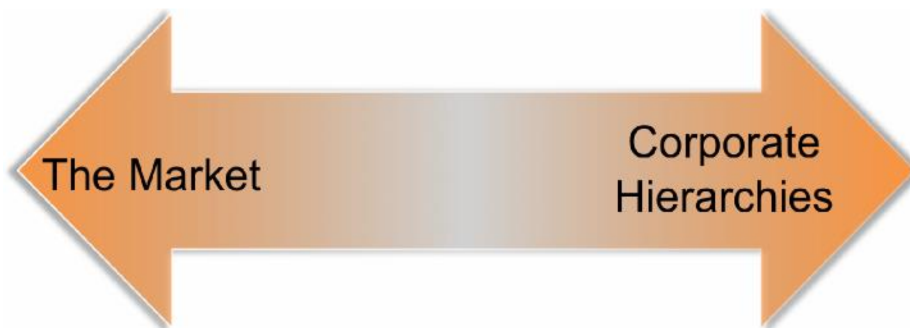
The market (buy/outsource) mode has high-powered incentives, little administrative control and a legal rules contract law regime. The market mode uses an unrestricted market, or basically an ideal transaction featuring an absence of dependency and with governance accomplished through competition.

The downside to the market mode is that service providers are often "competed" into outsourcing agreements that pose risks. For example, Dr. Williamson points out that service providers might have "specialized investments" that can easily expose the business to significant loss if the contract fails and for which no safeguards have been provided. When this happens service providers will raise their price to reflect the level of risk they have taken on. To counteract this and thus provide a more acceptable price to the customer, service providers will often negotiate heavily for contract safeguards in the absence of certainty. For each safeguard that is put in place, the service provider typically reduces the price charged. This "give and take" is a normal part of market-based negotiations.

The other traditional choice, the corporate hierarchy (make/insource) is exactly the opposite: 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 third parties are not shared or developed. This results in vertically integrating activities instead of outsourcing them. Because there are additional bureaucratic costs involved in taking a transaction out of the market and organizing it internally, "internal organization is usefully thought of as the organization of last resort," Dr. Williamson says. In other words companies should not in-source services that are not core unless they absolutely have to. Dr. Williamson – like Peter Drucker – challenges organizations to do what they do best and outsource the rest. This will be discussed later in greater detail.

Perhaps the best way to think of Dr. Williamson's work is to consider outsourcing in terms of a continuum with free-market force on one side and corporate hierarchies on the other.

Figure 2: A Continuum of Outsourcing Solutions



Source: Vitasek, Manrodt, Wilding and Cummins

Dr. Williamson advocates for a third "hybrid approach" to contracting as the preferred method for dealing with complex services that need to be performed under an outsource arrangement. Under a hybrid contracting approach (where the majority of outsource contracting resides), added security and contractual supports "take the form of interfirm contractual safeguards." Unfortunately, he also notes that when companies have taken the hybrid approach, it works well - "but not surpassingly well" – because often companies don't approach contracting as wisely as they should. Dr. Williamson states, "The viability of the hybrid turns crucially on the efficacy of credible evidence (penalties for premature termination, information-disclosure and verification mechanisms, specialized dispute settlement and the like), the cost-effectiveness of which varies with the attributes of transactions."

Advice for the Practitioner: Deciding to insource or outsource is rarely a yes or no decision. Most often the decision will encompass a tradeoff between safeguards and price, and a "hybrid" highly collaborative partnership is the best approach. When developing business relationships and supporting contracts it is important to follow the nine other Lessons to decrease your transaction costs, and in turn lower your overall costs (or increase the profits generated by the relationship)

Lesson 2: Develop Contracts that create "Mutuality of Advantage."

Once a company has answered the make/buy decision, an organization must determine the strategy for working with its suppliers. Dr. Williamson cites fellow economist James Buchanan, who stated that the notion of economics as a 'science of contract' rather than as a 'science of choice' is underdeveloped. Buchanan's 2001 article ("Game Theory, Mathematics and Economics" in the *Journal of Economic Methodology*) said, "Mutuality of advantage from voluntary exchangeÉ is the most fundamental of all understandings in economics." A game in the context of outsourcing includes a set of companies, a set of moves (or strategies) available to those businesses, and details of the payoffs for each combination of strategies applied.

Dr. Williamson points to the power of win-win approaches, which in the realm of performance-based and Vested Outsourcing includes Game Theory, Behavioral Economics, Solutions concepts and the Non-Zero Sum Game.

Win/Win /Game Theory thinking has grown in popularity among academics studying mathematics and economics. To date eight Nobel Prizes have been awarded to Game Theorists, the first being John Nash in 1994 for his famous "Nash Equilibrium." Most practitioners have heard about win/win thinking; however it is important to understand that win-win thinking is more than just a popular phrase saying that companies need to collaborate better. Win-win thinking should be a key strategy for companies. What most practitioners do not realize is that droves of economists and mathematicians have simulated and strategically proven that agreeing to play a win-win game enables individuals and organizations to come out ahead.

In outsourcing, achieving equilibrium among the parties by committing to a win-win strategy through collaboration, flexibility and foresight can grow both organizations businesses. As Nash demonstrated, the key lies in players working together toward a mutually beneficial strategy that

optimizes for the cumulative payoff. The idea is not to optimize for the status quo, but to look for ways to change the game, or the contract process, to achieve a larger payoff for everyone.

The size of the pie is not fixed! Companies can and should work together to find ways to make more pie. By working together they can indentify opportunities to reduce costs and increase service.

Our research found that even when companies talked win-win they often still contracted under typical win-lose thinking. For example, we often hear business people talk about "collaboration" and the "long term" but their contracts would clearly spell out 30 or 90-day terms for convenience clauses. A panel of shippers described how important their carriers were to their success, yet none of these contracts lasted longer than a single year. That is like telling a five year old to sit still for an hour in order to get a treat. That's a strategy that won't work very well for the short or the long term.

Advice for the Practitioner: Dr. Williamson helps to take the concept of game theory out of the land of economics and into the land of contracting. He shows that the contract itself can have negative impacts on the business if an organization does not think through how to structure and negotiate the contract properly. A properly structured contract can increase the profits for all, while a poorly structured contract tends to simply divide the benefits – or even shrink them. **In short don't just say win-win contract for win-win.**

Lesson 3: Understand the Transaction Attributes and their Impact on Risk and Price.

Once a company understands that outsourcing should be seen as a continuum instead of a simple insource vs. outsource decision, the question then should become "what is the best approach for structuring the relationship and contract" to drive out non-value added transaction costs.

Dr. Williamson points out that companies need to understand three attributes of their business environment in order to help them make better discussions with outsource providers and ultimately lead to better contracts. Each of the attributes is identified in the table below.

Table 1: Impact of Attributes On Risk to a Service Provider

ATTRIBUTE IMPACTING RISK	RISK TO SERVICE PROVIDER	
	Low	**High**
Asset specificity	Widely available and generic assets can be used to provide services	High degree of customization and investment needed in order to provide services
Uncertainty of work	Static environment; little likelihood of the work changing or be eliminated	Dynamic environment; high degree of work scope changing or being eliminated
Variable frequency	Consistent levels of work to amortize over assets	Inconsistent levels of work to amortize over assets

Source: Vitasek, Manrodt, Wilding and Cummins

Understanding these three attributes and how companies view them can and does have a direct influence on how a company and a service provider will "behave" when it comes time to write a contract because each element can and does add risk to a service provider.

In a perfect world, a company and the service provider can take a snapshot of the business and create an agreement that allows for the service provider to price the work under a set of given circumstances. The service provider clearly understands the task and the attributes of the work and provides a "price" to the company.

Unfortunately, the world of business is not perfect. Dr. Williamson says that the more an outsource agreement contains higher risk in the three attributes noted above (asset specificity, uncertainty, and variable frequency), the more a service provider will feel potential risks and will want to put in "safeguards" into a contract to protect them from the risk of changes. It is recognized by Williamson that many firms are opportunistic and act with self-intent. Therefore he advocates safeguards to protect against opportunism.

Dr. Williamson suggests that if asset specificity is high, and disturbances are high, one can assume that transaction costs are at their highest. In these instances it would be less expensive from a TCE perspective to keep things in-house. If the asset specificity is low and disturbances are minimal, then transaction costs are much more predictable and therefore lower.

His logic is fairly simple. The higher a customer's need for asset specificity, the more uncertain and the less frequent the work, the higher the transaction costs, or price that they should expect to pay. From a service provider's perspective, the greater the degree that these attributes are present – the higher the risk for the service provider. As a result the service provider will need to charge a premium for the work.

As mentioned previously, savvy companies should consider the total costs of all transactions – not just the price paid. Organizations should address these attributes in a transparent and open dialogue and work towards optimizing the best way to mitigate the risks associated with each attribute. In other words, by reducing the degree that these attributes are present, the team can minimize risk and costs associated with the work.

Let's look at three real world examples to put this into perspective.

> **Example 1:** There is a significant risk associated with the uncertainty of currency fluctuations for a back office procure-to-pay BPO (business process outsourcing) project between Microsoft and Accenture. In this example, the contract originally stated that Accenture would manage the currency fluctuations associated with the accounting processes it managed. However, after monitoring the impact of the currency fluctuations, it was determined that this was causing Accenture to bear too much risk. Rather than raise the price to cover this risk, the two companies agreed that Microsoft would be better suited to bear the risk of currency fluctuations. Accenture still manages the procureto-pay process under the outsourcing agreement, but Microsoft manages the currency fluctuations and "hedges" in order to beat the market and create further value. By recognizing that currency fluctuations were an uncontrollable risk, the companies could evaluate which one was best suited to bear the risk. In the end, Microsoft was able to use its hedging skills to best manage the risk while still leveraging Accenture's skills in managing the actual accounting process.

> **Example 2:** A conventional way to price for transportation is on a per-mile basis. Trucking companies must pay for the fuel. If fuel costs rise, the trucking company bears the risk and the cost increase eats into their profit. As such, most trucking companies will impose a "fuel surcharge," which is often the cause of contentious debate and negotiations. Rather than fall back to negotiating, one company looked at fuel rates and the impact on the trucking rates and then created an outsourcing arrangement whereby the cost of fuel was removed from the transportation costs. With non-controllable costs burdened by the company, the company's carrier agreement was then centered on having the carrier manage and optimize transportation efficiency and service levels.

> **Example 3:** Often network (bandwidth, telephony, etc.) costs are included in an infrastructure outsourcing relationship. Network costs, while trending lower, vary greatly over time and by region. Network technology advances rapidly, often providing innovation that will lower telecommunications costs over the life of the relationship. These dynamics create a perverse incentive for the service provider to resist innovation that could lower costs for the customer in an effort to preserve the service provider's revenue and margins.

Anticipating network cost improvements also leads to contentious negotiations, often resulting in complex management protocols to ensure the cost savings are shared between the parties. This drives up transaction costs, often outweighing the savings to both parties.

A more successful approach was to place the telecommunications costs outside of the contract and provide incentives for the service provider to improve network utilization and implement management and technology innovation to reduce costs.

Advice for the Practitioner: Companies should look to identify all costs, including transaction costs associated with asset specificity, uncertainty, frequency and work to develop solutions that can mitigate these risks and the costs associated with them. The goal of the contract should not be to "negotiate" the risks, but to identify them and try to determine the best way to manage them without exposing a one-sided agreement pushing risks on the service provider or the customer. Doing so will simply cause the service provider to raise costs without trying to manage the real issue Resulting in increased transaction costs in the long term.

Lesson 4: The More Bilateral Dependencies, the More the Need for Preserving Continuity.

Unfortunately, the world of business is not static or perfect and companies and their service providers will try to develop a relationship that can best address a dynamic environment. This can create a bilateral dependency that makes it difficult to "undo" an outsource agreement. For example, often a service provider invests, develops or creates assets or skill sets to be used specifically for a specific customer. This could be the purchase of a facility near the client's site, or hiring specialized labor to manage specific needs of the customer. The cost of redeploying these assets to alternative uses becomes increasingly difficult, placing the service provider at risk should the contract expire.

Alternatively, service providers gain additional information about the processes that are performed and at some point may be more skilled at performing work than the customer. This places the customer at risk, as they could fall victim to predatory pricing. Care is taken to make sure the service provider is good, but not too good.

In other cases, both service providers and customers increase their asset specificity over time as well, such as by creating interdependent processes and systems. These bilateral dependencies can make it costly to undo a relationship if things go wrong over time. Dr. Williamson argues that contracts should have a "preserving governance provision." In other words, there should be a governing structure in place to avoid a loss in the first place. The governance structure should be flexible enough to account for "disturbances," or "maladaptations" when things go wrong.

Unfortunately, a recent International Association of Contracting and Commercial Management (IACCM) study highlights the problem of these dependencies and how opportunistic behavior can take place. According to the report, "Many powerful organizations simply ignored inconvenient terms and insisted on their renegotiation. Others made unilateral, non-negotiable changes, in particular in areas such as payment terms (interestingly, the fact that suppliers felt forced to accept such changes led buyers to see 'increased collaboration', whereas the suppliers felt that collaboration had taken a hefty negative blow)."

Advice for the Practitioner: The higher degree of complexity and bilateral dependency, the more the need to spend the time to create a governance structure to preserve continuity. Companies that frequently bid and move work to new suppliers are likely to experience higher overall costs than if they developed a fair and equitable contract that preserves continuity and eliminated switching costs.

Lesson 5: Use a Contract as a Framework – Not a Legal Weapon.

Recently deceased author and leading legal academic Ian Macneil was ahead of his time in 1968 when he professed that business -to-business contracts should be 'instruments for social cooperation'. Unfortunately, many companies have lawyers that are creating outsourcing contracts that are so tightly defined with self-interested terms that their contracts are legal weapons instead of instruments of social cooperation.

All practitioners know that the world of business is not static; it changes and evolves over time. As such, Dr. Williamson argues that organizations "need to come to terms both with bounds and rationality." He points out that "all complex contracts will be incomplete – there will be gaps, errors, omissions and the like." And, as human actors we are bounded by our inability to know everything.

Dr. Williamson advises that a contract should provide a flexible framework and a process for understanding and managing the parties' relationship as the business world changes.

If we stop and think about it – having a contract as a flexible framework makes perfect sense. All practitioners know that the world of business is not static; it changes and evolves over time. As such, Dr. Williamson argues that organizations "need to come to terms both with bounds and rationality." He points out "all complex contracts will be incomplete – there will be gaps, errors, omissions and the like." And, as human actors we are bounded by our inability to know everything. The contractual framework, thus must be highly adjustable or adaptable rather than prescriptively outline the detailed working relations.

Our research found a common mistake that companies make in outsourcing today is that they create detailed statements of works (SOWs) and try to define too tightly the work to be done. Dr. Williamson advises that the contract should have "the effect of which is to facilitate adaptation, preserve continuity and realize mutual gain during contract implementation." Contracts should be structured with flexibility to deal with unanticipated disturbances so as to relieve potential maladaptations.

IACCM's research also supports this finding. According to the previously cited IACCM study, today's contracts are filled with self-interested terms designed to protect self-interest rather than promote social collaboration between companies. Their study found the terms receiving the most emphasis are about self-protection, indicating that companies are using their contracts as legal weapons to protect themselves in the case of risk. Table 2 highlights the terms that are negotiated with the greatest frequency.

Table 2: Terms that Were Negotiated With The Greatest Frequency

Limitation of Liability
Indemnification
Price / Charge / Price Changes
Intellectual Property
Confidential Information / Data Protection
Payment
Service Levels and Warranties
Delivery/ Acceptance
Liquidated Damages

Source: IACCM, 2010, page 5.

It is difficult to see how focusing on these terms will provide the framework needed to be adaptable in a changing environment. Instead, these terms coupled with overly prescribed Statement of Works - create a rigid operating environment. When the business does change (as it always does) the parties begin to get uncomfortable and tension arises and fingers are pointed. A better approach is to simply realize that the business environment can and will change and that companies need to address how to best mitigate the risk versus trying to shift risk.

What makes this more interesting is that using a contract as a legal weapon is something that is done by choice not by law. "The distinguishing feature of contractual obligations (in business) is that they are not imposed by the law but undertaken by the parties', (Smith, 1993 as cited by Macneil). In other words, companies choose to design contracts with terms that defeat collaboration; they are not required by law to do otherwise. If we have chosen the contractual obligations we are imposing on ourselves, shouldn't they be beneficial to everyone involved?

Advice for the Practitioner: Creating a detailed contract and associated statement of work puts the outsource provider into a "box" and forces the provider to stay there under the contract. Likewise, using terms that promote self-interests further deteriorates the spirit of cooperation and collaboration by encouraging finger pointing when the business environment can and does change. Instead of being a prescriptive do cument, the contract should provide a flexible framework and process for understanding the parties' relationship. This means that this framework/process must be highly adjustable or adaptable. However, in achieving this "flexible framework" the contract will never accurately indicate real working relations. Instead of trying to "guess" about the future, it is better to indicate a rough idea of the work to be done, and provide recourse for ultimate appeal.

Lesson 6: Develop Safeguards to Prevent Defection.

A flaw in human nature is that people (and organizations) are often tempted to act in a self-interested manner. We tend to deflect responsibility when risks are high or when things go wrong. In laymen's terms, organizations will defect from a contract if the advantage from defecting is better than the staying. Dr. Williamson notes that, due to bounded rationality, costly breakdowns continue in spite of efforts to develop sound contracts. A key reason for contractual breakdowns is that business and market dynamics can and do change the economics of the agreement. What was once a viable contract may become a burden to all.

Many have heard of the horror stories of suppliers closing up shop or companies that outsource invoking their "terms of convenience" clauses. In either case – one party is left holding the proverbial bag and feels the pain associated with defection. The conventional approach is to negotiate safeguards to "protect" each party's interest. Suppliers do this by increasing their price. Companies that outsource protect their interests with terms of convenience clauses.

Rather than be fearful of the risks associated with a bad contract, organizations should work to develop proper safeguards that allow for organizations to disentangle their relationship in a fair and equitable manner without harming the other party. We like to think of this as an off-ramp or exit management clauses. Whatever you call it, the purpose it to develop safeguards that protect either party in the event that one of the parties no longer wants to continue to do business under the contract. By addressing the transaction costs associated with exiting the business arrangement, companies can address the risk and costs head-on rather than hide the costs. Typically off-ramps and exit management clauses will tend to make one of the parties "whole" if the contract is terminated prematurely. For example, if a service provider invests in a specific piece of equipment or other asset, and their client invokes their term of convenience, the off-ramp would likely have a provision to payback some or part of the suppliers investment.

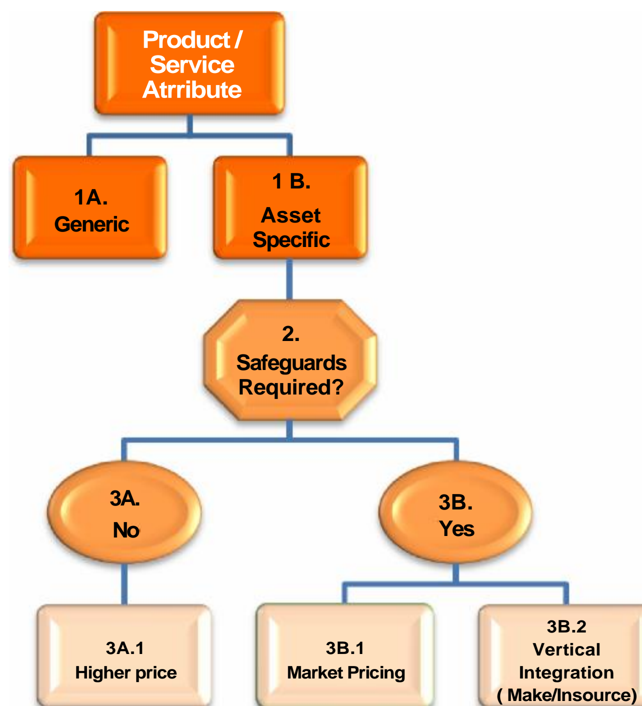
Where should the work go when business relationships go sour and need to be terminated? Dr. Williamson warns companies against the temptation of bringing the work back in-house. This is due to the additional "bureaucratic costs" involved in taking a transaction out of the market and organizing it internally. He warns that an "internal organization is usefully thought of as the organization of last resort."

Advice for the Practitioner: It is important to recognize that business relationships may need to change due to changes in the market; for this reason contracts need a well thought out exit management plan. A perfect supplier (or customer) today might not be a perfect match in the future. For this reason, practitioners should clearly identify the costs associated with terminating a contract. Create safeguards in the contract that are fair and equitable in terms of keeping either party "whole" in the event that a contract needs to be terminated prematurely. And, just because the relationship failed does not necessarily mean that the work should be brought back inside the organization.

Lesson 7: "Predicted Alignments" can Minimize Transaction Costs.

As mentioned in Lesson 3, Dr. Williamson writes that transactions have various attributes that operate in different governance structures. The goal of TCE is to minimize transaction costs. To do this Dr. Williamson points to a concept called "predicted alignment." Here the goal is to create an alignment that results in the economizing or minimizing of transaction costs, to the extent possible, given the uncertainties inherent in market dynamics and forecasts. In simple terms – this means the business and the contracting approach need to be in synch. This is described in detail below in Figure 3.

Figure 3: Contractual Alignment To Minimize Transaction Costs



Source: Adapted from Williamson, 2008

The first decision a company must make when aligning the business with the right type of contracting approach is to determine if what is being sourced is generic or asset specific. If there are no specific assets involved and the parties are "essentially faceless," then the product/service is generic (depicted as 1A) . A company can buy the product from one supplier that is no different than buying it from another. In the case of a generic product/service, there are low virtually no transaction costs because switching suppliers is very easy.

In cases where some specific assets are required (depicted as 1 B), transaction costs will increase because of the inherent risks associated with investments in the assets that are needed to perform the service. This creates a "bilateral dependency" between the buyer and the seller, and both parties are inherently incented to promote continuity of supply to avoid transaction costs associated with switching suppliers. It is at this stage of the decision process that organizations begin to discuss safeguards that

reduce their risk. This is depicted as 3. For example, in the case of the supplier, the supplier will want to rely on contractual safeguards such as minimum order quantities or a long-term contract to help protect against their investments in the specific assets.

Companies that enter into contracts requiring specific assets and do not use safeguards should expect higher prices from their suppliers because the supplier will use pricing as a way to hedge against their risk in order to protect their investments in their assets (depicted in 3A1). To mitigate from higher prices (or to protect their risk), companies should include safeguards into their contract (depicted as 3B).

The conventional approach a company uses to negotiate asset specific contracts is a market pricing approach under a competitively bid environment (depicted in 3B1). The rational is that frequent competitive bidding will regulate cost and risk by pitting suppliers against each other to drive down the price with suppliers absorbing risk in hopes of winning the work. Once market prices are known, a company can then decide if they want to buy (outsource) as depicted in 3B1 or make (vertical integration) as depicted in 3B.2.

To demonstrate Dr. Williamson's model, let's suppose a supplier is asked to make a part requiring them to make a special die. The cost of the tooling has to be added to the price charged by the supplier. If no safeguards are put in place, such as a year long contract or a guarantee on a minimum of parts ordered, the company can expect to pay more for the part. The supplier can only cover their risk (making a special die) by increasing the price of the part. If, however, safeguards are put in place, such as a minimum quantity, or a year long contract, the risks borne by the supplier are minimized and the cost of the die can be spread out over all of the parts to be produced.

However, what if the part is of strategic importance to the company? Or the costs being charged by the potential supplier are far too great? In these cases the company may decide to keep the work internal and integrated with the rest of the firm, assuming that the firm has the ability to perform the work. Or, it may be beneficial for the firm to own the die and allow the supplier to use it.

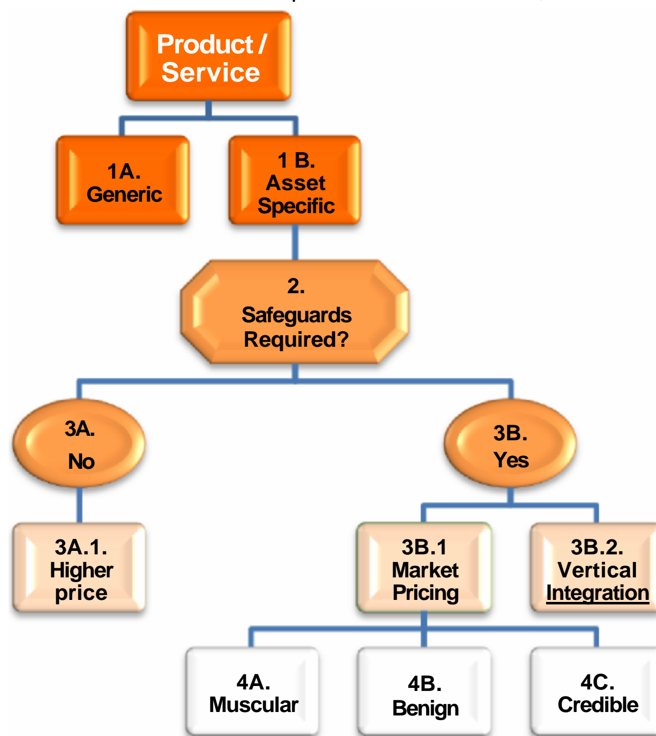
Dr. Williamson's insights point companies to work through the options to help them select the most logical path to solve their product/supply requirements. Using Dr. Williamson's framework, complex outsourcing agreements should absolutely rely on safeguards for protecting both the service provider and the customer because the complexity drives unknowns. Organizations should *transparently* discuss the risks and how to deal with the risk through properly defined safeguards. Our field research shows that the most successful outsource arrangements openly discuss risk and work collaboratively to determine how to mitigate the risk (see Lesson 2). Failure to have transparent discussions about risks and safeguards will result in higher prices from the supplier as well as higher transacti ons costs.

Advice for the Practitioner: Companies that outsource non-commodity services especially complex service that require supplier investment must proactively work to identify the risk associated with the unknowns and have candid and transparent discussions to address proper safeguards to protect investments. *When at all possible, create a shared vision, which will guide how both the company and the service provider will work. Companies should create mutually beneficial outsourcing agreements whereby the service provider is rewarded financially for achieving the desired outcomes for the company that is outsourcing. Develop pricing models that will reward and incentivize service providers for achieving the desired outcomes.*

Lesson 8: Your Style of Contracting Matters; Be Credible.

For those relying on market pricing, Dr. Williamson describes in some detail the three styles of contracting, which he refers to as muscular, benign and credible. This can be found in Figure 4 below, specifically in 4A, 4B, and 4C in the graphic.

Figure 4: Contractual Alignment And Contracting Styles
Source: Adapted from Williamson, 2008



Muscular

The muscular contracting approach has one of the parties holding the balance of power, and does not hesitate to exercise it. While both buyers and suppliers in theory can hold power positions, more often than not it is the buying organization that demonstrates its power, and tells a service provider what it wants and expects.

Dr. Williamson calls the muscular approach to outsourcing of goods and services “myopic and inefficient.” Our research found examples of companies we termed “800 pound Gorillas” that would use a heavy-handed approach in dealing with their supplier simply because they could. Companies using this

approach typically have war stories of bankrupt suppliers, or worse, a dwindling number of suppliers willing to work with them.

A classic example was an organization known for poor relationships with their transportation carriers. The customer's reputation was so bad that soon none of the major carriers bid on any of their business, even though it was worth several million dollars. In one instance, the firm partnered with a carrier on a special project; this required an investment of both time and assets on the part of the carrier. After a three-month trial run with great results the company bid the business out to another firm. Pitted against their 800-pound Gorilla customer, the muscular approach left them rather weak.

Dr. Williamson's statement that "muscular buyers not only use their suppliers, but they often Ôuse up' their suppliers and discard them" is apt. When this happens the company will need to bear the cost of switching suppliers or worse, have the risk that their supplier leaves them high and dry when they go out of business.

Yet, this risk is not borne just by the muscular party. Increasingly it is recognized that competition is no longer between individual companies but rather between their respective supply chains. The goal is to create a highly competitive supply chain. By forcing a supplier into bankruptcy you not only destroy that company, but also create the seeds of your own destruction by potentially making the supply chain you are part of noncompetitive in relation to the supply chains of your competitors. Companies also risk paying more when a market consolidates, when suppliers merge with one another or if they leave the market entirely. We contend that a weak global economy has given companies far too much of an excuse to adopt muscular behaviors that will result in higher costs for all.

Dr. Williamson adds that when organizations adopt this muscular approach the supplier really has two choices for defense in the contract negotiation. They can charge higher prices and try to recoup their costs that way, or they can ask for safeguards in a contract.

Dr. Williamson's point is that bullied suppliers will come up with overt and covert options to protect themselves and this approach is bad for the company because no matter what countermeasures the suppliers take to protect themselves it will ultimately result in higher overall total costs.

Benign

The benign approach assumes that both parties will cooperate; both parties will give-and-take in the relationship. This works well until the stakes are raised. In other words, the temptation becomes too great and one party will take advantage of the other. The impact that such behavior will have on the offending party may help to deter this behavior. However, that is part of the transaction cost thus taken into account. This cooperation "eventually gives way to conflict and mutual gains are sacrificed unless countervailing measures have been put into place."

The benign approach doesn't work well for long-term agreements, as the risks (transaction costs) are too high. Being too nice can lead to being taken advantage of. The benign approach blindly assumes too much trust on the part of all or some parties. It also assumes that cooperation to deal with unforeseen contingencies to achieve mutual gains will always be there.

Our field research found evidence of organizations that were too trusting in the initial stages of the relationship and were taken to the cleaners as a result. One example (which we saw repeatedly) was when service providers would extend too much trust by developing a “gain-share” with their customer. If the service provider found savings they would receive a share of the benefit. The agreement was clear in most cases – a 50/50 split. The problem was defining the rules of how to split the savings. In several cases a service provider identified and implemented ideas that drove savings for a client and the client would come up with excuses as to why they did not have to pay.

Clearly a company should not be gullible. To avoid this Dr. Williamson recommends companies use a third approach, which he calls a credible contracting approach. The fundamental philosophies outlined in a Vested Outsourcing approach follow Dr. Williamson’s credible contracting style

Credible Style

Dr. Williamson describes credible contracting as hardheaded and wise. It is hardheaded because it strives for clear results and accountability, but it is not mean-spirited, as in the muscular type. It is also wise because it arises out of an awareness that complex contracts are “incomplete and thus pose cooperative adaptation needs” and require the exercise of feasible foresight, meaning that “they look ahead, uncover potential hazards, work out the mechanism and factor these back into contractual design.” To address these potential risks, Dr. Williamson argues that credible commitments should be introduced to effect hazard mitigation.

Credible contracting is not new. Contract safeguards can take unconventional forms, as discussed by Dr. Williamson with respect to ancient Mesopotamia, where self-inflicted curses were used to deter breaches of treaties. The key point is that a good hybrid contract for a complex outsourced service will be above all fair and equitable to both parties in the agreement and it will challenge the organizations to focus energy on unlocking inefficiencies rather than negotiate for the win at the other party’s expense.

Advice for the Practitioner: Organizations that use their “muscle” to gain an advantage over their suppliers may have a short term win, but they will lose in the long term. Companies will ultimately face higher market costs and transaction costs from transitioning suppliers, or at a minimum from suppliers being forced to use conventional negotiations to put in myopic and costly contractual provisions and behaviors that simply drive up hidden costs.

Lesson 9: Build Trust: Leave Money on the Table.

Dr. Williamson also says that TCE does not necessarily embrace “user-friendly” concepts such as the “illusive concept of trust.” He wonders what benefits might come from the more widespread use of trust among outsourcing buyers, and at what cost. Trust should not necessarily supplant power entirely and indefinitely, he argues, and that is where the credible part of contracting comes in.

We would propose that the most effective and collaborative contracts, the ones that are truly credible, must include trust. The idea of vesting, or committing, one’s self or a company in a contract arrangement implies a large degree of initial trust in the value of the enterprise, a large degree of give-and-take to achieve mutual goals and a large degree of good faith during the course of the relationship.

Trust is implicit in Dr. Williamson's suggestion that it's often better to leave money on the table, or not insist on winning every negotiating point. It's an idea that goes against the usual low-cost, transaction-based grain in a traditional contract.

In a new and potentially long-term arrangement constructive and strategic contractual intentions are sometimes hard to differentiate. What exactly are the parties' intentions going into the negotiation?

If there is a strategic rather than constructive purpose that skews the contract in one party's favor "and if real or suspected strategic ploys invite replies in kind, then what could have been a successful give-and- take exchange could be compromised," Dr. Williamson explains.

If each party, or even one party has a strategic agenda and wants to gain an upper hand – or go muscular – asymmetry will result. This "could plainly jeopardize the joint gains from a simpler and more assuredly constructive contractual relationship," he says.

"Always leaving money on the table can thus be interpreted as a signal of constructive intent to work cooperatively, thereby to assuage concerns over relentlessly calculative strategic behavior." What can result is a pragmatic and ultimately wise outsourcing contract with credibility from start to finish.

Advice for the Practitioner: Leaving money on the table may sound foolish, but when striking a strong business relationship it can signal a constructive intent to work cooperatively that will build an environment that is credible from start to finish. A large degree of give-and-take is required to achieve mutual goals.

Lesson 10: Keep it Simple.

Dr. Williamson points out the importance of trying to keep things as simple as possible. "Keeping it simple is accomplished by stripping away inessentials, thereby to focus on first order effects – the main case as it were – after which qualifications, refinements and extensions can be introduced," he writes.

Getting it right entails working out the logic, and making it plausible. Plausibility means to preserve contact with what is actually occurring in the market and in the contract while avoiding what Dr. Williamson calls "fanciful constructions." Getting it right and keeping it simple also entails translating economic concepts into accurate mathematics or diagrams or words.

Conventional thinking is that the "best practice" for outsourcing is to create more detailed statement of works and tightly defined service level agreements to monitor the business in great detail. This trend is often coupled with complex pricing models and associated penalties for service providers that do not meet the metrics. Unfortunately, too many organizations are focusing on measuring for measurement's sake and they are often perplexed to find out that their scorecard is "green" but the business is not as profitable and customers are not as happy as they would like.

Our field research found that some of the most successful outsourcing arrangements bucked conventional best practice thinking and instead chose to focus on few (five or less) clearly defined and measurable desired outcomes. While the parties agreed that measuring the business was essential – the contract itself focused on creating a shared vision and how to measure success against desired

outcomes – not on defining and micro-managing day-to-day operational metrics. The outsourcing agreement then focused leveraging a governance structure that used data to drive business improvements jointly rather than point over whose fault it was when a Service Level Agreement was missed.

The complexity of life, systems and business interactions make simple models in each case attractive and necessary. Simplicity is simple to say but can be quite complicated to achieve. It requires knowledge, the ability to prioritize and a high degree of flexibility and pragmatism.

Advice for the Practitioner: Keep it simple, keep it pragmatic, make it plausible and get it right: Those are excellent lessons in life and for a good contract.

The Bottom Line

The bottom line on Dr. Williamson's work is that the bottom line is not always apparent at first look; you have to look at the hidden costs of doing business as well as the price of what you are buying. This includes understand the costs of poorly structured contracts and bad behavior such as using a muscular approach for negotiating with your service providers.

Dr. Williamson's work also shows how businesses can address conflict resolution. He takes the concepts of game theory and focuses them around the contracting process itself – looking through the "lens of the contract" and how organizations behave when it comes to the contract and how people behave during contract negotiations.

Dr. Williamson's thoughts on outsourcing go beyond the numbers and substantiate the value of a collaborative, win-win approach to outsourcing and 3PL contracts. It is some of the best academic work to show how the contract and governance structures need to be addressed in developing outsourced relationships.

The main reason Dr. Williamson's work is so useful to us is that his work with mathematical and economic models aligns nicely with what we have learned in our applied case base research on Vested Outsourcing, Performance-Based Outsourcing and Collaborative supplier relationships:

- Win/win relationships are a must when there are complex requirements. Not only is win-win a common sense thing to do – but applying "muscular" win-lose thinking actually increases the cost of outsourcing. We call this establishing a WIIFWe (What is in it for We) vs. WIIFMe (What is in it for Me) foundation.
- An effective outsourcing arrangement should include a shared vision and a "predicted alignment" with clearly defined and measurable desired outcomes that guide the decisions of how the companies work together.
- Focusing on price alone only provides a partial picture of the true TCE of an outsourcing relationship. Companies need to establish transparent pricing models with incentives that optimize for cost/service tradeoffs. These pricing models should include a well thought out exit management plan with the desire to drive continuity of service
- Putting in place a good governance structures is essential. The contract should be seen as a flexible framework, augmented with well thought out governance structure designed to manage the business with the understanding that the business environment will likely change
- Dr. Williamson's lessons are simple and profound when you reduce them to their core essence. We hope more people will understand the contribution of his work after reading this document.

About the Authors

Kate Vitasek is a nationally recognized innovator in the practice of supply chain management and outsourcing. Vitasek's approaches and insights have been widely published with more than 100 articles in respected academic and trade journals such as the Journal of Business Logistics, Supply Chain Management Review, Harvard Business Review, and Outsourced Logistics. Her latest book is a must read for practitioners on how outsource better – Vested Outsourcing: Five Rules that will Transform Outsourcing.

Vitasek is a faculty member at the University of Tennessee's Center for Executive Education. She's been recognized as a "Woman on the Move in Trade and Transportation" for her leadership in the profession and was recently honored as a "Woman of International Influence" by *Global Executive Women*. She has served on the Board of Directors for the Council of Supply Chain Management Professionals and has been called a "Rainmaker" for her tireless effort in educating the supply chain profession. She can be reached at kvitasek@utk.edu.

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Dr. Manrodt was recognized as a "2004 Rainmaker" by DC Velocity Magazine and in 2005 was awarded the Eugene Bishop Award for Sustained Academic Excellence by the College of Business at Georgia Southern University. He served on the Board of Directors for the Council of Supply Chain Management Professionals as well as other leadership roles with the Warehouse Education Research Council. In addition to serving as an editor, reviewer or editorial board of numerous academic and practitioner journals, he has given over 150 presentations on six continents. He can be reached at: kmanrodt@georgiasouthern.edu.

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At the European Supply Chain Distinction Awards 2008, Professor Wilding received the `Distinguished Service Award for Thought Leadership and Service to Supply Chain Management`. In 2010 his biography was entered into “Who’s Who” described as "Britain's most famous reference book" for those who have "reached the pinnacle of excellence in their field" and "demonstrated lasting significance.”

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Additional Resources

Vested Outsourcing site: *www.vestedoutsourcing.com/*

Oliver Williamson:
Nobel Prize Lecture (video) –*http://nobelprize. org/nobel prizes/economics/laureates/2009/williamson-lecture.html*

Slides: *http://nobelprize.org/nobel prizes/economics/laureates/2009/williamson-lecture-slides.pdf*

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