CONSIDER THE BEST STRATEGIC SOURCING MODEL FOR YOUR BUSINESS

By Kate Vitasek

Research by the University of Tennessee has found that many, if not most, of the world's most-used sourcing strategies are incomplete for modern procurement challenges. The way we think about procurement has its roots in buying strategies that were developed more than 30 years ago, but they don't work well in today's complex and often volatile marketplace.

Those older strategies are limited in scope because they are based mainly on "lowest cost" and engage heavily in shifting risk. For the most part conventional procurement practices cannot keep up with the pace of change, today's economic realities, and the need for more collaborative, value-creating, and systems-based approaches in buyer-seller relationships.

Today procurement officials need to become *architects*: they must design the best value-based supplier relationships that give equal attention to both the relational and economic aspects of sourcing contracts. But can they accomplish that essential task?

Research into progressive companies finds that their suppliers are looking beyond typical transaction-based procurement models for their sourcing needs. More and more organizations such as P&G, McDonald's, and Microsoft are redefining winning as based on innovating and creating value by working collaboratively with suppliers—rather than simply thinking of suppliers in "make" or "buy" terms.

Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models in Modern Procurement, profiles how organizations are seeking to "shift up the sourcing continuum" by using more sophisticated sourcing business models purposely designed to harness the potential of suppliers.

Sourcing Continuum

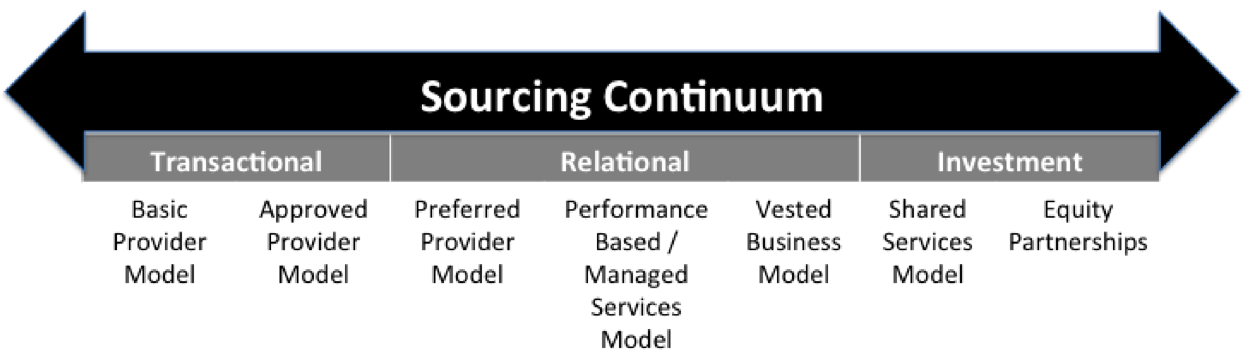

Figure 1

A brief overview of the seven sourcing business models follows.

BASIC PROVIDER MODEL

The basic provider model is a transaction-based economic model, where there is typically a set price for individual products and services; there is a wide range of readily available, standard market options, with little differentiation in what is offered. This model is best suited in situations where there are low cost, standardized goods and services in a market with many suppliers. Buyers typically use frequent competitive bidding (oftentimes through pre-established e-auction calendar events) and there is little or no impact to the business in the event that suppliers are switched.

APPROVED PROVIDER MODEL

An approved provider model is also a transaction-based approach, with goods and services purchased from suppliers that meet a pre-defined set of qualification characteristics, quality standards, previous proven performance or other selection criteria. Frequently organizations will have a limited number of pre-approved suppliers for various categories from which buyers or business units can choose. In these transactions risks and costs are known and/or are relatively low. Multiple suppliers mean costs are competitive, and one firm can easily be replaced with another if the supplier fails to meet performance standards.

PREFERRED PROVIDER MODEL

A key difference between the preferred provider and the other transaction-based models is that the buyer is choosing to move to a more strategic, relational approach. Buying companies seek to do business with a preferred provider to streamline their buying process and build longer-term relationships with key suppliers. They often enter into multiyear contracts by using a master agreement that allows them to conduct repeat business efficiently. While the preferred provider model is still transactional, the way the parties work together and the efficiencies they achieve go beyond the simple purchase order.

PERFORMANCE-BASED/MANAGED SERVICES MODEL

A performance-based model is typically a longer-term, formal supplier agreement that combines a relational contracting approach with an output-based economic model, based on a supplier's ability to achieve predefined performance parameters or savings targets. Performance-based agreements shift the thinking away from transactional activities to predefined outputs or events. Some companies call the results "outcomes," but in performance-based agreements the meaning of "outcome" is defined as the achievement of an event or deliverable that is typically finite in nature and is therefore easily understood. A good example of an output is a supplier's ability to achieve predefined service level agreements (SLAs).

VESTED MODEL

The Vested sourcing business model is highly collaborative; the buyer and supplier have an economic—vested—interest in each other's success. The Vested model combines an outcome-based economic model with the Nobel award-winning concepts of behavioral economics and the principles of shared value: companies enter into highly collaborative arrangements designed to create value for the buyer and supplier above and beyond the conventional buy-sell economics of a transaction-based agreement. A Vested model works best when an organization has transformational or innovation objectives that it cannot achieve itself or by using conventional transactional sourcing models (basic provider, approved provider, preferred provider) or a performance-based agreement.

SHARED SERVICES MODEL

A shared services model is an internal organization based on an arms-length outsourcing arrangement. Using this approach, processes are typically centralized into a "shared service" department or organization that charges members for the services used. Organizations use this model for a variety of functional services such as human resources, finance operations, and administrative services (such as claims processing in health care).

EQUITY PARTNERSHIPS

If an organization does not have adequate internal capabilities to acquire mission-critical goods and services, and does not want to outsource or invest in a shared services organization, it may opt to develop an equity partnership. Equity partnerships create a legally binding entity, and take a number of different legal forms, from acquisition of a supplier, to creation of a subsidiary or cooperative, to an equity-sharing joint venture.

WHICH SOURCING BUSINESS MODEL IS THE MOST APPROPRIATE FOR YOUR SITUATION?

It depends!

University of Tennessee researchers have worked with participating organizations to craft a new resource/toolkit designed to help buyers and sellers answer this question. The result is an open source tool that organizations can use to "map" their various spend categories, known as a Business Model Mapping toolkit.

For simple transactions with abundant supply and low complexity, a transactional model is likely the most efficient way to go. However, transactional models fall short for more strategic, complex sourcing initiatives and often require a performance-based (managed services) or Vested sourcing business model. Shifting along the sourcing continuum to these more sophisticated models allows organizations to move from "value exchange" to "value creation" because the deal architecture is designed to motivate suppliers to invest in continuous improvement, transformation, and/or innovation geared to reducing cost structure or other strategic business outcomes.

No single sourcing business model is preferable over another. Rather, most organizations probably should use multiple sourcing business models. Sourcing models can evolve over time as the business changes and events occur. An organization might start out with an approved provider model and shift along the sourcing continuum to a preferred or later even a performance-based relationship model.

Each of the sourcing business models work. The key is to know when to use the right sourcing business model for the right situation; each serves a different purpose and will garner different results and behaviors from suppliers. The Business Model Mapping toolkit is the guide.

TWO COMPONENTS OF A SOURCING BUSINESS MODEL

A crucial part of determining the right sourcing business model is for stakeholders to answer two questions.

First, what is the most appropriate *contractual relationship framework* for your situation? There are three choices: transactional, relational, and investment-based approaches. There are four questions to answer spanning 14 attributes such as:

- What is the overall level of dependency associated with my spend category?
- What is the strategic impact of the spend category?
- Does this spend category provide the organization with a core competency or competitive advantage?
- What is the degree of risk associated with this spend category?

The second question is what is the most appropriate *economic model*? An economic model defines how you will measure and ultimately compensate your supplier. Again there are three choices: transactional, output, and outcome-based models.

To determine if you should use a transactional, output, or outcome-based economic model, consider 11 attributes such as:

- How much potential is there to create mutual advantage by collaborating with a supplier?
- What is the nature of the workscope?
- What is the criticality of the work?
- What are your risk tolerance preferences?

BUSINESS MODEL MAPPING

There are four steps to determine the most appropriate sourcing business model for a particular buyer-supplier situation.

Step 1: Select the defined spend category/categories you are sourcing or potentially sourcing. This includes products and/or services that are currently insourced, currently outsourced, or possible new products or services needed in the make or buy decision.

When most organizations consider spend categories they usually think in terms of "*direct*" spend or "*indirect*" spend (e.g., facilities management or accounting services). Each spend category should be mapped separately. "Bundling" the various spend categories is suggested to see if it will make a difference in thinking about the category from a more strategic perspective. For example, Procter and Gamble chose to bundle its real estate and facilities management into one globally integrated agreement that ultimately used a Vested sourcing business model with the goal to achieve strategic desired outcomes and drive innovation. The P&G case study is profiled in *Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships*.

Step 2: Use the Business Model Mapping template to determine the best *relationship* model for what you are sourcing. This will help answer questions about the business environment, such as the overall level of dependency, the risk comfort zone, and the strategic impact of each spend category. For example, one of the attributes to "map" is the level of supplier integration/interface. The answers (in Figure 2) range from none to critical.

Level of Supplier Integration/Interface

Attributes to Determine the Best Relationship Model	Transactional Contract		Relational Contract			Investment
	A	B	C	D	E	F
Level of supplier Integration/interface required (systems, support processes)[4,54]	None	None	Medium	High	Very High	Critical

Figure 2

Step 3: Use the Business Model Mapping template to determine the best economic model for what is being sourced. As noted, the most widely used economic model in businesses today is a transactional-based model. They are the easiest to administer—typically the supplier is paid per activity. However, as you move along the sourcing continuum you will want to shift to more of an output- or outcome-based economic model because it gives the supplier greater degrees of freedom to provide solutions that will create value and drive innovation. Figure 3 illustrates one of the Business Model Mapping attributes when determining the best economic model—potential efficiency gains.

Potential Efficiency Gains

Attributes to Determine the Best Economic Model	Transaction-Based Economic Model			Output -Based	Outcme -Based	
	1	2	3	4	5	6
Potential Efficiency Gains	None	Low	Medium	High	Very High	Significant

Figure 3

Step 4: Use the Business Model Mapping matrix to develop a consensus view of the sourcing business model that is right for your situation. The best sourcing model will be a combination of the relationship model and the economic model chosen. For example, if your map indicates you should use a relational contract model (column D) and an output-based economic model (column 4), the matrix will indicate a performance-based agreement is the most appropriate sourcing business model for your situation.

Business Model Mapping Matrix

ECONOMIC MODEL	RELATIONSHIP/CONTRACT MODEL		
	TRANSACTIONAL CONTRACT (MARKET)	RELATIONAL CONTRACT (HYBRID)	INVESTMENT (VERTICAL INTEGRATION/ HIERARCHY)
OUTCOME-BASED Economics tied to boundary spanning/business outcomes	Mis-match—not a viable strategy N/A	Vested (E - 5)	Equity Partnership Vested Shared Services (F - 4,5)
OUTPUT-BASED PERFORMANCE-BASED/ MANAGED SERVICES Economics tied to supplier output	Mis-match—not a viable strategy N/A	Performance-based (managed services) agreement (D - 4)	Equity Partnership Shared Services (Performance-Based Shared Services) (F - 4)
TRANSACTION-BASED Economics tied to activities (e.g. per unit, per hour)	Basic provider Approved provider (A - 1)	Preferred provider (C - 1,2,3)	Equity Partnerships Transaction-Based Shared Services (F - 1,2,3)

Figure 4

CONCLUSION

Remember that no single model is "better" than another. The key is to let the business model mapping process help guide you to the most appropriate model. It might be tempting to think that a performance-based or a Vested sourcing business model sounds good because it motivates a supplier to invest in innovation and transformation. But if the mapping exercise indicates a preferred provider model is more appropriate for your particular situation, you will just be over-engineering the process.

ABOUT THE AUTHOR

Kate Vitasek is a faculty member on the University of Tennessee's Haslam College for Business Administration. She is the principal author of six books on the Vested business model and methodology. This article is based on her latest, *Strategic Sourcing in the New Economy*, published in October 2015.

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