THE UNIVERSITY OF TENNESSEE, KNOXVILLE

Unpacking Pricing Models
2nd Edition

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Making “You Get What You Pay For” Real for Business Relationships

(2nd Edition)

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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 negotiating 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 supplier often “get to yes” and establish a business agreement, they will frequently face renegotiations. Buyers especially become frustrated, frequently blaming suppliers for not honoring the original price. Rather than being frustrated, buyers should look in the mirror and ask, “Did I get what I paid for? And if not — why?”

The primary reason for this 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 buying company and its supplier establishing a “price” that reflects the circumstances at a point in time when the business agreement is established. This “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 designed to keep a buyer and supplier relationship in equilibrium as “business happens.”

Our premise is that if a company is not happy with its deal, or its business relationship, it should look closely at the 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 it matches the right tools to the right business needs.

This white paper has four parts:

Part 1 briefly introduces the three primary reasons for discord when it comes to pricing complex deals.

Part 2 defines and explains the various pricing tools in a business professional’s toolkit. We address five common questions that organizations often struggle with in pricing complex deals. In answering the questions, we define and explain the pricing tools practitioners can use to make getting to a fair price easier. We also provide recommendations where appropriate.

Part 3 provides an in-depth review for 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.

Part 4 challenges buyers and suppliers to negotiate prices through a different lens. Transparency and an approach that encourages the parties to have deeper and more meaningful economic discussions will expand their agreement zone to 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.

PART 1: 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 known and now the price is no longer fair. In the logistics and transportation industry "cost creep" is the number one reason 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 1980s, 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 to lower dependency on suppliers. This has led to over-commoditization in many industries as companies seek to "bid and transition" 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 constrained by formal, legally oriented corporate policies.[3] There is growing awareness this approach is ill-suited for 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]

The bottom line? Companies that want to prevent these common traps should start by first understanding all of the pricing tools in their toolkit. 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, answering five common questions about some of the most used, and often misused, tools.

PART 2: UNDERSTANDING THE BASICS — KNOW YOUR TOOLKIT

Many business professionals struggle when it comes to pricing. A key reason is that far too many don't understand the fundamentals of pricing.

Companies that want to get on the right track on pricing their next deal should start by making sure they know how to use all the pricing tools in their toolkit. This section of the white paper provides answers to five common questions we often get about some of the most used, and often misused, tools. As we answer each question, we identify ***key terms in bold italics*** and provide a definition in the glossary in the Appendix.

To help frame the answers we have picked a commonly outsourced service – facilities management – and provide examples to show how pricing can be addressed when buying/selling facilities management services.

WHEN SHOULD I USE A PRICE VS. PRICING MODEL?

One of the most common questions we get is "when should I shift from using a 'price' to a 'pricing model'?"

To answer, one must first understand the difference between a 'price' and a 'pricing model'? A ***price*** is how much you pay for something. You pay $4.25 for your Starbucks Grande two-pump vanilla latte. A facilities management (FM) supplier may have a price of $6.00 for every workorder processed by the company's customer service representative.

A ***pricing model*** is dynamic and enables the parties to adjust the underlying pricing assumptions as "business happens." Fundamentally the model includes mechanisms to determine the optimum monetary exchange between a buyer and a supplier by deriving the outputs based upon the input components. A good pricing model equitably allocates risks and rewards explicitly to realize mutual gains during 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 of ownership (TCO).* A TCO analysis determines all direct and indirect costs so optimal decisions can occur. A comprehensive TCO includes the costs incurred by the customer in managing and supporting the delivery of the service or goods they are contracting for.

A *best value assessment*. The best value assessment 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 *input assumptions*. Common input assumptions include volumes, the costs of raw materials, market share estimates, currency assumptions and base exchange rates, inventory and workload mix.

Risk allocation. Rather than shifting risk arbitrarily to either the buyer or the supplier, a pricing model seeks to jointly identify risks, understand the potential costs of those risks, determine which party is best suited to manage and mitigate each risk, and establishes an appropriate allocation of risk coverage (price-premium) for the party who agrees to bear the risk.

Desired *compensation method*. There is no one "right answer" for 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* triggers and techniques.** Margin matching is a mechanism designed to allow a buying organization and a supplier to fairly adjust prices based on movements in the defined underlying pricing model assumptions, in response to specific market changes. The goal of margin matching is to avoid having one party "win" at the other party's expense when "business happens." It can also protect the supplier's revenue or margin when a proposed innovation that saves the buyer money also reduces the supplier's earnings.

***Contract duration*.** Contract length is an essential element of a pricing model. Achieving step-level improvements can take time and need a significant investment on the part of the supplier which are often amortized over the life a contract.

Incentives. Coupling incentives to business agreements is 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 mutually beneficial to the parties in order to offset the flaws of using conventional compensation methods.

So, when should companies shift from using a 'price' to a 'pricing model'?" As a rule of thumb, use a price when you have a transactional sourcing business model and use a pricing model when you work with a more strategic performance-based or outcome-based Vested sourcing business model.

The business exchange in a transactional deal should be simple and predictable (e.g., janitorial supplies in an office environment) and as such, there is likely little room for the supplier to create value beyond simply providing the good or service. Companies should shift to a pricing model when the work is more complex and/or highly variable, or there is a higher likelihood of creating value by collaborating closely with suppliers (e.g. reducing costs, innovating, global deals or highly integrated cross-functional scopes).

WHAT COMPENSATION METHOD IS BEST: FIXED-PRICE OR COST-PLUS?

No matter which is used — a price or a pricing model — companies must determine the appropriate 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's costs and an acceptable profit margin. Note that both compensation methods have ***inherent perverse incentives***. Each is discussed below.

In a ***fixed-price*** compensation method, buyers and suppliers agree in advance to a price per unit of activity. The fixed-price may relate to an individual transaction (e.g., price per call, per minute, per full-time equivalent, per hour, per unit, per shipment, per square foot, etc.) or to a set of transactions bundled together (such as a fixed monthly management fee). A GMP deal (referred to as both guaranteed maximum price or a gross maximum price) follows this logic to the extreme by agreeing to a single fixed-price for an entire array of services.

A ***cost reimbursement*** compensation method pays suppliers their actual costs in performing a service and then compensates the supplier for overhead and profit through payment of some form of markup. The markup can be a percentage (cost-plus) or a fixed fee (often called a management fee).

Most complex deals use a variety of pricing mechanisms. Highly variable activities (such as infrequent project management services) are often priced as a fixed unit price (price per sf or % of construction) while predictable actions requiring dedicated staff (such as ongoing move-add-change staffing) are more frequently priced on a cost reimbursement basis. The key is to determine which is the right pricing mechanism for each type of service.

There are pros and cons to each mechanism.

The first pro for a fixed-price compensation method is that it provides the buyer predictability. The risk of performing lies with the supplier. If the supplier improves efficiencies, its profit margins rise; if it performs inefficiently (in a true fixed-price, margins fall. However, many fixed pricing constructs fix only one aspect of the price. For example, in a fixed-price per hour model, the risk lies with the client, as a supplier is not incented to perform quickly or efficiently, unless there is a separate cap or benchmark used to measure efficiency.

A second pro is that fixed pricing is easy to administer. For example, contracts that use fixed-price per transaction simply need to invoice for the price X quantity of transactions.

One concern of a fixed-price method is lack of transparency. Once a fixed-price is agreed, the supplier is under no obligation to share with the client the composition of the charges. For many organizations, this can drive a level of mistrust and concern.

In addition, a fixed-price compensation method does not work well in a highly changeable environment. Simply put, it is impossible to predict every reality in a complex agreement. As such, the supplier is forced to price-in “worst case” scenarios to compensate for their risk. If the worst case doesn’t happen the supplier keeps the margin priced to cover it. This would be fair if they also covered the cost of any unexpected occurrences without asking for additional compensation. However, experience demonstrates that suppliers almost always go back to the client to request additional compensation to cover extraordinary expenses. For example, in a multi-million square foot portfolio based in the northeast, budgeting for snow removal is an educated “guesstimate.” A supplier will look at historical snowfall averages and include a cost to ensure they can clear those amounts and then add a contingency buffer. If in any given year, instead of the average 100 inches of snow, the region experiences minimal activity, the supplier will not step forward to offer a price reduction because it snowed only 25 inches. However, if the region is hit by 200 inches of snow, the supplier will typically request an increase in compensation to cover the overage as it was out of their control.

Proponents of a fixed-price/GMP deal will often say, “Well that’s not a true GMP or fixed-price deal.” While they are right, many suppliers can only absorb a limited amount of extraordinary expenses before their margins are diminished or eliminated. In a low margin business such as facilities management, a fixed-price approach often pressures the supplier. A supplier who loses money will find other ways to cut costs and protect their margins, often to the client’s detriment. In the worst case, held to an untenable fixed-price, the supplier will simply walk away from the contract, leaving the buyer with the challenge of establishing a new one.

Under a cost reimbursement method, when structured correctly, the risk is more evenly shared. Suppliers develop an annual budget based upon expected volumes and activities. If snow fall totals are above or below budgeted expectations, the supplier passes through the actual cost of the snow removal, and the risk falls (as it should) to the client. This model provides increased transparency of underlying cost structures. Transparency brings many benefits, including creating a more fair and accurate way to measure cost savings. Transparency also makes it much easier to identify opportunities for cost reduction because the underlying cost drivers are visible.

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.

Remember, even with a reimbursement model, there is some aspect of fixed-price. Whether through a markup or a management fee, the supplier needs to be compensated for their profit and overhead. How best to determine what the price, fee or markup should be is often addressed via a competitive bid. However, it can also be derived through direct negotiations with the preferred supplier. Concerns about market competitiveness can be addressed through benchmarking or use of a Standing Neutral or independent advisor.

For more information about the role and benefits of a Standing Neutral download the University of Tennessee's *Unpacking the Standing Neutral* white paper at www.vestedway.com

One way a buyer can mitigate risk in both the fixed-price and cost reimbursement methods is to include key performance metrics or Service Level Agreements (SLAs) that define target or required levels of quality expected for the price paid. Deploying SLAs can ensure a buying organization gets what they pay for by designating some of the supplier's fee as "at-risk" based on performance. If a supplier's performance is sub-par, the portion of the at-risk fee payable for achieving targets would be reduced to account for sub-par performance. Use of an at-risk fee is common in performance-based deals. However, if used, care needs to be taken to ensure SLAs are appropriately structured to drive desired behavior.

Another common structure in use today represents an evolution in fixed priced compensation methods, where a supplier typically guarantees a fixed fee with a pre-agreed price reduction target (e.g. 3% year over year price decrease) based on the assumption that the supplier will deliver on productivity improvements. These guaranteed savings are often called a "glidepath" because the buyer will see an annual price reduction.

On the surface, the glidepath approach appears to be a "good deal" for the buyer because it shifts the risk to the supplier as they "guarantee" savings. Essentially this is a "bet" by the supplier in the beginning of a contract term that it can drive improvements over the guaranteed savings. If it does, the supplier will reap the benefits — with the potential for high margins. The positive is that the buyer enjoys certainty. The negative is that if the supplier cannot achieve those savings, it most often will find ways to make itself whole through a variety of tactics unlikely to benefit the buyer.

SHOULD I USE AN OPEN OR CLOSED-BOOK APPROACH? AND WHAT ARE THE BENEFITS?

There are degrees of “***open***” and “***closed***” ***book*** approaches. In a true fixed-price structure, the supplier’s books are completely “closed” to the buyer. The supplier quotes a price. Embedded within that price is the supplier’s underlying costs for labor, materials, equipment, subcontractor expenses, corporate overhead and profit. The supplier may choose to document some assumptions they have made to place boundaries around what is included in the fee (and therefore what is excluded). Commonly the buyer doesn’t see or understand what the supplier’s true cost drivers are.

In a cost reimbursement pricing structure, the books are more “open.” The buyer provides detailed documentation relative to the costs of labor, subcontracted expense, materials and other items they wish to pass through for reimbursement. However, depending upon how the management fee is quoted, the supplier may have “closed” books relative to things like the actual burden rate for staff, any markup on costs, corporate overhead charges and profit margins.

Truly open book approaches are transparent and allow a buyer and supplier to build a fact-based discussion around actual costs for both sides. The parties agree to reasonable profit margins for the supplier and strive to manage the total cost across the delivery stream effectively. The primary benefit of an open book approach is that it enables both companies to understand the actual total cost of ownership and allows them to shift their focus to working collaboratively to eliminate non-value-added activities, duplicative efforts and risks that drive up costs.

True open book pricing requires a high level of trust between the parties and a willingness to be fully transparent. Although many companies see the value of this transparency, actual execution across the supplier and buyer organizations can be difficult to achieve given corporate cultures and constraints.

HOW DO I CALCULATE A “BEST VALUE” PRICE?

As mentioned above, a ***best value assessment*** allows organizations to understand a fair price for the supplier based on intangibles such as market risks, social responsibility, responsiveness and flexibility. A good best value assessment allows you to compare various suppliers to determine which supplier provides the best value for your money.

Common best value criteria include:

- Environmental sustainability
- Diversity program excellence
- Social responsibility
- Business interface efficiency
- Market penetration
- Brand image
- Speed to market
- Market dominant supply chain
- Competitive market advantage
- Technological advancement

- Innovation
- Cultural competence
- Growth capability
- Cash management

There is no formal way to measure the adoption of Best Value concepts, however we can look at public procurement law to indicate a trend. For example, the U.S. Government's Federal Acquisition Regulation (FAR) is the uniform policies and procedures manual for all Federal acquisitions. FAR (section 15.101-1 – Tradeoff Process) states: "a tradeoff process is appropriate when it may be in the best interest of the Government to consider award to other than the lowest priced offeror or other than the highest technically rated offeror." And: "This process permits tradeoffs among cost or price and non-cost factors and allows the Government to accept other than the lowest priced proposal. The perceived benefits of the higher priced proposal shall merit the additional cost, and the rationale for tradeoffs must be documented." [5]

While country, state and local laws vary, many governmental procurement functions are making the shift to allow for Best Value pricing. For example, in 2001, the state of Minnesota enacted a statute (§161.3410) that infused Best Value discretion into its procurement process.[6] The City of Philadelphia, Pennsylvania amended the city's Home Rule Charter in 2017 to allow the city to negotiate procurement contracts using a Best Value approach rather than simply awarding contracts to the lowest responsible bidder.[7]

Even though the law allows for Best Value pricing, many procurement professionals are hesitant to use a Best Value approach. For example, Best Value was only used six times in Minnesota between 2001 and 2009. However, it has grown in popularity after the highly successful Minnesota Department of Transportation (MnDOT) construction project for the I35 bridge replacement after the collapse in 2009.

The results of the bridge project were spectacular. Even though MnDOT selected a contractor with the highest price, they received the overall Best Value, resulting in one of the most successful bridge construction projects in history. It was erected in a staggeringly short timeframe of less than 12 months and won dozens of awards. A University of Tennessee case study on the MnDOT project provides a detailed review of how MnDOT applied Best Value supplier pricing for selecting the most appropriate supplier to rebuild the I35 bridge.[8]

The MnDOT example – like all good Best Value assessments – ensured transparency and objectivity in the selection process. MnDOT listed selection criteria for every stage of the process and provided the evaluation weight of each criterion. MnDOT transparently outlined the performance criteria for selecting a contractor by clearly documenting the formal evaluation criteria and evaluation process. The contractor whose proposal scored the highest according to the weighted criteria won the award.

MnDOT determined the Best Value price by combining three components: Price, Days to Complete the Project, and Technical Score (e.g., Quality). See **Figure 1** on the following page.

Figure 1 – MnDOT Best Value Selection Process[9]

BEST VALUE SELECTION PROCESS

Design Build A + B, Best Value Formula

Three Components

- "A" = Contract Bid Price
- Plus "B" = Number of Days to Complete Project, which is multiplied by $200,000 per day - $200,000 per day based on 50% of road user costs
- Divided by Technical Proposal Average Score

Result: Adjusted Bid = **(A) + (B X $200,000) divided by TPA**

CONTRACT AWARDED TO LOWEST ADJUSTED BID

The "technical" score was determined based on nine criteria across four main themes of quality, aesthetics, enhancements and public relations (see **Figure 2** for the breakout of each).

Figure 2: Value-Based Supplier Selection Criteria

Quality		**(50%)**
	Experience and Authority of Key Individuals (20%) Extent of Quality Control / Quality Assurance (10%) Safety (10%) Measures to Evaluate Performance in Construction (10%)	
Aesthetics		**(20%)**
	Enhancements to the RFP (10%) Approach to Involve stakeholders (10%)	
Enhancements		**(15%)**
	Geometric Enhancements (10%) Structural Enhancements (5%)	
Public Relations		**(15%)**
	TOTAL	**100%**

Use of Best Value (vs. just price) enables an organization to shift beyond price to the value a supplier can bring. However, it means the organization needs to be smart about the weighting criteria. For example, how much will "price" still count and how much will "quality" count in the equation?

A second example comes from Vancouver Coastal Health, which used Best Value to select a supplier to perform environmental services across the region's health care operation (hospitals, nursing homes). The VCH "Mutual Value Request for Proposal" included a down-select process and final selection process both based on Best Value. **Figure 3** provides an excerpt from their RFP for the initial down-select, showing the price was valued at 10%.[10]

Figure 3 Excerpt from VCH Mutual Value Request for Proposal

Each Proponent's Concept Proposal and Concept Presentation will be evaluated against the desirable criteria set out below.

Desirable Criteria	Weighting
1. EVS Concept - how the Concept addresses each component of the opportunity - how the Concept addresses the business challenges, risks, and objectives - how the Concept delivers the Service Outcomes - how the Concept provides the needed flexibility and scalability for EVS	30
2. EVS Operations and Transition - approach for providing the underlying infrastructure required for the Concept - labor strategy of Concept - union strategy, staff retention, staff competency maintenance, staffing model, and staffing and supervision benchmarks - commitment of Proponent's staff to engage in the MVS Process and the Contract(s) - approach to transitioning EVS and key success factors - approach to meet customer needs during transition and minimize service impacts on customers	30
3. Governance/EVS Standards -governance approach -commitment to manage partnerships -definition of success for a mutually beneficial long-term arrangement for the EVS Project -how the Concept addresses ongoing compliance to the EVS standards -key issues and, to the extent that there are potential barriers, the resolution of such barriers, to complying with the approach to achieving a mutually beneficial governance model and complying with EVS standards -proposed leading practices and benchmarks for EVS incorporated in the Concept	20
4. Risk and Deal Structure -key risks associated with the EVS Project and high-level approach to allocate, manage and mitigate risk -areas where risk and reward sharing are envisioned -proposed deal structure and supporting reasoning of such structure	10
5. Economic Model and Indicative Price -overview of proposed economic model -benefits of the proposed economic model derived by the Health Organizations and the Proponent -flexibility of proposed economic model to handle changes in program deliverables over a long-term contract -issues and potential barriers to achieving the proposed economic model -pricing approach -indicative price (*see Indicative Pricing Template*) -financial assumptions in economic model and indicative price	10

Upon completion of the evaluation, the top two (2) ranked Proponents will advance to the MVS Definition Phase. However, if all three (3) Proponents achieve an overall evaluation score of at least 75 points, all three (3) Proponents will advance to the MVS Definition Phase.

While many organizations try to get it right, sadly, many do not. A 2014 study[11] in the construction industry in the Netherlands shows that 58% of all public tenders using the EU's BPQR (best price-quality ratio) approach has had a weighing for quality between 20% and 60% (so "price" counted between 80% and 40%). On the surface, this sounds like a good approach. However, almost 30% of all tenders which used BPQR put the weighing on quality between 1% and 10%. This means that although these organizations *said* they were using BPQR mechanisms, 90% of the tender result was still based on price!

A University of Tennessee white paper on Best Value suggests that non-price criteria weight of at least 60% when using Best Value.[12]

One alternative to mitigate the impact of inappropriate weights on pricing is to use a price per quality point system (**Figure 4**). In this way there is no need to arbitrarily weight the price. Bids are scored based on weighted quality or value criteria. The price is then divided by the total value or quality score. The provider with the best price per quality point is then awarded the business. This method has been used consistently in corporate awards for facilities management outsourcing for more than a decade.

Figure 4 Example of Cost Per Quality Point Methodology

		Bidder 1		Bidder 2		Bidder 3	
Evaluation Category	**Weight Factor**	**Score**	**Total**	**Score**	**Total**	**Score**	**Total**
Company Profile	**15%**	90.00	13.50	88.00	13.20	86.00	12.90
Service Delivery	**25%**	87.60	21.90	80.10	20.03	80.50	20.13
Operational Plan	**20%**	92.40	18.48	80.00	16.00	78.50	15.70
Proposed Team	**20%**	88.70	17.74	77.50	15.50	77.00	15.40
Technology Solution	**20%**	93.20	18.64	81.50	16.30	78.90	15.78
TOTAL QUALITY SCORE	**100%**		**90.26**		**81.03**		**79.91**
Resultant Ranking		**1**		**2**		**3**	

	Bidder 1	Bidder 2	Bidder 3
Financial Bid - Grand Total	$10,680,349	$10,467,185	$9,999,849
Price Per Quality Point (total financial bid divided by the total score)	$118,329	$129,185	$125,147
Legal Evaluation	PASS	PASS	PASS
Reference Checks	PASS	PASS	PASS

Source: SIREAS LLC

WHAT TYPES OF INCENTIVES CAN I USE?

An ***incentive*** is a reward for the supplier used to encourage their best thinking to generate savings and bring added value to the buyer's account. When speaking of incentives, most people think of ***tangible incentives*** given to a supplier for a job well done. However, some of the most powerful incentives are ***inherent incentives,*** meaning they are embedded into the overall framework of a buyer-supplier relationship through the contract structure or pricing mechanisms used. Inherent incentives can be powerful because they naturally drive behaviors between a buyer and supplier — often creating positive results.

A good example of an inherent incentive is a longer-term contract which generates an incentive for a supplier to invest in the relationship as they will have a longer period of time to amortize the expense. However, if the overall contract is not structured properly a long-term contract can also result in a perverse incentive where the supplier becomes complacent.

Unfortunately, many companies rarely realize the inherent incentives they create through their contract structure, compensation method, and pricing approach are, in reality, perverse incentives. A ***perverse incentive*** is a direct negative or unconscious behavior that drives unintended consequences. Using the contract term example again, a very short-term contract will likely ensure that the supplier does not invest as much in the relationship given that the opportunity to recover any investment is so short.

Not all tangible incentives are monetary; however, many are. Below is a list of some of the most common incentives.

Gainshare/cost savings incentive**:** Many organizations encourage suppliers to increase efficiency, eliminate non-value-added activities and reduce costs above and beyond the base level of performance required. In return, a percentage of the net savings generated is shared with the supplier for a finite period. While these can be very effective, they can also generate discord. Clear definitions of what constitutes savings, upfront agreement on percentages to be shared, and joint understanding of when and how pay-outs will occur are all critical to ensuring a successful gainsharing program.

Pay for Performance Incentive**:** A performance incentive is ideally designed to incrementally augment the supplier's profit when it achieves specific targets. The incentive fee can be fixed or variable, but always correspond 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. Completion of an effective transition to the supplier, on time and on budget with minimal disruptions to the customer base is a common performance incentive.

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. A good example is the Department of Energy's Rocky Flats closure project, which paid Kaiser-Hill an award fee upon the successful cleanup and closure of the Rocky Flats nuclear site.

Non-Monetary Incentives: Incentives such as public recognition, endorsements in 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 relatively small but well regarded in its industry may be able to deliver more value, particularly if its industry is one that supplier considers strategic.

Award Term (Contract Extension): A great incentive for a supplier is more business (provided it is profitable). An Award Term is an automatic renewal/contract extension added when a supplier meets agreed targets. In some cases, especially for 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.

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.

PART 3: ALIGNING THE RIGHT PRICING MECHANISMS WITH THE RIGHT SOURCING BUSINESS MODEL

In Part 2 we outlined the fundamental tools practitioners can use for pricing a complex deal and challenged professionals to understand the pricing tools in their toolkit. While knowing the right tools is a great first step, one of the biggest mistakes 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 (e.g., compensation method, price vs. pricing model) with its chosen sourcing business model.

Part 3 is a deep-dive into why and how to construct the most appropriate pricing approach for each sourcing business model starting with transaction-based models. We continue to use facilities management examples to share typical pricing mechanisms and discuss inherent incentives and pros/cons for each sourcing business model.

TRANSACTION-BASED MODELS

Transaction-based business models have been the cornerstone of business endeavors for centuries and remain the most common sourcing business model in use today. There are three transaction-based sourcing business models: **Basic**, **Approved Provider** and **Preferred Provider** models. Each is explained in the book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement*.[13]

Typical Pricing Mechanisms 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 in a facilities management outsourcing deal are:

- An HVAC contractor supplies labor to manage PMs on a blanket PO, supplier bills for staff on a fully loaded cost per hour
- An interior designer provides design development documents for a flat price per usable square foot designed
- A move labor contractor provides services inclusive of trucks, labor, boxes, and supplies at a set price per person moved
- A local broker provides transaction support for a set price per rentable square foot

There are two common pricing approaches for transaction-based agreements; staff augmentation and price per transaction. 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 completing a product unit/unit of service.

Figure 5 (on the following page) summarizes the typical characteristics of staff augmentation and price per transaction approaches.

Figure 5: 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 (e.g., Hourly/Daily Rate per FTE) Can be *cost reimbursement* or *fixed-price* with more tendency to be *fixed-price* with profit and OH as a markup on people cost	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

Source: University of Tennessee

While transaction-based agreements can be open 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 with limited visibility for the buyer into the composition of the unit price.

Inherent Incentives – Pros and Cons

By far the biggest advantage of a transactional pricing model is simplicity and flexibility. Agree on a price and pay for what is used. The strength of transactional pricing is also the Achilles Heel because the supplier revenue is directly tied to the volume of transactions; the more transactions, the more revenue. The more revenue, the more profit. Transactional pricing creates an inherent perverse incentive for the supplier to focus on performing activities versus driving efficiencies. It makes sense when you think about it: if the supplier is paid on a price per hour or per person basis for a custodial worker, the supplier is most profitable when it uses many hours and employs many people.

Recommendation

Transaction-based pricing is effective for simple transactions with an abundant supply, low complexity, and little asset specificity (unique or custom requirements). If the level of dependency and the shared value is low, a transaction-based approach is the way to go. Transaction-based pricing also works well when there is high variability in volume – i.e., when full-time ongoing services are not needed or are needed occasionally.

Transaction-based pricing doesn't work well if there is a high degree of customization, significant training or if the service requires tight integration with the buyer or other supplier organizations. Each variable would require investment by the supplier and the supplier could not recover that investment without some guarantee of volume or length of the contract.

OUTPUT AND OUTCOME-BASED MODELS

There is a trend to shift to output-based and outcome-based economic models, especially for procuring complex services and outsourcing deals. Output and outcome-based models link a supplier's compensation to the ability to perform against pre-negotiated goals or commitments.

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 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 called the “Power-by-the-Hour”[14] 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 aircraft are operational.

Output and outcome-based business models have increased in popularity in the last few years. There are two broad classifications: Performance-Based agreements (which focus on supplier-controlled outputs) and Vested agreements (which focus on boundary-spanning business outcomes).

Figure 6 (following page) summarizes the typical characteristics of Performance-Based and Vested approaches.

Figure 6: Summarized Characteristics of Output vs Outcome Approaches

	PERFORMANCE-BASED/ MANAGED SERVICES (Output-Based)	VESTED (Outcome-Based)
BUSINESS MODEL		
Economic Model	Output-Based	Outcome-Based
Relationship Model	Relational Contract Collaborative	Relational Contract Highly Collaborative
Vision & Intent	Performance to SLA Process Efficiencies	Shared Vision Desired Outcomes Value Creation
SCOPE OF WORK		
Statement of Work and Objectives	"What" (Narrowly defined as the Suppliers Responsibilities- as defined by the Client)	"What" (Broadly defined as the areas to be addressed as collaboratively agreed)
PERFORMANCE MANAGEMENT		
Performance Focus	Output-Based Service Level Agreements	Strategic Desired Outcomes
Performance Measures	Operational + Relational (Values & Behaviors)	Operational System-Wide KPIs + Relational (Values and Behaviors) + Transformational Measures
PRICING		
Pricing Model and Incentives	Price or Pricing Model with Incentives and/or Penalties	Pricing Model with Value-Based Incentives
GOVERNANCE		
Relationship Management	Oversight Emphasis: Supplier Relationship Management	Insight Emphasis: Strategic Relationship Management
Improve, Transform, and Innovate	Supplier Driven to Meet SLAs/Price	Joint and Proactive Transformation Management
Exit Management	Performance-Based Termination for Cause w/Safeguards	Joint Exit Management Plan
Compliance and Special Concerns	Corporate-Based Audit Requirements	Outcome-Based Joint Requirements

Source: *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement*

We explore both models in more detail below with the emphasis around a deep-dive into how pricing works for each.

PERFORMANCE-BASED AGREEMENTS

A Performance-Based Agreement (sometimes also called a Managed Services Agreement) seeks to create a formal, longer-term relationship with the intent that the supplier's compensation is linked directly to performance, and/or the ability to deliver cost savings or other service improvements. Buyers typically define the level of performance required and competitively bid the work to determine which suppliers can meet the buyers' needs at the best value. Performance-Based pricing agreements are sometimes called "pay for performance" because they often have positive and/or negative incentives tied to outcomes (often called gainshare/painshare).

Typical Pricing Mechanisms Used

Performance-Based agreements can be structured as fixed-price, fixed-price per unit, or cost reimbursement. One approach for structuring a Performance-Based agreement is to create a GMP deal. GMP deals have grown in popularity – especially for facilities management and construction deals - because they enable budget predictability. In many industries such as facilities management, outsourcing has matured and organizations have shifted to more of a hybrid approach using a mix of fixed-price (management fee), transactional, and cost reimbursement components in their pricing models to better align with the breadth and complexity of services within the scope.

At its core, a well-designed Performance-Based agreement provides behavioral incentives for the supplier to keep costs low and performance high. A hallmark design principle of a Performance-Based agreement is the use of incentives and at-risk fees to help align the parties' interests by creating a band of performance tied to the supplier's price. The incentives and at-risk fees help align the economics of the relationship based on the level of service received. For this reason, Performance-Based agreements typically require high levels of interaction between a supplier and a buyer to review performance against SLAs and assess the incentive or at-risk fees typically included in the contract. These reviews are periodically scheduled and include representatives from the supplier and the buyer company.

Inherent Incentives – Pros and Cons

A powerful advantage of a Performance-Based agreement is the fact it ensures a supplier keeps its eye on performance and costs. Well-structured pricing models tightly align the economics of the deal to the supplier's performance and inherently incentivize the supplier to meet contractual SLAs at committed prices. GMP deals allow buying organizations to have a predictable budget because the supplier commits to keep costs at or below the price they quote.

A good Performance-Based pricing model also creates a self-executing contract with clearly defined metrics and measurement methodologies; determining the actual incentive payment simply becomes a reporting exercise. While the self-correcting nature of the agreement is a core strength, it can also be a downfall because a tendency towards over-simplification often leads to inherent perverse incentives.

One inherent perverse incentive is that the supplier optimizes service/costs only for itself and just for the duration of the contract length. For example, a city utility district that operates a large water treatment plant hired a supplier to manage the maintenance of the plant. Under the Performance-Based agreement, the supplier was incentivized to achieve operational SLAs. The supplier worked hard to meet the contractual obligations for performing preventive maintenance tasks outlined in the statement of work, securing a green scorecard and earning their fee-at-risk portion of the pricing. While this is great for the supplier, it would be far more beneficial for both parties if the supplier invested research and innovative practices to optimize the city's TCO. Unfortunately, it can be easy for suppliers to justify foregoing investing over the short-term. After all, why invest now when the buyer is likely to bid out the work at the end of the contract? And if the supplier made the investments and lost the bid, it would face a lose-lose scenario because it may not recoup the investment. Correctly structuring metrics and aligning the pricing model to focus on the lifecycle optimization and not just operational SLAs can mitigate this risk.

Many buyer organizations like the city utility district above struggle with how to properly apply incentives. A great example of a bonus system gone awry is 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 supplier to complete employee moves before 5:00 AM on Monday, the value of the service will likely be degraded if the supplier is still moving people during the workweek; however, it is unlikely that getting the moves completed on Saturday instead of Sunday 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.

GMP (guaranteed maximum price) deals have several perverse incentives built-in. GMP means that the supplier cannot go back to the buyer and request more funds unless there has been a change in scope. This means the supplier must factor all potential risks into the pricing structure. As an example, because the supplier cannot predict snowfall, it will likely assess what is the “average” snowfall for a given site and then include a contingency factor to cover their risks if there is extraordinary snowfall. As a result, the buyer will pay for that risk. If the snowfall is average or below, the buyer will receive no rebate. Another perverse incentive is that GMP deals are, by design, rigid. A supplier will be far less flexible in assuming more work under a GMP because they have bid a fixed-price for a fixed set of services. Each new service or activity will need to be scoped and bid separately, and the contract will need to be amended to accommodate the negotiated incremental costs. When new activities are added it presents an opportunity for both parties to behave poorly. The supplier could gouge with high pricing if they believe they have the buyer over a barrel, or the buyer could misuse their market power and demand an artificially low price. Neither behavior will build trust and confidence in the relationship.

Another potential drawback of inappropriate application of a Performance-Based contract is what University of Tennessee researchers call a “***Watermelon Scorecard***.” This happens when suppliers are meeting SLAs, but the buyer perceives the supplier is still failing to meet the company’s business objectives. Simply put, performance is green on the outside, red on the inside — like a watermelon. If you are experiencing a Watermelon Scorecard, it may be a sign that your business is better suited for a Vested business model or that you are not measuring the things important to the buying organization. Ongoing governance and review of the performance measures throughout the life of the contract and relationship can help mitigate this risk.

Other potential drawbacks occur when clients bury the cost of governance into the supplier’s transaction price or management fee without ensuring there are enough funds to cover this responsibility. Suppliers also suffer when their clients do not invest in proper governance. Suppliers often will bring ideas to buyers to help drive efficiencies, only to find the buyer does not have appropriate mechanisms to drive sound decision-making and support the implementation of these ideas. Or worse, they make investments right for the relationship only to find that a “new Sheriff” rides into town and does not honor previous decisions, which places their investments at-risk.

Finally, when suppliers are held accountable to meet 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 be switched with the “C-team.”

Recommendation

Performance-Based approaches can succeed wildly or be hugely disappointing. Failure occurs most often when companies use a Performance-Based sourcing business model when another approach 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.”

We recommend the use of a Performance-Based agreement *if the level of dependency and the potential shared value is relatively limited.*

Before adopting a Performance-Based pricing approach, ask these questions:

- Do you have a sound baseline where the supplier can feel comfortable signing up for specific service levels at committed prices?
- Is the scope of work stable and predictable? If it is variable, can you ensure the supplier will not be asked to take on risk that is not appropriate?
- Can a discrete scope of work be carved off into a "black box" for the supplier to optimize? Work that requires significant input from the buyer or external sources may not be a good fit because the supplier doesn't control it.
- Are the cost components controllable? A general rule of thumb is that a supplier should not be held accountable for "guaranteeing" a price if there is a substantial potential risk outside of their control (e.g., foreign currency exchange, commodity fluctuations, service demand fluctuations).
- Are you both prepared to devote proper governance levels to the relationship? This is especially true for the supplier as governance is often absorbed into overhead versus distinctly called out in a more comprehensive *pricing model.*

If the answer is "yes" to each of these, a Performance-Based agreement potentially is a good fit. If the answer is "no," the parties may face friction in their relationship because the supplier will be signing up for risk not within its control. If the answer is "no," the parties should consider either a transaction-based or a Vested approach depending on the complexity and impact of the relationship.

VESTED AGREEMENTS

A Vested agreement – as with a Performance-Based agreement – purposefully seeks to create a formal, longer-term relationship with the intent that the supplier's compensation is linked directly to performance. However, the mindset and design principles are different. The Vested approach consciously shifts to view the supplier as a business partner – not simply as a supplier. Vested takes buyer-supplier alignment to a new level by structuring a true "win-win" pricing model that establishes an economic engine that generates high-level value for all parties. 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.[15]

Vested Pricing Model Design Principles

There are four essential design principles for developing a Vested pricing model.[16] These are:

1. Pricing Model (not a Price)
2. Incentives tied to Desired Outcomes
3. Compensation for costs and risks in line with the six common Guiding Principles
4. Margin Matching to ensure continual alignment

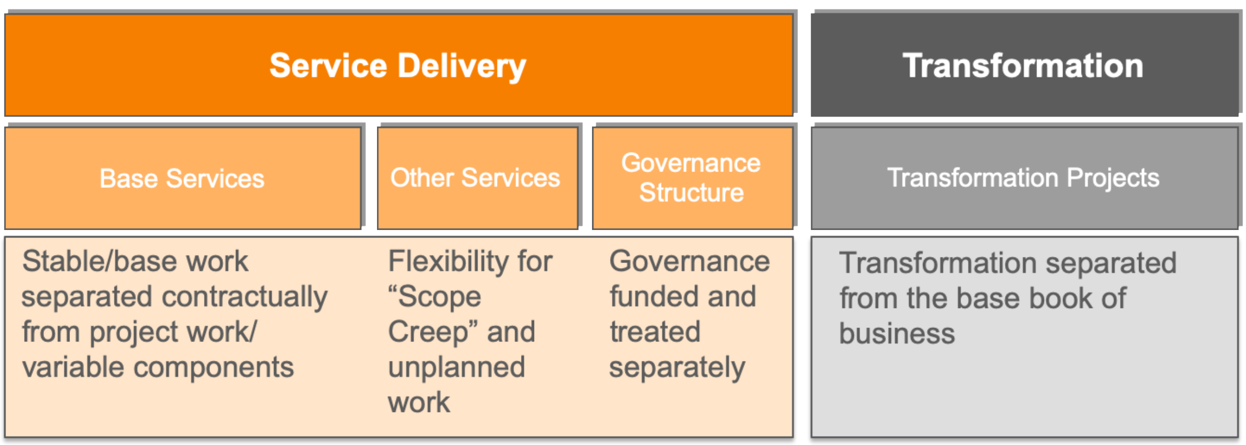
Each design principle is discussed in the following pages.

1. Pricing Model (Not a Price)

The first design principle is that a Vested business model uses a ***pricing model*** – not a price. Shifting to a pricing model – versus using a "price" - is key because a pricing model enables flexibility important for sustaining a healthy business relationship over the life of an agreement. A properly structured Vested agreement always reflects a fair and balanced economic model where the buyer and supplier win together and lose together. When compensation for Suppliers is based on a fixed-price, both sides have the potential to lose out on economic opportunities over the life of the relationship. Flexibility is lost and there is a danger that the economics of the relationship will get out of equilibrium with the risks when business happens.

There is no one method to design a good pricing model. However, we strongly recommend using four "buckets" that align with the types of work a supplier does to create value for the buying organization as shown in **Figure 7**.

Figure 7: Recommended Pricing Model Framework



Note: Vested can be applied to products as well as services. Often a Vested Agreement includes scope for a combination of products and services.

Let's look at each bucket in terms of a facilities management deal to get a better understanding of why each bucket is essential to the success of a Vested pricing model.

Base Services: The "base services" consists of repetitive and stable cost drivers associated with basic service requirements (e.g., deploy maintenance to ensure the lights stay on, keep the facilities clean, have compliant processes). By virtue of their stable nature, both the buyer and supplier can comfortably budget for volumes and therefore costs associated with this aspect of the services.

The pricing in the base services is somewhat like a Performance-Based agreement in that the economics are tied to performance. However, the mindset and approach in the pricing model are different. Rather than have a "fee-at-risk" for non-performance, Vested pricing strategically guarantees a minimum profit for the supplier for the base book of work; the supplier will never lose money on the deal. This provides everyone peace of mind, knowing the work will be done effectively and efficiently, while also guaranteeing that the supplier's payroll will be covered, and the equipment or facilities will be properly maintained. The profit or management fee added to the base services cost as they are passed through to the buyer is such that the supplier would be making less than market rates of profit. The supplier can then earn incentives tied to performance and to its ability to create value (e.g., through continuous improvement of innovation).

Other Services: A Vested pricing model should also encourage flexibility. This is done by creating pricing mechanisms to address how the parties will manage "other services." Other services include either ongoing costs with significant variability, one-off needs that are unplanned and cannot be budgeted for, or new services. For example, "project" type work that is unplanned should fall under other services.

In a Vested agreement, there is a commitment to the partnership. When new work is added into the supplier's scope it should go to that partner by default provided the partner is capable and cost-effective. Having a pre-agreed way to manage other services designs in flexibility and reduces friction associated with lock-in and scope creep. Having a pre-agreed way to manage for other services also ensures the parties think about a fair way to compensate the supplier for work before there is a need. Pricing for "other services" needs to be well-thought-out to ensure the supplier receives the agreed-upon margin and the buyer pays a rationale price for the service commitment required.

Governance: A Vested pricing model explicitly incorporates the costs for governance. The fact that the relationship is long-term and future-focused means governance is essential. Vested pricing models always include how the organizations will fund and pay for governance – for both the buying organization and the supplier. Governance costs should ***not*** be embedded in the "base services." Why? By nature, a buying organization almost always wants to reduce the costs of the base services. If governance costs are part of the base services, the supplier will have a perverse incentive to reduce the cost of governance and, for example, replace the A team with the C team. For this reason, we recommend governance costs be budgeted separately and in their own "bucket."

Transformation: A Vested agreement is anchored on the buyer and supplier working jointly to deliver on mutually defined and measurable Desired Outcomes. While some Desired Outcomes may be linked to base service, most Vested agreements have most of their Desired Outcomes tied to future-focused objectives that – when delivered - create value or a competitive advantage. Future-focused Desired Outcomes almost always require an investment in an innovative idea or transformation initiatives – even if it is simply the time needed to implement continuous improvement efforts. For this reason, the pricing model needs to compensate the supplier for investing in innovation and transformation ideas that help the buying organization achieve their Desired Outcomes. The logic is simple. Why would a supplier invest in innovation and transformation (the hard stuff) if there is no future hope of a return on their investment?

2. Incentives Tied to Desired Outcomes

A Vested pricing model uses incentives (not penalties). The supplier earns incentives when it performs well and the parties achieve mutually defined Desired Outcomes. The basic logic is if a supplier does a good job at achieving the Desired Outcomes, it generates more value for the buyer, who then makes more profit. Linking incentives to Desired Outcomes aligns the interests of the buying organization and the supplier as they both have a vested interest in generating added value.

A typical best practice is to have five or fewer Desired Outcomes with no more than 12-15 clearly defined and measurable objectives. Each objective is typically linked to a pricing model bucket. For example, incentives can be linked to the base services (e.g., achieving base service performance targets).[1] Other services might be linked to reducing time to market on a project while governance might have an incentive such as improving a corporate objective such as increasing Tier 2 supplier diversity spend. Likewise, one might consider an incentive for developing an innovation that achieves the Desired Outcome to improve the buying company's employee productivity for the transformation bucket.

Incentives can be a powerful motivator when designed appropriately. A good example of linking supplier incentives to Desired Outcomes is the environmental services contract between the Department of Energy's (DOE) and Kaiser-Hill for the successful closure and cleanup of the DOE Superfund site known as the Rocky Flats Closure Project. Kaiser-Hill earned a base management fee of 3.7% (average market margin 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.). Kaiser-Hill developed over 200 innovations and ultimately earned incentive payments of $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 early – something most thought was impossible.[17]

Of course, it is important to realize that value cannot always be expressed monetarily. For example, in one Vested agreement, an objective was to increase the J.D. Power ranking for customer satisfaction in bank branches. The CRE supplier could influence and impact the J.D Power ranking but could not solely control it. Here, the parties used a non-monetary incentive. Other non-monetary incentives include things such as automatic contract extension incentives, expanded scope of services, or even the customer's willingness to provide references.

Another best practice when linking incentives to Desired Outcomes is to focus on the ***Total Cost of Ownership***/value created versus simply cost savings against a budget. Making the shift to TCO and value helps the organization drive much deeper and more creative ideas to achieving the Desired Outcomes because a TCO approach is boundary-spanning: savings might be found in both the buyer's side of the P&L and within the supplier's budget.

As an example, a Desired Outcome for one integrated facility management agreement was to optimize employee efficiency of the people using the space. The supplier developed a "meeting scheduler" software application that optimized how employees scheduled and used meeting space. The result was an employee efficiency gain of 21 minutes per employee per week. The cost savings from the employee efficiency gains were not in the CRE budget but rather were in each of the functional departments through headcount costs.

Many people confuse ***value sharing*** with ***gainsharing***. Performance-Based agreements often use a concept known as gainsharing where the supplier is given a share of any cost savings they deliver (typically against budget). A Vested pricing model goes beyond gainsharing and expands the thinking to value sharing. What is value sharing and why care? Harvard Business School's Michael Porter and Mark Kramer focused on the "big idea" of shared value in their excellent Harvard Business Review article, "The Big Idea: Creating Shared Value."[18] 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

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[1] *In some industries the concept of tying incentives to the base services is referred to as "fee-at-risk" or "pay-for-performance." Incentives linked to base services should only be for supplier controllable metrics (not boundary spanning business outcomes). We also recommend the majority of measures link to governance and transformation.*

should be designed to share any value gained from achieving the Desired Outcomes over and above what is covered in the base services. One way to do this is to acknowledge that if you expand the pie, you share the bigger pie.

Value sharing seeks to improve the overall value for both the buying organization and the supplier, not just to reduce cost as in gainsharing. Let's return to the example of the supplier that developed the meeting scheduler which improved employee efficiency by 21 minutes per employee per week. Because the employee efficiency gain was not accounted for in the CRE budget the buying organization could not simply give the supplier a gainshare because the buying organization's CRE unit had no physical "savings or gain" to share. However, the buyer could compensate the supplier with non-monetary incentives such as extending the term of the agreement, allow publishing of a case study, or agree to speak at an industry conference on behalf of or with the supplier that would attract additional clients. Additionally, if the contract is structured appropriately, the supplier could re-utilize the scheduling software with other clients thereby generating additional revenue outside of this specific relationship

There are several rules of thumb when creating incentives tied to Desired Outcomes. These include:

- Use non-monetary incentives (e.g., contract extensions, references) if there is a great deal of interdependency and there is no clear quantified value (e.g., increasing J.D Power rankings)
- While some of the Desired Outcomes/objectives can be tied to the base services – typically over half of the Desired Outcomes/objectives are 'future-focused' with the purposeful intent to drive innovation and transformation. For example, incentives may be tied to achieving sustainability goals.
- Don't cap incentives. When incentives are capped in any given year it may cause the supplier to postpone bringing an idea to the table until a later date. This is known as sandbagging; the delay reduces the value to the buyer.
- Use a Return on Investment (ROI) approach versus a simple 50/50 (or 70/30, 40/60 split) for sharing value created from continuous improvement or innovations. The logic is that an incentive should be tied to the supplier making an investment in time and money. Let's use a hypothetical example where a supplier's idea costs $1,000 to implement but generate a $100,000 in value. The use of a 50/50 split would pay the supplier a $50,000. Most buying organizations (and individuals) would feel the $50,000 payout would be an unfairly high amount given the investment. While it is true the supplier's idea was a huge success, the large payout will likely leave the buying organization viewing the large payout as egregious (the $1,000 investment would generate a 5,000% return on investment). Typically, one would calculate any savings net of investment. The buyer would cover the investment costs out of the savings first (i.e. reimburse the supplier for the expense) and then share the resulting savings at an agreed-upon rate. If the supplier is expected to make the investment and not be reimbursed for it, the return they receive should be exponentially higher as they are taking the risk. We would suggest compensating the supplier for costs and risks in line with six common Guiding Principles (see design Principle 3).

3. Compensation for Costs and Risks in Line with Six Common Guiding Principles

Once the parties commit to developing a Vested agreement, they formally embed the following six Guiding Principles into the agreement.

Reciprocity	**Autonomy**	**Honesty**	**Equity**	**Loyalty**	**Integrity**

The Guiding Principles are proven social norms. By embedding the social norms into the agreement, they become business norms for the relationship and help the parties work through pricing fairly. For example, the parties discuss specific details such as how to fairly allocate risks (discussed below) and how to fairly compensate the supplier for creating value above performing base services. A Harvard Business Review article profiles the merits of embedding Guiding Principles as part of a formal relational contract in the article *A New Approach to Contracts: A Better Way to Build Strategic Partnerships.*[19]

We have seen dozens of pricing models since the inception of the Vested methodology in 2010 and one thing is certain: no two are alike. However, most have three features we consider as best practice: appropriate risk allocation, transparency of costs, and applying Maslow's Hierarchy logic to each of the four pricing model buckets. Let's explore each best practice.

Appropriate Risk Allocation: The conventional approach for contracting is to shift risk to the other party whenever possible. After all, if the other party will take the risk, why not let them?

A Vested agreement is different because it sees risk as something that should be mitigated and managed with a high degree of transparency and collaboration – not simply transferred. When risk is shifted to a supplier (either in the form of operational risk, legal terms and conditions, or unknown risk) the supplier is forced to factor the risk into its pricing. This is known as a risk premium. Smart suppliers factor in the risk and add a risk premium to their costs. And when forced to project risk, it is in the supplier's best interest to estimate high, which ultimately leads to higher prices than needed.

Viewing risk through the lens of the Guiding Principles versus a risk-shifting or opportunistic lens means risks are not something to shift to the other party but are a fact of the business that must be fairly addressed. A key step in developing a Vested pricing model is to complete a thorough risk analysis and determine which party should appropriately bear the risk. If a supplier bears the risk, they are paid a risk premium. A key goal is to collaborate to reduce risk – thus lowering any risk premiums, which ultimately creates value for both the buying organization and the supplier.

> The University of Tennessee's Collaborative Contracting course teaches how to rethink risk and contractual clauses through the lens of the Guiding Principles. To learn more about the course visit www.vestedway.com/overview/

Transparency: Transparency is a best practice because it enables the parties to see the true cost drivers of the business for both the buyer and the supplier. The vast majority of Vested agreements use a ***cost-pass-through model*** where "the costs are the costs are the costs" and there is no markup by the supplier. The supplier's profit is separated from the costs and linked to the supplier's performance and the value generated. Decoupling costs and profit eliminate a perverse incentive for a supplier to have higher costs. It also prevents "markup on markup" when using subcontractors, which is common in complex deals.

Complete transparency may extend to the creation of a joint Profit and Loss statement that documents both the buyer's and the supplier's costs to deliver the product/service.

The cost-pass-through model ensures transparency; it enables the buyer and supplier to focus on reducing overall total cost vs. just the supplier prices. While the pricing model should be transparent, the parties may decide to use mechanisms that are easy to administer and as such may have some components that are translated into fees for billing purposes. For example, the supplier's profit and overhead could be charged as a monthly "fixed management fee."

Apply Maslow's Hierarchy Logic: A third best practice when developing a Vested pricing model is to apply Maslow's Hierarchy, which states it is vital to meet certain lower needs before higher needs can be addressed.[20]

The base of Maslow's Hierarchy is "Physiological Needs and Safety." The equivalent of Maslow's base in a facilities management deal is the "base services" consisting of the repetitive and stable costs associated with the basic service requirement (e.g., deploy maintenance to ensure the lights stay on, keep the facilities clean, have compliant processes). For the buyer, basics tend to be ensuring the supplier can deliver on base services as defined. For the supplier, the basics are getting a fair price that ensures they will not lose money – especially on uncontrollable risks. Simply put, a supplier can't possibly focus the needed time and attention to help their client solve complex business problems if they don't cover basic costs.

The applied practice of Vested pricing models provides some good "rules of thumb" for compensating a supplier for the agreed-upon base services. A general rule is that a supplier earns a small margin for base services when there is little risk and where the actual activities/work are more of a commodity. This typically translates into 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.

The middle of Maslow's Hierarchy is "Esteem and Love/Belonging." Here the Vested pricing model addresses the more complex aspects of a deal and includes two design principles. The first is how the parties will manage "other services" that are more variable and riskier by nature and the second is governance.

The general rule of thumb for dealing with "other services" is to compensate the supplier with a higher margin than the base – but typically less than market margin. The rationale is the buying organization commits to award "other services" to the supplier under a no-bid situation as their strategic partner, and the supplier agrees that they will not hold the buying organization hostage due to lock-in. Having a pre-agreed way to manage "other services" designs in flexibility and reduces friction associated with lock-in and scope creep.

The Vested pricing model also designs-in how the organizations will fund and pay for governance. The rule of thumb is the supplier should earn above market margin for governance so they have an inherent incentive to hire and keep the "A" team. As stated previously, governance costs should not be embedded in the "base services" because it will create a perverse incentive for the supplier to reduce the cost of governance and replace the A team with the C team to cut costs. While pressure to reduce the cost structure associated with the base services often makes sense – it is not smart in terms of securing and maintaining the top talent responsible for delivering proactive solutions for the buying organization.

The top of Maslow's Hierarchy is "Self-Actualization." Organizations enter into a Vested agreement with the goal to drive innovation and/or transformation initiatives to achieve mutually defined and measurable Desired Outcomes. Organizations – like people – cannot think about a future filled with innovation and transformation if the basics are not delivered. For this reason, most Desired Outcomes reside at the top of the needs pyramid when crafting a Vested agreement. The pricing model also needs to compensate the supplier with high margins for their risk and investments in helping the buying organization achieve the Desired Outcomes. Most Vested agreements use a rule of thumb to compensate the supplier at 3X market margin for successfully delivering on Desired Outcomes. Using the 10% as "market margin," a Vested pricing model would allow the supplier three times the market margin — or up to a 30% profit margin — if the supplier successfully incorporates transformation and innovation to achieve the Desired Outcomes.

A good example of this in practice is the Department of Energy's "Rocky Flats" contract for environmental services. The market margin was 4.1% and the supplier – Kaiser-Hill – earned an 11.7% margin through incentives.[21]

4. Margin Matching to Ensure Continual Alignment

A key goal of creating a Vested Agreement is to create a win-win relationship. A properly designed Vested pricing model prevents one party from "winning" at the other party's expense. This means the economics of the relationship ensure the parties always win together and always lose together. When "business happens," the parties are equally affected, which prevents a win-lose scenario that can lead to shading and shirking.[22] For this reason, a Vested pricing model uses a concept known as ***margin matching*** to keep the economics of the deal in continual alignment. Margin matching is a technique used to fairly adjust actual prices to be paid based on movements in the defined underlying pricing model assumptions. Margin matching includes establishing a trigger point that activates to reset prices when an economic threshold (e.g., min or max ***guardrail*** is met). For example, inflation rates may go high enough to trigger resetting inventory carrying costs charges. The goal of using a margin matching technique is to establish pricing fairness, which ultimately builds trust and a better working environment.

In practice, margin matching means setting both a "low" and a "high" margin matching target for the supplier regarding market margin for the supplier. Let's say the market margin for facilities management firms is 10% for a complex integrated corporate real estate deal. The low margin target for a supplier might be 5% (half of market margin) and the high 30% (3x market margin). Please note we are not saying this is the market margin but are purely using this as an example.

Margin matching also means putting in a governance process where the pricing model itself is monitored to make sure it remains fair for both the buyer and supplier organizations throughout the duration of the relationship. This is crucial since complex contracts almost always evolve over time because the nature of business is dynamic. When the pricing model generates a payout to the supplier below their minimum profit ***guardrail*** (e.g., 5%) or above what can be deemed as a reasonable ROI on the total book of business (e.g., 30%), the margin matching trigger prompts the parties to review the pricing model and assumptions and - if needed - make necessary changes.

Let's first look at why a low-end margin matching target is needed. Having a low-end supplier guardrail for margin is logical when you think about applying Maslow's Hierarchy best practice noted above. The low-end target protects the supplier from losing money. Some buying organizations might ask, "Why do I care if the supplier loses money?" The answer is simple. A supplier who is losing money will likely make decisions to increase their profit. These decisions involve reducing service levels or replacing the A-Team with the C-

Team – neither which is optimal for the buyer. Using a margin matching trigger protects a supplier's margin at the low-end.

Now let's look at the logic for using a high-end margin matching target. Many organizations often question using a high-end margin matching trigger, often stating it contradicts the best practice of not capping incentives. Let's refer to the earlier example about the supplier who made a $1,000 investment that saved the buying organization $100,000. In that case, the supplier's return on investment was $50,000 – or 5,000% return on investment. This is where a high-end margin matching target makes sense; few people would suggest that an ROI of 5,000% is reasonable.

While the above example is hypothetical, suppliers almost always have some "winning" ideas and perhaps others they may invest in that don't even generate a positive ROI. For this reason, the best practice applied by most organizations is to use a portfolio approach and look at the overall actual margin from a supplier over time. As a memory jogger, the general rule of thumb is for the supplier to have the opportunity to earn a high-end margin of 3x market margin (e.g., 30% in a business where 10% is the average margin).

5. Inherent Incentives – Pros and Cons

Organizations that make the shift to Vested find they have a significant increase in trust because the parties speak the same financial language – both one that uses transparency and a common return on investment approach for rewarding suppliers for driving continuous improvement and innovation.

One might think that moving to a Vested pricing model is a risky venture for a company and its supplier(s) because it is "new" and "not proven." While the approach might be new for a particular buyer and supplier relationship, the Vested approach is not new. In fact, in service segments such as CRE, it is fast becoming a best practice.[2] One of the biggest advantages of using a Vested sourcing business model is the tight alignment of interests between the buyer and supplier.

A Vested model can deliver on the promise of transformation, but it is also different and hard. To succeed, it is imperative buyers understand a "bigger payoff" must be shared, requiring a mindset change for most organizations. Companies choosing a Vested sourcing business model must resist the urge, and corporate pressures, to demand the lowest possible price from suppliers. Suppliers must get comfortable with a transparent approach to financials. And the companies must make the shift to a collaborative approach for developing a pricing model as the parties truly co-create the pricing model versus "negotiate" prices.

Organizations must also go beyond merely saying and using the term "partnership" to create a commercial pricing model that equitably allocates risks and rewards to create shared value during the agreement. If companies cannot do this, they should not enter a Vested approach.

The biggest complaint about a Vested approach is the amount of time it takes. While it is possible to create a Vested agreement in less than three months, most take four to seven months once the provider has been selected, as the Vested methodology is often thought of as a "paradigm shift."

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[2] See for example the Corporate Real Estate Journal article, "Vested outsourcing in corporate real estate and facilities management," Vol. 6, No. 4 (June 2017). The article is discussed at https://www.sireas.com/vested-outsourcing-corporate-real-estate-facilities-management/#more-1045

Recommendation

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*.[23] Each party must clearly understand the goals and financial drivers of the relationship. A Vested approach is effective when:

- A company has transformation or innovation goals it cannot achieve itself and needs to create a “win-win” pricing model to incent the supplier to make investments needed to achieve the transformation/innovation objectives (known as Desired Outcomes)
- There is a need or desire to share risks and rewards. Vested deals are ideal when the business is complex and risky. It is also ideal when the buyer has decided CRE is not a core competency and wants/needs a strategic business partner to make investments on its behalf.
- There is a high level of dependency (e.g., integration, high switching costs)

PART 4: A CALL TO ACTION - NEGOTIATE WITH A DIFFERENT 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. With 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 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 do not simply 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.[24] Further research shows that organizations that embrace a transparent approach can creatively solve tough business problems. In fact, effective information flow promotes more balanced agreements and, more important, better solutions. With solution development, the 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 they cannot trust anyone at the bargaining table.

Complete sharing is powerful because it builds trust. True strategic partnerships are highly transparent — sharing all relevant information to help their partner make an informed decision. One example[25] 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, a 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 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 also noted how moving to a transparent approach changed 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 chose to trust - sharing key financial information to benefit the partnership.

Sykes' willingness to be transparent paid off. The client was receptive to the information and to discussing the operating income percentage with Sykes points at various locations. By sharing information intended to help the client make an informed decision, Sykes showed the client that Sykes was not trying to take advantage of them. 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’s 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[26] that outlines each party’s’ expectations of the other. Authors Jeanette Nyden, Kate Vitasek and David Frydlinger advocate for this in the book *Getting to We: Negotiating Agreements for Highly Collaborative Relationships*.[27] Statements of Intent should be developed early 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.

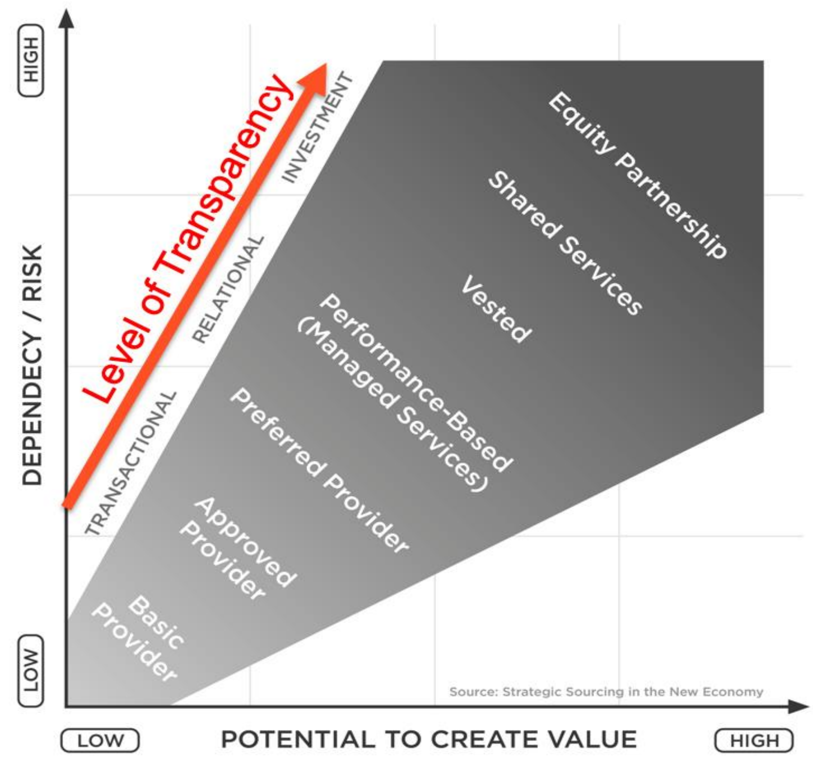
A second criticism about transparency involves the buying company. Often when it comes time to share critical information, the buying company will narrowly define transparency as a one-way street — that is, the supplier is supposed to share but the buying company doesn’t have to. This is a real criticism 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 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, share as much information as feasible. Over time as the companies get more comfortable and trust each other more, they can revisit and refine the ***price*** or ***pricing model.***

When to Use Transparency

There are no black and white answers 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 recommend Vested agreements should always follow a transparent ***open book*** approach. **Figure 7** illustrates 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 the concept of "leaving money on the table" 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,[28] which demonstrates why two individuals might not cooperate even if it is in their best interests to do so.[29] The game gets its name because two players are each accused of 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 will 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 defect. A defection is a competitive move characterized as non-cooperative and self-serving in nature.

Axelrod's findings were described in *The Evolution of Cooperation.*[30] Playing "nice" — or cooperating — led to the best results and maximized mutual gain for both players. Axelrod summarized his findings as follows:[31]

- 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.

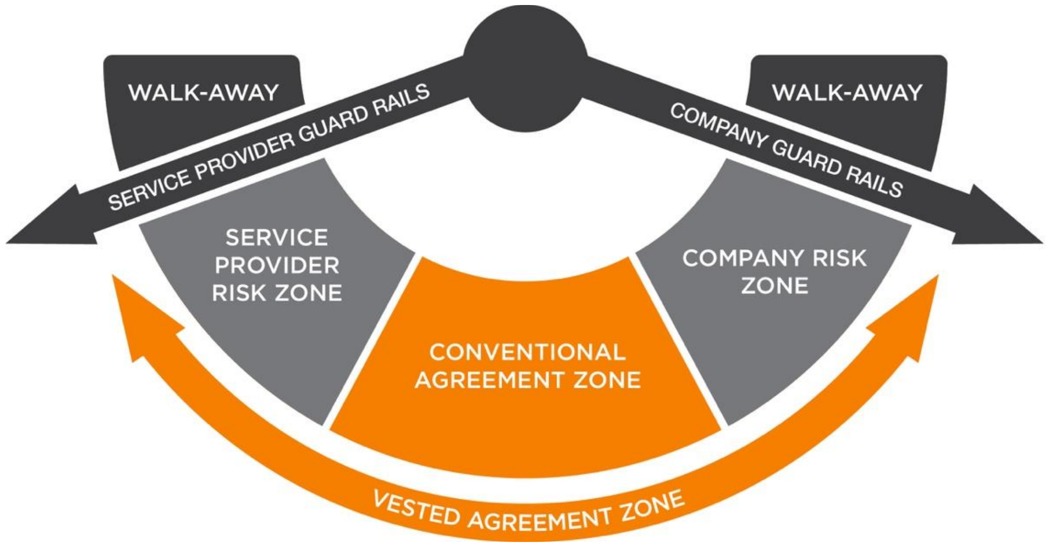
EXPAND THE AGREEMENT ZONE WITH SMART RISK/REWARD ALLOCATION

Most companies use conventional negotiation 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 to create value.

An expanded agreement zone encourages the buyer and the supplier to take on risks they would normally push to the other party, so 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 place 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, basically expanding the pie for both parties. Note also that with the larger pie comes more risk.

Figure 8: Vested Agreement Zone



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 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, they 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 rewards of working together efficiently and effectively. Partnership no longer is merely spoken; it is paid for and contracted.

CONCLUSION – YOU GET WHAT YOU PAY FOR

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

As we have highlighted, it is easy to get a fair price for purchasing goods and services with 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 companies evolve their business relationships, they must challenge their thinking to go beyond a “this deal, this time” mindset; they 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 invest 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 is that 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 for creating a pricing model, Vested or otherwise. What is needed is an approach based on **transparency, cooperation, and smart risk/reward allocation.** 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.” However, there are four design principles of a Vested pricing model. Including:

1. Pricing Model (not a Price)
2. Incentives tied to Desired Outcomes
3. Compensation for costs and risks in line with the six common Guiding Principles
4. Margin Matching to ensure continual alignment

Fortunately, 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 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. Remember 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 to create much-needed innovation.

The bottom line? You really do get what you pay for. Make sure you pay (or get paid) for what you really want.

APPENDIX: GLOSSARY

Assumptions: Underlying financial and operational factors that – if change – affect the output of the pricing model. Common assumptions include volumes, the costs of raw materials, market share estimates, currency assumptions and base exchange rates, inventory and workload mix.

Award fees: Fees paid at the conclusion of a fixed-duration agreement for achieving a desired goal.

Award term: An incentive in the form of a contract extension. When a supplier meets annual goals, the contract is extended for an additional length of time. Synonym: contract extension.

Best Value Assessment: An assessment that bases pricing decisions on the value associated with the benefits received, not on the actual prices or cost. It uses decision criteria that go beyond costs and include decisions on intangibles such as market risks, social responsibility, responsiveness, and flexibility.

Compensation method: 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.

Cost model: A model that typically helps the buyer do scenario what-if testing with cost drivers.

Cost reimbursement: A compensation method that reimburses a supplier for its actual cost-plus an additional markup. The markup can either be variable or a fixed fee. By definition, cost reimbursement is a variable price agreement. A cost-reimbursement approach is appropriate when it is too difficult to estimate a fixed-price with enough accuracy and when the supplier will not agree to assume the risks associated with unknowns. A cost-reimbursement compensation commonly is used to develop a new product or service or for research and development activities. For example, the U.S. government has agreed to cost reimbursement compensation models with military defense companies developing new technologies for national defense. Synonyms: cost-based pricing, cost-plus agreement, cost reimbursement agreement.

Fixed-price: A compensation method in which the supplier's price is agreed in advance and typically is not subject to adjustment. The parties agree on the fixed-price, which includes the supplier's costs and profit. A fixed-price agreement eliminates budgeting variation for the company. Because the total fee for the products and services is fixed, the supplier, not the company, absorbs the peaks and valleys.

Gainshare: A monetary incentive where the supplier shares in cost savings. The focus is on driving out costs of limited value and sharing the cost savings. See also value sharing for a more progressive view of gainsharing.

Glidepath: Refers to a formula that defines the asset allocation mix of a target date fund, based on the number of years to the target date. The glidepath creates an asset allocation that becomes more conservative (i.e., includes more fixed-income assets and fewer equities) the closer a fund gets to the target date. The term is derived from an aircraft's line of descent to land.

Guardrail: Agreement boundaries or structured parameters that can block the parties from developing a formalized agreement to frame their Vested business relationship. Guardrails define the limits of acceptable risk either company is willing to assume in an outsourcing relationship; a risk outside of a guardrail boundary would likely be considered a “walk away zone.” Establishing guardrails up front provides the Pricing Team with the authority to develop a pricing model within clearly stated boundaries and sets a tone of “no surprises,” which will likely be a relief to both corporate authorities and the team creating the pricing model. Guardrails thus provide the team that is drafting the agreement with the authority to develop a deal within clearly stated boundaries.

Incentive: A type of award for the company or the supplier. Incentives can be monetary or non-monetary. In a Vested pricing model, incentives should be based on achievement of incremental performance of the Desired Outcome. In a Vested Agreement, incentives motivate suppliers to make decisions that ultimately will meet the company’s Desired Outcomes.

Incentives framework: A mechanism that the parties use to measure incremental performance and establish incentive payments. Monetary incentives are calculated using a mathematical formula, non-monetary incentives are granted when a performance target is met. The simpler the incentive framework is, the better.

Margin matching: A technique used to fairly adjust actual prices to be paid based on movements in the defined underlying pricing model assumptions. This avoids having one party “win” at the other party’s expense. Margin matching includes establishing a trigger point that activates to reset prices when the point is met. For example, the inflation rate might be a trigger point for resetting inventory carrying costs charges. The goal of using a margin matching technique is to establish pricing fairness, which ultimately builds trust and a better working environment.

Output-based business model: A model in which a supplier’s compensation is linked to the delivery of a defined set of outputs – often in the form of achieving agreed-on Service Level Agreements. An output-based business model typically shifts risk to the supplier for achieving the output. A well-structured agreement compensates a supplier’s higher risk with a higher reward and **only** shifts risk to the supplier that is under their control. A properly structured output-based business model uses an output-based economic model.

Outcome-based business model: A model in which a supplier is paid for the realization of a defined set of business outcomes or business results. An outcome-based business model typically involves shared risk and shared reward between a buying company and the supplier. A well-structured agreement compensates for a supplier’s higher risk with a higher reward. A properly structured Vested agreement uses an outcome-based economic model.

Performance-based/Managed services model: A formal longer-term supplier agreement that combines a relational contracting model with an output-based economic model. A performance-based model drives supplier accountability for output-based Service Level Agreements and/or cost reduction targets. This type of agreement typically creates incentives (or penalties) for hitting (or missing) performance targets.

Perverse incentive: A direct negative reward or unconscious behavior that drives unintended consequences.

Price creep: Refers to increased costs associated with changes that occur when a good or service has not been properly specified. It is generally considered harmful. See also **scope creep.**

Pricing model. A physical mechanism companies use to establish an amount to pay a supplier. A pricing model differs from price as it includes mechanisms to determine the optimum monetary exchange between and buyer and supplier, not just a negotiated price. We use the term *model* because often prices change for various business reasons. In most cases, a pricing model consists of a spreadsheet. A good pricing model enables the parties to manipulate the assumptions of the various pricing model components. The pricing model components are:

- The compensation method (e.g. fixed-price, cost-plus, hybrid)
- Input assumptions
- Total costs and best value assessment
- Risk allocations
- Margin matching
- Contract duration

A good pricing model:

- Equitably allocates risks and rewards to realize mutual gains for the duration of the agreement
- Allows buyers to align a supplier's payment with the value received, in essence validating that a company gets what it pays for

Relational economics: The study of the quantified impact of the behavior of individuals in a contractual relationship and the direct impact that their collective behavior has on the achievement of the Desired Outcomes and realization of mutual gain.

Relationship management: The practice of establishing joint policies and processes that emphasize the importance of building collaborative working relationships, attitudes, and behaviors. The structure by necessity will be flexible and will provide top-to-bottom insights about what is happening with the Desired Outcomes and, just as important, the relationship between the parties. The goal of relationship management is to streamline and make more effective the processes between a company and its supplier(s). This is most definitely not a "whose-throat-to-choke" exercise; rather, it is the establishment of processes for communication, reporting, and improvement.

Relationship model: A concept based on Oliver Williamson's Nobel prize-winning work that classifies an organization's sourcing needs into three categories: "market" (transactional Sourcing Business Models), "hybrid" (relational/hybrid Sourcing Business Models), and "hierarchical" (investment-based Sourcing Business Models).

Risk allocation: The process of appropriating risk to the party that can best mitigate or manage the risk on behalf of the relationship in order to maximize value. A Vested pricing model should ensure that the party that takes on risk is appropriately compensated.

Scope creep: Refers to uncontrolled changes or continuous growth with associated workscope. Scope creep is very common when buying services such as construction or software development. It can occur because the buyer adds on additional specifications when the scope is not properly defined, documented, or controlled. It is generally considered harmful. Synonym: requirements creep.

Service Level Agreement (SLA): A documented agreement between company and supplier that identifies services and service targets, including prerequisites for service levels and measures for performance.

Sourcing Business Model theory: A theory that suggests sourcing should be thought of as a business model between two parties with the goal to optimize the exchange. Sourcing Business Models are based on two factors: relationship models and economic models. The seven Sourcing Business Models are (1) basic provider, (2) approved provider, (3) preferred provider, (4) performance-based model, (5) Vested business model, (6) shared services model, and (7) equity partnership. Each Sourcing Business Model creates a system to optimize for the business situation. An organization uses a Business Model Mapping template and assesses 25 attributes to determine which Sourcing Business Model is best suited for their situation. See the book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement* for more detail.

Standing Neutral: A trusted neutral expert selected by the parties at the beginning of their relationship readily available throughout the life of the relationship to help the parties work through issues and avoid disputes. There is a growing trend to use Standing Neutrals to assist parties in structuring their business agreements.

Total Cost of Ownership (TCO): The foundation for any Best Value decisions that need to be made. A TCO analysis includes determining the direct and indirect costs of acquisition and operational costs – from both the buyer and supplier perspective. Determining the TCO helps the parties clarify decisions for pricing.

Transaction-based business model: The business model typically used by companies for all of their commercial agreements when they make buy decisions. Conventional approaches to transaction-based models keep suppliers at arm's length. Three types of transaction-based sourcing relationships have evolved over time as businesses wrestle with how to create supplier relationships better suited for more complex business requirements: basic transaction providers, approved providers, and preferred providers.

Transaction-based pricing model: An outsourcing model where payments to the supplier are based on the number of transactions executed (e.g., per unit, per hour, per shipment, per call, per mile).

Transaction costs: Costs that occur when participating in a market. The level of transaction costs depends on three important factors: (1) transaction frequency, (2) level of transaction-specific investment, and (3) external and internal uncertainty. To use a very simple example, when buying a book, to be considered are not only its purchase price but also the costs incurred in purchasing it, which could include energy and effort in selecting the book, the costs of traveling to the store or using the Internet, the time waiting for receipt of the book, and the effort and costs of making the payment. Transaction costs are the costs that go beyond the book's price. They include actual monetary costs, expertise, flexibility, risk, asset specificity, the cost of managing the relationship, and supplier setup and switching costs, to name only a few.

Transaction cost economics (TCE): In its simplest form, the study of the economics of the hidden costs associated with the transactions that companies perform. TCE is an economic model that adopts a contractual approach to the study of economic organizations. Oliver Williamson is a pioneer in the study of TCE and won a Nobel Prize in 2009 for his research and thought leadership on TCE.

Value sharing: The practice of allocating a share of the total value derived from improvement or innovation to the parties. The savings are based on the entire value to all stakeholders, not just the company. Value sharing encourages supplier innovation for total overall value.

Vested®: Vested is a business model, movement, and methodology that enables true win-win relationships in which parties are invested in each other's success. Vested combines a relational contract with an outcome-based economic model. When applied, a Vested approach fosters a highly collaborative environment that sparks innovation, resulting in transformation, improved service, and reduced costs. Vested is a progressive approach that takes business relationships to the next level, sparking innovation, improving service, and reducing costs—creating a true win-win.

Vested Agreement: An agreement between two or more companies whereby the beginning foundation of the agreement determines its future success—shared value. Vested's Five Rules and Ten Elements provide the flexible, customizable framework for the agreement to enable both parties to "contract" for mutual success.

Vested pricing model. A pricing model designed to reward both the company outsourcing and the supplier for achieving their Desired Outcomes. When properly structured, the pricing model should generate returns in excess of target margins for the parties when they achieve the Desired Outcomes. Vested pricing models always include input assumptions. Think of input assumptions as the levers that will affect the parties' prices and bottom lines. When the lever is pulled (triggering increases or decreases), the profit potential of one or both of the companies is affected. The parties will use assumptions to establish actual prices and to model estimated profits.

Watermelon scorecard: A term coined by University of Tennessee researchers to explain the concept that a supplier can meet a buyer's required specification but not proactively collaborating to drive innovative value over the long-term for the buyer. In essence, the scorecard is green on the outside but red on the inside.

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The Sourcing Industry Group (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 25-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, SIG University certification program and online Resource Center, which was developed by and for professionals in sourcing and outsourcing. The organization is unique because it blends practitioners, suppliers and advisory firms in a non-commercial environment. For more information, visit http://www.sig.org

NEVI is the Dutch Association for Purchasing Management and was founded in 1956. Since then NEVI has grown to become one of the world's leading Purchasing Management organizations. NEVI is a member of IFPSM (International Foundation for Purchasing and Supply Management) and chairman of the European division. With over 6.500 members working in the private and public field, NEVI is the world's third-largest supply management association. NEVI is the principal authority for matters concerning purchasing in the Netherlands and is the leading procurement training & development organization in Europe. For more information, visit www.nevi.nl

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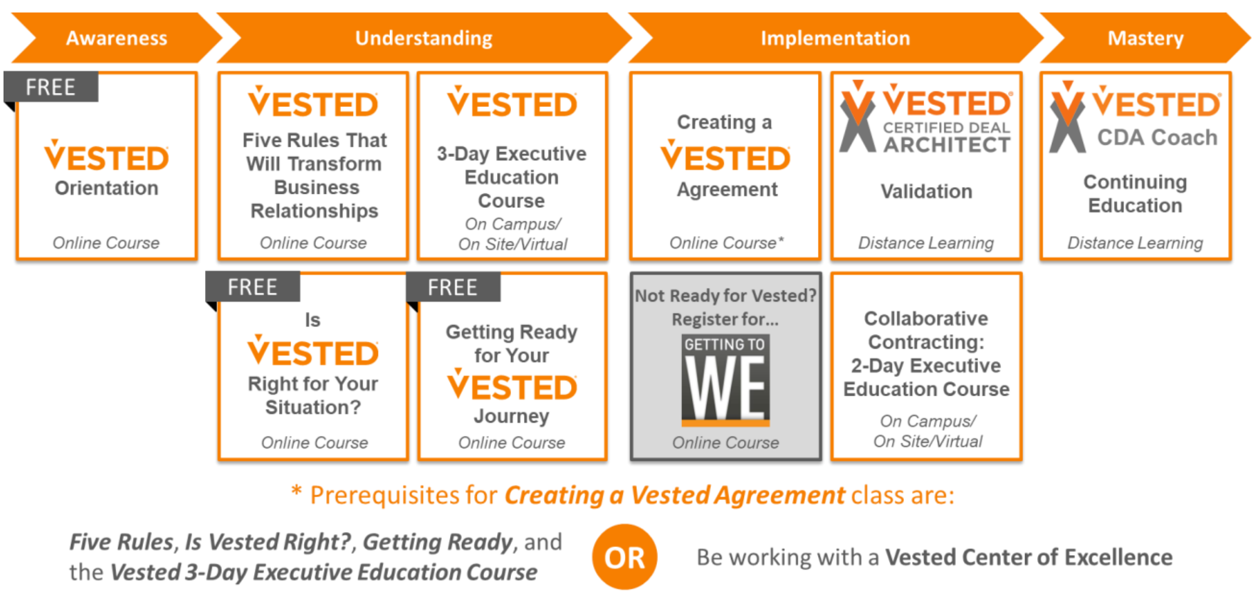
FOR MORE INFORMATION

The University of Tennessee is highly regarded for its Graduate and Executive Education programs. Ranked #1 in the world in supply chain management research, researchers have authored seven books on the Vested business model and its application in strategic sourcing.

WHY | WHAT | HOW | WHEN | NEGOTIATE THE RELATIONSHIP | TELLS THE REAL STORIES

We encourage you to read the books on Vested, which can be found at most online book retailers (e.g., Amazon, Barnes and Noble) or at [www.vestedway.com/books.](http://www.vestedway.com/books)

For those wanting to dig deeper, UT offers a blend of onsite and online courses including a capstone course where individuals get a chance to put the Vested theory in practice. Course content is designed to align to where you are in your journey ranging from Awareness to Mastery. For additional information, visit the University of Tennessee's website dedicated to the Vested business model at http://www.vestedway.com/ where you can learn more about our Executive Education courses in the Certified Deal Architect program. You can also visit our research library and download case studies, white papers and resources. For more information, contact kvitasek@utk.edu.



ENDNOTES

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[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 regarding 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." *op. cit.*

[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] Federal Acquisition Regulation, Part 15 Contracting by Negotiation. Available at: https://www.acquisition.gov/sites/default/files/current/far/html/Subpart%2015_1.html#wp1095855

[6] See Minnesota Revisor of Statutes, 161.3410 Design-build Contracts; Definitions. Available at: https://www.revisor.mn.gov/statutes/cite/161.3410

[7] Kate Vitasek, "Philly Voters Back 'Best Value' Change To City Procurement System," *Forbes*, May 18, 2017. Available at https://www.forbes.com/sites/katevitasek/2017/05/18/philly-voters-back-best-value-change-to-city-procurement-system/#40554e2ba963

[8] See "Vested For Success: Minnesota Turns 1-35 Bridge Tragedy into Triumph," A University of Tennessee Report by Kate Vitasek, Karl Manrodt and Jeanne Kling. 2012 Available at: http://www.vestedway.com/vested-library/

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[10] See "Vested For Success: How Vancouver Coastal Health Harnessed the Potential of Supplier Collaboration," A University of Tennessee Report by Kate Vitasek, Jeanne Kling and Bonnie Keith 2016. Available at: http://www.vestedway.com/downloads/VCH_Case_Study_collaborative_bidding_Mar6.pdf. See also Request for Proposals Evaluation Guide, https://www2.ed.gov/about/inits/ed/implementation-support-unit/tech-assist/request-proposals-evaluation-guide.pdf

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[12] Unpacking Best Value: Understanding and Embracing Value Based Approaches for Procurement*, A University of Tennessee White Paper.* Available at http://www.vestedway.com/vested-library/

[13] Bonnie Keith, Kate Vitasek, Karl Manrodt and Jeanne Kling, *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement* (New York: Palgrave Macmillan 2016).

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

[15] Kate Vitasek and Karl Manrodt, with Jeanne Kling, *Vested: How P&G, McDonald's, and Microsoft are Redefining Winning in Business Relationships* (New York: Palgrave Macmillan, 2012).

[16] The name "Vested Outsourcing" was 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 States 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. See Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing*; Second Edition; (New York: Palgrave Macmillan, 2013).

[17] *Vested*, Ibid.

[18] 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

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[20] Saul McLeod, "Maslow's Hierarchy of Needs," *Simply Psychology*, updated in 2018. Available at https://www.simplypsychology.org/maslow.html

[21] See chapter 4 of *Vested.* Also see the University of Tennessee case study, "Vested For Success: How the Dept. of Energy and CH2M-Hill Transformed a Plutonium Site to Prairie Land." Available at http://www.vestedway.com/vested-library/

[22] To learn more about shading and shirking in contract, refer to the various works of Nobel laureate Oliver Hart – especially those after 2008.
[23] Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing*; Second Edition; (New York: Palgrave Macmillan, 2013). 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 Pricing Model with Incentives that Optimize the Business
Rule# 5 Governance Structure Should Provide Insight, not Merely Oversight
[24] J. K. Butler, Jr., "Trust, Expectations, Information Sharing, Climate of Trust, and Negotiation Effectiveness and Efficiency," *Group & Organization Management* 24, no. 2 (1999): 217–38.
[25] Jeanette Nyden, Kate Vitasek and Steve Frydlinger, *Getting to We: Negotiating Agreements for Highly Collaborative Relationships* (New York: Palgrave Macmillan, 2013).
[26] See Chapter 2 of *The Vested Outsourcing Manual*.
[27] Vitasek, K. et. al., *Getting to We: Negotiating Agreements for Highly Collaborative Relationships* (New York: Palgrave Macmillan, 2013).
[28] 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.
[29] Cooperation would mean remaining silent about one's own involvement and the involvement of the other player in the crime.
[30] Robert Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984).
[31] Ibid, 119.

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