

Vested Outsourcing: A BETTER WAY TO OUTSOURCE

**By Kate Vitasek and
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Almost all outsource arrangements—regardless of what is being outsourced—have room for improvement. Outsourcing as a large-scale business practice simply has not been around long enough for companies to have worked out all the kinks. Many companies jumped in without fully understanding how to do it right. The result: Outsourcing deals that are structured with fundamental flaws in the business model and the relationship. And while there are more successes than failures, almost all companies still struggle with how to improve their outsourcing efforts.

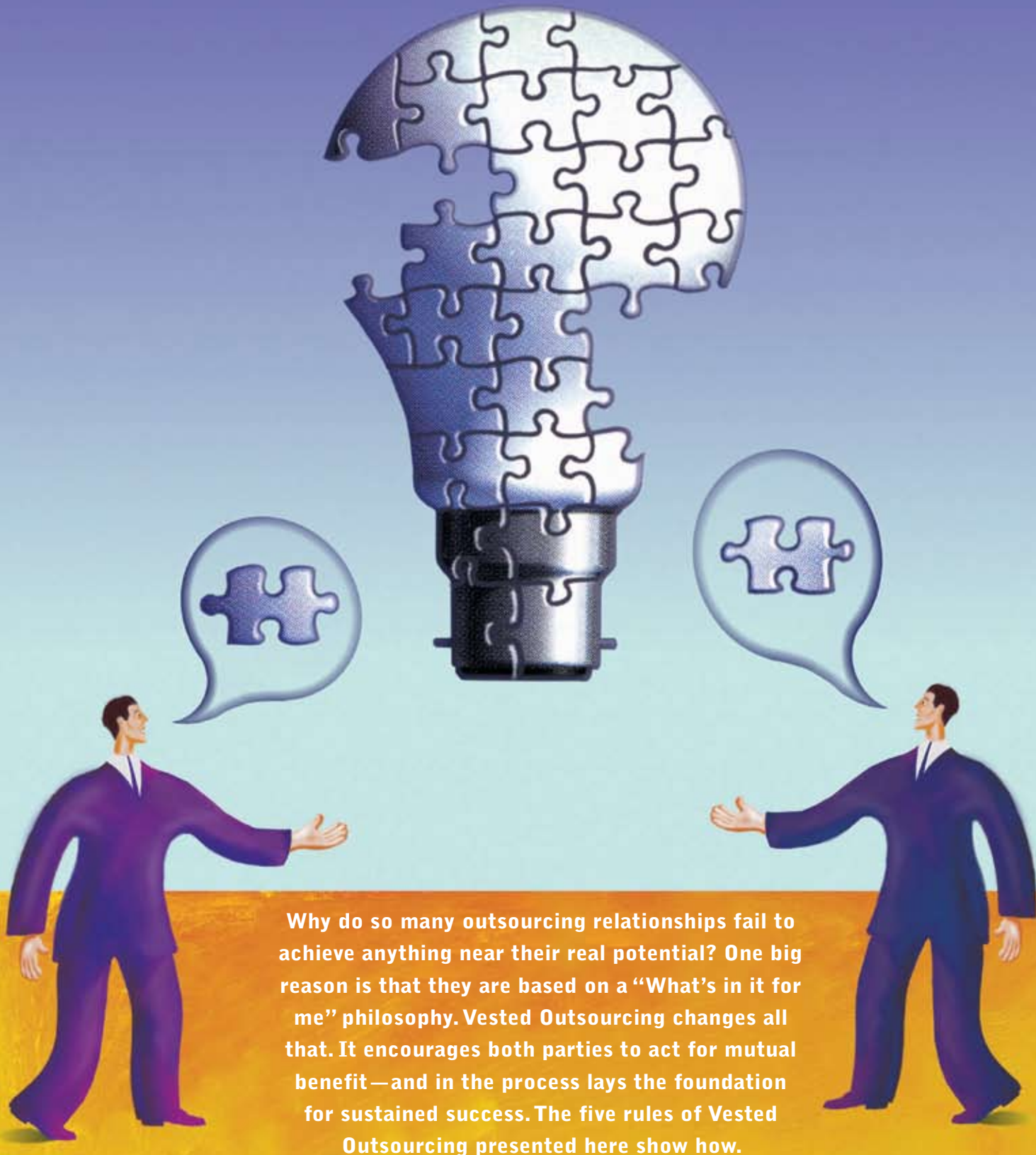
For the past two years, the authors have participated in a University of Tennessee research program funded by the U.S. Air Force to study companies that were employing performance-based approaches for outsourcing. A key part of the research was to distill our observations into courseware for the Defense Acquisition University. In addition, we worked on the implementation of actual defense projects to ensure that participants had a deep understanding of how to develop a solid outsourcing agreement (known as a service acquisition in the

government sector). In this article, we will explore performance partnerships as a unique approach to outsourcing.

This article is based on our research and hands-on experience working with organizations that have adopted symbiotic performance partnerships that truly unlock win-win solutions. While many believe “win-win” is just a buzzword that’s largely theoretical in nature, our research has proved differently. We have uncovered a set of unwritten rules companies can use to develop performance partnerships that enable both parties to achieve much higher levels of performance and cost savings than previously thought possible. We have distilled our lessons and approach into what we call “Vested Outsourcing.” We selected this term because it underscores the importance of both parties having a stake in maintaining the arrangement and working together to create a performance partnership. This type of partnership takes both the company outsourcing and the service provider to new levels of cost savings, service improvements and profitability.

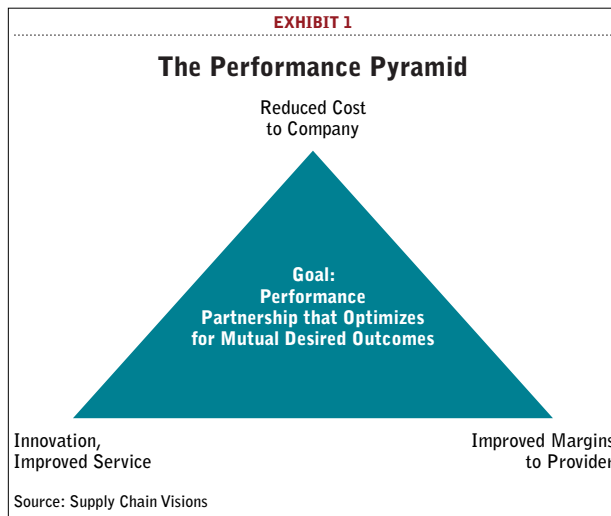
In Search of a Better Way

Thought-leading companies have been challenging conventional outsourcing



Why do so many outsourcing relationships fail to achieve anything near their real potential? One big reason is that they are based on a “What’s in it for me” philosophy. Vested Outsourcing changes all that. It encourages both parties to act for mutual benefit—and in the process lays the foundation for sustained success. The five rules of Vested Outsourcing presented here show how.

ing models for the past ten years. One result of this has been the emergence of Vested Outsourcing. And while no two Vested Outsourcing partnerships are alike, all good ones achieve a similar goal: A performance partnership based on optimizing for innovation and improved service, reduced cost to the company outsourcing, and improved profits to outsource provider. (See the Performance Pyramid depicted in Exhibit 1.) In successful performance partnerships, companies and their service providers work together to develop performance-based solutions that are aligned to their respective interests. Importantly, both parties receive tangible benefits from the relationship.



At the heart of a Vested Outsourcing contract is an agreement on desired outcomes that both companies will achieve. The agreement clearly defines financial rewards for meeting or exceeding the agreed-upon outcomes and specifies the penalties for falling short. Simply stated, if the outsource provider achieves the desired outcomes (results), it receives a bonus. It is important to understand that Vested Outsourcing is not just gainsharing. Gainsharing is usually structured to return to the service provider a portion of cost savings that they bring to the relationship. It is based on productivity measures, and on reducing the cost of service for a specified range of activities.

Vested Outsourcing is much broader. While it certainly includes the cost reduction concepts of gainsharing, it also includes increases in revenue, service level improvements, process improvements, and so forth. Where profit-sharing is based on profitability or cost measures—or, managing one’s portion of the existing piece of the pie—Vested Outsourcing focuses on value creation, making the pie bigger so all parties can enjoy a bigger share.

This new approach challenges and encourages the outsource provider to apply innovative solutions and/or investments to solve a client’s problem and to create value. But in doing so, the outsource provider also takes on some risk, in essence putting “skin in the game.” The provider looks at how it can best apply world-class processes, technologies, and capabilities that will drive value. This commitment to deliver against the projected value for the company outsourcing (such as a commitment to reduce costs or improve service, or both) shifts risk to the outsource provider. In exchange for achieving this incremental value, the company outsourcing commits to allow the provider to earn additional profit—above and beyond industry average profits for their service area. The result is a win-win Vested Outsourcing partnership.

Going the Whole Nine Yards

While the notion of partnerships is widely applauded in business, our experience and research has found that most organizations optimize “partnerships” for their own self interests. This typically reflects a “What’s In It for Me?,” or WIIFMe mentality. Western cultures are ingrained with “winning” from early childhood. Similarly, business schools and law schools focus much of their curricula on winning. Procurement and sales professionals, too, are trained in the art of negotiations to help them “win.”

Companies that embark on a Vested Outsourcing agreement must put aside WIIFMe in favor of WIIFWe (What’s In It For We). This latter approach seeks to unlock a greater opportunity than is currently realized by either party. Put another way, it increases the size of the entire pie vs. maximizing the size of the slice for any one party (for example, lower costs at the expense of the outsource provider’s profits). Only by working together can both parties succeed. WIIFWe effectively tosses the conventional win/lose mentality out the window.

Developing a WIIFWe relationship is easier to describe than to do. It’s not easy for most organizations to quickly transition from a culture of oversight and control to one of mutual respect. True win-win requires effort and commitment by both parties. Outsourcing does not mean abdication: it must be a partnership with regular, frequent communication to manage the expectations as well as the work. One of the most pernicious problems infecting traditional outsourcing arrangements results from micromanagement. A different set of equally destructive problems can emerge when a company hands over a process completely to the outsource provider, washes their hands of that process, and walks away. (The accompanying sidebar lists the ten most common ailments impacting outsourcing relationships.)

A Vested Outsourcing relationship succeeds because both organizations work together to achieve mutually agreed upon, mutually beneficial goals. In our experience, only those organizations that truly set aside the WIIFMe for the WIIFWe mentality were able to achieve true Vested Outsourcing partnerships that delivered outstanding results.

The New Rules of Outsourcing

Our research identified five principles that are embedded in sound outsourcing arrangements. We have come to view these principles as the “rules” of Vested Outsourcing. (See Exhibit 2.) When implemented in conjunction with a win/win What’s-in-it-for We philosophy, game-changing outsourcing relationships can happen.

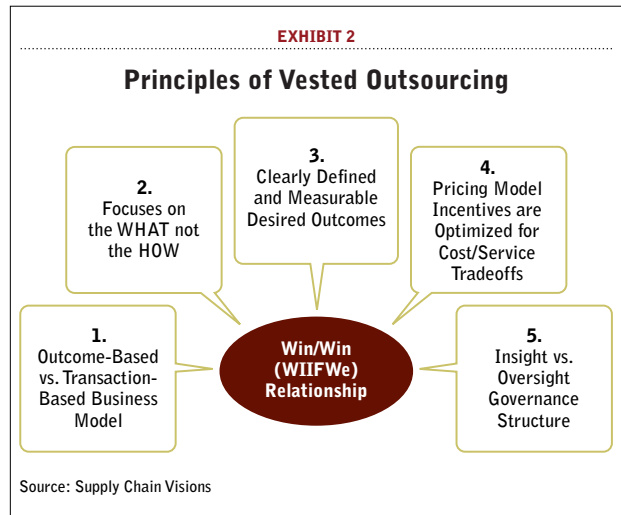
Rule 1: Adopt an Outcome-Based vs. Transaction-Based Business Model

Traditionally, many outsource arrangements are built around a transactional model. (See also discussion of the Activity Trap in the sidebar.) Most often this transaction-based model is coupled with a cost-plus or a competitively bid fixed price per transaction pricing model to ensure that the buyer is getting the lowest cost per transaction. Under this conventional method, the service provider is paid for every transaction—regardless of whether or not it is needed. The more inefficient the entire process, the more money the service provider can make.

The conventional business model does achieve the lowest cost for transactions for the company outsourcing. However, it often does not help the company achieve what it really wants or needs. Why? The company that has outsourced gets what they contracted; but what they needed is an efficient and low-cost total support solution.

Vested Outsourcing, by contrast, operates under an outcome-based model in which the provider aligns its interests to what the company really wants (the efficient, low-cost total solution).

A Vested Outsourcing model fundamentally shifts how a company buys services. The concept is fairly straightforward. Instead of paying a provider for unit transactions for the various services provided—such as pallets in the warehouse, miles traveled, spare parts shipped, technical support hours, and so forth—the company and its service provider agree upon desired performance outcomes. Desired outcomes are still quantifiable, but take a different form: they can be availability, reliability, cost, revenue generation, employee or customer satisfaction, or even asset investment targets. For example, in a traditional outsource relationship the 3PL would be paid based on units received, pallets stored, units picked and packed,



orders processed, and so forth. In a vested outsourcing agreement, by comparison, the 3PL would be paid based on meeting the performance level for orders filled, products available, or on time delivery. In essence, Vested Outsourcing buys outcomes, not individual transactions.

Rule 2: Focus on the WHAT not the HOW

Adopting a Vested Outsourcing business model does not change the nature of the work to be performed. At the operational level, there is still a need for material to be stored, orders to be managed and fulfilled, calls to be answered, and goods to be delivered. What does change is the way in which the company purchases the outsourced services.

Under Vested Outsourcing, the buyer specifies “what” they want; the provider is responsible for determining “how” it gets done. Your in-house operations are either too expensive or ineffective (or both) and you’re looking outside for someone who can do the job better than you can do it. So when you find that provider, you let them do the job, right? The problem that often arises here, however, is something we call the Outsourcing Paradox. By outsourcing, companies effectively concede that they are not in the best position to do a specific job or jobs. Yet when they turn the work over to someone more competent, they can’t resist telling that service provider how to do the job.

The most effective Vested Outsourcing partnerships include minimal discussion of the processes the service providers must follow to meet the requirements. Instead, they focus on performance expectations. It’s up to the service provider to figure out how to put the supporting pieces together to achieve the company’s goals.

Performance partnerships let each firm do what they

do best. Unless the outsourcing company has both the skills and the resources to keep up with the latest innovations in the service they are outsourcing, they should leave the details to the experts.

Rule 3: Clearly Define and Measure the Desired Outcomes

The third rule of Vested Outsourcing is to clearly define and measure desired outcomes. Both parties must be explicit in defining the desired outcomes. These outcomes are expressed in terms of a limited set (ideally, no more than five) of high-level metrics. Organizations should spend time during the outsourcing process, and especially during contract negotiations, to explicitly define how the relationship's success will be measured. Attending to this upfront helps ensure that neither time nor resources are wasted pursuing the wrong objectives.

Once the desired outcomes are agreed upon and explicitly expressed, the service provider can propose a solution that will deliver the required level of performance at a pre-determined price. Under the purest form of Vested Outsourcing, the outsourcing company only pays for results (namely, orders shipped complete and on time), not transactions (picking, packing and shipping). The service provider is paid for the value delivered by its overall solution, rather than being paid for the activity performed.

We cannot stress enough the importance of getting this right. Carefully defining and measuring the desired outcomes will position the relationship for success, by assuring that the right things get done in the right way. Conversely, getting it wrong will result in potentially hundreds of thousands (if not millions) of dollars wasted in a relationship plagued by the common outsourcing ailments we have noted in the sidebar.

Rule 4: Optimize Pricing Model Incentives for Cost/Service Tradeoffs

The fourth rule centers on a properly structured pricing model that incentivizes the optimal cost/service tradeoff—or put another way, avoids the “Penny Wise and Pound Foolish” trap. The pricing model is based on the type of contract (fixed price or cost reimbursement) that will be used to reward the outsource provider.

When establishing the pricing model, businesses need to apply two principles. First, the model must balance risk and reward for both parties. The agreement should be structured to ensure that the provider assumes risk only for decisions within its control. For example, a transportation service provider should never be penalized (or rewarded) for the changing costs of fuel. Second, the

agreement needs to require the service provider to deliver solutions—on time and complete shipments—not just perform pick, pack and ship transactions.

When properly constructed, Vested Outsourcing will incentivize the service provider to solve customer problems proactively. Service providers are thus encouraged to develop and institute innovative and cost-effective methods of performing work to drive down total cost while maintaining or improving service.

Vested Outsourcing essentially is a strategic bet by the service provider that it can meet the service levels at the set price, for example 98 percent on time and complete shipments. Inherent in the business model is reward for the provider to make investments in process, service, or associated products that will generate returns in excess of contract requirements. Performance partnerships are usually based on achieving the desired tradeoff either by achieving:

- Higher service levels at the same cost.
- The same service levels at lower costs.
- Higher service levels and lower service levels.

If the service provider does a good job, it will reap the rewards of greater profitability.

Vested Outsourcing does not guarantee that service providers will reap higher profits. However, it does give providers the authority and autonomy to make strategic investments in their processes and product reliability that can generate a greater ROI compared to conventional cost-plus or fixed price per transaction approach. Vested Outsourcing also typically seeks to encourage service providers to meet the desired performance levels at a flat or decreasing cost over time. Therefore, the service provider has to leverage its unique skills and capabilities to make the processes much more efficient. In addition, the provider may realize intangible benefits such as contract extensions or references from their clients.

Rule 5: Governance Structure Must Emphasize Insight vs. Oversight

In the early days of outsourcing many companies made the mistake of simply throwing the work over the fence to their provider without clearly defining the requirements or developing performance metrics or SLAs (service level agreements). As scary as it may seem, we still see some companies today that operate without benefit of a formal contract or any real agreement in place. Fortunately, this is a declining minority. Yet some have gone to the other extreme, succumbing to the measurement minutiae ailment. They often have a small army of people often referred to as “program managers” who micromanage the outsource provider.

An effective Vested Outsourcing partnership outsources processes to service providers that are real experts in those processes. The partnerships should be managed to create a culture of insight vs. oversight. Let's look at the meaning of both words to get a better understanding of the difference.

- *Insight*. Power of acute observation and deduction; penetration, discernment, perception.
- *Oversight*: Watchful care; superintendence; general supervision. Escape from an overlooked peril.

If you have done a good job picking the right outsource provider and you trust them and their expertise, why do you need a small army providing "general supervision" over them? A sound governance structure should establish good insight—not provide layers of oversight.

How Vested Outsourcing Rules Work Together

In Vested Outsourcing, the organizations work together upon a foundation of trust and mutual accountability to achieve the outcomes. Supported by the careful alignment of performance objectives and controls, the service provider is empowered to pursue improvements that will deliver higher performance, greater profits, and lower total ownership cost. Vested Outsourcing uses the power of free market innovation to improve the outsourcing relationship. This can be a challenging mindset to embrace. But participants should always keep in mind the ultimate goal: performance partnership that optimizes for mutual desired outcomes.

For the service providers, Vested Outsourcing is an

10 Common Outsourcing Ailments

1. Penny Wise and Pound Foolish
When outsourcing, you need to think beyond the short-term bottom line. The danger in focusing on the cheapest offer is that it inevitably leads to tradeoffs in quality and/or service. Unfortunately, many executives view outsourcing as a quick-fix solution to resolving balance sheet problems. Often companies suffering from a "Penny Wise and Pound Foolish" mentality, fall into a loop of frequently bidding out their work, picking the lowest price provider, and then transitioning to that supplier. This can lead to a vicious cycle of bid and transition, bid and transition, bid and transition.

2. The Outsourcing Paradox
This ailment typically begins with the "experts" at the outsourcing company developing the "perfect" set of tasks, frequencies and measures for the engagement. The result is an impressive document containing all the possible details on how the work is to be done. At last, the perfect system! However, this "perfect system" can actually sow the seeds of failure of the outsourcing effort. The reason: it's the company's perfect system, not one designed by the provider of the services, who's supposed to be the experts at getting the job done.

3. The Activity Trap
Traditionally, companies purchasing outsourced services have used a transaction-based model where the service provider is paid for every transaction—regardless of whether or not it is needed. Businesses are in business to make money; providers of outsourcing services are no different. The more transactions they perform, the more money they

make. There is simply no incentive for them to reduce the number of non-value-added transactions because it would result in a reduction of revenue. Make sure your outsourcing agreement is not based on pushing the cash register button every time a specified activity is performed, especially when that activity is not value added.

4. The Junkyard Dog Factor
When the decision to outsource comes down, it usually means that jobs will be lost as the work and jobs transition to the service provider. This often results in employees hunkering down and staking their territorial claim to certain processes that simply must stay in house. Even if the majority of the jobs are outsourced, many companies choose to keep their "best" employees on board to manage the new outsource provider. These employees are often the same ones who were asked to help write the statement of work (SOW). Is it any wonder then, that SOWs become rigid documents that dictate conventional and less-than-optimal ways of performing the tasks being outsourced?

5. The Honeymoon Effect
At the beginning of any relationship, both parties go through a honeymoon stage. Outsource providers will jump through hoops as they ramp up for their new client, who's happy just to have someone else doing the job. But while the provider remains conscientious about meeting the company's expectations and service levels outlined in the contract, it never progresses beyond this point. The Honeymoon Effect lingers on, even while performance levels for the services provided may be improving industry wide. The prob-

opportunity to exercise greater flexibility in deciding how support is provided, to ensure cash flow stability through long-term contracts, and to increase revenue. For the company doing the outsourcing, it's a chance to enhance performance while decreasing costs and assets employed. In short, vested outsourcing changes the fundamental business constructs of the typical outsourcing approach.

Companies wanting to embark on a Vested Outsourcing partnership and thereby realize lower costs for the outsourcing company and higher profits for the service provider, neither of which can be attained by one organization working alone, will need to fully embrace the WIIFWe philosophy. Further, they will need to consistently live the five rules of outsourcing to ward off the common ailments that can weaken—and even destroy—

an outsourcing partnership. Vested Outsourcing is game-changing; it is the way to healthy and thriving outsourcing relationships. ☞

Authors' notes: Our upcoming book, *Vested Outsourcing*, published by Macmillan, will offer a comprehensive guide for developing successful Vested Outsourcing partnerships. It is designed to help all companies begin their effort to take their outsourcing relationships to the next level.

The University of Tennessee offers a three-day open enrollment class at the school's Center for Executive Education, titled Performance-Based Outsourcing: Buying Results, Not Activities! (See <http://PBO.utk.edu>) You can also contact Bric Wheeler at the University of Tennessee (BWheeler@utk.edu) for information on customized, in-house training on performance-based outsourcing. Also, readers are encouraged to visit the authors' blog at www.vestedoutsourcing.com, which includes additional resources, success stories, and other material.

lem: while the honeymoon lasts, there's no inherent incentive to raise service levels (or decrease the price) beyond what's contained in the Service Level Agreements.

6. Sandbagging Let's look at a typical outsourcing example of sandbagging. Many times during contract negotiation, someone on the company side, often a senior manager, will ask, "Just how much can I save?" Rather than establish the highest level of savings achievable as early as possible (which would be most beneficial to the company outsourcing), the provider will sandbag and offer up the savings in smaller increments over time. Why deliver everything up front when you know that your hardnosed customer is just going to hammer you for more next quarter or next year? The providers know that total savings are made up of "low hanging fruit" and long-term savings. They often hold back some improvements in an effort to manufacture future savings opportunities in case they don't perform well in a given quarter or year.

7. The Zero-Sum Game Companies that play this game believe, mistakenly, that if something is good for the outsource provider, then it's automatically bad for them. Providers feel the same way from the other perspective. Many organizations fail to understand that the sum of the parts, when combined effectively, can actually exceed the whole. This was proven by John Nash's Nobel Prize winning research, commonly referred to as game theory. The theory's basic premise is that when individuals or organizations play a game together (or work together to solve a problem) the results are always better than if they had played against each other (i.e., worked separately).

8. Driving Blind Disease The Driving Blind Disease afflicts companies that have not done their homework in preparing for the outsourcing engagement. Specifically, it relates to the lack of a formal governance process to monitor the performance of the relationship. Research from the Aberdeen Group shows that one of the biggest challenges organizations face today is assuring that negotiated savings are actually realized on the bottom line.

9. Measurement Minutiae When companies try to measure everything, they usually succumb to the malady of Measurement Minutiae. What's remarkable is the scale of the minutiae that some organizations are able to create. We have found spreadsheets with 50 to 100 metrics on them. Measurement minutiae is often associated with companies that are suffering from the junkyard dog factor and with agreements that have fallen into the activity trap. If you find yourself micromanaging your service provider, you're either bored or you don't trust them.

10. The Power of Not Doing The saddest of all ailments is the one we call the Power of Not Doing. This happens when a company falls into the trap of establishing measures for the sake of measures, without thinking through how those measures will be used to manage the business. We've all heard the old adage that "You can't manage what you don't measure." But if you don't use your measures to make improvements, you should not expect results.