

The 10 Elements of a Vested Outsourcing Agreement

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CENTER *for* EXECUTIVE EDUCATION



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Vested Outsourcing is....

- A game changing approach to outsourcing that
 - Leverages “win-win” thinking associated with Game Theory / Behavioral Economics
 - Is centered around buying **results instead of tasks and/or activities** with the conscious effort to use incentives to drive process innovation which prevents many perverse incentives of conventional outsourcing
 - Creates a contract that follows “5 Rules”
 - Uses incentives to transform the work to achieve “tradeups” versus conventional cost/service tradeoffs
- Transformational when applied
 - Endorsed by the International Association for Contract and Commercial Management, the Sourcing Interest Group, Center for Outsourcing Research Excellence, and the International Association of Outsourcing Professionals
 - Being associated as the “business concept of the decade” similar to Lean and Six Sigma

Win-Win Thinking is Real

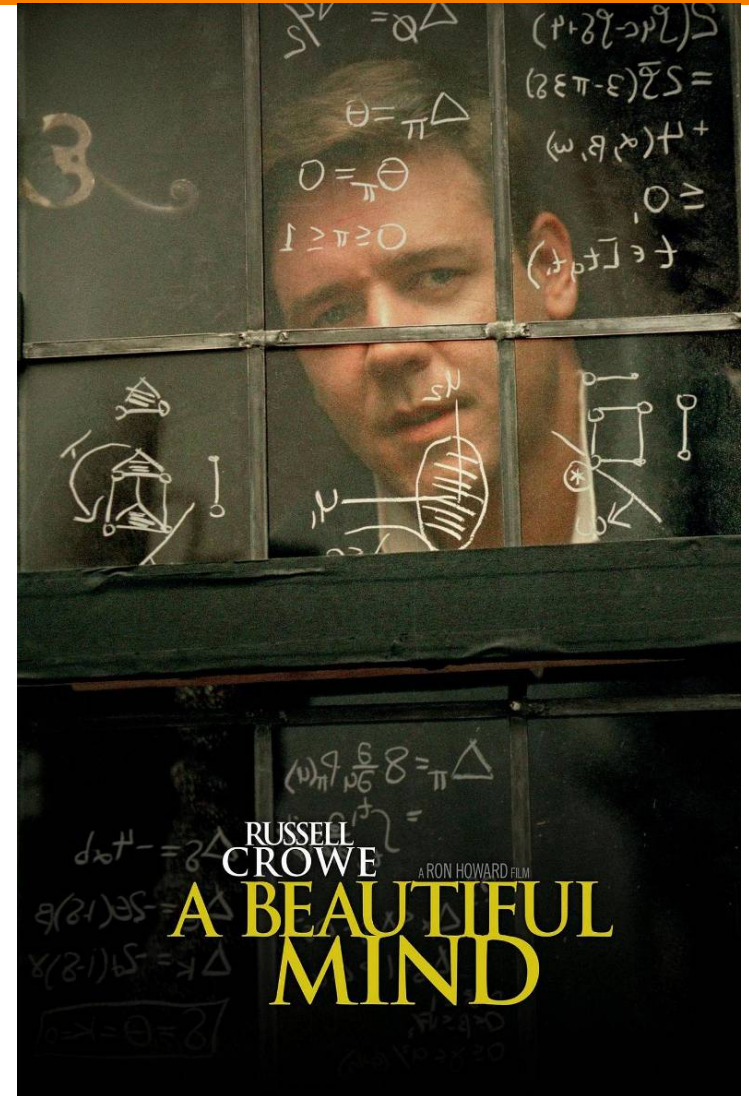
...and it is Really Beautiful!

Win-Win solutions concepts is based on what is commonly known as Game Theory. The most famous of the Game Theorists is John Nash.

The **Nash equilibrium** states that, no player can benefit by changing their strategy while the other players keep their strategies unchanged. That set of strategies and the corresponding payoffs constitute the Nash Equilibrium.

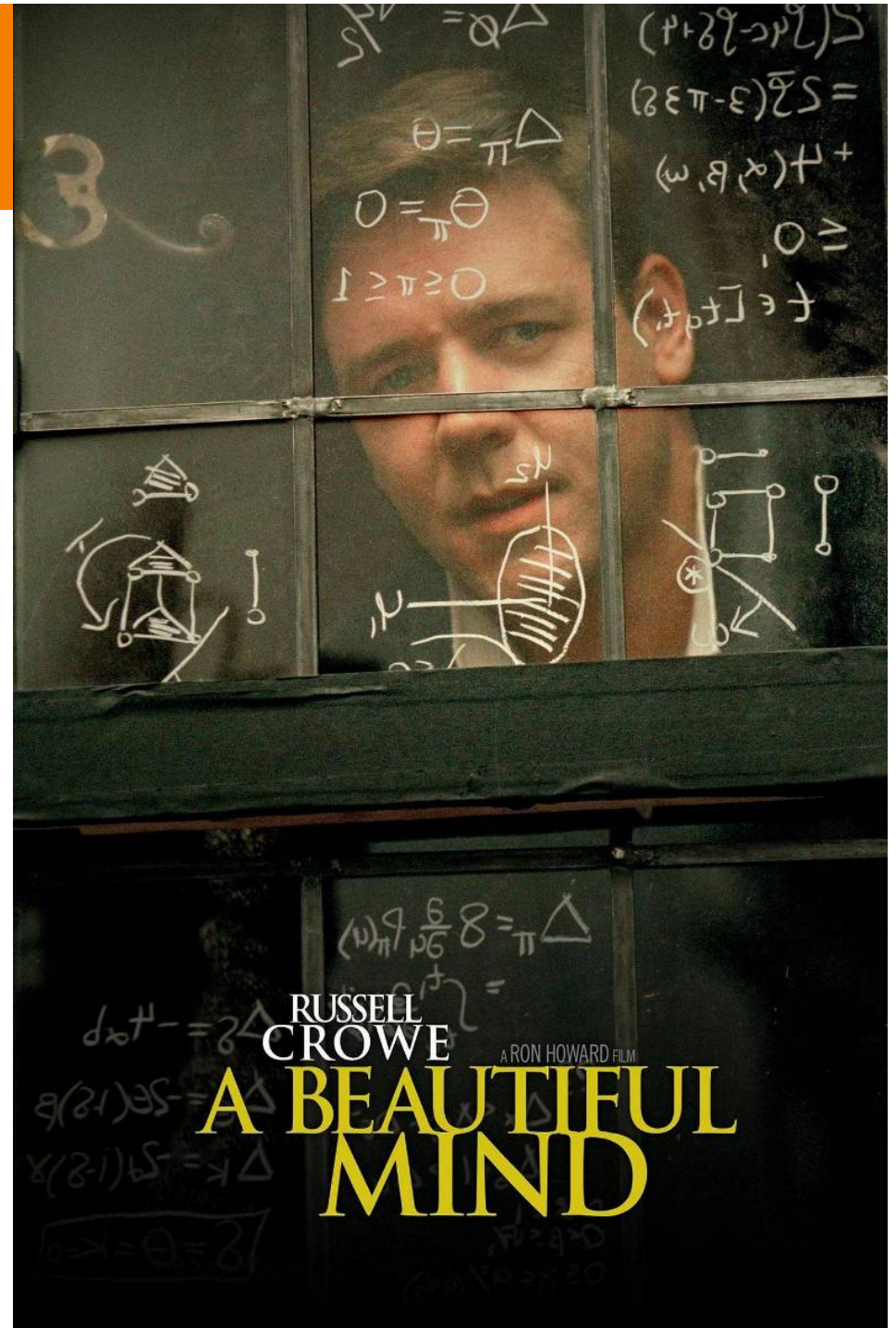
Nash shared the 1994 Nobel Memorial Prize in Economic Sciences with game theorists Reinhard Selten and John Harsanyi and the movie A Beautiful Mind portrays his story.

Win-Win solutions concepts are at the heart of game theory. Eight Nobel prizes have been awarded to Game Theorists.



“Adam Smith was wrong....”

- Adam Smith said: “The best results comes from everyone in the group doing what is best for themselves.
- That is incomplete.
- The best result will come from everyone in the group doing what is good for himself and the group. It is the only way we all win.”



...and not playing nicely can cost you

Dr. Oliver Williamson shared the Nobel prize in 2009 for his work on Transaction Cost Economics (TCE). One part of his research is in analyzing the economic efficiency of commercial arrangements.



“Muscular buyers not only use their suppliers, but they often ‘use up’ their suppliers and discard them.

The muscular approach to outsourcing of goods and services is myopic and inefficient.”

Why Vested Outsourcing Works

WIIFWe Drives Supplier Innovation

- Vested Outsourcing is the creation of a mutual symbiotic “deal” where all parties win.
- All parties become aligned to the same quantifiable objectives
- The rules of the game are clearly spelled out through the contract
- Contract incentives balance risk/reward, encourages supplier innovation

I WIN
with higher
service levels
Customer



GOAL
**PERFORMANCE
PARTNERSHIP
THAT OPTIMIZES
FOR MUTUAL
DESIRED OUTCOMES**



Supply
Chain
Manager

I WIN
with lowest
possible costs



I WIN
with higher
profits
Supplier

Shifting From ME to WE

ME

- Getting the supplier to meet my needs
- It's in the contract, now it's the supplier's problem
- Blame and punish the supplier
- Unpleasant surprises

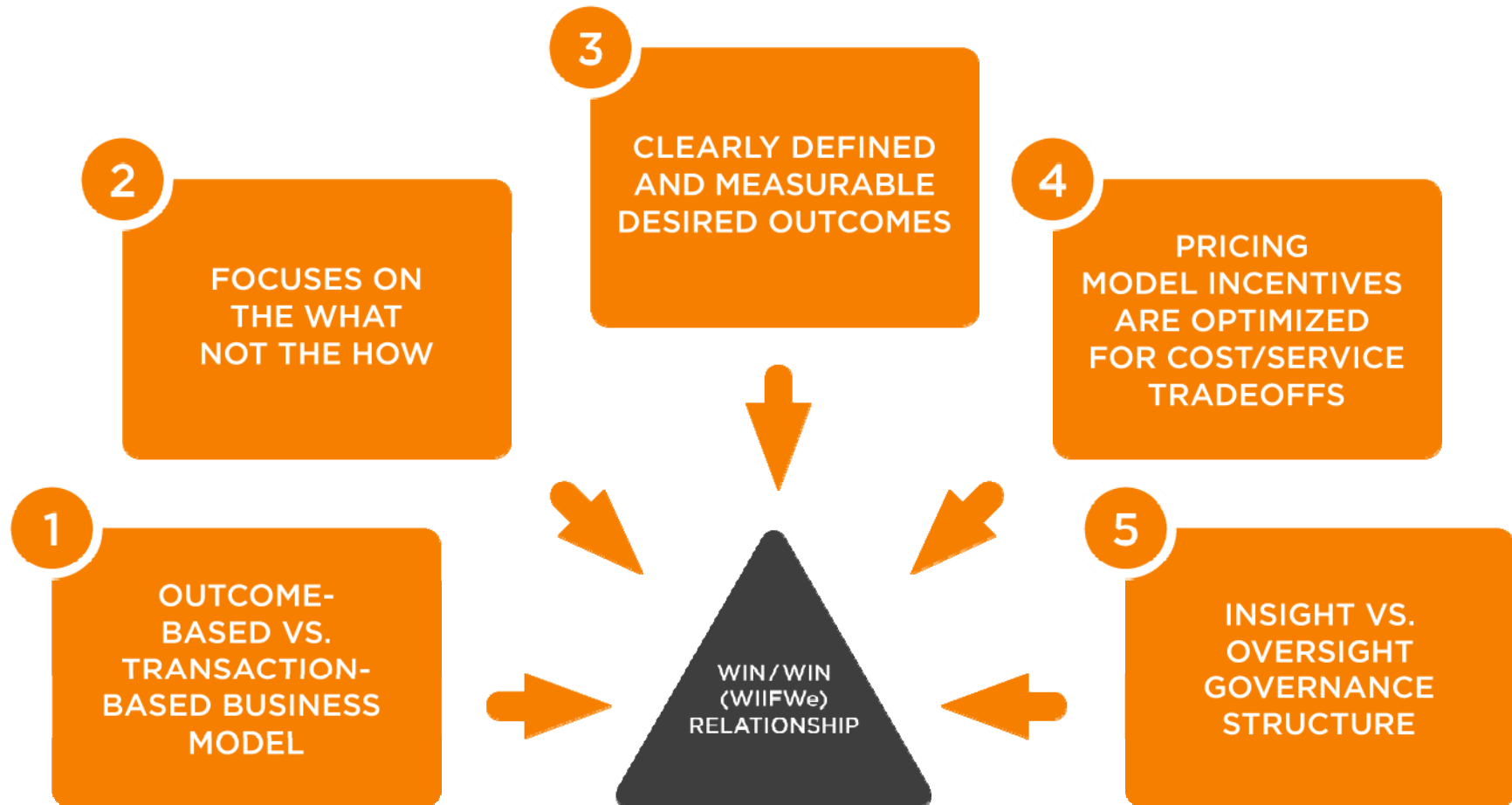
BECOMES

WE

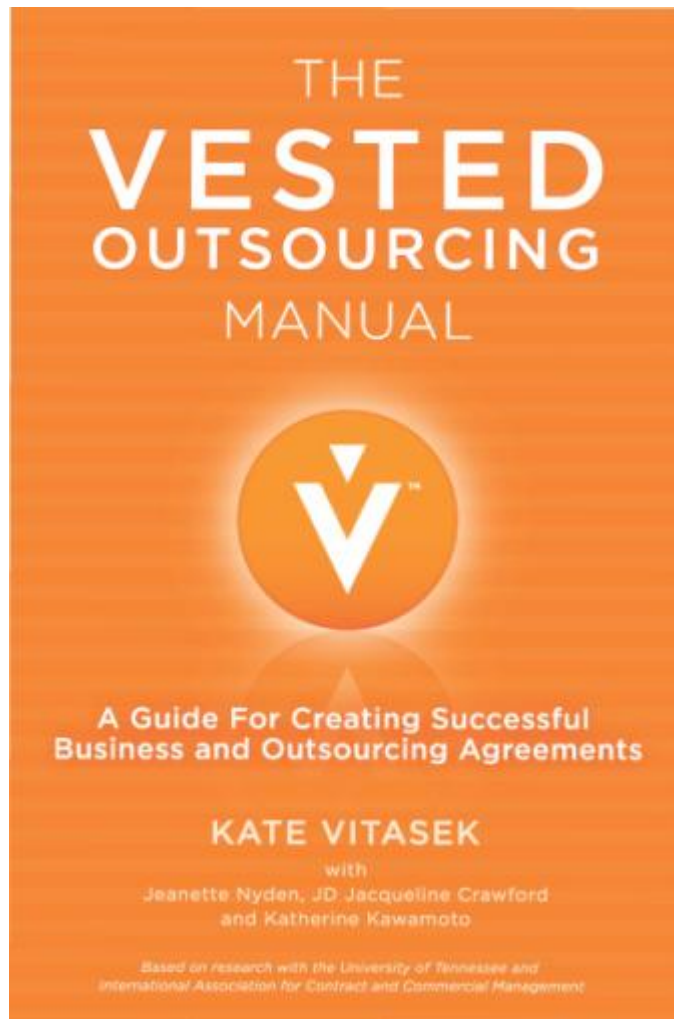
- Finding a way to meet both our needs
- Work together to achieve the performance and compensation goals
- Communicate the issues, jointly find solutions
- Integrated planning and communications

It is about managing how a customer works together with their suppliers to enhance the value of the relationships

The 5 Rules of Vested Outsourcing



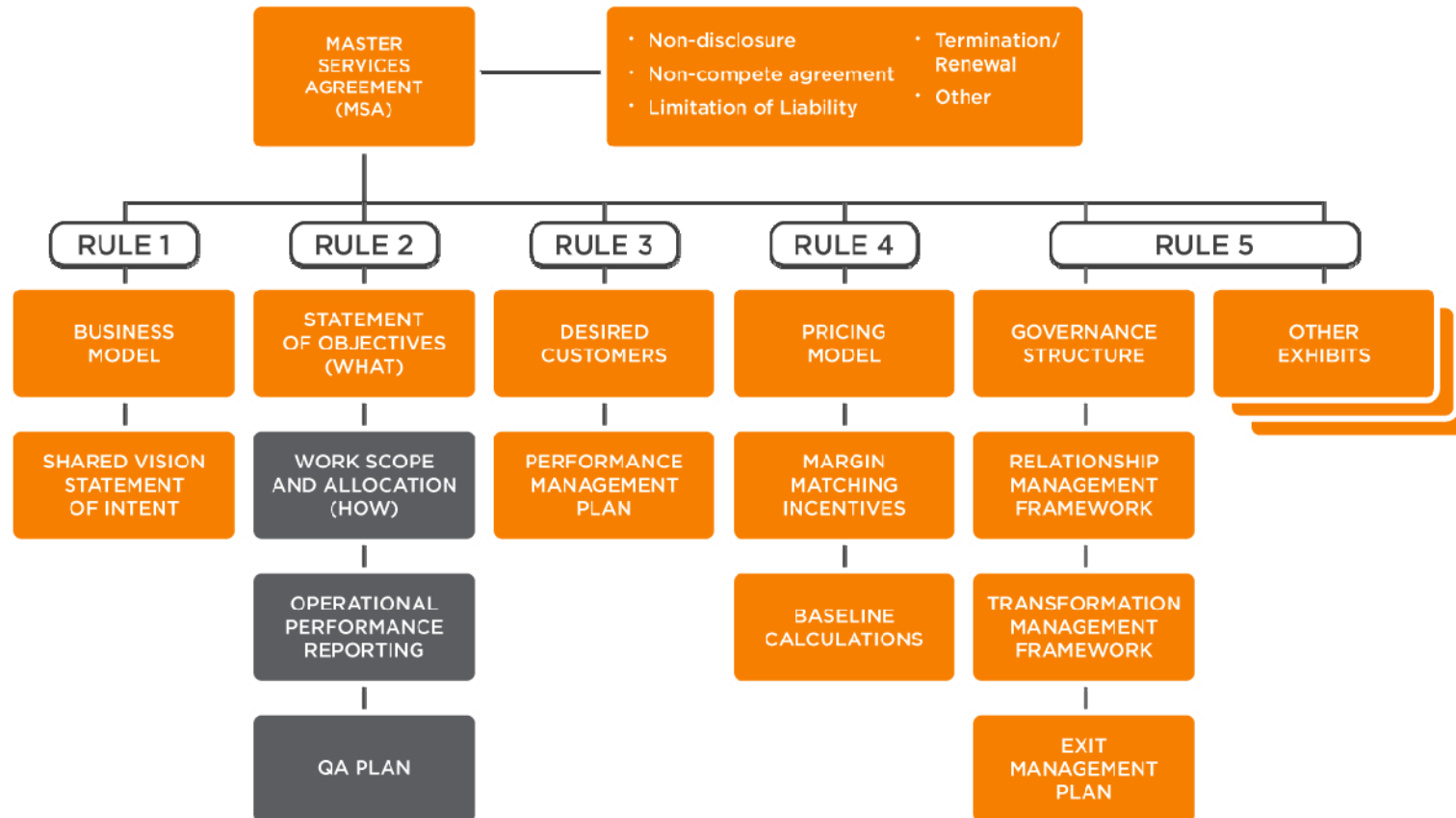
Getting Your Agreement To Vested



10 Elements of a Vested Agreement	
Rule 1: Outcome-Based vs. Transaction-Based Business Model	
Element 1	Business Model
Element 2	Shared Vision Statement and Statement of Intent
Rule 2: Focus on the WHAT, not the HOW	
Element 3	Statement of Objectives/Workload Allocation
Rule 3: Clearly Defined and Measurable Desired Outcomes	
Element 4	Performance Metrics for Desired Outcomes
Element 5	Performance Management
Rule 4: Pricing Model Incentives are Optimized for Cost/Service Tradeoffs	
Element 6	Pricing Model (Margin Matching / Incentives Framework)
Rule 5: Insight vs. Oversight Governance Structure	
Element 7	Relationship Management Framework
Element 8	Transformation Management
Element 9	Exit Management Plan
Element 10	Special Concerns and External Requirements

Building a Vested Agreement

VESTED OUTSOURCING AGREEMENT STRUCTURE



■ SERVICE PROVIDER OWNED

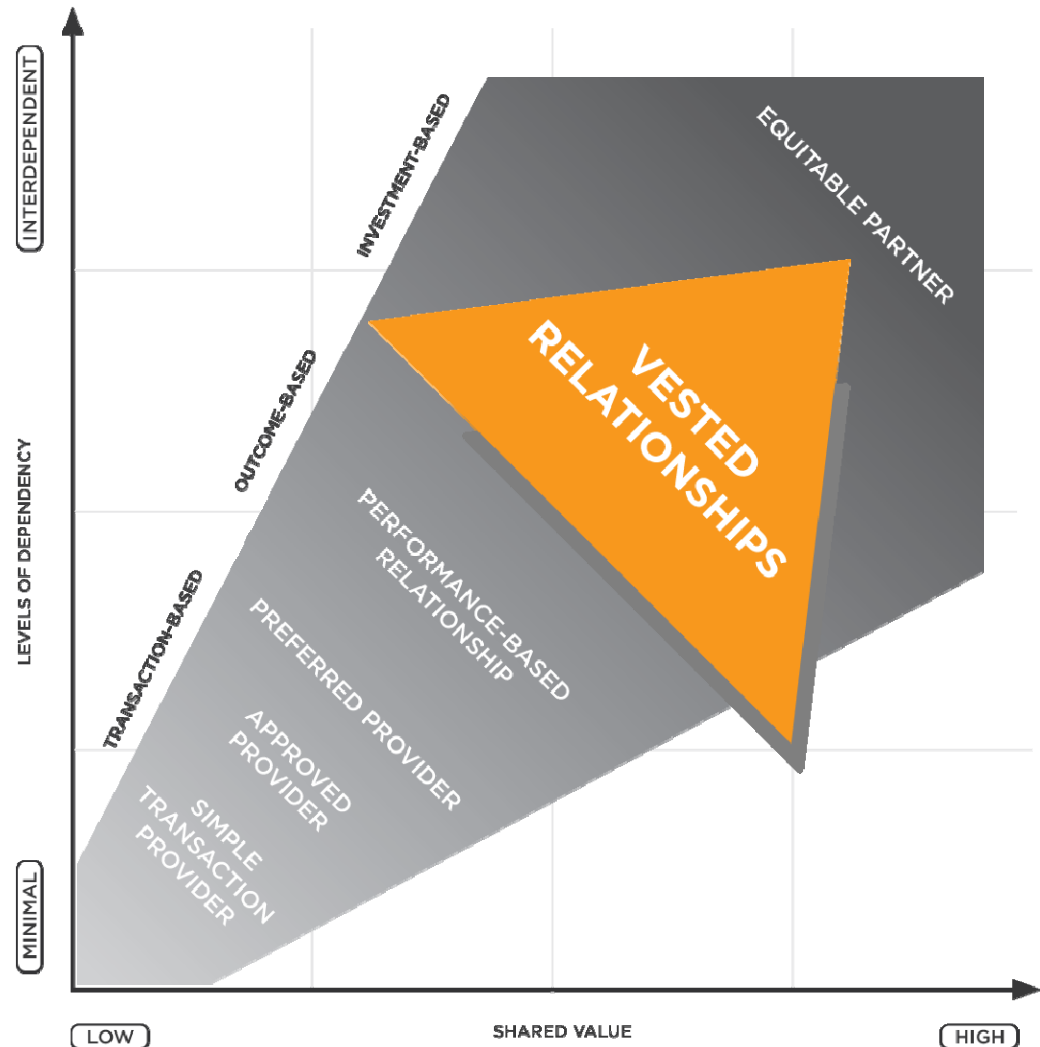
Element 1: Business Model

- The first step in the journey is to take the time to map potential outcomes and to each other's goals
- Aligning strategic interests lead to:
 - collaboration
 - loyalty and mutual satisfaction
 - market share
 - sustainable profit
- Defined outcomes creates a culture where the company and the service provider can maximize profits by working together more efficiently, no matter who is doing the activity



Vested Outsourcing Business Model

- Vested Outsourcing
 - **focus attention on outcomes** and not *transactions*
 - encourage the service provider to innovate
 - ensure that the selected business model **rewards positive outcomes**
 - carefully craft **collaborative agreements**
- Share Value!



The Vested Business Model

- Document how the outsourcing company and the service provider will work together to achieve the desired outcomes
- Envision how the two companies will interface to best achieve results
 - Current culture within the different organizations will be important
 - Teams should be very careful that the “easy path” does not lead straight to the Outsourcing Paradox, the Junkyard Dog Factor, and/or the Zero-Sum Game
 - Control must be given to the service provider to overcome the inherent risks that come with assuring the desired outcomes

Element 2: Shared Vision & Statement of Intent

- A joint vision guides you for the duration of your Vested journey
- The vision form the basis of a Statement of Intent drafted by the outsourcing teams
- Establishing intensions set the right dynamics for the relationship
 - Cooperative and collaborative
 - Integrity, respect and trust



The Statement of Intent

- Can you agree on how you will work together?
- Is made up of seven elements:
 1. Shared Vision and Purpose
 2. Communication
 3. Perspective
 4. Trust and Confidence
 5. Flexibility
 6. Focus
 7. Feedback

**Living up to your intentions is more difficult than stating them...
...live by your intentions for a successful Vested agreement!**

Why Desired Outcomes?

- *Desired Outcomes*
 - Desire: Strong feeling of wanting to have or to do something.
 - Outcome: (1) The final result of a process, meeting, activity, and so on; (2) the possible or likely result of something.
- A Desired Outcome is a result that someone or some company strongly wants to achieve
- Typically are boundary spanning - requiring that the company and the service provider work together to achieve success

Element 3: Statement of Objectives/Workload Allocation

- Focus on the “What” not the “How”
- Enables the parties in the Vested partnership to do what they do best
- Together they develop a Statement of Objectives (SOO)
- Simply put, a SOO describes intended results, not tasks.



Defining a Statement of Objectives (SOO)

- Allows for the greatest input from the supplier
 - Asks for innovation solutions / outcomes
 - Most flexible
 - NO tasks are in the SOO
- Most flexible contract development tool
- In a SOO, the supplier responds with a PWS or a SOW
 - Supplier writes the PWS, which is a critical part of the SOO
- Supplier can propose the Quality Assurance (QA) plan
 - This serves as the basis for assessing the provider's performance

Source: Performance-Based Acquisition: Recent Developments, Don Mansfield

Element 4: Performance Metrics for Desired Outcomes

- Work together to define and quantify Desired Outcomes
- Outcomes must be expressed in terms of a limited set of high-level metrics
- Jointly and collaboratively define exactly how relationship success will be measured
- The service provider will propose a solution that will achieve the Desired Outcomes and deliver the required level of performance at a predetermined price

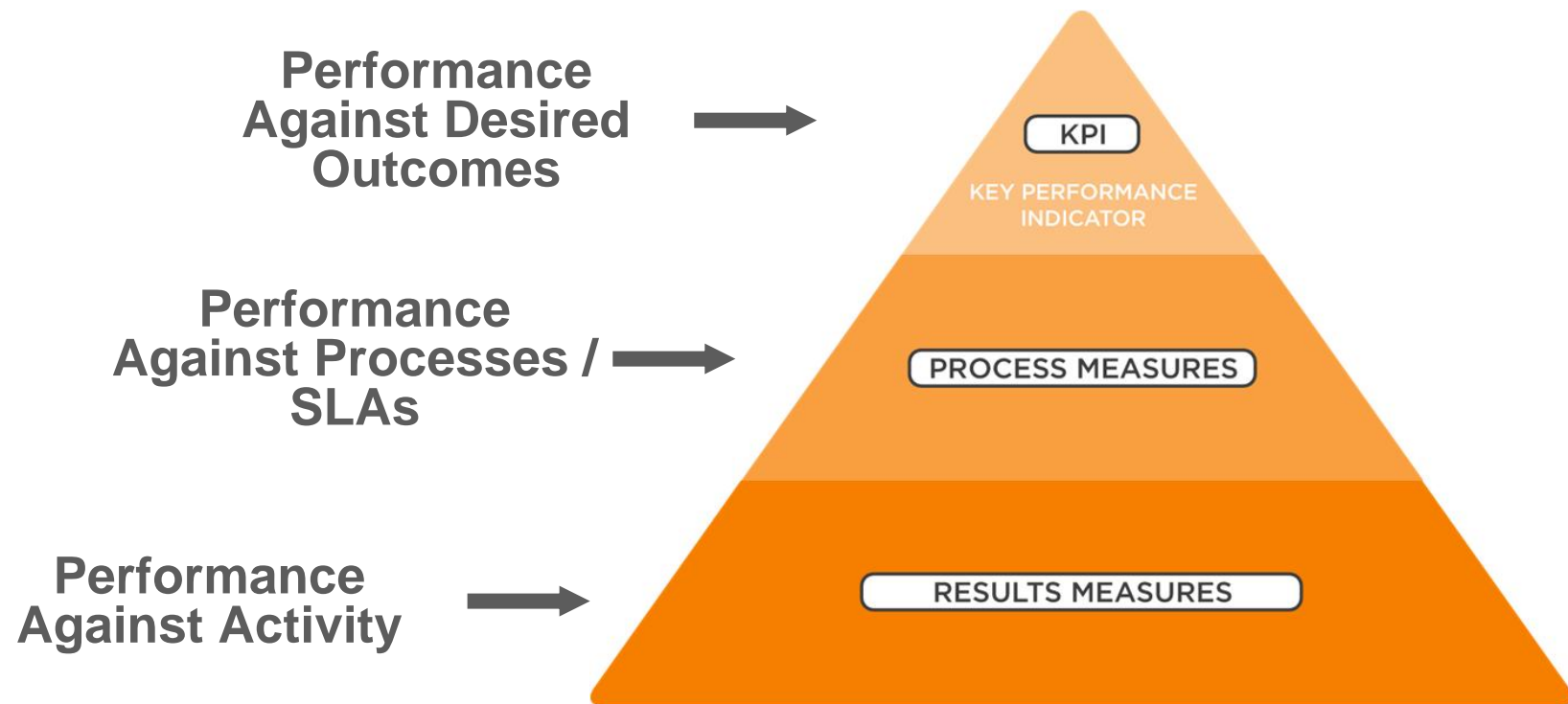


Element 5: Performance Management

- Measure performance to determine if the Desired Outcomes are being met
- Include high-level performance management measures that are easily understood by business stakeholders and all parties involved in the process
- The metrics will help align performance to strategy



Metrics Hierarchy



Element 6: Pricing Model

- A Vested pricing model incorporates incentives for the best cost and service trade-off
- The strategic bet—and paradigm shift—of Vested Outsourcing is that the service provider's profitability is directly tied to meeting the mutually agreed upon Desired Outcomes
- Inherent in this model is a reward for service providers to invest in process, service, or associated products that will generate returns in excess of agreement requirements



12 Steps to Fair Pricing

12 Steps	Vested Pricing Model
Step 1	Form the Team
Step 2	Establish Guardrails / Share Assumptions
Step 3	Document Assumptions (input assumptions)
Step 4	Develop Total Cost Buildup and Best Value Assessment
Step 5	Perform Risk Assessment and Allocate Risks
Step 6	Agree on Compensation Model
Step 7	Determine Target Agreement Duration
Step 8	Complete Pricing Model and Establish Prices
Step 9	Test the Model and Agree on Baseline
Step 10	Define Margin Matching Triggers and Techniques
Step 11	Agree on Incentives
Step 12	Document Deployment Processes

Vested Pricing Model
A pricing model that is designed to reward the outsourcing company and the service provider for achieving mutually agreed Desired Outcomes.

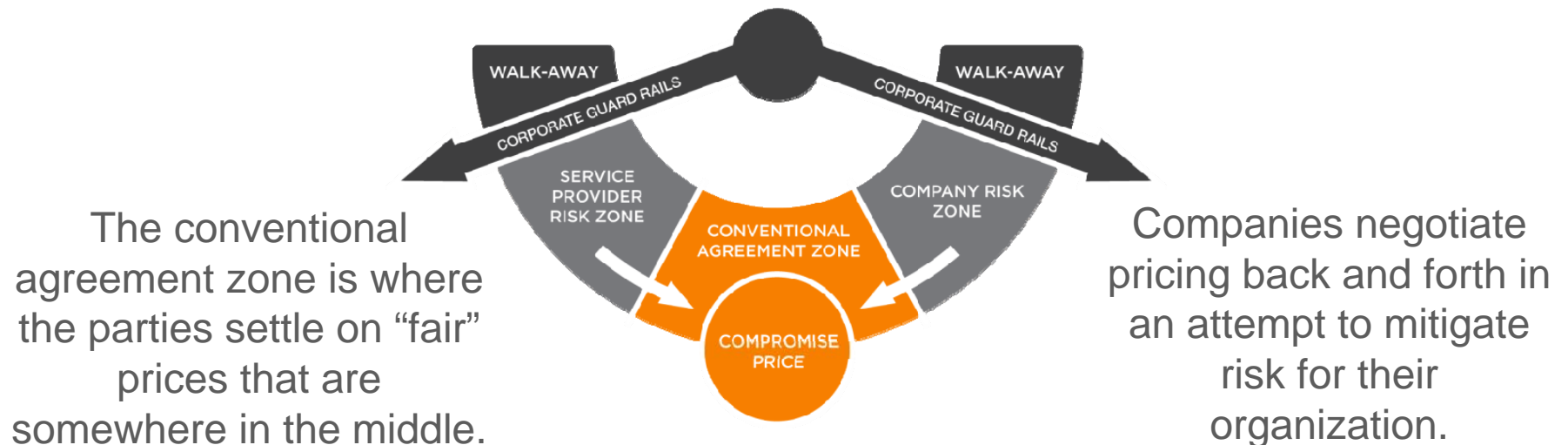
Conventional Pricing Approach

“I want to mitigate MY risk”

Corporate Guardrails define the boundaries between a service provider’s and a company’s risk zone

Agreements outside the limits of the guardrails are the “walk-away” point for each party.

Risk zones for each party lie immediately inside the guardrails.

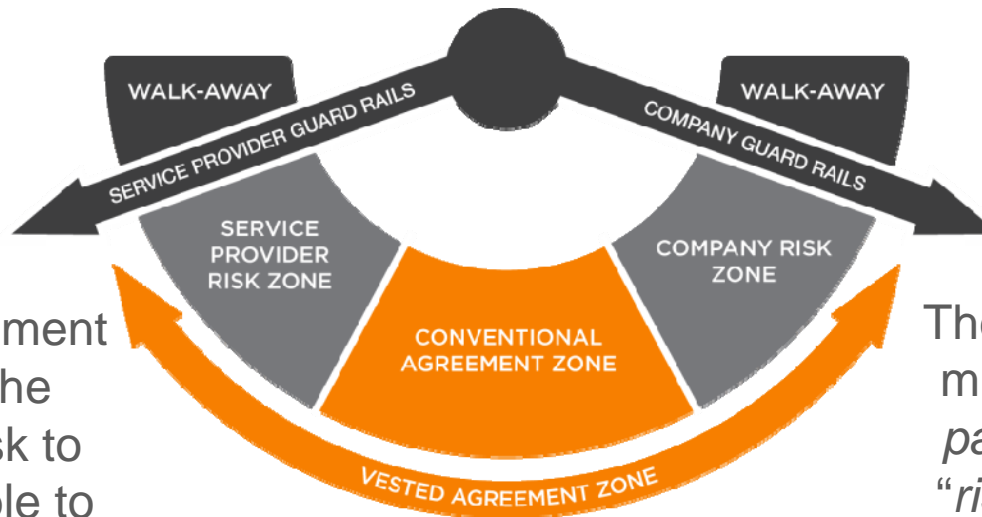


The actual agreement price is the “compromise” price—because both parties had to settle for something less than they had hoped for.

The Vested Pricing Approach

“We want to mitigate OUR risk”

The Vested Pricing approach highlights true WIFWe thinking



The Vested agreement zone is where the parties assign risk to the party most able to mitigate it

The parties attempt to mitigate *risk for both parties* and assign a “*risk premium*” to the party who assumes the risk

The Vested price can fall at any point between the guardrails

The much larger “Vested Agreement Zone” represents the opportunity for greater gains by expanding the pie for both parties.

Getting It Right

When properly structured, the pricing model should generate returns in excess of target margins for both parties when the parties achieve the Desired Outcomes

- Establishing the right pricing and incentive mix is complicated
- There is no one-size-fits-all pricing model in Vested Outsourcing
- A fair pricing structure is reached through cooperation, flexibility, and innovative thinking

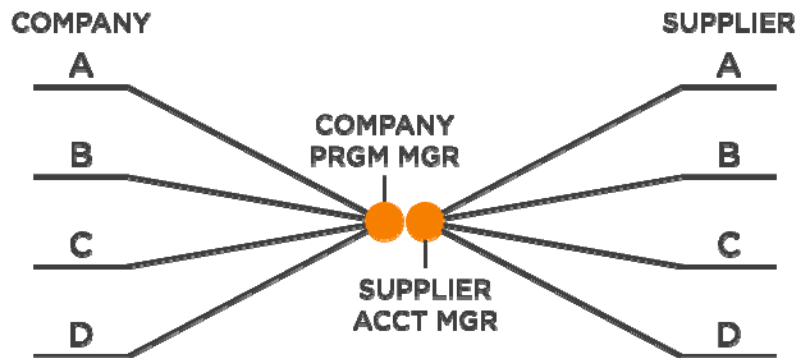
Element 7: Relationship Management Framework

- A sound governance structure provides consistent management along with cohesive policies, processes, and decision rights that enable parties to work together effectively and collaboratively.
- A governance framework enables the parties to manage performance and achieve transformational results throughout the life of the agreement.
 - within the framework of a flexible governance structure
 - that provides top-to-bottom insights not oversight
 - that emphasize the importance of building collaborative working relationships, attitudes, and behaviors

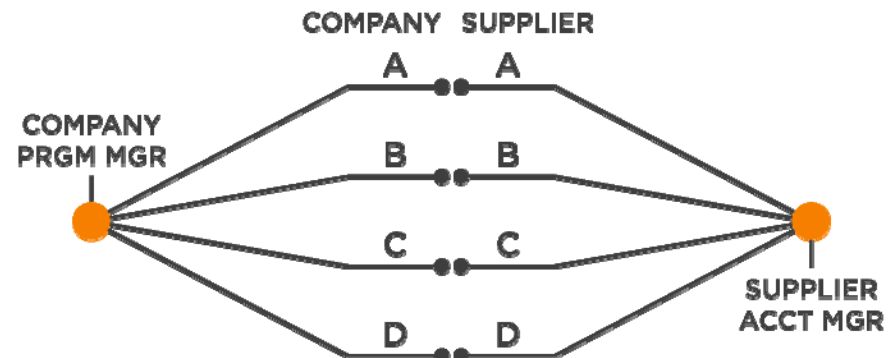


Relationship Management Framework

TRADITIONAL BOW TIE

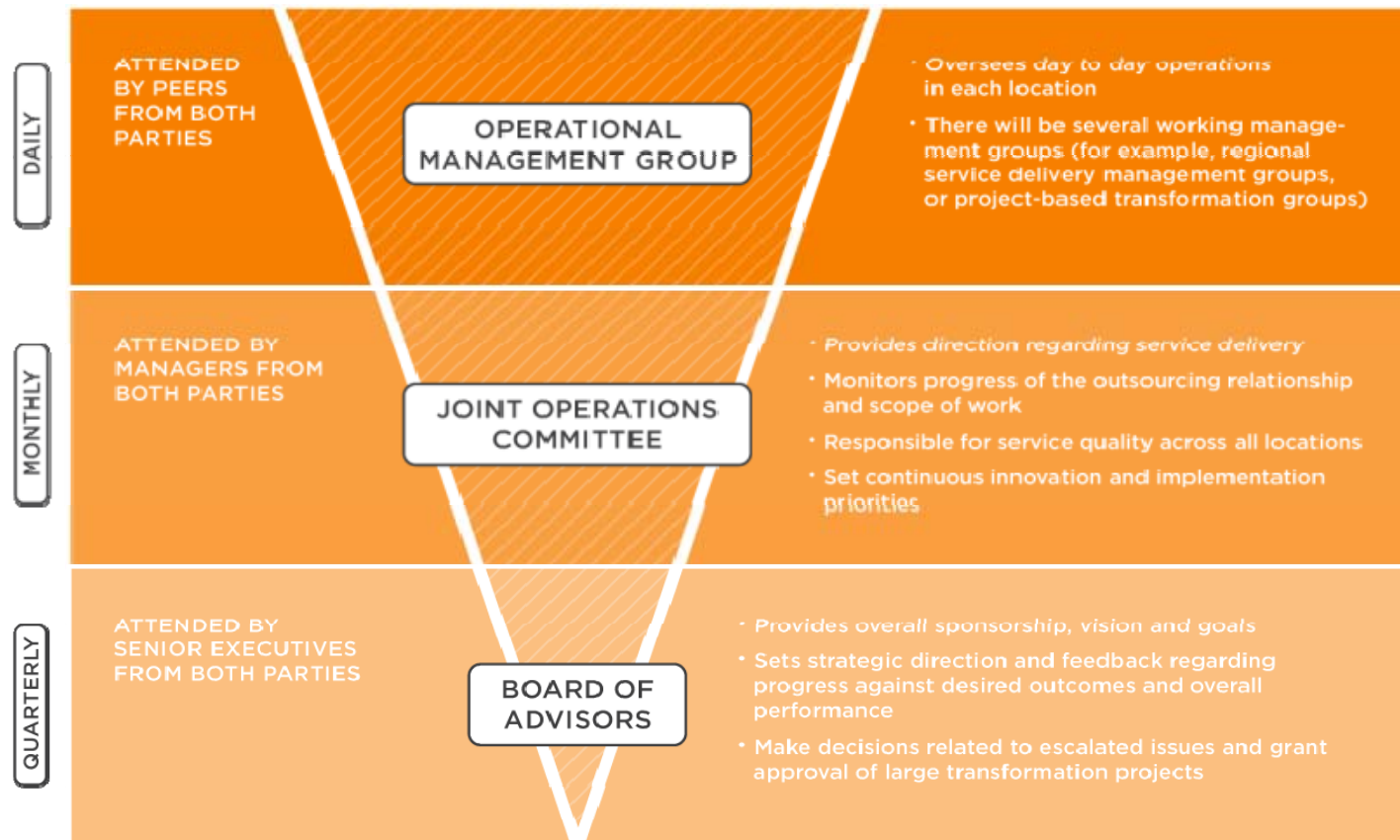


REVERSE BOW TIE



- Moving from the traditional hierarchical communication to direct functional communication improves the flow of information
 - This should be established in the beginning with the Supplier
 - Resist the temptation (and/or supplier pressure) to revert at the first “breakdown”
 - It is essential that the managers hear about problems from their teams FIRST!

Governance Structure



The Vested governance structure is tiered... each layer is accountable for examining the relationship and business success

Element 8: Transformation Management

- To be successful, your agreement should include transformation management processes to help your organization stay aligned in a dynamic business environment
- End-to-end business metrics, mutual accountability for Desired Outcomes, and the creation of an ecosystem that rewards innovation and of an agile culture of continuous improvement



Key Components of Transformation

- Transformation management element of your agreement should contain four key components, each targeted for different types of transformation:
 - A common understanding on how the initial transition of work is managed
 - Include philosophies for driving overall transformation initiatives
 - Contain a process for managing day-to-day continuous improvement efforts or business problems that arise
 - Include a process for updating and managing any changes to the actual agreement

Element 9: Exit Management Plan

- Business happens, and companies should have a plan when assumptions change
- An exit management strategy can provide a template to handle future unknowns
 - Termination notice
 - Exit transition period
 - Exit transition plan
 - Exit governance and reporting
- The goal is to establish a fair plan and to keep the parties whole in the event of a separation that is not a result of poor performance



Off-Ramps

- Vested contracts should include adequate exit criteria
 - Supplier inability to (or loss of interest in) continuing to provide support
 - Exit criteria should be included as negotiated options
 - Transfer, or use of, necessary technical data, support/tooling equipment
 - Appropriate conversion training required for reconstitution or recompetition of the support workload



Is a 30 day termination-for-convenience really an acceptable off-ramp?

Element 10: Special Concerns and External Regulations

- Governance frameworks are not one-size-fits-all, especially in more technical or complex relationships
- Pay attention to all the things that are unique to your Vested deal to help make it work more smoothly over its term
- With regulatory and compliance issues point to the regulation and assign ownership to monitor the regulation



Benefits of a Vested Outsourcing Approach

- Better competition: not just suppliers, but solutions
 - *Supplier buy-in and shared interests*
 - Variety of solutions from which to choose
 - Supplier flexibility in proposing solution
- Focus on intended results, not activities
 - No detailed specification or process description needed
 - *Well defined outcomes and expectations*
 - Increased likelihood of meeting corporate goals and objectives
 - *Mutually beneficial , shared incentives permit innovation and cost effectiveness*
- Better value and enhanced performance
 - *Shared decision making and governance*
 - *Cooperative, open and trusting relationship*

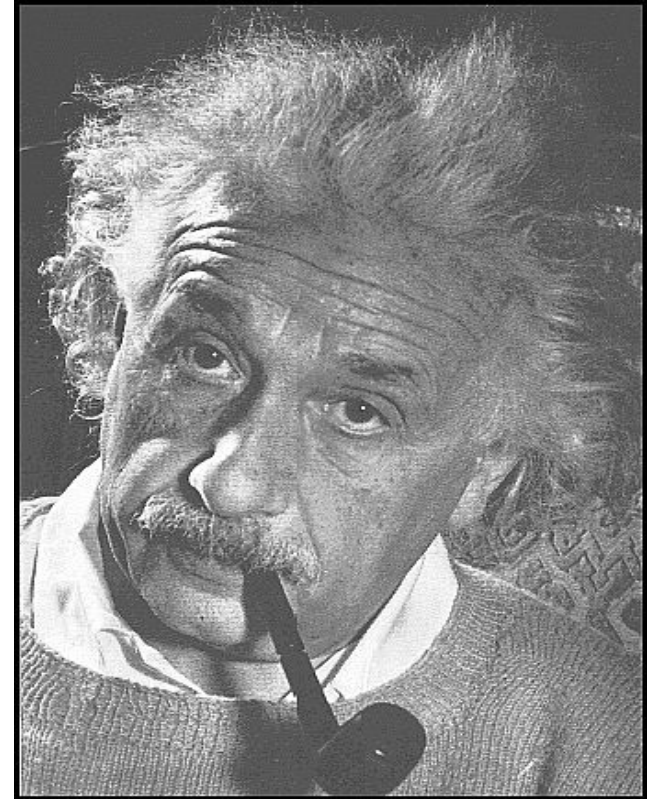
Source: http://acquisition.gov/comp/seven_steps/index.html

Getting your outsourcing agreement right can be a game changer!

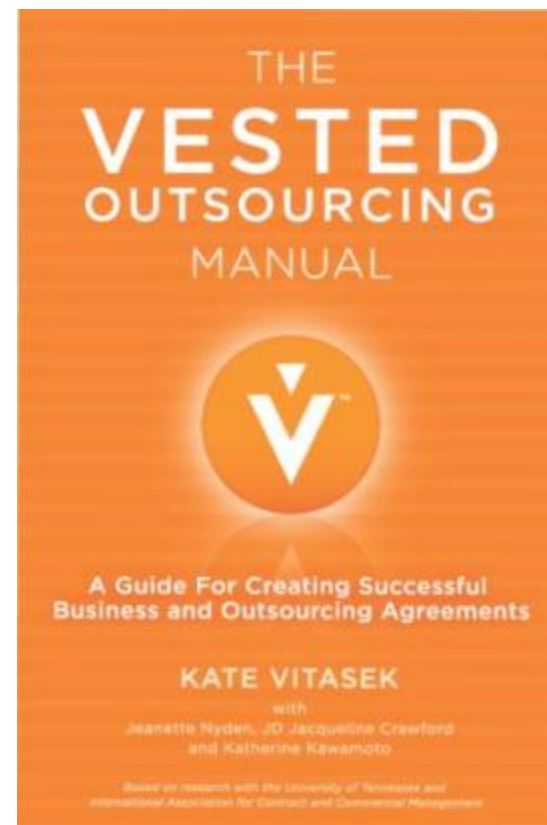
“Any intelligent fool can make things bigger and more complex...

It takes a touch of genius - and a lot of courage to move in the opposite direction.”

- Albert Einstein



Based on research by.....



Contact Us

- Visit the University of Tennessee's dedicated Vested Outsourcing website at www.vestedoutsourcing.com
- Contact Kate Vitasek – the lead researcher and faculty for Vested Outsourcing at kvitasek@utk.edu
- Register for one of the University of Tennessee's open enrollment classes at <http://vo.utk.edu> or contact [Bric Wheeler](mailto:bwheeler@utk.edu) for a private, custom event at bwheeler@utk.edu
- Read the books [Vested Outsourcing: Five Rules that will Transform Outsourcing](#) and [The Vested Outsourcing Manual : A Guide to Creating Successful Business and Outsourcing Agreements](#)

