HOW DO I KNOW I'M GETTING A GOOD DEAL IN A VESTED ARRANGEMENT?

ANDREW DOWNARD AND KATE VITASEK

We have written a few articles in this magazine now on the Vested business model and provided some insight into how it works, and a brief outline of some case studies of organisations that have successfully implemented Vested. Obviously we are committed and enthusiastic about the Vested approach to outsourcing and we hope that most of our readers are rapidly approaching this same level of enthusiasm. We are, however, realistic and recognise that either in your own mind, or perhaps in the minds of those to whom you are going to be selling the idea within your business, is the question: "are we going to get the best price"?

Now while we would suggest that people need to be focusing on value rather than price, we accept that 'price' is in the forefront of people's minds, when it comes to taking a new approach to making a deal. This concern is magnified when you start to talk to your trading partners. Probably no other topic creates as much apprehension between two companies as trying to determine a fair price. The conventional procurement process pits buyers and sellers on opposite sides of the table. Senior leaders on both sides of the arrangement see this as the only way to be sure that they have secured the best deal. So how can those wishing to create a Vested deal, persuade their internal leadership that they will get a good price, whilst at the same time convincing their trading partner that the eventual pricing will be fair?

The University of Tennessee's research into highly successful buyer-supplier relationships demonstrated that companies are rethinking this conventional approach.

In fact, our work has led to a book, Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships (published in late 2012 by Palgrave Macmillan).

What makes these companies successful? They tightly align with their suppliers — and that includes carefully crafting a pricing model with incentives, where a win for the buyer means a win for supplier. In short, the parties have a vested interest in each other's success.

But how do you create a win-win pricing model?

First and foremost, we have found the very best relationships start with both parties sitting on the same side of the table, holding transparent, fact-based discussions about the business and desired outcomes. Each party must truly understand the goals and financial drivers of the relationship.

Second, we stress the importance of understanding the difference between a 'price' and a 'pricing model'. A transactional approach uses prices. A Vested approach uses a pricing model.

Let's look at the difference. A price is something you pay for each transaction. You pay $3.50 for your café latte. Call centre suppliers have a price of $.50 a minute every time an

agent picks up the phone and acts as a company's customer service representative.

A pricing model is fundamentally different, because it is a mechanism that companies use to determine the optimum price between the company and the supplier. In some cases, the pricing model consists of nothing more than the actual costs, volume targets, and incentives based on estimated value of desired outcomes such as market share, total costs savings, or customer satisfaction levels. Most pricing models are expressed in a simple spreadsheet; however, some are more like a small customised software package or macro-based Excel spreadsheet.

We use the term 'model' because it enables the parties to manipulate underlying pricing assumptions. This allows the parties to 'model' the outputs relative to the input components to determine a fair way to pay for goods and services. A good pricing model, with properly crafted incentives, enables organisations to go beyond merely paying lip service to the term partnership.

It creates a commercial pricing structure that equitably allocates risks and rewards with the purpose of realising mutual gains for the duration of the agreement. The issue of risk is important, and generally we find traditional outsourcing contracts try to shift or dump risk on the other party rather than manage it. The risk should reside with the party best able to manage it and they should be recompensed for doing so.

But how do you establish a fair and flexible pricing model that fosters the true win-win? There is no one-size-fits-all pricing model in a Vested arrangement, but you need not be an accountant, a mathematics professor, or an economic scientist to recognise the benefits of a fair pricing structure, reached through cooperation, flexibility, and innovative thinking.

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While there is no template or standard spreadsheet to guide you to the correct pricing 'answer', there are steps you can take in developing a Vested pricing model – twelve of them to be exact. Our book, *The Vested Outsourcing Manual: The Guide for Creating Successful Business and Outsourcing Agreements*, provides a very comprehensive chapter on pricing. However, we'll highlight the steps:

1. Form the team.
2. Establish guardrails.
3. Document input assumptions.
4. Identify total ownership costs and perform best value assessment.
5. Perform risk assessment and allocate risks.
6. Agree on the compensation model.
7. Determine target contract duration.
8. Complete the pricing model and establish prices.
9. Test the model and agree on the baseline.

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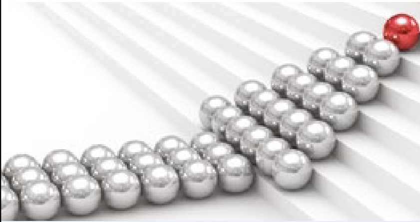

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10. Define margin-matching triggers and techniques.
11. Agree on incentives.
12. Document deployment processes.

Some of the steps are fairly self-explanatory, such as forming the team, and doing a risk assessment, so we'll elaborate further on a few of the others. Remember that the steps should be taken jointly and in order.

Establish guardrails – Identify and deal early on with corporate boundaries that could impact or even derail the business relationship and pricing framework. For example, a company might have a firm policy that payment terms cannot be less than net 45 days and anything less is a 'walk away'. This is a guardrail that the resulting deal needs to incorporate. Firms are likely to have many of these guardrail issues and some will be around price and margin. It is typically against the norm to share guardrails at the start of negotiating an agreement; however, it is important to understand boundaries when formulating a Vested agreement. The goal is to avoid 'surprises' and the process of reaching a Vested agreement moves forward. It might seem counterintuitive to declare your 'walk-away' position up front when negotiating on pricing, but the experience of those that have successfully implemented a Vested deal supports this approach.

Identify the total cost of ownership (TCO) – It's vital that the parties be open and honest, to the maximum extent possible, about the 'hidden costs' associated with a deal. These can include, for example, training and retirement costs, maintenance costs, equipment costs and software costs. The transparency that comes with identifying TCO enables the parties to make clear and accurate decisions on pricing.

Once the parties agree on the type of pricing model they will use (Step 6), they are ready to move on to the nitty-gritty of completing the model and establishing prices (Step 8).

Margin-matching – We highly recommend the use of the margin-matching pricing method, which addresses market events and fluctuations by creating a mechanism to fairly adjust prices based on movements in the underlying pricing model assumptions (Step 3). The pricing adjustment is based on trigger points that, when activated, reset prices as fluctuations occur. The goal is to maintain economic alignment in the relationship as 'business happens', ensuring fairness for each party. This avoids one party bearing the full cost of a change they cannot control. An example might be the cost of fuel in a transport services contract, often managed via a levy in non-Vested deals, which are not always transparent to the customer.

Incentives – Most companies are familiar with incentives and they know that they should incorporate incentives that are mutually beneficial to the parties. The challenge becomes establishing the right incentive to motivate the parties to make decisions that ultimately will meet their desired outcomes. Note that gain-sharing (aka shared savings) and value-sharing are not the same. In value-sharing, the parties look beyond mere cost savings to include the change in the total value the solution brings to the company. The key to designing the right mix of incentives — whether they are cost or performance incentives, nonmonetary incentives or awards — is aligning interests and developing a pricing model that rewards proper behaviours and results.

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The issue of incentives and driving/rewarding the right behaviours is central to value-creation in a Vested deal. In terms of the margin loss or gain it makes sense to have an asymmetrical arrangement to wins or losses for a service provider. For example, a very broad rule of thumb might be that the service provider is at risk of losing up to half of their margin if there is a substantial failing to achieve the desired outcomes.

Note that the margin in this case is likely to be the normal market margin in the particular industry. Should they exceed the requirements required under the deal then they can achieve up to three times the market margin.

Why the larger gain on the upside? If a service provider thinks that they will incur a major loss, as they would if the penalty was more than their total margin (below breakeven), then this is going to impact on their willingness to put forward solutions that might impact on the performance against the contract. They are going to be very risk-adverse, regardless of the potential upside. With the asymmetrical approach they know that if a solution does not deliver as expected, they have not ruined the company, and that if it comes off the upside, is worth trying for.

In setting up the incentives, it is also important to think about the scale of the businesses involved. For a large supplier where the contract

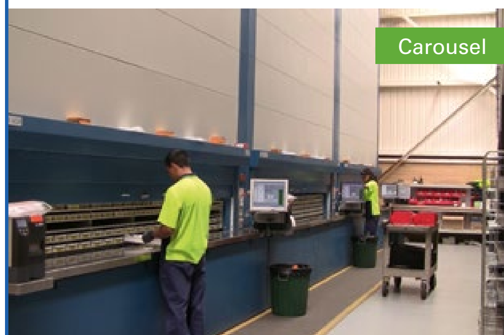
is not a significant portion of turnover, the risk and reward consideration is different than for a smaller business where the contract is a major portion of turnover. The smaller business might be betting their future in putting forward an idea versus the larger organisation, who might see the risk as a rounding error.

Our work at the University of Tennessee has gone a long way in helping to establish how to structure a great outsourcing agreement and relationship. For much more detail on the Vested pricing model, see chapter 6 of *The Vested Outsourcing Manual: The Guide for Creating Successful Business and Outsourcing Agreements*. The key thing we have found that people setting up the 'pricing mechanism' need to keep in mind is that it should not include 'perverse incentives' and should drive both parties to increasing the value delivered by the deal. (A perverse incentive is a term describing an incentive that has the opposite effect of that intended. Perverse incentives by definition produce unintended consequences. Source: The Language of Psychology)

The service provider should be able to clearly see how they will be rewarded for providing innovative solutions to the customer. The customer, on their part, should be able to clearly see (and measure) the benefits that are accruing to them by providing the incentives to the service provider. Both get value by behaving well and focusing on meeting the desired outcomes.

Andrew Downard is a consultant and educator specialising in supply chain relationships and supply chain risk management. He is undertaking a PhD by research at the Institute of Supply Chain and Logistics at Victoria University and has contributed to publications and books on the subject of collaboration and change. Andrew has established a Centre of Excellence for Vested in Australia to help promote and educate practitioners on the benefits of a Vested approach to contracting.

Kate Vitasek is a faculty member at the University of Tennessee's Center for Executive Education and is the author of Vested Outsourcing: Five Rules That Will Transform Outsourcing and The Vested Outsourcing Manual, both published by Palgrave Macmillan. A third book, Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships, published by Palgrave Macmillan in September 2012. *mhd*



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