Book Vested Outsourcing

Five Rules That Will Transform Outsourcing

Kate Vitasek, Mike Ledyard and Karl Manrodt
Palgrave Macmillan, 2010
Listen now

- play
- pause

00:00
00:00

Recommendation

Outsourcing is a fact of life for most businesses, generally for services like facilities management, market research or trouble-shooting over the phone for customers. But traditional outsourcing arrangements don't always deliver all the value they could for either the client firm or the outsource provider. Supply chain management consultant Kate Vitasek (writing with Mike Ledyard and Karl Manrodt) calls for a new approach to outsourcing that shifts the relationship from adversarial to collaborative, and thus delivers tangible benefits to both parties. The US Air Force, "which spends more than 50% of its entire procurement budget on procured services," sponsored this study under the auspices of the University of Tennessee's Center for Executive Education. This report provides a template for companies and providers searching for better outsourcing results and for more lucrative savings or profits. *BooksInShort* recommends this thorough, illuminating guide to new and veteran outsourcing clients and providers.

Take-Aways

- "Vested outsourcing" is a new partnership-based model wherein both the client company and the outsource provider benefit from being collaborative.
- Typical cost-driven outsourcing creates an adversarial dynamic where the supplier has no incentive to improve service or cut costs for the client.
- Ten defects can plague traditional outsourcing deals, from clients or suppliers who sacrifice quality to combative parties who view their relationship as a zero-sum game.
- A long-standing supplier's standards may slip over time. Clients can ruin the relationship by not measuring the results, measuring them too much or failing to use the right data.
- To implement vested outsourcing, follow fives rules, as follows:
- Remunerate the supplier based on results, not on a per-transaction basis.
- Don't dictate how your suppliers should conduct business. They are experts in their field.
- Together with your supplier, define up to five mutually beneficial rewards.
- Create a pricing model that equalizes "risk and reward" for both parties.
- Use "insight" instead of "oversight." Don't spend time supervising the supplier. Work together to improve business and make everyone happy.

Summary

Going the Distance

The practice of outsourcing is as old as humanity. As soon as people realized they could multiply their productivity by sharing their work, they abandoned selfsufficiency and began parceling some tasks out to other people who specialized in those jobs either by learned skill or innate ability.

> "Progressive companies are starting to challenge conventional outsourcing approaches and tools in search of a better way."

Modern outsourcing took off as a global enterprise in the late 20th century. In the 1970s, along with other innovators, "technology services provider" EDS pioneered (and, some say, named) outsourcing. In the 1980s, companies farmed out limited processes. In the 1990s, rapid advances in technology gave outsourcing a rocket to ride. The growing sophistication of computer communication let businesses become "placeless," allowing them to operate anywhere, at any time. The concept of "core competencies" became another force impelling the contemporary emergence of outsourcing. Following *In Search of Excellence* co-author Tom Peters's dictum, "Do what you do best and outsource the rest," firms focused on areas where they excelled and rushed to farm out nonessential operations to third parties. Companies now routinely outsource their information technology, human resources functions, building management and real estate, warehousing, accounting, client services, call centers, market research, and just about anything else that is not central to their strategies. Outsourcing is a cornerstone of modern, global business, and it is usually driven by money.

> "Vested Outsourcing is a fundamental business model paradigm shift in how the outsourcing company and its service providers work together."

When a firm outsources a pivotal business operation to a service provider, the client's costs and the provider's pricing usually rule the relationship. The client wants lower costs and the supplier wants the best price for its services, so their dynamic is usually adversarial. To get a lower cost, a firm has to browbeat its service provider, while the provider – who usually operates on a fee-per-transaction basis – has every incentive to make more money by working at the lowest possible cost, even if that is inefficient. By collaborating instead, both the client and the provider could achieve better returns, making outsourcing a win-win proposition. The "Vested Outsourcing" approach is the basis for a new model, "Outsourcing 2.0," using "the four influential business concepts of the 21st century: outsourcing, collaboration, innovation and measurement."

> "Outsourcing as a large-scale business practice has not been around long enough to work out all the kinks."

Firms can buy labor (it's "offshoring" if the workers are in a different country), engage in "business process outsourcing" or contract for "full outsourcing," whereby a third party supplies "assets, people, business processes and management of an area." The large, growing outsourcing industry is worth some $6 trillion and employs around 150,000 specialized professionals. More than 60% of the companies in a recent PricewaterhouseCoopers survey reported that they outsource part of their business; in fact, chief executives often see outsourcing as a strategic tool because it "is delivering results."

Solving 10 Outsourcing Issues

While cost reduction drives most corporate decisions to outsource, other reasons include: necessary product or service enhancements, worker scarcity, "capacity constraints," poor cash flow, and risk mitigation. Clients enter outsourcing contracts optimistically expecting to fulfill these goals only to find that some deals eventually collapse, requiring companies to reabsorb work in-house or shift their contracts to new suppliers. Defects in outsourcing agreements can crop up over time, perhaps when a supplier can't meet its goals or when a contract's structure throws off "perverse incentives," that is, unintended consequences that can doom an outsourcing relationship. Many outsourcing setups suffer from one or more of these 10 "ailments":

1. **"Penny wise and pound foolish"** – When cost drives outsourcing, it can pound a client's relationship with its provider into the ground. Firms intent on saving money constantly rebid their contracts to look for a lower-cost provider, while ignoring the expense of moving their business around. As one chastened manager notes, "We were stepping over a dollar to pick up a dime." Eventually, qualified service providers spurn the extreme bargain-hunter, and the firm is left with only second-rate suppliers. Also, the pressure to win business leads some providers to bid under their own costs of doing the work, resulting in shoddy performance and sometimes even the supplier's bankruptcy.
2. **"The outsourcing paradox"** – When a company decides to outsource a process, it develops a "Statement of Work" (SOW) that explains and defines procedures for the supplier. But some firms include too much limiting detail, holding suppliers to inefficient, costly standards. For example, one provider overstaffed his warehousing service for a particular client – based on its insistence on a set number of employees – rather than using fewer workers to get the job done. Providers are experts in their fields; clients should let them operate to their best standards and not impose too many rules.
3. **"Activity trap"** – Many outsourcing contracts stipulate paying the supplier per transaction, so the more activities the supplier performs, the more money it makes. This disincentive to create efficiencies costs the customer money. Monitoring often lapses over time. One firm failed to discard outdated merchandise that its "third party logistics provider" (3PL) was warehousing, but the 3PL didn't report the mistake because trashing the stored materials would cost it a monthly inventory fee. Early in another outsourcing deal, a client firm contracted for a monthly report from its supplier. Over time, the client ran up a bill of more than $100,000 for the report before realizing that it wasn't needed.
4. **"The junkyard dog factor"** – Employees of firms considering outsourcing know their jobs are on the line. To protect themselves, they often insist that certain functions must remain in-house and not go to the outsourcing provider. They also tend to create such narrowly defined SOWs that the outsourcing itself results in fewer cost savings or to retain too many staffers as "supplier managers."
5. **"The honeymoon effect"** – Like all relationships, outsourcing starts rosy, but standards slip over time. If the supplier has no ongoing incentives to increase productivity, both parties can experience "the Seven-Year Itch." The client may want to move its business elsewhere, but contractual ties can make that shift both costly and time-consuming.
6. **"Sandbagging"** – To compensate for the honeymoon effect, firms often negotiate supplier incentive bonuses for efficiency improvements over time. Suppliers, however, know that clients will demand upgrades every year, so it's in the supplier's best interest to enhance just the minimum "low-hanging fruit" to keep its revenues climbing steadily and its client satisfied. Some service providers dole out real improvements slowly over time to hedge against possible declining performance in the future.
7. **"The zero-sum game"** – Both sides of an outsourcing relationship can approach their work in win-lose terms, assuming that a gain by one party means a loss for the other. Victims of the activity trap, the outsource paradox or the junkyard dog factor take such adversarial positions, not realizing that their client-supplier relationship could work as a win-win, where both players can achieve more without diminishing anyone's benefits.
8. **"Driving blind disease"** – Many early outsourcing contracts lacked solid performance metrics. Aside from counting transactions and costs, clients gave little thought to increasing outsourcing efficiencies or to assessing "savings leakage," the gap between what the client assumed it would save and its true savings. Now, both parties more often agree to measure actual results with quantifiable "scorecards and dashboards."

9. **“Measurement minutiae”** – The flip side of not measuring is measuring too much unnecessarily. Books full of data printouts are useless unless clients have the time and personnel to manage all the information, and if they did, that would undercut any expense savings or productivity gains that outsourcing could deliver.
10. **“The power of not doing”** – Even with the right metrics, if organizations don’t use the information, they might as well drive blind. Clients often miss the opportunity to get the most out of outsourcing by failing to hold regular provider meetings or to follow up on indicators that show suboptimal performance.

“Changing the Game”

Technology giant Intel outsources some 100 business functions across the globe, but its policy of pursuing “the best market price” meant its suppliers couldn’t afford to invest in improving their service. Intel, which prides itself on innovation, found it was dampening the creativity of its outsourcing partners by chiseling away at cost. It needed a new approach and became interested in Vested Outsourcing’s partnership paradigm.

> “In Vested Outsourcing, the Pony is the difference between the value of the current situation and the potential optimized solution.”

Vested Outsourcing, which takes its cues from game theory, changes the outsourcing dynamic from adversarial, zero-sum, “the size of the pie is fixed” thinking into a win-win, bigger-pie situation. The two parties to an outsourcing deal enter a “performance partnership” with three goals: “innovation and improved service, reducing cost to the company outsourcing” and “improving profits to the outsourcing provider.” Vested Outsourcing spells out each participant’s motivations, measurements and goals, and it includes financial rewards or “penalties” for each side for beating or missing planned objectives. The client and the provider can both benefit: The customer realizes more efficiency, productivity and, thus, savings, and the provider can increase revenues by achieving set targets. Vested Outsourcing changes the outsourcing concept from “what’s-in-it-for-me” (WIIFM) to “what’s-in-it-for-we” (WIIFWe).

> “The catch: The company has to share the value of the Pony with the outsource provider that helped achieve it.”

Microsoft outsources its facilities management – 100 buildings on five “campuses covering approximately 10 million square feet” – to Grubb & Ellis in a Vested Outsourcing contract. Among other provisions in their arrangement, Grubb & Ellis earns back part of every dollar it saves Microsoft through process innovation and productivity. This creates better service and lower costs for Microsoft and higher revenues for Grubb & Ellis.

> “Ultimately, you should be willing to change places with the person sitting on the other side of your outsourcing deal and feel good about it.”

To implement Vested Outsourcing, follow five rules:

1. **“Focus on outcomes, not transactions”** – Rather than agreeing to pay an outsourcer by the activity – for example, for units inventoried, items transported or time spent in tech maintenance – both client and provider identify optimum results and base compensation on those results – such as reliability measures, end-user satisfaction or profit increases. “Vested Outsourcing buys desired outcomes, not individual transactions.”
2. **“Focus on the what, not the how”** – Clients, who should acknowledge outsource providers as specialists, don’t need to dictate procedures in minute detail. This frees client firms to focus on what they do best, and it allows the outsourcers to maximize their own work to meet established goals. For example, an outsourcer that is responsible for maintaining a company’s restrooms is free to handle plumbing problems as it wishes.
3. **“Agree on clearly defined and measurable outcomes”** – Both parties should invest considerable time and effort at the beginning to set “no more than five” mutually defined goals and metrics that transfer responsibility and risk to the service provider.
4. **“Optimize pricing model incentives for cost/service trade-offs”** – The outsourcing agreement needs to equalize the “risk and reward” factors on each side. End results should deliver better service at stable costs, comparable service at less cost, or better service at reduced costs.
5. **“Governance structure provides insight, not merely oversight”** – Having chosen the right provider for its outsourcing needs, a firm should not have to spend time and money closely supervising its provider. Rather, the client should expect to receive insightful feedback from its outsourcing partner on how they can improve their mutual business.

Get Started

Implementing Vested Outsourcing takes the time and efforts of many people in both organizations. Making mistakes in an agreement wastes time and money. To begin, decide whether your firm is ready to commit to a Vested Outsourcing. Identify your “Pony” – the one aspect in the deal, whether it’s $1 million in savings or a 30% increase in consumer satisfaction – that represents for your company “the pure happiness...on children’s faces when they learn they can get a pony for Christmas.” The Pony “funds” the shared reward of great performance. Then, “lay the foundation” by doing your homework, “understand the business” you want to outsource, “align interests” between your firm and your outsourcer, “establish the contract” and “manage performance.”

About the Authors

Kate Vitasek, founder of Supply Chain Visions, teaches at the University of Tennessee’s Center for Executive Education. **Mike Ledyard** is the co-author of *Keeping Score: Measuring the Business Value of Logistics in the Supply Chain*. **Karl Manrodt** teaches at Georgia Southern University.