

Vested Outsourcing – The Next Generation of Outsourcing

By Kate Vitasek, Managing Partner, Supply Chain Visions

Editor's Note: This article is an excerpt from a book co-authored with Mike Ledyard, to be published by Macmillan. It is the output of research funded by the US Air Force. These fresh ideas about outsourcing could change the way in which logistics services are purchased and managed in the future. KBA

Our work is focused on a new kind of outsourcing. Because both parties have a stake in maintenance of a partnership, we have labeled it *vested outsourcing*. When it works well, it is a “win-win” relationship that should endure for many years.

We need a change because the current system is in poor health. Symptoms include the 10 ailments outlined here.

1. Penny Wise and Pound Foolish

Many buyers look at outsourcing as nothing more than a cost reduction tactic. If the service is bought primarily on price, there can be two unintended consequences: First, providers will get tired of constant bidding exercises and will decline to compete for the contract. Second, a low-cost bidder will encounter serious operating losses that curtail services and eventually force termination of the contract.

2. The Outsourcing Paradox

Experts within the buying company try to develop the perfect statement of work, one that tightly defines the results. The result is an agreement that stifles creativity and results in waste because the statement of work is not a realistic description of the job to be done.

3. The Junkyard Dog Factor

This ailment becomes extreme when combined with the paradox described previously. When the buyers' employees suspect that jobs will be lost, they will stake a claim to processes that should stay in the house. One of these is the job of managing the outsource provider. The result is an inefficient and overbuilt infrastructure. The buyer gets what was contracted for, but that is not what is really wanted.

4. The Activity Trap

When the outsourcing agreement is transactional with no incentives for improvement, sometimes the service

provider may ignore opportunities to make the warehouse more efficient.

5. The Honeymoon Effect

At the beginning of any relationship, both parties go through the honeymoon stage. Over time, the downside can lead directly to the Seven-Year Itch. The supplier fails to invest in new technology, and productivity levels begin to decline. The buyer then wants to switch to a new supplier. Switching is both expensive and risky.

6. Sandbagging

To prevent the honeymoon effect, some buyers establish bonus payments for providers to achieve desired levels of performance. This can create a perverse effect, whereby the contractor achieves only a small amount of improvement in order to earn the incentive. Rather than establish the highest level of savings achievable, the provider will offer up savings in small increments over time.

7. The Zero-Sum Game

Some procurement people believe that anything that is good for the outsource provider is automatically bad for the buyer. The first step in overcoming this ailment is to realize that an outsourcing relationship can and should seek win-win solutions.

8. Driving Blind Disease

This ailment results from lack of a process to monitor performance. The typical blind driver tracks costs, but does not measure performance. Eventually the relationship fails because of unclear definition of success.

9. Measurement Minutiae

The hallmark of this ailment is trying to measure everything. Unfortunately, few companies have the diligence to actively manage all of the metrics that they have created.

10. The Power of Not Doing

The old adage says that “you can't manage what you don't measure,” but if you don't use the measures you have to make improvements, you should not expect results!

Vested Outsourcing: A Better Approach

After seeing 10 ailments, you might be asking, “is there a better way?” Our answer is a next-generation model called *vested outsourcing*.

Traditional descriptions of outsourcing describe three types of relationships.

- **Transactional:** The service provider is kept at arms length, with a unit price and a purchase order for each service.
- **Preferred Supplier:** The supplier is prequalified and may have a long-term agreement. A blanket purchase order is used.
- **Strategic Alliance:** This is characterized by a “C” level relationship between buyer and vendor, with shared intelligence and operational tie-ins.

Vested outsourcing creates a new level in between Preferred Supplier and Strategic Alliance. While no two vested outsourcing partnerships are alike, the best of them achieve the performance partnership based on innovation and improved service, as well as reduced cost.

The heart of the vested outsourcing contract is agreement on desired outcomes, which explicitly state the results on which both companies will base their contract. The vested outsourcing agreement defines financial rewards or penalties for exceeding or not meeting desired outcomes. Vested outsourcing is *not* gain sharing. The service provider is challenged to provide brainpower and/or investments to solve the buyer’s problem. Providers may also take on risks to accomplish this, in essence putting “skin in the game.” The result is a win-win vested outsourcing partnership.

Vested Outsourcing is a model paradigm shift in how the outsourcing company and their service providers do business. At the heart of a Vested Outsourcing agreement are five major rules:

- ① Outcome-based vs. Transaction-based model
- ② Focuses on the WHAT, not the HOW
- ③ Clearly defined and measurable desired outcomes
- ④ Pricing model incentives are optimized for cost/service tradeoffs
- ⑤ Insight, vs. Oversight governance structure

A performance-based business model fundamentally shifts how a company buys services. The concept of Vested Outsourcing is fairly straightforward: Instead of paying an outsource provider for unit transactions for various services, the company and its service provider agree upon desired performance outcomes. Desired outcomes take a different form: they can be availability, reliability, cost, revenue generation, customer satisfaction, or even asset investment targets. In essence, *Vested Outsourcing buys outcomes, not transactions.*

Under Vested Outsourcing, the company outsourcing specifies “what” they want and moves the responsibility of determining “how” the “what” gets delivered to the outsource provider. Focus on system performance expectations. It’s up to the service provider to figure out how to put the supporting pieces together to achieve the goals.

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, often in terms of cost per unit usage. This fundamentally shifts the business model, shifting risk from the company that is outsourcing to the service providers. Under the purest form of Vested Outsourcing, the company that is outsourcing only pays

for results, not transactions. Rather than being paid for the activity performed, service providers are paid for the value delivered by their overall solution.

The pricing model must apply two principles. First, the model must balance risk and reward. It must ensure that the provider assumes risk only for decisions within their control. For example, a transportation provider cannot be penalized for rising costs of fuel. The agreement should provide incentives for achieving one of the following:

- Higher service levels at the same cost
- Same service levels at lower costs
- Higher service levels and lower costs

Explore what the buyer can do to encourage the service provider to improve performance, and reward that performance with additional profits.

An effective Vested Outsourcing partnership out-sources to service providers that are real experts. The partnerships should be managed to create a culture of insight versus oversight. Let’s look at the meaning of both words to get a better understanding for the difference.

Insight. Power of acute observation and deduction; penetration, discernment, perception

Oversight: Watchful care; superintendence

If you have done a good job picking the right outsource providers, why do you need a small army to manage them? A properly structured governance structure should establish good insight; not provide layers of supervisory oversight.

To Go The Whole 9 Yards Or Not

Keep in mind that just because you *can* do vested outsourcing, it does not mean you *should*. Vested outsourcing is hard and it takes time. It should only be done with areas that have a big bang for the buck. Conventional outsourcing is best used for contracts and does not add strategic value to operation. However, if there is low expertise but high-value, then that activity might be a good target for vested outsourcing.

A critical component of a successful vested out-sourcing is to identify what we call “The Pony.” That is the difference between the value of the current outsource contract and the potential optimized solution. The pony is the value of the things that the contractor wants but was not able to get with existing service providers. The bigger the pony, the bigger incentives the service provider should have the chance to earn. However, the outsourcing company has to share the value of the pony with the provider who helps to achieve it.



Kate Vitasek is founder of Supply Chain Visions. She has written more than 75 articles that have been published in respected academic and trade journals. She has been recognized as a “Woman on the Move in Trade and Transportation and was recently honored as a “Woman of International Influence” by Global Executive Women. She is also a faculty member at the Univ. of Tennessee’s Center for Exec. Education.

KEN'S COMMENTS

Leadership And Change



Willingness to change is one of many criteria that separate leaders from managers. Many people are afraid of change, and some actively resist it. All of us are descendants of people who faced change and took risks. Whether your ancestors came to this country last year or many hundreds of years ago, the most common motivation was change, and the search for a better life.

The current business climate will force significant change, and, at the same time, present significant opportunities. If high-priced fuel is a permanent fact of life, people and businesses that learn to use energy more efficiently than they have in the past will prosper, and those who do not change their ways will suffer. If global terrorism has become permanent, those discovering new ways to stay safe and/or control the sources of terror will survive. If climate change results in increased frequency of severe weather, those who discover new ways to control the risk will be available to assist those who cannot adapt to a changing world.

As we consider the business of warehousing, leaders will find new ways to implement advanced technology without curtailing flexibility.

As business is conducted increasingly in densely populated cities, in which the cost of space is significantly

higher than in the US, leaders will develop innovative ways to increase the use of existing space intensively.

In each of these areas, those who embrace change are those who will prosper in our dynamic environment.



Is This A Time For “Imagination Breakthroughs?”

The term comes from General Electric's chief executive, Jeff Immelt. GE has always rewarded innovation. Immelt has promised to protect those working on breakthroughs from the “budget slashers.” When short-term performance is emphasized, innovation may be stifled by the reluctance to think differently or take risks. The business of warehousing sometimes has been marked by radical innovation. What better time to promote it than now?



Can't We Simplify The Language?

We have lamented the fact that “3PL” is a mysterious term open to pollution. The numbers, in a short time, were escalated, first to 4PL and then to 4.5 and 5. The term “logistics service provider” is both more accurate and more widely understood. If a superior party is involved, the better descriptive term is lead logistics provider.

We were dismayed to discover that the Reverse Logistics Association has coined a new term: 3PSP, which is translated as “third-party service provider.” The association has not explained why this new language is necessary, and we are confident that nobody will understand it without an interpreter. Effective leadership requires effective communication. The introduction of obtuse language does not help the process.

WAREHOUSING TIPS

Choosing The Best

As the economy recovers, warehouse operators will start searches for people to staff startup operations or existing operations that are growing. When staff is added, certain principles should apply.

- Never leave the hiring process in the hands of your operating managers. They are stressed because they need additional workers, and, because they are under pressure, they are likely to be less critical than necessary. While the final decision always should rest with operations staff, initial interviewing and screening should be completed by people who are not under pressure. When hiring, keep the following in mind:
- Pay attention to attitude. Skills can be taught, but attitudes cannot easily be changed.
- Hire people who want to prove themselves. The best hires have the humility to learn, and the hunger to succeed.

- Ethics and integrity are everything. Dishonesty will stain the reputation of the best warehouse operators.
- Check references and records. Credit or arrest problems of a candidate cannot usually be erased.

Give attention to references. Ask the question, "Would you re-hire this individual?"



Tips For Slotting

Slotting is the process of finding the best storage location for each item in the warehouse. The time-honored rule is that the fastest moving SKUs are stored close to the door and close to the floor. Other rules are less obvious.

Consider product characteristics. Isolate items that are difficult to handle or store, such as long pipe, and very fragile products.

Maintain a clear path for pickers, avoiding congestion. Storing too many fast-moving items in a confined area will result in an unsafe picking situation.

Stay flexible. Be sure that the layout is designed for seasonal growth.

The Threat of Global Gridlock

By George Stalk Jr., *Harvard Business Review*, July 2009, pg. 126.

While the statistics presented are limited to the USA, the thesis is that inadequate expansion of global truck, train, ship and air transport systems will prevent manufacturers from serving a world economy effectively. For retailers, an unreliable supply chain can result in overstocks or stockouts, either of which will erode margins significantly. Massive plants that make only a few products for worldwide distribution may no longer make economic sense. Development of a rapid response supply chain becomes a major strategic opportunity.



Leadership In A (Permanent) Crisis

By R.Heifetz, A.Grashow and M.Linsky, *Harvard Business Review*, July 2009, pg. 62.

These authors suggested that economic recovery may not be imminent, and when it comes, things won't return to normal. A new leadership style will be required, and become skilled in the following three processes.

- ① Foster adaptation. Recognize the need to adapt to changes in our environment.
- ② Embrace disequilibrium. Keep your hand on the thermostat. If the heat is too low, people won't make tough decisions. If the heat is too high, they might panic.
- ③ Generate leadership. Work on the development of tomorrow's leaders.



Contain Optimism About The Future

By Peter Bradley, *DC Velocity*, March 2009, pg. 57.

Makers of reusable containers hope to persuade managers that the ability to recycle a container has particular value in a difficult economy. The companies most likely to see a swift return on investment are those that use large numbers of containers and turn them around quickly. Returnables work best for shippers that have fairly standardized order quantities or lot sizes.



Device Soothes Aching Floor Joints

By George Garber, *Material Handling Management*, November 2008, pg. 12.

Described in this article is an invention called the joint stabilizer, that has been used successfully to control damage caused by loose floor joints in the warehouse. The stabilizers are seven-inch long aluminum cylinders, three inches in diameter. They fit into a drilled hole centered on the joint, locking floor panels in place so they cannot move. Information is provided at www.someromatsongroup.com.

1870 Redux

By Clifford F. Lynch, *DC Velocity*, June 2009, pg. 27.

The Railroad Antitrust Enforcement Act of 2009, is a bill that would extend jurisdiction over rate cases in both the Department of Justice, and the Surface Transportation Board. The arguments for the bill are similar to those made 140 years ago, leading, ultimately, to the Interstate Commerce Act of 1887. While reregulation is not advocated in the bill, it is a dangerous first step.



Pallet Debate Heats Up

By Mary Aichlmayr, *Material Handling Management*, April 2009, pg. 27.

During September 2008, the National Association of State fire Marshals (NASFM) issued the report, "Pallet Fire Loading Impact on Sprinkler Design." Fire protection officials have long been concerned about the risk of piling empty pallets within a warehouse. Created by this report is a code enforcement challenge for many users. In it, a claim is made that all wood pallets represent a "severe hazard," requiring significant upgrades in sprinkler protection. The author explored the possibility of using pallets made from material other than wood, but did not consider the option of storing idle pallets outdoors. Advertisements for aluminum and plastic pallets appear on the same pages as this article.



Why 3PLs Need to Build Their Brand

By R.C. Lieb and K.J. Lieb, *Supply Chain Management Review*, November, 2008, pg. 46.

Logistics service providers fear the "commoditization" of their services. The authors suggested that providers build, refine and strengthen their brands. The research revealed three key market differentiators. Superior IT solutions, global reach, and high quality customer service. It seems likely that two of these three are claimed by most companies in the business.



Get More Bang From Your Pick-To-Light Buck

By Susan Lacefield, *DC Velocity*, May 2009, pg 49.

The technology has existed for decades, but penetration in the marketplace has been limited, because it is expensive. Pick-to-light will boost accuracy and productivity at the same time. It is quick and easy to convert an unskilled worker into a competent pick-to-light order selector. Described in this article are the conditions under which this technology works best, as well as those in which it is likely to be inferior to other order selection options.