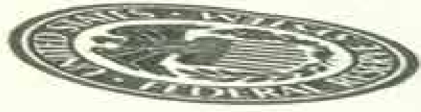
INNOVATION

Sourcing as an evolving system

Kate Vitasek of the University of Tennessee says the power of sourcing business models can drive innovation

"As organizations source more complex products the cost-only approach no longer works."



Research at the University of Tennessee is helping sourcing professionals put logic around when and how to use different sourcing business models for different situations.

Sourcing is a continuum

For centuries organizations have thought of procurement as a "make vs buy" decision, especially when it involves complex strategic business relationships. This was especially true as organizations began to explore outsourcing. Many organizations have assumed that if they "buy," they should use competitive market forces to ensure they are getting the best deal. In doing so the default approach is to use the transaction-based model, which works well for simple sourcing deals with abundant supply and low complexity where the market can correct itself. Just rebid the work if a supplier does not perform.

However, as organizations outsource and procure more complex goods and strategic services, this approach no longer works. All too often buyers become co-dependent on suppliers, switching costs are high and suppliers have a locked-in position.

Oliver Williamson – professor of economics at the University of California, Berkeley – challenged the traditional view of sourcing practices with his Nobel Prize-winning research in transaction cost economics. One of his key lessons is that organizations should view sourcing as a continuum rather than a simple, market-based, make vs buy decision.

A good way to think of Williamson's work is to consider (in Figure 1) free market forces on one side and what Williamson refers to as "corporate hierarchies" on the other. In the middle, Williamson advocated that organizations should use a hybrid approach for complex contracts.

Seven sourcing business models

Research by the International Association for Contract and Commercial Management shows that most organizations operate under conventional transaction-based models that are constrained by a formal, legally oriented, risk-averse and liability-based culture. There is growing awareness that transactional-based approaches do not always give each party the intended results.

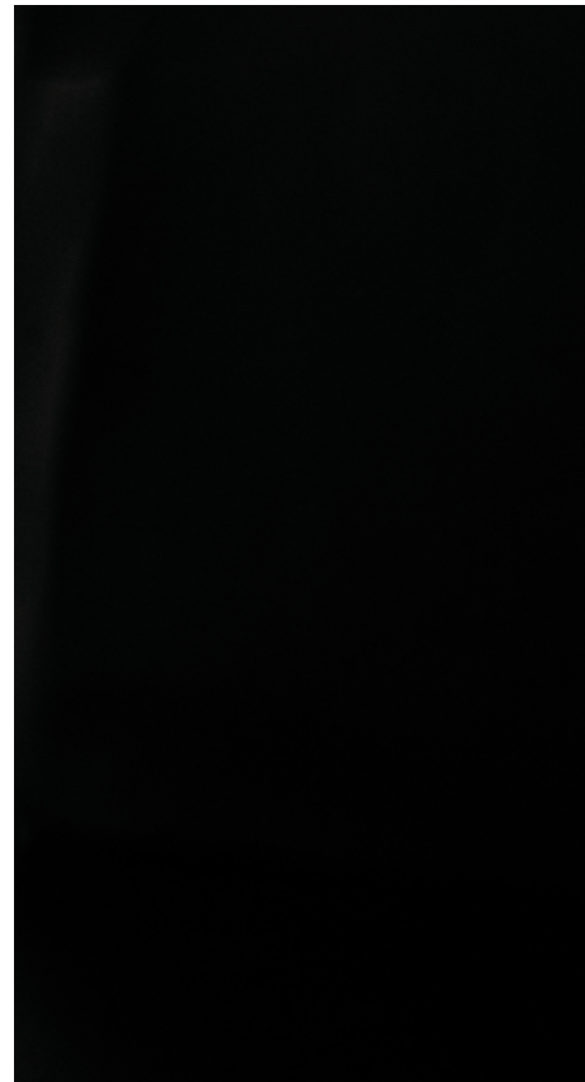
University of Tennessee research and industry-specific experiences apply alternative output and outcome-based approaches for complex sourcing contracts. That experience demonstrates that alternative sourcing business models are viable approaches to the conventional transactional methods.

The seven sourcing business models are described in the book, Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models in Modern Procurement.

Basic provider model

The basic provider model is transaction-based. It usually has a set price for individual products and services for which there are a wide range of standard market options. Typically, these products or services are readily available, with little differentiation in what is offered.

Figure 1: The continuum of outsourcing solutions



A basic provider model is used to buy low-cost, standardized goods and services in a market where there are many suppliers, and switching suppliers has little or no impact on the business. Buyers typically use frequent competitive bidding (frequently with pre-established electronic auction calendar events). Often, a purchase requisition will trigger transactions that signal that the buying company agrees to buy preset quantities of goods or tasks (e.g. widgets or hours).

Approved provider model

An approved provider model also uses a transaction-based approach: goods and services are purchased from prequalified suppliers that meet certain performance or other selection criteria. Frequently

an organization has a limited number of approved suppliers for various spend categories from which buyers or business units can choose. Multiple suppliers mean costs are competitive, and one firm can easily be replaced with another if the supplier fails to meet performance standards.

An approved provider is identified as a prequalified option in the pool of basic providers. They fulfil conditions for specified service through a set of criteria or previous experience with performance reliability. To reach approved status, suppliers frequently offer some level of differentiation from other transactional suppliers and provide a cost or efficiency advantage for the buyer. The differentiation could come in the form of geographical location advantage, a cost or quality advantage or a minority owned business.

Procurement professionals often turn to approved providers as regularly solicited sources of supply when bidding is conducted. In order to create a seamless and readily accessible supply chain, many organizations develop lists of approved providers. An approved list saves time when seeking particular goods and services. The approval process also ensures parity between bidding-qualified suppliers. As an organization selects its approved provider list, it moulds the required qualifications to its unique business objectives and strategy.

"An approved list saves time when seeking particular goods and services."

Preferred provider model

Like the basic and approved pro- ▶

▶ vider models, a preferred provider model also uses a transaction-based economic model. But a key difference between a preferred provider and the other transaction-based models is that the buyer has made the choice to move to a supplier relationship where there is an opportunity for the supplier to add differentiated incremental value to the buyer's business to meet strategic objectives. This insertion of the supplier's contribution into the buyer's business processes creates the need for a relational model. Thus, contracts with specifically chosen suppliers assume a more collaborative relationship. Repeat business and longer-term and/or renewable contracts are the norm.

Similarly to an approved provider model, buyers seek to do business with preferred providers to streamline their buying processes. Buying organizations typically enter into multi-year contracts using master agreements that allow them to conduct repeat business efficiently. While preferred providers are still using transaction-based economic models, the nature and efficiencies of how the organizations work together go beyond a simple purchase order and consider how a supplier can provide value-added services. A preferred provider is a prequalified supplier.

Performance-based/managed services model

A performance-based (or managed services) model is generally a formal, longer-term supplier agreement that combines a relational contracting model with an output-based economic model. A performance-based model seeks to drive supplier accountability for output-based service-level agreements and/or cost reduction targets. A performance-based agreement typically creates incentives for hitting performance targets, or penalties for missing them.

Sourcing decisions are based not only on a supplier's ability to provide a good or service at a competitive cost, but also on its ability to drive improvements based on its core competencies. Performance-based agreements shift thinking away from activities to predefined outputs or events. Some organizations call the results outcomes. A performance-based agreement should hold a supplier accountable only for what is under its control. For that reason, in performance-based models, the word outcome typically means a supplier's "output". An output is a well-defined and easily measured event, or a deliverable that is typically finite in nature.

Performance-based agreements require a higher level of collaboration than preferred provider contracts because there is a higher degree of integration between the supplier and the buying organization.

"An output is a well-defined and easily measured event."

Vested sourcing business model

A vested sourcing business model is a hybrid relationship that combines an outcome-based economic model with a relational contracting model while incorporating the Nobel Prize-winning concepts of behavioural economics and the principle of shared value. Using these concepts, companies enter into highly collaborative arrangements designed to create and share value for buyers and suppliers above and beyond conventional buy-sell economics of a transaction-based agreement. In short, the parties are equally committed to (vested in) each other's success.

Vested outsourcing (vested for short) is a highly collaborative sourcing business model where the organization and the supplier have an economic interest in each other's success.

A vested business model is best used when an organization has strategic transformational and/or innovation objectives that it cannot achieve by itself, or by the using conventional transactional sourcing business models (basic provider, approved provider, preferred provider) or a performance-based agreement.

These transformational, innovation objectives are referred to as desired outcomes. A desired outcome is a measurable strategic business objective that focuses on what will be accomplished as a result of the work performed. Desired outcomes are strategic in nature and often can only be achieved with a high degree of collaboration between the buyer and provider and/or with investment by the supplier.

Shared services model

Organizations that struggle to meet complex business requirements with a supplier can always invest to develop capabilities themselves, or insource. One approach is to develop an internal shared service organization (SSO) with the goal of centralizing and standardizing operations that improve operational efficiencies. A shared services model is an internal organization based on an arm's-length outsourcing arrangement. Using this approach, processes are often centralized into an SSO that charges business units or users for the services they use. In some instances, SSOs are formed externally to the company (such as a subsidiary).

SSOs typically act like outsourced suppliers, performing services and then "charging" their internal customers on a per-transaction or actual cost basis. SSOs generally mirror conventional preferred provider models. The main difference is that the SSO is an internal supplier rather than an external supplier.

Organizations can use a shared services model for a variety of functional services, such as human resources (HR), finance operations, or administrative services (such as claims processing in healthcare). For example, large organizations may centralize HR administration into an SSO to provide benefits management to their own employees and even external clients. Small enterprises can benefit from a shared services model by joining forces to create specialist service centres that

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economically provide a functional service to each of the smaller firms.

Equity partnerships

An equity partnership creates a legally binding entity that can take different legal forms, from buying a supplier (an acquisition), to creating a subsidiary, to equity-sharing joint ventures, or entering into cooperative (co-op) arrangements. Equity partnerships are best used when an organization does not have adequate internal capabilities and does not want to outsource.

Some organizations decide they do not have internal capabilities, yet they do not want to invest in a shared services organization. In these cases, organizations may opt to develop an equity partnership such as a joint venture or other legal form in an effort to acquire mission-critical goods and services.

Equity partnerships, by definition, bring costs in-house and create a fixed-cost burden. As a result, equity partnerships often conflict with the desires of many organizations to create more variable and flexible cost structures on their balance sheet.

Different models for different needs

While business needs have evolved, the fundamental nature of how goods and services are procured has not. The vast majority of organizations (public and private) still use the same transaction-based approach for procuring complex goods and services as they do to buy more simple commodities and supplies.

Many business professionals wrongly assume that a transaction-based business model is the only way to architect a supplier contract. For simple transactions with abundant supply and low complexity, a transaction-based business model is the most efficient model. The real weakness of a transaction-based approach emerges when any level of complexity, variability, mutual dependency, or customized assets or processes are part of the transaction. A transactional approach cannot produce perfect market-based price equilibrium in variable or multi-dimensional business agreements. Thus, hybrid sourcing business models built with relational contracts and output, or outcome-based economic models are a more appropriate sourcing innovation.

Think of a sourcing business model as a system: each is built to optimize and add innovation to business needs.