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Vested®

A contract and business model for successful partnerships within complex customer-supplier relationships

CIRIO LAW FIRM

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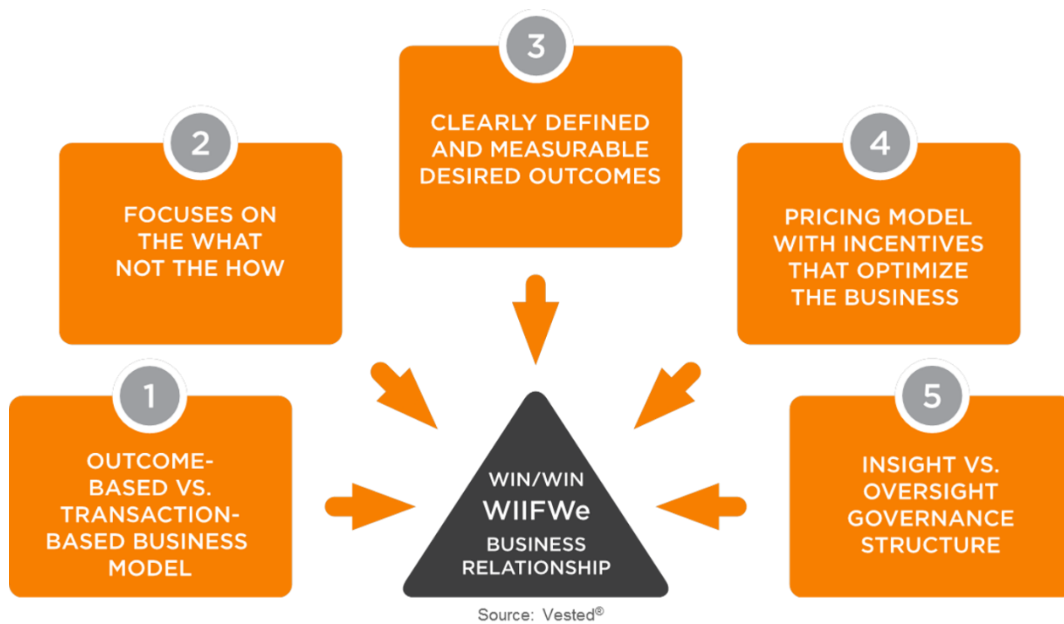
1 Vested – a summary

There is a need for a new approach within outsourcing and other complex customer-supplier relationships. The traditional contract and business models are unable to deliver results in complex transactions where focus is no longer only short-term cost reductions or standardized services, but lower overall cost of ownership, increased customer satisfaction and continuous innovation.

A business and contract model that is increasingly gaining popularity is the Vested model, which is based on research at the University of Tennessee. The model has been applied by companies such as Microsoft, Telia, Dell and Intel within a variety of areas such as business process outsourcing, IT-outsourcing, facilities management, construction, as well as purchasing and logistics.

The basic philosophy of the Vested-model is the question ***"What's in it for We?"***. The model consists of five rules, which implement a combination of a relationship-based contract and an outcome-based business model. These 5 Rules are:



Source: Vested®

The Vested model meets corporate and other organizations needs for new business and contract model that continually gives customer and supplier the interest to creating long-terms values, competitive advantages, innovation, and the flexibility to meet the rapid changes in the market.

2 The necessity of partnerships

Why is it so difficult to get things to work really well between the customer and the supplier in an outsourcing contract or other customer-supplier relationship? Why do so many customers experience what is referred to as the watermelon scorecard, that is, the SLA reports are green while the customer doesn't get what is expected (i.e. the inside is red)? And what is really required to achieve true partnership between customer and supplier, which can create reduced costs as well as more innovation for the customer, while providing the supplier with a reasonable margin?

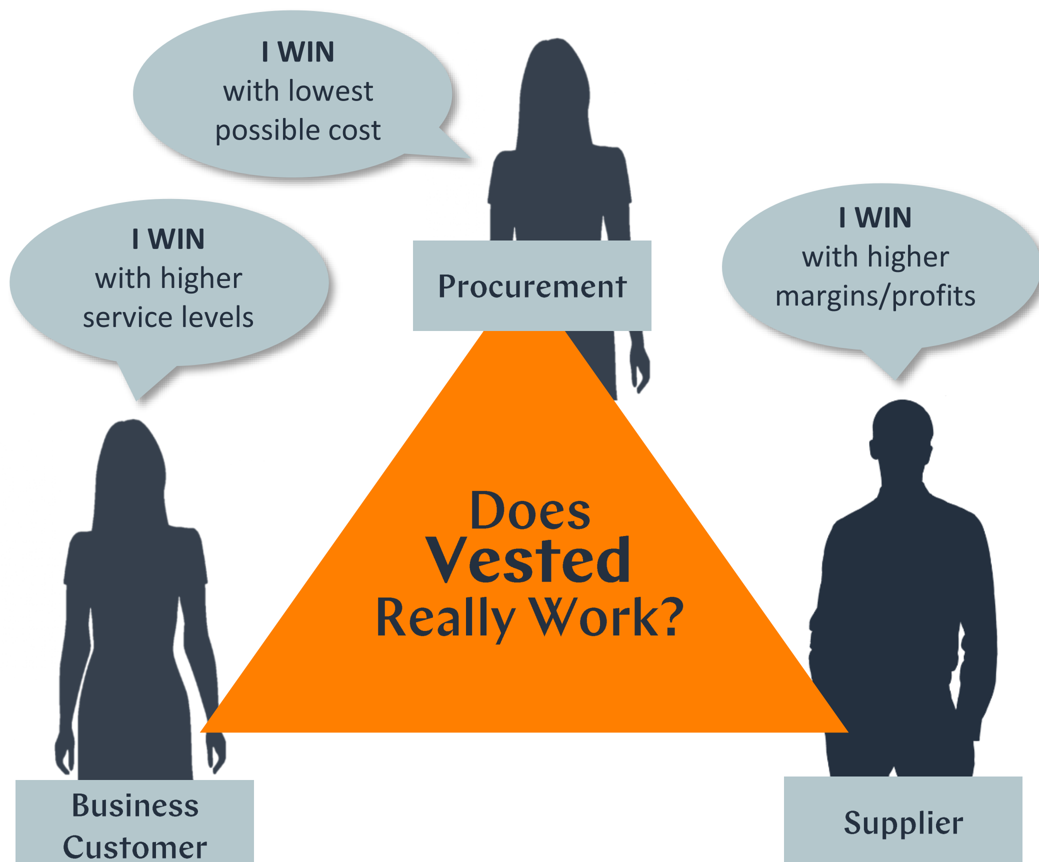
Today, it's not enough to outsource with a view to achieving short-term cost reductions. To maintain and strengthen its competitiveness, a company must instead outsource in order to reduce costs while **creating** innovation and increased quality. Neither is it sufficient, in more complex transactions, to focus only on price and quality for well predefined service areas or tasks. The world is changing too fast, new needs arise, unexpected things happen.

Success requires a combination of efficiency and flexibility for change so that focus is maintained on the desired results. Here, customers and suppliers experience problems, often major ones. The anticipated cost reductions turn out to be higher overall costs than before outsourcing. The sought-after, innovative and proactive ideas for boosting – innovation – are lacking. Instead, many get bogged down in long discussions about what is actually included in the supplier's undertaking and what is not included and justifies extra charges. The often difficult-interpret contract is used as a bat in a discussion that both parties really know is futile but that no one is able to get out of.

In some transactions, the supplier and customer succeed in achieving good results with the outsourcing year after year. But often, the good is the enemy of the best, and even in these more successful relationships, very often the parties find that they are stuck and don't have the ability to raise the outsourcing to the next level. Then there are the companies that manage to achieve partnerships of absolute masterclass. Transactions where the customer has reduced costs, higher productivity, innovative ideas and annual

increases in customer satisfaction while affording the supplier good margins, extended commitments and constantly increasing the scope of its task.

So how are the most successful partnerships achieved? In fact, the answer to that question is known because these partnerships have been studied scientifically and systematically. Researchers at the University of Tennessee studied for several years the factors that explain success in outsourcing and other complex relationships between customer and supplier. The difference between failed and successful outsourcing and similar transactions is explained by the parties' business model and contract model - of the model on how value is created and distributed between the parties, of the process of how the contract is entered into, the structure of the contract, the basic principles and other terms of the contract and for the parties' processes in order to manage your relationship within the contract. The successful partnership is created through a combination of a relationship-based contract and business models that drive coherent interests for shared value creation. These successful partnerships are based upon the spirit of the question "What's in it for We?". University of Tennessee has transformed its research findings into a model and process for entering into successful partnerships based on relationship-based contracts. This model is called Vested and is today used by an ever-increasing number of companies.



3 Ten common ailments in contracts

Many contracts are based on to business models that give the parties conflicting interests and lack rules of play to discourage the parties acting in accordance with these incompatible interests. The conflicting interests create a number of different kinds of problems or rather ailments within many contractual relationships. Poorly structured contracts are often affected by either of these ten ailments. The Vested model is explicitly designed to cure each of these. These ailments are:

1	Penny Wise and Pound Foolish
2	The Outsourcing Paradox
3	The Activity Trap
4	The Junkyard Dog Factor
5	The Honeymoon Effect
6	Sandbagging
7	The Zero Sum Game
8	Driving Blind Disease
9	Measurement Minutia
10	The Power of Not Doing

See Appendix 1 for an explanation of each these aliments.

4 Five rules for building successful partnerships

The ten types of ailment are due to the fact that outsourcing and other transactions are mostly built in such a way that conflicting interests arise between the customer and the supplier. Firstly, it depends on the use of the transaction-based business model. Secondly, it is because the contracts are not written to create conditions for achieving the parties' commercial goals, but largely to allocate risks. In this way, few successful commercial relationships are built. Success within outsourcing and similar transactions is no coincidence but a direct result of following the right principles and rules. Partnerships are not built by themselves but through conscious efforts.

A Vested relationship is characterised by strong mutual gain and concerted interests between the parties - the parties have a vested interest in each other’s success. The philosophical mantra in Vested is, as set out above, an attitude expressed in the question "What's in it for We?". This attitude is implemented in practice by systematically building the relationship step by step in a certain order. The model is structured around five rules, which also indicate the order in which the relationship is to be created.

Rule 1: Outcome-based vs transaction-based business model

The Vested Model's first rule is to apply a business model that at its core provides the parties with mutual interests. The rule consists of two separate elements: firstly, a focus on valuable results and, secondly, a common vision and guiding principles for the

partnership. Vested rests on a results-focused business model (outcome-based contracting) where the supplier gets its main margin to achieve jointly defined goals or results that are valuable to the customer.

A transition to an outcome-based business model implies a necessary, yet fundamental, change of perspective within outsourcing. The traditional contract rests on the transaction-based business model. The supplier will then be paid per transaction, for example per hour, per server, per application, per support matter and so on. The transaction-based model, although used so often, is not well suited for more complex deliveries of services that are critical for the customer without constituting a core business. The transaction-based business model easily guides the parties into the activity trap, the outsourcing paradox and the zero-sum game (see section C above and App 1). The reason is that it basically creates conflicting interests between the customer and the supplier. Instead, the customer receives an incentive to limit the number of transactions in order to keep costs down.

The outcome-based business model here represents a fundamental change as it essentially creates aligned interests between the customer and the supplier. The supplier receives remuneration to achieve what is valuable for the customer.

However, it is not enough to get aligned financial interest in creating a successful partnership. The very concept partnership implies that the parties must have their eye on something more than short-term self-interest, even if these interests arealigned. The term refers to a community. The basis for this community is built into the Vested model by adopting at an early stage a common vision and a number of guiding principles for its partnership. A common vision fills the same function between companies as within companies. It creates focus and an understanding of partnership and meaning.

The guiding principles guide the parties' behaviour towards mutually beneficial solutions throughout the negotiation process and beyond the life of the partnership. Not least, the guiding principles regarding equity, loyalty and integrity will characterize the clauses in the relationship-based contract.

Rule 2: Focus on the what, not the how

The second rule of the Vested model is to focus on what to achieve instead of how the services are to be performed. It is necessary to follow this rule in order to give the supplier space, on the basis of its experience and expertise, to find innovative solutions to meet the customer’s needs.

The traditional contract often contains extensive service descriptions (SOW) which, with more or less a high degree of detail, describes how the supplier will deliver its services.

The parties then end up in the outsourcing paradox, which means that the customer outsources to an expert while the customer details how the expert should do what the supplier is said to be an expert on. This detailed management reinforces the disadvantages of the transaction-based business model because the supplier is completely divested of responsibility for the results achieved with the services; as long as the supplier does exactly what is stated in the description of the service, the contract will be followed and compensation will be paid.

The Vested agreement therefore only includes a description of the functions that the supplier will provide without a travel plan describing how the supplier will assist the customer in carrying out a move from present to future. The travel plan contains strategic goals that often have to be achieved by the supplier together with the customer. The strategic goals are broken down into sub-goals for which the supplier has a specific responsibility and which incentives are linked to the pricing model.

Rule 3: Clearly defined and measurable desired outcomes

The third rule of the Vested Model is to agree on clearly defined goals and achievements. The traditional contract often contains comprehensive goal formulations but often lacks a plan and incentive for the parties to achieve the goals. The contract often contains measurements, but these generally imply that the parties end up with driving blind and measurement minutia problems (see section B). The contract's SLA appendix often contains a large number of service levels with associated penalties. The SLA reports, however, tell very little about whether the customer gets what the customer really wants, and the penalties constitute less in the way of compensation than a reminder that the customer wants something other than just the penalty.

Vested's third rule should address these shortcomings. The rule is a direct consequence of the first two rules. In order for it to be possible for a transition to an outcome-based business model and focus on what to deliver, the desired goals and achievements must be clearly defined. The customer must be made aware of what the criteria for success are and when success has been achieved. They must also agree on the data that will be used to measure goal achievement, how to measure and how often. The Vested contract also measures the base services themselves and not just the achievement of strategic goals. Here the parties agree on the key KPIs - key performance indicators - for the partnership. It is then often about factors that both parties share and influence, such as end users' satisfaction with the services. Occasionally, the performance of other organisations may also affect the performance. Nevertheless, it is the KPIs that measure what the customer really wants. The KPIs can then be broken down at service levels or SLAs that the supplier controls, such as availability of services and response times but these are not used as a part of the price model. In almost all Vested agreements, organisations have chosen to completely abandon a penalty model and instead work with positive incentives for the supplier.

Rule 4: Build a pricing model with incentives

With the Vested model, the parties leave the traditional price negotiation and price list with a benchmarking clause behind them. Instead, the parties jointly build a flexible model based on the issue: Given that we now want to achieve the goals set up jointly within the framework of Rules 1-3, how should we build a price model that creates optimal conditions for achieving the goals while maintaining the trust and reciprocity that our partnership must rest on?

The price model in a successful partnership must thus fill two basic functions:

Firstly, the price model must provide the supplier with the right incentive to achieve the strategic goals and sub-goals. This means partly completing the transition from a transaction-based to an outcome -based business model. There is no single way to do this, but fundamentally, most of the supplier's margins must be linked to the achievement of specified goals instead of individual transactions. If a strategic goal is to lower the total cost of ownership of outsourced services, the supplier is compensated for this cost reduction in relation to how successful it is.

Secondly, the price model must ensure that the partnership holds over time. Few things, if any, create such a breeding ground for conflicts of interest between the parties as negative changes in the cost components on which the parties' business cases are based. What happens, for example, if the energy costs of running a data center should increase dramatically. Should the supplier bear that risk or should it be permitted to raise the price and allow the customer to bear the risk? The Vested model discusses these types of risks and cost variables openly, after which the parties agree on marginal adjustment mechanisms to handle changes. The Vested model requires a high degree of transparency between the parties, and this applies not least to the pricing model. Both parties need to have a good insight into each other's relevant costs, partly to create trust and partly to continuously drive the partnership towards increased productivity and efficiency.

Rule 5: Insight vs oversight governance structure

The Vested model’s fifth and final rule is about governance. Management of customer-supplier relationships should not only be a way of controlling the supplier and checking whether agreed service levels are met. Good governance is, first and foremost, focusing on the partnership as such and not just one of the parties. In addition, the governance should be a learning process whereby the parties, through structured communication and on the basis of facts for a dialogue in order to ensure that the relationship is guided toward the goals set by the parties.

Within a Vested relationship, the parties work with the traditional layered structure at an operative, tactical and strategic level. However, the parties establish separate

processes for continuous performance measurements, for continuous innovation management, continuous risk management and escalation of disagreements. The frequently used model with a communication interface between a customer manager for the supplier and its counterpart for the customer is abandoned. Instead, several communication interfaces are set up, where e.g. those responsible for customer innovation, discuss directly with their supplier counterparts. The governance model also contains clear rules and restrictions on how the parties may replace people who work with governance. Successful outsourcing relationships must largely be based on trust. Ultimately, trust is built between individuals, not between organisations. If important employees of the customer or supplier are frequently being replaced, this hampers the necessary creation of trust which quite simply takes time.

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Appendix 1

1. Penny wise and pound foolish

Price levels and costs continue to be what companies primarily focus on when hiring a supplier in outsourcing or other complex transactions. Other factors are often important, e.g. quality and flexibility. But the cost issue still dominates. Unfortunately, this strong focus on cost often leads to the first type of ailment, namely, the customer is extremely careful about small amounts of money and extravagant with large ones. This means that the customer is thinking short-term and is blinded by the supplier's price list, but in the long-term finds that the total ownership cost of the outsourced features or purchased services did not decrease but rather increased. A common phenomenon is that the customer procures a number of well predefined functions or work activities through a strong price-slashing procurement process and that the chosen supplier then compensates for low margins through additional orders of items beyond the defined assignment.

2. The outsourcing paradox

The outsourcing paradox arises when the customer outsources to an expert but still prescribes in detail in long service descriptions how the supplier should perform its duties. This detailed management limits the supplier's flexibility in a way that eliminates the potential for transforming innovations of both solutions and work processes. As the supplier's compensation is often connected to the activities in the service description, the parties often end up in long discussions about what is actually within the supplier's remit and what is beyond the scope of the service.

3. The activity trap

The activity trap crops up and strikes again due to the use of the transaction-based business model, i.e. when the supplier is remunerated for activity or transaction regardless of the value created for the customer. This may be reimbursement by the hour, by work activity, kilometre travelled, managed error, etc. The transaction-based business model creates directly conflicting interests between the customer and the supplier. The supplier will want to maximize the margin per transaction and maximize

the number of transactions, regardless of whether the transactions are of value to the customer, e.g. if they increase the customer's productivity or its revenue. The customer, on its part, will want to lower the price per transaction. Most of the ten ailments are the result of the conflict of interest that arises with this business model.

4. The junkyard dog factor

An outsourcing is rarely done without impact it affecting several of the customer's employees, either because they are moved over to the supplier or because the content of their current work is changing. It is not uncommon for some employees to play an important role in the outsourcing, despite the fact that they have a personal interest in it. This often leads to problems. The employee can take a rigid position that his or her function is so important in the business that it cannot be outsourced or that it is in any case so important that it isn't possible to rely on the supplier to do a proper job, which means that he or she must be given very detailed instructions in the service description (SOW). It often ends with the customer ending up in the outsourcing paradox, with an expert vendor who is not given space to be an expert.

5. The honeymoon effect

The honeymoon effect has arisen when, after the agreement has been signed, the customer and the supplier initiate the collaboration with enthusiasm and almost romantic expectations, after which the enthusiasm is replaced step by step by disappointment when expectations are not fulfilled. It turns out that the parties didn't have a proper plan for converting the newly-acquired energy into long-term positive effects and often a sense of disillusionment sets in.

The honeymoon effect arises because the supplier's incentives in the contract are not designed to meet the romantic expectations. Most often, but not always, it depends on the use of the transaction-based business model that leads to the activity trap (see above).

6. Sandbagging

Many customers understand the importance of giving the supplier the right incentive to achieve the customer's goals. However, the customer is often reluctant to share too much of the value created by the supplier, thus setting limits for bonus payments and

other incentives. This then leads to the supplier, rationally, performing just as much as it takes to get its bonus, but nothing beyond that. A situation such as this resembles that of the Ukrainian pole vaulter Sergei Bubka who received a reward from his sponsor every time he set a world record: he raised the bar a centimetre at a time and set the world record 35 times.

7. The zero sum game

Most people intuitively understand that it is better to do business if both parties have something to gain from it. However, in practice, many customers and suppliers have difficulty translating this intuition. Instead, they perceive the transaction as a zero-sum game: if you win something, I lose the equivalent. The customer can interpret a price increase concession from the supplier as a direct loss, and the supplier can e.g. interpret certain work to be carried out within a fixed price correspondingly. In principle, the attitude of the parties makes it virtually impossible for them to "increase the size of the cake" before the cake is divided up. The zero-sum game is perhaps the most fundamental ailment of all and forms the basis of many of the others. The zero-sum game is caused primarily by the use of a traditional contract model - the transaction-based – tacitly understood to see the transaction as a relationship at arm’s length where the parties have conflicting interests. Here, the solution lies in switching to a relationship-based contract aimed at creating continuous coherent interests between the parties.

8. Driving blind disease

In many business relationships, ambitious and long-term goals are set, yet the parties don’t achieve them. In fact, the parties often don’t know where they are going or where they started. They have suffered from the blind driving ailment. It all often comes back to a flawed governance structure. The traditional three-way governance model with an operational, tactical and strategic level is often introduced in a perfunctory manner and without the parties having thought through properly how the model and the parties' communication should be used in order to help the parties achieve their goals.

9. Measurement minutia

However, driving blind business relationships are often characterized by highly detailed measuring instruments. The contract may contain several hundred SLAs or KPIs, which

should be reported in green, yellow and red each month in detailed reports. The phenomenon is closely linked to the outsourcing paradox where the highly detailed job description is followed up with highly detailed SLAs. The problem is that these detailed measurements are combined with insufficient insight into how the information should be interpreted and used to achieve the transaction’s goals. The parties simply tend not to see the forest for all the trees.

10. The power of not doing

A fundamental law of physics is that in order to get a resting object to move, an influencing force is required that is stronger than the gravity that holds the object at rest. Even within and between organisations, the status quo, the unchanged current situation, has a strong inherent power and requires focused and disciplined measures to achieve long-term changes. Unfortunately, many customers and suppliers get stuck here in a passive trap, where management structures and measurement systems have been introduced for their own sake, but without creating the momentum required to create change. Customers often start complaining about the supplier's lack of proactivity and the suppliers feel frustrated that they feel that the customers really don’t want change but only the same at a lower price.