Creating an outsourcing RELATIONSHIP

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Successful outsourcing depends as much on the kind of relationship developed as it does on the details of the operational execution. When the provider and the client set expectations early on, communicate openly and honestly, and establish the right business structure, they position themselves for outsourcing success. Here's how to put those relationship building blocks in place.

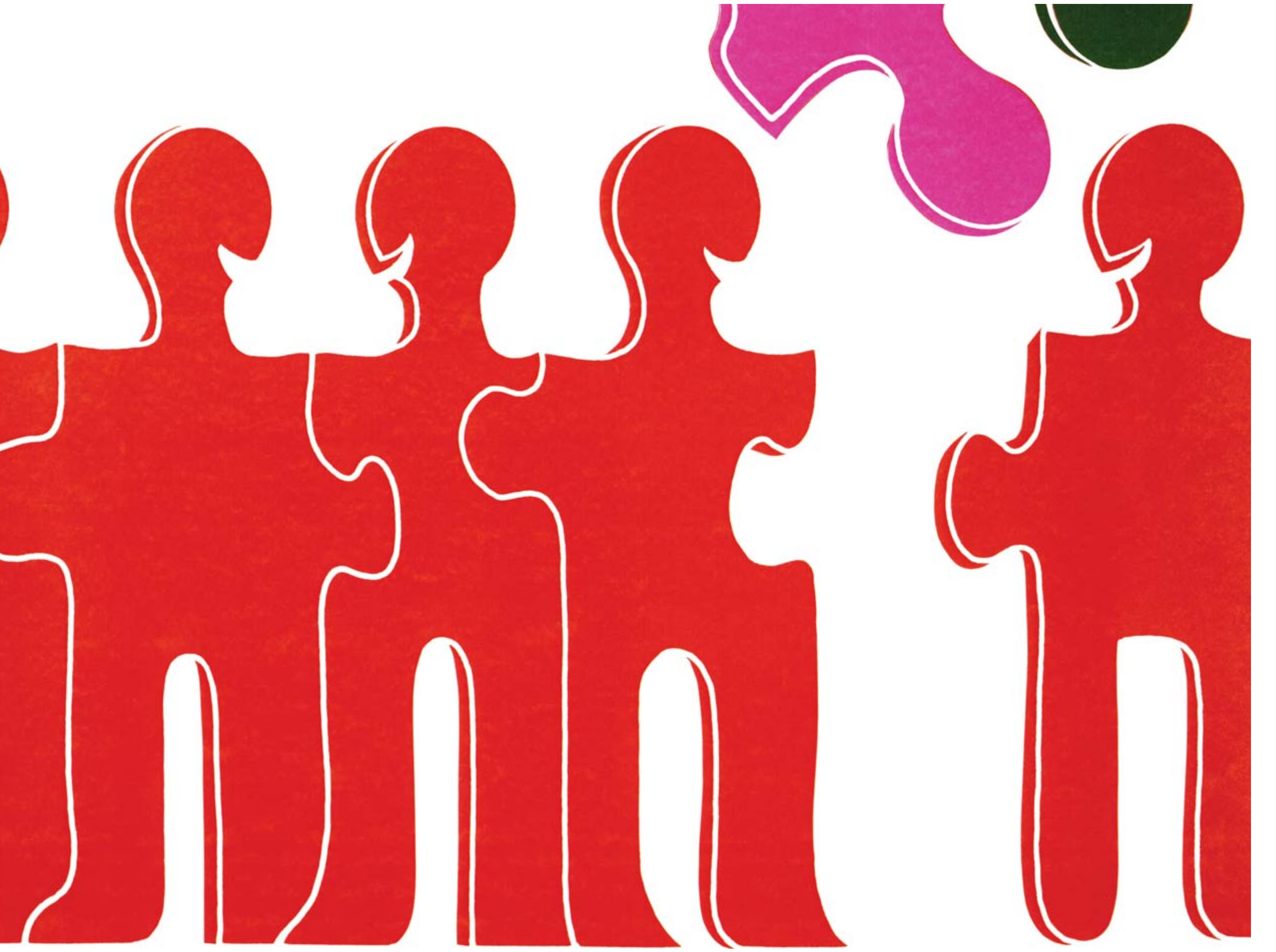
Once you have selected the best provider for your outsourcing initiative, you will be eager to move forward. You will have plans, deadlines, and products, and your company will be ready to focus on its primary core functions. You must be careful at this point. Successes and failures in outsourcing initiatives are often attributable to the relationships developed between the client and the outsourcing provider rather than the business issues. After a company selects an outsourcing provider, there is a tendency to devote a lot of time to defining the outsourcing process, what metrics will be used, IT coordination, and more. The company and the provider, however, spend much less time communicating or understanding that the relationship between a client and an outsourcer is a partnership. This is a mistake.

Outsourcing requires giving up control of a business function and trusting others to handle that function for you. Many have an intellectual understanding of this fact, but emotionally they have a hard time accepting it. Rather than just a business tool, outsourcing is a new way to think about business. Therefore, the relationship between a company and a provider of outsourcing services is not the same as the relationship between a supplier and a customer.

The relationship between you and your outsourcing provider cannot be taken lightly. It is not a "hands-off" process. In fact, this relationship is critical to the success of your initiative....

The first step in this process is creating the outsourcing relationship, which involves:

- Getting the relationship started.



- Determining the relationship structure.
- Selecting a fee structure.
- Conducting a validation (relationship due diligence) process.
- Setting realistic timeline expectations.

This article focuses on creating the relationship and examines the activities listed above. The main goal is to effectively evolve what was understood or perceived in the selection process into a working relationship that takes you through the contracting process to implementation. Throughout this process, you must communicate openly, honestly, and without bias. Otherwise, you will be left with false perceptions, unrealistic goals, lowered exceptions, and a weak relationship that may jeopardize your entire outsourcing initiative.

Getting the Relationship Started

By its nature, outsourcing brings together at least two organizations with internal structures, terminology, information capabilities, and operating philosophies. As a result many outsourcing relationships start poorly, and a poor start leads to an ineffective relationship. A failed relationship can lead to complicated and costly legal battles.

Therefore, as soon as is practical, you should create a new team—the implementation team—comprised of members of both companies to begin the process of creating your relationship. The purpose of the team is to establish multiple touch points between your company and your provider. These should go beyond the provider's sales organizations and your outsourcing team, and should involve the people who are actually going to do the work. Therefore, the members of the team should come from two different groups of people—those who understand implementation and project management and those who will be responsible for the day-to-day business of the partnership. All team members should be current on the RFP (request for proposal), the solution, and the negotiation on the terms sheet and contract.

Once you have created the implementation team, its first task is to get the relationship started. This involves the following actions:

- Set initial expectations.
- Identify resources upfront.
- Determine where you are now and your destination.
- Plan for resistance.

The sections that follow explore these aspects of getting the outsource relationship started.

Set Initial Expectations

Relationships between client and outsourcing provider are labeled as failures when one party does not do what the other party expects. Most often, this is a result of mistakes providers and clients make early in the process. For example, providers commonly oversell themselves, set expectations that are too high, fail to gain a true understanding of why the client is outsourcing, and involve themselves with a member of the client's organization who is not the decision maker. The mistakes that clients might make include holding back information, putting someone who is opposed to outsourcing in charge of the initiative, assuming that an outsider can fill in the company's internal information gaps, and providing an inadequate picture of operations. Trying to repair these mistakes and the damage they can cause can be very difficult. It is better to invest your energy into preventing them rather than fixing them. Setting expectations early is the best measure for avoiding these mistakes.

As with any relationship, honesty is the best policy when you discuss expectations. Do not attempt to hide strategic plans or cloak the project in an air of secrecy by labeling some discussions as confidential or "offline." If you are honest with your provider, they are more likely to be honest with you. By treating them as a partner, making them privy to your goals and plans, they will be encouraged to treat you the same way, and together you can work to set realistic service expectations candidly and openly.

Throughout the outsourcing process, you must communicate openly, honestly, and without bias.

Jointly Identify Resources Upfront

In today's competitive environment, outsourcing providers can be influenced by the need not only to keep proposed costs within your budget but also to make sure they have the lowest price. At the same time, they may promise services that they may not be able to deliver at rates they have persuaded you (and themselves) are achievable. In many cases, the provider may not know the real cost of providing the services until well into the implementation process. This is compounded when you do not know your own costs of providing the service. Therefore, as part of getting your outsourcing relationship started, you and your provider should work together to identify the resources needed to perform the outsourcing functions.

It is important to remember that resources need to be identified in all areas affecting the relationship's success, including financial resources, operations, and legal and technical resources. It is also vitally important to clearly identify the roles and responsibilities of the resources involved in the relationship. It is important that all parties have a clear understanding of who will be doing what tasks; therefore, you and your provider should explore all boundaries for responsibilities. The responsibilities must be communicated to both organizations to ensure that everyone is aligned.

Once you have jointly identified resources and roles and responsibilities, you are ready to work with the team on the goals you want the outsourcing provider to help you achieve.

Determine Where You Are Now and Your Destination

During the process of identifying core functions and outsourcing targets (as part of the provider selection process), you collected a great deal of data that helped you establish your company's current baseline and allowed you to determine the goals you planned to achieve by using an outsourcing provider. Now is the time to share this information with the provider.

Basically, you need to take the time to tell them where you are and then discuss where you want the outsourcing initiative to take both of you. In other words, you and your selected provider need to set outsourcing goals and determine how to achieve and measure success. Key questions to guide this process are:

- Where do we want this outsourcing initiative to take us?
- How will we get there?
- What is the science of the initiative?
- What values will we practice?
- How will we measure success?

Plan for Resistance

Typically, when a company announces it is planning an outsourcing initiative, the reaction internally is to oppose the project. This backlash is unfortunately inevitable, and therefore, you must have plans for easing staff concerns, which typically center on such issues as: fear of the unknown, fear that they will lose their jobs, and fear that they will become the provider's employees and have to adjust to new and different cultures.

To help ease these and other above concerns, you should do the following:

- Communicate openly, honestly, and frequently. Conduct meetings that explain why you are outsourcing and accent the positive aspects of the initiative while taking care to address the changes it will bring. If you feel employees have something to contribute, ask for feedback. (However, you should keep control of this process to make sure it does not deteriorate into a round of angry accusations.)
- Share your rollout plans. Explain the initiative's timetable and what implementation will mean.
- Emphasize the close relationship and partnering aspect of outsourcing.
- Have the provider conduct face-to-face communication with your staff. This allows employees to "put a face" on the situation.
- Provide placement services for those individuals who will not be part of the future or do not wish to be.

It is important to remember that addressing internal staff concerns is not a one-shot deal. Resistance is inevitable, and you will face it throughout the initiative. Therefore, you might have to take the steps outlined above a number of times. Do not be discouraged—eventually, most resistance will recede. Meanwhile, you can use the process of easing concerns to strengthen your relationship with the provider as you strive to structure your relationship.

Determining the Relationship Structure

Each provider-client relationship is unique with no absolutes. Fundamentally, the structure of the relationship between the outsourcer and the provider is based on how each reacts to the other day to day. However, you must not use this uniqueness as an excuse for not defining the type of relationship you want to have with your provider. You and the selected outsourcing provider must take the time to determine the basis of your relationship, identify how all parties will interact, and determine the structure of your relationship.

Structure is important. You are more likely to have a successful relationship with your provider if you both focus on the structure of the relationship.... Without a strong relationship structure, your initiative will lack control. Customer satisfaction, communication, and understanding of the business scope will be poor or nonexistent. Technolgy will most likely be inadequate and the management of the initiative will become reactive rather than proactive.

The first step in structuring the relationship is to define jointly what each of you means when you say you want a good relationship. After that, you need to set the parameters that will help you achieve this good relationship. These parameters can include:

- Metrics and reporting content, calculation, and timing.
- A communication plan and resources for both implementation and steady state.
- Problem resolution and development of steering committee.
- Invoicing format and relevant backup data.

Another parameter is the method you will use to gain consensus. Should all understandings be written to ensure that all involved agree? Or will implicit understanding work better? You should keep the methodology simple, but make sure that it is complete. It is critical that you involve the right people in this process—they should be those people from both companies who can make decisions and accept responsibility for them.

Once you have set these basic parameters, you can determine which structure will work best for you and your outsourcing provider. In the case of logistics outsourcing, there are almost as many relationship structures as there are third-party logistics (3PL) agreements. However, the most common types are:

Dedicated-sole: This is a one-on-one relationship with a provider that has dedicated a warehouse, manufacturing site, or truck fleet initiative.

Dedicated-multiple: This is similar to dedicated-sole relationship except that it covers several regions or countries, involving more than one warehouse, site, or fleet.

Multi-client: In a multi-client structure, the provider is operating other contracts under the same roof, and co-mingling product in trucks.

Lead logistics providers (LLPs): In an LLP structure, one provider takes the lead in the initiative and may manage one or more subproviders to achieve the client's goals.

Formed companies: In this structure, the provider and outsourcer develop a legal entity (company).

To determine which of these types of relationships works best for you and your provider, you both must answer some questions, such as:

- What is the magnitude of the outsourcing scope of work? Is it on the level of running and managing a fleet of trucks, or does it involve an entire distribution or manufacturing network spread all over the world?

Outsourcing requires giving up control of a business function and trusting others to handle that function for you.

- What is the provider's level of experience? Have they basically flown solo, or have they worked with several providers on different levels to integrate a supply chain?
- Are you comfortable with "all of your eggs in one basket"? Do you want one outsourcing provider to mange everything, or do you want to utilize several providers?
- What is the geography of the outsourcing initiative? Is it nationwide, regional, or global?
- Will the outsourcing initiative involve specialization? In other words, are there special requirements involved with the initiative, such as returns, fulfillment, or customer mandates?
- What tasks will the outsourcing provider expect of us? Are we prepared to service their needs?

As you answer these types of questions, you will begin to get a clearer picture of which type of relationship structure best fits your needs. Below are a few tips for making sure the structure you have identified is successful:

- No matter which structure you choose, you must be very clear about accountability and responsibility. Make sure that both you and your provider understand your roles in the outsourcing initiative and what you expect each other to manage.
- Communicate, communicate, and communicate. We cannot stress enough how important it is for you and your provider to share information openly and honestly. The more each of you knows, the better you can work together within your relationship structure.
- Maximize value for both the client and the outsourcing provider. All participants must win within the structure. Make sure that all parties will benefit from the relationship.

A structure that benefits one participant or a group of participants at the expense of others is a poor structure.
- Company cultures can be everything. It is important that each company understands the other's culture and that both can work in harmony so that the relationship structure can evolve. Trust will grow as expectations are met. Open discussions about trust are to be encouraged.

Once you and your provider have determined your relationship structure and taken the first steps toward ensuring that your relationship is based on trust, the next step is to establish the fee structure for the initiative.

Setting a Fee Structure

The fee structure for an outsourcing initiative serves as the basis for the service agreement between an outsourcer and a provider. The best fee structures are developed mutually after the parties have explored all of the possibilities.

Honesty is the best policy when you discuss expectations. Do not attempt to hide strategic plans or cloak the project in an air of secrecy by labeling some discussions as confidential or "offline."

Otherwise, you may wind up with a fee structure that is too rigid and does not allow for changes inherent in a long-term outsourcing relationship. Fee structures should be as flexible as the relationships that create them.

At the highest level the pricing (fee) options are:
- Fixed-cost.
- Transactional.
- Cost-plus.
- Activity-based.
- Management-fee.
- Combined.

Each option has its advantages and disadvantages. It is important that both you and your provider explore each option before you decide which you will apply to your outsourcing initiative. Your goal is to develop the structure that works best for your solution. The sections that follow discuss the structures in more depth.

Fixed-Cost Fee Structure

This fee structure works best when the outsourcing initiative involves predictable volumes. In its simplest form, the provider agrees to do the work for a set price rather than being paid on a time and materials basis. A more complex form (although it is still simpler than other models) is a service-level-driven, fixed-cost agreement ("fixed-price service-level agreement"). In this case, the provider must meet predetermined performance levels before it can realize any revenue.

Fixed-cost fee structures have several benefits. For one, it is difficult to misinterpret a fixed price. In fact, the pricing is easy to understand, and it simplifies the client's budgeting process.

The disadvantages are that when providers determine their fixed fees, they are prone to overestimating their costs to minimize their risk and guarantee that their fixed costs will be covered. Also, if wages are involved, they can rise over time, creating the possibility that the provider will lose money.

Transactional Fee Structure

The transactional fee structure is the most common pricing model. Most public warehouses and a number of dedicated 3PLs use this approach to pricing. Basically, a flat fee is charged per unit cost of work, such as miles driven, pallets handled, and cases mechanized. For example, a transaction fee structure for outsourcing transportation might include a cost per mile, a labor charge per hour, a charge per door shut, and a trailer-per-day fee.

The transactional fee structure offers several advantages. Like the fixed-cost model, it simplifies budgeting because the client knows in advance what the provider's services will cost. Also it is easy to understand because each item is broken down into a dollar amount. Invoicing is easy because the provider can submit invoices based on the charges determined before the work starts. Finally, there are industry benchmarks for most costing so the client can be sure that the provider's fees are reasonable and fair.

The disadvantages include:
- It is difficult for providers to cover their fixed costs when this structure is used because costs are based on workloads that vary with volume.
- The outsourcer can end up paying too much if the rates are not based on reasonable time estimates to perform each function.
- The costing is based solely on volume, when in fact other variables such as fixed costs for utilities and fuel don't vary based on volume.
- The elements in the costing structure are unclear and too much is left open to interpretation.
- It is a commodity approach rather than a partnering approach.

Cost-Plus Fee Structure

This pricing option is the actual cost of the initiative plus a percentage fee or flat fee (see Exhibit 1). It is especially effective if your outsourcing project is volatile and is less likely to be applied to a long-term initiative. The cost-plus fee structure is popular with large providers, mainly because they will make money in every circumstance. In some cases, a provider may mandate that this model be used.

For example consider a warehousing outsourcing project. Using the cost-plus model, the following would be included in the operational costs: staff, management, equipment, facility, consumables, communication, and hardware/software costs. Included in corporate overhead would be IT, accounting, electronic data interchange (EDI), customer service, sales, and senior management costs. The one-time costs in the new account startup block would be engineering and logistics design, travel, systems integration, communications, leasehold arrangements, and capital requirements costs.

This fee structure has a number of advantages, which is why it is popular. A key benefit of the cost-plus structure is that it can be combined with other fee structures. Another advantage is that it builds trust between a provider and a client as they work out all the costs and "do the math." Clients will have an accurate picture of costs, and providers will have a picture of their profits, which are guaranteed even when the unexpected happens. Cost-plus also improves startup when a costing structure is unclear and eliminates contingency padding. Also, if volumes fluctuate or are not easily defined, the provider is not at risk. At the same time, clients do not feel that they are overpaying, and they perceive the structure as innovative and flexible.

The disadvantages of this type of fee structure are:

- The provider must be able to capture costs accurately.
- There is often a perception among outsourcers that this structure provides no built-in motivation for the provider to reduce costs and improve productivity without including incentives for reducing costs and enhancing service.
- Disagreements over what constitutes a cost can arise.
- Budgeting is more difficult for the client because the only constant is the markup.

Activity-Based Fee Structure

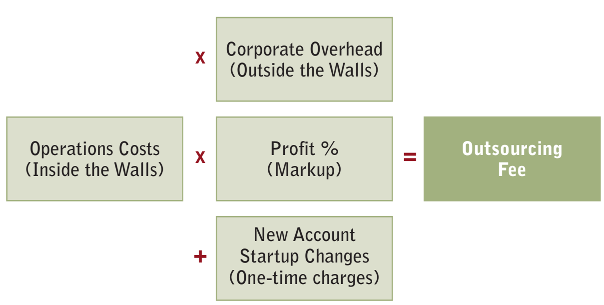
This hybrid fee structure includes a flat-fee component and a transactional-fee component. If the provider you selected is a 3PL, the flat-fee components are building space, equipment depreciation, and equipment leases. The transactional fee is based on volume and covers those costs that vary for the provider such as labor, maintenance, and fuel.

The advantages of this fee structure are similar to those of cost-plus pricing. It can protect a provider when volume is unpredictable. Also, the provider is more likely to charge a fair price because they do not feel obliged to "fatten" their unit prices to protect themselves from losses related to their fixed costs. It also reflects more accurately services rendered and expenses incurred. In addition, this structure allows clients and providers to track logistics costs more accurately because they usually have more highly detailed invoices.

Like the benefits, the disadvantages of activity-based fee structures resemble those of cost-plus. Their pricing structures are complex to develop, and there are no inherent financial incentives for the providers to pursue continuous improvement. Also, activity-based pricing is difficult to structure for new relationships since there might be many unknowns.

EXHIBIT 1

The Cost-plus Pricing Model



Management-Fee Cost Structure

The management-fee pricing model is structured as a fixed, annual charge for required services. In a few cases, it includes all elements of the agreement, including direct costs, overhead and fixed costs, and profit. Typically, however, the client is responsible for direct costs as they are billed, and a set management fee is used to cover the provider's overhead and profit.

Like the activity-based and cost-plus models, the management-fee structure can be combined with other fee structures and is a viable option for projects where units are not easily defined and volume and shipping levels are speculative. Other advantages include fewer disagreements over operating charges and service levels than with other structures, improved management productivity, and fixed provider profit and overhead.

The problems with this structure include no set method of passing along productivity gains. Also, setting the appropriate fee may be problematic. Like all the other fee structures, there are no built-in motivators to improve effectiveness. Nor is there any incentive for the provider to expand needed supervisory/management efforts.

Combined Structures

Many fee structures developed between clients and providers are combinations of several structures. It is fairly common for a pricing model to be a combination of the transaction, cost-plus, and management structures.

There are other successful combinations of fee structures that you may use if you choose. Of course, what is best will always be debated and is an interesting subject of conversation in each outsourcing relationship. For example, some industry insiders will tell you that you should never use cost-plus. Yet in a situation where there are too many unknowns or your business processes are changing radically, a cost-plus structure works well. Once your processes become more stable or after the initiatives have been underway for some time, you may want to revisit the fee structure and make mutually agreed-upon modifications. Or you may find that you don't need to make any adjustments at all.

What is important is that you and your provider explore all the pricing possibilities and their ramifications before you settle on a fee structure. You both should keep in mind that what worked best for one provider-client relationship—even if that relationship involved one or both of you—may not be best for this particular initiative. Pricing is a difficult subject, at best. But if you and your provider approach it with open minds and a view toward flexibility, as well as with full disclosure and no assumptions, together you can find the right approach.

Once you have determined which fee structure to use, you can begin discussions about how to build in improvement factors. As you may have noticed when you read the disadvantages of the various structures, most of them do not have inherent, built-in measures for encouraging continuous improvement, enhanced service, or cost reduction. At this stage, you want to approach the concept cautiously; however, it is important that you and the provider discuss your joint expectations of the potential for continuous improvement and fee structure. Then, you will be ready for the next step in creating your relationship: validation or relationship due diligence.

Validation (Relationship Due Diligence)

Consider this situation. After an extensive review of responses to request for information (RFIs) and RFPs, Company A selected Provider X to operate several distribution centers (DCs). Provider X had impeccable financials; its records showed a strong, solvent company with the latest software and, according to its references, its employees were well-trained. Site visits to other DCs managed by Provider X revealed efficient operations. So Company A entered into an agreement with Provider X. In the end, however, Company A's outsourcing initiative failed. Why? Because Company A made false assumptions about Provider X based on what they read and saw. Yes, provider X had the latest software, but unfortunately its IT staff did not know how to install it on Company A's legacy systems. Provider X's operations were efficient because of well-defined processes and methodologies; however, the company did now know how to apply those processes and methodologies in Company A's DC.

This story illustrates one of life's lessons: "What looks good on paper does not necessarily work in real life." Provider X looked like the perfect candidate to Company A. However, real life revealed otherwise. What both companies should have done before signing any agreements, was to go through a validation process, often called relationship due diligence. Had they done this, Company A may have realized that it needed to upgrade its legacy systems, or Provider X might have hired personnel who had experience installing up-to-date software on older systems. Had Provider X discussed Company A's DC operations before signing the agreement, they might have realized that the processes needed an overhaul before their workforce took over.

During validation, a client and a provider work together as a team to understand what the other is selling and what each needs. Both must be prepared to change assumptions or make adjustments to their expectations. The provider should take the RFP and make sure the client clarifies it. The provider should ask probing questions and work toward a more granular level of detail than the RFP provides. In turn, you should ask your provider for detailed data analysis and ask revealing questions about their proposed solution. During this process, you should also assess your organizations' cultural fit, identifying differing philosophies and determining how to make them work or how to overcome them.

> **The first step in structuring the relationship** is to define jointly what each of you means when you say you want a good relationship.

Once the validation process is complete, you and the provider can create a timeline.

Setting Realistic Timeline Expectations

Before you and your provider get involved in the legal issues necessary for cementing your relationship, you need to develop a realistic and detailed timeline. To create this timeline, you and your provider need to consider the following:

- Due diligence.
- Term sheet signing.
- Service agreement signing.
- Communication plan—internal.
- Communication plan—customers, vendors.
- Resource assessment.
- Create project teams.
- Regulatory issues.
- Transition planning.
- Operations planning.
- Technology planning.
- Benchmarking activities.
- New equipment/facilities acquisition.
- News releases.
- Go-live dates.
- Human resource issues.
- Training.
- Testing.
- Inventory planning—product movement plans.

Conclusion

Discussing the elements above and the key dates of the initiative creates common thinking about the process and the next steps. It will also result in an outline that will become your final outsourcing plan. As you can see, communicating and interacting with your provider as a true partner will help ensure a successful relationship. And a strong relationship, established at inception and carried throughout, will prevent outsourcing setbacks later.