



Unpacking Best Value

Unpacking Best Value:

Understanding and Embracing Value Based Approaches for Procurement

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Executive Summary

Probably no other topic creates as much apprehension between two companies as trying to determine a fair price. The conventional procurement process pits buyers and sellers on opposite sides of the table. Classical negotiations training uses tradeoffs and concessions as tactics in order to get the best possible price (or preserve as much margin as possible if you are a supplier). A win for the supplier means a loss for the buyer. The result? A zero sum game. A mindset where the parties fight over taking bigger slices of the pie instead of combining talents to make a bigger pie.

Progressive companies are starting to challenge conventional approaches by looking at the world through a different lens. Simply put, it is not how much a company pays, but how much they get – or Best Value. This requires procurement professionals to move beyond price and truly understand the total cost of ownership (TCO) and associated hidden risks in order to determine the Best Value for the goods or services they buy and use.

Despite the fact that TCO and Best Value have become industry buzzwords in the last decade, the use of the concepts is far from widespread. Although it is widely understood that both terms fundamentally mean “more than just price,” the fact remains that many companies have yet to embrace the concepts in a way that shows they truly understand the approaches and how to use them to maximize value.

The primary goal of this white paper is to help procurement professionals to better understand value-based approaches for procuring goods and services. This white paper explores:

- Price vs Best Value: Why a Best Value Approach is Needed
- TCO and Best Value: A Brief History and Key Definitions
- Boundary Spanning Transparency – The Foundation for Success
- How to “Buy” Best Value
- An Overview of Value Based Pricing Models

Our goal is for procurement professionals and suppliers to learn from the concepts shared in this white paper and openly challenge conventional approaches to determining the right “price” with suppliers.

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Price vs. Best Value: Why a Best Value Approach is Needed

Simply put, it's not how little you pay, it's how much you get.

That's the basic difference and tension between price and value. And today's procurement professionals need to not only understand the difference, they should seek to apply tools from their procurement toolkit to help them put the concept into practice. When used, Best Value approaches become the bridge that spans that tension because determining the true cost and value equation gives companies the confidence they are getting the best "deal".

Unfortunately the prevalent modus operandi for many businesses is to seek price reductions that provide immediate gratification rather than buying on Best Value, which for many managers is too long-term, involves too many departments and is too complicated and abstract. Picking a supplier on price is so prevalent that many corporations and even government agencies have had policies that enforce the "low price" practice for decades. For example, beginning in 1954, the Minnesota Supreme Court ruled that state agencies were required by law to award contracts to the supplier with the lowest price using an open bid process. The rationale? To divest public officials of discretion to avoid even the appearance of "fraud, favoritism, and undue influence."¹

The low bid approach is paved with good intentions of "watching out for taxpayer dollars." However, the conventional approach has fundamental flaws. Experience has shown that sticking with low bid contracts does not necessarily generate savings. Indeed, cost and time overruns are often run-of-the-mill and there is little motivation for the contractor to innovate or bring expenses down because doing so may actually reduce profits.

While many organizations do not have to follow "low bid" policies, all too often they fail to do their due diligence in digging below the purchase "price" to determine overall total costs of ownership and conduct a proper Best Value analysis.

A good example of a company not doing their homework is an original equipment manufacturer (OEM), which chose to move from an onshore supplier to an offshore supplier in China. Original estimates showed a price savings of almost 75 percent compared to work performed by the supplier in region. What the company did not factor in were the increased costs to manage the relationship with the Chinese supplier. The company's travel budget increased by 400 percent as engineers and quality teams flew business class to visit with the supplier for new product launches and quarterly reviews. While this is an extreme example of being "Penny Wise and Pound Foolish," it is not a

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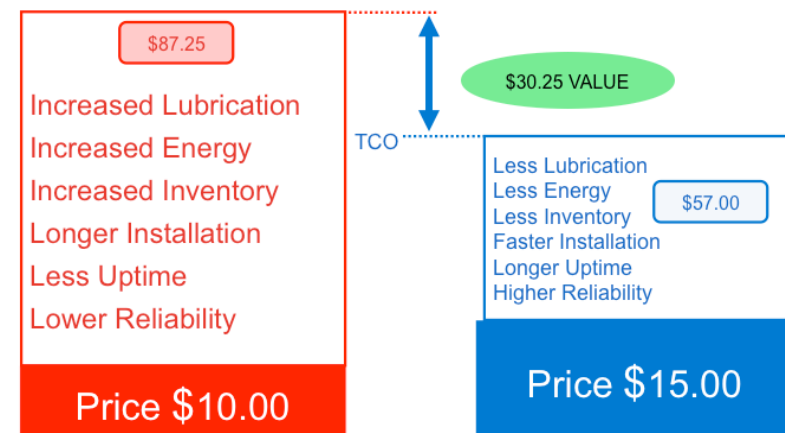


reflection on making onshore vs. offshore decisions. It is simply an example that shows how 100% of the promised savings did not hit the bottom line because the company failed to factor in the total cost of doing business with an offshore supplier before making a final decision.²

The good news is that Best Value approaches, tools, and methods such as Total Cost of Ownership (TCO) are finally gaining traction. Even government agencies that traditionally relied on competitively bid “lowest price” policies have started to deploy Best Value concepts. In 2001, the state of Minnesota enacted Statute §161.3410 that infused discretion back into the process. The Minnesota Department of Transportation used the new law for selecting the contractor to build the I35 bridge replacement after the sudden collapse in 2009. Why? It would enable them to balance cost, quality and timeliness as key factors in how they chose the contractors that would ultimately be charged with rebuilding the bridge. The result? They selected a contractor that had the highest price – yet had the overall Best Value resulting in one of the most successful bridge construction projects in history, winning dozens of awards and being erected in a staggeringly short timeframe of less than 18 months.

Suppliers are also seeing the value of applying Best Value and TCO concepts. Some companies such as SKF – the world’s market leader in bearings and related industrial products – have embraced the concepts of Best Value and TCO. SKF is so serious about it that the company appointed a full time Global Manager of Value to study, improve, and institutionalize the concepts within SKF.

For SKF, seeking to better understand TCO and Best Value has advantages. By knowing their costs and the value their products provide, they can help their customers conduct business cases that help support SKF’s premium price. Once such example is the justification that a \$15.00 part can save \$30.25 over its’ lifetime.



Source: SKF

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TCO and Best Value: A Brief History and Key Definitions

The concepts of Best Value and Total Cost of Ownership are closely related. The main difference is that Best Value goes one step further than TCO because it compares alternative solutions based on value derived not simply on cost. While a TCO analysis seeks to identify true costs, a Best Value assessment adds decision criteria to include intangibles, such as market opportunities, social responsibility, responsiveness, and flexibility.

Total Cost of Ownership

The concept of Total Cost of Ownership (TCO) first emerged in the 1950s when experts such as Michigan State's Dr. Don Bowersox challenged conventional approaches to understanding the costs associated with logistics.³ He and a few colleagues believed that warehousing professionals needed to understand the total cost of a shipment—not just the warehousing and transportation costs.

Bowersox and other thought leaders established the National Council of Physical Distribution Management, which is now known as the Council of Supply Chain Management Professionals, to promote what they called total landed costs. The concept of total landed costs has evolved and expanded outside of the logistics profession. Today most industries refer to the concept as TCO.

TCO began to get widespread traction in the information technology field in the late 1980s with the Gartner consulting group where TCO was used to calculate all the costs of owning a desktop device, including capital, technical support, administration and end-user costs.⁴ The TCO concept has evolved considerably over the years to embrace a more holistic approach for understanding the entire economic investment associated with any product – including costs of acquisition, operation and disposal. In fact, this cradle to grave mentality is the basis of how most people define TCO. The existing literature and market consensus is that the TCO is the “sum of purchase price plus all expenses incurred during the productive lifecycle of a product, minus its salvage or resale price.”⁵ However this definition assumes that total costs – once calculated – are static and do not change. Contemporaries are pushing the concept of TCO further back in the supply chain and encouraging suppliers to capture their total costs, challenging a more dynamic approach and encouraging companies to consider risks as well.

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The authors put forward the following definitions and calculations to help clarify the concept of understanding a buyer's total cost.

Suppliers Costs = Suppliers Direct Costs + Suppliers Indirect Costs

Supplier Cost ≠ Suppliers Total Costs

Suppliers Total Costs = Suppliers Cost + Suppliers “Hidden” Soft and Hard Costs + Costs Associated with Supplier’s Risk

Purchase Price = Suppliers Total Costs + Suppliers Profit

Buyers Total Costs = Purchase Price + Buyers “Hidden” Soft and Hard Costs + Costs Associated with Buyers Risk (think should be plus or minus +/-)

The TCO concept can best be described through a simple example of buying a car. Each person considers different criteria important when purchasing a car. Intuitively, once the specifications are chosen, such as a four-door family sedan with automatic transmission, air conditioning, and a certain size engine, then one could assume the choice is made based on a unit-price comparison of the options that meet those criteria. However, the costs of owning a car do not end with the initial purchase. The operating costs such as fuel consumption, average cost to repair or service, financing, insurance, depreciation rates, and numerous other costs live well beyond the acquisition of the car. With this data, one might find that the car that initially appears to be expensive will actually provide the *lowest total cost*, and is therefore is a “better deal.”

Practical approaches for applying TCO for comparing cars is getting traction. There are even free TCO calculators available on the Internet to help people determine the costs of owning different types of cars; it includes such costs as depreciation, interest on the loan, taxes and fees, insurance premiums, fuel costs, maintenance, and repairs.⁶ Edmunds, a website for car buyers, has created their own TCO acronym, “true costs to own,” which allows customers to calculate the differences between cars <<http://www.edmunds.com/car-buying/true-cost-to-own-tco.html>>.

While the conventional definition of TCO is exclusively concerned with the cost side of customer value, the real power is that TCO provides a foundation for making Best Value sourcing decisions. In *The Vested Outsourcing Manual*, published in 2010, TCO is defined as the foundation for making Best Value decisions. The advantage to

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using a TCO model is that by quantifying expected outcomes, you can make clear and informed decisions when it comes to price/value decisions.

But how do you determine the value side of the equation? Using a “Best Value” analysis can point you to the answer.

Best Value

The easiest way to explain the concept of “Best Value” is through a basic example, such as picking a restaurant for lunch. There are many reasons why someone might pick one restaurant over another. Some criteria might include proximity for reduced travel time, service levels, taste and variety of food, atmosphere, and price. These options likely are considered every time a decision is made on where to go for lunch. Depending on the situation, different restaurants will be chosen. What is a great choice for a business lunch with a client might not be the same choice an individual would make for a quick bite to eat in order to get back to the office to finish working on a report.

Determining Best Value for a product or service is no different—it is about picking the best option that fits the need. The options go well beyond costs. Researchers Jaconelli and Sheffield describe the intent of Best Value as enabling a balance between cost and quality considerations while ensuring ongoing value for money and promoting continuous improvement to further value for money.⁷

The United Kingdom government has been the most notable advocate in the area of shifting procurement decisions to adopt Best Value thinking. In 1997, it announced an initiative to abolish compulsive competitive tendering (CCT) and to introduce a Best Value approach. Between 1997 and 2003, adoption of the Best Value concept was voluntary in the United Kingdom. Scotland emerged as a notable leader in applying Best Value thinking.⁸ Scotland has been a leader in applying the concept of Best Value because of a unique political situation whereby the Scottish Parliament was separated from that of Great Britain only in 1999. Under the devolution, the Scottish Parliament established 32 local authorities that suddenly gained significant power and budget in procuring public services ranging from education, to street cleaning, to housing, to leisure and cultural services, to welfare services. The local authorities were eager to improve the services received for their money.⁹ Because of Scotland’s success using Best Value principles, its Parliament enshrined Best Value concepts into legislation under the Local Government in Scotland Act in 2003. The act sets out eight main criteria to define Best Value:¹⁰

- Commitment and leadership
- Competitiveness and trading
- Responsiveness and consultation

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- Sustainable development
- Sound governance and management of resources
- Equalities
- Review and option appraisal
- Accountability

It is interesting and instructive that the 2003 Act does not list a price component. Although the above list is a good one, Best Value criteria will vary for every product or service that is being purchased. As stated earlier, determining Best Value is about picking the best option that fits a particular need. Other common best value criteria include:

- Environmental Sustainability
- Diversity Program Excellence
- Social Responsibility
- Business Interface Efficiency
- Market Penetration
- Brand Image
- Speed to Market
- Market Dominant Supply Chain
- Competitive Market Advantage
- Technological Advancement
- Innovation
- Cultural Competence
- Growth Capability
- Counter Trade Optimization
- Cash Management

Calculating Best Value

Best Value can really be thought of as an equation that balances the decision criteria when choosing from alternatives. The simple calculation below provides a high level visual representation of how to calculate Best Value.

$$\begin{aligned} &\mathbf{Best\ Value = Optimum\ Benefit} \\ &\mathbf{(sum\ of\ criteria\ as\ defined\ by\ the\ buyer)} \\ &\mathbf{- Buyers\ Total\ Costs} \end{aligned}$$

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A good example of a Best Value calculation comes from the Minnesota Department of Transportation (MnDOT) when they were selecting a contractor for rebuilding the I35 collapsed bridge.¹¹ To assure transparency and objectivity to the selection process, MnDOT was required by law to list selection criteria for every stage of the process and the evaluation weight of each criterion. The 2001 law was designed to reduce concerns about excessive discretion and after-the-fact justifications for awards.

MnDOT carefully outlined the performance criteria for selecting a contractor by clearly documenting the formal evaluation criteria and evaluation process. The contractor whose proposal scored the highest according to the weighted criteria earned the award.

The RFP listed MnDOT's six primary Desired Outcomes the potential bidders needed to solve.

1) Safety

- a) Provide a safe project area for workers, the traveling public, community, environment and emergency services during the execution of the Project.
- b) Provide a solution consistent with Mn/DOT design and construction standards.
- c) Provide a solution adaptable to the recovery efforts of the collapsed bridge

2) Quality

- a) Implement a quality management system that ensures the requirements of the Project will be met or exceeded and ensure public confidence.
- b) Reduce future maintenance costs by providing a high quality project.

3) Schedule

- a) Complete construction by December of 2008.

4) Environmental Compliance

- a) Provide a quality product with minimal impacts to the environment while using context sensitive solutions.

5) Budget

- a) Implement innovative solutions to maximize the return on taxpayer investment by reducing costs and improving quality of the transportation system.

6) Aesthetics

- a) Utilize visual quality techniques and context sensitive design to incorporate the bridge into the surrounding environment.

MnDOT ultimately created a "Best Value Formula" that would become the litmus test for selecting the winning bidder, with the contract award going to the bidder with the **lowest adjusted bid** representing the Best Value for MnDOT– not the lowest price. The formula comprised of a technical score, the number of days to complete the project, and the contract bid price.

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MnDOT BEST VALUE FORMULA

Three Components

- “A” = Contract Bid Price
- Plus “B” = Number of Days to Complete Project, which is multiplied by \$200,000 per day - \$200,000 per day based on 50% of road user costs
- Divided by Technical Proposal Average Score

Result: Adjusted Bid = **(A) + (B X \$200,000) divided by TPA**

CONTRACT AWARDED TO LOWEST ADJUSTED BID

While budget and schedule were easy to measure and can be taken straight from the supplier’s proposals, the more technical components (safety, quality, aesthetics, and environmental compliance) were more subjective in nature. As such, MnDOT created a Technical Review Committee to score the technical components. The Proposal Evaluation Plan summarized the five assessment levels:

Excellent (91-100%)

The Proposal demonstrates an approach with unique or innovative methods of approaching the proposed work. The Proposal is considered to significantly exceed stated requirements/objectives in a beneficial way (providing advantages, benefits, or added value to the project) and provides a consistently outstanding level of quality.

Very Good (76-90%)

The Proposal demonstrates an approach offering unique or innovative methods of approaching the proposed work. The Proposal exceeds the stated requirements.

Good (61-75%)

The Proposal demonstrates an approach that is considered to adequately meet the RFP requirements/objectives and offers an acceptable level of quality.

Fair (50-60%)

The Proposal demonstrates an approach that marginally meets the RFP requirements/objectives.

Fails (0-49%)

The Proposal is considered to Not Meet the RFP requirements or is Non-responsive.

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Each Technical Review Committee member (six in total) assigned a percentage based on the Qualitative Assessment Rankings shown above. Then, the committee multiplied the percentages by the maximum number of points in each category. The product became the final Technical Proposal Score value.

Comparison of Proposals

Proposer	Technical Proposal Score	Days	Price	Adjusted Score
Ames Lunda	55.98	392	\$ 178,489,561	4,588,953.50
McCrossan	65.91	367	\$ 176,938,000	3,798,179.34
Walsh	67.88	437	\$ 219,000,000	4,513,847.97
Flatiron-Manson	91.47	437	\$ 233,763,000	3,511,129.37

The lesson learned from the MnDOT example is important. Clearly identifying value-based criteria (e.g. time, safety) helps the parties develop deeper discussions regarding value instead of just price. In the end, Flatiron-Manson best met MnDOT's criteria and won the competitive bid process in spite of having the highest price.

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Boundary Spanning Transparency: The Foundation for TCO

To be successful, procurement professionals need to look at and weigh what is the best net value for the whole organization. Unfortunately, sometimes outdated thoughts such as “that’s not what I am measured on” or “that’s someone else problem” creep up. It is imperative that management insist on and consistently reaffirm that shareholders care about the best net long term decision and not on one function saving a little and it costing another function a lot more. For this reason, procurement professionals should seek a transparent and boundary spanning approach when performing TCO analysis and Best Value assessments.

Boundary Spanning Baseline Cost Model

The only way to get to the real total costs is to document total costs from an end-to-end perspective—capturing the costs from *both* the buyer and supplier. This includes all cross-departmental costs within the buyer’s organization as well. The earlier example of the procurement group who moved to a Chinese supplier is a good example of how costs “popped up” in other areas – such as travel – that were not obvious to the procurement team when they first did their price comparison.

A cost model is a key component to any strong sourcing process and helps buyers identify the areas where there is room for improvement. It also helps establish the groundwork for a good pricing model, since each has different variables that might influence the outcome. If conducted effectively, a cost model analysis will result in recommendations that can be built into action plans designed to take costs out of the supply chain. Cost modeling can also be used as a tool for creating performance measures in contracts and can help monitor the effectiveness of contract incentives.

Many consulting firms have “Cost Modeling Toolkits”. A Denali Group Paper provides a logical way for companies to think about cost modeling.¹²

What it is: A tool to be used to:

- identify largest areas of opportunity
- set baselines for negotiations
- analyze whether process improvements and decisions are being pursued from a logical/objective cost savings or an emotional basis
- help people think about "Total Cost"

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What it is not:

- the only item to consider when choosing a supplier
- ever-changing—it is static in nature, therefore must be updated periodically
- an answer to everyone's question
- a method to judge performance
- a "Product"

Components of a Cost Model

A baseline TCO analysis includes the costs under the current scenario as well as what is projected based on the set assumptions. As mentioned previously, the preferred approach is always transparency, where the total costs to own a product or use a service over time is factored into the price. Some of the most common items to include in a TCO analysis include:

- Design and development costs
- Hard costs (e.g., labor and assets)
- Operating costs (e.g., energy and maintenance costs)
- Soft costs (e.g., overhead, "corporate allocations", training)
- Installation and Commissioning costs
- Governance costs (e.g., cost to manage the relationship)
- Software costs
- Supply chain support costs
- Retirement, disposal costs or residual value
- Opportunity costs, including reduced downtime, increased production yield, or sales value or increased sales or margin for developing a better product
- Transaction costs, including cost of switching suppliers and costs associated with a competitive bid and contracting process
- Environmental or sustainability costs or savings

While the list above provides guidelines, the physical act of identifying true total costs is not entirely straightforward and often not easy. Borrowing from a tried-but-true concept, this "Priceberg" graphic depicts the "below the surface" costs, which ironically are estimated to contain roughly 80% of total costs. The Priceberg illustrates the importance of looking at the hidden costs. Understanding only the price (above the waterline) is analogous to seeing only the tip of the iceberg. Often what is out of sight



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can and will cause the greatest damage. For example, many companies do not consider disposal costs, which can often be significant. Numerous studies confirm initial purchase price can often be the smallest component of a company's costs. For example, in industrial equipment (such as pumps, fans, or gearboxes) an Accenture Consulting report shows purchase price represents only 12 percent of its total cost.¹³

Developing a cost model is not an exact science; nor is it rocket science. Fortunately, many consulting firms such as the Denali Group offer Cost Model Toolkits as free resource to help their clients develop appropriate cost models.

While cost models are the foundation for TCO, leading authorities of TCO are further pushing the boundaries of what should be included in a TCO analysis, arguing that cost of risk should be also be considered. Over the course of the last decade, supply chains have grown increasingly vulnerable to supply chain disruption.¹⁴ The costs associated with these risks – if realized – are real and should be factored into any TCO decision. Examples of risk include natural events (blizzards, earthquakes, floods, hurricanes, tornados, tsunamis, wildfires), external manmade events (labor strikes, riots, terrorist attacks, trade embargoes, and wars), and internal man-made events (industrial accidents, business failures, product recalls, machine breakdowns).¹⁵

To illustrate the cost of risk, consider Mattel, who was fined \$2.3 million for importing toys from Chinese suppliers that violated lead paint safety standards. In addition to the fine, Mattel has the hard cost associated with the recall of approximately 20 millions toys¹⁶ as well as the soft cost of consumer reaction.

A good approach for determining the impact of risk on the potential costs is do a risk assessment and sensitivity analysis. Companies can develop a model to determine the impact of various assumptions and risk factors. When developing a sensitivity analysis, companies should rank the probabilities of specific outcomes. Some companies even invest in risk simulation software using the Monte Carlo method to help boost awareness of the various risk probabilities and their impact. Monte Carlo simulation methods were originally used for space exploration, but are now more routinely used by regular businesses to help predict the probability and impact of risk events.¹⁷ Once companies understand risk probabilities, they can create approaches in their pricing model that help offset the risk in the smartest manner. Offset approaches could include insurance, training, and detailed protocols.

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Transparency as an Enabler

The best way to capture the true boundary spanning TCO components is with a high degree of transparency that exposes the hidden costs across all parties – both the functional silos within a company and the supplier. While it might be hard to capture internal costs, it will be impossible to capture costs without transparency with a supplier.

A transparent approach to sharing company and supplier costs often starts with what is called an “open-book approach.” Using an open-book approach with suppliers allows both parties to build a fact-based discussion around actual costs. By understanding true costs, the companies can shift their focus from sitting across the table negotiating price to probing on how both parties can work collaboratively to eliminate non-value added activities, duplicative efforts and risk that drive up costs.

Buyers and supplier often have differing viewpoints about transparently sharing costs and profit data. Unfortunately, both can have a tendency to avoid transparency. Concerns and criticisms about openly sharing costs, profits and other key data are real. For this reason we encourage buyers and suppliers to openly address concerns about transparency early on in their discussions.

Suppliers can feel especially exposed when they share costs. If a supplier reveals their true costs, it is easy for the buyer to determine the supplier’s profit—which makes many suppliers uncomfortable. A major fear is that the company will use the information to attack the supplier’s margins, which in turn reduces their profitability. Buyers that do choose to attack a supplier’s margins often find suppliers are good at hiding the real costs, which results in a virtual shell game as the supplier shifts costs around in an effort to maintain their target margins. Smart buyers will work collaboratively with their suppliers drive efficiencies and reducing non-value added work rather that focus on margin reduction as a quick win for a price concession.

If suppliers are hesitant to transparently share their costs, we encourage procurement professionals to stress their TCO analysis will only be one part of helping them make informed decisions and that the lowest cost is not the only factor being considered. In addition, we recommend procurement professionals go out of their way to make suppliers comfortable that they will use the TCO analysis to focus on “cost reductions” and not “margin reductions” in order to make suppliers comfortable and more willing to transparently share cost data.

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Another criticism about transparency involves the buying company. Often when it comes time to share, the buying company will look at transparency as a one-way street—the supplier is supposed to share information, but the buying company is exempt. This situation occurs often, but there are three ways to address it.

First, we recommend starting with why is always a good rule of thumb.¹⁸ A comprehensive explanation of why certain information is needed helps allay company concerns. For example, in one case, a third-party logistics supplier asked its client about the three-year outlook estimate—was it going to stay the same, grow, or decline? Once the company realized that the supplier needed this information to estimate the maximum size of the building it would need to secure for the duration of the contract, it felt more at ease.

A second way to ease these concerns is to have a clear understanding of the business at hand, and mutual agreement on a Statement of Intent that explicitly states margin targets and what the company will do with the TCO assessment. For example, a Statement of Intent might indicate that the goal of transparency is to allow the buyer to identify costs drivers and develop improvement initiatives that can help reduce costs. As another example, a major retailer and supplier might work on packaging that to decrease shipping costs. With a proper job of setting margin targets early in the discussions, transparently sharing costs - and margins - is easier and more comfortable. Example: Toilet manufacturer had increased shipping costs and damaged packaging as a result of trying to save packaging costs. The reality was that by spending more on packaging enable better shipping with less damage.

A third approach companies find helpful is to jointly create an end end to end process map between the two parties. Using this approach enables the parties to discuss and allocate cost to the various buckets of activities as a way to highlight where value is added (or where there is duplication of effort). A good example is a facilities management service provider putting a resource in place as a interface to facilitate communication and handoffs of new initiatives. This person does not directly managing facilities as part of direct costs, but still plays an important role.

Choosing a path of transparency will enable a much higher shared understanding of the true TCO. Although transparency is strongly favored in establishing accurate total costs, it may not be feasible for some companies. Therefore, the only way to get close to a true TCO is for both buyers and suppliers to share as much information as possible. Over time, companies get more trusting, and they can revisit and refine the pricing model as they learn more.

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How to “Buy” Best Value

Once a company has developed their cost model, they should turn their procurement focus to making their supplier selection based on best value. Unfortunately, many companies do not use Best Value principles for procuring their goods and services. For those that are applying Best Value principles, a common trap is focus solely on reducing costs and risk. A good best value analysis will also focus on increasing the top line. Best Value should be about quantifying the total value created; including viewing how suppliers can help the buyer increase revenues, reduce risk, reduce working capital or fixed capital investment, or any other value adding activity that positively impacts the company’s profitability. For this reason we advocate buyers and suppliers adopt a “pricing model” philosophy instead of a “price” philosophy.

Adopt a “Pricing Model” instead of “Price Mentality”

The trick to “buying” using a value-based principle comes from determining what is “fair” compensation for the supplier. So just how do you establish what is fair? The customary way is to use a competitive process, get bids from suppliers, and compare the various “prices” from suppliers. This works well for commodities where there is a great deal of competition, products and services are relatively standardized, and the environment is more static than dynamic in nature. But what happens when there is little competition or the environment is in flux, which can pose risks for either the buyer or supplier based on changing market conditions? In these cases we advocate the use of a “pricing model” instead of a “price.”

It is important to first understand the difference between a “price” and a “pricing model”. A price is something you pay for each transaction. The price for your Starbucks grande two pump vanilla latte is \$3.25. Call center suppliers may have a price of \$.35 a minute every time an agent picks up the phone and acts as a company’s customer service representative.

A pricing model is fundamentally different than a “price” because it is a mechanism that companies use to determine the optimum commercial agreement between the company and the supplier. In some cases a pricing model consists of nothing more than costs, volume targets, and incentives based on helping a company achieve value - such as market share, total costs savings, or customer satisfaction levels.

Most pricing models are expressed in a simple spreadsheet; however, some are more like a small, customized software package or macro-based Excel spreadsheet.¹⁹ The term model is used because a good pricing model enables the parties to manipulate the underlying assumptions. This allows the parties to “model” the outputs relative to the

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input components to determine a fair way to pay for goods and services. In a dynamic environment, a good pricing model creates a commercial pricing structure that equitably allocates risks and rewards with the purpose of realizing mutual gains for the duration of the agreement.

But how exactly do you establish a pricing model to foster a win-win relationship? Unfortunately, there is no one-size-fits-all approach. There is no generic template or standard spreadsheet to help you get the correct pricing “answer.” Establishing the right pricing and incentive mix can be complicated and technical. Yet you do not have to be an accountant, a consultant, or a software engineer to recognize the benefits of a fair pricing models that rewards for value creation. The good news is that developing a pricing model is not a guessing game. Rather, it is a process that parties go through together with the goal to create value.

The best pricing models are based on transparent relationships that use a fact-based approach that start with a sound TCO foundation. Buyers and suppliers should develop a pricing model through a Best Value lens, striving to understand profitability levers that can add value for the buyer through increased revenue, reduced risk, improved working capital and capital investment productivity, or anything else that positively impacts a company’s profitability. Because value is based on the overall impact on a firm’s profitability, the companies should establish the appropriate mechanisms for triggering payments when value is received.

Some of the characteristics of a good pricing model include:

- Input assumptions that are changeable. This allows for dynamic business conditions and enables the buyer and supplier to track the real impact of value versus assumed impact.
- Proof points that are supported by references and technical reasoning.
- Ranges of expected outcomes. Ranges help focus the discussion based on reference points. In some cases where risk is high or in extremely large deals, companies do sensitivity analysis or even Monte Carlo simulations to clearly show the potential impact.
- Clearly understandable calculations. The logic and calculations should be obvious.
- Use of benchmarking data when possible to help set reasonable targets for potential benefits.

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Using a Business Case to Quantify Value Received

As mentioned earlier, it is not how much you pay but how much you get. Doing a business case to quantify expected value can help companies make proper purchasing decisions. It can help a company answer a question such as “Should we focus on reducing the price of an asset by 10%, when it is only 12% of its TCO or on buying a better asset that has a 2% lower operating and disposal costs, that covers 88% of its TCO?”

Companies that use a Best Value approach look at the world through a different lens. In many respects, establishing a fair price based on value speaks directly to the bottom line of both the buyer and the supplier. The very best relationships start with both parties sitting on the same side of the table holding transparent, fact-based discussions about the business and desired outcomes. Each party must truly understand the goals and financial drivers of the relationship. Without the backing of data, financial models, and in some cases guarantees of minimum value created, procurement professionals often have no choice but to pay a supplier based on price.

For this reason, it is imperative that both the buyer and supplier jointly understand (and jointly develop if at all possible) a mechanism to quantify value received. One of the most powerful approaches is for the buyer and supplier to create a business case to determine the impact of the baseline on profitability for both the buyer and the supplier.

But why look at the profitability of *both* the buyer and supplier? Because often an improvement in the value for a buyer can mean the supplier’s profitability suffers. And when that happens, suppliers are apt to shun value creation opportunities for their clients if they face a “win-lose” situation. In other cases, buyers are not comfortable looking beyond price in the hopes of future benefit promised by the supplier.

To demonstrate, let’s consider an example where a supplier embedded lucrative consulting services along with their equipment installation to help the buyer achieve optimum usage of the equipment. The buyer was leery of the effectiveness of the training and consulting services, feeling the supplier was overpromising the potential value of their consulting service. How could the buyer be certain that the consulting effort be effective at helping them increase their throughput? The buyer responded by doing a TCO analysis to understand the cost of the equipment and the consulting services separately and eventually persuaded the supplier to unbundle the consulting services and lower their price.

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In the buyer's traditional cost-focused TCO analysis, the buyer properly sought to unbundle the supplier's costs. However, the buyer reacted to the supplier's high margins of the consulting service and did not take into account the profitability that could be generated with more effective operations. The buyer declined the consulting services to reduce the immediate price. The result? The production manager complained about poor efficiencies. Later the supplier was engaged for their consulting services and was able to help the buyer increase his throughput, yielding an increase in net profit of over \$18 million annually. The consulting services could have easily been justified if the buyer had expanded their view to look beyond the cost side of their TCO analysis and include revenue enhancement opportunities.

The challenge is to both buyers and suppliers can demonstrate how the performance of products or services will reduce costs and/or increase revenue. Without proper justification, the term "lowest price" becomes the discussion point. The best way to demonstrate value is through a business case using the TCO data as a foundation.

One question that often arises is who should develop the business case – the buyer or the supplier? There are two schools of thought when it comes to comparing business cases. The first approach involves each company creating separate profit and loss (P&L) and balance sheets for the business in scope and then sharing them. This approach is fairly simple because typically each party already has created a business unit or a customer P&L based on a standard set of assumptions. Using this approach, the supplier's "revenue" in essence becomes one of the company's "cost" items. The goal is to identify as many "levers" as possible so both companies can best understand the impact of potential cost savings or revenue enhancing ideas/projects.

The second approach is to create a pro forma or a "mock P&L" similar to what companies commonly do in a merger and acquisition scenario. Such a P&L statement represents what the financials of the business would look like if the companies operated under an investment-based business model and shared one P&L and balance sheet. This approach helps the parties look at the scope of the service delivery through a new lens, a unified perspective that helps them focus on improving the bottom line of the business and not just each one's company.

Regardless of the approach, companies need to start by developing baseline TCO analysis and developing a business case to establish the profit projections for *both* companies. Only when this is done can the companies ensure the parties are establishing a fair commercial agreement for each party. The main goal of the business case is to calculate the incremental "value surplus" that the buyer hopes to receive and then work backward to establish a fair compensation for the supplier.

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For example, if a supplier's offering helps an OEM create a machine that lasts longer, uses less energy, and is less expensive to repair, the parties would need to calculate how much value surplus was created. A key part of the business case is to run numerous simulations, based on best available data, industry benchmarks, and assumptions on improvements to identify the potential of "value surplus."

Simulations allow the parties to establish a range of the potential value surplus. For example, the buyer and supplier might agree to pay the supplier an incentive payment for any value surplus created above the established baseline. The supplier might earn a 10% incentive payment if their products perform to X levels and 20% incentive payment if their product performs to Y level.

Often a value surplus is based on the assuredness of the quantified value and time frame the value is realized. If the value is immediately recognizable and very hard in measurement terms, the buyer and supplier might agree for the supplier to keep a higher proportion of this value created. However, if the payback is longer-term, the hardness of the value less visible, and the certainty less, the supplier might retain less of the value surplus.

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An Overview of Value-Based Pricing Models

Procurement professionals might be “penny wise and pound foolish” when it comes to buying, but suppliers are only helping to confuse the matter. Marco Bertini and John Gourville’s June 2012 article in Harvard Business Review titled “Pricing to Create Shared Value” is a plea for action, challenging companies to rethink how they price for their services.²⁰

The way most companies make money is not just broken; it is destructive.

*Harvard Business Review,
June 2012*

Traditionally, the best suppliers demand a price “premium” for their product or service as a way to justify what they perceive is a higher value offering. In other cases, they charge very high consulting fees to justify the “brainpower” in value-added services – regardless of whether the solution provided creates the desired results.

Many buyers and suppliers are easily frustrated when it comes time to negotiate a fair price for value. In fact, it is almost paradoxical – on one hand the parties are discussing value, while on the other hand they are bickering about what is fair with conventional tug of war negotiation tactics. Value-based pricing concepts have emerged that provide alternatives for establishing a fair risk/reward ratio. Value-based pricing models shift the accountability to the supplier to “prove” the value surplus and requires buyers to reward the supplier when value is received. Simply put, they take the guessing game out of quantifying “value” until value is received.

Many different and creative approaches are emerging to help buyers and suppliers establish ways to pay for value received. One of the simplest forms is to compensate suppliers for value through incentive payments. The most common approach is known as “gainsharing,” whereby a supplier receives a portion of any costs savings that is realized. This in essence becomes a price premium for a supplier. Gainsharing is good when cost reductions are a focus, but different approaches are needed when suppliers help buyers achieve value beyond costs. More progressive value-based commercial models have emerged where payment to the supplier is tied directly to the supplier’s ability to achieve outcomes. Two of the more notable approaches are performance-based and Vested Outsourcing agreements. Each is discussed below.

Performance-Based Agreements

The relationship with suppliers under a performance-based agreement is different than with transactional providers. Typically performance-based agreements begin to shift the thinking away from activities to outcomes; however they often still pay a supplier using transaction-based pricing triggers. Performance-based agreements are also called “pay

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for performance” because they often have an incentive tied to achievement of a pre-determined performance target. Two examples include:

- Industrious Company buys bearings for their heavy equipment. Bearings Company agrees to sell their high performance bearings to Industrious Company for a price similar to a competitor’s lower performing product, but has incentive payments based on how well the product performs as defined by machine downtime reductions. Industrious Company agrees to pay Bearings Company an incentive payment at a pre-defined ratio if the product beats reliability targets. Simply put, the longer Bearings Company’s products last, the higher the incentive.
- Softco sells specialty software to the construction industry. They outsource their call center and sales support to Telco who answers the phones, takes the order and answers basic technical support questions. Softco pay the customary cost per transaction fee of a price per minute – but wants to make sure Telco is responsive to their customer’s needs. Telco agrees to penalties for key service level metrics such as answering 80% of the calls within 20 seconds. They also receive an incentive when their representatives upsell customers to upgrade their software.

Vested Outsourcing Agreements

Vested Outsourcing is a highly collaborative business model where both the buyer and supplier have an economic vested interest in each other’s success. Under a Vested agreement, buyers and suppliers enter into highly collaborative arrangements designed to create value for all parties involved above and beyond conventional buy-sell economics of a transaction-based agreement.

The Vested Outsourcing business model is best used when a company has transformational or innovation objectives referred to as Desired Outcomes. A Desired Outcome is a measurable business objective that focuses on what will be accomplished as a result of the work performed. A Desired Outcome is not a task-oriented service-level agreement (SLA) that often is mentioned in a conventional statement of work or performance-based agreements; rather it is a mutually agreed upon, objective, and measurable deliverable for which the supplier will be rewarded—even if some of the accountability is shared with the company that is

Collaboration: A Real Win-Win

A 2007 study sponsored by the International Association for Contract and Commercial Management and the Strategic Account Management Association found buying companies realized 40% more value from their most collaborative suppliers than their least collaborative suppliers. The same report also found suppliers reported an average 49% more value to their most collaborative key customers.

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outsourcing. A Desired Outcome can focus on cost, schedule, market share, revenue, customer service levels, or performance.

A good Vested pricing model rewards the supplier for delivering Desired Outcomes in the form of solutions rather than simply paying a supplier on a transaction-based approach for performing activities or supplying goods. The better the supplier is at achieving the companies Desired Outcomes, the more profits the supplier makes. This encourages suppliers to institute innovative and cost-effective methods of performing work to drive down total cost and/or drive up revenue while maintaining or improving service. Properly structured, a Vested pricing model creates an economic exchange where the more successful the customer, the more successful the supplier. Likewise, a supplier that is not effective would be paid well below market rates.

A good example of a Vested agreement is Jaguar and Unipart. Unipart was inherently incentivized under their 10-year agreement to make heavy investments that would increase dealer support and ultimately improve customer loyalty for service parts management effectiveness and efficiency. Under the agreement, Unipart helped Jaguar move from number 9 in JD Powers customer loyalty to number 1. Together the companies were able to reduce the number of cars waiting on warranty parts by 98%, while reducing inventory by 35%.²¹

Because Vested relationships are often longer term in nature and require investment from the supplier, it is important the buyer and supplier devise a pricing model that both incentivizes the supplier for the effectiveness of their innovation as well as prevents the supplier from becoming complacent under their longer-term relationship. Vested pricing models typically follow Abraham Maslow's theory of motivation when balancing risk and rewards. Maslow's Hierarchy states that it is vital to meet certain lower needs before higher needs can be addressed. As such, a Vested pricing model usually uses low margins for the base services coupled with incentives that enable suppliers to earn very high margins when they create value by achieving their customers' Desired Outcomes and solving their business problems.

A general rule of thumb is that "low" means below market margins if the work would be bid – often as low as 50% of market margin. For example, if the work was bid out and the "market" margin was 10%, a Vested deal might have a 5% margin for the base services. Using the 10% as "market," the rule of thumb we see in a Vested pricing model allows the supplier to earn 2-3 times the market margin – or up to 20-30% profit margins – if they are successful in bringing transformation and innovation to their customer.²²

Regardless of what approach is used to compensate a supplier, it is important that buyers understand that suppliers should earn a fair return for their investment.

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Conclusion

The 21st century demands a sober second thought that challenges the traditional competitive bidding process for establishing a “fair price”. But shifting from a competitive bid process focused purely on price leaves many buyers skeptical, leaving buyers asking, “How can I be assured that I am not overpaying?”

As companies seek (and demand!) more value from their suppliers, they must realize that suppliers must be compensated with a fair return on their investment, ideas, and innovations that are at the heart of creating value. Companies are encouraged to take to heart the following lessons from this white paper:

- Adopt a transparent approach to identifying the true TCO and jointly developing business cases that identifies value surplus opportunities
- Expand the lens with which you calculate value to include a “System” wide approach, including developing business cases that look at the profitability factors for both the buyer and the supplier
- Consider moving away from “prices” and opt for developing “pricing models” that reward suppliers when value is received.
- Learn about and test alternative commercial agreements such as Performance-Based or Vested Outsourcing that shift accountability for delivering value to the supplier, yet seek to reward them fairly for their risk.

The bottom line is that those who find themselves using last centuries approaches will find themselves in a race to the bottom, bickering over low price rather than seeking ways to establish sustainable supplier relationships that more fairly create value for both buyers and suppliers.

Still not convinced? Consider the following two studies.

The first, a 2010 study by the Monitor Pricing Group found that companies that take a value pricing approach (creating, calculating, communicating and pricing based on value created) had a 36% higher net operating margin than companies in the same industry that took a share or cost driven strategy. The second, a report by the Manufacturers Alliance (MAPI), found that companies that had a defined methodology to buy on Total Cost of Ownership (a measurement of best value) had a 35% higher net operating margin than ones that did not, and companies with a TCO methodology are twice as likely to enter into pay-for-performance agreements with suppliers, nearly twice as likely to realize 90% or more of savings promised by a supplier, and more than seven times as likely to receive supplier offers with a TCO component.

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ENDNOTES

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