Comparing the why, what and how of performance-based and Vested outsourcing models in CRE

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Abstract

The concepts of Vested outsourcing® (as developed by University of Tennessee [UT] researchers) and performance-based contracting have significantly gained in popularity as more and more corporate real estate (CRE) organisations look to increase the value of their outsourcing relationships. This paper builds on 'Choosing the right sourcing model for CRE outsourcing agreements' which was featured in Corporate Real Estate Journal (CREJ) Vol. 7, No. 3 by providing a comparison of performance-based and Vested models. Both models share many of the same principles such as focus on the supplier's expertise and considering value above 'price'. However, performance-based contracts and vested are distinctly different in their focus, application, methodology and resulting relationships. This paper explores the similarities and major differences between these two proven approaches. It also provides guidance relative to when to use each model.

Keywords: sourcing, sourcing business models, real estate, facilities management (FM), outsourcing, Vested outsourcing, performance-based, outcome-based

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INTRODUCTION

In *CREJ* 7.3 the authors shared how to apply sourcing business model theory to sourcing and contracting for CRE services. As an organisation's need becomes more complex, riskier and/or requires higher levels of continuous improvement or innovation, sourcing business model theory suggests an organisation should consider shifting to a performance-based or vested model as the foundation for their outsourcing relationship.

While this paper will go into detail comparing and contrasting the performance-based and vested models, to provide context, we start with a short and simple primer describing the essence of each model.

A performance-based model seeks to consciously create a formal, longer-term relationship with the intent that the supplier's compensation be linked directly to performance, and/or ability to deliver cost savings or other service improvements. These contracts are also called pay-for-performance (or 'painshare'/'gainshare') because incentives and/or penalties are often tied to specific service level agreements (SLAs) outlined in the contract. Buyers typically define the level of performance required and competitively bid the work to determine which suppliers can meet the buyers' needs at the best value. As we will address later, performance-based contracts can come in many different shapes and sizes.

Now let us look at the essence of a vested model. Vested is a hybrid business model that combines an outcome based economic model with a relational contracting model. Vested incorporates the Nobel Prize-winning concept of behavioural economics and the principle of shared value.[1] Using the concepts of behavioural economics and shared value,[2] organisations enter into a highly collaborative relational contract that formally anchors the relationship around a shared vision and mutually developed desired outcomes with the purpose to create business value for both parties. A well-structured vested agreement aligns the goals of the organisations such that a 'win' for the buyer is a 'win' for the supplier — and vice versa. In essence, the parties are vested in each other's success.

At the heart of both the performance-based and vested models is a desire to create a more strategic and longer-term outsourcing relationship between a client and a supplier, with a goal to tap into the supplier's expertise to drive efficiencies. While the models are similar in some respects — they are also very different. The purpose of this paper is to help CRE professionals and suppliers understand the why, what and how of each of the models.[3] To do this, we compare and contrast five essential dimensions of each model. These dimensions include:

(1) Underlying business model — including the vision and purpose for the outsourcing relationship and the type of economic model and relationship model;
(2) Scope of work — including how an organisation should think about and write the contractual aspects of the work-scope;
(3) Performance management — including the performance focus and differences in how performance metrics are determined and managed;
(4) Pricing — including the fundamental differences that separate a performance-based model from a vested model;
(5) Governance — including the philosophical as well as tactical approaches to managing the relationship, risk, innovation, exit management and compliance.

Figure 1 compares the two models and serves as an outline and reference point for the structure of this paper. Each dimension is explored in detail to provide insight into the why and how of a performance-based and Vested model, highlighting the similarities and differences of each.

We conclude the paper with some advice on when to use which model.

	Performance-based/managed services	Vested
Business model		
Economic model	Output-based	Outcome-based
Relationship model	Relational contract — collaborative	Relational contract — highly collaborative
Vision and intent	Performance to SLA — process efficiencies	Shared vision, desired outcomes and value creation
Scope of work		
Statement of work and objectives	'What' (narrowly defined as the suppliers responsibilities — as defined by the client)	'What' (broadly defined as the areas to be addressed as collaboratively agreed)
Performance management		
Performance focus	Output-based service level agreements	Strategic desired outcomes
Performance measures	Operational + relational (values and behaviours)	Operational + transformational + relational system-wide KPIs
Pricing		
Pricing model and incentives	Price or pricing model with incentives and/or penalties	Pricing model with value-based incentives
Governance		
Relationship management	Oversight emphasis: supplier relationship management	Insight emphasis: strategic relationship management
Improve, transform and innovate	Supplier driven to meet SLAs/price	Joint and proactive transformation management
Exit management	Performance-based termination for cause with safeguards	Joint exit management plan
Compliance and special concerns	Corporate-based audit requirements	Outcome-based joint requirements

Figure 1 Comparison of performance-based and Vested models[4]

BUSINESS MODEL

The first dimension we will use to compare a performance-based and a vested model is the underlying business model. Both share several similarities, but at their heart each are fundamentally different business models. Here we compare and contrast the models based on the overall vision and intent of the relationship, nuances in how each model uses the nature of the contract and risk management, and the differences in the economic model.

Box 1	Performance-based/managed services	Vested
Business model		
Economic model	Output-based	Outcome-based
Relationship model	Relational contract — collaborative	Relational contract — highly collaborative
Vision and intent	Performance to SLA — process efficiencies	Shared vision, desired outcomes and value creation

Vision and intent

Both a performance-based and a vested model seek to consciously create a formal, longer-term contract with the intent for the supplier to drive improvements to the business. Both models are good candidates when an organisation wants to shift to a more 'integrated' facilities management (FM) approach that bundles various services under one contract such as hard and soft repairs and maintenance, janitorial, project management, move-add-change, reception, office services, etc.

While both models seek to create more 'strategic' relationships designed to create value, the underlying philosophy on how each model achieves this value is very different.

Let us first review the vision and intent for a performance-based model. A buying organisation enters into a performance-based model with the intent to ensure consistent performance against predefined SLAs and to tap into the supplier's expertise to drive efficiencies to reduce costs or enhance service delivery. In practice — the buyer negotiates for specific service level expectations at an approved budget — most often the supplier places a portion of their management fees 'at risk' as a commitment that they will achieve the SLAs. The underlying premise is that the management fee is a price agreed to for a very specific level of service. If that level of service is not delivered, then the management fee is automatically adjusted by an agreed amount for a lower level of service. Some view this as a penalty to the supplier when they do not meet the SLAs.

While not unique to performance-based contracting, the buyer also often bundles multiple services and/or locations to enable the supplier to bring efficiencies and economies of scale which may reduce costs. Depending upon the pricing strategy, costs savings can be committed to via a negotiated savings 'glidepath'. As part of the service expectations, the supplier is typically required to provide value added services such as improved systems, reporting and ongoing innovation.

Suppliers receive value in a number of ways. A longer-term contract precludes the need to bid for the services annually and allows the supplier time to recover initial investments made to assume the account. Typically, the supplier is awarded a broader array of responsibilities within their scope, which enables them to be more integrated within their delivery team and with the client, increasing their efficiency. Most performance-based contracts also contain incentive provisions which compensate suppliers for creative ideas that generate measurable value to the client. These 'gain-share' provisions can be structured in many ways. Talented suppliers are willing to put their fees at risk to guarantee performance against predefined SLAs.

Now compare that to a Vested model. The primary purpose of a Vested model is to create a highly collaborative relationship that drives mutual benefit where both the buyer and supplier have aligned interests to co-create business benefits that are often boundary spanning in nature. The parties create a formal shared vision and mutually agree on often long-term and lofty business outcomes that go far beyond meeting operational performance targets and/or beating the budget.

The vested business model uses shared value principles to create a 'win-win' deal.

The parties collaboratively innovate to find the best solutions by working in an integrated and mutually beneficial manner; it is about partners in a business arrangement unlocking the most efficient and effective solutions with the goal to mutually share the rewards. It also means consciously making investments in the business — often with the purpose to drive transformational change or innovations.

Relationship model

Both a performance-based and Vested model (if properly structured) should shift to a relational contract vs a purely transactional contract.

The best way to understand a relational contract is to compare it to the dominating contract model — a *transactional* contract which is the primary contracting vehicle used in business-to-business relationships. Traditional contracts are formulated on two foundations — price and power. Simply put, buyers leverage their power and use market competition to ensure they get the best price by breaking down what is bought into 'apples-to-apples' comparisons. As such, transactional contracts pay a supplier for transactions — such as a price per hour, per activity, per unit or per call. However, as the nature of what we are exchanging (more intangible goods or services) and the environment in which we operate (more global, faster changing, less predictable and more regulated) grows more complex, transactional contracts are increasingly riskier because of the extent of the 'incompleteness' or uncertainty that cannot be fully captured in the contracts.[5]

A relational contract fundamentally starts with the intent to allow for the parties to easily contract for repeat business over a period of time using a master services agreement (MSA). Essentially, the parties enter into a 'relationship' over a period of time which involves a 'bundle' of various services in the scope with overarching pricing mechanisms that allow for easy invoicing and payment (rather than having to bid out or go through the sourcing and/or contracting process every time the buyer needs the service). However, a well written relational contract is much more than having a MSA that allows for easy repeat business; rather it means consciously choosing to cooperate to drive benefit to for the business.

A well-designed relational contract provides the means for sustaining long-term and complex contracts with a high degree of flexibility. This allows parties to express their detailed knowledge in specific situations and adapt to new environments and solve more complex problems versus simply performing an activity for a price.[6] As such, a properly structured relational contract will embody a spirit of collaboration as the parties seek to work together to improve the value derived from the relationship such as improved performance or lower costs.

A key differentiator between a performance-based contract and a Vested agreement is, first and foremost, the mindset of how an organisation approaches the relational aspects of the contract — including the philosophy for managing risk.

A performance-based agreement — while collaborative in nature — typically would not be 'all in' with a supplier. For example, the buyer wants a long-term relationship (3–5 years) but not a true partnership with an evergreen contract structure. As another example, it is not uncommon to have multiple performance-based contracts with suppliers responsible for specific geographies. You would typically not see that with a Vested relationship.

A Vested relationship fully embraces a relational contracting mindset — what UT researchers call a 'What's in it for We' (WIIFWe) mindset as part of the highly collaborative working relationship. Under Vested, buyers and suppliers change the lens through which they look at problems; they adopt a boundary-spanning view based on trust, alignment and collaboration, and work cross-organisationally to make improvements in complete solutions that achieve real business outcomes regardless of who performs an activity. An example of a boundary spanning outcome would be 'cleanliness that inspires confidence in our healthcare environment' vs a performance-based objective of 'achieve best-in-class facilities services at a market competitive cost'. The first encompasses responsibilities of both parties, while the second refers solely to provider responsibilities.

As mentioned previously, this starts by formally developing a shared vision. But it is also augmented by the parties formally documenting a 'statement of intent' that commits the parties to mutually agreed good behaviour — such as a formal commitment to known social norms: honesty, integrity, equity, reciprocity, autonomy and loyalty, as well as defining the desired behaviours the parties want to foster such as flexibility, courage, transparency and trust.[7] The shared vision and the statement of intent are formally included in the actual contract making the 'relational contracting' aspects much more 'real'.

Economic model

It is important to note that the longer-term focus of performance-based and Vested models increase the buyer and supplier's codependency on each other. This means there is an increased focus and awareness on risk associated with the 'interconnectivity' of the supplier into the buyer's organisation. While the interdependency creates risk, the way each model addresses the risk is very different.

A key difference — and one to not be overlooked — is the fact that a performance-based model uses an out*put*-based economic model while a Vested model uses an out*come*-based model. An output-based economic model links a supplier's payments to the supplier's ability to achieve predefined service expectations. It is essential to properly define the outputs or expectations, because these are, basically, the suppliers 'results' or contractual commitments to the buying organisation. If a supplier does not meet SLAs the supplier clearly bears the risks associated with underperforming. Let us use an example of measuring maintenance effectiveness. For example, if a supplier has committed to a specific response time or completion of all critical preventive maintenance work orders within a given timeframe, and the supplier consistently does not achieve these levels of performance, the client will downgrade their score appropriately and their management fees will be adjusted through the 'fee at risk'.

By contrast, a Vested model uses an outcome-based economic model with shared risk and shared reward. Sharing risk and reward tied to mutually defined and boundary spanning business outcomes ensures the buyer and supplier have aligned interests; you win together, and you lose together. Let us come back to the example of measuring maintenance effectiveness used above. The supplier's scope of work is similar to that for output-based metrics, in that the supplier is accountable for preventive maintenance (PM). However, this example is PM in a manufacturing environment, and the supplier is challenged to work cross-organisationally to look for ways the buyer can increase the effectiveness of the machines used in production. In one Vested agreement the supplier invested in analytical equipment, implemented inventory parts planning and worked with a regional parts distributor to put in a vendor-managed inventory programme for maintenance, repair and operations ([MRO) suppliers. These investments yielded a working capital reduction of 20 per cent on MRO supplies. The supplier also implemented a condition-monitoring programme that would prevent machine downtime by fixing problems before they happened. This programme reduced unplanned downtime by 7 per cent. Lastly, the supplier shifted some key bearings and lubricants from a cheaper solution to more expensive options; however, the added costs were well justified because the more expensive bearings and lubricants resulted in a 28 per cent improvement in the number of hours a machine could operate between PM actions. As a result, the buying company was able to improve manufacturing throughput, which positioned it to gain market share. Note, this works well in a manufacturing environment where the supplier is able to invest capital and significantly impact the process and therefore the total lifecycle cost. This may be somewhat more difficult to do in a typical facilities environment where the assets are leased, or the equipment is part of the structure and difficult to modify.

SCOPE OF WORK

Performance-based and Vested models are most similar when it comes to their approach to the scope of work. First, both encourage the buying organisation to consider bundling work-scope (eg an 'integrated' real estate services agreement). In the last ten to 15 years many organisations have chosen to bundle an array of services. As early as 1999, Microsoft chose to bundle an array of FM services within the Puget Sound Campus and across their US field portfolio under a single award.[8] In 2008, a global telecommunications firm bundled FM services nationally along with engineering services, transaction management and project management services across their entire portfolio. In the mid-2000's, State Street first awarded integrated FM services in their northeast portfolio. Over the next five to seven years they awarded FM in the US, then Europe and then Asia to the same provider. In time, transaction management and project management were also included within the same provider's scope.[9]

In addition, both models staunchly believe the supplier is the expert and the statement of work (SoW) should 'focus on the what, not the how'. With this in mind, both models advocate a less prescriptive SoW.

Remember, buyers use performance-based and Vested models when they want, need and value a supplier's expertise and ability to create value through efficiencies or even innovations. As such, a less prescriptive SoW is essential because it allows the supplier the flexibility to drive continuous improvement and innovation across the services provided.

Entering into a performance-based or Vested model sends a strong signal to the buyer's internal organisation: 'We hired the expert; we need to let them be the expert'. A foundational philosophy must exist in the buyer's organisation to allow the supplier control to make changes to existing processes. As such, a well-structured performance-based and Vested model both shift work-scope definition from 'who' and 'how' to the 'what' — often totally eliminating the 'how'. After all, you have hired the expert, right?

Sceptics believe that performance-based and vested agreements are risky. They are concerned they will lose control over compliance and regulatory matters. This is not true. A well-structured agreement includes governance protocols that ensure the appropriate business owners and/or quality leads retain a front-row seat on governance teams for any compliance and regulatory concerns.

While a performance-based and Vested agreement share the same underlying philosophy relative to documenting the scope of work, there are differences. Remember a performance-based agreement focuses on supplier controllable output while a Vested agreement focuses on boundary spanning business outcomes. For this reason, a Vested agreement approaches documenting the scope of work differently in the actual contract.

A performance-based SoW traditionally spells out the supplier's responsibilities. The Vested model shifts away from a SoW and instead uses what UT researchers refer to

Box 2	**Performance-based/managed services**	**Vested**
Scope of work		
Statement of work and objectives	'What' (narrowly defined as the suppliers responsibilities — as defined by the client)	'What' (broadly defined as the areas to be addressed as collaboratively agreed)

a 'taxonomy' and 'workload allocation' to document work which has a bi-lateral (vs one-way) focus. The taxonomy is basically a complete 'inventory' of all the work that needs to be done and the 'workload allocation' is often a table or an Excel spreadsheet that literally 'allocates' accountability for each aspect of the work. This is essential because a Vested relationship is working towards boundary spanning business outcomes and the buyer/client plays a key role in the end-to-end success. It is important to note that the rule of thumb when completing a workload allocation is the buyer and supplier should not both be accountable for a specific part of the work. This avoids duplication of effort and minimises the opportunity for the buyer to micromanage the supplier.

For organisations that fear a supplier will not have strong process controls without a detailed SoW that states the 'how', you can choose to include a performance-work statement (PWS). The difference is that the PWS is provided by the *supplier* not the buyer. Also, it is strongly encouraged that the PWS is not made a part of the actual contract, but instead is included as a separate document that can be modified as needed without requiring amendment to the MSA.

PERFORMANCE MANAGEMENT

Performance management is essential to both a performance-based and Vested model. While both models promote strong performance management, the focus of performance management and the performance measures themselves are different.

Performance focus

As discussed above, a performance-based model focuses on supplier controllable output-based SLAs while the Vested model focuses on strategic desired outcomes.

Output-based SLAs shift thinking from measuring a functional activity to measuring the results of a process that is controlled by the supplier. A good example of making the shift from measuring an activity is the US Air Force, which found that it reduced its costs by 50 per cent by specifying that floors must be clean, free of scuff marks and dirt, and have a uniformly glossy finish, rather than requiring that the contractor strip and rewax the floors weekly.[10]

It is important to note that buyers often have inputs (such as information, timely approvals, subcomponents, activities, etc.) to the supplier that are essential for success; thus, it is important to ensure that buyers measure the inputs for optimal success and that the supplier is only held accountable for what is within their control. It is important for buyers and suppliers to mutually define and agree on the operational scorecard and associated metrics under a performance-based model. Why? Because suppliers typically put their fees at risk or have penalties based on their ability to achieve success against the scorecard.

A well-structured Vested relationship focuses on delivering success against true business outcomes, not simply performance to a set of SLAs. For example, the original Procter & Gamble (P&G)–Jones Lang LaSalle (JLL) contract outlined these five desired outcomes:

Box 3	**Performance-based/managed services**	**Vested**
Performance management		
Performance focus	Output-based service level agreements	Strategic desired outcomes
Performance measures	Operational + relational (values and behaviours)	Operational + transformational + relational system-wide KPIs

(1) Provide services of equal or better quality at a lower cost;
(2) Enjoy world-class supplier support, dedicated account management;
(3) Build a global relationship to support P&G business objectives;
(4) Have a supplier that guarantees the availability of resources;
(5) Allow JLL to satisfy the facilities management needs of a world-class global corporation.

These outcomes were supported by ten outcome-level measures that included three critical success factors and seven operationally focused key performance indicators. In addition, P&G and JLL annually reviewed and defined business objectives which were measured as part of their governance structure. For example, when P&G acquired Gillette that year a smooth and efficient integration of the Gillette business was a key objective. It is essential that the buyer and the supplier mutually define and agree on desired outcomes and how they will be measured.[11]

Performance measures

A well-structured performance-based or Vested agreement should measure both operational *and* relational success. Consciously adding metrics to monitor the relationship health is important because the parties have become more codependent under a performance-based or Vested model.

Simple performance-based agreements tend to use customer satisfaction as one of the critical measurements. More complex relationships create more advanced mechanisms for measuring overall relationship health. In most cases, performance-based agreements measure satisfaction in the relationship on a one-way basis — that is, 'how satisfied is the buyer with the supplier'. A Vested agreement almost always uses a bilateral relationship monitoring process. For example, one company uses a neutral third-party compatibility and trust assessment to monitor the overall health and trust levels for the Vested agreement.[12]

A key difference between a performance-based and Vested agreement is how they measure strategic impact. A performance-based agreement will likely include one or more strategic key performance indicators (KPIs) that assess the level of innovation or strategic impact the supplier brings to the table annually. By contrast, a Vested agreement measures the transformational success of the partnership; because transformation to achieve the mutually defined desired outcomes is fundamental for the success of a Vested relationship. In the case of the P&G–JLL contract, the parties use what they call 'discretionary governance measures' which are reviewed annually based on P&G's business priorities. For example, today, environmental and sustainability goals are a key priority for the relationship. P&G and JLL won an International Association for Outsourcing Professionals GEO award for innovation in outsourcing for how they manage their innovation pipeline.[13]

PRICING MODEL

A key dimension of any relationship is the pricing mechanism. Let us now compare the similarities and differences between a performance-based model and Vested model relative to pricing strategies.

Box 4	**Performance-based/managed services**	**Vested**
Pricing		
Pricing model and incentives	Price or pricing model with incentives and/or penalties	Pricing model with value-based incentives

A well-structured performance-based pricing model utilises an array of pricing mechanisms appropriately aligned to the various services. Whether you choose to use a cost reimbursement model with some form of fixed fee for profit and overhead or a true guaranteed maximum price (GMP), it is imperative that the controls in place align appropriately with your chosen model. Most importantly, you should use a 'pricing model' vs a 'price' to enable appropriate sharing of risk for variables not within either party's control.

A common technique in performance-based contracts is to place a percentage of a supplier's management fee at risk based upon their ability to perform to the defined service expectations. Keep in mind, the supplier achieves 100 per cent of the full market margin when they perform to 100 per cent of the service expectations. (This does not mean they are perfect, it means they perform to target.) If they underperform, they receive less than the full market price.

Well-structured performance-based contracts also include incentive payments. These incentives are earned for adding value above and beyond the defined expectations. These value-adds may be cost-savings, which often result in 'gainshare' payments. They could also be earned contributing to the client's ability to achieve strategic objectives, performing beyond expectations in extraordinary circumstances or bringing creative solutions to the table. The volume, value and structure of these incentives vary widely. Unfortunately, too many performance-based deals also include penalties and limit a supplier's upside incentive to gainshare of cost savings.

There are key factors to consider when making the decision to use a GMP vs a cost reimbursement method. For some, the inability to hold the supplier to a guaranteed budget is sub-optimal. For others, it is preferred. Determination of acceptable margins and risk/reward splits are typically identified through some form of market bid or negotiation. It is also imperative that the model chosen aligns with a client's need for reporting and transparency. The level of transparency varies based upon client and supplier willingness or desire to share pricing components. Full visibility, and the ability to quickly modify the deal to accommodate change does not align well with a GMP structure.

If a performance-based agreement is designed to distribute risk based on market negotiations, a vested relationship is designed to share risk and reward. One might wonder why a buyer would share risk and reward when it can simply push risk onto the supplier. A primary reason to share risk and reward with a supplier is to structure a relationship in which the goals of both buyer and supplier are tightly tied to mutually defined desired outcomes. Many describe the relationship as both the buyer and supplier being in the same boat. Linking incentives to common goals is powerful because it naturally drives highly collaborative behaviours.

A second key reason to share risk and reward is because shared value creation is highly motivating for the most innovative suppliers. Why should a supplier invest if there is no hope of a future return on investment (ROI)? It is crucial to develop supplier relationships where the economics work for all parties involved.

With that in mind, the Vested pricing model is a joint solution conceived through an open and transparent process — not as part of a competitive bidding and negotiation exercise. A buyer's pricing team sits on the same side of the table as the supplier — collaborating to come up with a transparent pricing model, with incentives, that are designed to optimise the business outcomes. Together, the parties develop a pricing model that creates an effective, fair economic exchange between a buyer and the supplier.

The idea of jointly creating a pricing model may appear counterintuitive. By doing so, however, buyers and suppliers can see the complete big picture of costs and explore hidden costs. Candid and transparent discussions allow both parties to determine the true total cost of ownership and apply best value techniques that justify the cost of business requirements. These fact-based and frank conversations enable the buyer and supplier to reach a pricing model that is fair and motivating for both organisations.

Also, a Vested pricing model *always* includes incentives.

A key difference in a Vested versus a performance-based model is that a vested model makes the hard shift to *always* create a pricing model — not to use a 'price' such as in a GMP deal. This is a conscious decision to provide flexibility and fairness because all contracts will be incomplete and 'business happens'.

A Vested deal splits the pricing model into three buckets: the base work (which is predictable, variable work [such as projects]), governance (which covers the suppliers account management team and other key overhead type costs) and transformation incentives which are paid to the supplier for achieving the desired outcomes (or improvements towards to the desired outcomes).

A Vested pricing model should be fully transparent. Most Vested agreements typically pay the supplier costs for the 'base work' via cost pass-through (no mark-up on the actual costs) and then has incentives tied to performance against both operational, relational and transformational metrics. A general rule of thumb is that a supplier should earn half of market margin on the base services and three times market margin with incentives. The logic is to remove an inherent perverse incentive for the supplier to solely focus on 'today' (green scorecard against operational metrics) and to highly incentivise the supplier to drive transformational improvements against the desired outcomes.

To put numbers to this, assume in a competitive bid deal the average market margin is 6 per cent. In a Vested deal the supplier's costs would be covered (with no mark-up) and they would have a guaranteed minimum margin of 3 per cent (half of market margin). However, the supplier would have incentives tied to operational, relational and transformation measures that could earn them up to three times market margin — or 18 per cent. As you can see, doing so creates an inherent incentive for the supplier to drive success against transformational goals above and beyond getting a simple 'green scorecard'.

The actual incentives should be based on ROI, in that the supplier should be earning a fair ROI. In addition, a Vested model uses what is known as 'margin matching triggers' which ensure the economics of the relationship are fair and balanced, and that one party is not 'winning' at the expense of vested.[14] As an example, let us say a supplier's margin on a $1,000,000 service is 6 per cent. A recommendation to reduce or eliminate that service by $100,000 would reduce that margin to from $60,000 to $54,000. The client benefits by $100,000 and the supplier loses $6,000 in revenue. Margin matching would guarantee the supplier $60,000 in revenue for those services and effectively increment their margin to 6.7 per cent. The client saves $94,000 and the supplier is whole. Incentives would be triggered based upon a net savings of $94,000 which when paid encourage the supplier to strive for continuous improvement. The client saves $94,000 a year (less the incentive payout), and the supplier increases their margin and earns an incentive payout. Everybody wins.

GOVERNANCE

As the complexity of the deal shifts along the sourcing continuum, so too does it drive the need for additional governance. Organisations need to adopt more rigorous governance practices to handle the more

Box 5	Performance-based/managed services	Vested
Governance		
Relationship management	Oversight emphasis: supplier relationship management	Insight emphasis: strategic relationship management
Improve, transform and innovate	Supplier driven to meet SLAs/price	Joint and proactive transformation management
Exit management	Performance-based termination for cause with safeguards	Joint exit management plan
Compliance and special concerns	Corporate-based audit requirements	Outcome-based joint requirements

strategic nature of a performance-based or Vested relationships.

Good governance consists of four elements: relationship management, transformation management, exit management and compliance and special concerns. Performance-based and Vested models approach some of the these in a similar manner and others very differently.

Relationship management

Performance-based and Vested contracts should both include a formal schedule or appendix that outlines how the buyer and supplier will proactively manage the relationship. A well-structured performance-based model applies formal strategic relationship management (SRM) processes and protocols. Many formal SRM frameworks are available that are quite good. Although each SRM framework is unique, several best practice themes apply to a performance-based model. These include:

- *The business owns the relationship.* Procurement plays a key role in facilitating the SRM process and in establishing a cross-functional team so that the interests of all relevant stakeholders are served. However, the business owns the relationship and directly collaborates with the supplier so that business objectives are achieved;
- *Executive sponsorship and involvement*. The importance of partnerships is emphasised, and the right priorities are set;
- *Dedicated governance structure.* Buyers and suppliers have key roles in how they work together. The structure is essential because supplier relationships are often not established in a structured way so that reporting lines, roles and responsibilities, and communication are clear. Unclear communication is exacerbated by the fact that often employees are involved in partnerships part time only, which results in a lack of focus.

A key theme in a Vested governance structure is managing the business with the supplier, not just managing the supplier. As such, a well-structured Vested relationship goes beyond the formal SRM processes and protocols and applies a concept known as systems thinking. A system is an interconnected set of elements, sub-elements and components that are structured in a way that achieves a defined purpose. A well-designed system with the right motivation has the structural ability to manage itself, much as the Slinky® toy's helical springs create a self-contained system that enables the toy to move down stairs unimpeded. A properly structured system keeps the relationship in alignment throughout its duration.

A Slinky is a self-managing system, but we have all seen what happens when the toy runs into a bend or reaches the bottom of the stairs. This is why a Vested governance structure applies processes and protocols based on insight, not just oversight. Buyer and supplier constantly scan the environment and performance against desired outcomes and make adjustments to ensure their Vested relationship continues to drive a competitive advantage for both partners. Simply put, a well-defined governance structure can redirect the relationship as business happens.

A Vested relationship uses an appropriately scaled SRM framework that defines and documents the following mechanisms in the contract:

- Formal communications protocol and plan;
- Change management/commercial management mechanisms;
- Formal escalation process;
- Formal continuity of resource plan to ensure consistent relationship interface (including *key man* provisions as appropriate).

A good example of practical difference in action is in how the parties think about continuity of resources. A Vested agreement would be more bi-lateral in nature and have key personnel named for both the buyer and supplier while a performance-based deal would typically only require the supplier honour a key personnel clause. A Vested agreement requires a far more robust internal governance team than a performance-based agreement. Vested uses a 'two-in-a-box' staffing model to ensure effective alignment between the client and the supplier. This incremental staffing can prove problematic when clients do not have the ability, capacity, budget or resources to staff the governance team appropriately.

Transformation (continuous improvement/innovation management)

A performance-based model is designed so that the supplier takes risks to achieve performance and/or cost savings targets for the scope of work under its control. This means that the buyer has already identified and contracted for the desired level of improvements and the burden of continuous improvement lies with the supplier. Within a performance-based agreement, the supplier has the flexibility and freedom necessary to drive essential changes in order to meet SLAs, enhance delivery and achieve cost reduction targets. Although the supplier is ultimately accountable and contractually obligated for improvements, an organisation must ensure that the buyer and business stakeholders help the supplier drive process changes. In particular, the governance processes should include mechanisms for recording ideas and projects, tracking their progress and ensuring both parties are aligned on improvement areas. When the buying organisation provides senior-level sponsors for the suppliers' project teams, it helps to break down barriers and deliver the performance both parties desire.

A Vested agreement takes the element of transformation management a step further. A key reason to enter into a Vested agreement is to drive innovation/and or transformation in the spend category. For this reason, buyers and suppliers should develop a joint transformation management framework. A joint buyer–supplier team is important because each team member plays a critical role. Both the buyer and supplier develop business cases to justify changes. The buyer plays a critical role by driving awareness, approval and buy-in of the process or product improvements. The supplier plays the lead role in implementing the approved changes. Together, they can achieve far greater success than when the supplier drives the changes under a performance-based agreement.

A good transformation management framework for a Vested agreement includes four areas:

- Processes and protocols for driving overall transformation initiatives through

a continuous innovation management process for 'big ideas';
- Processes and protocols for driving smaller day-to-day continuous improvement efforts or solving business problems that arise;
- A formal process for updating and managing any changes to the actual commercial agreement or contract;
- A common understanding on how any work-scope transition will be managed. This is essential for new relationships but can also apply to existing relationships where work-scope may flex to accommodate to new situations.

Exit management

A third aspect of governance is exit management. As organisations shift to performance-based and Vested models, they by design add an increased element of co-dependency in the relationship. While performance-based agreements can be 'project' based (eg construction projects), a performance-based agreement for facilities management would typically be longer-term in nature. Longer-term contracts allow suppliers to recover investments and improve margins after making those investments. The more supplier investment needed, the longer the contract length should be. It is not uncommon for performance-based models to include options to extend the contract for up to five to seven additional years.

As mentioned before, performance-based and Vested models are designed to give suppliers the freedom and flexibility to make changes to the work-scope — the 'how'. Typically, buyers bundle work-scope to provide more flexibility for suppliers to make improvements. For example, by bundling dining and cleaning services into an 'integrated' FM contract, suppliers can drive cost reduction through economies of scale in overhead and staffing management.

Combined, larger and longer-term contracts increase the risks for both buyers and suppliers and make exiting a performance-based or Vested relationship much more complex. With added risk comes added responsibility to put more time and energy into exit management planning. The more co-dependency, the more structured and formal the exit management plan should be. In both models, a formal exit management plan should be included in the actual contract.

Buyers and suppliers must be fair and balanced in terms of how they plan to exit both a performance-based and Vested relationship. The intent for both should be that neither party should be harmed if an exit is necessary. As buyers and suppliers work through exit management, they should seek to understand and appreciate each other's perspective. Rather than negotiate standard termination clauses that are common in typical buy-sell agreements, they should instead seek to reach a fair and balanced approach for how the parties will unwind if necessary.

Many organisations wonder how to deal with standard termination for convenience and termination for cause clauses in performance-based and Vested agreements. Buyers can start with the organisation's standard clauses; however, it is likely that suppliers will push back on standard clauses. This is not only expected, it is appropriate because suppliers are making investments in the organisation's business solutions. The more asset-specific the investment, the more buyers need to look at these two termination clauses through different lenses. A key differentiator is not the clauses themselves but the amount of time and protocols for how buyer and supplier will unwind. For example, ask: 'What is the appropriate amount of time to safely shift work to a new supplier?'

There are some key differences in how exit management is handled in a performance-based versus a Vested model.

Performance-based agreements focus on an array of termination options including termination for performance failures.

Regardless of the reason for the termination, termination clauses should consider the costs associated with early termination, especially terminating for convenience. If suppliers make asset-specific investments that have not been amortised, buyers need to make the suppliers whole if buyers terminate early for convenience.

A Vested relationship, by design, creates supplier codependency. A supplier's commitment to make strategic investments creates a competitive advantage and helps the buyer attain its desired outcomes. Vested relationships are longer-term in nature than performance-based agreements, typically a minimum of five years and often with evergreen provisions. Many vested agreements include an incentive where the supplier earns a contract extension at the end of each year. For example, at the end of year one, the supplier can earn a sixth year. At the end of year two, the supplier can earn a seventh year. This effectively creates an evergreen contract with a rolling five-year contract duration that highly motivates suppliers to keep making investments in order to earn contract extensions. As such, the parties do not use a conventional 'termination for convenience' but rather spell out business reason for termination (eg change of ownership, exit of a business unit, etc. as well as termination for cause for performance).

Special concerns/requirements

Compliance matters — regardless of what kind of sourcing model you use. But often buying organisations have a heightened awareness of compliance because of the strategic nature and/or co-dependency associated with a performance-based or Vested model. For example, many large financial institutions utilise fully integrated FM providers to deliver a wide array of services across their portfolios. These institutions are subject to very strict regulatory controls relative to managing the risks associated with utilising third parties. The financial institution remains fully obligated to ensure compliance with these regulations. The integrated facility management (IFM) provider, who subcontracts many of the services delivered, is held equally accountable to ensure their client, the financial institution, has all of the requisite information needed to demonstrate effective compliance to the regulators.

A key difference in Vested arrangements is that, in many cases, suppliers have a significant role in ensuring that standards are met because there is shared risk and shared reward. In some cases, a supplier takes on the responsibility for managing the risk associated meeting regulatory compliance since they are the expert.

A good example of a special concern is how the parties will deal with intellectual property. Most Vested agreements also have a fair and balanced way to manage intellectual property and are designed to motivate suppliers to invest in innovation, especially for innovation that is customised for buyers. Buyers and suppliers need to think though the ramifications of intellectual property. Many find creative ways to jointly manage and reward innovation through licensing agreements.

IN CONTEXT

Organisations looking to shift along the sourcing continuum to a more strategic performance-based or Vested model should understand that — while the benefits can be significant — they are not right for all types of CRE deals. As we discussed in *CREJ* 7.3 it is important to apply sourcing business model theory to sourcing and contracting for CRE services. Transactional sourcing and contracts are appropriate for many CRE deals. However as an organisation's need becomes more complex, riskier and/or requires higher levels of continuous improvement or innovation, organisations should consider shifting to a performance-based or Vested model as the foundation for their outsourcing relationship. Both models enable strategic engagement and create more supplier dependency. But with that dependency comes a willingness for the supplier to bring their expertise and invest in innovation and transformation which ultimately creates more value in an outsourcing relationship (see Figure 2).

We cannot stress enough that one model is not better than the other; and each has its challenges and benefits. What is clear is that not all deals should be performance-based or Vested. Figure 3 puts performance-based and Vested models in context to the other types of sourcing business models. Simply put, the vast majority of an organisation's contracts are likely to be more transactional in nature.

IN SUMMARY

Performance-based and Vested agreements are definitely on the rise. While the authors do not have any statistics to show the number of deals that fall into each model, there is evidence that more and more companies are making the shift. For example, as early as 1998 the United States Office of Management and Budget began to formally promote performance-based contracting as a best practice for more complex sourcing situations.[15]

The UT does track the number of individuals and organisations that enroll in their Vested outsourcing courses and go on to create a Vested deal. UT first launched its programme in 2010 and since then 1,438 individuals from 341 companies have taken one or more of their courses. Of those, 57

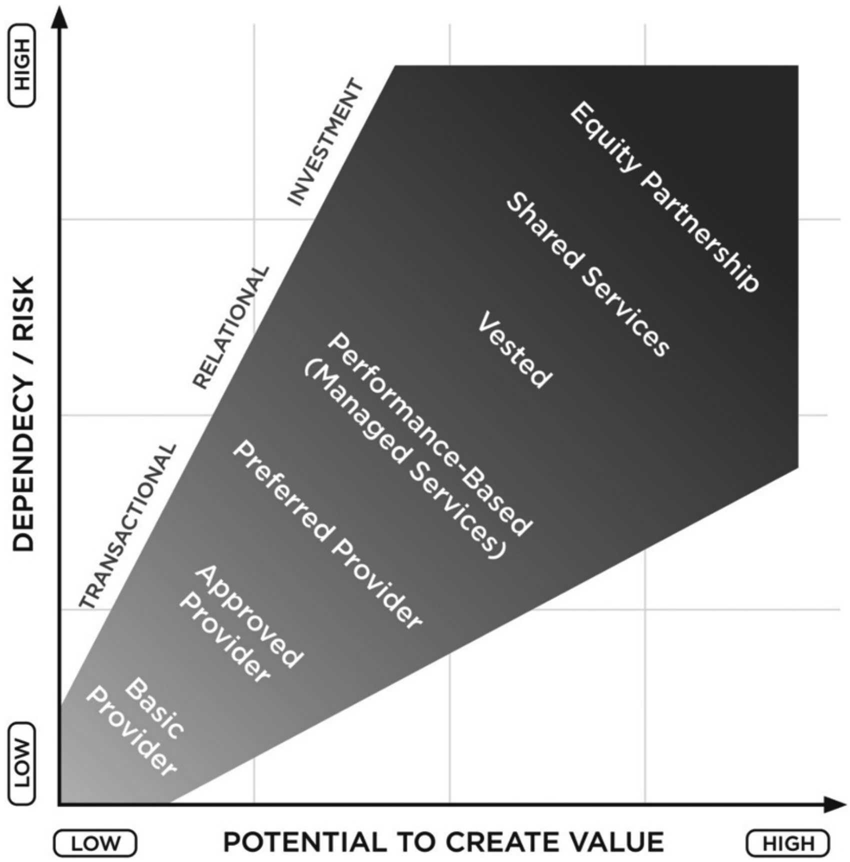

Figure 2 Sourcing Continuum Framework
Source: Strategic Sourcing in the New Economy

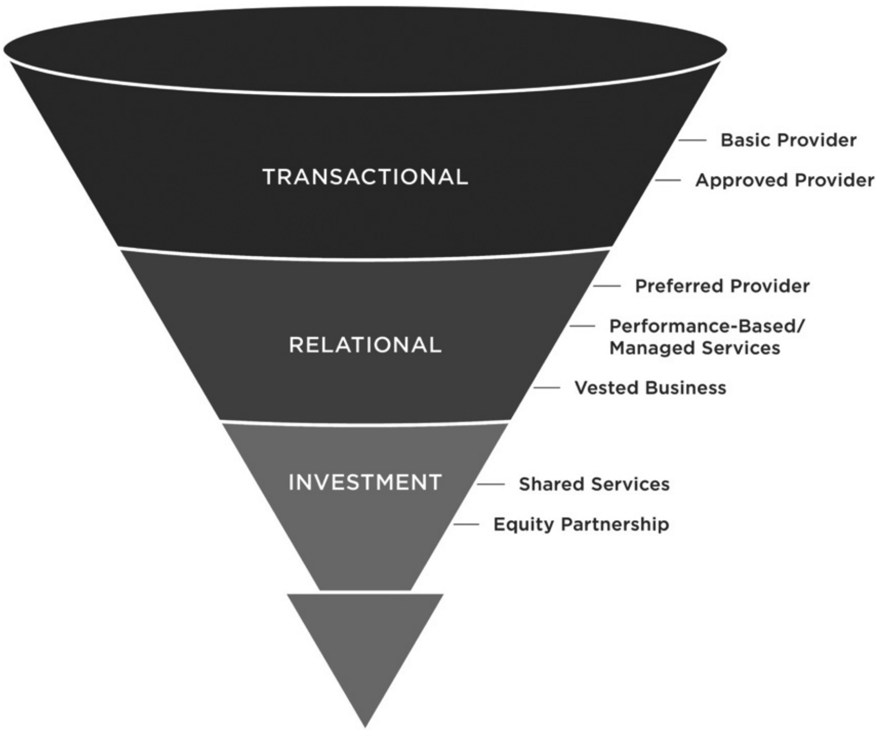

Figure 3 Sourcing Business Models in Context

companies have created Vested agreements with one company using the vested methodology for five different strategic deals. In total, UT has graduated 79 Certified Deal Architects from the programme — which can take up two years to complete with the 'homework' being the outsourcing contract architected to follow the rules outlined above.

Performance-based agreements work well when an organisation wants to measure outputs vs activities and is prepared to move toward true partnership with a supplier. Shifting to an output-based economic model creates a more holistic view tied to business objectives. Typically, the supplier takes on a broader scope and places fee at risk based on its ability to achieve performance commitments. Effective performance-based relationships require significant upfront commitment of resources from the buyer and steady, ongoing support. The buyer needs to clearly define their business objectives, the scope of services required and the performance standards to be utilised prior to going to market. Once negotiated, the buyer needs to remain an active participant in the governance of the relationship. If continuous improvement and innovation are part of the desired objectives, the buyer needs to engage continuously to enable the supplier to achieve these goals.

A Vested relationship is a good fit when organisations want to drive transformational change in the delivery of CRE services, and are prepared to be completely transparent and partner fully with outside experts. If individuals in your organisations are using words like 'outcomes', 'innovation', 'transformation' and 'risk' then you might want to consider looking into a vested model. Although Vested can be applied to any supplier relationship, most organisations consider Vested approaches primarily for their most strategic supplier relationships that have the highest potential to create value. Unlike the performance-based model, the Vested model does not require the buyer to independently define the scope and specifications upfront. However, it does require the buyer to work openly and collaboratively with the selected supplier to develop the same level of definition and documentation prior to contract execution. The model requires significant commitment of time and resources across the buyer's organisation, from the current service delivery team to executive management and from the end-user client to the sourcing team. It also requires extensive resource commitment from the supplier to develop the solution in tandem with the client prior to contract execution. In addition, vested is not just a sourcing methodology. Rather it is a system that requires ongoing commitment and support throughout the life of the relationship. Change management, education of newcomers to the relationship, ongoing education of executive management and continual reaffirmation of the shared vision and desired outcomes is critical to its success.

As noted throughout this article, there are many similarities in the two models. However, there are key differences as well. We do not recommend trying to implement a 'best of both' approach. Performance-based is structured as a client buying very specific services from the supplier. Vested is co-delivery of an outcome between the client and their external partner. Unless a buyer is truly prepared to accept equal partnership, equal accountability and be fully transparent with the supplier, Vested will not work. While analogies can prove helpful, they can also add ambiguity, as nothing is exact. Given that, we would view a Vested relationship as similar to a marriage of two equal parties who both bring value to the relationship with common goals. Performance-based relationships are much closer to a parent–child relationship where one party (the client/buyer) defines the expectations and judges acceptability of the other party's performance (the supplier). Both parties still have common goals, but clearly one is in charge and drives the relationship.

Regardless of which model you pick, it is important to keep in mind there is definitely an art *and* a science to structuring a good performance-based or Vested deal.

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(2) Behavioural economics is the study of the quantified impact of individual behaviour or of the decision makers within an organisation. The study of behavioural economics is evolving more broadly into the concept of relational economics, which proposes that economic value can be expanded through positive relationships with mutual advantage (win-win) thinking rather than adversarial relationships (win-lose or lose-lose). Shared value thinking involves entities working together to bring innovations that benefit the parties — with a conscious effort that the parties gain (or share) in the rewards. Two advocates are Harvard Business School's Michael E. Porter and Mark R. Kramer, who profiled their 'big idea' in 'Creating Shared Value', Harvard Business Review (January–February 2011), available at https://hbr.org/2011/01/the-big-idea-creating-shared-value (accessed 28th January, 2015). The article states that shared value creation will drive the next wave of innovation and productivity growth in the global economy. Porter is renowned for his Five Forces Model of competitive advantage. Due to his prominence, it is likely that his take on shared value, although focused on society, will cause practitioners to embrace shared value approaches.

(3) The information and graphics are derived from Keith, B., Vitasek, K., Manrodt, K. and Kling, J. (2016), *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern*

Procurement, Palgrave Macmillan, New York.
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(15) *Ibid.*, note 10.