Five Rules To Change Procurement

April 2017

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I love tough times…… And I love tough times as a CEO. When the tide is lifting all of the boats it is very hard to differentiate yourself. When things get tough that is when market share moves; that is when leaders are created.

Source: Marketplace
Is There A Better Way?

“The significant problems we face cannot be solved at the same level of thinking we were at when we created them.”

Is there a better way to manage business relationships?
Studying Business Relationships for Nearly A Decade

Why

What

How

Negotiate the relationship

Tells the real stories of...
Discussion Topics

- Playing games
- How to build business relationships
- What does it mean for me?
Discussion Topics

- **Playing Games**
- How to build business relationships
- What does it mean for me?
Win-Win Thinking is Based on Research…

John Nash won a Nobel Prize in 1994.
In non-zero-sum games, a gain by one player does not necessarily correspond with a loss by another.

Win-win game theory emphasizes the importance of cooperation, sharing and overall group success in contrast to domination and personal gain.

All players are treated as equally important and valuable.

When both parties cooperate they both win! When they don’t, they end up with less or both lose!

<table>
<thead>
<tr>
<th>Command</th>
<th>Cooperate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lose-Much Lose-Much</td>
<td>Win-Win</td>
</tr>
<tr>
<td>Lose-Lose</td>
<td>Win Much-Lose Much</td>
</tr>
</tbody>
</table>
Win-Win solutions concepts is based on what is commonly known as Game Theory. The most famous of the Game Theorists is John Nash.

The Nash equilibrium states that, no player can benefit by changing their strategy while the other players keep their strategies unchanged. That set of strategies and the corresponding payoffs constitute the Nash Equilibrium.

Nash shared the 1994 Nobel Memorial Prize in Economic Sciences with game theorists Reinhard Selten and John Harsanyi and the movie A Beautiful Mind portrays his story.

Win-Win solutions concepts are at the heart of game theory. Eight Nobel prizes have been awarded to Game Theorists.
Dr. Oliver Williamson shared the Nobel prize in 2009 for his work on Transaction Cost Economics (TCE). One part of his research is in analyzing the economic efficiency of outsourcing arrangements.

“Muscular buyers not only use their suppliers, but they often ‘use up’ their suppliers and discard them.

The muscular approach to outsourcing of goods and services is myopic and inefficient.”
Discussion Topics

• Playing games

• How To Build Business Relationships

• What does it mean for me?
# Need The Right Model For The Relationship

## Supply Business Relationship Models

<table>
<thead>
<tr>
<th>Sourcing Relationship</th>
<th>Focus</th>
<th>Interaction</th>
<th>Cooperation Level</th>
<th>Required Trust Level</th>
<th>Characterized by</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transaction Based Business Model</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Simple Transaction Provider</strong></td>
<td>Cost and Efficiency</td>
<td>Standard Terms, Fixed Price</td>
<td>Low-Automated where possible</td>
<td>Minimal – single transaction</td>
<td>Abundant and easy to resource, no need for a relationship</td>
</tr>
<tr>
<td><strong>Approved Provider</strong></td>
<td>Economies of Scale, Ease of transactions</td>
<td>Blanket, Negotiated Terms, Pricing Agreements</td>
<td>Medium – based on pricing or specifications</td>
<td>Medium – common terms and price agreement</td>
<td>Managed by category locally and cross business sector and bundled for economies of scale</td>
</tr>
<tr>
<td><strong>Preferred Provider</strong></td>
<td>Capability, Capacity, and Technology transactions</td>
<td>Contract, SOW, Pricing Agreement, Possible Gain Sharing SLAs</td>
<td>High – Set out in long term service contract</td>
<td>High – defined by contract, high spend zone</td>
<td>Integral supply across business units, delivering added value and capability, not so abundant, a pain to re-source</td>
</tr>
<tr>
<td><strong>Outcome Based Business Model</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Outcome-Based/Performance-Based Relationship</strong></td>
<td>Outcomes or Performance</td>
<td>SRM Governance, Performance</td>
<td>Integrated</td>
<td>Integrated</td>
<td>Longer term relationship</td>
</tr>
<tr>
<td><strong>Vested Outsourcing Relationship</strong></td>
<td>Mutual Gain, Shared Outcomes</td>
<td>Vested Agreement, Vested Governance Framework, Performance Incentives, Margin Matching</td>
<td>Integrated – cooperative, Win-Win</td>
<td>Integrated – behave as single entity</td>
<td>Interdependent outcomes, aligned, mutual gain, managed performance, long term relationship</td>
</tr>
<tr>
<td><strong>Investment Based Business Model</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity Partner</strong></td>
<td>Equity Sharing</td>
<td>Joint Venture, Asset Based, Governance Framework</td>
<td>Integrated – cooperative, interrelated structure</td>
<td>Integrated – dictated by equity sharing</td>
<td>Legally bound, formal strategic partnerships, mergers and acquisitions, asset sharing/holding</td>
</tr>
</tbody>
</table>
Rule 1 –

Outcome vs. Transaction-Based Business Model

1. Outcome-based vs. transaction-based business model
2. Focuses on the what, not the how
3. Clearly defined and measurable desired outcomes
4. Pricing model with incentives that optimize the business
5. Insight vs. oversight governance structure

Source: Vested®
Focus On Transactions Can Be Costly

<table>
<thead>
<tr>
<th>Company outsourcing for 3(^{rd}) party logistics services</th>
<th>Service providers typical reaction under a Transaction-Based Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>I forecast over</td>
<td>We charge you to store and count your product monthly… the more you have the more we make</td>
</tr>
<tr>
<td>I forecast under</td>
<td>We charge rush fees to expedite your products to market</td>
</tr>
<tr>
<td>I manage my suppliers poorly</td>
<td>Your suppliers caused us to rework your product into new packaging. We have to charge you more money to rework</td>
</tr>
<tr>
<td>Inventory working capital is killing me</td>
<td>We don’t own your inventory…we just provide services to you. Actually, we like when you have too much because we charge to hold it</td>
</tr>
<tr>
<td>I specified the wrong shipping requirements</td>
<td>We ship as we are told. You didn’t tell us about the special label</td>
</tr>
</tbody>
</table>

The service provider is paid for every transaction – whether it’s needed or not
Rule 2 –

Focus on the WHAT, not the HOW

1. OUTCOME-BASED VS. TRANSACTION-BASED BUSINESS MODEL
2. FOCUSES ON THE WHAT NOT THE HOW
3. CLEARLY DEFINED AND MEASURABLE DESIRED OUTCOMES
4. PRICING MODEL WITH INCENTIVES THAT OPTIMIZE THE BUSINESS
5. INSIGHT VS. OVERSIGHT GOVERNANCE STRUCTURE

WIN/WIN WIIFWe BUSINESS RELATIONSHIP

Source: Vested®
2. Focus on the WHAT not the HOW
Rule 3 –
Clearly Defined and Measurable Desired Outcomes

1. Outcome-based vs. transaction-based business model
2. Focuses on the what not the how
3. Clearly defined and measurable desired outcomes
4. Pricing model with incentives that optimize the business
5. Insight vs. oversight governance structure
Where Are You Headed?

You got to be very careful if you don’t know where you’re going, because you might not get there.

-Yogi Berra
### Align Metrics To Outcomes

<table>
<thead>
<tr>
<th>Desired Outcome</th>
<th>Performance</th>
<th>Tolerance/ AQL</th>
<th>Annual Incentive</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objective</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eliminate company subsidy immediately</td>
<td>For standard cafeteria (6AM – 2PM)</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>For catering services</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>
| Increase utilization rate of employees that eat in the cafeteria at lunchtime | Target levels:  
Yr 1 – 57%  
Yr 2 – 62%  
Yr 3 – 64%  
Yr 4 – 66% | Target level must be achieved to earn incentive.  
Targets do not change even if exceeded in prior year | $50,000 for each 1% above specified target level |
| Pricing to employees should remain at or below established benchmark | Benchmarks (value to be established)  
• Hot entrée  
• Sandwich  
• Salad bar  
• Pizza | Benchmark value can be adjusted semi-annually for changes to consumer price index | None |

- Foodservice that eliminates subsidized costs to the company, and increases utilization by employees.
Rule 4 – Pricing Model with incentives

1. Outcome-based vs. transaction-based business model
2. Focuses on the what not the how
3. Clearly defined and measurable desired outcomes
4. Pricing model with incentives that optimize the business
5. Insight vs. oversight governance structure

Source: Vested®
Watt Double-Acting Steam Engine

- Started first engine in 1763
- Finalized in 1775
- James Watts with Matthew Boulton as the investor
- Used 75% less fuel than existing models
Watch for Perverse Incentives!

It is not about giving an incentive for doing an activity better
Rule 5 – Insight vs. Oversight Governance Structure

1. Outcome-based vs. transaction-based business model
2. Focuses on the what not the how
3. Clearly defined and measurable desired outcomes
4. Pricing model with incentives that optimize the business
5. Insight vs. oversight governance structure

Source: Vested®
5. Insight vs. Oversight Governance

**ME**
- Getting the supplier to meet my needs
- It’s in the contract, now it’s the supplier’s problem
- Blame and punish the supplier
- Unpleasant surprises

**WE**
- Finding a way to meet both our needs
- Work together to achieve performance and compensation goals
- Communicate the issues, jointly find solutions
- Integrated planning and communications

Manage the Business…Not Just the Supplier!
Discussion Topics

- Playing games
- How to build business relationships
- What Does It Mean for Me?
Bringing It All Together

Transformation

Building For The Future

Trust

Transparency
Supply Chain Case Study: McDonald’s

- Ray Kroc founded McDonald’s on the premise that “None of us is as good as all of us”
- In 2004, McDonald’s put this concept on steroids, tightly aligning their most strategic supply chain providers (services and products) to their “Plan to Win”
- The results? McDonald’s views their supply chain partners as a competitive weapon
- Food safety and quality “10x higher than a school kids lunch” (USA Today)
- Undisputed cost advantage against benchmarks
- Suppliers investing millions in McDonald’s, innovating on a regular basis
- McDonald’s has risen every year in the DOW rankings, achieving the top ranking on all 30 of the DOW’s 30 criteria
- McDonald’s has risen every year in Gartner’s supply chain ranking – reaching the #3 spot in 2012

“McDonald’s has a secret sauce. And it is not the one you are thinking of. It is how McDonald’s treats their suppliers.”
Ray Kroc Emphasized The Stool

- The McDonald’s supply chain is one-of-a-kind in the food industry
- The 3 legged stool:
  - McDonald’s Corporation
  - Owner/operators running the restaurants
  - Suppliers working together
- Each leg in the stool needs to do well for anyone to prosper
- The three-legged stool has become to be known as the “System” and “System First” thinking is the common behavior demonstrated by all three legs of the stool
  - Where’s the contract?
Beyond Partnership

- The concept of partnership is taken seriously for McDonald’s suppliers
  - Expectations rise to levels normally reserved for a company’s employees
- Suppliers keep the question, “What’s best for the System?” at the top of their consideration
- Suppliers have accepted that their key role as a supplier is *not letting McDonald’s consciously make a mistake*
- A supplier’s job is not simply to fulfill McDonald’s managers requests, but also to question decisions that could negatively impact the brand and the System
System Sharing – Even With Competitors

- McDonald’s has created a virtual playground for suppliers to openly share breakthrough advancements with one another, feeding off each other to drive improvements that not only benefit McDonald’s – but the suppliers.

- There are several types of Councils:
  - Commodity Councils
  - Food Improvement Team
  - Joint Development Initiatives
  - Supplier Advisory Council
Sharing Through Councils

- McDonald’s consciously creates opportunities where McDonald’s and suppliers can engage in open dialog to solve some of McDonald’s problems
  - One avenue for supplier collaboration is all day forums referred to as Councils
  - These meetings can be regionally or commodity focused, or by exclusive invitation
  - While some of the councils have authority to make decisions on behalf of McDonald’s, all are taken seriously as a way to help McDonald’s openly debate ways to improve the System

- Guiding Principals
  - Sharing supports the System and provides a unique supply chain advantage for all
  - The councils provide opportunity for McDonald’s to share plans, results, and market changes
  - Suppliers share with one another new techniques and successes
  - Open communication strengthens the System as a whole

Vested For Success
McDonald’s Example of TRANSPARENCY
Sharing Innovation... With The Competition

- McDonald’s has found that the potential for successful innovation is exponentially increased through strategies that institutionalize collaboration between McDonald’s and the suppliers and between suppliers.

- It goes back to “what’s best for the System” and it works because suppliers unequivocally believe that the improvements in the System equate to improvements for the supplier and to the underlying trust that suppliers have that McDonald’s will reward them fairly if they share their ideas.

- As innovative solutions and/or new products are developed, McDonald’s expects suppliers to share the advancements with what suppliers would think of as their competitors.
What Suppliers Say…

- Eric Johnson, CEO of Baldwin-Richardson Foods, explains his reactions when he first came to into the McDonald’s System.

  “Outside of McDonald’s most of the suppliers are typically in a short term win-lose environment that is typically cut-throat trying to win the next big RFP or purchase order. At McDonald’s, I found myself sitting at the same table and engaging in discussions about how we could all partner to make real impacts for the System. No other customer I had ever dealt with was even close to this kind of collaboration. …I quickly learned that it is much better (and fun) to grow the pie than worry about how big your slice is today. There is plenty for all.”

- Jerry Dean, CEO of Keystone, a major supplier of beef contemplates the unusual nature of this kind of supplier collaboration.

  “Our other customers are very hesitant to share. They feel threatened by the need to embrace their suppliers. McDonald’s just does it – actually, insists on it – and it is part of their culture. Once you have been in the McDonald’s system, it’s hard to imagine not participating in these ways. It’s very open. We look at the System First – our own interests next. Sometime after doing it for so long –you don’t even question it because you have come to learn that when you help the System (which includes helping your suppliers) good things will come back in the long term.”
McDonald’s View

- Gary Johnson Senior Director of Worldwide Supply Chain, McDonald's.

“It is easy to make a supply chain decision that can sub optimize the system. But when you have restaurant owners/operators and suppliers challenging your decision constantly it keeps you on your toes… McDonald’s supply chain professionals must be good on both the technical and the financial sides of the coin because their goal is to ensure suppliers deliver value – yet stay healthy in terms of their bottom line. It’s not just a procurement job – it really is about managing the BUSINESS… In fact, when you look at it, our supply chain team members spend very little time on the actual procurement aspects of their job.”
Thoughts For Monday

- What relationship would benefit from transformation?
  - Who is willing or interested in partnering?
- What level of trust do I have in my suppliers?
  - What level of trust do they have in me?
  - How much do we need?
- How open are we with our partners?
  - Do we need to be more open?
  - How will we do this?
- What benefits can we derive from being more open with our suppliers?
Thank You

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