

# Supplying Innovation

## Unlocking innovative behaviours in the supply chain

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Large incumbent companies in various industries have, historically, been known for an inability to act with agility in bringing in innovative products, techniques, and solutions.

Internal innovation programmes can bring benefits. Often company employees are very experienced in the industry, and when incentivised to do so, produce exceptionally innovative ideas. However, it is arguable that companies who restrict innovation sourcing to their own employees are missing a huge range of ideas from different industries, from suppliers, and from customers.

An alternative to internal innovation programmes is to **source ideas through the existing supply chain**. This can be achieved through re-focusing suppliers, allowing them the space to innovate by measuring them not against outputs, but on outcomes.

Encouraging suppliers to innovate requires more than a traditional approach – it needs a **collaborative environment, ideally with multiple, co-operating partner companies**, incentivised on a risk- and reward-sharing basis to deliver better outcomes for customers.

# Outcomes-based contracting to drive external innovation

Most large companies recognise the need to innovate; to bring to market new products, services, processes, and solutions that positively impact their business, employees, and customers. However, innovation programmes often fail to provide the value expected of them. This could be due to a lack of strategy, a reluctance to collaborate, or an inclination to filter out the most transformative ideas as too difficult<sup>1</sup>.

With so many pitfalls, it is unsurprising that companies are increasingly turning to suppliers to bring in innovative products and services to decrease costs and improve customer satisfaction. However, there are barriers to innovation inherent in the contractual approaches traditionally used, which can be overcome with the novel direction adopted here.

In traditional, output-based contracts, suppliers provide service components based on service level agreements (SLAs), or deliver projects to achieve output objectives. Often, the methods by which these are achieved are not subject to contractual agreement between the supplier and client. Therefore, commonly, a solution can be chosen which meets an SLA despite failing to improve a client performance measure. These can even have negative impacts. Suppliers in output-based agreements rarely focus on end-customer issues caused by solutions, as they do not see value from this.

By moving to outcome-based contracts, suppliers get rewarded when the experience for end customers and other stakeholders is

improved. Stakeholders could include regulators, consumer councils, and quangos such as the Environment Agency. Suppliers are incentivised to change the scope of their considerations to include end customers as key stakeholders. In many cases, suppliers will take on responsibilities and related risks that were originally carried by clients. This balances the inclusion of reward sharing in contracts.

A further adaptation of these contract arrangements is to include multiple suppliers, forming an alliance of companies. This is set to be increasingly common, given the large, complex nature of contracts needing a wide range of expertise and depth of capability.

An alliance should be relatively independent of its partner companies, which include the client – a signal that the clear distinctions between the client and suppliers are fading away. Every partner is required to work together to deliver solutions and services that achieve the desired outcomes. An engaged supply chain is indispensable for the success of an alliance; it is expected that many will want to work with the alliance to develop and deliver new and innovative services.

Many of the themes in this article were pioneered in the water industry in the UK<sup>3</sup>. The Office for Water Regulation (Ofwat) is directing the industry to become outcome- rather than output-focused<sup>4</sup>. A number of UK water companies have responded to this by forming alliances to deliver capital, operational, and other functions.

**\$71.7 bn**  
spent on R&D  
programmes in 2015  
by the top 10 global  
innovators<sup>2</sup>

## The steps to achieving success in outcome-based contracts using an alliance approach

In single-supplier contracts, the relationship between the supplier and the client is much easier to build. Concerns focus on whether the scope of the projects is within control, whether mutual expectations can be managed, whether the supplier has the capability to deliver projects, and whether the client has the capability to absorb the business changes. However, if an alliance is formed to deliver outcome-based contracts, the situation can be much more complex. The three fundamental themes for the alliance are the decision on commercial solutions (e.g.: the risk and reward mechanism), the embedding of collaborative working, and the design of the operational practices.

No single theme is more important than any others; they are mutually reinforcing, and each essential to success. Each of the points of action detailed below will contribute to the motivation for the partners to deliver innovative projects, and their ability to collaborate in doing so.

### Collaboration

We have identified four crucial points of action that enable and encourage collaboration. An

alliance needs to **define the strategic objectives** based on the outcomes to be achieved, and to clarify how they affect employees across the alliance hierarchy<sup>5</sup>. Responsibilities across the alliance should be clarified in how they impact customer experience and the alliance outcomes.

To **create a positive organisational culture**, the alliance needs to draw the best in culture from each of the partners to create an organisation greater than the sum of its parts. Employees should feel first and foremost part of the alliance, comfortable to share information and express ideas in a collaborative atmosphere.

For an alliance with multiple partners, suppressing competitive behaviour is crucial to **engendering trust**. To behave with integrity and to trust others are important in an alliance. It means each partner should be willing to provide information and assistance, trust other partners' decisions based on their expertise, and pay attention to their own performance.

In order to achieve the shift in mind-set needed to achieve outcomes versus outputs, **strong, consistent, educational communications** are required. Physical and electronic communication methods should be used to reinforce operational practices, and to raise awareness of business changes – and the

89%

of CxOs expect a high level of collaboration with partners within 3-5 years<sup>8</sup>

## The obstacles to making the shift

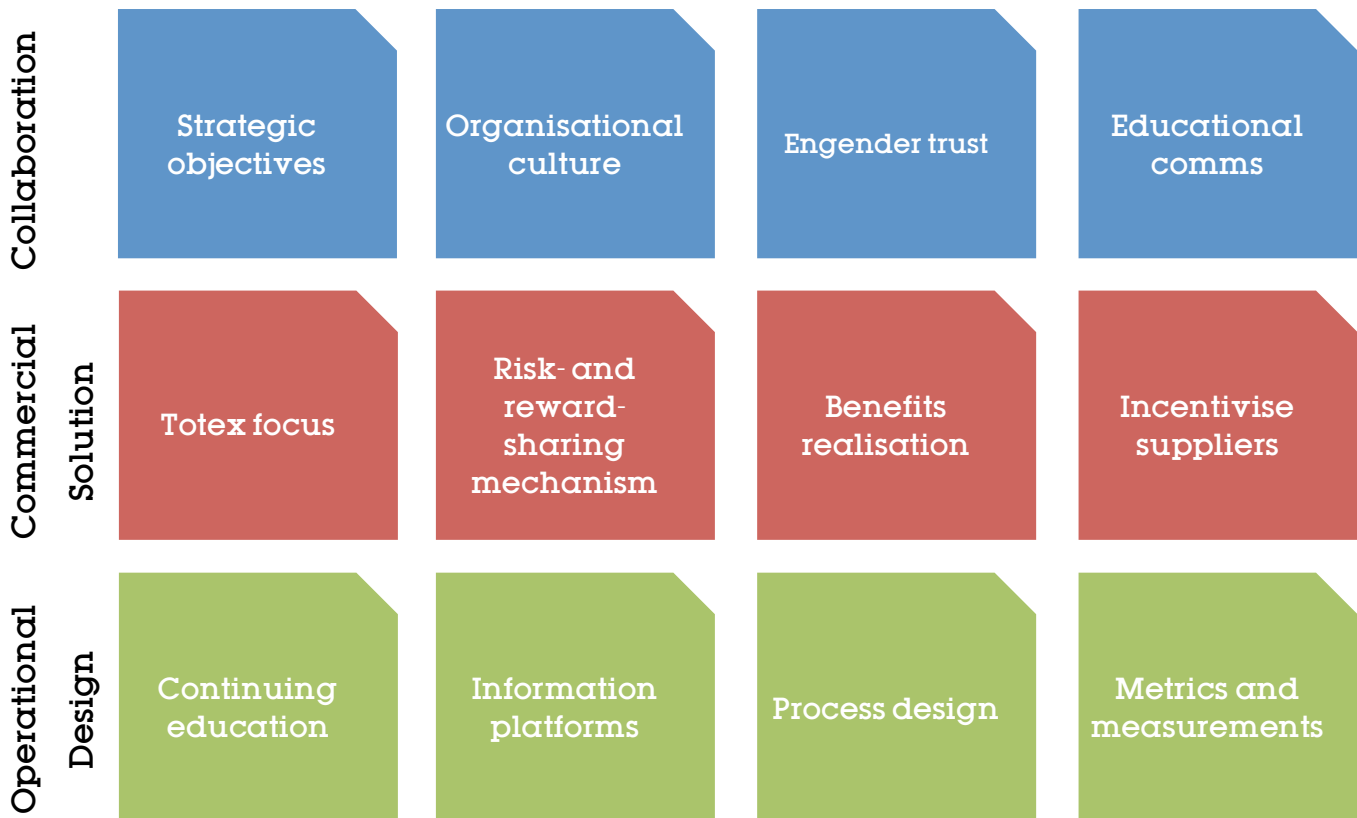
The shift to outcome-based contracts can bring huge benefits in improved customer experiences and efficiency, but comes with an inherent set of obstacles. This shift needs to happen across the alliance partners, the extended supply chain, and in the industry environment. As such there will be many practices within these diverse organisations that need to be adapted. There should be a focus on these obstacles when adopting this approach.

### Collaboration obstacles

- Among partners: It is challenging to achieve collaboration among partners within an alliance, especially if the partners are competitors outside an alliance, or if partners' previous relationships were not smooth before the formation of the alliance.
- With extended suppliers: If the industry environment is not collaborative in nature, it is challenging to build collaborative and trusting relationships with extended suppliers.

### Outcome model obstacles

- Among partners: Partners have different business models and conflicts can arise when they are brought in to a single outcome-focused model. The outcome-focused model with an alliance approach is often very new and complex, and currently has few case studies to learn from.
- With extended suppliers: When the industry is still at an output-focused stage, extended suppliers don't have either the capability or the confidence to be contracted on outcomes.



Each of the twelve points of action, identified against the three key themes for successful alliance delivery.

resulting successes – in the wider workforce.

### Commercial Solution

To deliver solutions that lead to the best possible customer experience, the **boundaries between capital and operational expenditure should be eliminated** focusing instead on total expenditure ('Totex')<sup>6</sup>. 'No-build' operational solutions should be considered alongside capital interventions on the grounds of risk and cost to decide which is most appropriate. The alliance should not be incentivised to deliver one over the other.

Whether an alliance can exist depends on whether a **risk- and reward-sharing mechanism that is mutually acceptable** can be designed. The key points here are how benefits are shared, based on contributions; how risks are shared, depending on accountability; and how outcome KPIs are transferred from the client to the alliance. This final point will define the extent to which the alliance is measured against end customer outcomes.

A **robust benefit realisation mechanism** should be developed in order to mitigate the inherent conflicts between short-term

commercial objectives and long-term customer outcomes. These can arise when solutions that have a high return on investment have a detrimental impact on customer outcomes. There can also be clashes between customer outcome improvements and the timescales by which the alliance, the partner companies, and the industry measure such improvements.

Where possible, the **supply chain should be incentivised** on the same outcome-focused model as the alliance partner companies. Evaluating relationships with suppliers, clarifying outcome objectives and measurements, and definition of mutual commitments should be finalised before procurement decisions are made. Risk should not necessarily be passed down to suppliers; it may be best managed at an aggregate level.

### Operational Design

**Continuing education** in an alliance is crucial to instilling the right culture. Training sessions on customer focus and outcomes thinking, and the impact of employee actions on these, are necessary in order to achieve desired goals. For core managers, leadership sessions are valuable, while training to improve well being

for alliance members will help to improve engagement and morale<sup>7</sup>.

Information platforms should be designed for the **sharing of data, knowledge, and capabilities among partners** in an alliance. An effective platform facilitates the flow of data in an efficient, frustration-free way while maintaining partners' data security.

Good **process design is essential** to the development of an alliance, as this is how concepts become embedded in to real practice. Six aspects of process design to be considered by an alliance include staff reward mechanisms, customer interaction processes, culture change, decision-making processes, collaboration, and risk management process design.

**Metrics and measurements should be developed** to measure contributions of each partner to alliance objectives and outcomes, indicators to measure the financial status of the alliance, indicators to control and track the achievement of outcomes, and metrics to measure individuals' behaviours.

## Conclusion

The need for companies to innovate to remain competitive has never been higher. The often narrow focus of internal innovation programmes means that companies will have to cast a much wider net in order to source transferable innovation from suppliers and other sectors. However, to develop ground breaking, original ideas, it is crucial to provide an incentive for companies to deliver the best

solution possible, not merely the most profitable.

The freedoms regarding the range of possible solutions available to contractors when employing an alliance approach will encourage innovation in the supply chain; the contractors are incentivised to deliver more efficient solutions that provide exceptional customer outcomes. A collaborative environment should lead to genuine industry leading, cross-company innovation, combining talents from multiple partners. It is expected that the innovative approaches will help companies to more easily meet regulators' expectations.

There are real challenges. Ambiguity of partners' accountability, barriers to collaboration, and lack of experience with these novel methods can present significant risks to companies choosing to partner in an alliance. This is not a silver bullet, and should not be used for all projects; decisions should be made carefully whether to contract based on this model.

Yet the benefits of doing so can be immense. The three fundamental themes for success in this model – a robust commercial arrangement, unhindered collaboration between partners, and effective operational design – when carefully designed and implemented, will engender confidence in partners, client, and industry. Confidence in the outcomes-focused model will encourage innovation in the solutions implemented; will lead to improved customer experience; and will deliver increased financial benefits for both clients and contractors.

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