One of These Things is Not Like the Others: Special Issues in Collaborative Sourcing

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Introductions

Joe Parker – Joe is a consulting partner at PricewaterhouseCoopers LLP, advising both public and private sector clients in matters of strategy, structure, governance, sourcing and financing. In his over 25 years of professional experience, Joe has been involved in the development, implementation or operation of over 30 collaborative arrangements, including pioneering work in Public-Private Partnerships in Canada.

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Agenda/Introduction

Continuum of choices

What is collaborative sourcing

Why and is it right for your organization

Decision and plan – what are the key steps to get there

- Strategy and tactics
- Planning, governance
- Scope and performance
- Operating model
- Where (geography)
- Infrastructure
- SLA, remedies, pricing and financing
- Transition, timing and funding
- Business model
- Contributions and valuation

Legal, contracting and IP matters

Pricing, tax and international matters

Barriers, risks and issues

What you need to succeed/what not to fail

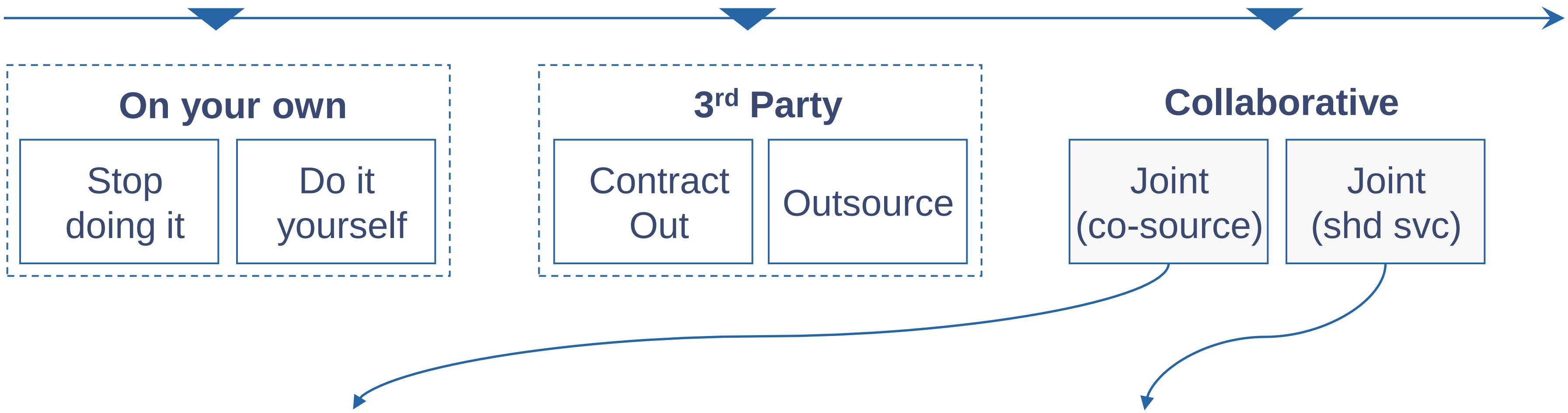
Post deal – relationship (aka contract) management,

What can we cover in our brief time today?

Elements of shared services and/or co sourcing that differ from a typical outsourcing arrangement including:

Governance & structure
Scope & service levels
Pricing & remedies
Legal
Some lessons learned

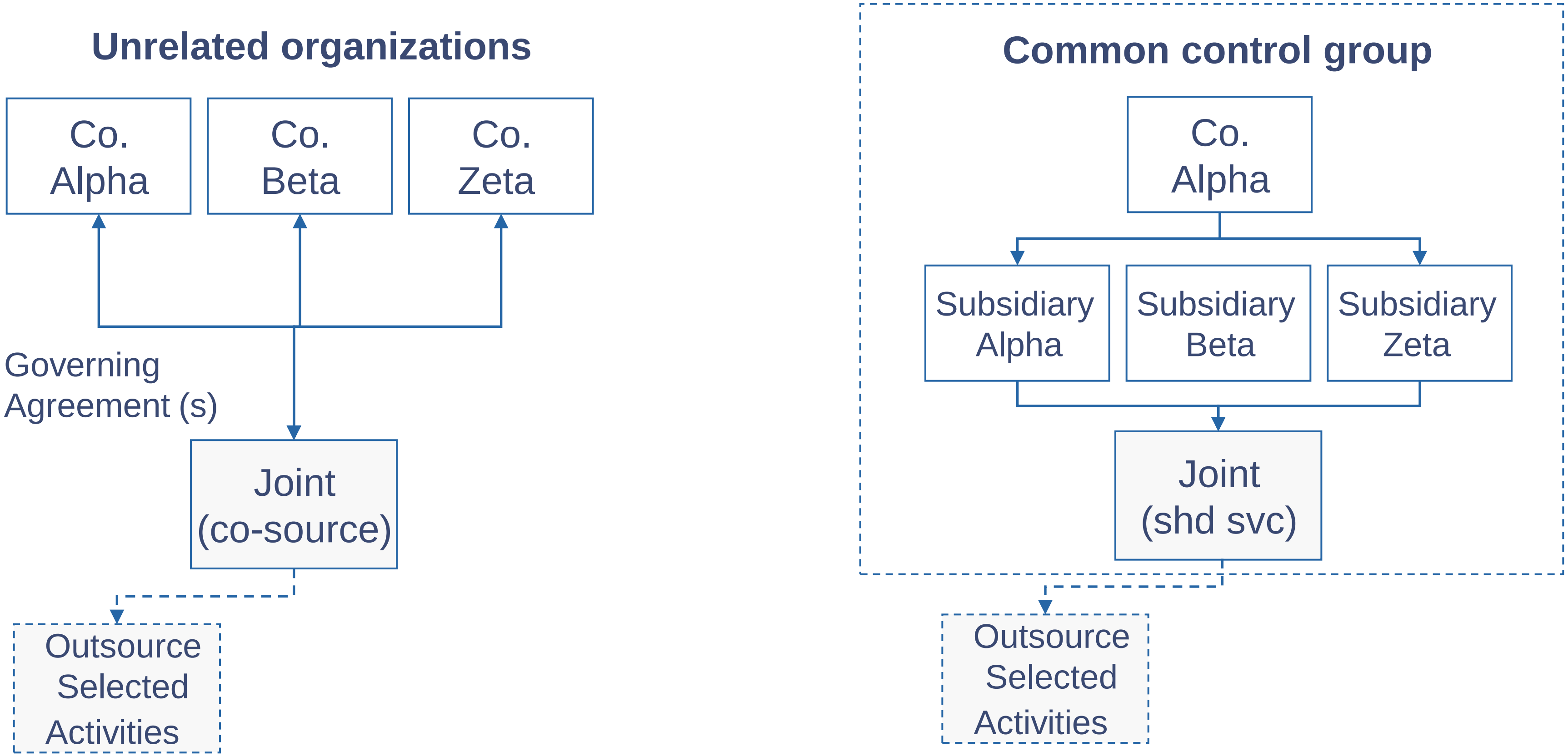
The strategic sourcing continuum – today we will focus on the elements that typically distinguish collaborative ventures from more usual contractual arrangements



Alliance with *external* business "partners"
•Purchasing as agent or principal?
•Corporate model: e.g. service provider; corporate entity; partnership?
•Governance, exit/entry, voting/changes
•Value of initial contributions and on exit/wind down
•Service level alignment packaging, alignment, etc
•Pricing at "market", and mechanisms to benchmark
•Distribution of surpluses
•Financing, funding of deficits
•Liabilities
•Tax positions
•Location

Alliance with *internal* business "partners"
•Governance
•Value of initial contributions
•Service level packaging, alignment and enforceability, effectiveness of financial remedies
•Pricing at cost, cost plus, market
•Distributions and other "joining" incentives?
•Financing and funding?

Illustration of two collaborative arrangements



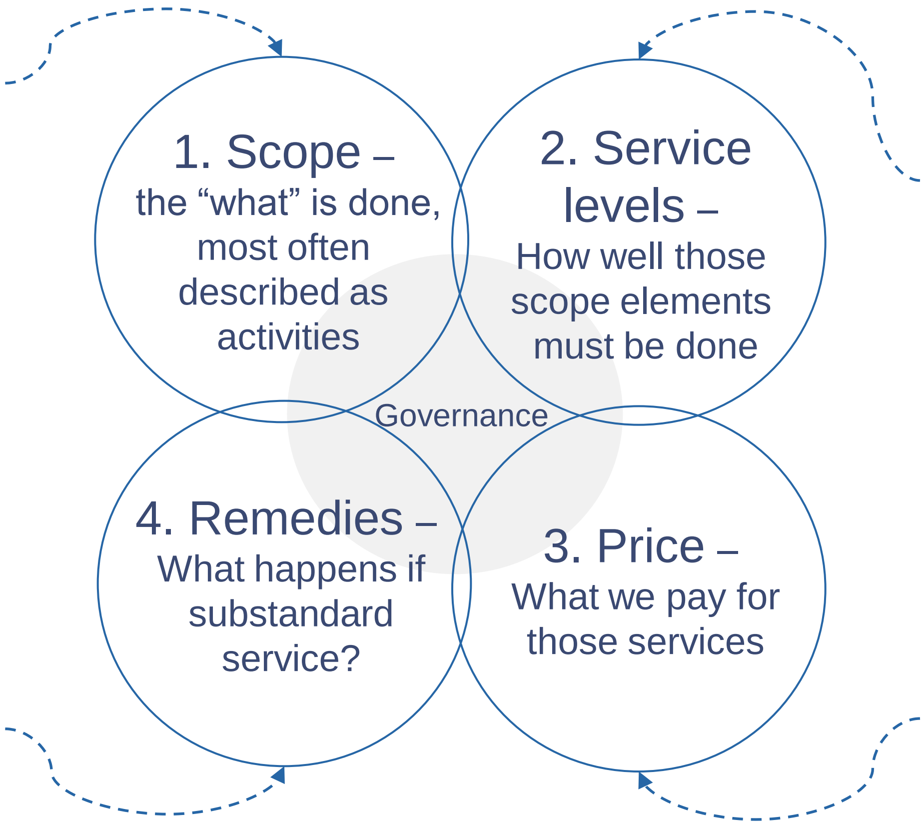
Examples of Co-Sourcing Structures (Health Care Sector)

1. One hospital is the buyer and provides the services to all other hospitals pursuant to a service agreement or a joint venture arrangement: e.g. London hospitals
2. A non-share capital corporation is the buyer: e.g. Plexxus
3. A share capital corporation is the buyer: e.g. Shared Healthcare Supply Services (“SSHS”)
4. A partnership is the buyer.

The axiom – each deal is unique, and there is a fundamental interdependency amongst …scope, service performance, price, remedy and governance (the tie that binds). Change one, others must flex to accommodate.

Clear alignment and delineation of activities amongst the players

Harmonizing of levels/ packages, aligned with scope (and ideally *reconciled* to market) And are there collaborator service obligations as well?



Equitable (remediation and financial) mechanisms to create proper performance tension, established in advance, but realistically in a closely held situation, who is it costing anyway

Compared to market?

Governance & structure

Think about	**Comment**	**Shared services**	**Co-source**
Structure	Separate body or centres of excellence? Partnership, incorporated joint venture, contract?	Often “centre of excellence”, or corporate centre oriented *	Typically a separate legal entity *
Ownership and voting	Different scale of collaborators? Are ownership and voting in the same proportion? How do you deal with differing value contributions?	Often by parent edict, but might be helpful to better engage the parties and engender cooperation	Allocate voting rights bases on: Value of contribution? Volume of usage? Often equal voting even if disproportionate value/scale. BUT founder’s may have voting rights whereas new members may not.
Voting – for what	Can be a standard array of escalating elements which could include some with simple majority, super majority and a few with unanimity.	Often by parent edict, but might be helpful to better engage the parties and engender cooperation	Along a spectrum: closer to unanimity = likely more acceptable
Valuing contributions, settlement and variability of input factors	How does value of initial contributions get determined? Hard assets contributed? Business volume? How is the initial contribution paid for?	Key if cross border/ tax etc considerations	Vital to participation, exit and sharing of “profit/loss”
Entry/retirement of members	Are subsequent collaborators allowed? On what terms? How are initial parties allowed to exit? What are events of windup?	Dictate by parent	Essential to get it right -

* - depending on legal, tax and location considerations

Governance & structure continued

Think about	Comment	Shared services	Co-source
Adding/changing services or standards	Inevitable that changes will occur	Consider implications on standard service offering	…and how to deal with added costs/who pays
Access to assets/IP created	Property of the venture or of the collaborators?	Consider offshore implications	Consider value implications
Distribution of surpluses / funding losses	There must be pricing (see next), so there will be years of excess and deficit	Depending on how de-central the decision making is, but consider incentives for participation, etc. Special issues for non-profits.	..and consider appropriate “pricing” and the potential implications of disproportionate contributions
Financing	For what items? From what bankers? Parent guarantees?	Typically corporate centre	Typically self financed

* - depending on legal, tax and location considerations

Scope & service levels

Think about	Comment	Shared services	Co-source
Scope and activity definition	Think Generic/unique activities rather than core/non-core	Could be broad definition – consider mandatory vs optional participation	Probably more narrow, market defined activity (e.g. purchasing)
Costing of self-provision	Essential to the base case and economic proposition	Vital to the initial business case	Same
Harmonizing of performance standards	Decision: (a) Determine all of the current performance standards, and complete gap analysis against best-practice, for each entity, then set appropriate standards to allow gradual improvement to same = will significantly extend transition-in period **VS.** (b) set external standard based on best-practice = faster, but larger risk of disruption.	Internal balanced scorecard approach can give a head-start.	Internal balanced scorecard approach can give a head-start.
Bundling / grouping of standards	For both economic and operating purposes, it is important to group into service packages. Will also facilitate any outsourcing.	Same	Same
Remedies / enforceability of / viability of	Given that, other than for the non-share capital corporation, excess revenue could be distributed to the Members, the application of service level credits in the case of a performance deficiency is problematic. Greater emphasis on robust governance model is therefore required.	Basically penalizing ourselves	Could be highly valuable where for example the collaborators have performance inputs

Pricing

Think about	Comment	Shared services	Co-source
Tax implications: major driver in determining form of service entity. For example: * If purchasing as a principal, will Buyer be required to charge GST on supplies resold to members (a) if sold with mark-up?	1. Service entity: yes 2. Non-share capital non-profit corporation under ITA: yes 3. Share capital profit corporation under ITA: yes 4. Partnership formed by all equity members: yes.		
(b) If not sold with mark-up (i.e. sold at cost)?	1. Service entity: no 2. Non-share capital non-profit corporation under ITA: no 3. Share capital profit corporation under ITA: yes 4. Partnership formed by all equity members: yes.		
Transfer pricing issues generally			

Legal and liability considerations

Think about	**Comment**	**Shared services**	**Co-source**
If service entity is providing joint purchasing services, is Buyer purchasing as agent for each member, or as principal?	If purchasing as “agent”, entity will have limited liability, but each member, as principal, will be exposed to liability, potentially joint and several as per member contract. BUT if purchasing as a principal, will Buyer be required to charge GST on supplies resold to members? [See discussion in Pricing above.]		
Will the proposed structure shelter members from business liabilities?	1. Service entity: not for Buyer entity, although contractual indemnities from each member can assist in mitigating risk. Yes for each member. 2. Non-share capital non-profit corporation under ITA: yes. 3. Share capital profit corporation under ITA: yes 4. Partnership formed by all equity members: no, as members generally joint & severally liable.	Less of a concern re allocation of liability between members as all related.	Adoption of corporation model can lead to complexities where some of Buyer’s activities are outsourced to a third party vendor (see next issue)

Legal and liability considerations

Think about	Comment	Shared services	Co-source
Where functions of Buyer outsourced to third party, how will liability be addressed?	•Tension: Members want to maximize shelter from liability vs. third party vendors want the ability to recover directly from each Member. •**Payment/Damages risk:** Concern of vendors is Buyer entity may be thinly capitalized, with minimal assets (e.g. staff and assets may be "loaned" to entity by each Member). Vendor will want to "look through" corporate shell to ensure can recover from each member. **Licensing risk:** Concern re enforcing software licenses against each member •**Problem for each Member:** why bother having a Buyer entity if still end up having direct liability exposure to vendors?	Vendor may seek, for: • **Payment/damages risk:** a parental guarantee •**Licensing risk:** a master licence with parent, with each member being a sublicensee	Vendor may seek, for: • **Payment/ damages risk:** privity agmts, or through member guarantees •**Licensing risk:** direct privity with each member, through direct End User Licence Agreements ("EULA"'s). •**Alternatives to privity arrangements:** •**Payment risk** for vendor can be mitigated through payment mechanism (e.g. payments in advance, rather than in arrears) •**Damages risk**: can be mitigated through Buyer carrying appropriate insurance

Legal and liability considerations

Think about	Comment	Shared services	Co-source
Will Buyer effectively act as integrator for each third party vendor?	Integrator model will suggest that the remedies of each member, where the service in question is provided by a third party, will be limited on a flow-through basis, to whatever remedy is available under the Buyer-third party vendor contract.	Likely	Likely
If Buyer is acting as principal, how will existing contracts with the Members be treated?	•Will the "best" and most "scaleable" be assigned? Due to assignment and service bureau restrictions, will most likely require consent, and again, the licensor may require that some form of guarantee where the Buyer is insufficiently capitalized. •Will those contracts which are not assigned be "managed contracts" for the Buyer, even if on interim basis?	Scope of use of existing agreement may permit related party use.	Parental guarantee may be required
How to respond to Members which are "high maintenance" or fail to perform their collaborator/"customer responsibilities"?	Options: set baseline cost, periodically adjustable, for expected allocated cost of servicing each Member, such that if Member cost is materially exceeded, Member may be responsible for additional charge-backs.		

Simple Illustrations & Potential applications – these collaborative structures have been used successfully for many years, for many “activities” or functions, in all industries, including

- Common / shared administrative services or goods procurement in **government/healthcare**
- Common processing of routine clearance transactions in **banking**
- Financial coordination centres for commercial activities in **multi-nationals**
- Collaborative distribution arrangements for **beverage** businesses
- Centralized research or marketing in **chemical specialties** companies
- Real estate holding and/or management in **retail** organizations

Some final thoughts and lessons learned

Some of our observations

Complicates matters if we want to sell one of the served businesses

Admit new non-founding collaborators (Scalability #1)

Valuing and "the real value of" initial contributions

How do we deal with transition, start up and other initial costs?

Changing value of the "contributed business"

Allow the venture to handle products/services other than those brought by the founders (Scalability #2)

What do we do if there is profit (or worse, a deficit)?

Initial and ongoing scope and service level alignment, how are inequities in performance paid for?

Mechanism to manage disputes

High level mark for services

The oft quoted learnings

Enduring management support

Select the processes/activities that will benefit most

Establish clear objectives and priorities – communicate them with key participants & stakeholders

Alignment of objectives of participants

Clear description of the business model

Clear governance model

The changes are ongoing

Communicate – often