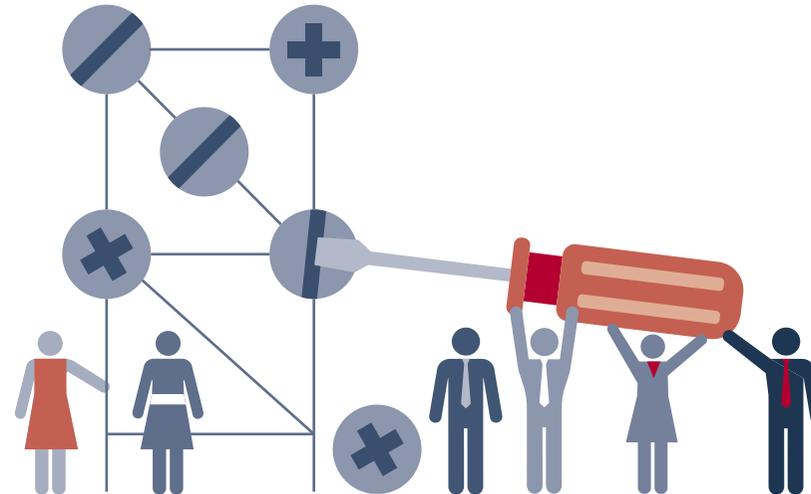




# Supplier-Led Innovation and Continuous Improvement

How Best to Achieve them in Contracting



**An Examination of Market Practices and Results**  
August 2019

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The origins of this paper lie in a presentation and panel discussion at an academic symposium, jointly organized by IACCM and Leeds University and hosted by the Leeds University School of Law on April 25th, 2019.



## Summary

Innovation and continuous improvement are essential to human progress and to the functioning of business and government. Over recent years, they have received sustained attention and recently there has been growing focus on supplier-led innovation and improvement.

Research shows that a high proportion of contracts include provisions relating to these topics, yet there is a wide-spread sense that they are frequently ineffective. This paper is based on preliminary research which suggests that in most cases contractual provisions are vague and unsupported by the type of governance processes and incentives required for success. The authors draw on these findings to propose methods and techniques that will increase the frequency and likelihood of innovation and improvement delivery.



## Introduction

More than 50 years ago, management guru Peter Drucker identified innovation as one of the basic ways in which a business builds and maintains a competitive position in the marketplace.

However, it was much more recently that companies not only started to examine internal environments conducive to innovation, but also began working on how to better identify, cultivate and take advantage of a wide variety of external sources for innovation – in particular through their immediate network of suppliers.

This paper focuses on supplier-based innovation and concludes that for many it remains a wish rather than a reality. A significant proportion include terms related to innovation or continuous improvement in their contracts (see Figure 1) – yet some 70% acknowledge these are frequently ineffective. Our study sought to understand whether this is because of unrealistic expectations, or due to inappropriate methods. Based on the overall findings, the authors conclude that it is more due to the latter (inappropriate methods) than the former (unrealistic expectations).

Suppliers are recognized as having especially large innovation potential because they have the possibility to know what their customers and prospects are doing, as well as bringing perspectives from different industries. According to the IBM IBV Chief Procurement Officer Study, top-performing procurement organizations cited 'bringing in supplier-led innovation to the enterprise' as a top priority, second only to reducing costs and increasing profitability for the business *Zhong, '5 Steps to Harnessing the Power of Supplier Innovation', IBM Watson Customer Engagement, July 2016*. In the

public sector, the OECD, European Commission, G20 and individual governments have all emphasized the role and importance of innovation driven by public procurement *Uyarra & Yeow, 'Barriers to innovation through public procurement: A supplier perspective', Technovation, Volume 34, Issue 10, Pages 571-646, October 2014*.

### Differing Interests and Incentives

In theory, mechanisms for knowledge transfer from supplier to customer are typically in place, but years of evaluating collaborative working relations in various manufacturing and service industries reveal that it is one thing for a mechanism to be available and quite another to successfully achieve it. Collaborative innovation is, in fact, often limited by 'relational stress' created by differing interests, especially with regard to price *Henke & Zhang, MIT Sloan Management Review, January 2010*. Within the public sector, additional barriers frequently cited by suppliers are the lack of interaction with procuring organizations, the use of over-specified tenders as opposed to outcome based specifications, low competences of procurers and poor management of risk. As if these factors were not enough, key inhibitors include (lack of) feedback from unsuccessful bids, a low appreciation of unsolicited ideas and previous private sector delivery history, and the difficulties for participation posed by pre-qualification procedures and conditions (Uyarra & Yeow).

Figure 1. IACCM survey May 2019

# 79%

of contracts include terms related to innovation or continuous improvement, but...

# 70%

say these are frequently ineffective



## The Factors that Deliver Results

Turning to the factors that are associated with greater innovation from supplier-buyer relationships, these include a strong sense of collaboration and partnership. Incentivizing success is one method of rewarding a supplier for innovation, but more important still is creating a sense of partnership and security, wherein both sides can offer input, feedback, and creativity. Joint goal setting, ensuring both sides understand the others' needs, is highly effective in establishing a solid and successful partnership.

There are common factors that influence the likelihood of a partnership developing. For example, an adversarial relationship based primarily on demands for cost reductions, or those where there is an unbalanced risk allocation, instill a sense of unfairness or dissatisfaction on the part of the supplier. This power imbalance discourages innovation and inhibits communication, both in quality and frequency, which negates goal-sharing and joint growth strategies, McKevitt, 'Suppliers say a lack of incentives hampers innovation', *Supply Chain Dive*, June 2017.

In an IACCM survey (May 2019), half of the suppliers surveyed say they have held back from proposing an innovation or improvement due to

Demands for cost reduction or an unbalanced risk allocation, instil suppliers with a sense of unfairness.

lack of incentive or customer openness. Whether it's a more affordable way to package goods, or a new product innovation, organizations that fail to engage with suppliers risk leaving major value, cost savings and expertise on the table – and in many cases, those innovations go instead to their competitors. This again is especially the case if there is a lack of trust or a sense of unfairness. Examples cited include situations where customers routinely demand rights over intellectual property or, even worse, take a supplier's ideas and open them to competitive bid.

### Operational Readiness a Key Factor

Problems with innovation also arise when customers lack the organizational and operational structures that make collaboration efficient and practical. Seventy percent of suppliers in the 3M study stated that at least half of the customers they supply do not have a strong system and process in place for buyer and supplier collaboration 'Driving growth and innovation through supplier partnerships', research study by 3M, published February 2017. The IACCM study reached a similar conclusion.

In the case of services, most ongoing commercial relationships between clients and service providers have 'service improvement' built into them as a goal or requirement. Clients need this to ensure they derive additional business benefit over time and that their service providers can support evolutionary changes to their business i.e. doing better within the current environment.

However, one former client described its inclusion as "A last minute catch all which will enable anything overlooked by the client to be added later at no charge."

Some service providers see such provisions having the effect of transferring unquantified risk to them. Conversely, it is possible that providers have been content to accept vague drafting in contracts on the basis that if the obligation is unclear, it is less enforceable. Illustrating this problem, while 50% of clients claim that they define what is meant by innovation and continuous improvement, only 28% of suppliers agree.

### Figure 2. Where a contract has provisions for continuous improvement or innovation, how often are they defined or described?

Clients say

**50%**

But suppliers say only

**28%**



Interviews with those who have experienced success suggest that sustained improvement and innovation may be more likely if managed by way of a contingency element which is outside the scope of the core contract and supported through a clear and specific governance framework.

The recent survey by the IACCM showed that while most clients talk about innovation, they believe that continuous improvement delivers more tangible benefits. However, the survey and interviews suggested that in many cases there is a degree of confusion over the difference between 'innovation' and 'continuous improvement'. It is understandable (especially in the case of services) that the line becomes blurred, but the frequent lack of definition highlighted above clearly does not help and several of the IACCM interviews confirmed that those seeing greatest success ensure there is clarity in these definitions.

### Summing Up

In summary, some of the concerns raised by service providers about offering innovation and what may therefore hinder optimal performance include: the client may just take the ideas and give them to a competitor to achieve a lower price; the client may not equitably share the savings; the best efficiencies or innovations may require or be based upon changed ways of working or revisions to the requirements of the client – and that feedback may not be well received.

The secret sauce, therefore, is trust and resultant collaboration. One example of how trust is developed is the creation of an Advance Supplier Relationship (ASR) or Supplier Quality Meeting: the client teams up with suppliers and together they define mutual KPIs and work together to achieve them. The key point here is a genuine co-operation in a shared objective, with shared benefits. Once success begins, it tends to multiply.

The aim of this paper is to review some of the terms used in respect of service improvement, to define and explain them and to set out when they ought to be used to secure the best outcome for both parties in an agreement. We have gathered input from industry experts who are on Client or Service provider side and some who have spent time on each side. We have done this by way of anecdotes, written inputs and by questionnaires. From the information gathered, we have produced a look-up table to help practitioners decide the best approach in their specific context.

Trust is the secret sauce that results in collaboration.



## Innovation

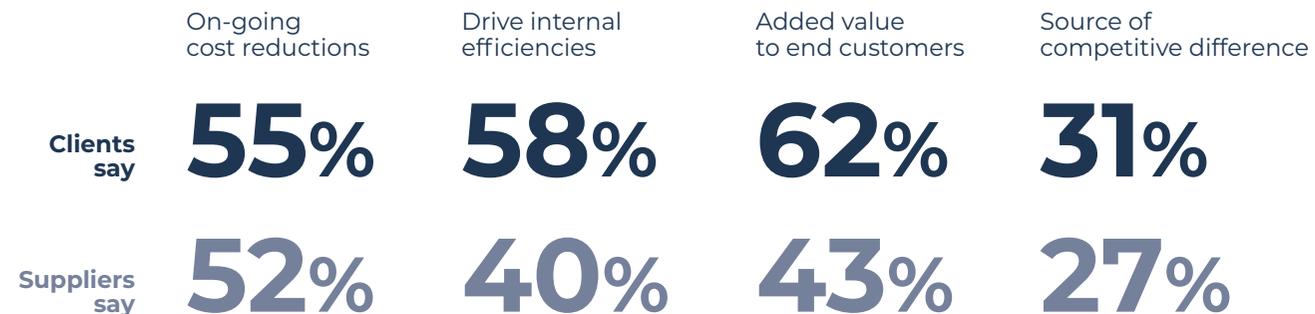
The Client may demand innovation as a scored element in its tendering process or the Service Provider could offer it as a 'sales' strategy to commit to the client to help them to explore new technologies.

For example, a service provider can help the client to explore new technologies that may assist the client innovation roadmap, or explore changes to the environment the client has today which might increase speed or generate cost savings. From the client perspective, innovations are sought to add measurable value (see Figure 3). Therefore innovation is proactive, is done with more collaboration with the client, sometimes requires service provider investment and co-investment with the client, and is more strategic in thought and application, being focused on actual business outcomes. It may need to operate over several years to obtain the benefit. Innovation is likely to include multiple business functions – commercial, technical, service etc.

It is typically important to undertake planned innovation with suppliers who have been objectively segmented as strategic to the client's business, and that have aligned values and behaviors, and share fundamental motivation to achieve the desired outcome. Executive sponsorship from both organizations in these cases is active, visible and ready to break impasses. Where opportunities stretch accepted conventions for sanctioning, executives are prepared to intervene and help guide the establishment of new frames for evaluating the attractiveness of an agreement or initiative.

By its nature, innovation should be beyond the accepted conventions for sanctioning; recognizing and accommodating this is a critical success factor in innovation. It should not be used by the supplier as an excuse to showcase other elements of its portfolio without a clear use-case for the client. In a trusted relationship, innovation ought to be presented from the supplier's wider knowledge and experience and may include introducing solutions from other providers within the supplier's ecosystem to increase value.

**Figure 3. What are the primary motivations for including continuous improvement or innovation provisions?**





Not all commercial agreements will warrant or require wider scope innovation, but the larger and more complex the relationship, the more likely it will be advantageous and can justify the significant investment in resources and capital typically required. In some industries, a trend away from long term, high value contracts means that businesses must find ways to foster innovation that are not dependent upon one contract, but rather on a wide and deep relationship between the parties, with shared reward.

In this context, 'innovation' and 'continuous improvement' may be very different, in that improvement is more likely to be related to a specific agreement.

In order to maximize the potential for success, the early stages of some joint innovation activities can be treated as if they were collaborative Research & Development projects. They should have clearly defined milestones, at which point the parties jointly evaluate the progress and benefits to decide whether to further fund or terminate the project. The reward system could be as simple as the service provider gets the IP rights and a level of additional revenue and the client gets to use the innovation at no additional cost. Depending on the product / service being developed, there may be a period where it cannot be provided to competitors. Otherwise, commercial complications can easily become so complex and cumbersome with gain share, joint ventures or other mechanisms that they become unmanageable.

Successful collaborative innovation needs a set of key enablers put in place – in the context of the relationship – to manage, develop and deliver innovation. These include:

**Leadership** – sponsorship from the top – not only stressing the importance of joint innovation but also putting in place the enablers to make it happen.

**People** – operational leaders responsible for finding and progressing the best challenges and ideas; wider access to people in both parties to provide input in various stages of the process.

**Process** – to address client challenges, develop ideas, capabilities and business cases, manage funding and move quickly through to delivery and benefits realization.

**Funding** – for the early stages of idea generation and innovation development – up to the point the business case is generated – after that the 'innovation' project should stand on its own feet or be quickly culled.

**Culture** – less tangible but vital – ensuring people work together for common goals, creating a buzz through positive communications, etc.

**Platform(s)** – much innovation will be digital, so use of digital platform(s) to quickly develop and try things out is often critical for speed of delivery.

In his book 'Collaborative Innovation: How Clients and Service Providers Can Work by Design to Achieve It' Tony Morgan outlines a simple – Five Step Approach – for practically driving joint innovation once using these enablers, based upon his experience of leading an innovation programme at IBM.

**1. Define Innovation** – Create a joint definition of what 'innovation' is in the context of your relationship – so the client will know if they're getting it and the service provider will know what they need to deliver.

**2. Agree Scope** – Should 'innovation' focus on initial transformational change, continuous service improvement, wider scope ongoing innovation within scope of the agreement and / or innovation across the wider client's business units?

**3. Agree Key Themes** – don't try to innovate everywhere. What's important to the client? Where can the service provider add value? Is there something in it for the service provider?

**4. Drive the Action Plan** – People, process and funding to run workshops, hackathons, etc against key client challenges, select and develop the best ideas, prove the business case, move to delivery, track benefits.

**5. Governance and Communications** – joint exec level oversight to set priorities, address roadblocks, celebrate and communicate success.



## Getting Started

Based on the research input (see Figure 4), it would seem there are many who actually need to start at Step Zero. This is about clients developing a structure and process and suppliers earning the right to have a wider scope joint innovation agenda. For this to happen, suppliers need to ensure their quality of service is up to scratch and delivering on their promises. Clients need to understand that innovation won't simply get done to them, and many times they would not like it if it did; they need to actively participate in a spirit of partnership, so that both organizations work together to put the key enablers in place. Indicating the scale of the divide, while 32% of clients claim to have a formal structure, only 15% of suppliers agree and over 40% have never encountered a client with such a structure in place.

Innovation can be expected to include:

- doing something differently that makes a significant improvement
- the ability to enable some things to be achieved that were previously unachievable
- or enable something previously achievable, but with significantly more resources or skills or costs
- 'breakthroughs'
- the creation of something new that is likely to have discontinuous relationship to what came before
- likely to have required some level of lateral thinking to move thought patterns out of previous tracks
- creativity and inspiration
- 'disruption'
- some form of end product that is more than an idea. It must be an idea that is translated into an outcome.

**Figure 4. Is there a formal structure to evaluate and accept supplier initiatives for continuous improvement or innovation?**





## Continuous Improvement

As per ITIL (Information Technology Infrastructure Library) definitions 2011, the CSI (Continual Service Improvement) process uses methods from quality management in order to learn from past successes and failures.

The ITIL CSI lifecycle stage aims to continually improve the effectiveness and efficiency of IT processes and services in line with the concept of continual improvement adopted in ISO 20000. Its reach has expanded beyond purely IT related improvements. Continuous improvement is likely to be completed within a contract year. It generally relates to improved, measurable performance within the 4 corners of the deal.

It can be aimed at a specific contractual performance measure (for example improving CSAT scores and response rates for a retail client because the CSAT tool has been replaced by a better product, or increasing click-sales by deploying an AI application that tailors shopping visibility based on past purchases).

We have already discussed how 'continuous improvement' will generally be incremental in nature and evolutionary and thus is often considered as 'business as usual' unlike 'innovation' which is more likely to be transformational or revolutionary. However continuous improvement rarely happens unless it is similarly encouraged and actively fostered. Service providers need it to generate productivity gains, to increase profitability and / or deliver the sliding scale pricing commitments they've made to their clients because they have improved performance under the contract.

The key enablers for 'continuous improvement' are similar to but subtly different from those for 'innovation' and thus in complex high value contracts there needs to be a distinction between, and emphasis placed on both.

**Leadership** – leaders need to actively foster a culture of continuous improvement, establish the necessary processes to initiate and exploit improvement activities, and be seen to stress the importance of collaboration and joint initiatives.

**Process** – is probably the most critical enabler to deliver 'continuous improvement' through establishing a rigorous evaluation of business processes, formally capturing best practices from other clients and industries, and enabling 'great ideas' to be exploited. For the service provider documenting all such activities is essential in convincing the client that the service is being improved.

**People** – many continuous improvement initiatives should emerge 'bottom-up' from the operational teams, and this requires leaders to encourage such ideas and foster an open supportive culture

**Culture** – as for innovation this is less tangible but vital to ensure both organisations' people work together for the common good through improving service delivery.

**Funding** – for continuous improvement is far less important than for innovation and thus is more likely to be prevalent in low margin contracts where the service provider cannot afford to invest significant amounts into the contract. Continuous improvement initiatives must demonstrate short term value and in most cases the benefits case is obvious. Some seed funding for continuous improvement from the client and contractual incentives (as described later) can facilitate their implementation.

Unlike innovation, which can be transformational or revolutionary, continuous improvement is generally incremental and evolutionary.



### Innovation and Improvement 'By Design'

We often focus on the negative, but there are many great examples of clients deriving significant business benefit from driving collaborative innovation in their commercial relationships and service providers using the approach to grow their business too.

A similar explicit approach to drive continuous improvement which recognises that this requires a different approach than fostering innovation can also pay dividends. The key to both is to do this collaboratively and 'by design', whether this is written into a contract schedule or driven pragmatically by commercial leaders on both sides.

When there is a clear understanding of the market, and benchmarks are used objectively to drive continuous improvement, it can be healthy, as long as it is well defined and in particular, the parties share in the results. If it is used as a last-minute contractual requirement to further reduce the price after the service provider has been through a competitive process, it will very likely result in dissatisfaction on quality over time. This unsophisticated tactic is often used by organizations that do not bother to understand the true cost components of a service / product or the underlying cost / competition dynamics in the industry, purely as a thinly-veiled aim to reduce the price.

Unsophisticated clients use last-minute continuous improvement requirements as a thinly-veiled device to reduce costs.



## Incentives – Shared Risk and Reward

Given the commercial landscape noted above, with each party having at least one eye on immediate financial benefits, there is room for risk / reward schemes, which can apply to innovation and to continuous improvement.

One key to making such risk / reward schemes work is to ensure that they are attractive to both parties and that the contract structure limits the possibility of opportunistic or gaming behaviour. Another is to differentiate as clearly as possible between new work, likely to be covered by a variation order, and better ways of doing the current work. This is difficult and a certain amount of pragmatism is likely to be required.

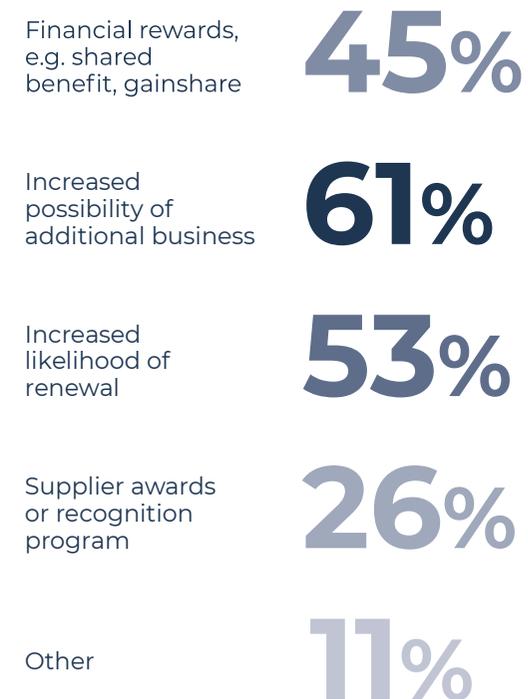
Once parties are engaged in pedantic discussions around taxonomy, the likelihood of making serious commercial progress is self-limiting. That implies good governance, the ability to escalate and executives being willing to intervene and ensure balanced judgment. However, it also requires clarity for the supplier about the likely benefit. As Figure 5 shows, for many, the main incentive is maintaining customer goodwill.

For innovation and continuous improvement to work, 'opportunistic' behaviour must be removed and this means that risk allocation is reasonably balanced and the price is right, or roughly right, for each party, whether that is the price for the original scope or for adjustments as the contract progresses.

For many contracts, a traditional three-four bid process against a known scope, rooting out outlying prices, will be sufficient. For others, a staged pricing process may be better – that is, a pricing mechanism that allows parties, over an onboarding period, to develop means of assessing the right price for the contract, subsequent to which the price is fixed or a target cost agreed and a variable or fixed fee mechanism is introduced. That mechanism is the baseline, the norm, the day-to-day fee for the work agreed. Such an approach is in many ways similar to 'agile contracting', a method used when there is a high degree of uncertainty over final requirements or how they will be achieved.

It is often tempting for clients to seek exclusive rights to innovative intellectual property and there may be a price at which the provider will agree. However, in cases where the provider uses its know how and experience to generate the idea. It will also almost certainly be core to their business, so they will not unreasonably refuse to restrict their rights and may also limit the client's use rights – for example, to share the IP or software with a future supplier. Innovations such as this may have been envisioned by the original contract, but will often require an addendum or even a new, stand-alone agreement.

**Figure 5. Are there incentives to innovate / provide continuous improvement? (client view)**





Assuming that innovation or improvement will be a contractual requirement, it should be clear that either can result in cost or scope increases or decreases. The issue should come down to whether service improvement will occur, whether such improvement is sufficiently beneficial and how the parties will be impacted and that impact shared. Think about this in terms of scope. If an innovation or improvement results in reduced scope or reduced cost, the service provider ends up with a lower fee, possibly in absolute and relative numbers. That means the provider has little or no incentive to put forward such ideas. Therefore successful programs will typically include a risk / reward scheme which analyses the cost benefits or cost increases which result from innovation or from improvement and will:

- For long-term innovation which increases cost, treat it as extra scope, with the existing contract payment and incentive schemes applying.
- For long-term continuous cost reductions provide a split between client and service provider. A 50 / 50 split, 'though radical, tells everyone that the scheme is serious.' A side issue is that of empowerment for front-line decision makers; compliance and process rules should be reconsidered to support nimble decisions on innovation and improvement.

**This example relates to shared risk / reward in practice:**

- Costs for overhauls based on the number of running hours with the target Time Between Overhaul (TBO) correlating to normal overhaul costs. Paying by running hours means that if the engine requires an overhaul prematurely then client pays less, conversely, if it runs longer than planned client pays more. i.e. win-win. This leads to potentially increased uptime for the client, leading to higher revenue for supplier.
- The management fee is at risk linked to achieving an availability target.
- Services contract that includes unplanned maintenance up to a cap providing an incentive to avoid rework and drive a 'right first time' mentality.
- Performance KPIs –performance metrics that we report and review during bi-annual performance review meetings. These are not linked directly to financial incentives but they do get management attention and do drive performance.

- Efficiency clauses – increasingly linking annual price reviews to efficiencies.
- Consortium established with suppliers and the wider ecosystem with incentivised performance metrics established to drive intended outcomes (cost, schedule, other).
- Gain share mechanism included in maintenance contracts as incentive to transform performance related to annually agreed performance metrics.
- Incentive scheme established with turnaround project management and execution contractors to safely deliver on or ahead of schedule.
- Gain share mechanisms embedded in contracts to reward contractors for outcomes related to joint project delivery success.
- Gain share mechanism established to incentivise delivery of mutually agreed transformation initiatives.



## Price Reductions

Often the desired result of a request for service improvement is actually to achieve on-going price reductions or savings.

The IACCM survey confirmed that most suppliers see one-sided savings or price reductions as the client's core agenda and (as shown in Figure 5, on page 12), in their experience the most common incentive is the possibility of repeat business. They feel that the client's real objective is seldom clearly expressed and requests for 'continuous improvement' or 'innovation' mask true goals. This lack of openness dilutes trust and means that the sort of governance mechanisms that could potentially lead to cost reductions are not put in place, leaving the ground set for future disappointment or discord.

There are certain situations in which it is extremely difficult for service providers to make reductions during the term of the contract. This can occur where strongly competitive tenders are used to drive the price very low before the contract is awarded. It is not unusual for the winning provider to depend on either price increases or cost reductions in order to achieve a profit.

In circumstances where it is reasonable to seek price reductions, these should be set out in the contract to ensure certainty.

Although now falling out of favor in some jurisdictions, Private Finance Initiatives (PFI) are another area where it is extremely difficult to secure price reductions during the life of the contract. The model is based on the service provider being able to recover initial investment, then make a reasonable profit in the remainder of the contract. Only where there are demonstrable supernormal profits would price reduction be possible. In general, services that are priced unfairly low have the unwelcome effects of driving out competition, killing creativity and increasing risk of project failure.

### Respecting the Need for Supplier Profit

Clients should also give some consideration to the use of indexation, which in certain circumstances could serve as a 'double whammy' when coupled with a required price reduction. Other provisions, such as disallowing a supplier's increased costs from new regulations, can also undermine profitability, as can practices such as extended or late payment terms. There are, however, circumstances where it is very reasonable to seek price reductions and it would be better if these were set out in the contract to ensure certainty.

Such circumstances include when there has been true and accurate benchmarking which indicates the pricing is unreasonably high. This can happen when the cost to the supplier of raw materials or labor has decreased. Open book accounting can be useful to demonstrate this as the contract progresses. Price reductions can also work well in situations where the volume of orders under the contract is increasing; the service provider also has something to gain from the situation. The opportunity to sell different services to the same customer also presents a saving opportunity, as does extending the term.

In short, price reductions are effective only when clearly stated as a requirement in the tender and when the original pricing situation has become more manageable for the service provider (by becoming less costly or by increasing sales). Clients who consider this at the tender stage are more likely to receive a satisfactory outcome.



## Summary Points of Responses to Questionnaire and Findings:

1. People seem to request continuous improvement more than innovation, but it is accepted that expectations are poorly defined.
2. The rationale stated to be behind a request for service improvement is often value for the client's client. This requires shared understanding of the supply chain.
3. The reward to the service provider in delivering the requested service improvement is often stated to be the prospect of more business. However, there is no hard evidence that more business is generated. In public procurement, the work in one tender cannot be considered in another, so it would only be of true benefit to the service provider if the service improvement can be applied by way of a change note to the existing contract (to the extent OJEU permits expansion, which may present a significant challenge in respect of innovation). Experience shows it is extremely difficult to secure additional benefit in this way and therefore service providers are not encouraged or incentivized to offer true service improvement. Each service provider has a duty to maximize value for its own business. If there is no way for service improvement to achieve this aim, it will not lead to the desired impact.
4. There is some evidence to suggest that innovation, in particular, should not be incorporated within the core contract or agreement, but rather requires its own form of agreement that is administered separately and may involve a different set of stakeholders. There are several reasons for this. For example, innovation will often require significant levels of investment by one or both parties and the project team frequently lacks the skills and the authority to make such decisions. Also, there is a very real difference between the resources and skills needed for day-to-day performance management and those required to assess and evaluate true innovation. Finally, there are advantages in moving strategic decisions on innovation out of the sometimes emotive and personality-driven environment of project and contract delivery. This is especially the case when there is a long-term, multi-dimensional relationship between the client and the provider, with more than one agreement under management.



## Recommendations

1. Review and agree the type of service improvement you are seeking in the context of your opportunity.
2. Set out a definition in the Agreement so that all parties are very clear about the aim and their respective responsibilities to ensure the aim is achieved.
3. Progress must be monitored in the ongoing relationship. This may be in the context of a specific contract, or as part of a separate agreement (e.g. in a long term, strategic relationship). In either case, there must be an agreed governance process with well-defined entry points and fair, balanced procedures.
4. Ensure there are appropriate mechanisms for the level of innovation or improvement envisaged – specifically, authority levels for decision-making and funding.
5. The more complex the methodology set out, the more trust between the parties is required. Trust must be developed and maintained to ensure success.
6. Both parties have to be able to benefit from the initiative and the relationship.
7. Consider ways outside of a specific contract to develop innovation as contracts become shorter and less complex.
8. Get the basics right to foster a positive environment for collaborative innovation,
9. Establish a simple joint mechanism for managing, developing and delivering collaborative innovation, such as the 'Five Step Approach' described in the innovation section above, and don't forget to celebrate your successes.



# Appendix

## Innovation and Continuous Improvement – Written Submissions

### Views From the Field

The following pages contain input from IACCM members outlining their ideas and experiences related to innovation and continuous improvement. The views are a mix of customer and supplier perspectives and come from large, international corporations in a variety of industries.

I recall when these continuous improvement clauses became a hot topic a few years ago. Unfortunately, the way it landed lower in the organization was as an edict to contractually require suppliers to reduce costs by 5% every year. It took quite a bit of work to undo this perception and prevent the inclusion of such draconian clauses in our contracts.

Fortunately, we've been able to move past the idea that the key to success is to threaten suppliers with the loss of contracts if they don't reduce costs. Since then, our teams have been trained and have embraced more collaborative approaches. I've heard many success stories – typically involving our more strategic and long-term suppliers.

Suppliers are sometimes hesitant to share efficiency ideas for a few reasons:

- The customer may just take the ideas and give them to a competitor at a lower price.
- The customer may not equitably share the savings.
- The best efficiencies may be in changed ways of working or requirements of the customer – and that feedback may not be popular.

The secret sauce, therefore, is trust. This only works if the two parties can first establish a respectful and trusting relationship.

I never experienced the terms being confused with each other, but both often lack clarity.

The Innovation clause is often a last-minute negotiation and a way to squeeze just a little more out of the suppliers. Suppliers often agree to it because it is poorly defined and seldom materializes. When I was on the client side I described it as “something clients asked for so that, if we stumble onto something they forgot or want, they can ask for it to be included without paying for it.” This is obviously is not what innovation is about. In my view, it only works if there are clearly defined innovation plans / programs that benefit both sides, and for which a certain amount of money is set aside each year. It then needs to be managed as an R&D project with clearly defined milestones at which point the parties jointly evaluate the progress and benefits and decide to further fund or terminate the project. The reward system can easily become so complex and cumbersome with gain share, joint ventures etc., most of which seldom yield benefits. I believe it needs to be as simple as ‘the supplier gets the IP rights and the customer gets to use the innovation at no additional cost’. Depending on the product / service being developed, there may be a period where it cannot be provided to competitors.

Continuous improvement can be good or bad. However, it is often just a synonym for price reduction. If again, it is used as a last-minute tactic to further reduce the price after one has already put the supplier through a competitive process, it will very likely result in dissatisfaction on quality

over time. This tactic is often used by organizations that do not bother to understand the true cost components of a service / product or the underlying cost / competition dynamics in the industry and use it purely as another tactic to reduce the price. On the other hand, when there is a clear understanding of the market, and benchmarks are used to drive continuous improvement, it can be healthy, as long as it is well defined and in particular, the parties share in the results.

Innovation and continuous improvement are – in my view – different provisions. Usually demanded by customers and mostly in outsourcing contracting contexts. In the past it was mostly service improvements and now (more and more) innovation. Providing such service improvement and innovation seems to be these days part of overall customer satisfaction / customer expectations. No client would expect a service or solution not evolving during the contract life. In a nutshell, the difference between the two could be major changes to the existing environment (innovation) versus small tweaks to the existing environment and / or process changes (continuous improvement).

In my modest opinion, for future contracting models this will clearly change. New contracting models are of shorter term duration (no longer outsourcing major and long deals), so little chance to really improve, and many will be based on flexible service provision (as a service?) where you pay for what you consume, so clients could not be expecting more ‘service improvement’ and could be expecting more ‘embedded innovation’ in what they pay for what they consume.



Anyway, some thoughts about it:

**Innovation:** Is something customer may demand (as explained, as part of their expectations) or even the Supplier could offer as a 'sales' strategy to commit to the client to help them to explore new technologies. For example, a Supplier can incentivize a Customer to decide for a deal, under the compromise from Supplier to invest (time, resources...) along some time of the contract duration and help Client to explore new technologies that could help the Client innovation roadmap, or explore changes to the environment the client has today (as a different way of doing things that could have advantages for the client, such as increased speed or cost savings). From Client perspective Innovations are adding value, which is measurable (e.g. lower costs, leaner processes, less administration).

Therefore Innovation is more proactive, is done with more collaboration with the Client, sometimes requires Supplier investment (or co-investment), and is more strategic in thought and application, being focused much more on actual business outcomes that do not necessarily have direct IT performance measure (for example improving CSAT scores and response rates for a retail customer because the CSAT tool has been replaced by a better product, or increasing click-sales by deploying an AI application that tailors shopping visibility based on past purchases). The technology is there – but the focus is on the client end result. Finally, innovation is more likely to include multiple business functions – commercial, technical, service etc.

By contrast '**Continual Service Improvement**' is linked to Service (not involving other business

areas) and is more particularly about **doing better within the current environment**. It focuses on the current services, is more tactical and is focused on IT measurement (improving Service Levels).

This can be reflected in YoY price reductions as the Supplier is expected to become more efficient, or SLAs becoming more challenging each year, or execution of process improvements such as replacing manual tasks with automation demanded.

If you want to read more about Continual Service Improvement, you probably already know that it is described in the ITIL book. As per ITIL definitions 2011 (We have now ITIL V4 published Feb. 2019 but did not find its glossary so I paste here the official definition still from 2011 glossary):

**Continual service improvement (CSI)**

(ITIL Continual Service Improvement) A stage in the lifecycle of a service. Continual service improvement ensures that services are aligned with changing business needs by identifying and implementing improvements to IT services that support business processes. The performance of the IT service provider is continually measured and improvements are made to processes, IT services and IT infrastructure in order to increase efficiency, effectiveness and cost effectiveness. Continual service improvement includes the seven-step improvement process. Although this process is associated with continual service improvement, most processes have activities that take place across multiple stages of the service lifecycle. See also Plan-Do-Check-Act.

I find that many time clauses are added simply because people don't know which to use and it's more of a CYA activity than it is understanding which are the best / appropriate. With the number of contracts being issued and the complexity of those contracts increasing along with a limited number of resources, it becomes more of a 'throw everything at them' type of exercise. With many people covering many commodity areas now, that complexity level increases.

I also believe the lack of clarity is purposeful (from both sides) in order to protect each company if / when legal becomes involved. The more general and less clear, the easier to interpret from a legal point of view.

Many times the buyers are caught in between what is needed to cover a service (if the resources are on our properties vs offsite) and what is needed to protect the company. To me, many items that have become clauses, actually fall more under performance / metrics etc, but no one knows the best ways to handle. Anything that is not in a template seems to become a clause, part of this may be because we have become over templated and allow for less critical thinking by our buyers.

An interesting topic! I can understand why the terms are used interchangeably as I feel there is a high degree of overlap: in many instances, innovation – which tends to respond to a specific issue or challenge – can lead to continuous improvement if the learning & practices from that innovation are embedded.

Within the global Commercial function there are a few things that attempt – and I believe are successful! – in driving innovation and continuous improvement;

- We have a 12 month rolling Global Commercial Function Plan which sets out specific actions to evolve and continuously improve the function, and responds specifically to the company strategy. The Global Commercial Council meet specifically once a year to review the strategy and the preceding Plan and agree which actions will continue into



the following year and any new ones. The Plan is cascaded down into the business functional plans. Many of our improvement initiatives within the function are generated through this mechanism

- We also implement a Commercial Achievement Award Scheme which recognises exceptional, innovative practices taking place. In my experience, this innovation invariably focuses on addressing Customer requirements and challenges, but can also be internally focused. And many respond to the Customer's desire to drive down price – which doesn't necessarily give the best value! Which then moves into the realms of good business acumen by our Commercial teams to influence and inform the Customer into a value proposition discussion rather than a transactional, price discussion.
- Moving back to continuous improvement, we are also in the process of developing and implementing a common self-assessment process against our Operational Framework level Commercial Policy with the primary aim to drive continuous improvement within the function. Businesses will rate themselves Compliant, Better or Best against each of the Policy mandates which as you would imagine focus very much on our role. The process will be underpinned by business to business peer reviews where a number of focus areas will be explored where Better or Best ratings have been achieved, with the aim of sharing good practice across businesses which we are traditionally not very good at. The top level results for all businesses will be captured through our Operational Assurance process and shared with all the businesses to allow improvement discussions outside the peer reviews.

In my experience we have achieved more innovation and continuous improvement from suppliers when we REALLY partner with them rather than when we add a 'wish' in our contracts. In our lookbacks we observed that prior but very close to contract execution, we remember that we need to add something in the contract about innovation and collaboration. Hence we add very vague terms to indicate parties will get together after contract execution and will define ways to collaborate / innovate. Most of, if not all, the time that is just an empty declaration of good intentions that never become operational or bring any meaningful results.

I observed good innovation via the creation of Advance Supplier Relationship (ASR) or Supplier Quality Meeting: we team up with suppliers and we define mutual KPIs and we work together to achieve them. I was involved in a Chemical ASR that we focus on products that although increase the cost of the chemical treatment we bought it also increases production, hence the delta was very beneficial to both parties.

Or working together with a rig supplier to reduce head count on the rigs without missing efficiency (actually we gained efficiency).

1. Service contract for operation of capital equipment with performance bonus / malice provisions. Supplier retains title to the equipment and we pay only when the equipment is running in order to provide alignment of purpose w.r.t. reliability / uptime. We also have an Availability Guarantee in this contract with financial opportunity / risk attached in order to further increase the performance incentive for the supplier.

2. Costs for overhauls are based on the number of running hours with the target Time Between Overhaul (TBO) correlating to normal overhaul costs. However, paying by running hours means that if the equipment requires an overhaul prematurely then we pay less, conversely, if it runs longer than planned we pay more. i.e. win-win. A longer TBO = reduced hassle and potentially increased uptime for us = higher revenue for supplier.
3. The management fee is at risk linked to achieving an availability target.
4. Services contract that includes unplanned maintenance up to a cap providing an incentive to avoid rework and drive a 'right first time' mentality.
5. Performance KPIs – all rotating equipment global agreements include performance metrics that we report and review during our bi-annual performance review meetings. These are not linked directly to financial incentives but they do get management attention and do drive performance.
6. Efficiency Clauses – increasingly we're linking annual price reviews to efficiencies.
7. Consortium established with suppliers and construction companies with incentivized performance metrics established to drive intended outcomes (cost, schedule, other).
8. Gain share mechanism included in maintenance contract as incentive to transform performance related to annually agreed performance metrics.



9. Incentive scheme established with turnaround project management and execution contractors to safely deliver on or ahead of schedule.
  10. Gain share mechanisms embedded in contracts to reward contractors for outcomes related to joint project delivery success.
  11. Gain share mechanism established to incentivize delivery of mutually agreed transformation initiatives.
- Executive sponsorship from both organizations is active, visible and ready to break impasses.
  - Where deals stretch accepted conventions for sanctioning, Executives are prepared to intervene and help guide the establishment of new frames for evaluating the attractiveness of an agreement.

#### Lessons Learned

- While we have attempted various forms of contracting for CI or innovation, we tend to suffer from organizational amnesia, forgetting experiences of the past, and approaching each deal as if it is totally new. This can be inefficient.
- There are many parts of the company that contract to achieve outcomes, but sharing of contracting principles and lessons learned across organizational silos is uncommon. For example, our business development and revenue-facing commercial teams often negotiate highly complex innovative deals. Our PSCM organization has limited visibility to how this is done and what benefits / cost the company has incurred based on decisions made.
- Clarity on intended scope and desired outputs is not consistent. Where we are clear, more advanced contracting is possible. Contracting competency is also a necessity to be able to deliver these advanced concepts.
- Contracting for value is just the start. Innovative deals require constant performance management to ensure follow-through. These deals often fail to realize their value because the company ignores the incentive components of the deal (e.g. they

don't have budget to pay gain share, they don't have time to align stakeholders on performance objectives or measure performance outcomes, etc.) and revert to traditional transactional contracting to get work done.

I agree that these are often misunderstood by suppliers and customers alike. Here is how I've explained it in my career and I think a number of outsourcers follow this approach:

**Continuous Improvement** generally relates to improved, measureable performance within the 4 corners of the deal. 3rd party advisors and others tried to push a commitment and penalty based set of language on this in the SLA / KPI sections. I think the language used to be something about taking the average six performances above target SLA level and making that the new SLA Target level for the following year. It was a beautiful example of math and language devoid of reality and relationship and as such most big outsourcers rejected this or watered it down to something more akin to 'the parties will look at the SLAs annually and discuss options to increase SLA levels or compliance'. Effectively this took the teeth out of the clause, but still kept the perspective on 'SLA' performance which may or may not really tie to business outcomes. Companies which did well in the great automation push post 2013 flipped this a bit and started to get more into gainshare lite SLAs focused on more business outcomes (quicker cash, lower AR times, better collections, etc). But again, the model was based upon a measurable result and the frame of reference was still fundamentally an SLA – nice outcome language aside.

#### Where We Have Gotten It Right

- We know the difference between continuous improvement (in-year efficiencies) and transformative innovation (can be multi-year value, can fundamentally shift performance paradigms).
- We are clear on the scope we need executed as well as the outputs we expect and their total value to the business. And, our suppliers are clear on what this means for their business.
- We invest appropriate time and resources to a fully thought through deal with mutual clarity on how the negotiated business model impacts both organizations.
- For transformation, the companies see the long-term benefit (multi-year value, beyond cost, scalable solution) and are committed to funding, if necessary, the investment required to move the conversation forward.
- We work with the right supplier. One that is objectively segmented as strategic, has aligned values and behaviors, and shares fundamental motivation to achieve the deal.



Now, a good service provider can ensure SLAs say what they need to say. I don't say this to imply any lying or duplicitous nature. But as the great Will Rogers once said, there are "lies, damn lies & statistics". I would put SLA reporting in that bucket. This has created the 'Watermelon effect' on SLAs where everything looks green on the outside, but if you look at the real performance underneath it is all red.

This has led to some distrust, further misunderstanding and really a reporting for reporting sake mentality.

Providers who have been really successful have gotten away from these games and gotten more and more into true business outcome / share risk views on continuous improvement. This is not a uniform thing at all, but you can see these in case studies, advertising, etc. where mature customers and providers really look at what is a 'win' and spend more time on that than just using the remnants of SLAs – which really are remnants of the ITO push 30 years ago.

**Innovation** clauses have become a joke to be honest. Most big time providers use these as opportunities for cross-selling other products in their portfolio and showing them an innovation – no matter if this is germane to the needs of the client or not. In my new world we have taken up a new approach: Tech of the month. Once a month we show some of our key clients a new startup tech (some from the IACCM dragon's den) as a model and use case that could honestly help the client. We frame it as 'we are out there in the market, we see more than you – let us push you 1x per month with ideas out there'. This is going over very well.

Big players do treat this clause as a non-joke and actually write up gainshare language where they will say "if we bring you RPA / AI / etc. we can agree on where to try this and if it works we will share the benefits 50 / 50 after we (provider) recover our investment cost". I've seen this language for 15-20 years, but good vendors are actually taking this seriously now and getting good results.

#### Innovation:

- Innovation is not just about new products or even step changes.
- It is also about doing something differently that makes a significant change / improvement.

The improvement could:

- Allow some things to be achieved that were previously unachievable.
- That is, not achievable at all; or maybe previously achievable, but with significantly more resources or skills.
- Innovation is often linked to 'breakthroughs'
- It is the creation of something new that is likely to have discontinuous relationship to what came before.
- Likely to have required some level of lateral thinking to move thought patterns out of previous tracks.
- Can be done with teams but is usually characterised by creativity and inspiration.
- Often seen as in some way 'disruptive'.

- Importantly, an innovation has some form of end product and differs from an idea in this respect.
- Visually likened to step that has an end.
- The end may not be final as continuous improvement may refine the innovation, or further innovations could create a new product or capability.

#### Continuous Improvement:

- These are small incremental changes that make what is already in existence, better than it was.
- No real lateral thinking is usually required, more progressive and / or logical than creative.
- Often done in teams where the collective thinking and energy of a team is facilitated and motivated through being able to contribute and shape direction.
- Visually more like a slope rather than steps, although when looked at closely the slope is still a sequence of small steps.
- Continuous Improvement conceptually has no real end.

A neat analogy could be travelling down a river from a mountain. By removing rocks and deepening the shallows or taking out bends, you will get to your destination faster or more comfortably – this is Continuous Improvement. Innovation is jumping to a new river and getting to a different destination that you could not reach down the previous river or maybe to a destination that you didn't know existed.



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