

# Unpacking Best Value

Understanding and Embracing Value  
Based Approaches for Procurement

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## EXECUTIVE SUMMARY

Probably no other topic creates as much apprehension between two companies as trying to determine a fair price. The conventional procurement process pits buyers and sellers on opposite sides of the table. Classical negotiations training uses tradeoffs and concessions as tactics to get the best possible price (or preserve as much margin as possible if you are a supplier). A win for the supplier means a loss for the buyer. The result? A zero-sum game. A mindset where the parties fight over taking bigger slices of the pie instead of combining talents to make a bigger pie.

Progressive companies are challenging conventional approaches by looking at the world through a different lens. Simply put, it is not how much a company pays, but how much they get – or Best Value. This requires procurement professionals to move beyond price and truly understand the total cost of ownership (TCO) and associated hidden risks in order to determine the Best Value for the goods or services they buy and use.

Although TCO and Best Value have become industry buzzwords in the last decade, using the concepts is far from widespread. Although it is widely understood that both terms fundamentally mean “more than just price”, the fact remains that many companies have yet to embrace the concepts in a way that shows they truly understand the approaches and how to use them to maximize value.

The primary goal of this white paper is to help procurement professionals better understand value-based approaches for procuring goods and services. It is divided into five parts, exploring these concepts:

Part 1 explains the use of “**lowest price**” and its **disadvantages**

Part 2 seeks to put costs in a broader perspective and introduces **Total Cost of Ownership** (TCO)

Part 3 introduces the **concept of using value** instead of costs - (Total Value of Ownership) or quality

Part 4 shares **real examples** of using Best Value in the supplier selection phase

Part 5 explores the role of **Sourcing Business Models** theory and transparency

We end the paper with a **Conclusion** and a **Call to Action**.



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### PART 1: THE USE OF LOWEST PRICE AND ITS DISADVANTAGES

The simplest and easiest way to select a supplier is by picking the one with the lowest (initial or acquisition) price. After all, it is easy to compare suppliers on price alone. Consider yourself at a busy intersection surrounded by four gas stations all selling the same three common grades of gasoline. The price for gas that day is clearly posted on signs right in front of each gas station. It's no different when you go to Amazon and search for a 12-pack of No. 2 pencils. A quick click or two and you can rank the suppliers from least to most expensive. It's easy. It's quick. And most importantly, it's fair and non-controversial. The price is the price and you can quickly make a decision to pick a supplier based on the lowest price.

Picking a supplier on price is so prevalent that many corporations and even government agencies have had policies that enforce the "low price" practice for decades. For example, in 1954, the Minnesota Supreme Court ruled that state agencies were required by law to award contracts to the supplier with the lowest price using an open bid process. The rationale? To divest public officials of discretion to avoid even the appearance of "fraud, favoritism, and undue influence."<sup>1</sup>

Using price to pick a supplier is a good strategy when buying commodities such as oil, electricity or No. 2 pencils. Unfortunately, not all products or services are identical. For this reason, the concept of Lowest Price Technically Acceptable (LPTA) emerged as a viable supplier selection option. LPTA differs from the conventional "low price" approach because in LPTA, the "lowest price" bidder is not always selected. Rather, the award is given to the supplier with the "lowest price" *which has a technically acceptable offer*.

LPTA is an easily understood concept; the award goes to the lowest priced bidder who submits a technically acceptable proposal. The process is straightforward as well. A buyer identifies the low-price bidder and then determines if its proposal is technically acceptable. If yes, the award is made to that bidder. If no, the agency moves to the next low-price proposal to determine if it is technically acceptable, and so on until an award is made. A key benefit of LPTA is there are no judgments or trade-offs involved. The selection committee (or person) simply needs to review the pre-determined "technical" criteria and ensure the suppliers' proposals meet the criteria. This is always done through non-price factors evaluated on a pass/fail basis, eliminating the need for judgment.

LPTA procurements are intended to be used when the requirement is clearly definable and the risk of unsuccessful contract performance is minimal. Simply put, LPTA is a good solution for selecting a supplier when goods and services are very homogenous. However, in many cases, goods or services are not homogenous and there is a need for more than simple pass-fail technical criteria. This is especially true when considering services related to the purchase of a good (e.g. warranty, after service support, etc.).

The low bid approach is paved with good intentions of "watching out for taxpayer dollars" or "delivering maximum savings for the corporation." But experience (ours and most likely yours, too) has shown that sticking strictly with the lowest bidder may not necessarily generate savings, and in worst cases, may have serious consequences. A good example of the latter is an original equipment manufacturer (OEM), which chose to move from an onshore supplier to an offshore supplier several thousand miles away. Original estimates showed a price savings of almost 75 percent compared to work performed by the supplier in the region. What the company did not factor in were the increased costs to manage the relationship with the offshore supplier. The company's travel budget increased by 400 percent as



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engineers and quality teams flew business class to visit with the supplier for new product launches and quarterly reviews. Although this is an extreme example of being “penny wise and pound foolish,” it is not a reflection on making onshore vs. offshore decisions. It is simply an example that shows how 100% of the promised savings did not hit the bottom line because the company failed to factor in the total cost of doing business with an offshore supplier before making a final decision.<sup>2</sup>

Another potential disadvantage of strictly focusing on sales price occurs when dealing with cost overruns or expenses. Simply put, there is little motivation for the contractor to innovate or bring expenses down because doing so may actually reduce profits. But how big is the problem? A 2013 Market Connections and Centurion Research Solutions study cites sobering statistics regarding the effectiveness of LPTA. The report found 65 percent of contractors and 43 percent of government workers thought LPTA sacrificed long term value for short term savings.<sup>3</sup>

Fortunately, there is an appetite for adopting Best Value approaches. The state of Minnesota was one of the first to challenge the low bid approach when it updated its procurement laws in 2001. Other states are following suit. A recent survey<sup>4</sup> cites that, in the USA, 41 states “conduct some form of Best Value procurement” – so progress is happening. However, how much progress is debatable. For example, many states still have restrictive practices prohibiting interaction with suppliers during the RFI and RFP stages. Others encourage market research but conduct limited analysis on factors other than price. Still others are so prescriptive in their specifications that suppliers cannot showcase their true expertise.

Change is not just happening in the US. Most recently, new EU procurement law allows Member States to prohibit or restrict the use of “price only” to assess the selection of the best supplier, where they deem this appropriate, “to encourage a greater quality orientation of public procurement.”<sup>5</sup>

Sadly, many organizations are slow to make the change, and there’s still a long way to go. For example, the city of Philadelphia only changed its local laws allowing for use of value-based approaches in 2017.<sup>6</sup>

While many non-government organizations do not have laws forcing them to select low price bids, the prevalent modus operandi for many businesses is (still) to use price as the benchmark and to seek annual price reductions from suppliers. Why? Far too many procurement professionals seek immediate gratification of getting a cheaper “price” because buying on “value” is often perceived as too long-term, complicated and abstract, and involving too many departments. Couple this with the fact that many procurement organizations have a metric for their buyers on “purchase price variance” with year-over-year price reduction targets, it is easy to see how the typical procurement professional is less than motivated to go the extra mile to seek out the best value versus the best price supplier.



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### PART 2: TOTAL COST OF OWNERSHIP (TCO)

As discussed in Part 1, selecting a supplier based on lowest price or LPTA is not always the smartest approach. It is often more appropriate and wiser to consider the concept of Total Cost of Ownership. Total Cost of Ownership (TCO) considers the purchase price plus the costs of operation. Simply put, when selecting a supplier, buyers should look not just at an item's short-term price (which is its purchase price), but also at its long-term price, which is its Total Cost of Ownership. The item with the lower total TCO is the better value in the long run.

The concept of Total Cost of Ownership (TCO) first emerged in the 1950s when experts such as Michigan State's Dr. Don Bowersox challenged conventional approaches to understanding the costs associated with logistics.<sup>7</sup> He and a few colleagues believed that warehousing professionals needed to understand the total cost of a shipment—not just the warehousing and transportation costs.

Bowersox and other thought leaders established the National Council of Physical Distribution Management, which is now known as the Council of Supply Chain Management Professionals, to promote what they called “total landed costs.” The concept of total landed costs has evolved and expanded outside of the logistics profession, and today most industries refer to the concept as TCO.

TCO began to get widespread traction in the information technology field in the late 1980s with the Gartner consulting group, where TCO was used to calculate all the costs of owning a desktop device, including capital, technical support, administration and end-user costs.<sup>8</sup> The TCO concept has evolved considerably over the years to embrace a more holistic approach for understanding the entire economic investment associated with any product – including costs of acquisition, operation and disposal. In fact, this cradle to grave mentality is the basis for how most people define TCO. The existing literature and market consensus is that the TCO is the “sum of purchase price plus all expenses incurred during the productive lifecycle of a product, minus its salvage or resale price.”<sup>9</sup>

However, this definition assumes that total costs – once calculated – are static and do not change. Contemporaries are pushing the concept of TCO further back in the supply chain and encouraging suppliers to capture their total costs, challenging a more dynamic approach and encouraging companies to consider risks as well.

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## CALCULATING TOTAL COST OF OWNERSHIP

The authors put forward the following definitions and calculations to help clarify the concept of understanding a buyer's total cost:

<p><b>Supplier's Cost = Supplier's Direct Costs + Supplier's Indirect Costs</b></p> <p><b>Supplier Cost ≠ Supplier's Total Cost</b></p> <p><b>Supplier's Total Cost = Supplier's Cost + Supplier's "Hidden" Soft and Hard Costs + Costs Associated with Supplier's Risk</b></p> <p><b>Purchase Price = Supplier's Total Costs + Supplier's Profit</b></p> <p><b>Buyer's Total Costs = Purchase Price + Buyer's "Hidden" Soft and Hard Costs + Costs Associated with Buyer's Risk</b></p>
------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

The TCO concept can best be described through a simple example of buying a car. Each person considers different criteria important when purchasing a car. Intuitively, once the specifications are chosen, such as a four-door family sedan with automatic transmission, air conditioning and a certain size engine, then one could assume the choice is made based on a unit-price comparison of the options that meet those criteria. However, the costs of owning a car do not end with the initial purchase. The operating costs such as fuel consumption, average cost to repair or service, financing, insurance, depreciation rates and numerous other costs live well beyond the acquisition of the car. With this data, one might find that the car that initially appears to be more expensive might actually provide the *lowest total cost*, and is therefore a "better deal."

Practical approaches for applying TCO for comparing cars have gotten much traction. There are even free TCO calculators available on the Internet to help people determine the costs of owning different types of cars; including such costs as depreciation, interest on the loan, taxes and fees, insurance premiums, fuel costs, maintenance and repairs. Edmunds, a website for car buyers, has created their own TCO acronym, "true costs to own," which allows customers to calculate the differences between cars.<sup>10</sup>

## BOUNDARY SPANNING BASELINE COST MODEL

The only way to get to the real total costs is to document total costs from an end-to-end perspective—capturing the costs from *both* the buyer and supplier. This includes all cross-departmental costs within the buyer's organization as well. The earlier example of the procurement group who moved to an offshore supplier is a good example of how costs "popped up" in other areas – such as travel – that were not obvious to the procurement team when they first did their price comparison. Had they checked the cross-departmental costs within their organization, they may have avoided the error.



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Developing a cost model is a key step to any strong sourcing process and helps buyers identify the areas where there is room for improvement. It also helps establish the groundwork for a good pricing model, since each has different variables that might influence the outcome. If conducted effectively, a cost model analysis will result in recommendations that can be built into action plans designed to take costs out of the supply chain. Cost modeling can also be used as a tool for creating performance measures in contracts and can help monitor the effectiveness of contract incentives.

### COMPONENTS OF A COST MODEL

A baseline TCO analysis includes the costs under the current scenario as well as what is projected based on the set of assumptions. As mentioned previously, the preferred approach is always transparency, where the total cost to own a product or use a service over time is factored into the price.

Some of the most common items to include in a TCO analysis include:

- Design and development costs
- Hard costs (e.g., labor and assets)
- Operating costs (e.g., energy and maintenance costs)
- Soft costs (e.g., overhead, “corporate allocations” and training)
- Installation and commissioning costs
- Governance costs (e.g., cost to manage the relationship)
- Software costs
- Supply chain support costs
- Retirement, disposal costs or residual value
- Opportunity costs, including reduced downtime, increased production yield, sales value, increased sales or margin for developing a better product
- Transaction costs, including the cost of switching suppliers and costs associated with a competitive bid and contracting process
- Environmental or sustainability costs or savings

While the list above provides guidelines, the physical act of identifying true total costs is not entirely straightforward and often difficult.



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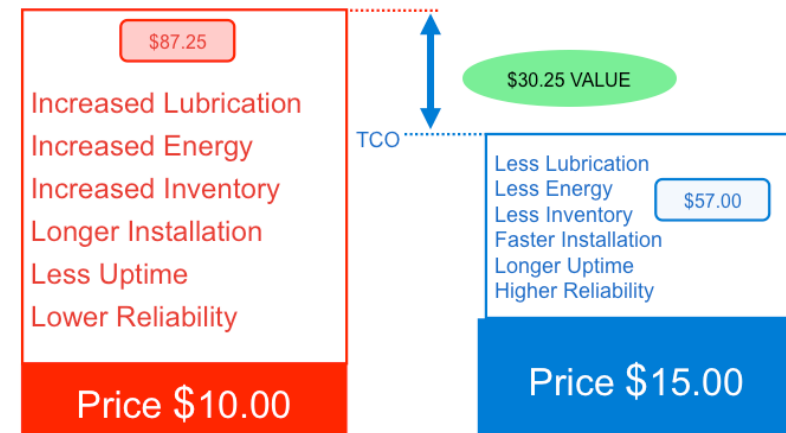


Borrowing from a tried-but-true concept, this “Priceberg” graphic depicts the “below the surface” costs, which ironically are estimated to contain roughly 80% of total costs. The Priceberg illustrates the importance of looking at the hidden costs. Understanding only the price (above the waterline) is analogous to seeing only the tip of the iceberg. Often what is out of sight can and will cause the greatest damage. For example, many companies do not consider disposal costs, which can often be significant. Numerous studies confirm the initial purchase price can often be the smallest component of a company’s costs. For example, in industrial equipment (such as pumps, fans, or gearboxes) an Accenture Consulting report shows that purchase price represents only 12 percent of its total cost.<sup>11</sup>



Suppliers are also seeing the value of applying TCO concepts. Some companies such as SKF – the world’s market leader in bearings and related industrial products – have embraced the concepts of TCO. For SKF, seeking to better understand TCO helps them articulate the value of their products compared to their competitor’s often cheaper products. Let’s look at the example of a typical SKF bearing product. In the below (real) example, the SKF bearing is \$15 while the competitor’s bearing is \$10.

Figure 1





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Doing a TCO analysis, SKF has shown that an investment in a premium SKF bearing can save \$30.25 over the part's lifetime (**Figure 1**).

While cost models are the foundation for TCO, leading authorities of TCO are further pushing the boundaries of what should be included in a TCO analysis, arguing that the cost of risk should be also be considered. During the last decade, supply chains have grown increasingly vulnerable to supply chain disruption.<sup>12</sup> The costs associated with these risks – if realized – are real and should be factored into any TCO decision. Examples of risk include natural events (blizzards, earthquakes, floods, hurricanes, tornados, tsunamis, wildfires), external manmade events (labor strikes, riots, terrorist attacks, trade embargoes and wars), and internal man-made events (industrial accidents, business failures, product recalls, machine breakdowns).<sup>13</sup>

To illustrate the cost of risk, consider Mattel, which was fined \$2.3 million for importing toys from Chinese suppliers that violated lead paint safety standards. Besides the fine, Mattel had the hard cost associated with the recall of approximately 20 million toys<sup>14</sup> as well as the soft cost of negative consumer reaction.

A good approach for determining the impact of risk on potential costs is to do a risk assessment and sensitivity analysis. Companies can develop a model to determine the impact of various assumptions and risk factors. When developing a sensitivity analysis, companies should rank the probabilities of specific outcomes. Some companies even invest in risk simulation software using the Monte Carlo method to help boost awareness of the various risk probabilities and their impact. Monte Carlo simulation methods were originally used for space exploration, but are now more routinely used by regular businesses to help predict the probability and impact of risk events.<sup>15</sup> Once companies understand risk probabilities, they can create approaches in their pricing model that help offset risk most smartly. Offset approaches could include insurance, training and detailed protocols.

A conclusion of this section is that it is wiser to consider Total Cost of Ownership than it is to consider only (initial) price (even though that initial price may seem very low!). And the good news is that while developing a cost model is not an exact science, is it also not rocket science. Many professional associations such as SIG and NEVI offer good training on cost modeling.



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### PART 3: TOTAL VALUE OF OWNERSHIP (BEST VALUE OR BPQR)

Buyers can and should go further than looking at the Total Cost of Ownership. This is done by not only looking at the costs, but also by weighing the value the supplier is bringing to the table. This broader perspective can be called Total Value of Ownership, or simply “Best Value” for short. In European procurement law, this explicit trade-off between price and quality is called BPQR: Best Price Quality Ratio. EU procurement law supports BPQR: “Contracting authorities should be encouraged to choose award criteria that allow them to obtain high-quality works, supplies and services that are optimally suited to their needs”<sup>16</sup>

The easiest way to explain the concept of Best Value is through a basic example, such as picking a restaurant for lunch. There are many reasons why someone might pick one restaurant over another. Some criteria might include “menu prices” (=initial price) or proximity for reduced travel time (which is part of TCO). But it could also include things like service levels, taste, variety of food and atmosphere. These options are likely considered every time a decision is made on where to go for lunch. Depending on the situation, different restaurants will be chosen. What is a great choice for a business lunch with a client might not be the same choice an individual would make for a quick bite to eat in order to get back to the office to finish working on a report.

Determining Best Value for a product or service is no different—it is about picking the best option that fits the need. The options go well beyond (total) costs. Researchers Jaconelli and Sheffield describe the intent of Best Value as enabling a balance between cost and quality considerations while ensuring ongoing value for money and promoting continuous improvement to further value for money.<sup>17</sup>

The United Kingdom government has been a most notable advocate in the area of shifting procurement decisions to adopt Best Value thinking. In 1997, it announced an initiative to abolish compulsive competitive tendering (CCT) and to introduce the Best Value approach. Between 1997 and 2003, adoption of the Best Value concept was voluntary in the United Kingdom. Scotland emerged as a notable leader in applying Best Value thinking.<sup>18</sup> Scotland has been a leader in applying the concept of Best Value because of a unique political situation whereby the Scottish Parliament was separated from that of Great Britain in 1999. Under the devolution, the Scottish Parliament established 32 local authorities that suddenly gained significant power and budget in procuring public services ranging from education, to street cleaning, to housing, to leisure and cultural services, to welfare services. The local authorities were eager to improve the services received for their money.<sup>19</sup> Because of Scotland’s success using Best Value principles, its Parliament enshrined Best Value concepts into legislation under the Local Government in Scotland Act in 2003. The Act sets out eight main criteria to define Best Value:<sup>20</sup>

- Commitment and leadership
- Competitiveness and trading
- Responsiveness and consultation
- Sustainable development
- Sound governance and management of resources
- Equalities
- Review and option appraisal
- Accountability



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It is interesting and instructive that the 2003 Act does not list a price component. Although the above list is good, Best Value criteria will vary for every product or service being purchased. As stated earlier, determining Best Value is about picking the best option that fits a particular need. Other common best value criteria include:

- Environmental sustainability
- Diversity program excellence
- Social responsibility
- Business interface efficiency
- Market penetration
- Brand image
- Speed to market
- Market dominant supply chain
- Competitive market advantage
- Technological advancement
- Innovation
- Cultural competence
- Growth capability
- Counter trade optimization
- Cash management

While there is no formal way to measure the adoption of Best Value concepts, we can look at public procurement law to indicate a trend. Best Value concepts have taken hold around the world with both the United States and European Public Procurement law embracing the concept. Many governments are also formally recognizing the need for Best Value approaches. For example, recent European Public Procurement law has gone one step further, explicitly stating there are multiple options for a public authority to use for procuring goods, services and projects. The law states organizations need to award a contract based on what is called “Most Economically Advantageous Tender” (MEAT).

This can either be:

- Lowest price (see Part 1)
- Lowest cost, using a cost-effectiveness approach such as life-cycle costing (or TCO) (see Part 2)  
or
- The best price-quality ratio (BPQR), to be assessed based on award criteria linked to the subject-matter of the contract.

BPQR can be defined very broadly. The EU procurement law states that such criteria may for instance comprise (not exhaustively):

- a) Quality, including technical merit, aesthetic and functional characteristics, accessibility, design for all users, social, environmental and innovative characteristics and trading and its conditions;
- b) Organization, qualification and experience of staff assigned to performing the contract, where the quality of the staff assigned can have a significant impact on the level of performance of the contract;  
or



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- c) After-sales service and technical assistance, delivery conditions such as delivery date, delivery process and delivery period or period of completion.

By using BPQR, public authorities should feel comfortable selecting a supplier on much more than just price. But it is imperative that they get the technical aspects right. This means being smart about the weighting criteria. For example, how much will “price” still count and how much will “quality” count in the equation?

While many organizations try to get it right, sadly many do not. A 2014 study<sup>21</sup> on using BPQR in the construction industry in the Netherlands shows that 58% of all public tenders using BPQR had a weighing for quality between 20% and 60% (so “price” counted between 80% and 40%). On the surface, this sounds like a good approach. However, almost 30% of all tenders which used BPQR put the weighing on quality between 1% and 10%. This means that although these organizations *said* they were using BPQR mechanisms, 90% of the tender result was still based on price!

We suggest weighting quality criteria at least 60% when using BPQR.

The US Government’s Federal Acquisition Regulation (FAR) is the uniform policies and procedures manual for all Federal acquisitions. FAR (section 15.101-1 -- Tradeoff Process) states something similar: “a tradeoff process is appropriate when it may be in the best interest of the Government to consider award to other than the lowest priced offeror or other than the highest technically rated offeror”. And: “This process permits tradeoffs among cost or price and non-cost factors and allows the Government to accept other than the lowest-priced proposal. The perceived benefits of the higher priced proposal shall merit the additional cost, and the rationale for tradeoffs must be documented.”

In 2001, the state of Minnesota enacted Statute §161.3410 that infused Best Value discretion into their process. However, many contracting officers were hesitant to use the new law. In 2009, the Minnesota Department of Transportation (MnDOT) used the new law for selecting a contractor to build the I35 bridge replacement after the sudden collapse in 2009. Why? It would enable them to balance cost, quality and timeliness as key factors in how they chose the contractors that would ultimately be charged with rebuilding the bridge. The result? They selected a contractor that had the highest price – yet had the overall Best Value – resulting in one of the most successful bridge construction projects in history, winning dozens of awards and being erected in a staggeringly short timeframe of less than 18 months.

The Minnesota Department of Transportation case study provides an excellent example of how they applied Best Value supplier selection criteria for choosing a contractor for rebuilding the collapsed I35 bridge.<sup>22</sup>

To assure transparency and objectivity in the selection process, MnDOT was required by law to list selection criteria for every stage of the process and the evaluation weight of each criterion. The 2001 law was designed to reduce concerns about excessive discretion and after-the-fact justifications for awards.

MnDOT carefully outlined the performance criteria for selecting a contractor by clearly documenting the formal evaluation criteria and evaluation process. The contractor whose proposal scored the highest according to the weighted criteria earned the award.



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The RFP listed MnDOT’s six primary Desired Outcomes the potential bidders needed to solve:

- 1) Safety
  - a) Provide a safe project area for workers, the traveling public, community, environment and emergency services during the execution of the Project.
  - b) Provide a solution consistent with MnDOT design and construction standards.
  - c) Provide a solution adaptable to the recovery efforts of the collapsed bridge.
- 2) Quality
  - a) Implement a quality management system that ensures the requirements of the Project will be met or exceeded and ensure public confidence.
  - b) Reduce future maintenance costs by providing a high-quality project.
- 3) Schedule
  - a) Complete construction by December of 2008.
- 4) Environmental Compliance
  - a) Provide a quality product with minimal impact to the environment while using context-sensitive solutions.
- 5) Budget
  - a) Implement innovative solutions to maximize the return on taxpayer investment by reducing costs and improving the quality of the transportation system.
- 6) Aesthetics
  - a) Utilize visual quality techniques and context-sensitive design to incorporate the bridge into the surrounding environment.

It is important that at the start of the tender procedure, the buyer is very explicit and transparent on the weighing schema. For example, the buyer states that the award criterion “aesthetic characteristics” has these possibilities:

Rating	Score
Very aesthetic design in the eyes of the committee	10 points
Reasonably aesthetic design in the eyes of the committee	5 points
Slightly aesthetic design in the eyes of the committee	3 points
Not aesthetic design in the eyes of the committee	0 points

Or for a project manager:

Rating	Score
The PM has excellent qualifications and experience	5 points
The PM has sufficient qualifications and experience	2 points
The PM has insufficient qualifications and experience	0 points



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It is important to make sure that the rating scheme is explicit for all award criteria. The criteria should be transparent, objective and non-discriminatory.

By using BPQR, authorities in complex procurement initiatives can feel comfortable selecting a supplier on much more than just price (or total costs).

When contracting authorities award the contract to the BPQR, they should define the economic and quality criteria that will help determine the tender that offers the most value for money. The quality criteria require a form of performance measurement. Performance measurement is an ordered set of plausible performance levels set on a quantitative or qualitative scale.<sup>23</sup> When using evaluation or BPQR-criteria, The Dutch Ministry of Transport (Rijkswaterstaat) uses both types of performance measurement:

- Quantitative scale, such as traffic congestion in traffic loss hours or delivery time in days.
- Qualitative scale, such as the table below which is frequently used in tenders by Rijkswaterstaat.

Level	Description
1	Only generic tasks are presented; with no clear durations
2	Only generic tasks are presented; durations are clearly assigned and an overall completion time of no more than 12 months is proposed
3	Most tasks are presented, divided by types of work; durations are clearly assigned and consistent with allocated resources; principal task relationships are presented; an overall completion time of no more than 10 months is proposed.
4	Almost all tasks are presented, divided by types of work; durations are clearly assigned and consistent with allocated resources; all task relationships are presented; an overall completion time of no more than 9 months is proposed.

Source: Example of a qualitative performance measure for a working plan quality criterion from Mateus, et al, 2010

The advantage of the quality criterion is that it complies with the rules for defining evaluation criteria. The disadvantage is that this type of criterion leads to less differentiation, because all tenderers will adjust their bid for level 4. The consequence is that the award eventually is made on the lowest price, with the negative consequences sketched earlier in the paper. The Best Value Performance Information Procurement System (PIPS) method developed by Dean Kashiwagi of the Performance-Based Studies Research Group of Arizona State University is a very specific way of applying BPQR, without an ex-ante decomposition of all criteria.<sup>24</sup>

Kashiwagi proposes a selection process with abstract qualitative award criteria (next to price: project capability, risk assessment plan, value-added plan and interviews with key personnel). These rather abstract award criteria will give the supplier space to show his expertise (many times qualitative award criteria are so prescriptive that experts cannot show their true expertise). Of course, the principles of transparency, objectivity and non-discrimination should still be in place.





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### PART 4: SELECTING A SUPPLIER BASED ON BEST VALUE

While the conventional definition of TCO is exclusively concerned with the cost side of customer value, the real power is that TCO provides a foundation for making Best Value sourcing decisions. Part 4 offers two sound examples of how real organizations are applying Best Value principles. It also offers an approach for applying Best Value to highly complex projects where it may not be possible (or practical) for a supplier to provide a “price” by using a “pricing model”.

#### USING TCO AS THE FOUNDATION FOR BEST VALUE

The Vested Outsourcing Manual defines TCO as the foundation for making Best Value decisions. The advantage of using a TCO model is that by quantifying expected outcomes, you can make clear and informed decisions when it comes to price/value. But how do you determine the value side of the equation? A “Best Value” analysis can point you to the answer.

It is first important to understand that the concepts of Best Value and Total Cost of Ownership are closely related. The main difference is that Best Value goes one step further than TCO because it compares alternative solutions based on value derived not simply on cost. While a TCO analysis seeks to identify true costs, a Best Value assessment adds decision criteria to include intangibles, such as market opportunities, social responsibility, responsiveness and flexibility.

When selecting a supplier based on “value” (next to price), it is important to have a solid calculation model. Value is often qualitative. The question then is how to combine “price” and “quality” (or value). This can be done in two ways:

- Define all quality aspects in “points” and also transform price into “points”
- Monetize all quality aspects into a value and deduct the value from the price.

We provide examples of both techniques below.

#### Example 1: Minnesota Department of Transportation I-35 Bridge Rebuild

MnDOT ultimately created a “Best Value Formula” that would become the litmus test for selecting the winning bidder, with the contract award going to the bidder with the **lowest adjusted bid** representing the Best Value for MnDOT– not the lowest price. The formula (shown in Figure 2) was comprised of a technical score, the number of days to complete the project, and the contract bid price.

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**Figure 2: MnDOT BEST VALUE FORMULA**

**Three Components**

- “A” = Contract Bid Price
- Plus “B” = Number of Days to Complete Project, which is multiplied by \$200,000 per day. The \$200,000 per day was based on 50% of road user costs
- Divided by Technical Proposal Average Score (TPA)

**Result: Adjusted Bid = A + B(\$200,000) divided by TPA**

***CONTRACT AWARDED TO LOWEST ADJUSTED BID***

While budget and schedule were easy to measure and can be taken straight from the supplier’s proposals, the more technical components (safety, quality, aesthetics, and environmental compliance) were more subjective in nature. As such, MnDOT created a Technical Review Committee to score the technical components. The Proposal Evaluation Plan summarized the five assessment levels:

***Excellent (91-100%)***

The Proposal demonstrates an approach with unique or innovative methods of approaching the proposed work. The Proposal is considered to significantly exceed stated requirements/objectives beneficially (providing advantages, benefits or added value to the project) and provides a consistently outstanding level of quality.

***Very Good (76-90%)***

The Proposal demonstrates an approach offering unique or innovative methods of approaching the proposed work. The Proposal exceeds the stated requirements.

***Good (61-75%)***

The Proposal demonstrates an approach that is considered to adequately meet the RFP requirements/objectives and offers an acceptable level of quality.

***Fair (50-60%)***

The Proposal demonstrates an approach that marginally meets the RFP requirements/objectives.

***Fails (0-49%)***

The Proposal is considered to Not Meet the RFP requirements or is non-responsive.



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Each Technical Review Committee member (six in total) assigned a percentage based on the Qualitative Assessment Rankings shown above. Then, the committee multiplied the percentages by the maximum number of points in each category. The product became the final Technical Proposal Score value. The final comparison of the proposals is shown in **Figure 3**.

**Figure 3: Comparison of Proposals**

Proposer	Technical Proposal Avg Score (TPA)	# of Days (B)	Price (A)	Adjusted Score $\frac{A + B(\$200,000)}{TPA}$
Ames Lunda	55.98	392	\$178,489,561	4,588,953.50
McCrossan	65.91	367	\$176,938,000	4,798,179.34
Walsh	67.88	437	\$219,000,000	4,513,847.97
Flatiron- Manson	91.47	437	\$233,763,000	3,511,129.37

The lesson learned from the MnDOT example is important. Clearly identifying value-based criteria (e.g. time, safety, etc.) helps the parties develop deeper discussions regarding value instead of just price. In the end, Flatiron-Manson best met MnDOT’s criteria and won the competitive bid process despite having the highest price.

### Example 2: The Netherlands (Ministry of Transport)

Like the state of Minnesota, The Netherlands has also been progressive at adopting Best Value approaches. In The Netherlands, a common practice for selecting the overall Best Value supplier is by “monetizing” the qualitative award criteria. Let’s look at the example below using fictitious numbers based on a real case in the Netherlands. The weighting of price/quality takes place based on the lowest tender price whereby the scores on the sub-awarding criteria are given a ‘financial value’ which generates a deduction or addition to the tender price of the tenderer in question. The higher the score, the greater the deduction, and the lower the fictitious tender price, the higher the ranking. This method works as follows:

$\text{Tender sum (tenderer's price from the price list) + (total) Addition = Fictitious Tender sum.}$
--------------------------------------------------------------------------------------------------------

The Rijkswaterstaat (Ministry of Transport) Extra Discharge Capacity (EDCA) Afsluitdijk (bridge) project provides a good example. Rijkswaterstaat decided to outsource the responsibility to write an Environmental Impact Report to an engineering firm. The engineering firm was selected using a Best Value process (with monetizing the award criteria).

The budget ceiling price for the project was €2.000.000. The supplier price has a weighting of 25%. Next to “price” there were four qualitative award criteria that reflected the value of the supplier. The four criteria were RAVA (Risk Assessment and Value Add) plan, Scope document, Schedule, and Interviews. Each criterion had a weighting factor (e.g. RAVA is “worth” 30% of the budget, hence €600.000.) The four criteria combined had a value of 75% of the budget.

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Using the logic expressed above, the maximum deduction that could be gained for the EDCA project was €1.500.000. For example, if a supplier scored a “10” (excellent) on all four criteria, he would get a “fictitious deduction” of €1.500.000 to his bidding price, leading to a low fictitious tender sum (which is good, the lower the better!).

**Figure 4** (following page) shows the EDCA Award criteria calculation model (with a price weight of 25% and the four value-based criteria being weighted collectively at 75%).

**Figure 4: EDCA Award Criteria**

<b>Budget Ceiling Price</b>		<b>€ 2.000.000,00</b>	
Risk Assessment and Value Add Plan	30%	€ 600.000,00	maximum fictitious value
Schedule	5%	€ 100.000,00	maximum fictitious value
Scope document	5%	€ 100.000,00	maximum fictitious value
Interviews	35%	€ 700.000,00	maximum fictitious value

**Calculation Model**

**Figure 5** shows the scoring table and corresponding addition/deduction.

**Figure 5: Scoring Table**

<b>Model</b>	<b>% of deduction /addition</b>	<b>Score</b>	<b>Risk Assessment &amp; Value Add Plan</b>	<b>Schedule</b>	<b>Scope Document</b>	<b>Interview</b>
Fictitious Deduction	100%	10	€ -600.000	€ -100.000	€ -100.000	€ -700.000
	75%	9	€ -450.000	€ -75.000	€ -450.000	€ -525.000
	50%	8	€ -300.000	€ -50.000	€ -50.000	€ -350.000
	25%	7	€ -150.000	€ -25.000	-	€ -125.000
Neutral	0%	6	-	-	-	-
Fictitious Addition	25%	5	€ 150.000	€ 25.000	-	€ 175.000
	50%	4	€ 300.000	€ 50.000	€ 50.000	€ 350.000
	75%	3	€ 450.000	€ 75.000	€ 450.000	€ 525.000
	100%	2	€600.000	€ 100.000	€ 100.000	€ 700.000

If the committee thinks the RAVA plan of one of the suppliers is excellent (“10”) the supplier gets a “deduction” of €600.000 to his bidding price. If the evaluation committee values the RAVA plan of the supplier as very poor (“2”), the supplier gets a (fictitious) addition of €600.000. You can see that supplier B has a “9” on RAVA (and therefore gets a fictitious deduction of €450.000). He also scores “9” on Schedule (hence a fictitious deduction of 75.000; this amount is lower than the “9” of RAVA, as the RAVA plan has a higher weighting.). Supplier C



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has a “3” on RAVA, which leads to an addition of €450.000 to his price. Supplier D scores a “4” on Schedule, and gets a “fine” or an addition of 50.000 to its price.

All actual scores (and corresponding additions/deductions) to the price are shown in Figure 6.

**Figure 6: Scores to the Price**

<b>Score Phase 1</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>
Risk Assessment & Value Add Plan	4	9	3	4
Schedule	4	9	3	4
Scope document	2	8	4	8
<b>Monetary Value</b>				
Risk Assessment & Value Add Plan	€ 300.000,00	€ -450.000,00	€ 450.000,00	€ 300.000,00
Schedule	€ 50.000,00	€ -75.000,00	€ 75.000,00	€ 50.000,00
Scope document	€ 100.000,00	€ -50.000,00	€ 50.000,00	€ -
Fictitious Value of the Documents	€ 450.000,00	€ -575.000,00	€ 575.000,00	€ 350.000,00
<b>Score Phase 2</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>
Interview 1	5	8	6	5
<b>Monetary Value</b>				
Interview 1	€ -	€ -350.000,00	€ -	€ 175.000,00
<i>Fictitious value of the Interviews</i>	-	€ -350.000,00	€ -	€ 175.000,00
<i>Total fictitious value (documents &amp; value)</i>	€ 450.000,00	€ -925.000,00	€ 575.000,00	€ 525.000,00
<b>Fictitious Tender Sum</b>	<b>€ 450.000,00</b>	<b>€ -925.000,00</b>	<b>€ 575.000,00</b>	<b>€ 525.000,00</b>

The table shows supplier B has (by far) the best quality. To calculate the ranking, vendor B gets a deduction of €925.000 of its price. On the other hand, vendor C gets an additional €575.000 to its price. We cannot disclose the individual prices of the vendors but all vendors offered between €900,000 and €1,600,000. The price of vendor B was the second lowest price. By deducting the fictitious value (€925.000) to its price, vendor B had the lowest fictitious tender sum and was the winner.<sup>25</sup>

The benefit of monetizing the qualitative criteria is that it is straightforward and not relative. This means that the Fictitious Tender Sum of a supplier is not dependent on the bid of a different supplier. In the example of MnDOT, there is a relative score (because in the equation the TPA is used). A relative scoring mechanism has the danger of what is called “rank reversal,” the phenomenon that the ranking between two bidders becomes reversed when, for example, one of the original bids is removed. In supplier selection, this is especially harmful when the rank reversal involves the winning bid. It can happen that supplier A was the winner, and supplier B was second, but because supplier D later appeared to have an invalid bid and was removed, its removal caused supplier B to be the winner and supplier A to be second. Rank reversal is highly undesirable, especially when non-competitive bids have the potential to influence the outcome. It is therefore highly recommended to avoid relative scoring.



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### USING A “PRICING MODEL”

In most procurements, the award selection uses “price”. The good thing is that more and more organizations are seeking to use price and qualitative award criteria as demonstrated by the examples above. However, what is the best thing to do in highly complex procurement situations where it may not be possible for a supplier to provide a “price” because some of the supplier’s costs are either not known or pose too much risk to the supplier which would, in turn, increase the supplier’s price?

The answer is to use a “pricing model.” One way to do this is to replace the (quantitative) award criterion “price” with a new qualitative “pricing model” criterion (next to the other qualitative criteria). When a pricing model is required for a bid, all award criteria are then qualitative.

It is important to first understand the difference between a “price” and a “pricing model”. A price is something you pay for each transaction. The price for your Starbucks Grande two-pump vanilla latte might be \$4.25. Call center suppliers may have a price of \$0.35 a minute every time an agent picks up the phone and acts as a company’s customer service representative.

A pricing model is fundamentally different than a “price” because it is a mechanism that companies use to determine the optimum commercial agreement between the company and the supplier. In some cases, a pricing model consists of nothing more than costs, volume targets and incentives based on helping a company achieve value - such as market share, total cost savings or customer satisfaction levels.

Most pricing models are expressed in a simple spreadsheet. However, some are more like a small, customized software package or macro-based Excel spreadsheet.<sup>26</sup> The term model is used because a good pricing model enables the parties to manipulate the underlying assumptions. This allows the parties to “model” the outputs relative to the input components to determine a fair way to pay for goods and services. In a dynamic environment, a good pricing model creates a commercial pricing structure that equitably allocates risks and rewards with the purpose of realizing mutual gains for the duration of the agreement.

But how exactly do you establish a pricing model to foster a win-win relationship? Unfortunately, there is no one-size-fits-all approach. There is no generic template or standard spreadsheet to help you get the correct pricing “answer.” Establishing the right pricing and incentive mix can be complicated and technical. Yet you do not have to be an accountant, a consultant or a software engineer to recognize the benefits of a fair pricing model that rewards for value creation. Developing a pricing model is not a guessing game; rather, it is a process that parties go through together with the goal to create value. When a pricing model is used in the selection phase, the supplier lays out his ideas of the pricing model. The buyer is evaluating the quality of the pricing model (in essence: assessing whether the supplier is thinking in an overall interest). If the supplier turns out to be the supplier with the “Best Value” (hence: the Most Economically Advantageous Tender), the supplier and buyer will work out the pricing model in greater detail in the execution phase.

The best pricing models are based on transparent relationships with a fact-based approach that starts with a sound TCO foundation. Buyers and suppliers should develop a pricing model through a Best Value lens, striving to understand profitability levers that can add value for the buyer through increased revenue,



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reduced risk, improved working capital and capital investment productivity, or anything else that positively impacts a company's profitability. Because value is based on the overall impact on a firm's profitability, the companies should establish the appropriate mechanisms for triggering payments when value is received.

Some characteristics of a good pricing model include:

- Changeable input assumptions. This allows for dynamic business conditions and enables the buyer and supplier to track the real impact of value versus assumed impact.
- Proof points are supported by references and technical reasoning.
- Ranges of expected outcomes. Ranges help focus the discussion based on reference points. Sometimes where risk is high or in extremely large deals, companies do sensitivity analysis or even Monte Carlo simulations to clearly show the potential impact.
- Clearly understandable calculations. The logic and calculations should be obvious (don't make it too complex.)
- Use of benchmarking data when possible to help set reasonable targets for potential benefits.

While most of the time a "price" is asked in the selection phase (next to some qualitative criteria) when using a Best Value approach, more and more organizations are shifting to using pricing models because they offer a more transparent and fair method for approaching pricing, especially in high-risk situations where there are many unknowns. However, the authors understand that the concept of using a "pricing model" rather than a "price" can be too abstract for some buying organizations, and offer two viable alternatives;

- 1) The buyer and supplier jointly develop a pricing model **after** the selection phase. This means omitting pricing from the supplier selection altogether. In this case, it is common to have the supplier(s) that have lost to be "in waiting" in case you are not contractually able to get to a satisfactory pricing model with the selected supplier.
- 2) The buyer has the supplier price-out a component of the overall book of business that is in scope. For example, the State of Tennessee did this for a state-wide bid to pick a supplier to perform facilities management across the states 8000+ locations. The scope was so diverse, they had the three bidding suppliers provide a "price" for only six locations. The evaluation criteria called for weighting criteria for both the price for the six locations and for a qualitative evaluation of the pricing model. Scalability and flexibility were two of the key qualitative criteria for evaluating the bidder's pricing models. In this case, the pricing model was then used to develop a "price" for each of the locations once they rolled in under the contract.

*For more on pricing models, see the University of Tennessee's whitepaper "Unpacking Pricing Models: Make 'You Get What You Pay For' Real for Business Relationships."*



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It can be downloaded at <http://www.vestedway.com/vested-library/>.

## PART 5: THE ROLE OF SOURCING BUSINESS MODELS

Until now we have discussed what is primarily referred to as the “selection phase” in a competitive bid process. This is where the buyer is selecting the supplier with whom it will work.

In this paper, we have explained the three primary ways to select a supplier:

1. Based on the “lowest price” (based solely on price or LPTA);
2. Based on the “lowest cost” (calculated by using a cost-effectiveness approach such as life-cycle costing or TCO); or,
3. Based on “Best Value” principles (in which TCO can be a component and a pricing model could be a component).

We often get asked, “Which approach is the best?” The answer is “it depends.” The appropriate approach highly depends on the context of your individual situation. To put the answer in context, think about how you would buy different things for your own household. Let’s say your child brings home his school supply list. All of the items are generic such as a “No. 2 pencil” and “red ink pen.” In this case, it is perfectly appropriate to use low price as the differentiator. But consider the decision to replace your family’s old gas-guzzling sedan? You are debating whether to buy a conventional gas car or an electric car. You will likely want to factor in the TCO and may even use the Edmunds TCO calculator referenced earlier. But what about selecting a college for your oldest son? Many factors will come into play – many of which are qualitative in nature. Here you will likely use Best Value principles in your decision-making process.

The same thinking applies to companies and governments. More and more organizations are realizing that a “one-size fits all” procurement process is not optimal.

One organization is the International Association for Contract and Commercial Management (IACCM). IACCM research shows that most organizations operate under conventional transaction-based models that are constrained by a formal, legally oriented, risk-averse, and liability-based culture. The University of Tennessee is another organization that has been studying buyer and supplier relationships for over a decade. Both organizations point to a growing awareness that output and outcome-based approaches for complex contracts can drive improved results (or even transformational results in the case of Vested relationships). Equally compelling is the link between procurement complexity, sourcing business models, and the need for Best Value practices.

The book *Strategic Sourcing in the New Economy: Harnessing the Potential for Sourcing Business Models in Modern Procurement* shares seven possible sourcing business models that fall along the sourcing continuum. (see Figure 7 on the following page).

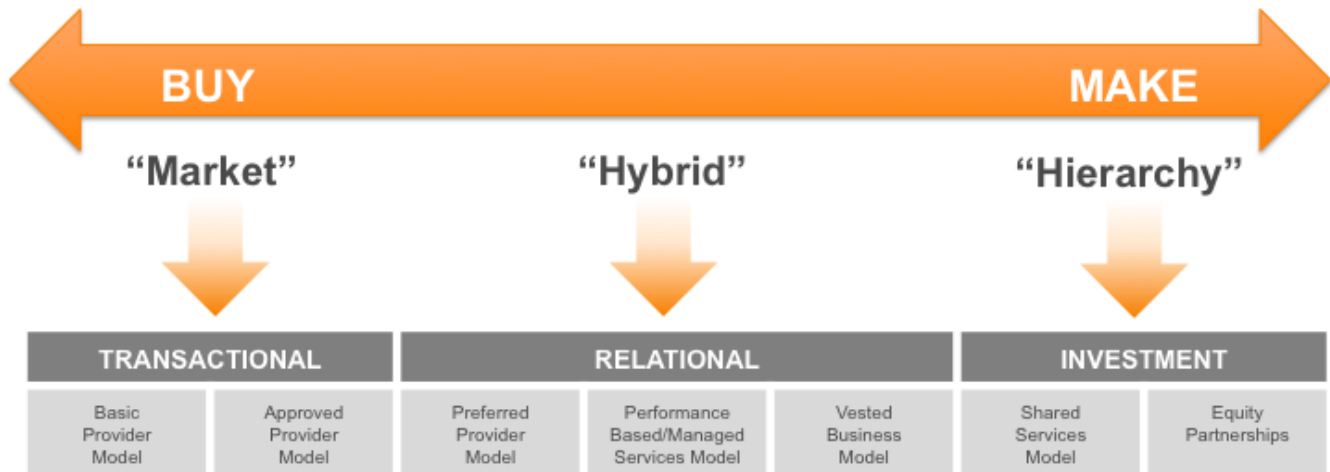


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Figure 7



Strategic Sourcing in the New Economy provides an in-depth understanding of when to use which sourcing business model. For a short overview, you can download the Unpacking Sourcing Business Models [white paper](#).

In transactional relationships such as the Basic Provider model or Approved Provider model, LPTA (Lowest Price Technically Acceptable) is widely used and is often the most appropriate selection criteria. **As you shift along the sourcing continuum, however, it is important to incorporate TCO and Best Value principles into your supplier selection process and in the underlying pricing approach to be used in your commercial agreements with suppliers.** For example, Microsoft uses a pricing model with incentives for their highly strategic “OneFinance” outsourcing relationship with Accenture for back office finance operations.<sup>27</sup>

While many organizations “get” the need to make the shift to Best Value, they often struggle with applying the concepts – especially TCO. Using TCO during the supplier selection phase can be difficult as organizations are still in “their own silo”. The best way to capture the true boundary spanning TCO components is with a high degree of transparency that exposes the hidden cost across all parties – in the functional silos both within a company and with the supplier. While it might be hard to capture internal costs, it will be impossible to capture costs without transparency with a supplier. This certainly will be the case when using TCO in a selection process.

This is why many organizations wait to apply an in-depth TCO analysis until after the selection phase. While using TCO is not as applicable with the purely transactional models on the left side of the sourcing continuum (Figure 7), it can be extremely effective when you have a more strategic supplier relationship (e.g. in a Vested model).



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#### THE ROLE OF TRANSPARENCY

To succeed, procurement professionals need to look at and weigh what is the best net value for the whole organization. Unfortunately, sometimes outdated thoughts such as “that’s not what I am measured on” or “that’s someone else’s problem” creep in. Management must insist on and consistently reaffirm that shareholders care about the best net long-term decision and not on one function saving at the expense of another. For this reason, procurement professionals should seek a transparent and boundary spanning approach when performing TCO analysis and Best Value assessments.

A transparent approach to sharing buyer and supplier costs often starts with what is called an “open-book approach.” Using an open-book approach with suppliers allows both parties to build a fact-based discussion around actual costs. By understanding true costs, the companies can shift their focus from sitting across the table negotiating price to probing on how both parties can work collaboratively to eliminate non-value-added activities, duplicative efforts and risks that drive up costs.

Buyers and suppliers often have differing viewpoints about transparently sharing costs and profit data. Unfortunately, both can have a tendency to avoid transparency. Concerns and criticisms about openly sharing costs, profits and other key data are real. For this reason, we encourage buyers and suppliers to openly address concerns about transparency early in their discussions.

Suppliers can feel especially exposed when they share costs. If a supplier reveals its true costs, it is easy for the buyer to determine the supplier’s profit—which makes many suppliers uncomfortable. A major fear is that the company will use the information to attack the supplier’s margins, which in turn reduces their profitability. Buyers that do attack a supplier’s margins often find that suppliers are good at hiding the real costs, which results in a virtual shell game as the supplier shifts costs around in an effort to maintain their target margins. Smart buyers will work collaboratively with their suppliers to drive efficiencies and reduce non-value-added work rather than focus on margin reduction as a quick win for a price concession.

If suppliers are hesitant to transparently share their costs, we encourage procurement professionals to stress that their TCO analysis will be one only part of helping them make informed decisions and that the lowest cost is not the only factor being considered. In addition, we recommend that procurement professionals use the TCO analysis to focus on “cost reductions” and not “margin reductions” in order to make suppliers comfortable and more willing to transparently share cost data. This can be done only when using models on the right-hand side of the sourcing business model continuum.

Another criticism about transparency involves the buying company. Often when it comes time to share, the buying company will look at transparency as a one-way street—the supplier is supposed to share information, but the buying company is exempt. This situation occurs often, and there are several ways to address it.

First, we recommend starting with an explanation of why the information is requested.<sup>28</sup> Having a clear understanding of the business at hand and a comprehensive explanation of why certain information is needed helps allay company concerns. For example, in one case, a third-party logistics supplier asked its client about the three-year outlook estimate—was it going to stay the same, grow or decline? Once the



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company realized that the supplier needed this information to estimate the maximum size of the building it would need to secure for the duration of the contract, it felt more at ease.

A second tip is to mutually create and document a formal Statement of Intent that explicitly details margin targets and what the company will do with the TCO assessment. Using a Statement of Intent that clearly indicates that the goal of transparency is to allow the buyer to identify cost drivers and develop improvement initiatives that can help reduce costs while still protect the supplier's margins can help alleviate supplier's concerns that revealing their costs and margin will be used against them.

Dell and FedEx provide an excellent example of two companies that made the shift to transparency and TCO in their commercial agreement. Before making the shift, the two companies worked on developing trust and a mutual Statement of Intent. Then they agreed to formally and transparently share all their actual costs involved in the end to end production, distribution, and returns process. And the companies agreed to provide incentives for FedEx to identify and implement initiatives that would reduce Dell's TCO. The results were nothing short of spectacular, with Dell reducing their TCO by over 50% in just three years through implementing dozens of initiatives. A key step was in laying the foundation with the Statement of Intent which did a proper job of setting margin targets early in the discussions. Those targets detailed that FedEx's profit would not go down when they reduced their (and Dell's) costs.

A third tip companies can use is to jointly create an end-to-end process or value stream map between the two parties. Using end-to-end process maps enables a buyer and supplier to discuss and allocate cost to the various buckets of activities to highlight where value is added (or where there is a duplication of effort.) A good example is a facilities management service provider that assigns a resource to facilitate communication and handoffs on new environmental initiatives. This person is not directly managing facilities as part of direct costs, but still plays an important role. By understanding there is a cost to these indirect services, the buyer can make more informed choices based on the value of this service.

The bottom line is that choosing a path of transparency will enable a much higher shared understanding of the true TCO.

Although transparency is strongly favored in establishing an accurate TCO assessment, it may not be feasible for some organizations. For example, a large aircraft manufacturer has both a commercial aircraft and a defense contract business group. A large OEM sold over \$1b in parts across both business groups. The defense business group wanted desperately to build a more trusting and transparent relationship with the supplier to help drive down cost structures and improve TCO associated with reliability and availability. After much discussion, the parties decided to shift their relationship along the sourcing continuum to a Vested relationship.

The OEM agreed with one guardrail; that the defense business unit create a firewall and not share the transparent cost and margin data with their sister commercial business group. Why? The commercial business group viewed the OEM as a "commodity" and constantly bid out their work using an LPTA approach where every purchase required three bids. Simply put, the OEM did not trust the commercial business group and believed they would use the information against the OEM in their frequent and antagonistic negotiations. The OEM also believed the commercial business group (right or wrong) would potentially even share the information with the OEM's competitors.



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In the end, the defense business group could not secure the firewall and the OEM decided to not be transparent.

Organizations that do not have the needed trust to “open the kimono” as the saying goes, should seek to build trust over time. The authors’ experience shows that as a buyer and supplier build trust, the parties are more willing to revisit their intention to become more transparent.



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### CONCLUSION

The twenty-first century demands a sober second thought that challenges the traditional competitive bidding process for establishing a “fair price”. But the shift from a competitive bid process focused purely on price leaves many buyers skeptical and asking, “How can I be assured that I am not overpaying?”

As companies seek (and demand!) more value from their suppliers, they must realize that it is essential to move away from “price” focused procurement and commercial models. This also means compensating suppliers with a fair return on their value-added services, investments, ideas and innovations at the heart of creating value. Organizations are encouraged to take to heart these lessons from this white paper and consider using qualitative criteria along with price when selecting a supplier:

- Adopt a transparent approach to identifying the true TCO and jointly develop business cases that identify value building opportunities.
- Expand the lens with which you calculate value to include a “System” wide approach, including developing business cases that look at the profitability factors for both the buyer and the supplier.
- Consider moving away from “prices” and choose to develop “pricing models” that reward suppliers when value is received.
- Learn about and test the alternative method for selecting suppliers based on Best Value. Also consider adopting commercial agreements such as a Performance-Based or Vested business model that shifts accountability for delivering value to the supplier, yet seeks to reward them fairly for their risk.

Still not convinced? Consider the fact that a study by the International Association for Contract and Commercial Management and the Strategic Account Management Association found buying companies realized 40% more value from their most collaborative suppliers than their least collaborative suppliers. The same report also found suppliers reported an average of 49% more value to their most collaborative key customers. <sup>29</sup>

The bottom line is the bottom line for today’s buyers and suppliers. Those who find themselves using the last century’s approaches will find themselves in a race to the bottom, bickering over low price rather than seeking ways to establish sustainable supplier relationships that more fairly create value for both buyers and suppliers.

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**Sarah Holliman.** Sarah is the Chief Marketing Officer for the Sourcing Industry Group. She has over 20 years of experience in the sourcing industry, including work with A.T. Kearney's Procurement & Analytic Solutions unit as well as with one of the largest commercial banks in the country. Sarah is a frequent blogger on supply chain topics and has a B.A. from Furman University and an MBA from the Anderson School at UCLA.

**Michèle Coquis.** Michèle is a Principal at The Forefront Group with over 25 years' experience in the IT, Professional Services, and Telecommunications industries. She is experienced in all aspects of labor and services procurement including strategy development, sourcing, category management, contracting, and supplier management. Michèle is a Certified Vested Deal Architect.



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**The Sourcing Industry Group (SIG)** is a membership organization that provides thought leadership and networking opportunities to executives in sourcing, procurement and outsourcing from Fortune 500 and Global 1000 companies and the advisors who serve them. SIG is widely known as a forum for sharing “next” practices and thought leadership through live networking events, virtual forums and a comprehensive online SIG resource center (SRC), which was developed by and for professionals in sourcing and outsourcing. The organization is unique in that it blends practitioners, service providers and advisory firms in a non-commercial environment. SIG is also the parent organization for SIG University, a one-of-a-kind certification and training program for professionals and executives seeking deep expertise in sourcing and governance for themselves or their teams, as well as *Outsource*, which provides unrivaled digital content for the opinion-formers and decision-makers at the heart of the outsourcing space. For more information, visit [www.sig.org](http://www.sig.org).

**NEVI** is the Dutch Association for Purchasing Management and was founded in 1956. Since then NEVI has grown to become one of the world’s leading purchasing management organizations. NEVI is a member of IFPSM and chairman of the European division. With over 6.500 members, working in the private and public field, NEVI is the principal authority for matters concerning Purchasing in the Netherlands. **Purspective** is a leading procurement training and development organization and the international branch within NEVI. Purspective originated within Philips, before becoming an independent company in November 2001. In 2002 Purspective joined forces with the Dutch Procurement Association, NEVI. As part of NEVI, the world’s third-largest supply management association, they incorporate academic research, peer communities and best practices in their tailored programs. For more information, visit [www.nevi.nl](http://www.nevi.nl) or [www.purspective.com](http://www.purspective.com).

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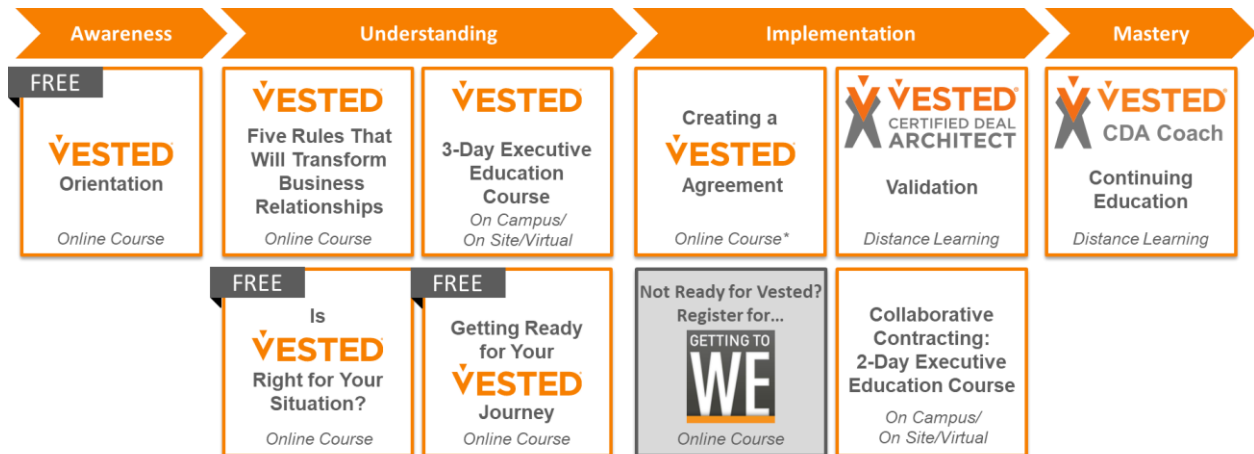
The University of Tennessee is highly regarded for its Graduate and Executive Education programs. Ranked #1 in the world in supply chain management research, researchers have authored seven books on the Vested business model and its application in strategic sourcing.



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We encourage you to read the books on Vested, which can be found at most online book retailers (e.g., Amazon, Barnes and Noble) or at [www.vestedway.com/books](http://www.vestedway.com/books).

For those wanting to dig deeper, UT offers a blend of onsite and online courses including a capstone course where individuals get a chance to put the Vested theory in practice. Course content is designed to align to where you are in your journey ranging from Awareness to Mastery. For additional information, visit the University of Tennessee’s website dedicated to the Vested business model at <http://www.vestedway.com/> where you can learn more about our Executive Education courses in the Certified Deal Architect program. You can also visit our research library and download case studies, white papers and resources. For more information, contact [kvitasek@utk.edu](mailto:kvitasek@utk.edu).



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