Unpacking Risk Shifting

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A Whitepaper Challenging Unreasonable Risk-Shifting in the Transportation and Logistics Industry

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UNPACKING RISK SHIFTING

EXECUTIVE SUMMARY

Gresham's Law is an economic principle that states bad money will drive good money out of circulation. We argue there is a "Gresham's Law" scenario occurring in the transportation and logistics industry as Global Shippers and Consignees (GSCs) seek extreme commoditization of those services and also apply bad contracting practices to them. This drives away good Third-Party Logistics (3PL) providers.

The good news? Organizations have gotten very smart about buying 3PL services. The centralization of procurement functions and automated procurement practices have enabled GSCs to have great success bundling highly complex logistics activities and reducing them to their simplest expression, allowing for savvy procurement professionals to commoditize the services and reduce the price per transaction.

The bad news? Many GSCs have gone too far in their efforts. Many want innovation and investment by the 3PLs. However, the 3PLs are reluctant to deliver, arguing razor-thin margins and short-term commodity-based contracts create a disincentive for 3PLs to make investments. Still worse, these same contracts also onerously shift an extraordinary amount of unreasonable risk to 3PLs by including significantly lopsided and aggressive terms and conditions. We argue that transactional ways to procure 3PL services are at a tipping point, and ripe for change.

The Genesis

This white paper was inspired by a discussion between Phil Coughlin, President of Global Geographies and Operations, Expeditors International of Washington, Inc., and Kate Vitasek, faculty member, the University of Tennessee's Haslam College of Business Administration, about poor contracting practices in the logistics and transportation sector. The discussion expanded and the concept of a white paper challenging better contracting practices for 3PL services was born. Passionate industry leaders joined in the discussion, becoming authors and contributors. All felt strongly that the entire industry—buyers and suppliers—will benefit from this paper.

This white paper highlights the poor commercial practices currently in place in the 3PL industry. The goal is to help GSCs and 3PLs be more aware of the need to create fair and balanced commercial agreements that promote healthy businesses on both sides. It has five main parts:

1. How GSCs are changing the landscape for buying 3PL services.
2. Identifying emerging trends where GSCs are shifting risk to suppliers.
3. Discusses our premise that the 3PL industry is at a tipping point, using the analogy of Gresham's Law.
4. Proposes a new approach for GSCs to change from a value extraction and risk shifting mindset to one of long-term value creation.
5. Finally, we summarize our discussion and conclude with a call to action for GSCs and 3PLs to drive proactive and positive changes in the transportation and logistics industry.

Our Disclaimer

This white paper is an opinion paper. It is the writers' and contributors' best attempt to "unpack" the complexities of poor contracting practices negatively affecting the 3PL industry. For those with the time and desire, we highly encourage you to read Kate Vitasek, Mike Ledyard and Karl Manrodt's pioneering book on the Vested sourcing business model, *Vested Outsourcing: Five Rules That Will Transform Outsourcing*.

UNPACKING RISK SHIFTING

TABLE OF CONTENTS

EXECUTIVE SUMMARY 0

The Genesis 0

Our Disclaimer 0

PART 1: THE CHANGING LANDSCAPE OF BUYING 3PL SERVICES 1

Have GSC's Gone Too Far? 2

Is Commoditization of 3PL Services Flawed Logic? 3

Commoditization Misses the Power of Collaboration 3

PART 2: BEYOND PRICE: SHIFTING RISK 5

What Risk is Appropriate to Shift? 6

Why Should a GSC Care? 7

PART 3: GRESHAM'S LAW IN PRACTICE 8

PART 4: A BETTER WAY 12

Redefining Value 13

The Rise of Vested Outsourcing 14

Collaborative Success Stories with Real Results 16

Finding the Pony 17

CONCLUSION AND CALL TO ACTION 19

ABOUT THE AUTHORS 20

FOR MORE INFORMATION ABOUT EXPEDITORS 21

FOR MORE INFORMATION ABOUT ADELANTE 21

FOR MORE INFORMATION ABOUT THE UNIVERSITY OF TENNESSEE 22

ENDNOTES 23

UNPACKING RISK SHIFTING

PART 1: THE CHANGING LANDSCAPE OF BUYING 3PL SERVICES

There has been a transformational change in how GSCs procure and contract for logistics, transportation, and other related supply chain services from 3PLs.

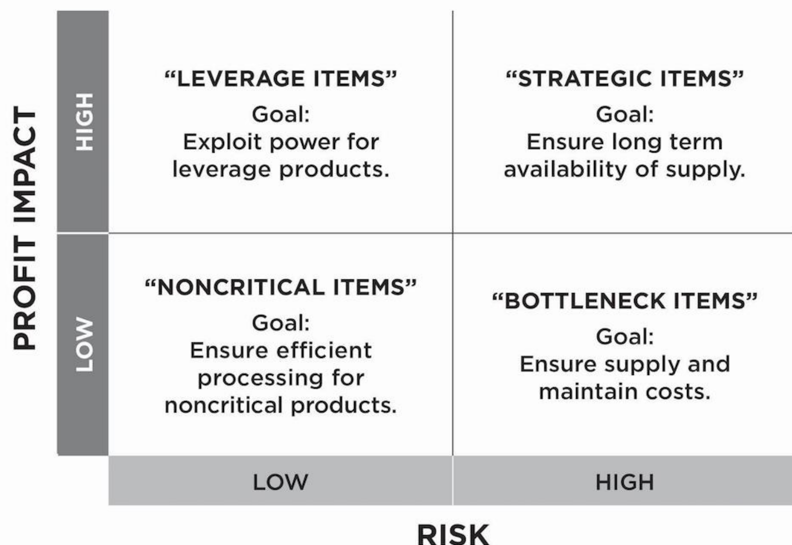
Not long ago, the users of 3PL services—the logistics and supply chain experts within a GSC—played the primary role in purchasing 3PL services. However, this has been changing in recent years and continues to evolve as many GSCs seek to create a centralized procurement function. GSCs are accomplishing this by creating “commodity managers” who are chartered as category experts with control over buying 3PL services. This shifts the buying power away from the actual users and/or consumers of 3PL services to procurement experts distanced from the 3PL services themselves.

It is easy to see why organizations are moving towards having procurement control the purchase of 3PL services. GSCs are under constant and intense earnings pressure. Many GSCs find themselves battling the competing forces of their customers’ constant demand for lower prices on their own products and the natural economic pressures associated with producing and distributing goods (i.e., think of fluctuating fuel costs and cost of living increases). In response, GSC procurement teams have turned to highly competitive bidding practices that seek to commoditize 3PL services. Moreover, GSCs have increased their efforts to shift the risk of fines and penalties associated with the rise of global trade and compliance regulations.

Procurement professionals have turned to conventional procurement strategies as they take on responsibility for buying 3PL services. One quick, easy, and popular procurement tool is the Kraljic Matrix – named after McKinsey consultant Peter Kraljic. The Kraljic Matrix allows procurement organizations to use a simple 2x2 matrix to help their organizations segment purchasing spend into one of four quadrants.

The figure below illustrates Kraljic’s teachings:

For many organizations, 3PL services are classified in Kraljic’s “Leverage” category (upper left quadrant). This is because 3PL services are often seen by procurement as a non-strategic “commodity” support service simply because the category has relatively high spend and relatively low risk since there are many suppliers. Unfortunately, many procurement professionals fail to understand and quantify the risk of a failed supply chain or the true switching costs associated with more global, complex and integrated services providers.



In their effort to commoditize 3PL services, procurement will often itemize 3PL services as transactional “activities” to easily compare suppliers’ price per transaction as “apples to apples.” Distribution services are reduced to “cost per pallet” and transportation is simplified as “price per lane from A to B.”

As procurement organizations seek to commoditize 3PL services, the Kraljic Matrix teaches the best strategy in what is referred to as an “Exploit” strategy, whereby an organization uses its buying power to get a better price. This can be done by using many tactics, but most often involves frequent and highly competitive bidding using short term contracts geared to make service providers ferociously compete on price to keep existing business. This is especially true for large companies with lots of volume, where losing a key client can have a highly negative impact on the supplier’s profitability.

Have GSC’s Gone Too Far?

Many argue a more structured process for buying 3PL services is desperately needed. ***We will not debate that.*** However, we do believe that many GSCs have gone too far, resulting in what we call an “over-commoditization” of the industry.

This over-commoditization quashes suppliers’ motivation to invest in new processes and technologies that ultimately can positively affect a GSC’s real business objectives. Logistics expert/analyst Adrian Gonzalez shares the following anecdote. “I know of a company that actually performed a reverse auction to select a 3PL to manage its nine-figure transportation spend and daily operations. In other words, this company was turning over several hundred million dollars of transportation management responsibility to the lowest bidder!”

3PLs that compete aggressively to win a bid all too often fall victim to what is commonly called “The Winners Curse” – which is where the winning supplier is “cursed” because the costs to service the client are much higher than anticipated. Outsourcing professors and experts Sara Cullen, Mary Lacity and Leslie Wilcox point out that once initial ‘fat’ has been removed from a spend category (such as 3PL services) through commoditization, a supplier is often unable to support the requirements, especially if there are any underlying cost structure variations (think fuel price increases, cost of living increases). The result? The “curse” is then passed back to the client via poor and unsatisfactory performance.[1]

Service degradation is not the only risk associated with over-commoditization of 3PL services. GSCs also complain they are not getting the desired “innovation” they are hoping for from their 3PLs. This brings to the forefront the following question: if 3PL services are truly a commodity, why are so many users of 3PL services—the logistics and supply chain experts within a GSC—seeking “innovation” and “value-added services” from the 3PLs? One 3PL found humor in a recent bid process. “I find it almost paradoxical that on one hand the client is claiming 3PL services are a commodity that requires no brainpower, while on the other hand they want innovation.”

Many argue commoditization does not prevent innovation. Rather, the fierce competition encourages 3PLs to invest in broadening their service offerings by building new but generic solutions that are a good fit for the market but are no longer more customized to specific

customer's requirements. This very well may be the case and is in fact happening in some places. However, this does not address the actual requirements of all GSCs—especially those that seek to create a competitive advantage through their logistics and supply chain operations. As one 3PL explained, "The more 3PLs commoditize in generic standardized offerings, the more GSCs complain that the 'uniqueness' of their requirements are ignored by suppliers." This is truly a vicious circle and one where the GSC becomes unsatisfied over time. This begs the question: "Is commoditization of 3PL services a flawed logic?"

Is Commoditization of 3PL Services Flawed Logic?

The Council of Supply Chain Management Professionals glossary of terms defines a commodity as follows: *Any physical item that is traded in commerce. The term usually implies an undifferentiated product competing primarily on price and availability.*

A key criticism is that the Kraljic approach emphasizes over-commoditization by simplifying and standardizing categories into "transactional activities." This is great for companies wanting a truly generic product or service. The problem is that many GSCs require 3PL services that are high impact, are very complex, and may require customized solutions and deeper degrees of collaboration for solving business problems. We argue that for many GSCs, 3PL services are not simply a commodity, but an ability to create value through increased customer services, faster speed to market, or through collaborative efforts to drive a reduction in the total cost of ownership that can positively affect a GSC's profitability by reducing supply chain costs as a percent of revenue.

Gerard Chick and Robert Handfield—scholars and authors of *The Procurement Value Proposition*—agree. They voice concern the Kraljic Matrix is too limited for today's dynamic business environment that includes service-oriented spending (such as 3PL services). They write, "While this approach [the Kraljic Matrix] was fine in the context of procurement in the 1980's – where there was a greater degree of certainty in markets, and the impacts of offshoring and a globalized market were much less impactful – the commodity-led approach that this tool [the Kraljic Matrix] drives does not address some of today's big issues."[2]

A key flaw in Kraljic's "Exploit" strategy is that suppliers have an inherent disincentive to innovate and continue to invest in the client's need for long-term success. University of Tennessee research refers to this result as a "Watermelon Scorecard," which is green on the outside, but red on the inside. Simply put, 3PLs meet required specifications but are not proactively collaborating to drive innovative value over the long term for the buyer.[3] Stories abound of GSCs with "green scorecards and red faces."

Commoditization Misses the Power of Collaboration

We believe the real Achilles heel of Kraljic's Matrix is the absence of recognizing a new form of power – the power of highly strategic and collaborative supplier relationships. Kraljic himself identified this same problem in 2008 in an interview with Philip Usherwood and Dick Russill for The Chartered Institute of Procurement and Supply (CIPS) Supply Business magazine. Underwood and Russill asked Kraljic "If you had the chance to rewrite the 1983 article with the benefit of 25 years'

hindsight, would there be anything to add?" Kraljic replied, "The importance of trust in long-term relationships with suppliers. You need [trust] to create win-win."[4]

We argue that commoditization misses the power of collaboration and the ability to achieve true win-win scenarios. Short term wins come at the expense of long-term gains. After all, how can you expect a 3PL to see value in investing time or money in collaborative initiatives when they are just a commodity? One pharmaceutical GSC provides an example of how a long-term strategic partnership in Canada is helping to create value:

"Today, secondary distribution weighs two-thirds of our global logistics spend and is mostly operated by 3PL suppliers. That said, a single focus on spend is insufficient to fully grasp the true value potential that lies in third-party logistics activities. In Canada, we've mapped an end-to-end taxonomy of our key processes with our strategic 3PL provider spanning 20 core processes tied to 50 categories of logistics activities which are further supported by more than a hundred warehousing & distribution operations. In a customer-centric environment driven by operational excellence, regulatory compliance, speed and agility, those who keep limiting value to saving a percentage of spend should be urged to visit a distribution center and get a glimpse of what really happens behind closed (dock) doors. Our collaborative efforts under a Vested Outsourcing agreement are incentivizing our 3PL to drive true cost structure reductions and other value-added activities we could never realize using a commoditization approach."

PART 2: BEYOND PRICE: SHIFTING RISK

Reversing the over-commoditization of 3PL services is only one part of the equation. GSCs must also realize that they need to look at risk from a more strategic vantage point.

The complexity of government regulations across the globe, such as the Sarbanes-Oxley Act (SOX)5, the Foreign Corrupt Practices Act of 1977 (FCPA)6, the UK Bribery Act7, and various regimes governing anti-trust (competition), sanctions, embargoes, export licensing, etc., coupled with the marked increase in government enforcement actions in recent years, has exposed GSCs to the ever-increasing risk of significant fines, penalties, and civil and even criminal actions. This list now includes Responsible Procurement, Health & Safety, Human Rights, Labor, Animal Welfare, Diversity & Inclusion, and Sustainability/Corporate Social Responsibility regulations and mandatory corporate initiatives.

As these risks increase, GSC procurement professionals are being nudged (or often mandated) by their own legal, finance and corporate risk managers to shift the inherent risk in their business to their 3PLs. This often means pushing 3PLs to sign unlimited liability clauses as part of “standard contracting agreements” that legal often views as “non-negotiable.” These same agreements will also contain unilateral open-ended indemnity provisions in favor of the GSC so that the entire risk associated with handling their product from beginning to end falls only on the 3PL.

3PLs who question the reasonableness of these requirements are often told:

“All your competitors have signed our standard contract.”

“You guys are inflexible – if you don’t sign, we’ll have to shift our work to your competitor.”

“We want you to have skin in the game.”

The sad fact is the procurement professionals are often also frustrated. One CPO lamented, “Procurement is not even the owner of the risk, yet our buyers and commodity managers are being asked to play with negotiations levers that they neither own nor understand.” What is noticeably absent at the negotiations are corporate finance and/or risk managers. One 3PL quipped, “How many times have you ever seen a risk manager invited to the 3PL negotiation table to support commercial discussions?”

Worse yet, risk shifting tactics are too often disclosed at the very end of the supplier selection process, to shortlisted bidders, but most often just to the award winner. This creates lots of tension in the final phase of the bid by opening a last-minute “can of worms” that has not previously been shared during the bidding process nor contemplated as part of the 3PL’s pricing in its bid response. We staunchly believe that GSCs have a fiduciary and ethical responsibility to proactively disclose all risks early in the initial stages of the bidding process, including at the initial RFP drafting phase.

To some degree the GSC is creating a game of chance where if the loss is large enough the 3PL will either be unable to provide the expected financial restitution or the claim of ‘force majeure’ could be made by the 3PL, thus avoiding any claim. In the end, a risk that is shifted but not managed at its destination has not been shifted at all.

UNPACKING RISK SHIFTING

What Risk is Appropriate to Shift?

Everyone knows there are inherent risks and associated costs with sourcing, producing, buying, owning and shipping goods across multiple geographies, jurisdictions, modes of transport, distribution channels, and handling points. GSCs know that their strategic decisions of where to source, how to produce, where to transport, how to distribute, and to whom to sell all impact the level of inherent risk, which they in turn bake into the costs of their goods.

These inherent risks and costs come in the form of delays, product loss or damage, trade compliance issues, and various other types of enterprise risk.

GSCs blur the lines of distinction between custodianship and ownership as they seek to shift that risk to their 3PLs. A 3PL is merely the custodian of the GSC's goods when in the 3PL's custody and control. Unlike a distributor or franchise commercial agreement, a 3PL is not the owner of the goods and derives no economic benefit from the sale of the goods. Yet more and more GSCs are seeking to shift all the inherent risks and costs to transport those goods to the 3PL, which is the type of risk indicative of being "owners" of the goods. This is particularly true in highly risk-averse industry sectors, such as the healthcare industry, that are being exposed to increasing regulatory requirements.

- We agree that 3PLs need to be held accountable for the performance of their services. But it is important to remember that 3PLs are not the owners of the goods they handle. As such, a 3PL's risk needs to be in proportion to the commercial benefit it will derive from the service it performs. Let's look at a real example where risk is clearly out of proportion to reward by reviewing the math associated with a GSC global airfreight award to a 3PL:
- Assume the award is $1 million in gross air freight revenue per annum.
- A reasonable assumption is that the 3PL will pass-through about 80% of this $1,000,000 award to the underlying airline, resulting in a 20% ($200,000) net revenue yield.
- As a rule of thumb, a large public 3PL converts about 5% of its gross revenue to cash, so in this case $1 million gross revenue will convert to about $50,000 cash per annum.
- It is now common for multi-national GSCs to require in their contracts full commercial value liability for cargo loss or damage (free all-risk cargo insurance) and broad indemnification provisions for almost every type of claim or risk imaginable. As a starting point, the risk exposure associated with such unlimited and broad-based indemnification requirements is incalculable. In the alternative, some GSC's will propose very high liability caps on indemnification and cargo claims, usually around $5 million or higher. Also, the liability is being tied to sales value, not just inventory value. In the case of a $5 million liability cap, the 3PL is taking on a cash-exposed to cash-earned ratio of 100:1. ***In other words, if the 3PL was forced to make a full liability payment under the contract, it would be equal to handling the GSC's business for free for 100 years! This type of risk is simply not sustainable nor a good business practice.***

UNPACKING RISK SHIFTING

Why Should a GSC Care?

Classic economic theory would suggest that 3PLs would increase their prices to accommodate the additional risk they are taking on. However, this is not happening as much as we would like to see. Instead, the 3PL market has reacted to aggressive procurement strategies with a reckless pursuit of more risk out of proportion to the reward they hope to receive.

Far too many 3PL's seem willing to sail into rocky shoals, lured by the irresistible song of freight revenue sirens. This scenario leads to bad service contracts that attract uninformed, desperate, undercapitalized, or cynical 3PL's, and drive away the informed, secure, compliant, and committed 3PLs. These are the real providers that GSCs stand to benefit from using over the long term and who are prepared to make the right type of investments for the GSC, provided the contract is fair and balanced.

Instead, GSCs are becoming disillusioned with their new low-bid supplier and the lack of innovation they bring to the table when services are provided under aggressive risk-shifting contracts. The result? Typically, more of the same. The GSC will do another competitive bid, this time seeking to add even more aggressive terms and conditions in their next agreement that are often even more punitive in nature. This cycle keeps repeating itself, with the end game being a race to the bottom – contracts with a lopsided risk-to-benefit ratio as shown in the example above.

But why care? After all, if competitive tension ensures a 3PL market will absorb the increased risk in their base pricing, why bother to create a fair and balanced contract? The answer is simple. If GSCs push too far the industry is pushed into a self-fulfilling cycle where bad contracting begets bad service. And bad service begets a new competitive bid. A costly cycle follows of bidding and transitioning that promotes a virtual death spiral race to the bottom. At some point, the bubble bursts and the market corrects itself, usually with great pain and many casualties.

To get a sense of how the assumption of risk left unchecked can go horribly wrong, consider the toxic dump of sub-prime mortgages and credit default obligations coupled with high commissions and bonuses for those that created and sold them. You can only tuck in so much risk and exposure into an agreement before it becomes toxic by nature. The real estate and Wall Street meltdown of 2008/2009 taught us it's fatal to a business if it doesn't understand the inherent risks in what it is buying, or even worse, if it blindly takes on risk and hopes nothing will happen.

We believe the 3PL industry is nearing a tipping point of over-commoditization and aggressive risk-shifting.

PART 3: GRESHAM'S LAW IN PRACTICE

We argue the 3PL industry is suffering from Gresham's Law.

Gresham's Law is an economic principle stating that good money is always replaced by bad money.[8] However, the analogy can be applied in the 3PL industry. Good 3PLs are slowly being replaced with bad 3PLs who are consciously or unconsciously allowing themselves to play a short-term game focused on winning bad deals simply to get revenue and win a key client at the expense of their competitors.

Gresham's Law is leading to the emergence of four distinct groups of 3PLs:

- ***Credible 3PLs losing market share*** – The first group is comprised of the best 3PLs. It is becoming increasingly harder for this group to take contracting seriously with the full intent to honor contractual commitments. A case in point is a CEO of a 3PL who was forced to walk away from a $20 million contract even though they were the incumbent supplier because they refused to sign their customer's "new standard contract template." While walking away from one bad deal may not seem significant, think about the impact of walking away from five deals totaling $100 million in revenue. Profit pressures put these "best" 3PLs at an inflection point where CEOs and CFOs are limiting investments as their profitability declines.

- ***Benign 3PLs*** -- The second group consists of those 3PLs that are unaware of the scope and depth of the risk associated with agreements they are signing. Often benign 3PLs rely heavily on sales reps with commissions to drive revenue. Unfortunately, contracts get signed that lead to a nice short-term commission check at the expense of overlooking or undervaluing the risk the firm is taking on.

- ***Cynical 3PLs*** – This group of 3PLs takes a passive-aggressive approach. They hope for the best as they bury their heads in the sand hoping the risks will not come to fruition. These 3PLs sign contracts with little assets at risk, and little capability or intention of honoring their contractual commitments should the risks exceed their economic return on investment. One cynical 3PL even created a subsidiary to "house" a bad client that had shifted too much risk onto it. The rationale? In the event that risks actually came to fruition, the subsidiary could be shut down, allowing the primary business of the 3PL to remain intact and ensuring the GSC would not be able to collect damages from the 3PL under the contract. The rise of mergers and acquisitions, fueled by private equity investors, is also leading some 3PLs to "unrealistically price their service offerings in order to win the business of high-profile GSC clients and make themselves more attractive to prospective investors," as one Credible 3PL who walked away from such a bid put it.

- ***Blind Faith 3PLs*** -- The last segment consists of those 3PLs in the industry that have entered into a "nudge-nudge, wink-wink" scenario with their clients. Often these are 3PLs that have had long-term relationships with clients who are not willing to walk away from an existing customer's revenue. They often have a key trusted individual who is advocating for the 3PL to go ahead and sign the contract to enable the GSC's procurement or legal

departments to "check the box" to meet internal audit requirements. These trusted individuals often seal the deal with a handshake saying, "We all know the best relationships simply put the contract in the drawer and forget about it." But what will happen if unforeseen risks do occur? Surely the 3PL will be held liable for the written word of the contract, especially if the trusted counterpart who nudged and winked at contract signing ever leaves the GSC. So, simply saying you have a good relationship and don't need the contract only works until a risk happens. Unfortunately, burying your head in the sand with blind faith does not make the risk go away.

Far too many GSCs fail to realize a fundamental flaw in their procurement practices: you can't convert a fundamentally weak, under-resourced, under-capitalized, unaware, or irresponsible 3PL into a responsible supplier through price concessions and shifting risk. Putting more pressure on a 3PL supplier will simply increase the speed of the death spiral of running good and credible 3PLs out of business.

Many will read this and think the industry is not in a death spiral. We accept that. However, it is likely that readers will at least recognize that the industry is in a Catch-22 at best.

A Catch-22, taken from the classic Joseph Heller novel, is a no-win situation that uses contradictory, circular logic. For instance, you need a pass to enter a particular building, but to get a pass you must visit an office in the same building.

A Catch-22 emerges because GSCs want logistics and supply chain solutions to close the gaps when they lack core competency. They seek "innovation" with the desire to create a competitive advantage from their supply chain, yet they are using tactics that drive commoditization. And the more a GSC drives commoditization, the less likely a supplier is to invest in innovation. Suppliers argue that investing in their customer's business is risky because buyers will simply take their ideas and then bid the work to their competitors for a lower price. Or suppliers find themselves in a situation where they may want to invest, but their thin margins prevent them from justifying investing. Thus, GSCs find their 3PLs meet contractual obligations and service levels — but they do not drive innovations and efficiencies at the pace they wish. The result is that the industry is at a crossroads, with both GSCs and 3PLs wanting innovation, but neither willing to make the investment.

The following outlines a few Catch-22 examples in action.

First, many organizations have procurement policies that are designed to promote competitive tension. It is not uncommon to find organizations that have "must bid" policies. Arjan J. van Weele - NEVI Professor Purchasing and Supply Management at Eindhoven University of Technology – warns procurement professionals that continuous and relentless competitive bidding are "ritual dances between purchasers and supplier (that) usually deliver limited results." He adds, "Moreover, this process consumes valuable time."[9]

Emmanuel Cambresy, Global Supplier Performance & Innovation Manager for one of the world's largest pharmaceutical companies, shares his insight about what he terms as "compulsive" competitive bidding. "A compulsive approach to competitive bidding not only reflects the failure of

many procurement professionals to proactively craft sustainable and flexible pricing models, but also to own and execute the “R” in SRM (Supplier Relationship Management). In more strategic spend categories – especially where business continuity is paramount – switching suppliers should ultimately remain the very last resort to consider, only when all existing supplier relationship levers have been truly exhausted on both sides.”

GSCs make the situation worse by using a power-based muscular style that pits 3PLs finalists against each other as they negotiate to get greater concessions. Many GSCs perceive the need to “win at all costs.” One firm’s procurement group got a reputation as the Pit Bulls of Procurement. One of the Pit Bulls openly admitted, “I used to know I was doing a good job when I had the vendor naked, bleeding, and crying at the table.” How can you expect to promote a positive relationship when you use trust-busting tactics like this?

The good news is that many thought leaders are openly challenging muscular power-based style to procurement. Dr. Oliver Williamson, the recipient of the 2009 Nobel Prize in Economic Science, spent his life studying the concept known as “transaction cost economics.” One of Williamson’s famous quotes from his research is, “Muscular buyers not only use their suppliers, they often use up and discard them. The muscular approach for buying goods and services is myopic and inefficient.”[10] The better approach, according to Williamson, is what he coins a “credible” approach that seeks to use facts and reason to get to the best overall solution with suppliers, not one that simply shifts risk or gets the lowest price because you can.

Lawyers are not helping the matter either. Lawyers – by design – have a job requirement to protect their firms. As such, they try to avoid risk for the buying organization and push suppliers to adopt “standard contract templates.” On one hand, the buyer is saying “strategic suppliers” but, on the other hand, legal is mandating a “no commitment of business” provision in which the 3PL agrees that the GSC does not have to purchase any services from the 3PL whatsoever after the contract is signed. To a 3PL’s Chief Financial Officer, this translates to great uncertainty about any expected revenue instead of an intended longer-term trusting relationship with the hopes that a supplier will invest in innovation and flexibility. Anyone in logistics knows this practice defies what is taught in universities, which points to the need for improved supply chain visibility to reduce costs. Purposely not sharing forecast data and not working collaboratively with 3PLs closely is imprudent and inefficient.

3PLs also argue that far too few GSC organizations have lawyers that don’t “get” intellectual property rights when it comes to services. GSCs expect 3PLs to bring them their best innovations since they are “strategic.” But from the 3PL perspective, the willingness to invest is removed as soon as the GSC’s lawyer insists the GSC owns the IP and all future derivatives.

Another vexing problem is that the 3PL industry is often hesitant to promote pricing transparency. GSCs expect a fixed price guarantee to protect them when underlying cost variables fluctuate, but fail to realize these costs and risks are really variable for 3PL’s too. Fixed pricing creates friction that could easily be avoided with transparent pricing and proper incentives that are implemented to drive down cost structures – not just the price. Emmanuel Cambresy shares his insight into price transparency: “I have seen a number of supplier agreements which have been structured to

promote improvements and process efficiencies, while simultaneously being supported by totally opaque/transactional cost structures. How can you and your supplier expect to agree on cost baselines, improvement targets and performance measurements against process outputs when the end-to-end costs of such processes are not shared? Simply put, a GSC's need to improve is best served by a transparent cost structure that enables a focus on true total costs."

But 3PLs are not innocent either. In the rush to do the deal, 3PL sales reps don't push back and demand due diligence. This is exacerbated by rigid pricing constraints imposed by the GSCs with little pricing transparency. This results in the 3PL not fully understanding the true costs of the scope of work. This is especially true for larger, more complex, or dedicated 3PL operations. The result? 3PLs often overcommit. When they realize the true costs of what it means to be a "Strategic Partner" they face internal pressures to cut costs and, perhaps, even cut corners.

When 3PLs face margin compression, they often:

- Forgo needed investments. For example, a 3PL may skip preventive maintenance on equipment if it feels the risks are low.
- Switch out the "A-Team" for the "C Team." To reduce costs, key account managers will spend more time working on other accounts rather than working on key GSC initiatives.
- Rob Peter to pay Paul. 3PLs are often quick to realize when their large, global clients lack alignment between business units or countries. When this happens the 3PL will meet its profitability targets by keeping pricing high for one group to compensate for lower margins from another group.
- Fight back with an aggressive approach to manage scope creep, and "nickel and dime" the buyer for any out of scope items. After all, the statement of work clearly says that shipping cutoff time is 3 PM and the internal pricing department is breathing down their necks to capture any and all expedite fees from clients.
- And of course, why *not* consciously take an SLA penalty for missing an on-time shipment for a critical shipment, rather than absorb the higher overtime costs associating with honoring the SLA.

Each of these actions creates a lose-lose for both the GSC and the 3PL.

PART 4: A BETTER WAY

For the past 23 years, Dr. Karl Manrodt and Dr. Mary Holcomb have surveyed GSCs in their "Annual Trends and Issues in Logistics and Transportation."[11] The report has become one of the gold-standards in understanding trends in how organizations buy and use logistics and transportation services.

For the last two decades, the pair has shown "The Masters of Logistics" were those that used their size to their advantage to create a competitive difference in logistics and transportation. The traditional "master"—those with consistently better performance—were large firms with over $3 billion in revenue. It's easy to assume the big guys would be better, given that they likely have more money to spend. However, as technology and the level of supply chain visibility are more widely available to companies of all sizes, the study reveals that the tide is turning.

Manrodt and Holcomb suggest that a new definition of "Masters," one described by their practice versus their pocketbook, is emerging. The latest survey says that the "New Masters" are those that focus on innovative ways to create value and therefore create competitive advantage. This means a clear shift away from commoditization to that of a mindset where 3PLs are working more collaboratively to develop solutions that help their supply chain become a competitive differentiator.

Holcomb explains, "While procurement is assuming control and responsibility for transportation in many companies, a critical mass of companies is moving in the opposite direction. They have developed strategic partnerships with carriers that enable them to keep costs low while providing innovative service to their customers. This value-added perspective is leading to performance that is significantly better than their competitors."

What makes these new high-performing GSCs different? Manrodt and Holcomb point to five key factors:

- They choose strategic partners that make them better
- They work with their strategic partners to develop a plan for achieving their respective goals
- They identify the gaps between current and desired future practices for both parties
- They develop shared solutions with their strategic partners to close the gaps
- As a team, they leverage the results of the previous efforts to create a shared competitive advantage

Their annual report is clearly pointing to a better way: one where the winners are redefining the definition of winning to one of creating value through collaboration.

UNPACKING RISK SHIFTING

Redefining Value

To understand how to redefine value, it's important to ask, "What does a GSC truly value?" Before we get into what a GSC values, we should first describe the components that make up a GSC's procurement process. In the 3PL world, a GSC is comprised of multiple components:

- Logistics/Supply Chain/Commercial: These are the people that use and rely upon 3PLs in the execution of their jobs.
- Procurement/Purchasing: These are the people that essentially approve or authorize the purchase of 3PL services. It is important to understand many procurement professionals are judged not on the performance of the 3PL but on the projected savings, cost mitigation, cost avoidance and in securing the most favorable terms and conditions.
- Legal, Finance and Risk Management: Each of these interests requires and mandates that certain provisions appear in every contract.

The challenge becomes aligning these divergent interests to ***optimize*** a logistics solution for the GSC, not just to ***buy*** the 3PL service. The secret sauce is in shifting away from thinking about price to measuring what you value. While no two GSCs are identical in what they value, most value one or more of the following:

1. Lowest priced capable supplier
2. Favorable terms and conditions
3. Operational Excellence
4. Integrated Products & Solutions
5. CRM/Account Management/Customer Service/single point of contact
6. Customer-facing systems; visibility, track and trace, et al.
7. Knowledgeable and properly trained employees
8. Supplier-led innovation and data analytics
9. Compliance
10. Brand/Culture/Financial Strength

Unfortunately, GSC procurement organizations often miss the "value" equation and rarely apply a true best value analysis when selecting suppliers.[1]

To think about value creation, one must also think about investment, risk, and return on investment *for both parties*. One of the easiest ways for a company to improve financial performance is to invest in process and product efficiencies that create value. For example, is the 3PL in the best position to invest in tighter process controls that improve shipping efficiencies? Or perhaps a GSC

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[1] Best Value approaches, tools and methods such as Total Cost of Ownership (TCO) are gaining traction. Even government agencies that have traditionally relied on competitively bid "lowest price" policies are deploying Best Value concepts. Determining Best Value for a product or service is about picking the best option that fits the need.

and a 3PL can invest in asset-specific processes or innovations that create a competitive advantage for the GSC? And what about collaborating to jointly create operational initiatives aimed at reducing inventory turns, which ultimately positively affect the GSC's balance sheet?

Another way to create value is to mitigate risk. The consulting firm Deloitte surveyed 600 manufacturing and retail executives in 2013, and 71 percent of them viewed supply chain risk as "an important factor in their companies' strategic decision making, including 20 percent who view it as extremely important," but 42 percent of the executives from large companies said their supply chain risk management programs are only somewhat or not effective.[12] When a supply chain disruption occurs, 3PLs can be a source of competitive advantage if they can help a GSC mitigate risk.

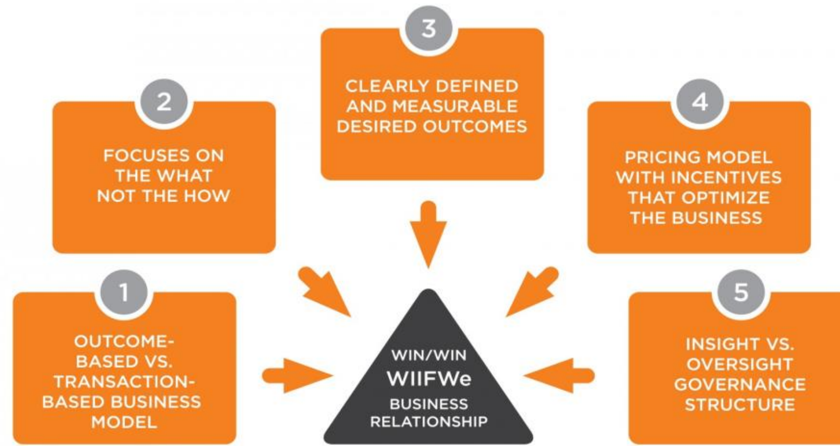
Unfortunately, GSCs think of risk myopically. Rather than working with 3PLs strategically to allocate, manage, and mitigate risk, far too many are simply shifting risk to their 3PL through contractual obligations. A better approach is to devise a commercial agreement that properly allocates risk to the best party to mitigate it, and to compensate that party appropriately for bearing that risk. If the 3PL can reduce risk, in essence it creates value.

The key question becomes, just how do you shift to buying value? And how do you reward a 3PL for its investments or ability to mitigate risk? That is a question the University of Tennessee addressed in a large research project funded by the United States Air Force to study. The research included many phases and ultimately resulted in award-winning research known as the Vested Outsourcing business model (or simply Vested for short). World Trade Magazine named Vested as one of the "Fabulous 50+1" most influential concepts affecting global trade.

The Rise of Vested Outsourcing

Vested® is a hybrid business model, methodology, mindset and movement based on award-winning research conducted by the University of Tennessee Haslam College of Business Administration and funded by the U.S. Air Force. What started out as a research project aimed at finding a better way to outsource evolved into a groundbreaking and award-winning methodology and business model we coined as "Vested," demonstrating that the Nobel laureate John Nash's equilibrium theory of cooperation, not competition, guarantees the best results for all parties when establishing business and outsourcing relationships. The Vested business model creates highly-collaborative relationships that create value for both parties through five "rules:"

UNPACKING RISK SHIFTING



Rule 1: Focus on Outcomes, not Transactions. Shift the mindset from a focus on specific transactions to desired outcomes – instead of buying transactions, buy outcomes, which can include targets for availability, reliability, revenue generation, employee or customer satisfaction and the like.

Rule 2: Focus on the "What," Not the "How." If a partnership is truly outcome-based it can no longer have a multiplicity of Service Level Agreements (SLAs) that the buyer is micromanaging. The outsource provider has won the contract because it has the expertise that the buyer lacks. Therefore, the buyer must trust the supplier to solve problems.

Rule 3: Agree on Clearly Defined and Measurable Outcomes. Make sure everyone is clear and on the same page about their desired outcomes. Ideally, use no more than about five high-level metrics. All parties—which may include users and other stakeholders that aren't directly signing the contract—need to spend time collaboratively, during the outsourcing process and especially during the contract negotiations, to establish explicit definitions for how relationship success is measured.

Rule 4: Pricing Model Incentives that Optimize the Business. Vested does not guarantee higher profits for service providers, they are taking a calculated risk. But it does provide them with the tools, autonomy and authority to make strategic investments in processes that can generate a greater ROI and value over time, perhaps more than a conventional cost-plus or fixed-price contract might produce over the same period.

Rule 5: Governance Structure Should Provide Insight, Not Merely Oversight. A flexible and credible governance framework enables all the rules to work in sync. The structure governing an outsource agreement or business relationship should instill transparency and trust in how operations are developing and improving. And, of course, identify where potential risks, threats and challenges may occur, because "business happens."

Collaborative Success Stories with Real Results

GSCs such as Intel are finding that a strategic, collaborative approach is saving dollars vs the dimes they were getting through aggressive competitive bidding and risk shifting. But what is the potential?

A good example of Vested in action is how Intel and DHL Global Forwarding worked together under a Vested pilot for one of Intel's key sites. Under Rule #5 (Insight vs oversight governance structure), Intel and DHL created formal "path-finding" meetings where joint Intel and DHL team members work together on Lean or Six-Sigma initiatives tied to Rule #3 – their clearly defined and measurable Desired Outcomes. Together Intel and DHL discovered new, shorter and more efficient processes that have saved a boatload (pun intended) of money.

For example, raw material brought in from Japan and Taiwan required six to seven surface days. Many more days were required for the material to sit in warehouses while arrangements were made to further disperse. DHL believed if shipments were better coordinated, significant savings could be reached. Together, Intel and DHL traveled to Asia to meet with suppliers and coordinate the process. DHL committed to a six-day arrival from origin to destination. The result was an improvement in on-time delivery from 95% to 98% and a reduction in transit time from eight days to six days. This enabled significant inventory reduction in the first year.

"This project was more about warehousing than our direct responsibility for freight," said Guido Hogen, DHL Regional Account Manager. "Without the visibility in inventory DHL now enjoys, we would never have seen this possibility. We shared credit and, with incentives, we will share in the reward. Without Vested, this would not have happened."

A win for Intel is a win for DHL. In short, DHL is vested in the success of Intel under the Vested agreement.

Expeditors has similar success stories with GSCs who have worked with them more strategically.

Kevin Taylor, Global Indirect Sourcing Lead at Weir Group, explains how they have worked more collaboratively with Expeditors. "The initial agreement Weir Group sent Expeditors was a 100-page contract designed for a manufacturing supplier. About 70% of the agreement did not relate to providing logistics or transportation services. Rather than trying to force a square peg into a round hole, we worked together to draft an agreement completely aligned with the services being sold and purchased, clearly explained mutual expectations and shared risk. This tailored approach significantly reduced the negotiation time, fostered an environment of partnership and mutual benefit that since has permeated the entire relationship. The lesson learned here is that negotiations do not have to be a competitive blood sport, but rather a collaborative and mutually beneficial process."

UNPACKING RISK SHIFTING

Finding the Pony

We find that many 3PLs—not just Expeditors and DHL—have the capabilities to create value. But to unlock that potential GSCs need to shift their mindsets to focusing on long-term Vested relationships that enable and reward suppliers for creating value through efficiencies and risk mitigation. We encourage GSCs to begin to change the discussion with their 3PLs to find the "Pony."

The book *Vested Outsourcing* describes the potential in terms of the Pony. It describes the Pony as "something the outsourcing company wants but was not able to get on its own or with existing suppliers," followed by a memorable story on The Pony:

It [The Pony] also represents what Ronald Reagan used to portray as the optimistic approach. Reagan used to tell a story about a man who came upon a young boy excitedly digging through a large pile of manure. "What are you doing, son? The man asked. "Well sir," the boy answered happily, "with all of this manure, there must be a Pony in here somewhere!"

Some examples of The Pony we have seen include:

Visibility on the Future*.* Transparency enables parties to share information they normally would not. This in turn helps the 3PL plan better. One 3PL indicated it would give a 4% better discount if they could know the dimensions of the shipment in advance for pickup.

Use Cube-Based Pricing*.* Cube-based pricing allows the 3PL to price by the space occupied, which should be the most important measure in load factor. Cube-based pricing provides a real incentive to the GSC to reduce packaging and shipment size, which in turn fosters a reduced carbon footprint for each shipment. The best GSC-3PL relationships often work collaboratively.

Increase the load factor*.* Load factor is the ability of the 3PL to maximize the cargo space. Rarely do LTL shipments reach the maximum weight allowed of 48,000 pounds per schedule. Help your 3PL understand how much space you will use so they send the right equipment. Remember, the 3PL is likely not just picking up your freight, but also most likely combining freight with several customers. The more advance information the 3PL has on the aspects of the shipment, the better.

Optimize packaging*.* Work with your 3PL to offer suggestions for improved packaging, which can create more dense shipments and/or reduce damages.

Loading & Unloading. GSCs may help offset the pickup and delivery costs by assisting the 3PL to load the trailer. (Check with local labor first).

View 3PL as a Supply Chain Risk Management Partner*.* The consulting firm Deloitte surveyed 600 manufacturing and retail executives in 2013, and 71 percent of them viewed supply chain risk as "an important factor in their companies' strategic decision making, including 20 percent who view it as extremely important" — but 42 percent of the executives from large companies said their supply chain risk management programs are only somewhat or not effective.[13] When a supply chain disruption occurs, 3PLs can leverage their people, assets, and technology to help clients recover faster and with financial impact less than their competition, but only if GSCs embrace 3PLs

as supply chain risk management partners, instead of just suppliers of transportation and warehousing services.

***Reduce deadheading/backhaul**.* Smart GSCs work collaboratively with their 3PLs to find ways to reduce backhauls. Grocery Haulers Inc. (GHI) has invested in dedicated carriage routing optimization to benefit its clients. GHI and a key client created a pricing model where investments by the 3PL or the GSC are transparent and jointly calculated to yield productivity improvements for BOTH the shipping and carriage functions. Recovery of investments is pre-agreed and transparent so both parties' management will be encouraged to invest further in the relationship.

***Pool Distribution**.* GSCs with significant volume can work with their 3PLs to create "pool distribution" points, where shipments are "pooled" together to a 3PL's distribution center or pool point, then shipped out from the pool point to the final destination. Pool distribution can help the 3PL and GSC avoid expensive line haul and break-bulk costs.

CONCLUSION AND CALL TO ACTION

The logistics and transportation industry is at a crossroads with how it structures commercial agreements. GSCs and 3PLs can choose to sit across the table, using their power and influence to preserve margins, in which case there will be winners and there will be losers. Or, they can choose to work together to share risk and share reward in a fair and balanced manner that promotes collaboration and investment in true business problems. In other words, a “win-win” situation.

There is no better time for GSCs and 3PLs to come together to address the real problem—how to optimize overall logistics and supply chain management processes producing tangible benefit for both GSCs and 3PLs. It’s time to take a strategic move to escape the death spiral – or at a minimum exit the Catch 22, that is creating an over-commoditization in the 3PL industry. However, to get traction both GSCs and 3PLs must have a vested interest in the success of the industry to be successful.

We challenge GSCs and 3PLs to get smart about how they are buying and selling 3PL services. This will mean actively having more strategic discussions around which sourcing business model is the most appropriate.

Yes, there will be some GSCs that simply should be buying a commodity. And for those, the status quo may be appropriate. But for others, this will mean shifting to fair and balanced Performance-Based Agreements or strategic Vested relationships designed to create value.

So how do you approach your client or suppliers to start a different dialogue? Some key questions to ask yourself are:

- What are my Desired Outcomes?
- What is the best sourcing business model for my environment? (A simple transactional provider or Preferred Provider? Or a more strategic Performance-Based or Vested Agreement?
- How do I develop a pricing model that will incentivize so that both the GSC and the 3PL are winners?
- How can I ensure my client/supplier is the best fit to meet my needs?
- What are the various resources I can use for selecting and creating more strategic commercial agreements with my business 3PL (or GSC)?

If you don’t know where or how to start, we invite you to attend the University of Tennessee’s 3 Day Vested Outsourcing Executive Education course where you will answer these questions. Ideally, we encourage GSCs and 3PLs to come together where they can have a neutral offsite, facilitated environment to help them begin to have a different discussion. Beyond learning the fundamentals of Vested and doing a deep dive with real success-stories, individuals leave with fresh perspectives on business partnering, strategic relationship management and value creation.

ABOUT THE AUTHORS

Kate Vitasek is one of the world's authorities on highly collaborative win-win relationships for her award-winning research and Vested® business model. Author of seven books and a faculty member at the University of Tennessee, she has been lauded by *World Trade Magazine* as one of the "Fabulous 50+1" most influential people affecting global commerce. Vitasek is a contributor for Forbes magazine and has been featured on CNN International, Bloomberg, NPR and Fox Business News.

Phil Coughlin is the President of Global Geographies and Operations at Expeditors. He has worked in the logistics industry for over thirty years. In this capacity, he has negotiated over 100 3PL contracts. He has a B.A. from the University of Illinois and a J.D. from The John Marshall Law School.

Peter Moore serves as a Vested Program Faculty Member at the University of Tennessee Center for Graduate and Executive Education. He also is Adjunct Professor of Business at the University of South Carolina-Beaufort. Peter has over 35 years of operational and executive roles in industry in and government supply chain and logistics and has a monthly column in Logistics Magazine entitled "Moore on Pricing". Prior to his academic career, Peter served as National Practice Leader in Logistics at Ernst & Young and Capgemini consultancies.

Adrian Gonzalez is President of Adelante SCM and Founder/Host of Talking Logistics. He is a trusted advisor and leading industry analyst with over 17 years of research experience in transportation management, logistics outsourcing, and other supply chain and logistics topics. Adrian speaks frequently at industry events and conferences and is regularly quoted in industry publications. He is also a member of the Council of Supply Chain Management Professionals and a LinkedIn Influencer with over 31,000 followers.

Karl Manrodt is a Professor of Logistics at Georgia College and State University. The author of five books and over 50 scholarly articles, Manrodt was recognized as a "Rainmaker" by DC Velocity Magazine and has served on journal editorial boards and various associations in the discipline. Manrodt is a popular speaker and has traveled around the world sharing his insights and advice on how to create a world-class supply chain.

Emmanuel Cambresy is leading Novartis' global Supplier Performance & Innovation (SPI) strategy for Warehousing & Distribution. Prior to this position, he held progressive strategic sourcing roles – including successfully leading the deployment of the first Vested Outsourcing partnership in the pharmaceutical industry worldwide. Cambresy has two Master's degrees in Global Sourcing and Supply Management, is a Certified Purchasing Professional, FORTH Facilitator and has been appointed a Vested Deal Architect by the University of Tennessee.

Andrew Downard is a consultant and educator specializing in supply chain relationships and supply chain risk management. He has held procurement and operations roles during his distinguished career – including roles at General Motors and Nissan – giving him a broad perspective on muscular and collaborative styles of procurement. Andrew leads his own consulting firm while pursuing his Ph.D. at the Institute of Supply Chain and Logistics at Victoria University.

FOR MORE INFORMATION ABOUT EXPEDITORS

Expeditors is a global logistics company headquartered in Seattle, Washington. The company employs trained professionals in 185 full-service offices and numerous satellite locations located on six continents linked into a seamless worldwide network through an integrated information management system. Services include the consolidation or forwarding of air and ocean freight, customs brokerage, vendor consolidation, cargo insurance, time-definite transportation, order management, warehousing, distribution and customized logistics solutions. For more information, visit www.expeditors.com

FOR MORE INFORMATION ABOUT ADELANTE

Adelante SCM is a peer-to-peer learning and networking community for supply chain and logistics professionals. Adelante's services include *Talking Logistics*, an online video talk show and blog featuring thought leaders and newsmakers in the supply chain and logistics industry, and *3PL Briefings*, a research service focused on providing supply chain executives with high-quality and trusted research, analysis, and briefings about the Third-Party Logistics (3PL) industry and leading practices in logistics outsourcing. For more information, visit www.adelantescm.com

FOR MORE INFORMATION ABOUT THE UNIVERSITY OF TENNESSEE

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.

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.](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.

* Prerequisites for ***Creating a Vested Agreement*** class are:

Five Rules, ***Is Vested Right?***, ***Getting Ready***, and the ***Vested 3-Day Executive Education Course***

Be working with a **Vested Center of Excellence**

ENDNOTES

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[4] Philip Usherwood and Dick Russill, “Reflections of a Pioneer,” Chartered Institute of Procurement & Supply, Autumn 2008 (available at http://www.supplybusiness.com/previous-articles/autumn-2008/features/reflections-of-a-pioneer/)

[5] The Sarbanes-Oxley Act of 2002 (often shortened to SOX) is legislation passed by the U.S. Congress to protect shareholders and the general public from accounting errors and fraudulent practices in the enterprise, as well as improve the accuracy of corporate disclosures. Definition retrieved from http://searchcio.techtarget.com/definition/Sarbanes-Oxley-Act

[6] FCPA is a United States federal law known primarily for two of its main provisions, one that addresses accounting transparency requirements under the Securities Exchange Act of 1934 and another concerning bribery of foreign officials. Definition retrieved from http://en.wikipedia.org/wiki/Foreign_Corrupt_Practices_Act.

[7] The Bribery Act 2010 is an Act of the Parliament of the United Kingdom that covers the criminal law relating to bribery. The penalties for committing a crime under the Act are a maximum of 10 years' imprisonment, along with an unlimited fine, and the potential for the confiscation of property under the Proceeds of Crime Act 2002, as well as the disqualification of directors under the Company Directors Disqualification Act 1986. Retrieved from http://en.wikipedia.org/wiki/Bribery_Act_2010.

[8] Gresham's law is an economic principle that states: "When a government overvalues one type of money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation." It is commonly stated as: "Bad money drives out good." Definition retrieved from http://en.wikipedia.org/wiki/Gresham's_law.

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