CHAPTER 12

LESSONS TO TRANSFORM HEALTHCARE CONTRACT PERFORMANCE: TRANSACTION-COST ECONOMICS

LEARNING OBJECTIVES

1. Describe the importance of Williamson's work for the healthcare supply chain.
2. Explain transaction-cost economics (TCE) and how this concept relates to supply-chain management.
3. Demonstrate an understanding of the ten key insights from Oliver Williamson's TCE model.
4. Categorize the types of supply chain present in a typical healthcare organization in terms of their associated risk to the healthcare organization.
5. Integrate healthcare supply-chain principles with TCE tenets to develop a list of considerations for a typical transaction in the supply chain.
6. Evaluate TCE in the context of the supply chain using the Value Chain model.

Introduction

Without a doubt, healthcare costs continue to rise. In the United States, healthcare costs are expected to reach $4.8 trillion by 2021.[1] According to the World Bank, healthcare costs were approximately 17.9% of GDP in 2011.[2] Supply-chain management in hospitals can account for as much as 30% of total hospital costs.[3] One expert, Bruce Johnson, CEO of GHX, states: "The supply chain is the second largest and fastest growing expense for healthcare providers; with only labor costing most providers more".[4] Approximately one-third (31%) of annual operating expense can be attributed to the healthcare supply chain.[5]

The technology of healthcare delivery is heavily dependent on supply-chain decisions, operations, and status. Adding to the concern of the healthcare supply chain are the tensions on reduced reimbursements for healthcare services, inflationary pressure of pharmaceuticals, high-preference supply items, high-volume supply items, and the move to "accountable care organizations." According to Vance Moore, CEO of ROi (the supply chain entity within the Sisters of Mercy Health System based in St. Louis, Missouri), in a 2008 presentation in Chicago, the trend in the cost of the healthcare supply chain continues to grow such that, if the trend continues, supply chain could equal labor cost for annual operating expenses for hospitals and health systems between 2020 and 2025.[6] Clearly, maximizing efficiency of the healthcare supply chain is an increasing concern. From an analysis of charges for fiscal year 2003, approximately 36% of inpatient nursing floor unit supply charge capture items were actually being charged correctly.[7]

Other industries have mitigated their market risks and cost increases through the use of strategic partnerships and outsourcing.[8] Firms like McDonald's, Proctor & Gamble, and Microsoft have obtained cost saving, flexibility, transformation, and innovation by developing key strategic partnerships.[9] This chapter explores the possibility of reducing costs, increasing flexibility, and transforming the work processes in healthcare through strategic relationships.

One way to view these strategic relationships is through the lens of TCE. This lens has been used by several researchers in the healthcare field over the past two decades.[10, 11, 12, 13, 14]

Specifically, we focus on a single article written by Williamson in 2008 for several reasons. First, the article describes various types of relationships firms can have with their suppliers, ranging from transactions to strategic partnerships. Second, his focus is on improving the performance of the supply chain. Finally, while our analysis provides insights on how these lessons relate to healthcare, many of them can also apply to other disciplines and industries as well. We begin with a brief overview of TCE, then apply insights from Williamson into ten specific lessons for healthcare professionals and discuss future implications. This chapter was prepared by James Stephens, Ph.D., Karl Manrodt, Ph.D., Gerald Ledlow, Ph.D., Richard Wilding OBE, Ph.D., and Christopher Boone, Ph.D. The authors would like to thank several individuals for their assistance on this chapter; these include Kate Vitasek and Tim Cummings.

What Exactly is TCE?

Transaction costs are the costs that occur when participating in a market. To use a very simple example, when buying a book, there is not only the purchase price of the book but also the costs you incur in purchasing the item. These could include your energy and effort in selecting the book, the costs of traveling to the store or using the Internet, the time waiting, and the effort and costs of making the payment. The costs that go beyond the book's price are the transaction costs. Transaction costs include actual monetary costs, expertise, flexibility, risk, asset specificity, the cost of managing the relationship, and supplier set up and switching costs, to name only a few that must be considered.

TCE adopts a contractual approach to the study of economic organizations. Briefly, TCE is best thought of as accounting for all the costs of a deal or contract, both the obvious and hidden costs.

Williamson (2008) notes there are transaction costs whether a firm decides to make or buy a product or service.[15] A company should strive to use TCE as the basic unit of analysis to determine these costs to make better, more meaningful decisions. A firm has to decide whether to do the work internally (make) or procure the service (buy), and it should consider all of the transaction costs—taking special care to identify hidden transaction costs. If a company does decide to outsource, it should work to reduce transaction costs with regard to how the companies work together—including the remaining internal transactions. That is, there is still a cost associated with managing the relationship that needs to be accounted for.

It is important to understand that there are transaction costs ranging from the simplest one-on-one commodity contract to the costs associated with vertical integration. There is no such thing as a zero transaction cost: there is a cost for bureaucracy and there is a cost for operating in the market. The goal then becomes to identify and quantify these and optimize for how you do business.

Ten Key TCE Lessons for Healthcare Practitioners

A key element of Williamson's work is to explain how behaviors and approaches to the contract can impact transaction costs. This section of the chapter examines ten key lessons that are directly applicable to outsourcing and supply-chain professionals. Each lesson is discussed, and is illustrated by an example drawn primarily from the healthcare field.

Lesson 1: Outsourcing Is a Continuum, Not a Destination

In 2004, Peter Drucker said, "Do what you do best and outsource the rest!" Most companies jumped on the outsourcing bandwagon and used conventional procurement methods for negotiating often large and complex outsourcing deals. For the most part the conventional approaches meant using contracting philosophies and approaches that were used for buying supplies and commodities.

Under conventional thinking about outsourcing there are basically two approaches: one is going to "the market" and the other is building "corporate hierarchies" and bringing the capability within the organization. Companies have generally made a make-versus-buy decision when it comes to outsourcing, and if they outsource they use conventional free-market economy and market-based approaches for developing the contract.

The market (buy/outsource) mode has an incentive for its use. There is little administrative control and well-established contract law to rely on. The market mode assumes an unrestricted market, or basically an ideal transaction featuring an absence of dependency and with governance accomplished through competition. Neither the buyer nor the supplier relies on the other. If one acts poorly, the other can easily exit the relationship.

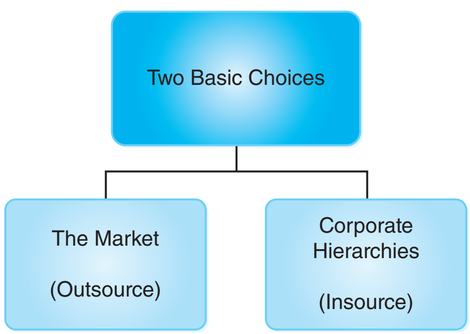
The downside to the market mode is that service providers are often "competed" into outsourcing agreements that pose hidden risks. For example, Williamson points out that service providers might have "specialized investments" that can easily expose the business to significant loss if the contract fails and for which no safeguards have been provided. When this happens service providers will raise their price to reflect the level of risk they have taken on. To counteract this and thus provide a more acceptable price to the customer, service providers will often negotiate heavily for contract safeguards in the absence of certainty. For each safeguard that is put in place, the service provider typically reduces the price charged. This "give and take" is a normal part of market-based negotiations.

The other traditional choice, the corporate hierarchy (make/insource) is exactly the opposite: low incentives, high administrative control, and a legal system that is "deferential to the management." As a consequence, innovations that might come from the market or third parties are not shared or developed. Because there are additional bureaucratic costs involved in taking a transaction out of the market and organizing it internally, it is usefully thought of as the "organizational form of last resort," (Williamson 2008, p. 5). In other words companies should not insource services that are not core unless they absolutely have to.

Perhaps the best way to think of Williamson's work is to consider outsourcing in terms of a continuum with free-market force on one side and corporate hierarchies on the other.

Williamson (2008) advocates for a third "hybrid approach" to contracting as the preferred method for dealing with complex services that need to be performed under an outsource arrangement. Under a hybrid-contracting approach (where the

FIGURE 12.1 Two Basic Approaches to Ensuring Supply



Vitasek, Manrodt, Wilding and Cummins, Unpacking Oliver - http://www.vestedway.com/wp-content/uploads/2012/09/unpacking_oliver_6.14.pdf, p. 8, Figure 1.

FIGURE 12.2 A Continuum of Outsourcing Solutions

Vitasek, Manrodt, Wilding and Cummins, Unpacking Oliver - http://www.vestedway.com/wp-content/uploads/2012/09/unpacking_oliver_6.14.pdf, p. 9, Figure 2.

majority of outsource contracting resides), added security and contractual supports "take the form of interfirm contractual safeguards." Unfortunately, he also notes that when companies have taken the hybrid approach, it works well—"but not surpassingly well"—because often companies do not approach contracting as wisely as they should. Williamson (2008) states, "The viability of the hybrid turns crucially on the efficacy of credible evidence (penalties for premature termination, information-disclosure and verification mechanisms, specialized dispute settlement, and the like), the cost-effectiveness of which varies with the attributes of transactions."

Insight

Insourcing does have its costs—and consequences—for poor performance. These costs are not just monetary, as this example highlights.

One of the authors served as an executive vice president and chief operating officer of a large 560-bed regional medical center. The organization made a decision to outsource the dietary services to an international hotel corporation. The purposes of outsourcing this service were the following:

A. To increase the quality satisfaction level of meals from our inpatients, employees, medical staff members, and outside families and guests.
B. To decrease the cost of providing meals to this large customer base.
C. A significant portion of our patients and employees were Hispanic; therefore, special dietary meals needed to be considered.
D. The group purchasing through the international hotel corporation allowed for significant rebates in dietary food purchases.
E. The contract with the international hotel chain allowed for the recruitment of qualified and experienced department directors, service-line managers, and dietitians.

The medical center was a complex organization that provided approximately 1,500 meals to inpatients each day, three daily meals to an employee group of 3,000, a medical staff of 700, and over 500 volunteers. We believed there could be significant cost reductions associated with providing dietary services for all these constituency groups. Not only was total cost of dietary services extremely important, but the satisfaction of patients and the morale of the various internal work groups were also at stake.

Before we contracted with an international corporation for dietary services, our cost per meal was significantly high compared to benchmark standards in our industry; and the satisfaction level of patients through patient surveys was low, as were the employee satisfaction surveys. The decision to outsource this nonclinical area resolved both cost and quality issues.

Before we made the change, our dietary department director decided to change the morning breakfast menu. With about 50% of our employees being Hispanic, we had provided on the breakfast menu beans, tortillas, peppers, etc. He removed those items from the breakfast menu, and the medical center almost had an employee uprising. Even though the department director did not directly report to me, I felt a need to step in and request that all items taken off the menu be placed back and that breakfast be provided free to employees for a week. Now we knew that changes were needed for this department.

Clearly, there were several costs that were hard to quantify based on the current insourced solution. Employee satisfaction and customer service were not being met. By moving to the other end of the continuum, we were able to meet the needs of both parties and reduce many of our apparent and less visible costs in dietary services.

Lesson 2: Develop Contracts that Create "Mutuality of Advantage"

Once a company has answered the make/buy decision, an organization must determine the strategy for working with its suppliers. Williamson (2008) cites fellow economist James Buchanan, who stated that the notion of economics as a "science of contract" rather than as a "science of choice" is underdeveloped. Buchanan writes that "Mutuality of advantage from voluntary exchange…is the most fundamental of all understandings in economics."[16]

Williamson (2008) points to the power of win-win approaches, which in the realm of performance-based and vested outsourcing includes game theory, behavioral economics, solutions concepts and the non-zero sum game. A game in the context of outsourcing includes a set of companies, a set of moves (or strategies) available to those businesses, and details of the payoffs for each combination of strategies applied.

Win-win/game-theory thinking has grown in popularity among academics studying mathematics and economics. To date eight Nobel Prizes have been awarded to game theorists, the first being John Nash in 1994 for his famous "Nash Equilibrium." However, it is important to understand that win-win thinking is more than just a popular phrase saying that companies need to collaborate better. Win-win thinking should be a key strategy for companies. What most practitioners do not realize is that droves of economists and mathematicians have simulated and strategically proven that agreeing to play a win-win game enables individuals and organizations to come out ahead.

In outsourcing, achieving equilibrium among the parties by committing to a win-win strategy through collaboration, flexibility, and foresight can grow both organizations' businesses. As Nash demonstrated, the key lies in players working together toward a mutually beneficial strategy that optimizes for the cumulative payoff. The idea is not to optimize for the status quo, but to look for ways to change the game, or the contract process, to achieve a larger payoff for everyone. In other words, work to create more opportunities to grow profitable work for both organizations. Companies can and should work together to find ways to create more opportunities. By working together they can identify opportunities to reduce costs, increase services, expand into new markets, or develop new products or services for the marketplace.

Our collective experiences have shown that even when companies talked win-win they often still contracted under typical win-lose thinking. For example, we often hear business people talk about "collaboration" and the "long term" but their contracts would clearly spell out 30- or 90-day terms for convenience clauses. A panel of shippers described how important their carriers were to their success, yet none of these contracts lasted longer than a single year. That is like telling a five-year-old to sit still for an hour in order to get a treat. That's a strategy that won't work very well for the short or the long term.

Insight

As a large health system with an embedded supply-chain operation, consolidated service center, and distribution system for twenty hospitals and eighty-three clinics across five states, creating an environment of "mutuality of advantage" was critical to reduce costs for high-cost and high-volume purchases. In the cardiology service line, for cardiac rhythm management items such as pacemakers and drug eluding stents, the health system was spending over $109 million. These manufactured items were necessary to meet the standard of care of the service line.

Approximately five vendors were being used to procure the items for the health system. A team consisting of the clinical staff, cardiologists, and cardiac surgeons were consulted to reduce the vendors and SKUs of the service line in an attempt to discount current pricing. After a considerable amount of effort, two vendors were adopted as the primary vendors for the service line. This reduced costs, with compliance of purchasing from the health system, but it became clear that further costs could be reduced for both the vendors and the health system.

To this end, the health system adopted a strategy of being the vendors' "low-cost but high-margin/profit" partner. Contract negotiation resulted in finding elements that would reduce vendor and manufacturer costs, reduce distribution/shipping costs while meeting the needs of the health system. The result was an annual reduction in cost to the health system of approximately $20.1 million as long as compliance to the contract, that included a high percentage of exclusivity, was at 90% or above. The vendors and manufacturers reduced their costs by approximately 7% while improving their margin/profit by 4.3 to 4.8%. The "mutuality of advantage" principle was used in this partnership to advantage of all parties.

Lesson 3: Understand the Transaction Attributes and their Impact on Risk and Price

Once a company understands that outsourcing should be seen as a continuum instead of a simple insource versus outsource decision, the question then should become: "What is the best approach for structuring the relationship and contract" to drive out non-value-added transaction costs?

Williamson (2008) points out that companies need to understand three attributes of their business environment in order to help them have better discussions with outsource providers and ultimately lead to better contracts. Each of the attributes is identified in **Table 12.1**.

Understanding these three attributes and how companies view them can and does have a direct influence on how a company and a service provider will "behave" when it comes time to write a contract because each element can and does add risk to a service provider.

In a perfect world, a company and the service provider can take a snapshot of the business and create an agreement that allows for the service provider to price the work under a set of given circumstances. The service provider clearly understands the task and the attributes of the work and provides a "price" to the company.

Unfortunately, the world of business is not perfect. Williamson (2008) says that the more an outsource agreement contains higher risk in the three attributes (asset specificity, uncertainty, and variable frequency), the more a service provider will feel potential risks and will want to put in "safeguards" into a contract to protect them from the risk of changes. It is recognized by Williamson that many firms are opportunistic and act with self-intent. Therefore he advocates safeguards to protect against opportunism.

Williamson (2008) suggests that if asset specificity is high, and disturbances are high, one can assume that transaction costs are at their highest. In these instances it would be less expensive—from a TCE perspective—to keep things in-house. If the asset specificity is low and disturbances are minimal, then transaction costs are much more predictable and therefore lower.

His logic is fairly simple. The higher a customer's need for asset specificity, the more uncertain and the less frequent the work, the higher the transaction costs, or price that they should expect to pay. From a service provider's perspective, the greater the degree that these attributes are present, the higher the risk for the

TABLE 12.1 Impact of Attributes On Risk to a Service Provider

	Risk To Service Provider	
Attribute Impacting Risk	**Low**	**High**
Asset specificity	Widely available and generic assets can be used to provide services	High degree of customization and investment needed in order to provide services
Uncertainty of work	Static environment; little likelihood of the work changing or be eliminated	Dynamic environment; high degree of work scope changing or being eliminated
Variable frequency	Consistent levels of work to amortize over assets	Inconsistent levels of work to amortize over assets

Vitasek, Manrodt, Wilding and Cummins, Unpacking Oliver - http://www.vestedway.com/wp-content/uploads/2012/09/unpacking_oliver_6.14.pdf, p. 12, Table 1.

service provider. As a result the service provider will need to charge a premium for the work.

As mentioned previously, companies should consider the total costs of all transactions—not just the price paid. Organizations should address these attributes in a transparent and open dialogue and work towards optimizing the best way to mitigate the risks associated with each attribute. In other words, by reducing the degree that these attributes are present, the team can minimize risk and costs associated with the work.

Let's look at two real world examples to put this into perspective.

Example 1: There is a significant risk associated with the uncertainty of currency fluctuations for a back office procure-to-pay BPO (business process outsourcing) project between Microsoft and Accenture. In this example, the contract originally stated that Accenture would manage the currency fluctuations associated with the accounting processes it managed. However, after monitoring the impact of the currency fluctuations, it was determined that this was causing Accenture to bear too much risk. Rather than raise the price to cover this risk, the two companies agreed that Microsoft would be better suited to bear the risk of currency fluctuations. Accenture still manages the procure-to-pay process under the outsourcing agreement, but Microsoft manages the currency fluctuations and "hedges" in order to beat the market and create further value. By recognizing that currency fluctuations were an uncontrollable risk, the companies could evaluate which one was best suited to bear the risk. In the end, Microsoft was able to use its hedging skills to best manage the risk while still leveraging Accenture's skills in managing the actual accounting process.

Example 2: A conventional way to price for transportation is on a per-mile basis. Trucking companies must pay for the fuel. If fuel costs rise, the trucking company bears the risk and the cost increase eats into their profit. As such, most trucking companies will impose a "fuel surcharge," which is often the cause of contentious debate and negotiations. Rather than fall back to negotiating, one company looked at fuel rates and the impact on the trucking rates and then created an outsourcing arrangement whereby the cost of fuel was removed from the transportation costs. With non-controllable costs burdened by the company, the company's carrier agreement was then centered around having the carrier manage and optimize transportation efficiency and service levels.

Anticipating network cost improvements also leads to contentious negotiations, often resulting in complex management protocols to ensure the cost savings are shared between the parties. This drives up transaction costs, often outweighing the savings to both parties.

A more successful approach was to place the telecommunications costs outside of the contract and provide incentives for the service provider to improve network utilization and implement management and technology innovation to reduce costs.

Insight

In the healthcare supply-chain world, medical and surgical supplies are different from pharmaceutical and biological supplies. As health systems and hospital networks attempt to reduce costs, understanding price and risk is paramount.

A large health system in the Midwest analyzed the composition, transaction costs, inventory and management costs, quality control costs, information system costs, and operational costs of the entire supply chain. Based on the pricing/costs and risks of the myriad of supply items, the health system determined that insourcing the medical and surgical supply chain to a great degree while outsourcing the pharmaceutical and biological supply chain was in the best strategic interest of the health system. This accounted for approximately 3,500 to 5,000 SKUs in the medical and surgical side of the equation and 500 to 1,500 in the pharmaceutical and biological arena.

Given the volatile nature of the pharmaceutical and biologicals pricing and availability, directly linked to pricing and risk, and the regulatory nature of the pharmaceutical aspect of the supply chain, partnering with a well-respected pharmaceutical company was the best approach. Over time, synergy of the partnership created a superior working relationship where costs are reduced for both partners while margins and profit have improved. The decision to insource (much directly from the manufacturer and not using a distributor) the medical and surgical supply chain and to outsource the pharmaceutical and biological supply chain was based on pricing and risk.

Lesson 4: The More Bilateral Dependencies, the More the Need for Preserving Continuity

Unfortunately, the world of business is not static or perfect and companies and their service providers will try to develop a relationship that can best address a dynamic environment. This can create a bilateral dependency that makes it difficult to "undo" an outsource agreement. For example, often a service provider invests, develops, or creates assets or skill sets to be used specifically for a specific customer. This could be the purchase of a facility near the client's site, or hiring specialized labor to manage specific needs of the customer. The cost of redeploying these assets to alternative uses becomes increasingly difficult, placing the service provider at risk should the contract expire.

This came home to one of the authors who was interviewing a large high technology firm on a different research project. During the discussion the firm noted that it needed a software link to be written between themselves and a third-party logistics firm. The third-party logistics firm offered to write the software; this offer was flatly and quickly turned down. This would have meant that the program would have been owned by the supplier. As a result, it would have been harder to undo the relationship if either party needed to do so in the future.

Alternatively, service providers gain additional information about the processes that are performed and at some point may be more skilled at performing work than the customer. This places the customers at risk, as they could fall victim to predatory pricing. Care is taken to make sure the service provider is good, but not too good.

In other cases, both service providers and customers increase their asset specificity over time as well, such as by creating interdependent processes and systems. These bilateral dependencies can make it costly to undo a relationship if things go wrong over time. Williamson (2008) argues that contracts should have a "preserving governance provision." In other words, there should be a governing structure in place to avoid a loss in the first place. The governance structure should be flexible enough to account for "disturbances" or "maladaptations" when things go wrong.

Unfortunately, a recent International Association of Contracting and Commercial Management[17] study highlights the problem of these dependencies and how opportunistic behavior can take place. According to the report, "Many powerful organizations simply ignored inconvenient terms and insisted on their renegotiation. Others made unilateral, non-negotiable changes, in particular in areas such as payment terms (interestingly, the fact that suppliers felt forced to accept such changes led buyers to see "increased collaboration," whereas the suppliers felt that collaboration had taken a hefty negative blow)."[18]

Insight

At a large integrated health system in the Midwest, it was our corporate policy to develop and preserve long-term agreements with major vendors for either operating and/or capital purchases. I will never forget one year when a healthcare entrepreneur made an appointment to meet with me about a major outpatient center proposal. It included an outpatient surgery center, rehabilitation facility, and a radiology center, which included the installation of an open-end MRI unit (which at this time was new technology to the market).

The entrepreneur's offer to our corporation was 50% of the enterprise if we agreed to up-front 50% of the capital cost. He mentioned that he had negotiated an agreement for the purchase of the open-end MRI unit. Our market area had yet to acquire such a unit because the technology was so new. In our health system, we already operated an outpatient surgical center and were building a major rehabilitation and cancer center. However, it was our strategic goal to be the first in the market with an open-end MRI unit. The entrepreneur gave me his business card and stated we had a week to decide on his offer. After that, he would approach one of our rivals in our healthcare market.

I contacted our main vendor for radiology equipment, which happened to be one of the world's largest corporations in this specific technology market for MRIs, CATs, and other radiological equipment. They advised me it would take 18 months to deliver a new open-end MRI, and I stated we needed one in 8 weeks or I would lose market share and significant revenue stream. Because we were a member of a multiple-billion dollar national health system and had a long-term working relationship with this corporation, we were able to receive the delivery of an open-end MRI unit in 12 weeks. The unit was $1.3 million and the preparation of the room to install was at a cost of $400,000 in addition to sending radiologic technicians to training on the new technology.

Such reactions to market changes in technology would never have happened if we had a history of frequent transition of new suppliers each year. The long-term relationship with a major supplier of high level radiology technology preserved continuity of maintaining our position as the market leader in healthcare services.

Lesson 5: Use a Contract as a Framework—Not a Legal Weapon

Ian Macneil was ahead of his time when he professed that business-to-business contracts should be instruments for social cooperation.[19] Unfortunately, many companies have lawyers that are creating outsourcing contracts that are so tightly defined with self-interested terms that their contracts are legal weapons instead of instruments of social cooperation.

Yet the world of business is not static; it changes and evolves over time. As such, Williamson (2008, p. 6) argues that organizations "need to come to terms both with bounds and rationality." He points out that "all complex contracts will be incomplete—there will be gaps, errors, omissions and the like." And as human actors we are bound by our inability to know everything. For this reason he advises that a contract should provide a flexible framework and a process for understanding and managing the parties' relationship as the business world changes.

A common mistake that companies make today is that they create a detailed statement of work (SOW) and try to define too tightly the work to be done. Williamson (2008) advises that the contract should have "the effect of which is to facilitate adaptation, preserve continuity and realize mutual gain during contract implementation." Contracts should be structured with flexibility to deal with unanticipated disturbances so as to relieve potential maladaptations.

IACCM's research also supports this finding.[20] According to the previously cited IACCM study, today's contracts are filled with terms designed to protect self-interest rather than promote collaboration between companies. Their study found the terms receiving the most emphasis are about self-protection, indicating that companies are using their contracts as legal weapons to protect themselves from unforeseen risks. Table 2 highlights the terms that are negotiated with the greatest frequency.

It is difficult to see how focusing on these terms will provide the framework needed to be adaptable in a changing environment. Instead, these terms—coupled with overly prescribed SOWs—create a rigid operating environment. When the business does change (as it always does) the parties begin to get uncomfortable creating tension between the parties. A simpler approach is to realize that the business environment can and will change—and that companies need to address how to best mitigate the risk versus trying to shift it to the partners.

TABLE 12.2 Terms That Were Negotiated with the Greatest Frequency

Limitation of liability
Indemnification
Price/charge/price changes
Service levels and warranties
Payment
Intellectual Property
Warranty
Performance/guarantees/undertakings
Termination

IACCM, Top Negotiated Terms 2015: No News Is Bad News, p. 4. © 2015 IACCM. All Rights Reserved.

What makes this more interesting is that using a contract as a legal weapon is something that is done by choice—not by law. That is, in business contractual obligations are undertaken by the parties, and not necessarily imposed by the law. In other words, companies choose to design contracts with terms that defeat collaboration; they are not required by law to do otherwise. If we have chosen the contractual obligations we are imposing on ourselves, shouldn't they be beneficial to everyone involved?

Insight

One of the authors was new to our healthcare system, where he served as CEO. Prior to joining the system, there had been an ongoing issue with the contracted radiologist group. The radiology group had ten radiologists and a contract with the health system for over twenty years. The previous system CEO would not challenge the radiologist group on issues relating to poor working relationships with the medical staff—especially the surgeons for night and weekend emergency coverage—and poor working relationships with the health-system employees and the health-system executive team. Finally, the radiologists had little interest in technological advancements in their own specialty. For these reasons the strategic future of this major clinical service was at jeopardy and unclear. After a year of little success in working with the group, the entire radiology group was given a ninety-day notice of contract cancellation.

The medical staff leadership and system executives had to determine a new contract process to successfully recruit a technologically advanced and highly motivated radiology group who would be shared partners in our mission. The new contract was designed where the radiologist group would focus all their attention on the needs of the medical center patients and medical staff and not have other outside contractual relationships. This had not been the case with the previous radiology group. The second major change in the process was that the new radiology group would meet regularly with leaders of the medical staff and the executives of the medical center to resolve issues and to assist in the development of strategic initiatives for the health system. Finally, we agreed to be the most advanced radiology department in the market by purchasing the newest and most advanced radiology equipment and by recruiting radiologists and radiology technicians with advanced training.

The new radiology contract increased the medical center radiology department's revenue by a million dollars in their first year of the contract with continued increases each year afterward. Because the health system focused on the process and tools to be used in a new contract, there was significant increase in patient, physician, and health system employees' satisfaction level, which allowed us to cement a dominant position for radiological services in the market.

Lesson 6: Develop Safeguards to Prevent Defection

A flaw in human nature is that people (and organizations) are often tempted to act in a self-interested manner. We tend to deflect responsibility when risks are high or when things go wrong. In laymen's terms, organizations will defect from a contract if the advantage from defecting is better than staying. Williamson (2008) notes that, due to bounded rationality, costly breakdowns continue in spite of efforts to develop sound contracts. A key reason for contractual breakdowns is that business and market dynamics can and do change the economics of the agreement. What was once a viable contract may become a burden to all.

Many have heard of the horror stories of suppliers closing up shop or companies that outsource invoking their "terms of convenience" clauses. In either case, one party is left holding the proverbial bag and feels the pain associated with defection. The conventional approach is to negotiate safeguards to "protect" each party's interest. Suppliers do this by increasing their price. Companies that outsource protect their interests with terms of convenience clauses.

Rather than be fearful of the risks associated with a bad contract, organizations should work to develop proper safeguards that allow for organizations to disentangle their relationship in a fair and equitable manner without harming the other party. We like to think of this as an off-ramp or exit management clauses. Whatever you call it, the purpose

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is to develop safeguards that protect either party in the event that one of the parties no longer wants to continue to do business under the contract. By addressing the transaction costs associated with exiting the business arrangement, companies can address the risk and costs head-on rather than hide the costs. Typically off-ramps and exit management clauses will tend to make one of the parties "whole" if the contract is terminated prematurely. For example, if a service provider invests in a specific piece of equipment or other asset, and their client invokes their term of convenience, the off-ramp would likely have a provision to pay back part of the supplier's investment.

Where should the work go when business relationships go sour and need to be terminated? Williamson (2008, p. 9) warns companies against the temptation of bringing the work back in-house. This is due to the additional "bureaucratic costs" involved in taking a transaction out of the market and organizing it internally. He warns that an "internal organization is usefully thought of as the organization of last resort."

Insight

Our primary market began to experience heightened competition. There was a new strategic entrance to our patient market area by the two largest health corporations in the state. One was the twelfth largest hospital in the United States, which had recently merged with the state's only medical school/medical center in addition to being a very prominent children's hospital, and the second was the largest insurance not-for-profit healthcare payer in the state. Both of these health organizations had the same strategic intent, which was to acquire forty to sixty primary care physicians associated with our health system. If either healthcare organization was successful, or even if they split the physician acquisitions among them, it would have serious long-term consequences for our health system's revenue streams and existing market share. Even though our health system did not believe purchasing physician practices was the best strategic and/or financial initiative, it was important for us to realize that drastic market changes were going to occur with severe consequences if we failed to respond.

The acquisition of the primary care physicians by the state's largest insurance payer was our biggest concern. While both corporations had the capital funds to purchase forty to sixty physician practices, we could not allow the insurance payer to have this leverage during our annual contract negotiations. If we did not agree to specific contract terms, then changes in patient flow to other rival hospitals might occur. The second health organization interested in acquisition of our primary care physicians became less of an external threat as time went by because our physicians did not like their arrangement offer or the centralized structure of their existing physician practice.

Because the majority of our primary care physicians were young in age (the health system had spent five years in a successful major physician recruitment plan), we already had a significant investment in this physician group. Our health system then developed a three-stage approach into acquiring physician practices. The first was to quickly execute contracts with the multiple physician groups; the second was to encourage those physicians in private practice to form group practices; and the third was to acquire those who wanted to remain in a private practice environment. We researched and obtained consulting advice in determining fair and equitable acquisition cost of the practice, salaries and bonus incentives, benefit plans, and office operations by specialty (general practice, internal medicine, OB-GYN, and pediatrics). We were particularly interested in the general practice, internal medicine, and the GYN part of the OB-GYN physicians because of payment reimbursement for these physician types.

The first concern relating to this significant strategic development and change in our market was to assure our health system that cost was clearly identified with any termination of the contracts and that the terms of the contract were fair and equitable so the physicians would remain associated with our health system even if the contracts were terminated in the future. After capital acquisition of the practices, salary, benefits, etc. was finalized for each physician group and/or private practice, the contract had a clause whereby the physicians had an exit plan that occurred at the eighth year of the contract. The exit term allowed each party to have safeguards to remain "whole" at the contract conclusion.

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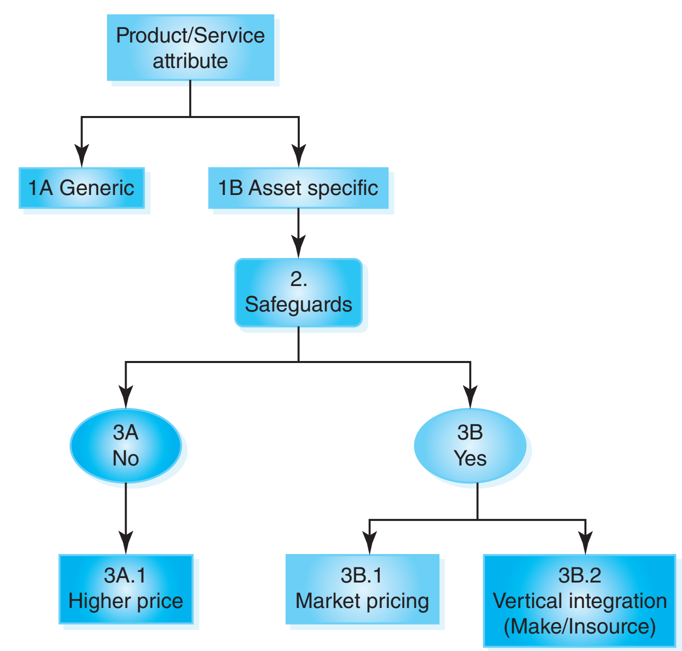
The health system was quite particular about which physicians were targeted for our acquisition. Such targeted acquisition was based on evidence-based medical practice, the quality of the practice, cost focus, and long-term loyalty to the mission of the health system. We did not want to acquire all the sixty primary care physicians but only those whom we had designated as solid and effective partners. The market was changing at a fast rate, so we planned to acquire forty-eight practices in eighteen months. The actual result was forty-two physician practices acquired, which were organized into a new physician group practice corporation (the health system having a fifty-fifty ownership structure).

As a result of the quick response, the health system kept its primary care physicians intact, the two larger healthcare organizations lost interest in the primary market, and we had an exit plan agreeable to all physician practices. A real win-win situation had just occurred for all parties associated with our organization.

Lesson 7: "Predicted Alignments" Can Minimize Transaction Costs

As mentioned in Lesson 3, Williamson writes that transactions have various attributes that operate in different governance structures. One of the goals of TCE is to minimize transaction costs. To do this Williamson (2008, p. 9) points to a concept called "predicted alignment." Here the goal is to create an alignment that results in the economizing or minimizing of transaction costs to the largest extent possible, given the uncertainties inherent in market dynamics and forecasts. In simple terms, this means the business and the contracting approach need to be in sync. This is described in detail in **Figure 12.3**.

FIGURE 12.3 Contractual Alignment to Minimize Transaction Costs



Data from Williamson, O. (, 2008). Outsourcing: Transaction Cost Economics and Supply Chain Management. Journal of Supply Chain Management. 44, (2): 5-16.

The first decision a company must make when aligning the business with the right type of contracting approach is to determine if what is being sourced is generic or asset specific. If there are no specific assets involved and the parties are "essentially faceless," then the product/service is generic (depicted as 1A). A company can buy the product from one supplier that is no different than buying it from another. In the case of a generic product/service, there are virtually no transaction costs because switching suppliers is very easy.

In cases where some specific assets are required (depicted as 1B), transaction costs will increase because of the inherent risks associated with investments in the assets that are needed to perform the service. This creates a "bilateral dependency" between the buyer and the seller, and both parties are inherently incented to promote continuity of supply to avoid transaction costs associated with switching suppliers. It is at this stage of the decision process that organizations begin to discuss safeguards that reduce their risk. This is depicted as 3. For example, in the case of the supplier, the supplier will want to rely on contractual safeguards such as minimum order quantities or a long-term contract to help protect against their investments in the specific assets.

Companies that enter into contracts requiring specific assets and do not use safeguards should expect higher prices from their suppliers because the suppliers will use pricing as a way to hedge against their risk in order to protect their investments in their assets (depicted in 3A1). To mitigate from higher prices (or to protect their risk), companies should include safeguards into their contract (depicted as 3B).

The conventional approach a company uses to negotiate asset-specific contracts is a market-pricing approach under a competitively bid environment (depicted in 3B1). The rationale is that frequent competitive bidding will regulate cost and risk by pitting suppliers against each other to drive down the price with suppliers absorbing risk in hopes of winning the work. Once market prices are known, a company can then decide if it wants to buy (outsource) as depicted in 3B1 or make (vertical integration) as depicted in 3B2.

To demonstrate Williamson's (2008) model, let's suppose a supplier is asked to make a part requiring them to make a special dye. The cost of the tooling has to be added to the price charged by the supplier. If no safeguards are put in place, such as a year-long contract or a guarantee on a minimum of parts ordered, the company can expect to pay more for the part. The supplier can only cover their risk (making a special dye) by increasing the price of the part. If, however, safeguards are put in place, such as a minimum quantity, or a multi-year contract, the risks borne by the supplier are minimized and the cost of the dye can be spread out over all of the parts to be produced.

However, what if the part is of strategic importance to the company? Or the costs being charged by the potential supplier are far too great? In these cases the company may decide to keep the work internal and integrated with the rest of the firm, assuming that the firm has the ability to perform the work. Or, to refocus on Lesson 1, where outsourcing is a continuum, it may be beneficial for the firm to own the dye and allow the supplier to use it.

Williamson's (2008) insights point companies to work through the options to help them select the most logical path to solve their product/supply requirements. Using Williamson's (2008) framework, complex outsourcing agreements should absolutely rely on safeguards for protecting both the service provider and the customer because the complexity drives unknowns. Organizations should *transparently* discuss the risks and how to deal with the risks through properly defined safeguards. Our field research shows that the most successful outsource arrangements openly discuss risk and work collaboratively to determine how to mitigate the risk (see Lesson 2). Failure to have transparent discussions about risks and safeguards will result in higher prices from the supplier as well as higher transactions costs.

Insight

Our market area began to experience many changes as the result of the federal government's Medicare/Medicaid Prospective Payment System using the Diagnosis Related Grouping (DRG) as the reimbursement structure for all Medicare patients. The initiation of this new payment plan began to be duplicated by both the for-profit and non-profit health-insurance payers. Therefore, our health system began discussion with our medical staff leadership to develop a corporate entity where both the health system and its medical staff could enter into contracts with insurance carriers and large employers. The new corporate structure was called a Physician/Hospital Organization (PHO) with joint corporate ownership between the health system and the physician group. It was the intent of the health system to only ask the physicians, both primary care and specialty, who had demonstrated in the past the highest quality and most cost-effective practice to be partners. This resulted in 310 physicians out of a total medical staff of 450 that became partners in the new corporation.

Needless to say, there were many physicians not pleased with this decision, but in order to successfully manage insurance health contracts, it was critical to only enter into partnership with physicians who practiced evidence-based medicine and controlled their costs by reducing length of stay for inpatients and appropriate utilization of clinical services.

A twelve-member governing board was appointed with the health system and the physician group each holding six seats. There were two people (one from the health system and one from the physician group) as co-chairmen. The payment system had incentives designed to financially reward physicians who demonstrated efficient and quality practice. This was determined by standards developed by the PHO members and by acquiring nationally recognized performance standards established for each physician specialty. For medical services not provided in the health system (organ transplants, pediatric trauma, burn cases, etc.), an outsourcing agreement with a tertiary medical center 40 miles from our primary market was signed.

The success of the PHO was to allow the health system and the medical staff to develop a "shared vision" that not only reduced transaction cost of providing medical care more effectively and at less cost to payer groups, but also gave us the structure and confidence to develop other new strategic ventures. The PHO successfully negotiated and executed ten major contracts with payer groups for medical care in our primary market.

Lesson 8: Your Style of Contracting Matters: Be Credible

Williamson (2008) describes in some detail the three styles of contracting, which he refers to as muscular, benign, and credible. This can be found in **Figure 12.4**.

Muscular

The muscular contracting approach has one of the parties holding the balance of power, and does not hesitate to exercise it. While both buyers and suppliers in theory can hold power positions, more often than not it is the buying organization that demonstrates its power, and tells a service provider what it wants and expects.

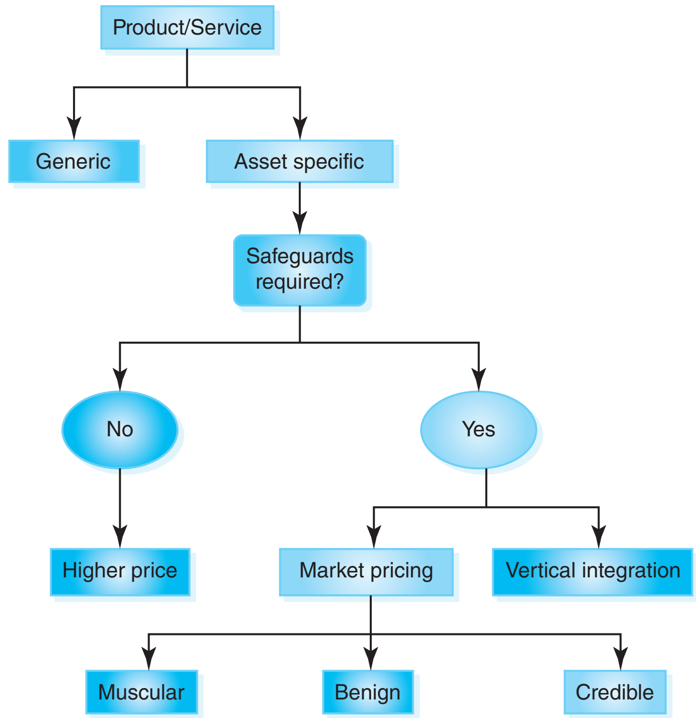
Williamson (2008, p. 10) calls the muscular approach to outsourcing of goods and services "myopic and inefficient." Our research found examples of companies we termed "800-pound gorillas" that would use a heavy-handed approach in dealing with their supplier simply because they could. Companies using this approach typically have war stories of bankrupt suppliers, or worse, a dwindling number of suppliers willing to work with them.

A classic example was an organization known for poor relationships with their transportation carriers. The customer's reputation was so bad that soon none of the major carriers bid on any of their business, even though it was worth several million dollars. In one instance, the firm partnered with a carrier on a special project; this required an investment of both time and assets on the part of the carrier. As an incentive, the carrier was told that this part of the business would not be bid out to competitors. Yet after a three month trial run—with great results—the customer reneged and bid the business. A lower-cost carrier won the business.

Williamson (2008, p. 10) writes that "muscular buyers not only use their suppliers, but they often 'use up' their suppliers and discard them." When this happens the company will need to bear the cost of switching suppliers—or worse, have the risk that their supplier leaves them high and dry when they go out of business.

Yet this risk is not borne just by the muscular party. Increasingly it is recognized that competition is no longer between individual companies

FIGURE 12.4 Contractual Alignment And Contracting Styles



Data from Williamson, O. (2008). Outsourcing: Transaction Cost Economics and Supply Chain Management. Journal of Supply Chain Management. 44, (2): 5-17.

but rather between their respective supply chains. Forcing a supplier into bankruptcy can not only destroy the company; it can also create the seeds of destruction for the customer by potentially making the entire supply chain noncompetitive in relation to the supply chains of its competitors. Companies also risk paying more when a market consolidates, when suppliers merge with one another or if they leave the market entirely. We contend that a weak global economy has given companies far too much of an excuse to adopt muscular behaviors that will result in higher costs for all.

Williamson adds that when organizations adopt this muscular approach, the suppliers really have two choices for defense in the contract negotiation. They can charge higher prices and try to recoup their costs that way, or they can ask for safeguards in a contract. Safeguards could include longer contracts or guaranteed volume, just to name a few.

Williamson's point is that bullied suppliers will come up with overt and covert options to protect themselves—and this approach is bad for the company because no matter what countermeasures the suppliers take to protect themselves—it will ultimately result in higher overall total costs.

Benign

The benign approach assumes that both parties will cooperate; both parties will give and take in the relationship. This works well until the stakes are raised. In other words, the temptation becomes too great and one party will take advantage of the other. The impact that such behavior will have on the offending party may help to deter this behavior. However, that is part of the transaction cost thus taken into account. This cooperation "eventually gives way to conflict and mutual gains are sacrificed unless countervailing measures have been put into place."

The benign approach does not work well for long-term agreements, as the risks (transaction costs) are too high. Being too nice can lead to being taken advantage of. The benign approach blindly assumes too much trust on the part of all or some parties. It also assumes that cooperation to deal with unforeseen contingencies to achieve mutual gains will always be there.

Our field research found evidence of organizations that were too trusting in the initial stages of the relationship and were taken to the cleaners as a result. One example (which we saw repeatedly) was when service providers would extend too much trust by developing a "gain-share" with their customers. If the service providers found savings, they would receive a share of the benefits. The agreement was clear in most cases—a 50-50 split. The problem was defining the rules of how to split the savings. In several cases a service provider identified and implemented ideas that drove savings for a client and the client would come up with excuses as to why they did not have to pay.

Clearly a company should not be gullible. To avoid this, Williamson recommends companies use a third approach, which he calls a credible contracting approach. The fundamental philosophies outlined in a vested outsourcing approach follow Williamson's credible contracting style.

Credible Style

Williamson (2008, p. 13) describes credible contracting as "hardheaded and wise." It is hardheaded because it strives for clear results and accountability, but it is not mean-spirited, as in the muscular type. It is also wise because it arises out of an awareness that complex contracts are "incomplete and thus pose cooperative adaptation needs" and require the exercise of feasible foresight, meaning that "they look ahead, uncover potential hazards, work out the mechanism and factor these back into contractual design." To address these potential risks, Williamson (2008) argues that credible commitments should be introduced to effect hazard mitigation.

Credible contracting is not new. Contract safeguards can take unconventional forms, as discussed by Williamson (2008) with respect to ancient Mesopotamia, where self-inflicted curses were used to deter breaches of treaties. The key point is that a good hybrid contract for a complex outsourced service will be above all fair and equitable to both parties in the agreement and it will challenge the organizations to focus energy on unlocking inefficiencies rather than negotiate for the win at the other party's expense.

Insight

Our health system experienced a very unusual situation with a large employer who was 40% of our corporation's net profit. The employer was, at the time, the largest corporation in the world. This corporation had a history of flexing their "muscle" with not only suppliers of the automobile industry but also with healthcare providers to their 800,000 employees. The health system typically increased its medical charge rates (12,000 different charges) on January 1 of each calendar year. The process of changing rates for a health system is quite difficult and involves intensive negotiation with the state's major health insurance payer. All charges then are changed in the health system's information system which has computer-to-computer billing structures.

The customer requested that the CEO of the health system travel to its corporate headquarters in Detroit for a meeting in the late part of November. Accompanying the CEO were several financial and contract executives, all who would meet with several of the automobile's health plan executives. The meeting was quite short and the health system was politely asked not to raise their medical charges to employees of their corporation for the next year. They were bluntly advised if they did not the customer would sign an "exclusive contract" with a rival healthcare provider. The CEO and his team were not only in a state of shock but also had a serious problem with only thirty days to resolve it.

The CEO advised them that their demands were unfair and maybe unrealistic. In addition, the CEO offered to provide information that their customer's would face higher market costs in switching contracts to an exclusive healthcare provider in our market because their charge rates were higher than ours. The automobile corporation's health plan executives were not in any negotiating mood and maintained their position of no rate changes to their employees for the next calendar year or else. Needless to say, the health system got the message.

Upon returning to the office, they immediately began to develop a new fiscal budget, strategic plan, and the renegotiation of agreements with their suppliers. The team based their planning philosophy on the belief that they would have to "bite the bullet" for the coming fiscal year. However, the year after that was the period when the large automobile corporation's contract with their employee's union expired. We believed this situation would occupy their complete attention and priority. It was a risky plan, but it worked to their prediction and to their best interest.

While the health system was forced to freeze a pay raise for its 3,000 employees, decrease the size of both the operating and capital budget, and recruit help from several of our larger supplier companies, the health system survived the fiscal year without a negative net income. The following year, as predicted, the automobile corporation was focused on potential shut-down of their plants. As a supplier to this large employer customer, the health system was forced to use conventional negotiation with its own employees and supplier groups; however, such contractual provisions and behavior in future years eventually drove up higher costs to our largest customer because of delayed operating and capital purchases.

Lesson 9: Build Trust: Leave Money on the Table

Williamson (2008) also says that TCE does not necessarily embrace "user-friendly" concepts such as the "illusive concept of trust." He wonders what benefits might come from the more widespread use of trust among outsourcing buyers, and at what cost. Trust should not necessarily supplant power entirely and indefinitely, he argues, and that is where the credible part of contracting comes in.

We would propose that the most effective and collaborative contracts, the ones that are truly credible, must include trust. The idea of vesting, or committing, oneself or a company in a contract arrangement implies a large degree of initial trust in the value of the enterprise, a large degree of give-and-take to achieve mutual goals, and a large degree of good faith during the course of the relationship.

Trust is implicit in Williamson's (2008) suggestion that it's often better to leave money on the table, or not insist on winning every negotiating point. It's an idea that goes against the usual low-cost, transaction-based grain in a traditional contract.

In a new and potentially long-term arrangement constructive and strategic contractual intentions are sometimes hard to differentiate. What exactly are the parties' intentions going into the negotiation?

If there is a strategic rather than constructive purpose that skews the contract in one party's favor "and if real or suspected strategic ploys invite replies in kind, then what could have been a successful give-and-take exchange could be compromised," Williamson (2008, p. 13) explains.

If each party, or even one party, has a strategic agenda and wants to gain an upper hand—or go muscular—asymmetry will result. This "could plainly jeopardize the joint gains from a simpler and more assuredly constructive contractual relationship," he says.

"Always leaving money on the table can thus be interpreted as a signal of constructive intent to work cooperatively, thereby to assuage concerns over relentlessly calculative strategic behavior (Williamson, 2008, p. 13)." What can result is a pragmatic and ultimately wise outsourcing contract with credibility from start to finish.

Insight

As the CEO of a 300-bed hospital, our medical facility had undertaken a $35 million construction project to develop a new women's center, new emergency room department, new radiology department, and renovation of other support areas.

The general contractors had three years to complete the project and a "liquidation damage" clause if they did not meet the completion date. The damage clause would assess a penalty of $10,000 per day for each day after the contract completion date. The general contractor was a very respectable corporation and had successfully completed other projects for the hospital.

The general contractor had chosen to use subcontractors who hired only union employees. During the construction period, the hospital had experienced a very cold and snow-related winter, and, unfortunately for the contractor and the hospital, the construction project had eight labor union strikes. Both situations were pushing the contractor into a serious situation with the contract completion date and possible enforcement of the liquidation damage clause in the contract. If this was not enough of a concern for all of us, the hospital architectural firm tested one side of the wall for a five-story new tower, which did not meet contract specifications and would have to be torn down and rebuilt. Now the construction contractor was in serious trouble in meeting the contract completion terms.

In a meeting with the president of the construction company, it was estimated that the bad weather, union strikes, and rebuilding a five-story tower wall would place the completion of the project approximately 300 days beyond the construction terms and would initiate a $3 million liquidation damages penalty to be paid to the hospital by the general contractor. Such a financial impact to the construction company stability plus overrun cost of the project would potentially bankrupt them and end employment for all of the company employees.

It was important to the management philosophy of the hospital to build strong and long relationships with suppliers and develop intent to work cooperatively with them so there is a credible understanding among all parties from start to finish. We finally negotiated with the construction company that they would have up to 200 extra days after the original contract to complete the entire project, and we would only execute liquidation damages for days after the first 200 days. The general contractor accepted these new terms under the condition that they were also willing to hire additional construction workers to complete the project.

The construction company completed the project under the new terms and protected its financial viability. The hospital was able to have access to the new and renovated areas; therefore, generating new revenue to pay the debt service of the construction project. Both parties continued their long-term relationship for future projects even though the hospital left money on the table for this specific project.

Lesson 10: Keep It Simple

Williamson points out the importance of trying to keep things as simple as possible.

"Keeping it simple is accomplished by stripping away inessentials, thereby to focus on first order effects—the main case as it were—after which qualifications, refinements and extensions can be introduced (Williamson, 2008, p.6)."

Getting it right entails working out the logic, and making it plausible. Plausibility means to preserve contact with what is actually occurring in the market and in the contract while avoiding what he calls "fanciful constructions (Williamson, 2008, p.7)." Getting it right and keeping it simple also entails translating economic concepts into accurate mathematics or diagrams or words.

Conventional thinking is that the "best practice" for outsourcing is to create more detailed statement of works and tightly defined service level agreements to monitor the business in great detail. This trend is often coupled with complex pricing models and associated penalties for service providers that do not meet the metrics. Unfortunately, too many organizations are focusing on measuring for measurement's sake and they are often perplexed to find out that their scorecard is "green" but the business is not as profitable and customers are not as happy as they would like.

Our field research found that some of the most successful outsourcing arrangements bucked conventional best-practice thinking and instead chose to focus on few (five or less) clearly defined and measurable desired outcomes. While the parties agreed that measuring the business was essential, the contract itself focused on creating a shared vision and how to measure success against desired outcomes, not on defining and micro-managing day-to-day operational metrics. The outsourcing agreement then focused on leveraging a governance structure that used data to drive business improvements jointly rather than point over whose fault it was when a service level agreement was missed.

The complexity of life, systems, and business interactions make simple models in each case attractive and necessary. Simplicity is simple to say but can be quite complicated to achieve. It requires knowledge, the ability to prioritize, and a high degree of flexibility and pragmatism.

Insight

We developed as one of the key components of our strategic plan to be the healthcare provider of emergency medical care. Therefore, it was quite important to contract with an emergency room (ER) physician group that would strive to keep such a relationship pragmatic, plausible, and in the best interest of all parties. We kept this relationship simple, functional in terms of the contract provisions, and highly professional. Of all the physician contracts the health system had executed, the ER physician contract was the shortest in number of terms, contract pages, and requirements. We had the best working relationship between the health system and them as compared to any of the other physician contracts. The health system's emergency department had the largest patient volume in the primary market, which was important to us because 40% of all inpatient admissions to our medical center came from this area.

In similar hospitals, it is typical for emergency services to be major problems to the health system because of patient complaints, wait time, and poor working relationships between the medical staff and the emergency staff in addition to other departments of the medical center. All of this was absent from our contract relationship with this specific ER physician group. We had a very good business relationship and supported each other when necessary because we kept it simple and focused on the needs of both parties.

Future Implications

The bottom line on Williamson's work is that the bottom line is not always apparent at first look; you have to look at the hidden costs of doing business as well as the price of what you are buying. This includes understanding the costs of poorly structured contracts and bad behavior such as using a muscular approach for negotiating with your service providers.

Williamson's work shows how businesses can address conflict resolution. He takes the concepts of game theory and focuses them on the contracting process itself—looking through the "lens of the contract" and how organizations behave when it comes to the contract and how people behave during contract negotiations.

Williamson's (2008) thoughts on outsourcing go beyond the numbers and substantiate the value of a collaborative, win-win approach to outsourcing and third party logistics (3PL) contracts. It is some of the best academic work to show how the contract and governance structures need to be addressed in developing outsourced relationships.

The main reason Williamson's (2008) work is so useful to us is that his work with mathematical and economic models aligns nicely with what we have learned in our applied case-based research on vested outsourcing, performance-based outsourcing and collaborative supplier relationships:

- Win-win relationships are a must when there are complex requirements. Not only is win-win a common sense thing to do but applying "muscular" win-lose thinking actually increases the cost of outsourcing. We call this establishing a WIIFWe (What is in it for We) versus WIIFMe (What is in it for Me) foundation.
- An effective outsourcing arrangement should include a shared vision and a "predicted alignment" with clearly defined and measurable desired outcomes that guide the decisions of how the companies work together.
- Focusing on price alone only provides a partial picture of the true TCE of an outsourcing relationship. Companies need to establish transparent pricing models with incentives that optimize for cost/service trade-offs. These pricing models should include a well-thought-out exit management plan with the desire to drive continuity of service.
- Putting in place a good governance structure is essential. The contract should be seen as a flexible framework, augmented with well-thought-out governance structure designed to manage the business with the understanding that the business environment will likely change.

Williamson's (2008) lessons are simple and profound when you reduce them to their core essence. We hope more people will understand the contribution of his work after reading this chapter.

Healthcare as an industry and the supply chain with specific consideration of strategic sourcing can benefit much from the principles set forth by Williamson. Known for years, there are many opportunities for improving efficiency and effectiveness in the healthcare supply chain. Williamson provides insight on a culture of knowledge and application to support better decisions, implementation, and performance oversight on a core business of healthcare.

Summary

Consideration of TCE is vital to understanding the cost and operational improvements for the healthcare supply chain. This chapter presented a strategic view of TCE with practical examples. Understanding TCE is important to lead people and manage resources in the healthcare supply chain.

Sarah Says

Transaction costs are the costs that occur when participating in a market where exchanges of goods and services take place. Transaction costs include actual monetary costs, expertise, flexibility, risk, asset specificity, costs of managing the relationship, time, and supplier set up and switching costs (to name only a few that must be considered). Williamson explains how behaviors and approaches to contracts can impact transaction costs. He focuses on ten major lessons to help manage the transaction costs. The following are the summaries of the lessons:

- The first lesson is "outsourcing is a continuum, not a destination." There are two basic approaches to outsourcing: going to "the market" and building "corporate hierarchies."
- The second lesson is "develop contracts that create 'mutuality of advantage.'" In outsourcing, achieving equilibrium among the parties by committing to a win-win strategy through collaboration, flexibility, and foresight can grow both organizations' businesses.
- The third lesson is "understand the transaction attributes and their impact on risk and price." Williamson (2008) points out that companies need to understand three attributes of their business environment in order to help them have better discussions with outsource providers and ultimately lead to better contracts.
- The fourth lesson is "the more bilateral dependencies, the more the need for preserving the continuity." Unfortunately, the world of business is not static or perfect and companies and their service providers will try to develop a relationship that can best address a dynamic environment. This can create a bilateral dependency that makes it difficult to "undo" an outsource agreement.
- The fifth lesson is "use a contract as a framework, not as a legal weapon." Unfortunately, many companies have lawyers that are creating outsourcing contracts that are so tightly defined with self-interested terms that their contracts are legal weapons instead of instruments of social cooperation.
- The sixth lesson is "develop safeguards to prevent defection." Rather than be fearful of the risks associated with a bad contract, organizations should work to develop proper safeguards that allow for organizations to disentangle their relationship in a fair and equitable manner without harming the other party.
- The seventh lesson is "'predicated alignments' can minimize transaction costs." Here the goal is to create an alignment that results in the economizing or minimizing of transaction costs, to the greatest extent possible, given the uncertainties inherent in market dynamics and forecasts.

- The eighth lesson is "your style of contracting matters: be credible." Williamson (2008) describes in some detail the three styles of contracting, which he refers to as muscular, benign, and credible.
- The ninth lesson is "build trust: leave money on the table." We would propose that the most effective and collaborative contracts, the ones that are truly credible, must include trust.
- The tenth and final lesson is "keep it simple." Williamson points out the importance of trying to keep things as simple as possible.

Understanding total cost economics is imperative in order to be able to better lead subordinates as well as effectively manage resources within an efficient, effective, and efficacious health organization.

Discussion Questions

1. Describe the importance of Williamson's work for the healthcare supply chain.
2. Explain transaction-cost economics and how this concept relates to supply-chain management.
3. Demonstrate an understanding of the ten key insights from Oliver Williamson's TCE model.
4. Categorize the types of supply chain present in a typical healthcare organization in terms of their associated risk to the healthcare organization.
5. Integrate healthcare supply-chain principles with TCE tenets to develop a list of considerations for a typical transaction in the supply chain.
6. Evaluate TCE in the context of the supply chain using the Value Chain model.

Exercises

1. Describe the importance of Williamson's work for the healthcare supply chain in one page or less.
2. Explain TCE and how this concept relates to supply-chain management, especially the function of acquiring, in one page or less.
3. Demonstrate an understanding of the ten key insights from Oliver Williamson's TCE model using healthcare supply-chain examples.
4. Categorize the types of supply chain present in a typical healthcare organization in terms of their associated risk to the healthcare organization in two pages or less.
5. Integrate healthcare supply-chain principles with TCE tenets to develop a list of considerations for a typical transaction in the supply chain and explain why you have each item on the list.
6. Evaluate TCE in the context of the supply chain using the Value Chain model in two pages or less.

Journal Items

Answer the following:

Describe TCE in one page or less.

What considerations would you have, and why, to lead, manage, and plan within the context of TCE of the healthcare supply chain?

Considering Chapters 11 and 12, what did you find most helpful in your thinking about leading, managing, and planning within the healthcare supply chain?

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