Supply management requires special care when sourcing innovation, because traditional procurement processes can miss the mark on deep value and relationships.

SUPPLIERS Who Deliver INNOVATION
By nature, supply management practitioners are experts at sourcing. They understand negotiations and cost analyses processes and can create strategic contracts enforced with carefully detailed key performance indicators. Traditional procurement processes are effective for the majority of purchasing decisions. However, when sourcing innovation from suppliers, traditional processes can equate to fitting a square peg into a round hole.

Innovation in the supply chain can be generalized into three areas: innovative ideas/products, unique people with the talent to develop innovations and access to a network of resources capable of innovation. Without a full understanding of which type of innovation is being procured, and treating innovation as “just another contract,” results can be less than optimal. Brent Perekoppi, director at Direct Energy in Houston, learned this firsthand when his company tried to fit the purchase of innovation into a traditional box.

“Innovation is not about lowest cost, and we as procurement professionals are accustomed to working with that parameter,” he says. “Innovation is about purchasing something very different. And you have to throw out the cost conversation and not try to turn innovation itself into a commodity.”

In the North American power and energy market, innovation is a hot topic. Much of the innovation in this space is happening around power generation and alternative sources of energy. However, not every energy company is positioned to undertake the massive investment of money and time required to develop new ways of harnessing and producing energy. In fact, investment cycles in new energy technologies can stretch over decades. Rather, they find other ways to stand out in a crowded market.

Energy retailer and service provider Direct Energy not only sells electric and natural gas power in a number of deregulated markets in North America, it also installs, repairs and replaces products that use a large amount of that power — furnaces, air conditioners and water heaters — as well as the technology to control it: thermostats. It’s these offerings that give the company a competitive market position. “We want to help our customers use less of the energy we sell,” says Perekoppi. He says the company accomplishes this service for customers by harnessing home energy usage data from smart meters and by offering energy efficient products such as Direct Energy’s learning thermostats.

“As an energy retailer, we reside in a place between the traditional, heavily
regarded, asset-heavy utility world with power plants and lines, and the consumers and the appliances they have in their homes. We have products that analyze point-of-use data to help our customers make better energy conservation decisions through ‘smart’ technology that taps into an intuitive network behind the scenes,” says Perekoppi.

Procurement Process Misses the Mark

Not long ago, the procurement team at Direct Energy was tasked with working with the company’s in-house innovation team to secure a new product.

Direct Energy’s innovation team conducted research and found a product manufacturer that it believed would best suit the company’s needs. Because this was a large, strategic purchase, the procurement team was called in to assist. Perekoppi assigned an experienced procurement team member to work with Direct Energy’s innovation team to complete the contract. Although the purchase went smoothly at the outset, signs began to emerge suggesting that the product would not be released by the target date. What led to the delay?

Procurement was doing its job, negotiating costs down with the supplier, and even identified three other companies that sold similar products. The buyer also sought out options to buy directly from distributors, leading to lower costs and a better warranty. These are all traditional, effective methods to close a contract.

However, this approach turned out to be a poor fit for this purchase. “What the buyer missed was that we weren’t buying only a product, even though that’s all it appeared to be on the surface,” explains Perekoppi. “We actually were buying access to a technology network attached to that product.

“We didn’t recognize the scope of what we were buying, and that’s where we encountered difficulty.”

It’s About Ideas, People and Networks

Direct Energy has learned that it’s crucial to fully understand exactly what is being purchased when considering a contract with a supplier of innovation. Of the different types of innovation — procuring an idea, developing a creative idea or accessing a network — it’s access to a network that can be the most challenging to understand, says Perekoppi, because it’s a group of companies that work together to create value.

The aforementioned deal was not in vain, as it was a learning experience for the procurement team. Today, Perekoppi has developed a three-step procurement process for innovation.

1) Profile the category. Research and identify trends within the product’s category, and undertake a needs analysis to determine why this item is necessary. Writing out the need adds basic clarification early on; for example, “We need an innovative product that will give our customers data about their energy use.” This is also the stage to identify potential suppliers and determine what differentiates each one from its competitors.

Activity mapping is a helpful tool to figure out competitive advantages for suppliers, especially when buying access to a network, says Perekoppi. Activity maps are designed to look at a company’s behavior and see what the company does to reinforce its success. For example, Southwest Airlines is well-known for its activity map. Southwest’s decision to fly only one type of plane makes it more efficient for the company’s crews to work on those planes, because of standardization. The crews are more efficient, which leads to lower ticket prices, enabling the company to sell more tickets and stay profitable. “Southwest has an entire self-reinforcing map of its activities, and this same logic can be applied to any activity or network,” says Perekoppi.

2) Choose between make versus buy. By definition, says Perekoppi, it’s unlikely that two different suppliers will offer the same innovation. This will mean the choice will come down to buying from the identified supplier that emerged from the category-profiling step, or self-supplying/making the item directly.

“If you are going to develop the desired innovation internally, quantify the required investment,” advises Perekoppi. At this time, calculate the risk-adjusted cost. “Innovation has a very high failure rate. So you have to examine not just the cost to make the item, but the probability of what it may cost if the innovation does not work out.”

The investment of time is important to consider as well. If there is a timeframe to get product to market, it may take too long to produce the desired innovation in-house. At the same time, communicate with stakeholders to determine if “make” is a viable opportunity versus “buy,” depending on the strategic importance of that specific innovation and its future capability to innovate. For example, in the 1980s, IBM entered the personal computer marketplace but outsourced innovative components to Microsoft and Intel in an effort to be quick to market and potentially reduce the company’s risk and exposure by being one of the first to reach customers. Perekoppi points out that although this made the most sense from a risk perspective, IBM “innovated its solution away,” and Microsoft and
Intel went on to eclipse IBM and dominate the market.

3) Focus on contracting and governance. Once a decision is made, Perekoppi recommends focusing on joint outcomes for effective management of the innovation going forward. However, the usual key performance indicators used in procurement do not effectively help manage innovation. “You can’t say you want, for example, a 98 percent delivery of two innovative ideas each month, or one idea per year must go viral,” says Perekoppi. “Innovation, and creative ideas, just cannot be governed in that way.” Instead, during contracting and governance phases, take time to ensure the incentives and outcomes are aligned. Also, the incentives must align motivations with centers of knowledge and decision-making rights. “This gets each party working together, with mutual access to each other’s knowledge and a balanced allocation of risk.”

Lessons Learned, a New Partner Earned

When the new product contract didn’t transpire as planned, Perekoppi accepted that procurement practitioners are accustomed to following structured processes. Thus, it was necessary to create three clear steps to help address the unique requirements of innovation purchases.

“Procurement requires structure. Yet, when we tried to use those traditional cost-centered processes, the back and forth led to a lengthy process before reaching a contract agreement with that manufacturer. This was unfortunate because it was the type of transaction that needed to be timely,” he says. “No one was happy throughout the process, and we were unable to negotiate the price down. As a result, the product launched four months later than planned.”

Because that last scenario was not considered a success, Direct Energy rapidly considered another innovative supplier.

“With this new partner, we took the steps to understand its network, what access to their algorithm would mean for us, and we knew we wanted to buy from them because they had something unique we couldn’t find elsewhere,” says Perekoppi. In return, the new supplier received access to Direct Energy’s customers and distribution methods.

“In this relationship, each of us is sharing the risks and building our relationship together. We have that alignment of motivations, and as our relationship with the supplier has grown, it’s deepened.”

Looking back, Perekoppi does not consider the situation with the previous product manufacturer a complete failure. “It’s not that its product failed. It’s just that we are not selling it in large quantity and the company is not partners in innovation with us,” says Perekoppi. “Today, what we are doing right with our new supplier is we’re fully aware of the scope of its capabilities and have a much more balanced relationship.”

How Something Wrong Can Turn Into Something Right

In innovation, it is OK to be wrong sometimes. It’s through failure that ideas are either scrapped or perfected, so the next attempt is more likely to be a success. Some of the most innovative corporations in the world understand this well — Jonathan Ive, the chief design officer for industrial design at Apple, has said one of the hallmarks of his team’s success is “being excited about being wrong, because it means that you’ve discovered something new.”

The procurement team at Direct Energy has discovered something new in this experience: the value of letting go of strict processes. “In supply management, we aren’t always comfortable having these conversations and working without that safety net we’re accustomed to,” says Perekoppi. “There’s real value to be found in thinking differently, and asking why something is being done rather than following standard procedure. We have learned that this is incredibly important when innovation is on the line.”

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