(RE)CONSIDERING SERVICE OUTSOURCING

The SerVAL model: a framework for analysis, insight and action

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SUMMARY

The pros and cons of service outsourcing are frequently debated.

In the UK, over the past few years, the well-publicised financial problems at a number of publicly listed service outsourcing businesses have led some commentators, politicians and customers to question its merits, particularly for public services.

Yet, despite these doubts and financial challenges, service outsourcing has proven to be a very successful approach for large numbers of customers and service providers in many countries.

The reasons for its success or failure lie, as ever, in understanding both demand and supply, namely:

- why organisations choose to outsource or not, and
- the economics of service delivery.

The latter is driven by how competitive the market is as well as the operational model and quality of execution of the service provider.

The range of factors driving demand and the different levels and nature of competition in different service markets mean that that the pros and cons for customers and service providers alike vary considerably.

This paper highlights a simple, structured approach-the SerVAL model- which can be used to support the analysis of the factors underlying demand. It also provides an illustrative application to a generic outsourced service.

Used in conjunction with well-established models for analysing market competitiveness, such as Porter's famous Five Forces Model, it can provide greater insight into how to create more sustainable value in service organisations.

This paper is designed to help those looking to better understand:

- What is going on in a service outsourcing market, and why?
- What is likely to happen in the future?
- How to develop, deliver, retain & improve a sustainable, compelling customer value proposition?

It provides another perspective, a "starter for 10" perhaps, or another analytical tool for your toolbox.

More about the model's in-depth application and the economics of service delivery can be found at **www.servalproposition.com** and in the strategic workbook **"(Re)Consider Your Service Value Proposition – How to create more value for the customers, employees and owners of service organisations."**

INTRODUCTION

Outsourcing has been a business model since the early days of human evolution. For example, the short hunter-gatherer requesting a tall friend to reach the berries at the top of the bush. Or the fast ones chasing game into the path of the stronger ones. This might be considered "playing to your strengths" and teamwork.

Local, regional, and international trade goes back thousands of years and is based on outsourcing. For reasons of climate, topography, soil, access to resources, cost of resources, and developed competencies, different areas can produce goods that others can't, can produce better ones, or can produce them more cheaply.

It was expressed as an organisational theory in 1776 by the famous economist Adam Smith in terms of the division (specialisation) of labour.

Outsourcing has also been extremely common in manufacturing for many years, where supply chain management and approaches, such as "Just in Time" stock management, are well-established disciplines and considered to be normal business practice.

However, it is a more recent phenomenon in service industries, or where the element to be outsourced is a service rather than a manufactured component. Such service outsourcing has arguably emerged as a significant strategic or tactical choice over the past 30 or 40 years.

The range of services outsourced over this period range from IT hard and software services, a whole range of facilities management services, customer response service centres, professional services, healthcare services, highway maintenance services and municipal waste collection services, to name a few.

Yet, despite even this relative maturity as an approach and the existence of many well-established providers of outsourced services, outsourcing a service is often seen as a byword for cost-cutting and/or service deterioration. And thinking around outsourcing can be very emotive in the public services arena, where it has been strongly led by doctrine and policy.

In some quarters, the perception of service outsourcing in the UK has soured over the past 5 years or so, because a number of the large, publicly listed, outsourcing companies have experienced well publicised financial challenges. This has led some to question the merits of service outsourcing.

So how can interested parties get a better understanding of what is going on in a service outsourcing market, of which there are many, each exhibiting different characteristics? And what should they do to respond to such?

The SerVAL model of service value creation is a service industry-specific tool which enables explicit, detailed, consideration of the factors shaping:

- The service demanded by and provided to customers
- The employment proposition for employees
- The value generated for investors, owners and other stakeholders.

In tandem with well-established models for analysing the levels of competition in markets, such as Michael Porter's "Five Forces" framework (Harvard Business Review, 1979), it facilitates consideration of how these are changing, or likely to change, due to competitive forces and evolving customer needs.

The following analysis provides a high-level indication of how the SerVAL model can be applied generically to service outsourcing, and thus to specific service(s) and the variant of that service provided by individual service providers.

THE CUSTOMER SERVICE VALUE PROPOSITION

All service organisations provide their customers with a service value proposition, which represents a trade-off between the Service Benefit & Service Experience they deliver and the Total Cost to Customer (which is more than just the price they pay) to receive it.

A simple example of a service benefit arising from a haircutting service might be "feeling more fashionable", or "meeting the requirements of your job".

A simple example of a service experience is the appearance of the hairdressing salon – whether it is clean or dirty, whether it is hot or cold, whether coffee or tea is provided, and whether the hairdresser is friendly or not.

The Total Cost to the Customer of the hair cutting service will include amongst other things the direct price of the haircut, the cost of travel to get to the hairdresser, the opportunity cost of the time spent travelling to and from the hairdressers and the time taken to receive the haircut, the "hassle" involved with booking the haircut, travelling, parking, etc.

Service organisations aren't sustainable without customer demand for their value proposition- which they are able to meet in a financially attractive manner.

Therefore, when considering a service, whether outsourced or not, the starting point needs to be the requirements of the customer.

- What did they want in the past?
- What do they want now?
- What are they likely to want in the future?
- Why do they want it?
- When do they want it?
- How much are they willing and able to pay for it?

It should be noted that customer wants are not the same as customer needs. Many of the things that people want they don't actually need!

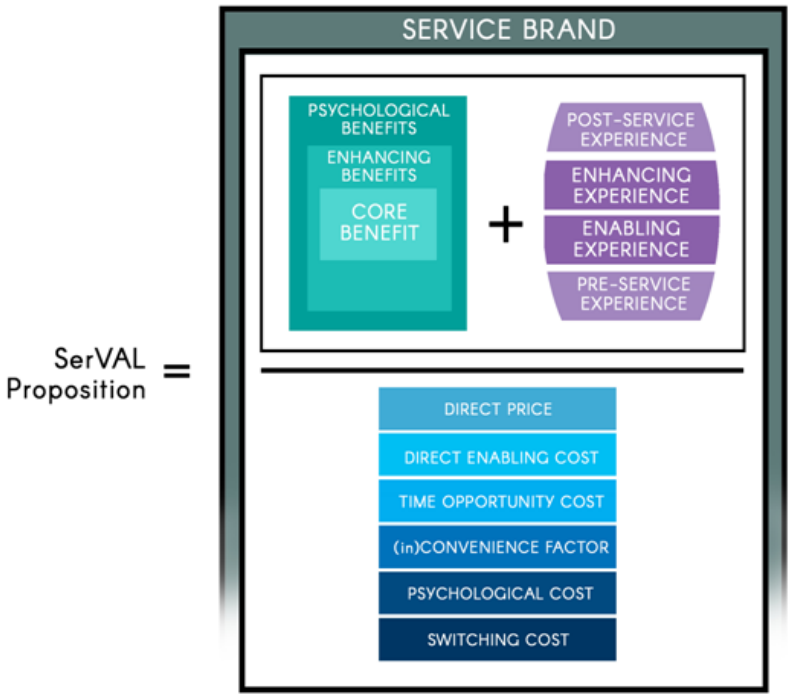
It should also be noted that identifying the customer of a service is not always as straightforward as you might think, and there may also be multiple customers of a single service event.

A tool developed specifically to enable such analysis is the SerVAL model. More about this model can be found at http://www.servalproposition.com

The SerVAL model considers a service in terms of the three core elements of the service value proposition, namely:

- The Benefit wanted by and delivered to the customer;
- The Customer Experience wanted and delivered; and
- The Total Cost to the Customer for them to obtain the Benefit and Experience.

Each one of the three core elements above contains, in turn, a number of components, which can be considered thus:



GENERIC CASE STUDY TO STIMULATE THINKING, CHANGE AND FUTURE SUCCESS

The high-level application of this model to a generic outsourced service, as set out below, illustrates how the model can be applied and how strategic and operational insight can be gained. It also considers how a value proposition might change over time.

It should be noted that this example is not designed to reflect any specific service or provider of such services. Application of the model by different parties might lead to different assessments of any particular service value proposition. The model is designed to provide insight to its user, not specific answers.

BENEFITS INITIALLY SOUGHT BY CUSTOMERS FROM OUTSOURCING SUPPORT SERVICE COMPANIES

The core benefits that are initially required from and promised by outsourcing service businesses might be a combination of completing the service activity faster and/or better than the incumbent in-house service delivery team, so a greater benefit is achieved (e.g."cleaner buildings") or it is received faster (e.g. "buildings cleaned by X o'clock") or is more reliable.

The better/faster/more reliable service benefit concept is easy to understand. The challenge can be to deliver it.

There can also be several other closely-related benefits, including, for example,

- The outsourcing benefit; and
- The transfer of risk

Note: Cost-saving is often also important and is covered further below under the Total Cost to Customer.

The "outsourcing" benefit was a big driver for the growth of the outsourced service market in the UK some 30 to 40 years ago: it might be argued that the outsourcing benefit was, initially, the core service benefit sought, for different reasons, by both the public and private sector of the economy.

The outsourcing, risk transfer, and off-balance sheet benefit for the UK public sector

A view might be taken that the initial service outsourcing benefit sought by the UK public sector in the 1980's was part of the Conservative Government's objective to shrink the size of the UK public sector, make it more efficient, and lower the cost of service provision.

The doctrine was that the private sector could undertake the tasks better and/or faster and provide a better service experience, or the same task performance and service experience at a lower cost than the public sector, as competitive pressures and the profit motive would lead to greater efficiency. Part of this doctrine was also that the public sector should not directly provide such services in the first place but, instead, limit its role to the procurement of such services. The view was that the private sector was better able to evaluate and manage the risks associated with the delivery of such services.

Public sector demand for outsourced service companies' services grew substantially at that time as part of the consequent privatisation drive, achieved through Government policies, such as Compulsory Competitive Tendering. Initial demand for the services of private sector companies that performed these activities was thus driven, in part, at that time, by doctrine (and cost).

Another major service outsourcing benefit sought by the public sector in the UK in the following decade was the construction and, for the first time, operation of a huge new wave of public infrastructure projects (hospitals, schools, roads, housing), with delivery, performance and cost risk transferred to the private sector. The funding for this was also to be provided by the private sector – and was thus kept off the public sector balance sheet – under the Private Finance Initiative (PFI).

The private sector outsourcing benefit

At the same time, another doctrine driving demand for outsourced service companies' services was being adopted by some private sector companies. This was the management philosophy of "focusing on the knitting" (Charles Handy and others) and focusing on the organisation's value chain (Michael Porter and others), and thus requiring other businesses to undertake non- core activities on their behalf.

There were, and are, also practical, non-doctrinaire, reasons for private sector outsourcing: for many small and medium sized companies seeking external solutions to meeting emerging needs- such as the provision of IT services- can be the only way they can practically and sustainably obtain the resources they need.

Psychological benefits of outsourcing

It might also be argued that service outsourcing can provide a psychological benefit to the leadership of the organisation that is outsourcing, namely handing the management, delivery and improvement of these tasks over to perceived experts.

Better service delivery by experts was, and is, part of the marketing message delivered by the outsourced service companies. This greater expertise, coupled with competitive pressures was, and is, expected to drive service innovation.

The initial benefits sought from service outsourcing might, therefore, be considered thus.

This simple example illustrates how the benefit being sought by customers from outsourcing may involve a number of elements, and may also not be as straight forward as "do it better"/"do it faster" etc.

These benefits can be very compelling- which is essential.

It is extremely important to remember that both generic demand, and specific demand for one organisation's service compared to another is driven by ***CINBBADS.*** *There must be a*

C*ompelling,* ***I****mmediate,* ***N****eed (want) for the service; as well as a*

B*udget*

And for that service solution and service organisation's service to be chosen, compared to another, it must be

B*etter than the* ***A****lternative* ***D****elivery* ***S****olutions.*

Not only is Sinbad the Sailor, but ***CINBBADS*** *is the seller!*

ENHANCED SERVICE EXPERIENCE

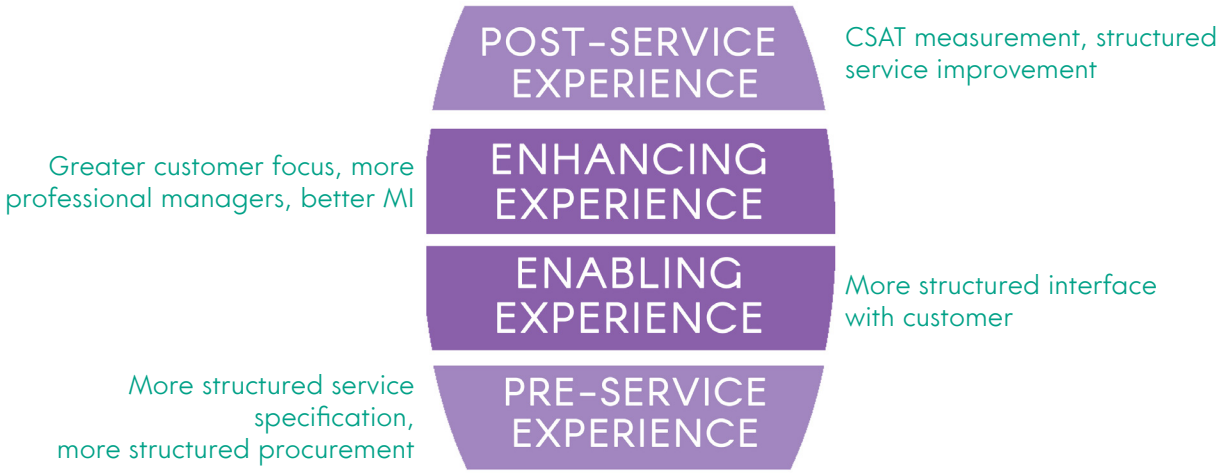
The service experience obtained from an outsourced provider is typically also expected to be, or required to be, better than that provided by an incumbent in-house team. It is expected that commercial pressures and a much clearer customer/service provider relationship will drive a more customer-focused service-enabling experience, and a better service enhancing experience.

During the initial waves of large-scale public and private sector outsourcing in the UK, service providers often promised, and often, if not always, delivered, an enhanced service experience, including much more management information, clearer service specifications, working to service level agreements with KPIs, and brought what was perceived, or sold as, a more "professional" management approach to the delivery of such services.

It is worth noting that this competitive threat also drove the introduction of a similar approach by in-house teams to the point where these are the norm in most large organisations.

Outsourcing also leads to the emergence of a different type of pre-service experience, as both the service procurer and service provider have to go through a more formalised negotiation or tender process and, potentially, a greater level of due diligence compared to the ongoing relationships with people in an in-house team, where an annual budgeting process is typically as far as such discussions go. This pre-service is experienced on a periodic basis, each time the service is re-procured.

The expected outsourced service experience might be considered to change as follows:



TOTAL COST TO CUSTOMER

A hugely important part of the SerVAL equation for any service is the Total Cost to Customer; it is all very well to promise and deliver a better service and service experience, but how much does the customer need to pay for such? The flip side being what levels of service benefit and type of service experience might follow from a much lower Total Cost to Customer?

Lower Direct Price

During the initial wave of large scale public sector outsourcing in the UK in the 1980s and 1990s, the Direct Price (i.e. the price for the service paid to the service provider) charged by service providers was often less than the cost of the in-house team. Without this cost reduction, the benefits of change might be perceived as being too low, unless the doctrine-based benefits were seen as material and overriding.

> It can be the case for some organisations that outsourcing might be more expensive than undertaking the task in house- however the in-house option may not be robust and provide too great a risk, and outsourcing would still proceed.

Lower opportunity cost

It is often expected that outsourcing will free up in-house management time so that it can focus on its core activities and not get dragged into the service delivery issues that are associated with non-core service delivery activities. The opportunity cost of a service would, therefore, be expected to fall with outsourcing.

To realise this reduced opportunity cost clearly requires good service delivery which meets the customers' expectations, and good customer management from the service provider, an "intelligent client" function within the customer to manage the service provider, and good working relationships between the two parties. Without this, in-house management can and does still get dragged into a lot of service performance issues, and the amount of time freed up is not as expected.

Less inconvenience

Outsourcing is also expected to significantly reduce the in-house management "hassle" associated with the provision of some services. For example, by outsourcing the provision of facilities services, building temperature, cleanliness, security, etc should no longer be the problem of the core in-house executive management. The outsourced provider will ensure that such issues don't arise, or if (and when) they do, they will manage all the issues and resolve them quickly, so the hassle will either not arise for in-house executives or be dealt with at a different level.

Higher enabling and switching costs

There can be an increase in some costs associated with an outsourced service – namely, the enabling costs and switching costs that are associated with service procurement.

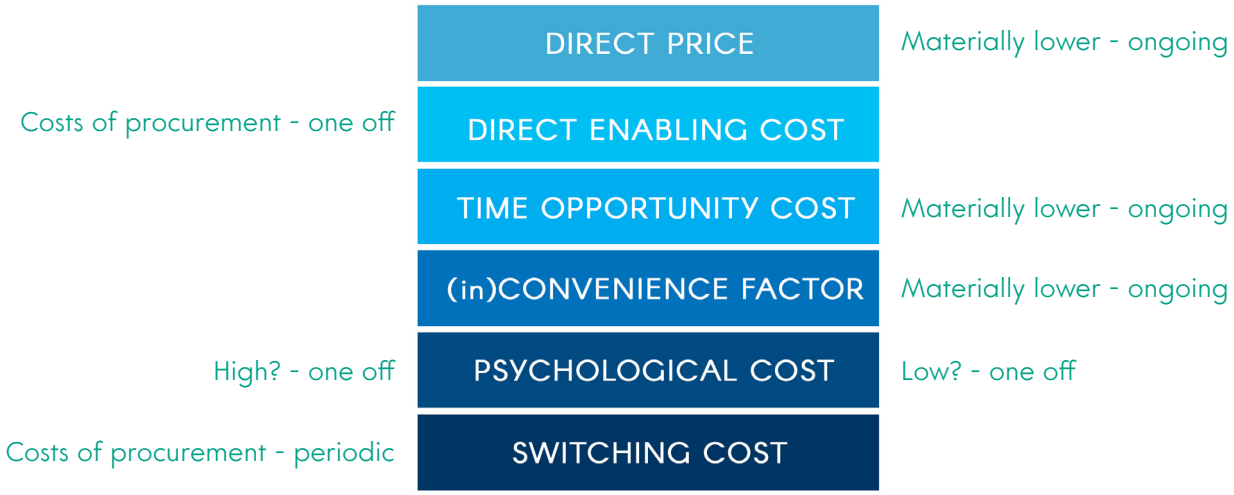
Psychological costs

During the initial waves of service outsourcing, and still today for "first time outsourcers", there were high levels of psychological costs associated with outsourcing. These tended to be either along the lines of

- "we can't outsource XXX, as they have worked for the organisation for 25 years, are very loyal and want to work for us, not Acme Service Corporation", or
- "it is not right that the private sector should provide these services – these people should still work for us".

Equally, there were, and still are, some whose view was/is that these were/are long-awaited solutions and the psychological costs low and the psychological benefits high.

The initial expected Total Cost to Customer of service outsourcing might therefore be considered as follows:



STRONG SERVICE VALUE PROPOSITION PERCEIVED

Applying this thought process and the SerVAL model to the early waves of outsourcing, or first- time outsourcing, it can be seen that, from a customer's perspective, the service value proposition to outsource can be seen as being very strong, delivering;

- Political or Corporate doctrinaire benefits
- Sustainable, practical, robust service delivery solutions;
- Promise of improved (better, faster) service delivery benefits by experts
- Transfer of risk to the service provider
- Promise of improved service experience
- Reduced direct costs
- Reduced time opportunity costs; and
- Reduced (in) convenience factor.

As service outsourcing becomes more established in a particular market and increasingly compelling then strong supplier brands tend to emerge leading to a reduction of psychological and procurement costs and providing greater psychological assurance to the outsourcer.

Who doesn't want a better and/or faster service, better service experience, lower cost, and their policy objectives achieved? And the transfer of performance risk!

HOW DO OUTSOURCING SERVAL PROPOSITIONS CHANGE OVER TIME?

The next section is going to consider, again using a generic example how an outsourcing SerVAL proposition might change over time and become more, or less, compelling.

So how might a service outsourcing value proposition look after, say, 20 years?

"TWENTY YEARS ON" THE TOTAL COST TO CUSTOMER

Direct costs are low and may need to increase

One of the most significant immediate gains from outsourcing some services is a reduction in the direct price that is paid for that service. In order to be able to sustainably offer such, the outsourced service provider needs to be able to deliver the service at a lower cost than the in-house team.

It might be argued that for service outsourcing to deliver significant direct cost savings, in-house teams need to be very inefficient and overstaffed, and/or benefit from significant diseconomies of scale, and/or be utilising very different service delivery mixes and models than those used by the outsourced provider; otherwise, the cost savings aren't there to be achieved.

In order to deliver cost savings, incoming service providers need to restructure and manage the resources very efficiently going forward. It is not unreasonable to assume that, in many cases, significant cost savings are effectively "one-off" benefits, or perhaps "two-off" benefits if further restructurings are possible later in the contract life cycle, perhaps after the contract has been retendered. Beyond that, direct cost savings arise either through more marginal gains from continuous improvement, or through more radical service transformation.

Over time, in a highly competitive, price sensitive market, this direct price to the customer would continue to be driven down until it reaches a point where it can go no lower on a sustainable basis because contractors' margins become too low and don't cover the risk taken on.

In such markets, at some point prices might need to rise- should competitive forces allow.

Alternatively – and potentially additionally – the whole service delivery model and service delivery mix of service providers might need to be transformed to rebuild margins. This would reduce cost (almost certainly by using technology to replace people and real estate in the service delivery mix) and also potentially have a knock-on effect on customer experience- and thus change the overall service value proposition.

The Service Delivery Model covers factors including where the service is delivered, the medium through which is delivered, the level of customer interface, the degree of customer self-help, how and when the service paid for is paid for, the basis of relationships with customers, etc.

The Service Delivery Mix is the range of resources used to deliver the service. It includes people, tools and equipment, systems and process, knowledge, real estate, and ICT.

Enabling and switching costs

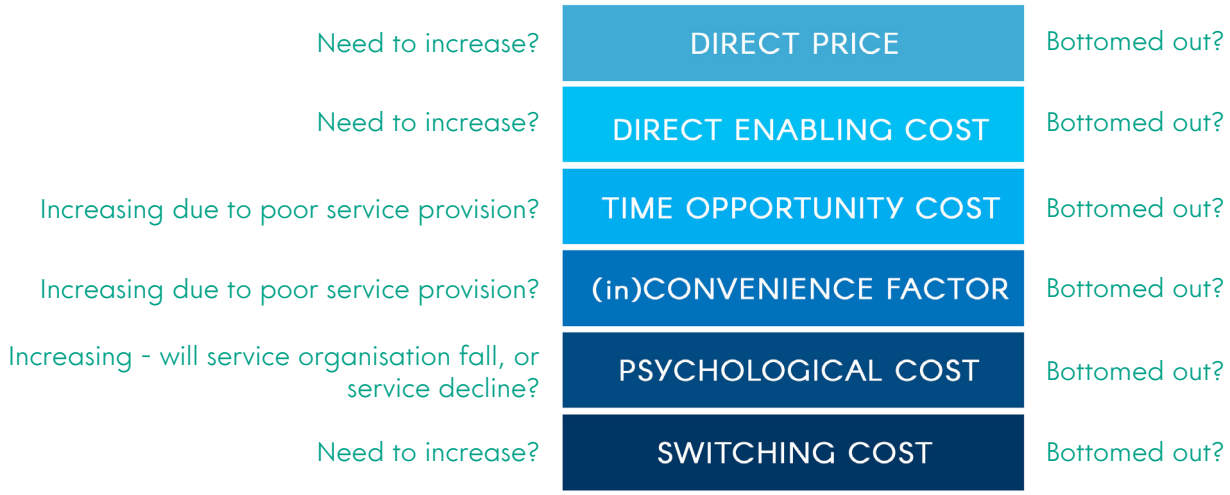
It might be expected that over time that service enabling costs will "bottom out" as procurement of that particular outsourced service becomes a well-established process. This would mean that, after a period, there would be little more to save from the procurement process, particularly if procurement takes place in an environment of stringent legislation and regulated process.

Furthermore, in some markets, over time, it might be that enabling costs need to increase if some of the results arising from the procurement process (Service Benefit, Service Experience, other elements of TCC, financial sustainability of service providers, etc) are not as expected or required.

Opportunity costs and inconvenience factor – starting to increase?

It may also not be unreasonable to think that the majority, if not all, of the available opportunity cost savings will be realised over time. They may also start to be reversed if more customer management time is taken up dealing with underperforming or failing contractors resulting from competitive pressures on price. The inconvenience factor would then go up for the same reason.

The evolved Total Cost to Customer might, therefore, look as follows:



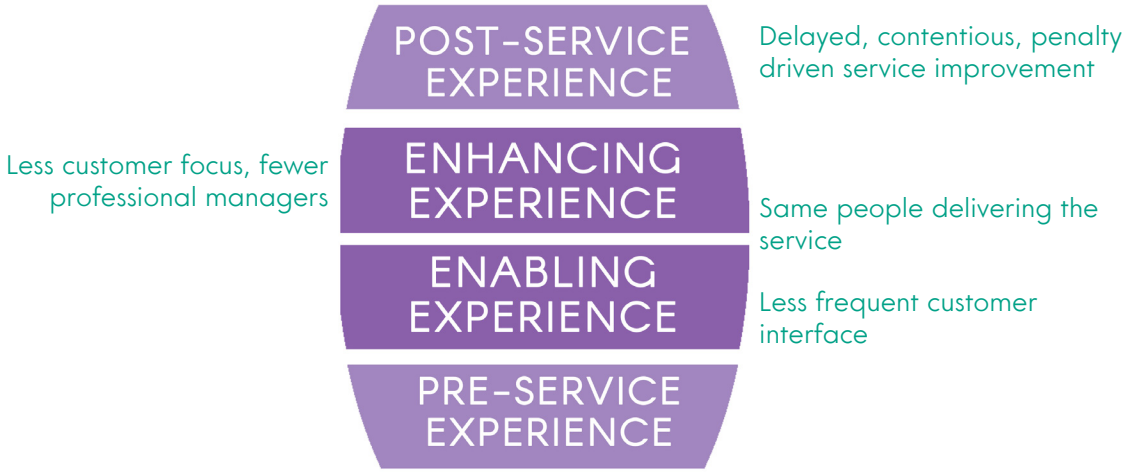
The TCC could therefore either be less attractive than it was in the past, not likely to become more attractive, or become less attractive in the future.

"TWENTY YEARS ON" THE SERVICE EXPERIENCE

High levels of competition may mean that, over time, the Service Experience could become relatively vanilla, or highly differentiated.

In some outsourced service markets, a combination of highly structured service specifications, the widespread sharing of best practice by consultants, and (in the UK) employment legislation ("TUPE") concerning the transfer of staff (and associated knowledge transfer) which means that a change of service provider typically results in the same staff continuing to provide the service but working for a different employer, can lead services down the "vanilla" service experience route.

High levels of competition and low margins might also mean that investment in developing the service experience, be that training and developing staff, the quantity and/or quality of managers and supervisors, or investment in technology, may be difficult to afford.



So, over time the Service Experience may also have stood still or deteriorated.

In higher margin services, where some of the factors set out above haven't applied, then there may have been a lot of investment in developing the customer experience, and potentially much greater differentiation of the service value proposition.

And what may happen to the Service Benefit?

"TWENTY YEARS ON" THE SERVICE BENEFIT

Where "outsourcing" is seen as a core benefit of the new service, this is typically a "one-off benefit" that thereafter is either no longer part of the value equation, or a part of the value equation taken for granted- unless doctrine and policy changes in which cases it might be seen as a disbenefit!

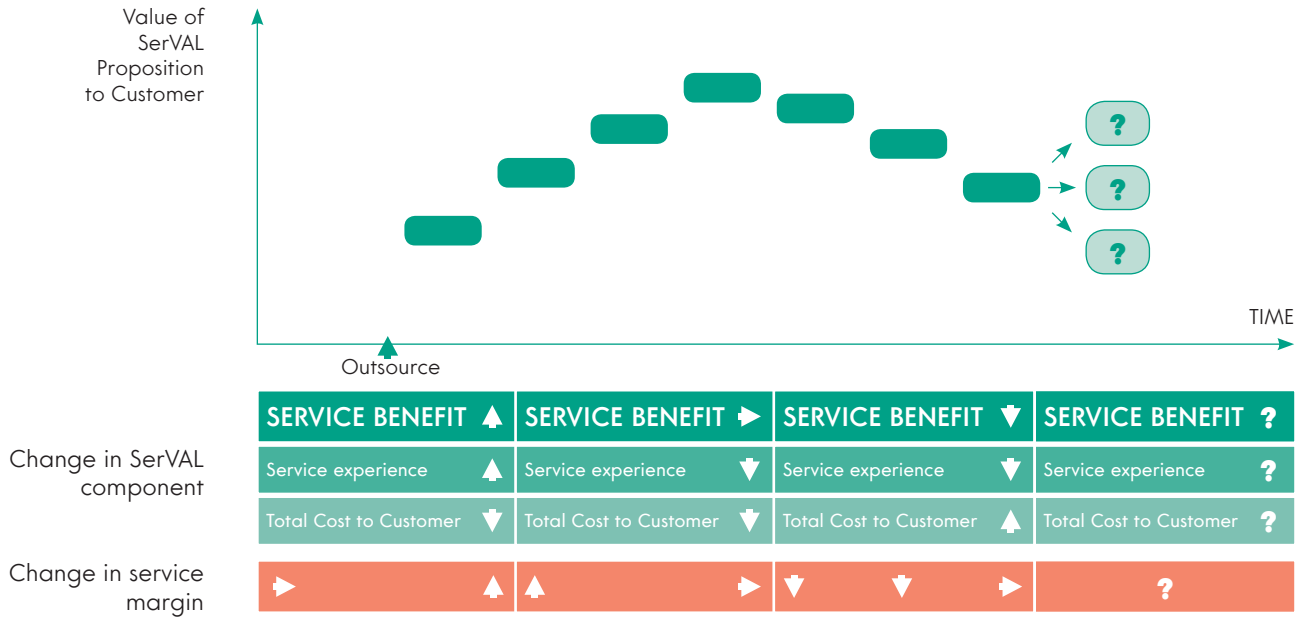
The remaining, long term, core benefit is thus a "faster and/or better" delivery of the tasks than an in-house team, or it may simply be "status quo task delivery", which is associated with a better service experience (but see above) and a lower Total Cost to Customer (see above).

COMPETITIVE EROSION OF SERVICE VALUE PROPOSITION

It can be seen through the above simplistic example, how an original generic service outsourcing Service Value Proposition might be significantly eroded over time due to a combination of:

- Significant one-off gains in Service Benefit, Service Experience and Total Cost to Customer having been achieved in the period following outsourcing.
- Significant competitive pressures in the market forcing the direct price down, and hence the ability of the service provider to invest in maintaining or improving the remaining Service Benefit and/or Service Experience.
- A reduction in Benefit and Experience leading to increases in Customers' Time Opportunity Cost, Inconvenience and psychological costs.

The SerVAL cycle for the customer and the impact on returns to the service provider in such circumstances might be considered as follows:



It is of course possible that the development of new SerVAL Propositions, or continuous improvement of existing ones, and/or the application of new Service Delivery Mixes or Models- which requires innovation and investment, can lead to Benefits which increase over time, or remain constant, whilst Service Experiences change (for the better), Total Costs to the Customer continue to fall or don't increase, and margins remain stable or grow at a sustainable rate.

SO WHAT?

The natural corollary to such changes in a highly competitive, price driven market such as described above would be at some stage,

- Direct Price to customers would need to rise, and, subject to the caveat below, would rise as service providers left the market or changed pricing strategy; and/or
- Customers would be forced to accept lower service benefits and a reduced service experience as the new norm ("you get what you pay for").

Alternatively,

- Service providers would radically redesign their service delivery model and service delivery mix in order to be able to generate sustainable financial returns from their current SerVAL Propositions; or
- Service providers could develop alternative SerVAL Propositions that are more attractive than the current ones to customers and are more financially sustainable; or
- The current SerVAL Proposition would not be seen as Better than the Alternative Delivery Solution – and customers would seek to insource the service again. This might particularly be the case if Direct Prices rise.

SO WHAT ARE YOU GOING TO DO?

If this simple analysis has got you thinking and reflects the challenges and opportunities faced by your organisation, your markets or the companies in which you have invested, then please give me a call if you would like assistance in:

- Analysing service markets;
- Analysing the Service Value Proposition of specific companies;
- Clarifying, reviewing and developing an outsourced Service Value Proposition, and/or
- Reviewing and improving or re-engineering your Service Delivery Mix and Model

Or buy the book.

BUY THE BOOK

(Re) Consider Your Service Value Proposition: How to create more value for the customers, employees and owners of service organisations

The book is designed as a practical workbook for Executives and Advisors involved with service organisations. These include organisations who deliver services commercially, those providing public services, and those that are "in-house" service departments.

Its objective is to:

- Assist the creation of additional customer value and organisational value; and
- Form the basis of competitive strategy for service organisations

It is structured to enable individual analysis and/or to form the basis of workshops and training within organisations.

It is based around some core models and theories, largely developed by the author and supported by simple practical examples, and it poses a series of key questions for consideration. Its essence is about identifying questions – not answers – to assist organisational improvement, and not to propose universal vanilla solutions.

It considers what is a service? And proposes a core model as a definition – the Service Value Proposition, or "SerVAL Proposition".

It highlights how the changing ingredients that are available to be used with services, and associated new service delivery models, which involve the increased use of ICT and the internet, are changing services in the greatest way since the invention of electricity, the telephone, the internal combustion engine, manned flight, TV and radio. It reveals the many pitfalls that can accompany this, as well as explores the underlying reasons why they can be game-changers.

It analyses who are the customers of a service – and that there is rarely a single one – and proposes a "customer stakeholder map". It considers how customers evaluate a service, and how organisations fail to deliver what customers want.

It explains the importance of the service organisations employees to successful service delivery, and proposes an expanded version of the "Service Profit Chain" model developed at Harvard Business School.

It illustrates how organisations create and receive value back from their customers, and how a balance needs to be both obtained and retained between value that is delivered to the customer and value received from the customer in order for organisations to be sustainable.

It summarises all this in a holistic model for service success.

There are questionnaires provided at the end of each chapter to allow organisations to apply the thinking and concepts therein to their own situation.

WHY IS IT DIFFERENT?

This book is different. It is not an industry or a circumstance-specific book. It is not a "how I did it book". It is not an academic book of theory.

It has been written by someone with the very unusual cross-industry experience of directly leading service organisations through change, who has also both studied and theorised about service.

It develops and explains a practical, applicable model of service improvement, from a customer's and employee's perspective, as well as a shareholder's or owner's.

It doesn't pretend to provide answers. It is designed to provoke thinking and share lessons, and thus to assist each service organisation to reach its own answers.

www.servicevalueproposition.com

It can be purchased from Amazon, or directly from the author.

(Re) Consider Your Service Value Proposition

The SerVAL model provides an integrated framework for achieving service success.

It is based upon a core definition of a service as a value proposition to customers- a service value proposition or "SerVAL proposition".

It considers the fundamentals driving demand for service and the price customers are willing and able to pay. It also highlights that price isn't the only element of the "Total Cost to Customer".

It explores how the different ingredients that go into delivering a service (eg, people, real estate, process), and the service model chosen to deliver the service, fundamentally shape the SerVAL proposition to customers, and the cost to deliver such a proposition. These are also material to the employee experience- which in turn impacts the performance and behaviour of employees, which are also critical factors for service success!

The model examines exactly who is the customer (and that typically, even for business to consumer services, there is rarely one customer), and how they assess the performance of their service provider and the SerVAL proposition received. It highlights how the characteristics inherent in services can influence this- and what service organisations can do to mitigate this.

Furthermore, it shows why service success is not based on being "customer focused" but on being "customer value focused"- and how this latter concept involves a fair and sustainable exchange of value between the service organisation and its customers. Without such a service organisation will not survive.

The SerVAL model does not provide the answers- it is based on a framework and a detailed set of questions to support service organisations find the best answers for their success.

Anyone with an interest in running a service business will benefit a LOT from reading "(Re) Consider your Service Value Proposition". Andrew has created a "playbook" for a service organization.

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