

CHAPTER 2

UNDERSTANDING THE LOGIC OF KNOWLEDGE SERVICE SUSTAINABILITY: CUSTOMER ALLIANCES

Abstract

A central theme in knowledge services is the critical role of customer alliances play in the competitive sustainability of these firms. In this chapter, the focus is on the particular nature of customer alliances and its advantages for reducing the clouding effects of providing services solutions to customers that are of high heterogeneity and intangibility. A classification of customer alliances – problem focused and lateral differentiation – is presented as strategies that are vitality important for developing novel solutions to customer priorities and building knowledge stocks. The distinct strategies are discussed as adaptive mechanism for anticipating customer priorities and the sustained viability of knowledge services.

“If it isn’t broken, fix it.”

This is the mantra for knowledge services and cuts to the heart of sustained competitiveness for these firms. If a solution to customer priorities appears to be effective in generating value, it is crucial for the service firm to seek new value-added solutions for competitive sustainability in dynamic and changing environments. IBM’s alliance with customers, such as Mayo and Boeing, has become a model for developing joint value-added solutions based on the notion that if a solution is providing value, it is imperative to develop new solutions. IBM does not wait around for its customers to arrive bearing priorities but instead encourages its engineers to dream up exotic and innovative services in anticipation of future customer priorities and peddle them to their customers. IBM’s alliances with customers allow the company to peer into the future and generate solutions for impending customer priorities and not rely on current solutions despite their added value.⁶⁷

It is essential to continuously improve processes and offerings within a knowledge service firm. New innovations are easily copied by competitors and unlike in manufacturing, cannot be protected by a patent. Therefore, soon after a successful service is launched, it is no longer unique to its innovator and the time for which it serves as a competitive advantage is limited.

The cycle of continuous innovation must continue, replacing services that are performing well if a firm is to stay ahead of the competition.

By partnering with their customers, managers of knowledge services such as IBM are better able to understand the environmental elements unique to their value constellations, and to exploit those elements. The object is to gain some understanding of salient activities that can create opportunities or generate threats. Addressing these activities will go a long way toward sustaining competitive advantages, while a failure to do this may condemn the firm to market irrelevance. In order to get a handle on how to apprehend environmental elements in knowledge services organizations, the place to begin is the firm's knowledge stocks. These are their commodity in trade and emerge from a complex network of stakeholders, primarily workers, customers, competitors, sanctioning bodies, and educational institutions as suppliers. The participants in this network are claimants with varying degrees of input into the service firm's production of knowledge and solutions. By network we mean a set of relations based largely on self-interested gain.

Network relations are essentially value constellations which are fundamental to the competitive sustainability of knowledge service organizations because they provide a way for the firm to understand the big picture of its role in its competitive environment while distinguishing itself from rivals. The network is useful because it creates a framework that focuses the manager's attention on the overall performance of the firm. This is directly reflected in the satisfaction of various claimants.⁶⁸ Achieving meaningful competitive sustainability within networks is basically a leveraging process; a process of co-production among key participants as each claimant provides resources along with varying expectations around solutions or value-added service outputs. If we observe the accounting service firm PWC for a moment, we can see that it provides expertise to be leveraged but also expects a steady stream of revenues as an auditor for the Xerox Corporation. The Securities and Exchange Commission provides oversight governance to both Xerox and PWC with the expectation that both organizations comply with GAAP (Generally Accepted Accounting Principles). Xerox, as customer, is not only a critical source of revenue for PWC, but serves as an indispensable element in the development of knowledge stocks and expected satisfaction with solutions or value-added service outcomes.

To gain a competitive edge, managers of knowledge services must identify the relevant claimants and determine just how much leverage these co-producers have in the building of knowledge stocks within the organization. The goal of such an analysis is to determine the claimants to whom the organization should be most sensitive because these parties will have a greater influence on the firm's competitive sustainability. It is of the utmost importance not only to determine the significance of the demands and expectations of claimants, but also to determine the implications inherent in satisfying

some claimants at the expense of others. This claimant analysis leverages the full value of the network in the services business context and reduces dissatisfaction among those claimants who could have the potential to adversely affect the organization's performance.

Balancing the demands of claimants for sustained competitive advantage is not an easy undertaking because it places managers in a delicate relationship with their constituents. Management has to assess just how its actions impact the overall stakeholder network. In a very real sense, knowledge service organizations are actively engaged in bargaining or exchange relationships within the network and, in order to meet expectations and realize continued gain, the organization must understand the dynamics among the participants within the network so as to maximize the development and generation of knowledge stocks. At the very least, managers of knowledge services must conduct some sort of claimant analysis and minimally satisfy their interests to ensure the supply of critical inputs. While the heterogeneity of the network may pose a myriad of problems for knowledge services, the most pressing challenges facing managers of these firms are the following:

- (1) Predicting the major changes taking place in the network of claimants.
- (2) Determining just what impact such changes will have on the firm's knowledge-stocks.

For example, HealthSouth Corp. (medical industry) undertook an ambitious, if risky, venture into consolidating rehabilitation services and outpatient surgery, two of the most profitable niches in the healthcare industry. In so doing, Richard M. Scrushy, former chairman and executive officer of HealthSouth, attempted to build a network of diagnostic centers, clinics, and hospitals in the 300 largest cities throughout the country. Going against the popular trend, HealthSouth's view was that the company had to be bigger in order to survive. HealthSouth expanded in the inpatient-rehabilitation business just when the industry appeared to have reached maturity. By not attempting to accurately predict the changes within the network of claimants, HealthSouth failed to identify nursing homes as new competitors, some of which offer the same services at lower prices.⁶⁹ Integrating the various services within outpatient rehabilitation clinics so that the company could realize synergies in its knowledge solutions in the face of both competition and shrinking markets was indeed difficult to predict and determine.

From 1993 to 1998, in terms of facilities operated, HealthSouth grew by almost 375% and operated in 1,900 locations in 50 states. Managing the colossal infrastructure created massive problems for the company, which resulted in the company being forced into bankruptcy in 2003. HealthSouth was faced with two of the fundamental issues of the network: uncertainty or

the difficulty of predicting how medical providers as competitors would extend themselves to hold on to customer-patients, and the effects of health care reforms on the company. It is clear that HealthSouth was forced to be more productive and efficient and was betting that its knowledge stocks, particularly the knowledge the firm had built on acquisitions and integration of outpatient-rehabilitation clinics, would reduce the uncertainty in the network of claimants. However, HealthSouth was unable to recognize the need for the wealth of knowledge stocks necessary for running a large organization. Their growth outpaced their ability to build knowledge stocks in areas of internal communication and organizational design. While they may have possessed the knowledge stocks to serve their patients, the organization became too large to control.

It is important to keep in mind that it is not any one force or claimant that leads to competitive advantage, but rather the coalescing of claimants. It is therefore incumbent on managers of knowledge services to spot the coalescing of environmental forces in order to position the firm favorably. It seems clear that the coalescing of claimants for IBM's recent successes involve (1) the decline of traditional manufacturing sector (2) the rise of knowledge services with profit margins higher in software than in hardware businesses to generate greater financial resources for the firm (3) the commoditization of its main product lines (4) a shift toward a younger workforce who control the means of production and are comfortable with being proventurers (more than 43% of IBM employees work remotely).⁷⁰ Combined, all of these factors forced the company to overhaul its business services with a series of acquisitions and, to a large extent, help explain the firm's recent first mover advantage into knowledge services.

CLAIMANT ANALYSIS

Given the heterogeneity of claimants on the sustainability of the firm, it is imperative that managers take into account the claimants who are most important, since not all claimants can be equally satisfied. Firms do not have unlimited resources. In order to isolate significant claimants that may impact and be impacted by the firm's activities, an analysis needs to be undertaken to prioritize which claimants are most important to the firm. When conducting such an analysis, many important elements have to be taken into account. However, a good guideline for knowledge services managers is to consider the following four germane factors as shown in Table 2-1:

Table 2-1. Claimant Analysis

<ul style="list-style-type: none">• Claimants affected by the firm’s knowledge stocks.• Claimants with an interest in the firm’s knowledge stocks.• Claimants in a position to affect the generation of knowledge stocks.• Those with the potential to become claimants.⁷¹
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Identifying each of these claimants and evaluating their influence and power is crucial. Failure to identify and rank claimants is setting the firm on a less than desirable course. Use of this general framework can assist managers in spotting the coalescing of environmental forces for sustainable competitive advantages. While knowledge service firms must be concerned with claimants both internal and external to the organization’s viability, the paramount focus should be on the activities of the most critical of its claimants—the engagement personnel or front-line worker—and on the customer.

THE LOGIC OF CUSTOMER ALLIANCES

One of the central purposes of knowledge service firms is the creation and transfer of ideas and information—knowledge—as value-added outputs. This means that these organizations operate under conditions wherein what they produce is highly intangible. The ever-present intangibility and variability of solutions to customer priorities in knowledge services makes it important that measures be taken to ensure that solutions create value for the buyer. One important way to accomplish this is to signal a firm’s competencies by building alliances, particularly with customers. In so doing, the firm becomes highly sensitive to market demands which, in turn, allow managers to quickly address and stay focused on customer priorities. The most effective way to address market demands is for the service organization to establish alliances with customers that directly and indirectly impact the generation of solutions and thus the firm’s performance. Customers are an integral part of the internal operations of knowledge services and this is what makes these organizations unique from other types of industries. Customers are a vital and indispensable part of the knowledge-generation equation.

Within knowledge services delivery, the customer acts as a supplier of information, assists in the solution, and is a consumer of the output.⁷² Hence, the notion of customers as “partial employees”, because they actually do per-

form task related activities in the generation of value-added solutions. In the healthcare industry, for example, customers or patients are becoming more assertive in offering doctors their own opinions and more often than not they have done quite extensive homework by making use of medical literature and references services. This trend is an outgrowth of rising customer activism and consumerism which have spurred direct involvement in the service output.⁷³ The net result is the creation of a complex interdependency which serves to elevate the customer to a co-producer and an active participant in the leveraging and generation of value-added services and the development of knowledge stocks within the organization.

Kaiser Permanente, the largest nonprofit health maintenance organization in the U.S., is a case in point. Kaiser allows its customers-patients to control their personal health records electronically through the use of Microsoft's Health Vault personal health record service. The patient is in a co-creator position, working to improve the quality of their medical care and contain costs. In the customer alliance, Kaiser patients, as co-producers of value-added solutions, have the ability to pose health related questions to doctors or other engagement personnel and even request prescription orders online. By linking consumer-controlled health records with Kaiser records, an information-sharing collaboration is established which makes it possible for the consumer to be more actively involved in the management of their health, particularly for chronic ailments such as diabetes, hypertension, and heart disease, which contribute significantly to health care costs.⁷⁴

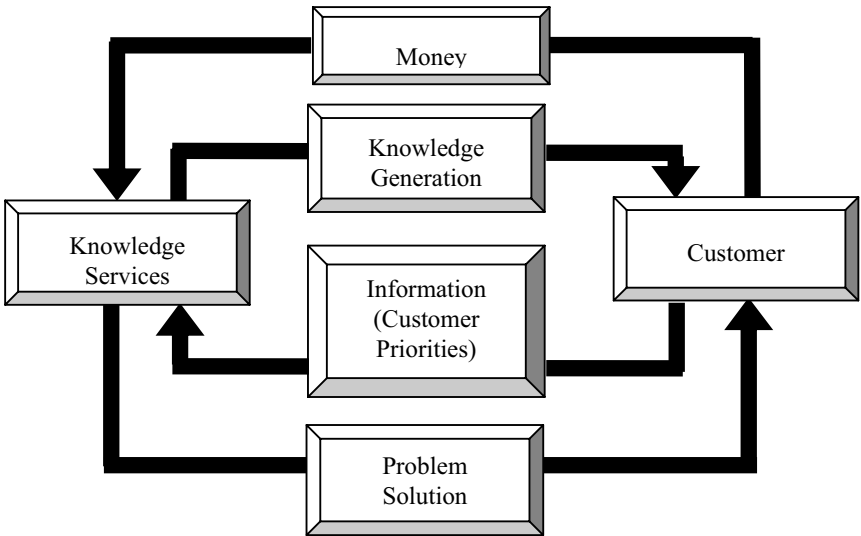
It has long been recognized that customer alliances are critically important to the activities of service firms and the overall competitive sustainability of these organizations.⁷⁵ In the generation of knowledge and solutions, both the organization and customers are in possession of resources—information, knowledge, skills—simply because of their positions as claimants both formally and informally. To the extent that resources are valued, scarce, and asymmetrically distributed in alliances, both the knowledge service organization and customers will have a vested interest in solutions, and will be induced to engage in mutually beneficial exchanges. It is paramount, therefore, for managers of knowledge services to recognize that customer alliances are partnerships or collaborations of the highest order which the firm can use to strategically leverage knowledge for value-added solutions. Put simply, the customer alliance is the focal point on which the success of the firm hinges. What distinguishes customer alliances from other types of customer relations is that customer alliances are first and foremost marketplace-based relationships⁷⁶ in which buyer and seller can negotiate and nurture the development of accumulated knowledge into exchanges for mutual gain. Thus, as cooperative problem solving relationships, customer alliances are implicit contracts between customers and knowledge service organizations in the rendering of solutions or value added services.⁷⁷

The agreement in such alliances provides a strategic framework between largely symbiotic parties to create value through which competencies are shared or transferred in attempts at knowledge creation and problem solving. This framework increases the switching cost of moving to another service firm for customers and makes it difficult for them to readily move to competitors. Customer alliances, therefore, have the potential to bind customers to the organization. It should be made clear that, strategically, customer alliances are not so much about managing or automating customer relationships as exemplified by the well known Customer Relationship Management (CRM). Instead, they set forth an evolving network mechanism to both connect and focus these service firms' resources with the environment in order to produce and leverage knowledge. As a result, the customer alliance becomes a most formidable competitive mechanism in its potential to create value from the transfer of competencies between claimants.

Customer alliances will only continue if there is mutual benefit or value for both the knowledge service firm and its customers. It is this potential for mutual gain that unites these two claimants or groups. As such, the knowledge resources transmitted are meaningfully expanded as the activities of one claimant become the inputs of the other. This exchange is pivotal and fundamental to knowledge service production. At the center of the firm's production is the customer alliance which is the core driver of all production activities. In this basic and complex relationship, attempts are being made to secure valued resources at the cost of others that are relinquished. When done well, the end result is greater satisfaction than existed before the parties took any action.⁷⁸

A strategic model of customer alliances in knowledge services firms is depicted in Figure 2-1.⁷⁹

Fig. 2-1. Customer Alliance: A Cogeneration & Exchange Model



The outer square of the diagram represents external markets of completed knowledge services. Here, customers and the knowledge service firm interact by exchanging money and knowledge in the form of solutions. The inner square of the diagram represents internal exchange of knowledge production resources. Here, information about customer priorities is the raw material that flows from the customer to the service firm. It is also here that knowledge or solutions are returned to the customer. One of the primary factors connecting the flow of resources (money, information, knowledge, effort, etc.) in alliances between knowledge service firms and customers is the value of such resources⁸⁰ or the firm's potential to create value for customers. In customer alliances, there is always an underlying assumption that the price being paid by customers will be equal to the value of the firm's knowledge solutions. This can be illustrated, for instance, in the alliance between health-care organizations and their patients. Healthcare firms are well aware that health insurance policies often exclude the cost of certain tests which may indeed be useful in assessing the overall well-being of the patient. Because hospitals are not in business to lose money, doctors will often refuse to perform such tests because they will not be paid.⁸¹ The doctors are simply adjusting their solutions to what the patient can realistically afford. Such adjustment is done in spite of ethical concerns and potential abdication of responsibility.

Advantages of Customer Alliances

Strategic Advantage: Customers are in possession of valuable information from which knowledge can be leveraged by the organization. With this as a backdrop, alliances with customers provide strategic problem-solving mechanisms not only to transfer tacit and explicit knowledge to consumers but for the organization to build firm-specific knowledge stocks as well. By being linked directly to the most important claimant in the value constellation—the customer—knowledge services can focus on building a more accurate strategic profile of customer priorities. Customer alliances provide a mechanism for knowledge services to make strategic decisions for the long-term future of the whole organization as a viable competitive entity. From this perspective, the knowledge service firm is capable of taking strategic actions to maintain its strengths while offsetting its weaknesses in order to exploit opportunities and counter threats.⁸² Such strategic decisions emerge from knowledge that is difficult for competitors to imitate. This is particularly the case in knowledge service industries where competencies tend to be subtle, hard to understand, and cause-effect relations in solutions are not apparent.⁸³

Consequently, strategic decisions for the firm can emerge from bold and insightful direction at the firm's lower levels by engagement personnel who are actively involved in customer alliances.

Fig. 2-2. Strategy from a Bottom-Up Approach



This is a bottom-up approach to strategy within the firm, as Figure 2-2 shows, which allows the firm to maintain its sharpness and uniqueness with little need to react to competitors. Instead, the firm maintains a competitive edge by seeing further into the future.

By focusing extensively on customer alliance for competitiveness, managers of knowledge service firms now have the potential to escape the insidious trap that these services often fall into: formulating their strategy reactively in attempting to keep up with competitors. Customer alliances keep the firm focused on customer priorities, resulting in the firm's ability to sustain a unique, competitive edge. These alliances afford the firm an opportunity to make strategic decisions that are more creative and forward-looking⁸⁴ as the firm is now capable of choosing just how best to fit its competencies and resources to the priorities of its customer. It is within this context that a comprehensive strategic plan can be developed for the generation and building of knowledge stock within the organization. Further, and more importantly, strategic decisions emerging from customer alliance create an overarching

guideline for subsequent subordinate decisions that are made within these service organizations. Solutions generated by knowledge services can become obsolete and perishable, particularly if the information defuses rapidly or loses its value.⁸⁵ Customer alliances create opportunities for increased and continued profitability by reducing outdated services and encouraging unusual insights by both engagement personnel and customers.

Signaling or Marketing Advantages: One of the inherent consequences of knowledge production is information asymmetry wherein engagement personnel, as proventurers, are in possession of more information than their customers. This creates a moral hazard as customers find themselves in a disadvantageous position because of the engagement personnel's potential to exploit the situation. A case in point is the recent (2003) Securities and Exchange Commission clampdown on tax shelters marketed by accounting firms. A 1991 change in the rules governing these organizations made it possible for accountants to charge performance-based fees similar to investment banks instead of the traditional hourly rate. Customers of the accounting firms offering the shelters contend that they were quite ignorant about tax law complexities along with the effectiveness of these shelters, and that they depended on the expertise of the engagement personnel and the reputation of the organization. Predictably, disadvantaged customers filed suits against their accounting firms.

There is an inherent credence factor in rendering knowledge services. Even after the customer's priorities are addressed, uncertainty still remains about the quality of the outcome. How can the customer be certain that the engagement personnel have appropriately addressed the customer's problems, particularly where quality and quantity of effort and skills are difficult to verify? For example, patients do not know if their physician is providing complicated, unnecessary tests. The patient is "uncertain" about the efficiency of the physician's performance. The same applies for programmers and contractors. When quality and quantity of outcome is difficult to determine the effort exerted by engagement personnel will serve as a reasonable substitute for output or assessing performance.⁸⁶ In other words, it is not so much the *solution* that is important, but the appearance of *effort* in the generation of solutions.

Customer alliances can serve to offset the clouding effects of information asymmetry and credence factors by making it possible to more closely observe and monitor the effort of the engagement personnel in signaling and presenting the firm's competencies and abilities to create value for the customer. The mutual potential for gain in customer alliance creates a framework through which both the firm and the customer can understand, gauge and exploit the efforts and performance of the other. Further, intent may be monitored as it pertains to the fulfillment of contracts and value creation.

Though information asymmetry still remains high (i.e., buyers still cannot adequately determine the value of knowledge), the alliance becomes a surrogate for ascertaining service quality and a potential source of competitive advantage because of the inherent vested interest of both firm and customer.

Tension Resolution Advantages: Anyone who has studied knowledge recognizes its hidden tension. Knowledge production—and by extension service solution—is largely created out of dialogue between peoples' tacit and explicit skills and experiences.⁸⁷ Under such conditions, conflicts and disagreements among claimants will inevitably emerge as new approaches to address customer priorities are attempted. Under conditions of such mild production turmoil, a degree of stability is accomplished by having some sort of mutual agreement between the knowledge service firm and its customers. This gives rise to gain-sharing in outsourcing contracts. For example, customers may base the perceived effectiveness of their lawyer's services by contracting on the outcome of the case while being unsure about the solutions proposed. The lawyer receives a bonus or a percentage of the settlement if the litigation is successful.

The same scenario can be seen in the relationship between a headhunter – employment recruiter and his/her clients. The recruiter finds qualified candidates for job openings and is typically paid a percentage of the new employee's first year salary. The headhunter has an incentive to find better-qualified candidates since these employees will be better compensated. This also benefits the newly hired employee since the recruiter is better off when they are able to place these individuals in better jobs. Conflict is reduced in the alliance because the recruiter and the lawyer have a vested interest in the outcome and all the consequences ensuing directly and indirectly from the generation of solutions to customer priorities.

This widely used approach of contracting on the outcome in customer alliances in order to reduce conflict provides a useful framework for mitigating goal incongruence or disagreement about expectations while simultaneously fostering the leveraging and generation of knowledge for addressing customer priorities. Both the knowledge services firm and the customer are afforded some degree of comfort in the alliance as a sense of equilibrium is realized. Further, and what is of strategic importance, the customer alliance, as an independent strategic unit, now undertakes a form of "franchising" (one party, franchisor, gives another party, franchisee, the right to be represented). This can again be seen through a lawyer-client alliance. Since the client is not well-versed in the legal system, the alliance or "franchise" is represented through decisions since they will be paid based on a percentage of the financial award determined in court. In so doing, contracting on specific outcomes, performances or agreements can serve as a quasi-control mechanism in providing knowledge service when customers would have difficulty moni-

toring the heterogeneous activities of engagement personnel. By sharing in the outcome, knowledge service firms and their direct representatives, engagement personnel, will be motivated because the outcome creates an incentive to be effective in those activities and skills the firm can control. Thus, by having a vested interest in the outcome, knowledge services firms will be less inclined to exploit their advantages and create conflict in customer alliances. Put simply, customer alliances emerge as a critical framework for reducing disparities in understanding by encouraging greater information exchange for mutual gain.

Social Capital Advantage: Customer alliances are social occasions because this is the way knowledge services allow new groups of people to interact.⁸⁸ At a very fundamental level, engagement personnel and customers, as buyers and sellers, can negotiate and nurture the generation and development of knowledge in an exchange relationship. What is quite important and implicit in customer alliance is a social contract consisting of a basic set of mutual expectations specifying the rights and obligations of customers and engagement personnel. As a community concerned with the generation and transmission of knowledge, customer alliances themselves become mechanisms for social action and therefore social capital.⁸⁹

While it is well recognized that there may indeed be challenges in creating this social capital such as communication barriers and physical distances between providers and customers, both engagement personnel and customers are in a position to learn about each other. Social capital can be advantageous to the firm because it provides access to contacts that may have vital information, skills, and knowledge for adaptive efficiencies. Stock research analysts at investment banks such as Morgan Stanley must develop a retail network of brokers who can provide a stream of commissions to pay for the analysts' advisory knowledge. Brokers and analysts are well aware of analysts covering stocks in particular sectors and the quality of knowledge they can generate. Knowing who knows what in alliances and having access to that information is social capital because such contacts will not only aid in reducing the amount of time and investment required to gather information for knowledge creation,⁹⁰ but will also aid in the firm's ability to adapt by making use of opportunities.

Bargaining Advantages: No organization can satisfy all its claimants. The resources to do so are simply not there. For sustained competitiveness, the firm must quickly realize that not all customers' priorities can be addressed. To believe otherwise would simply deplete scarce knowledge stocks and undermine the firm's capacity. Further complicating this issue is the subjectivity and heterogeneity surrounding output to customer priorities, which

invariably creates different versions of reality regarding the quality of service solutions.

These confining and restricting factors place knowledge service organizations in a constant trade-off between externally defined criteria for effectiveness of good services rendered to customers and the firm's internally defined criteria for rendering effective quality solutions or services. Generally, the customer perspective and the knowledge service firm's perspective are not in sync. This incompatibility is partially due to differences in the kinds of indicators that are used to generate the two perspectives. Knowledge service firms develop internal indicators or criteria based largely on measures of "objective knowledge input," while external indicators are based essentially on "subjective" measures of problem solutions from customer-client experiences and perceptions.⁹¹

Take a hospital for example. There is a growing recognition that a disconnect exists between the way medicine is viewed by doctors and how their patient-customers see it. Doctors in hospitals are rigorously trained to diagnose disease and treat it – internal indicators. In contrast, patients are mostly concerned with being tended to, being listened to, and being made well – external indicators.⁹² Some of these internal indicators can include screening mechanisms such as professional certifications and or college degrees.

In an effort to provide more of these objective measures, there has been an increase in the number of certifications available to service workers. A firm or employee who can demonstrate additional knowledge through these certifications stands a better chance when negotiating terms for a job or project. Contrasting subjective indicators with objective indicators when examining how effective knowledge services are rendered is sure to create incongruence between the two. The customer alliance has the potential to reduce such incongruence. Providing complex value-added services to customers entails a lot of bargaining as different views are leveraged. Customer alliances serve as an indispensable mechanism to reduce quality and effectiveness issues.

Competitive sustainability is all about using the organization's competencies and resources to address customers' evolving demands. This means that competitive sustainability, for knowledge service organizations, is a constant trade-off between what is critical by external definition and what is critical by internal definition, since the two are largely incompatible. Customer alliances can smooth the trade-off. Alliances provide a mechanism to facilitate the bargaining among claimants whose demands are continuously evolving as the firm builds knowledge stocks and competencies that are consistent with demands for sustainable advantages.

CLASSIFYING KNOWLEDGE SERVICES

Customer alliances are not all the same. They differ significantly in complexity and uncertainty, and are established to reflect the evolving priorities of customers. It is therefore not in the service organization's best interest to address all alliances in the same manner. Regardless the nature of the alliance, relationships are long lasting and must be addressed. The use of formal models to codify the alliance between customer and organizations are becoming increasingly necessary.⁹³ For strategic effectiveness and profitability, managers of knowledge services must instead segment and develop particular alliances with customers based primarily on the organization's knowledge stock and the particular priorities of its customers. What this means for knowledge services is clear. If emerging knowledge-based organizations are to continuously meet desired expectations and realize competitive sustainability, customer alliances have to be classified so that the organization can create value through the transference of matching competencies between buyer and seller.

Strategically, the types of customer alliances will impact the kinds of tacit knowledge-stock generated within the firm. A classification or typology of customer alliances is an important analytical tool to help better understand the demands and priorities of different customer niches and thereby to optimize value. Since tacit or firm-specific knowledge stock is a most valuable asset in emerging service organizations, the type of alliances from which such knowledge is generated becomes important. This has led to a rise in the number of highly specialized firms. Consider all of the law firms available for different types of cases. There are firms that specialize in insurance claims, personal injury, family law, criminal defense, and a large number of other detailed areas. This allows each law firm to be very strategic in selecting which lawyers to hire and which customers to pursue. The specificity allows the firm to generate deep knowledge stocks and become expert in one area.

Besides its analytical potential for managers, a classification of alliances focuses the knowledge service organization's investment in the leveraging and development of tacit knowledge. Consistently greater returns from investment in knowledge stocks can be expected from such expenditures. For knowledge-based firms, a classification of customer alliances is essentially based on four factors, as shown in Table 2-2. These features of the customer alliance define the value of the services to customers. For example, the ease with which one engagement personnel can be substituted for another reduces the costs of producing solutions and makes it possible for the service organization to offer its services to a larger number of customers at a lower cost.

Table 2-2. Classification Criteria for Customer Alliances

<ul style="list-style-type: none">• The complexity of the information leveraged in knowledge generation.• The dependence of the customer on the engagement personnel as reflected in:<ul style="list-style-type: none">a. Criticality of solutionsb. Degree of interaction intensityc. The duration of each contact episoded. The frequency of transaction reoccurrence• The nature of the problem solution as this pertains to:<ul style="list-style-type: none">a. Problem Resolutionb. Solution Ratification• Substitutability of engagement personnel in addressing customer priorities.

Based on these criteria, knowledge service firms can generate two fundamental types of customer alliances: **Problem Focused** and **Lateral Differentiation**. These types of customer alliances reflect different types of expectations between the organization and customer at the primary operating core or workflow in knowledge services. Workflow has to do with the interdependencies of key processes and people directly involved in the production of knowledge and the delivery of solutions to customers. One simple way to tease out the workflow in knowledge service organizations is to determine the activities necessary for knowledge generation and the delivery systems that have the largest number of engagement personnel.

Problem Focused Customer Alliances

Problem-focused customer alliances are customer relationships brokered to devise a solution to a very specific problem. These alliances emerge from short term interactions with engagement personnel and exist for a limited period of time. The duration of the interaction is just long enough for the service firm to satisfy a customer’s specific priorities. CVS Caremark Corp., the large retail pharmacy, exemplifies this alliance. CVS focuses on inexpensive solutions for the treatment of restricted health ailments such as sore throats

and rashes. The clinics generally prescribe basic drugs to customers. In order to provide the convenience and quality of care that customers desire, CVS focuses on providing a few services to a large number of patients. Volume is critical in the company's problem-focused alliance.⁹⁴

Problem-focused alliances entail a high degree of uncertainty and complexity. Customers in these alliances are generally quite knowledgeable about their priorities, but less certain about the knowledge needed for solutions and desired results. Customers of a brokerage firm know what sort of return on their investment they would like and expect the firm to use its expertise and knowledge stocks to fulfill the customers' expectations. Similarly, customers of an insurance firm expect agents to process and update policies and provide solutions to claims. The main intent of problem-focused customer alliances are to develop specific knowledge and skills for addressing recurring customer priorities along with the delivery of solutions to meet customers' demands and expectations. In problem-focused alliances, the service firm is in possession of explicit reusable knowledge stocks that are not generally accessible to the customer.

Since customers in problem-focused alliances are well aware of their priorities but lack the knowledge to solve their problems, engagement personnel rely heavily on innovative scripts to leverage and develop tacit knowledge for solutions. The alliance between Charles Schwab and its customers is a case in point. The alliance requires brokers, as proventurers, to spend time creatively assisting customers who are faced with many investment possibilities or alternatives. Using computer-generated stock ratings, Schwab provides full service investment advice at relatively lower cost than firms employing human analysts.

Once the problem is solved within defined constraints, the alliance is terminated or consummated. The firm is now in a better position to lower costs and realize gains, either through reduced competitive prices or increased margins. Cost efficiency is enhanced when certain solutions can be delivered to multiple customers. By focusing their services, firms meet the prior expectations of customers: speed and consistency of services. Value is realized when customers are served in the shortest period of time and at the least possible cost.⁹⁵ Thus, problem-focused alliances foster large numbers of customers and such alliances are repeated frequently.

As engagement personnel interact with multiple customers, they will gain experience over time in producing tacit knowledge in a variety of settings. This variety will give employees a greater understanding of their own potential services as they learn how to adapt them to solve the problems of individual customers. As such, the service firm will acquire tacit knowledge for a group of customers with a common set of problems. By focusing on developing tacit knowledge concerning the underlying problem which customers are

experiencing, customers with similar problems will respond similarly to various knowledge mix factors.

Recall the previously mentioned example of tax shelter devices developed by large accounting firms during the 1990s that produced a vast market of potential customers. What made these tax maneuvers so attractive to customers and profitable for accounting firms was that once they were devised, the firm could sell these instruments to a vast number of customers. The firm realized lucrative and efficient economies by simply selling the same transaction to a wide array of customers. In so doing, commonly understood implicit problem statements in the firm's customer alliances serve to economize on contracting time. This in turn allows the firm to increase its margins and to concentrate on leveraging and developing problem-based tacit knowledge.

Organizations in problem-focused customer alliances are characterized by power relationships in which much of the knowledge that is generated is concentrated on problem "resolution": addressing customer priorities. In this context, the engagement personnel occupy a relatively more powerful position in relation to the customer. The knowledge controlled by engagement employees, and thus their general power in the alliance, can be viewed as a function of valued skills, experiences, or desires by customers.⁹⁶

Lateral Differentiation Alliances

A lateral differentiation alliance seeks to create a "total solution" to the customer's needs. While there may be a specific underlying problem, the service worker is engaged to assess an entire department or organization, rather than simply one small issue. The customer's demands in lateral differentiation alliances generate a different set of expectations for knowledge service organizations. The relative complexity and breadth of problem solutions create demands such that the service organization in lateral differentiation alliances may be limited to a few, or in some situations, a single customer over an extended period of time. For example, it is not unusual in the banking industry for knowledge services to develop advisory relationships that typically drag on for years with customers concerning tax investment tactics. Some marketing agencies have long-term accounts with customers. This is exemplified in the advertising agency McCann-Erickson's 60-year alliance with Coca-Cola Co., which turns out to be one of the most enduring alliances in the annals of advertising.⁹⁷ Unlike problem-focused alliances, knowledge services adopting lateral differentiation alliances will not be exposed to enough variety to develop tacit knowledge regarding a set of underlying problems. While some learning regarding a customer's underlying problems may indeed occur, such understanding will be relatively small.

Knowledge service organizations with stable lateral differentiation will leverage and generate a different type of tacit knowledge because these alliances entail greatly varying contingencies. As these service organizations have repeated and prolonged exchange with a restricted set of customers, their knowledge production regarding the customers themselves will also expand. The knowledge gained from lateral alliances will allow the organization to better understand their customer's idiosyncrasies and in so doing, develop and generate new and other service solutions for such contingencies. The value to the firm is that this knowledge increases the switching costs for customers as it is now much more difficult and costly to purchase the services from competitors. Both parties have invested heavily in each other.

Consequently, the firm is now in possession of increased knowledge stock on how best to address the customer's current priorities as well as other customer-related issues. From this advantageous position, managers can anticipate the customer's future needs and develop solutions for such contingencies. In lateral differentiation, the intent is to provide total service solutions to customers. For example, the so-called "adaptive enterprise" tactic, undertaken by technology companies such as Hewlett-Packard Co., IBM, and Sun Microsystems Inc. to make their corporate customer more responsive to change, is an attempt to develop future solutions and new value propositions. The adaptive enterprise tactic seeks to generate total service solution tools which will enable customers to evaluate their IT systems and to identify how well those systems can adapt should there be unexpected demands placed on them.⁹⁸

Laterality is the incorporation of various aspects of the customer into a total or holistic product that is taken into account in the generation of knowledge and solutions.⁹⁹ For example, a financial advisor may have to consider not only a customer's financial status but also such factors as the customer's emotional state, physical health, familial situation, desires, consumptive patterns, personal relationships, and so on because these factors may affect the long-term investments in order to satisfy customer priorities. As the engagement personnel's laterality to the customer increases, a greater variety of alternative behaviors will be required. The laterality allows for the leveraging and generation of knowledge based on a wide array of activities in the customer's interest. This stretches the boundaries of possibilities when it is necessary to do so. Consequently, lateral interests in which the customer has to be considered as a whole adds complexity, scarcity, and costs to knowledge creation and solutions, which increase the cost to the customer in switching to a competitor.

In contrast to problem-focused customer alliances where the emphasis is predominantly "problem-based," laterality differentiation alliances are more "total customer-based." The requirements for fulfilling lateral differentiation or laterality are far from simple, and managers must be unconventional in or-

der to prevail. Laterality requires an understanding not merely of current priorities, but being able to anticipate what might be of future interest, primarily through peripheral offerings. CareGroup Healthcare System, a hospital company in Boston, has collected valuable information on its 2,500 doctors so that managers of CareGroup who work with doctors can spot trends and suggest ways for improving the rendering of medical services such as recommending certain prescriptions. Thus, lateral differentiation alliances provide an important opportunity for the firm to develop tacit and creative skills not only to leverage current customers' desires, but to anticipate future needs. This provides a competitive advantage for these service firms to create knowledge stocks in response to emerging market trends.¹⁰⁰

A distinguishing feature of lateral differentiation alliances is the concern in these relationships not only for problem resolutions but solution ratification as well. As an active participant or co-producer of tacit knowledge, customers often generate their own solutions to satisfy their priorities. When customers provide their own solutions, the role of the service organization is far different from problem resolution situations. The service firm is needed only to ratify or provide certification that the customer's problem solution is viable and appropriate. Frequently, customer-generated solutions often stretch the boundaries of what is generally recognized, because they have never been tried before and may be subject to scrutiny of some governing body. For example, in order to access the 40 million people without health insurance, many insurance companies have come up with the novel solution of selling low premium policies through associations. However, many states require that associations offering policies be formed and maintained for purposes other than the sale of insurance. The appropriateness of associations and health markets under the law is a debatable issue and has begun to attract the scrutiny of insurance commissions in many states, including California.¹⁰¹ In this case, knowledge service firms would provide certification to the insurance companies. The firms would verify the legitimacy of the association and provide "permission" to sell the insurance policies. This is an important service, given the legal issues and the fact that this tactic had never been tried before.

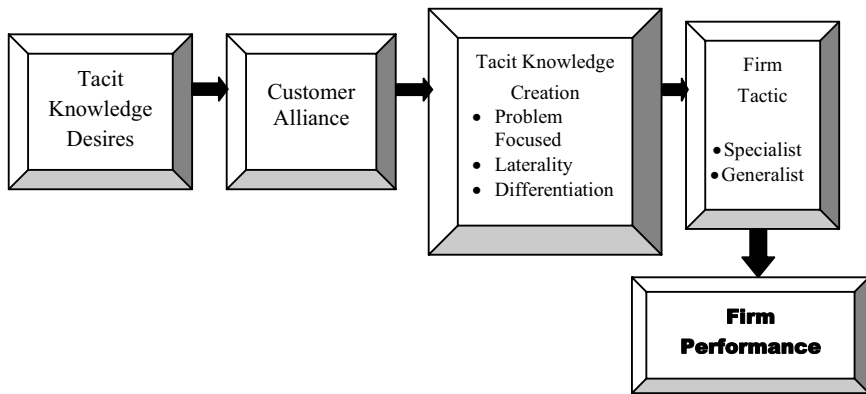
Lateral differentiation strategies have a lot of output heterogeneity; one factor that is potentially destabilizing. This is a result of customers' ignorance of both goals and processes and the uncertain vigilance of front-end service employees. This places crucial importance on the nature of the transactions throughout the initial and subsequent phases of the alliance. This is where professional distance by the engagement personnel comes in. Negotiations inherent in professional distance provide the forum to define meaning to objectives and expectations. Within this frame, evaluation is a merger of responses where claims, concerns, questions, and issues raised by the parties become the focus of attention.

Given that lateral differentiation strategies require a holistic view of the customer and heavy dependence of the front-line engagement personnel, vast opportunities are created to generate total solutions and in the process generate knowledge stocks for future customer priorities. One of the advantages of a lateral differentiation strategy is that the entrepreneur can adopt a generalist approach while innovating, taking risks, and exploring new service opportunities through expanded service lines. To sustain the momentum, the lateral differentiation strategy must be focused on three goals: exploiting the laterality of services, developing proprietary services, and maintaining a good reputation.¹⁰²

CUSTOMER ALLIANCES AND TACIT KNOWLEDGE STRATEGY

To create value and therefore competitive sustainability, knowledge service organizations must establish some sort of strategic framework that will creatively guide the firm in meeting desired expectations. For these organizations, the formulation of knowledge strategies is necessary for sustainability as the firm seeks to align its knowledge stocks and other capabilities with customer priorities in ways that would be clearly superior to those offered by other competitors.

It seems clear that customer alliances in knowledge services are important for competitive advantages because alliances are forms of collaboration that allow these service firms to cope, adapt, and anticipate environmental changes. The collaborative skills required and the resulting knowledge production process is not readily copied by competitors. Tacit knowledge, because of its tangibility, is developed from repeated experience, particularly by engagement personnel as they collaborate with customers. Tacit knowledge is therefore unique to these service firms. It is not easy to imitate since it tends to be subtle, hard to understand and cause-effect results are not apparent.¹⁰³ Furthermore, such knowledge creates competitive advantages because tacit knowledge is difficult to purchase.¹⁰⁴ Customer alliances provide a strategic problem-solving mechanism to leverage knowledge in building knowledge stocks that are specific to the particular firm in the alliance and thus sustain the firm's profitability.

Fig 2-3: A Model of Competitive Strategy in Knowledge Firms

Since tacit knowledge stock is the most valuable asset in knowledge service organizations, we can reasonably expect that the type of alliances from which such knowledge is generated becomes paramount in profitability and competitive sustainability. This is shown in Figure 2-3. The types of customers and the alliances in knowledge service firms have will impact the kinds of tacit knowledge the organization will generate. It is also important to note here that the importance of customer alliances in gaining competitive advantages for knowledge services organizations makes it extremely important for the firm to develop the ability to persuade customers of long-term alliances.¹⁰⁵ Further, such long-term alliances would be a clear signal not only of the firm's ability to address customer priorities, but just as importantly, it would also enhance the firm's reputation. Managers can use this reputation to build the firm's brand image for competitiveness and use it to create entry barriers for competitors trying to enter the industry. Long-term alliances provide for a more sustainable competitive advantage and the potential to generate more tacit knowledge: the more tacit knowledge a firm has in its possession, the more the firm has the potential to learn.¹⁰⁶ This, in turn, will create high switching costs for customers, which places the firm in a better position to charge a premium price for the value-added services generated.

Problem Focused Alliances and Knowledge Tactics

Given the high intangibility surrounding knowledge production and solutions to customer priorities in knowledge service firms, buyers have great difficulty ascertaining service value. Though the firm may be especially adept at producing solutions, customers may not be able to recognize this superior quality because of information asymmetry. In problem-focused customer alliances, where the emphasis is on a specific set of problems and an interaction with a variety of customers, information asymmetry can be reduced and competitive advantage realized by specializing in a particular kind of problem around which tacit knowledge is generated. In so doing, the knowledge service firm focuses not so much on a reduction of customer in-

put to the co-creation of solutions, but on the firm's ability to address a specific number of unique buyer needs.

Knowledge services in possession of problem-focused tacit knowledge for common customer priorities can realize economies of scale in the specificity of knowledge stocks, reducing costs which can then be passed on to customers in the form of lower prices. This production configuration creates a competitive advantage for these services firms because the organization is now in a better position to tailor its offering to the unique demands of a variety of customers. In so doing, the service organization has essentially adopted a **specialist** tactic wherein the firm possesses an advanced knowledge of how numerous knowledge solutions can address customer priorities. While advanced knowledge of this nature may indeed be generally the same for competitors in level, scope, or quality, the specific tacit knowledge content can be expected to vary among competitors, thus giving rise to tacit knowledge differentiation.¹⁰⁷

Consequently, a specialist tactic provides an opportunity for knowledge services in problem-focused alliances. New areas of knowledge stock are formed within the confines of a common set of underlying customer problems by developing and leveraging tacit knowledge to address these gaps. Because of the newness of these gaps or services lines, managers can sustain a competitive advantage. We can therefore expect that knowledge service firms in problem-focused alliances will develop tacit knowledge as they engage in customer priority specialization and limit the array of services they offer to those in the alliance from which their knowledge is generated.

Lateral Differentiation Alliances and Knowledge Tactics

In lateral differentiation alliances, the primary focus is on laterality in which the customer is given a total or holistic service. The firm is concerned with the generations of solutions to address a totality of customer priorities. Thus, these knowledge service firms are focused on total customer-based tacit knowledge that requires relatively more customized service offering. What is significant about total customer-based knowledge is that such knowledge is generated according not only to what the customer wants, but in anticipation of what is in the best interest of the customer.

Service firms in lateral differentiation alliances that possess total customer-based tacit knowledge face a different kind of challenge. Their competitive advantage does not lie in the production of a particular service, but rather in their intimate knowledge of the customer. The types of knowledge being alluded to here do not emerge from just going beyond expectations in satisfying the customer's immediate problems and priorities, but more importantly, they grant the service organization insight as to the future requirements of the

customer. Thus, service organizations with total customer-based tacit knowledge may be able to predict future problems that the customer is likely to encounter. In response, the service firm can construct a repertoire of knowledge stocks for value-added solutions (i.e., services) that can be sold to the customer in the event of, or even prior to, the occurrence of a problem. What is being generated and developed here is **advanced** or **anticipatory** tacit knowledge the content, scope or quality of which will create variation among competitors thus giving rise to what can be viewed as knowledge differentiation.¹⁰⁸ The seller is now capable of raising prices and realizing greater profitability.

However, managers of knowledge service firms in possession of total customer-based tacit knowledge may be confronted with another issue. Customers often cannot readily determine what is in their best interest, and therefore may not appreciate the quality and value of solutions. Customers, as buyers, will therefore look to other factors for gauging the quality of knowledge solutions and will focus particularly on secondary activities.¹⁰⁹ For total customer-based knowledge development, customers will make attributions based on the development of solutions for peripheral services or customer problems. For example, while a buyer may be able to ascertain the appropriate value obtained from a managerial consulting service, he or she may make attributions of value based on accompanying or secondary services, such as computer programming and hardware acquisition assistance.

For knowledge services in lateral differentiation alliances, competing successfully means developing knowledge stocks on several fronts with the possibility of providing a total solution that would include both primary and secondary customer priorities. This will provide “increasing returns”¹¹⁰ for the service organization and sustain its competitive knowledge advantage. What this does is place the knowledge service organization in a position of knowing more about its customers along with solutions to their priorities. It would take a vast amount of investment for competitors to develop such knowledge stocks in order to catch up. (e.g., IBM’s lead over HP in the business solutions services market and HP’s failed expensive attempt to acquire PWC in 2000 in order to build knowledge stocks in this market, or HP’s recent attempt to acquire EDS to catch up with IBM)

It is clear that in order to develop total customer-based knowledge stocks for sustainability, a **generalist** tactic provides these service organizations with a competitive advantage. Many customers’ needs and priorities would be well known in these lateral differentiation customer alliances, thus making it possible to provide a wide array of solutions and services to address such needs. As a result, the service firm is now in a more advantageous position to distinguish itself and charge a premium above competitors’ rates.

Table 2-3: Problem Focused vs. Lateral Differentiation Alliances

	Problem Focused	Lateral Differentiation
Generic Strategy	Low Cost	Differentiation
Skill Set	Specialist	Generalist
Target Focus	Economies of Scale	Holistic Service
Duration of Engagement	Short Term	Long Term
Increase profitability by	New service lines	Value added solution
Sample engagements	Corporate logo design	Ad agency on retainer to manage brand

THE SIGNIFICANCE OF GOOD ALLIANCE

It seems clear that strong alliances – aligning the interests of stakeholders or claimants – can be of immense benefit to the firm such as building knowledge stocks, gaining new customers and enhancing reputation. It is also the case that misalignment of alliances carries great risks. Poor alignment of alliances will create inappropriate strategic direction for managerial behavior with adverse effects on the firm’s performance and threaten the very existence of the firm. While some firms may adopt both a generalist and a collective of specialist, these tactics will be treated quite distinctly because each requires different managerial approaches for overall organizational effectiveness.

SUMMARY

We began this chapter with the perspective that possessing tacit knowledge is of the utmost importance to knowledge service organizations and that certain characteristics of the customer interaction can lead to challenges in developing and leveraging this resource. Knowledge services gain competitive advantages by engaging in various kinds of alliances with customers in order to build capabilities. Using the vantage point of these service organizations as leveraging tacit knowledge, a model was presented of knowledge services strategy and performance, suggesting that alliances with customers create knowledge competencies that these organizations can leverage particular tactics to achieve competitive advantage.

One of the important implications of the model is the importance of the two broad types of alliances, problem-focused and lateral differentiation. On one hand, these alliances create different forms of tacit knowledge. On the

other hand, alliances may also provide some understanding about the service organization's choice or knowledge strategy: to spread its resources across a broad spectrum of service offerings, or narrow its focus in the generation of tacit knowledge and thus the potential of value creation. Essentially, these alliance types may serve as a signal to customers regarding the types of knowledge solutions that the service firm possesses.



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