# BEYOND THE

# CONTRACT

## DRIVING VALUE FROM THE RENEGOTIATION PROCESS

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**The recent economic downturn has underscored the difficulties involved in the area of managing third-party spend, making contract renegotiations even more centerstage. That puts the focus on the numbers, which can be relevant. However, it can also be problematic as it can underplay the importance of the renegotiation process as an opportunity to reassess operational efficiencies.**

Since the 1960s, companies have increasingly moved away from vertical integration and instead veered toward greater specialization as they strive for competitive advantage. One indicator of this trend is the increasing size and breadth of the outsourcing industry. According to research analysts, IT and business process outsourcing are now a $400 billion to $800 billion dollar industry.[1] In fact, these numbers—while large—understate the true scope of outsourcing, as they do not include the outsourcing of industry-specific functions such as contract manufacturing, oil field services and clinical trials. Outsourcing relationships are clearly important, both financially and strategically.

This trend has had many benefits, but it also requires a core competency associated with building and maintaining an extended network of suppliers, distributors and other alliances. The recent economic downturn has underscored the difficulties involved in the area of managing third-party spend, making contract renegotiations even more centerstage. That puts the focus on the numbers, which can be relevant. However, it can also be problematic as it can underplay the importance of the renegotiation process as an opportunity to reassess operational efficiencies. For reasons we will describe, this process can be a valuable event.

## THE NOT SO FINE PRINT

Unlike salary and related costs, which are typically directly under the control of the company's management, spend with third-party suppliers is generally governed by stringent contracts, which often dictate terms such as the price paid to the supplier over the entire life of the contract. Such protections prevent suppliers from using any leverage after the contract has been signed. Yet quite often this protection against a rise in prices is the same stipulation that greatly limits the buyer's ability to reduce its spend with third-party suppliers through promotions such as quantity discounts.

There are significant limitations to the approaches many companies use in negotiating and renegotiating third-party contracts. Getting beyond these typical approaches can result in significant savings to the buyer of services, while preserving, or even improving, the relationship with the suppliers.

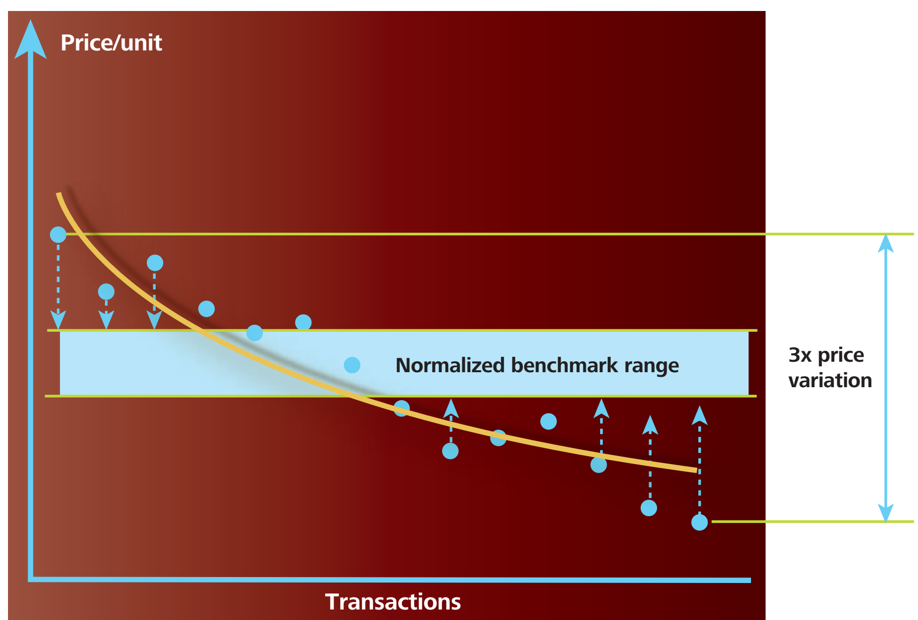
### *Typical Approach #1: Benchmarking*

When faced with financial difficulties, buyers of outsourced services frequently approach contract renegotiations aggressively. If they have the right to conduct a benchmark, they hire a benchmarking organization with the hope of discovering that the "market price" is substantially lower than their current contracted pricing.

Unfortunately, there can be issues with benchmarking. First, in many service areas, the price per unit varies tremendously, in our experience often by as much as 300 percent between the lowest and highest price in the market. This variance makes it technically difficult to conduct an assessment of pricing because the veracity of any purported benchmark will likely cause a nonproductive discussion.

Next, the process of benchmarking normalizes the actual pricing curve to adjust for various factors. This adjustment or normalization flattens the actual shape of the pricing curve in order to produce a set of comparable data points (Figure 1). While this may seem at first to be a coffeehouse conversation for statisticians, this reshaping of the pricing curve can remove what is potentially valuable information to the buyer and supplier. Specifically, the buyer often makes choices regarding level of service, method of service delivery (e.g., onshore/offshore) and level of customization that significantly drive up the cost of service delivery. The normalization process results in the removal of the effects of those choices on the range of pricing – effectively hiding from the buyer the cost of their decisions. The authors find that revelation of the true pricing curve often results in a very productive conversation in which the buyer and supplier can review the requirements and service levels and their impact on both cost and pricing. Together they can then make informed choices as to requirements going forward.

**Figure 1: Sample benchmarking exercise**




Finally, and perhaps most importantly, the benchmark focuses the dialogue with the supplier on proving or disproving the numbers rather than getting to the heart of the issue: What can the buyer and supplier do together in order to reduce

the cost of delivery and price of service, while maintaining or improving business performance?

*Typical Approach #2: Strong-arm*

In combination with or in place of benchmarking, the buyer often uses strong-arm tactics during contract renegotiations. In order to gain a small price reduction, the buyer may threaten to end the business relationship if the supplier does not meet his or her demands. This approach also has a number of challenges.

**While a natural focal point of any contract discussion tends to be "the number," it can be helpful to consider some of the other areas for negotiation. Often these will yield better results for all sides.**

First, contracts often contain termination clauses that either prevent the early termination of the contract or generously compensate the supplier should early termination occur. In other words, the buyer lacks leverage, and suppliers are often disinclined to negotiate. (A health plan provider recently asked 10 suppliers for price reductions as a result of the economic crisis. Out of the 10, only one offered a substantial price reduction – greater than 5 percent. Not too surprisingly it was the supplier whose contract term ended within 12 months.)

In one respect this is understandable – what may be viewed by the buyer as a modest price reduction (e.g., 10 percent) can represent two-thirds of the supplier's profit margin on the account. As a result, this difference in perspective on even a seemingly modest price reduction between buyer and seller can often result in contentious and unproductive discussions.

Finally, an almost gladiatorial focus on price can inhibit the ability of the parties to address additional underlying contractual issues and opportunities that can have a worthwhile impact on both parties.

## TAKING IT UP A LEVEL: A RELATIONSHIP FOCUS

During the renegotiation process it may be more beneficial and productive to consider a big picture view of a mature outsourcing relationship. A more

holistic approach can be more effective while preserving and generating value from the relationship with one's suppliers. Following are some important characteristics of a broader approach:

**Use the renegotiation as an opportunity to address many factors beyond price.** For example, the buyer may want to increase the supplier's scope of services provided in one area but decrease its responsibilities in another area. A common example of this in today's IT outsourcing market is to increase the amount of applications maintenance and support services provided by a supplier thus enabling the buyer's project managers and business analysts to be redeployed to more strategic development projects.

**Solicit the supplier's ideas, and solicit them early.** The supplier is often better positioned than the buyer to recommend opportunities for financial and operational improvement. There is a potential benefit to the early involvement of the supplier, as it can create positive momentum for the renegotiation and reduce the level of contention. A common concern in outsourcing is the potential lack of innovation from the supplier, however, any such fault is often mutual.

In one contract renegotiation we observed, the supplier developed a list of over 20 cost reduction ideas, many of which had not been identified by the buyer. One opportunity was to remove the duplication in the two quality assurance groups by using only the buyer's QA group, rather than the buyer's and supplier's, to measure service levels and audit quality. A second opportunity was to review the buyer's rather onerous security requirements, which resulted in unnecessary site startup costs in excess of $600,000 per site more than those of other supplier sites for companies in the same industry.

**Pull all negotiation levers, not just rates.** Many companies approach contract renegotiations purely from a financial standpoint: What is the rate paid? Can procurement negotiate a rate reduction of 10 percent? In the authors' experience, pure rate negotiations tend to result in minimal price reductions as suppliers' margins are directly impacted.

## AREAS FOR RENEGOTIATION

There are several additional areas that can be addressed during contract renegotiations that can positively impact both buyer and seller. Prominent among these are efficiency, demand management and contract structure.

### *Efficiency*

Efficiency is an obvious lever and opportunity for cost reduction. Reducing cost by leveraging the supplier's greater scale, experience and labor arbitrage is often the critical objective in an outsourcing transaction. However, there are two areas that the renegotiation team should analyze in order to determine the potential for improved efficiency.

The first area to explore is market-driven opportunities that have developed since the execution of the original contract. It is likely that the competitive procurement process revealed operating efficiencies available at that time. However, outsourcing markets evolve over time. Technologies improve. Price points come down. Suppliers increasingly find ways to drive down their costs through automation, better use of scale, self help and increased offshoring. As a result, there is often an opportunity to update and enhance the efficiencies associated with the current operating model, enabling a supplier to reduce the cost to serve and thus the price that supplier must charge.

The second area to analyze is the removal of certain contractual constraints placed upon the supplier. In a first generation contract, the buyer often imposes specific conditions upon the supplier such as requiring the use of certain assets, sites and personnel. This is not uncommon in the world of outsourcing,

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given the uncertainties associated with it. However, during contract renegotiation, the buyer may gain a better understanding of the supplier's capabilities and may be in a position to remove some of the restrictions stipulated in the original contract. Examples of such restrictions might include the use of the buyer's data center and associated software, the use of the buyer's customized software rather than the supplier's standard platform, and limitations on the use of offshore resources. Removal

of these constraints can allow the supplier to standardize its delivery of services for the buyer. The supplier may also develop stronger economies of scale in its client delivery model.

### *Demand Management*

An important task during contract renegotiations is to determine if the buyer is exercising proper governance over its demand for services. After all, one effective cost management approach is not to incur the cost at all.

In the case of one company, the scope of outsourcing services provided by the supplier was too large. The IT supplier was responsible for both the provision of computing power and the performance of the application portfolio. The IT supplier stopped regularly fine-tuning the applications' performance, and MIPS (a measurement of data center capacity) nearly tripled over a five-year period while the underlying business volumes grew less than 50 percent. Perhaps this is not a surprising result given that the supplier was paid per installed MIPS. After re-tendering the data center services, another supplier was found that would guarantee a reduction in data center capacity by a third without a degradation of the service to the business. This provided the buyer the ability to reduce cost by a third before even considering rate reductions and other potential cost reduction levers.

This example is far from atypical. Effective governance of any supplier is a necessity, and this often requires a refocusing of resources: While the delegation of the review of the financials to the finance department is common, that group may not have the subject matter expertise to exercise sufficient control over the resources expended.

### *Contract Structure*

Contract structure can provide incentives to the supplier to achieve the desired balance of cost, service levels and innovation. It can also motivate and improperly reward the supplier for actions that improve the supplier's margin without any corresponding benefit for the buyer. There are many examples of these contract structures that bear unexpected consequences. In application development and maintenance contracts, it is common to pay for support by the hour and to pay for development in a fixed fee arrangement. While there are positives to such rate structures, the potential negatives must be understood and mitigated. For the provision of application support services, pay per hour does not encourage productivity, as greater productivity equates to less revenue. A solution is to monitor cost of support per application group and other forms of productivity. Similarly, for the provision of application development services, fixed fee pricing can be useful in a competitive bid situation.

Although the above examples are specific to one form of outsourcing, there are similar challenges in other forms of outsourcing (e.g., pay per hour in a call center versus pay per call or pay per transaction). More generally, a very common structural challenge is in the annual cost of living adjustment (COLA) clause. The authors have seen many situations in which the COLA clause has inflated the price of service to 30+ percent over the first-year contract pricing in spite of the fact that market rates were flat during this period. The reality is that market pricing continues to fall in real terms in most service areas due to innovation and the never-ending competitive pressures. A long-term COLA charge not only prevents the buyer from benefitting from lower prices, but actually *raises* costs instead.

**Figure 2: Actual billing rate vs. Approximate offshore rate trend**

Source: Deloitte Consulting LLP analysis; Infosys Annual and Quarterly Investor Reports

## PUTTING IT INTO PLAY

While a natural focal point of any contract discussion tends to be "the number," it can be helpful to consider some of the other areas for negotiation. Often these will yield better results for all sides.

One example with which we are familiar brings many of these factors into play and highlights several underlying issues.

A U.S.-based health plan provider spent approximately $70 million per year with one primary IT supplier. While generally pleased with the relationship and the service levels, this company—like many health plans—faced significant cost pressures in 2009 due to the continuing recession and turned to its primary supplier to find ways to reduce those costs. However, (perhaps because the contract had been renegotiated and signed recently in 2006), the supplier was unable to offer substantial savings.

In fact, the initial price reduction offered was under 2 percent.

This seemed very low to the health plan provider and was not a particularly satisfactory outcome for either party. Leadership recognized that the conversation would have to be broadened beyond pricing for the status quo and appointed a team to conduct four weeks of analysis and data gathering. The team identified several opportunities for renegotiation:

- **Move out of the health plan provider's dedicated data center into a fully leveraged supplier data center.** This decision highlights an important aspect of renegotiations: *They are often the trigger point for a reassessment of efficiencies and service levels.* In this case, the supplier data center was an enabler for offshoring and—through scaling—much-improved disaster recovery capabilities as well as more cost-effective upgrade opportunities. The dedicated data center was a customized solution and perhaps made economic sense when it was created. But time and technology changed the cost and service level equations. The supplier did not knock on the buyer's door to recommend these potential changes. Nor did the manager of the dedicated data center have an incentive to reassess whether the status quo was the preferred solution. However, a joint analysis of the opportunities for improved efficiency surfaced the option and enabled a proper decision. A simple price renegotiation in this case would have resulted in lower levels of cost saving and potentially reduced service levels with increased operational risk over time.
- **Change the infrastructure support model by moving from a dedicated resource pool into the supplier's global delivery model.** Related to the move to the supplier data center, *cost savings were realized through offshoring with no negative impact to service levels.*
- **Right skill the delivery team.** The original intent had been for the IT supplier to perform, among other things, the network architecture role, resulting in a resource profile that was more senior in some areas than called for based on the types of work done. However, the health plan provider assumed much of the architecture function in-house. Tasks had changed in the interim, a very common situation in IT in any industry. But the contract had been structured with high-priced people in the data center even as the buyer had kept its own architects in place, essentially doubling the cost basis for this IT function. The lesson here was a simple one: Look at actual work being done and the assumptions made in the existing contract.
- **Move from input-based pricing (hourly rate) to an output-based model (fixed price per device per month).** The initial pricing approach,

paying at a blended hourly rate, has advantages and disadvantages in various environments. In the data center scenario, where task metrics were available, reliance on an hourly rate was not an effective motivator for improved productivity. During the renegotiation process, the team looked at service operations industry trends in terms of the number of calls handled, the number of PCs supported, the number of remote problems resolved on the first call and other measures. They determined that those metrics had improved industrywide. Rather than simply latching onto benchmarks and using those as a numerical cudgel, however, the team analyzed what had happened that had driven efficiency and which of those innovations or improvements had been implemented by the IT supplier. Renegotiation is an opportunity to assess what has happened in marketplace trends, to incorporate any such efficiencies into the resultant contract, and to determine

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that any marketplace technology gains are shared equitably. This was the basis for a collaborative conversation about how to apportion the gains. It is important to note that some efficiency gains require collaboration between buyer and supplier. For example, while a call center may be able to function more efficiently if a company uses a single sign-on process for its intranet applications, such a process may require technology changes driven by the company's CIO and perhaps organizational changes to overcome silo tendencies.

- **Improve the contract structure (e.g., by implementing a third rate card as opposed to the two rate card structure that was in place).** This

was a fairly straightforward change. In effect, the supplier had staffed positions billed at a $90 hourly rate (U.S.-based or "onshore") with medium-term workers in the United States. A third rate card captured the savings the supplier realized in staffing these roles and passed the cost savings to the health plan provider. The issue was not legality. However, it does reinforce the risk of focusing contract renegotiations solely on price and placing the supplier in a defensive, perhaps subtly adversarial, position.

The above opportunities represented a potential cost reduction between 15 percent and 25 percent by service area. After renegotiation and careful evaluation of these options, the health plan provider realized overall savings of approximately 20 percent. The vendor likewise emerged with an arrangement that was far preferable to taking a 3 percent haircut.

In another example, a telecommunications provider was divesting from a larger cell phone company to be in compliance with a regulatory requirement. It needed to negotiate a new contract for customer service (call center, interactive voice response {IVR} and so on) and associated functions and was under significant time pressure. Initially, to expedite the separation of its operations, the company decided to obtain a relatively standard bid from a single provider. It did not look for opportunities to leverage its volume of business nor encourage efficiencies.

As advisers on this project, we encouraged the telecommunications company to postpone the final award so as to renegotiate better terms, using the potential for additional business and the threat of reopening bidding to the second-place finisher as levers. Specifically, the business risk of an abrupt termination of call center services was considerable, making the contract language around termination support more important than what was reflected in the standard bid. In addition, the standard bid assumed a certain operational model without encouraging a search for efficiencies.

The outcomes brought several improvements that meshed well with the telecom company's interests and controlled costs in a way that was fair to both vendor and buyer:

- Agreed to a "stair-step" IVR model that rewarded the vendor with small increases in IVR pricing for significant increases in IVR call capture. The negotiated model had the potential to save over $1 million annually on billings in the $15 - $18 million range.
- Agreed to continue post-termination support as long as 18 months, providing the telecom company with the ability to terminate if necessary.
- Obtained better COLA language by removing cost items that do not actually

increase over time from the COLA calculation, thereby lowering cost in succeeding years of the contract.

- Strengthened contract language about at-risk service level penalties from 1 percent to more than 10 percent of monthly fees to put "bite" into the consequences of service level failures

In this case, an improved contract resulted from a closer look at the company's risk factors as well as a sharing of benefits derived from efficiencies.

## HANDSHAKE VERSUS HEAD BUTT

Companies increasingly rely on third-party suppliers for services ranging from support for their IT infrastructure through manufacturing of their core product line. If anything, this trend seems poised to continue as the economy becomes still more global and technologies make the vertically integrated, brick-and-mortar company far less common.

While this outsourcing trend can have many benefits, it results in a need for strong vendor management and a focus on innovation for the relationship to evolve and succeed over time. By approaching mature outsourcing relationships with their longer-term strategic importance in mind, it is possible—and desirable—to

get beyond immediate pricing considerations and more fully realize the "relationship" aspect of the arrangement.

There is a "procurement disconnect" common to outsourcing relationships. While the due diligence performed one or more years ago may have been proper, the analysis done at that point in time eventually becomes outdated. Technologies advance and offer new efficiencies. Strategic priorities and risks change, and with them the opportunities afforded by various suppliers. While contracts are of necessity fairly static, seemingly everything else changes as the ink dries.

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Endnote

1. Various sources such as Gartner and AMR Research estimate the outsourcing market between $400 billion and $828 billion depending on inclusions, exclusions and methodology for estimation, among other factors.