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BEYOND CONTRACT RENEGOTIATION

Keys to Managing the Sourcing Continuum

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ISG WHITE PAPER

INTRODUCTION

All contracts end. Some on a positive note, others… not so much. Clients might choose to terminate a provider's contract or craft a new deal, exercise an option year with a favored incumbent, or send some or all of the work out for bid. Whatever the decision, the choice needs to be well-considered.

In the old days of outsourcing, that choice was pretty straightforward: renew with the incumbent provider or rebid the work to the open market in hopes of finding a better deal. In today's multi-vendor environments, however, the considerations have become far more complex. With interdependent providers deeply ingrained in core governance functions, rebidding often grows increasingly risky, expensive and potentially disruptive. Simply defaulting to renewal, on the other hand, presents its own set of risks.

To further complicate matters, a contract "renewal" rarely means maintaining the status quo. Indeed, even the smoothest renewal requires adjustments to respond to evolutions in technology as well as changes in the business climate or market conditions, necessitating updates to the Statement of Work (SOW), Service Level Agreements (SLAs), contract terms and conditions (T's & C's), or pricing schema (not to mention the price itself). Such revisions oftentimes lead to protracted negotiations.

Under these circumstances, negotiating individual contracts and managing specific providers one at a time is not enough. Rather, it becomes imperative to view the sourcing process holistically, taking a strategic perspective. This approach analyzes interdependencies among providers, anticipates future needs, considers key decision and action points over the life of multiple contract terms, and allows the management team to rise above the fray of daily tasks. That said, a complementary tactical action plan is also essential – one that assesses market trends and conditions, provider capabilities and challenges, business requirements and alternative provider options on an ongoing basis.

This ISG white paper, co-authored by a senior IT leader at Boeing, discusses how an effective sourcing strategy requires a comprehensive and regimented process to address business needs, ensuring that decisions to renegotiate, renew or rebid contracts in a multi-sourced environment are made for the right reasons.

A MACRO VIEW

The first step to an effective sourcing strategy is to define business goals and success factors. Consider foreseeable prospects for growth, retrenchment, or acquisitions, as well as what will be needed to achieve your objectives for each scenario. For example, an organization planning to develop new products and enter new markets might require help with technology innovation, access to skills, and speed to market from its providers. On the other hand, cost reduction would likely be paramount for a business experiencing or expecting to experience a downturn.

A similar contextual perspective must be applied to business requirements and technology trends. For example, an organization with a long-term data center contract may want to incorporate cloud services such as PaaS, IaaS or SaaS to address emerging business needs without exceeding space, power, or cooling limits that would necessitate an expanded, more expensive lease (or secondary facility). Deals must be structured accordingly, enabling the necessary degree of flexibility and agility to accommodate future needs. A general consideration here is to avoid a hardware- and/or software-centric approach to contracting, as this can limit your ability to leverage services and business process outsourcing where it might better help the enterprise.

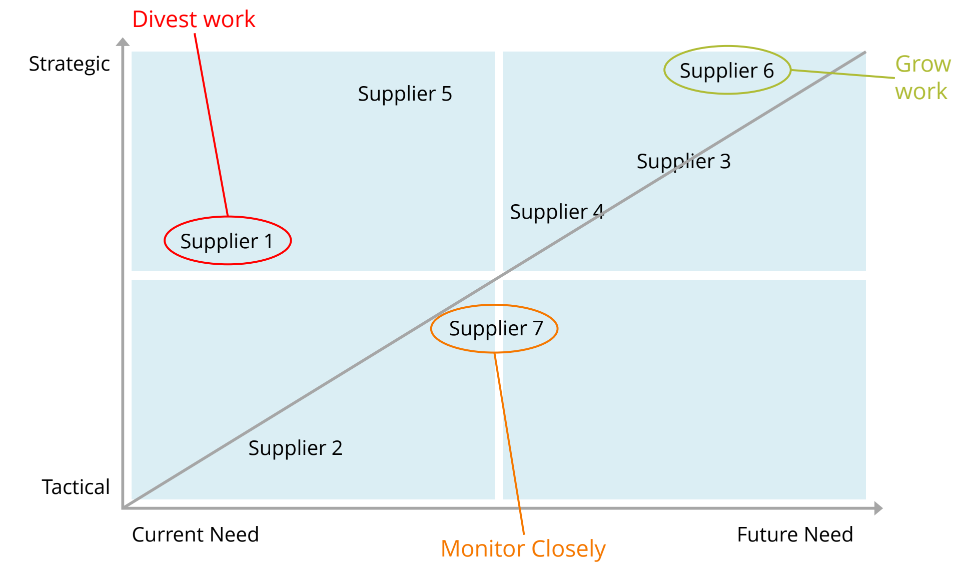
Consider the risks and benefits of current agreements.

Business environments and objectives, and technology trends and opportunities should then be assessed against the provider landscape, both in terms of existing providers as well as potential alternatives. For existing providers, assess current performance and possible future directions and investments, as well as potential business issues – such as financial strength and prospects of becoming acquisition or divestiture targets. More specifically, consider the risks and benefits of current agreements, in terms of interoperability amongst existing contract SOWs, and whether or not those agreements are coterminous.

Existing service delivery can then be benchmarked at a high level against the provider landscape of the open market. Again, the capabilities, risks and benefits of established providers should be considered, as should those of emerging niche players with increasingly specialized capabilities. This external context is essential to addressing the “compared to what?” Question of current service delivery.

Equipped with this macro view of your own organization as well what’s available in the marketplace, you can build a framework of touch points to start reviewing major contracts prior to expiration. By going through the list and ticking each item off, you will have the data you need to make the all-important decision to renew, re-compete or renegotiate each deal. This information can be plotted on a “dashboard” for easy reference.

A simplified example follows



ESTABLISHING A PROCESS

Current Environment: A multi-sourced environment can comprise dozens if not hundreds of hardware, software and services providers, many of which are vital to the success of your business. As a sourcing leader, you need to periodically assess your environment to determine if existing providers are the right fit and to understand if viable alternatives are available that could provide better value. Questions to consider include:

1. How well do our existing provider account teams understand and support our business?
2. How effectively does our current supply base work together to deliver end-to-end solutions that meet our needs?
3. Does our strategy need to change to meet emerging business imperatives?
4. Will our current provider mix still be appropriate in the near term (12 – 24 months)?
5. How entrenched are our current providers in our infrastructure?
6. What are the risks of change and how can they best be mitigated?
7. Based on their current and emerging capabilities, will our existing providers be able to continue to fill strategic roles over the long term (3 – 5 years)?

Provider Landscape: In addition to considering your immediate and long-term strategy, you also need to assess the marketplace to identify emerging capabilities, new players, likely mergers and acquisitions, impact of regulatory changes, on- and offshore labor arbitrage, economic uncertainty and other important trends. Questions to consider include:

1. Do we wish to be an early adopter of emerging technologies?

2. How can we best take advantage of new innovations, providers or markets to meet future business needs?

3. Are there evolving capabilities or technologies our existing providers do not currently provide that we need to access expeditiously?

4. Do potential mergers and acquisitions amongst our supply base present opportunities or risks?

5. Are there pending changes to laws, disclosure requirements, intellectual property rights, taxes and the like that must be considered in the decision-making process?

Come up with a plan well before each contract term expires — and keep it continuously refreshed.

Decision Points: By establishing a process that enables a clear understanding of existing service provisioning in the context of a dynamic business environment, you can anticipate rather than react to critical decision points. This means coming up with a plan well before each contract term expires and keeping it continuously refreshed. In this fashion, end-of-contract decisions will always be based on sound criteria. In most cases, this means starting the process for any given contract at least 18 months ahead of time, both to allow for sufficient evaluation and implementation as well as to increase negotiating leverage with providers if you choose to make a change. Even this lead time may not be sufficient where significant complexities are driven by interdependencies amongst contracts.

The amount of data meriting consideration can be overwhelming, but you can simplify the process via provider stratification. This means segmenting "strategic" providers (those that provide services critical to the business) from "tactical" providers (those that provide commodity type products that can be easily sourced from an alternate provider). Companies often use four or more strata to segment their supply base, but we'll keep it simple here and use just the two.

For the strategic providers, questions that need to be addressed include the following:

1. Are contractual SLAs in place to ensure adequate performance of individual providers for the scope of work they deliver?

2. Are these existing SLAs synchronized with business needs or is realignment necessary (are we paying gold-level when bronze would meet the business need or vice-versa)?

3. Where dependencies exist amongst provider SOWs, what mechanisms and measurements are in place to assure that they work closely together to deliver end-to-end services?

4. Do measurements such as Operating Level Agreements (OLAs) facilitate provider alignment and "pain-sharing"?

5. Individual contracts aside, how well is the overall arrangement working today?

6. Are the interrelated contracts coterminous or do they end at different times?

7. How well is the cultural fit/relationship with provider account teams working?

8. Are there any inhibitors (e.g., termination liability, wind-down provisions, data or intellectual property ownership) or facilitators (e.g., option years, acquisitions/divestitures, termination for convenience) to optimally aligning contracts that are not already coterminous?

For tactical agreements, the issues tend to be more price-focused, though other considerations are involved as well. Questions that need to be addressed include the following:

1. Where do service/capability gaps exist and how can they be addressed?

2. Can alternative delivery methods add business value (e.g., use of diverse providers, resellers, or incorporation of tactical SOWs into more strategic contracts)?

3. Are SLAs appropriate?

4. Is pricing in line with competitive market trends?

5. Are mechanisms (e.g., benchmarking, "most favored customer" clause) in place to assure ongoing price competitiveness over the term of the deal? Are they working?

6. Can we work with the incumbent provider to adjust pricing or is a move to an alternative provider warranted?

RENEWING VS. REBIDDING

Both buyers and sellers face significant financial motivations to make a renewal work. On the buy side, the cost of conducting an RFP for a major contract, evaluating bids, negotiating a deal and transitioning to a new provider can oftentimes exceed $1M. Furthermore, bringing on new providers typically means transition fees and some degree of operational disruption despite the best intent to eliminate it.

For service providers, incumbents lose more often than not when services go to RFP. And, pursuit of major accounts is very expensive, often reaching into the millions of dollars. In fact, according to the ISG Outsourcing Index, the non-incumbent win rate on competitive restructuring and renewal deals stands at 59 percent. As such, the proposition of competing for work and/or losing an existing customer is unpalatable.

Not all procurement efforts must end in an RFP.

Despite the difficulties associated with rebidding, incumbent providers may not be adequately responsive to changing requirements, or able to effectively leverage innovations or emerging technologies. This means lost opportunity. Buyers also lose significant leverage when renegotiating with an incumbent provider already under contract, degrading value as well.

Sometimes simply letting the incumbent provider know that an RFP is imminent can help. Proactive providers often turn these risks into valuable unsolicited proposals, service enhancements, or price concessions aimed at stopping the effort. Since the incumbent's personnel tend to be embedded in the buyer's organization, however, attempts at "bluffing" fail more often than not. This does not necessarily mean that all procurement efforts must end in an RFP; updated SOWs, SLAs, Terms, or pricing schema can be successfully used in subsequent negotiations even if an RFP is never released. And, if negotiations fail you can always go to market expeditiously using the updated documents.

MAINTAINING OPTIONS

The inherent complexity of multi-sourcing and the cost of rebidding are certainly strong incentives to renew contracts. That said, the objective of maintaining operational continuity should not trump the due diligence necessary to ensure that service delivery remains price competitive and is optimally aligned with your long-range business strategy. Decisions need to be made strategically, leveraging necessary facts and data. Ask yourself:

1. Is our core team of providers qualified to address today's business requirements?
2. Do the benefits of maintaining stability with a core team of providers outweigh the potential risk of not bringing innovative new providers into the mix?
3. What mechanisms can ensure competitive pricing and adjustments to changing business needs over the long term without periodic re-bids?
4. What opportunities do new technologies such as cloud represent for our business, and is our existing provider team best equipped to leverage these technologies?
5. If we choose new providers or capabilities, how do we identify the best fit, navigate the change, and ensure a smooth transition without any service interruptions?

If you do decide to renegotiate, a variety of mechanisms can be applied to make needed contractual adjustments, without necessarily going to market with RFPs. Many firms include benchmarking clauses in their outsourcing contracts to mandate periodic assessments of their providers' service delivery against competitive market standards. These analyses – typically undertaken 18 to 24 months into a contract term – identify gaps in pricing and service quality that can subsequently be addressed during the renegotiation. (*For more information on benchmarking, download this ISG white paper*.)

While executing a well-written benchmarking clause can eliminate price risk, successful contracting typically encompasses far more than just price. Service delivery, innovation, technology refresh/sunset, and a host of other issues must play a role as well. Again, a long-term perspective is essential—what will your business need five to ten years out and how will your supply base play a role in taking you there?

Set yourself up for success well in advance of transition.

All contracts end eventually, so set yourself up for success well in advance of transition by taking proactive steps to minimize disruption, ensure a smooth exit and commence service with a new provider (or incumbent with a different contract, SOW, SLAs, etc.). These steps include specific wind-down language around the use of data, knowledge transfer and intellectual property rights. A best practice for preventing service providers from simply "walking away" from a lost piece of business is to include an SLA that puts their final month's payment at risk for non-compliance with contractual wind-down provisions. The ultimate goal must be a smooth transfer to another provider (or contract) with no disruption of service or adverse impact to your company.

While assuring continuity of strategic provider contracts is a priority, effective organizations strike a balance and bring new providers into the fold to address changing needs, take advantage of innovative capabilities, replace a provider who fails to deliver, or benefit from more competitive pricing.

TAKEAWAYS

Buyers of outsourcing services need to develop and implement a comprehensive process that assesses their provider portfolio from a big picture perspective, while at the same time paying attention to critical details. This is a continuous process that starts early – not a "one-and-done" exercise conducted as contracts near expiration – and is aligned to strategic business objectives, rather than the tactics of deal negotiation. In addition to understanding your multi-vendor environment, you need to assess the external provider landscape against business needs to determine if alternative options exist that better suit your requirements.

Whether you renew with your incumbent provider, restructure and renegotiate your existing deals or rebid to the external market, a solid plan allows you to leverage facts and make those negotiation and competition decisions based on the right reasons.

ABOUT ISG

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