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HAVE I GOT A MARKET COMPETITIVE AGREEMENT?

When to Consider Renegotiation, Restructuring or Renewal

Owen Wheatley, Partner, ISG

ISG WHITE PAPER

INTRODUCTION

With a large number of contracts approaching their natural end dates and a focus on ensuring that existing agreements are delivering efficient and cost effective services, 2013 is likely to be a bumper year for the number of outsourcing contracts that will undergo some form of renegotiation. While such work represents its own challenges to client organizations, the opportunity to assess whether agreements are market competitive and ensuring that best value is delivered should not be ignored.

While a large part of renegotiation activity will be driven by contracts nearing the end of their original term, other business demands also contribute toward this statistic, including changes in business strategy, changes to the scope of services sourced, issues with pricing, the introduction of new technology and work practices and rationalization of the number of service providers. Such disparate drivers — coupled with demands to manage risk, time and budget — force organizations to think ever more carefully about their approach to re-contracting.

One of the most important building blocks of a strong and mutually beneficial outsourcing relationship is having a world class contract. Having said that, no contract — no matter how well thought-out — is ever perfect, and clients often subject their outsourcing agreements to some form of constant (mutual) review, which includes formal checkpoints to identify concerns and opportunities for improvement. When a client organization determines that it is time to revisit the negotiating table to address these concerns or opportunities, this is also the opportune time to assess whether the sourcing agreement is market competitive.

From a purely contractual perspective such an assessment is likely to be very detailed, focusing on key terms and conditions. Such a review, however, should also incorporate key business related themes:

Is the contract flexible enough to facilitate known and unknown changes in both business strategy and sourcing options?

1. **Flexibility and adaptability:** Is the contract flexible enough to facilitate known and unknown changes in both business strategy and sourcing options? Can the services be readily transferred in-house or to another service provider with reasonably predictable costs and with a clear exit plan to transition such services?

2. **Pricing:** Are the overall charges reasonable compared to the market? Is there a robust and fair pricing structure in place with a variable based pricing model? Is the treatment of inflation and foreign exchange fair and reasonable?

3. **Risks and liabilities:** Is the risk profile, including all delivery and other required consents, acceptable? Is it clear who takes on all legal and other external risks, for example external regulatory bodies?

4. **Risk of transition:** In the event that the client wishes to award the services to a new provider, would the transition from current contract to new contract constitute an acceptable level of business risk?

5. **Service definitions and measures:** Are the services clearly defined, including a clear demarcation between projects and ongoing operations? Are all technology refresh and other obligations reasonable? Is quality of service measured effectively and does poor service affect the service provider?

6. **Contract and relationship management:** Is there a reasonable and well-documented benchmarking set of provisions?

Ensuring contract terms are market competitive, though important, is only part of the equation. Client organizations also need to consider their wider sourcing portfolio of outsourcing service providers and assess whether it makes business and operational sense to change the status quo and alter who does what, particularly so if there are perceived financial or service synergies to be gained. For example, can the application maintenance work be

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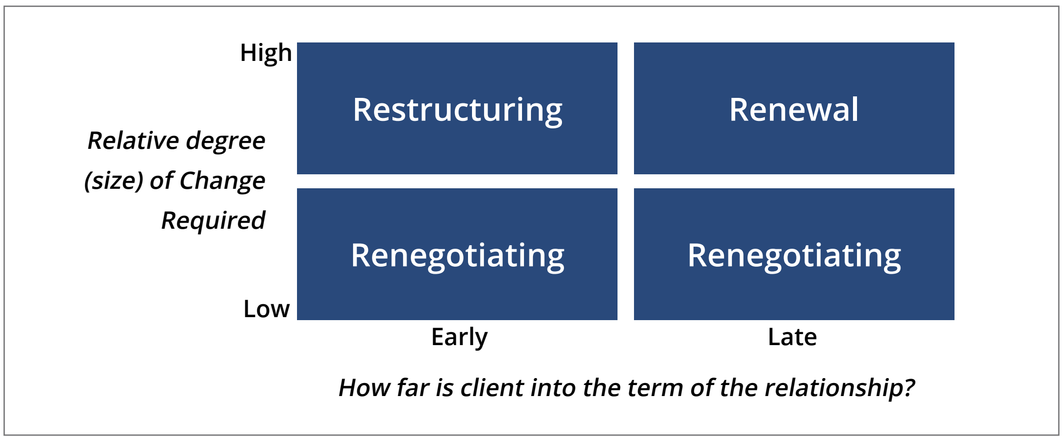
performed by a new, possibly cheaper service provider who was not involved in the original application development? Can help desk services be de-coupled into separate help desks depending on the service required? The list is of course endless, however renegotiation of an outsourcing contract is often a convenient point to question the existing operating model.

WHICH NEGOTIATION ROUTE?

There are varied routes an organization can take when negotiating their existing outsourcing contract depending, amongst other things, on the degree of change required and the relative age of the contract. The matrix that follows suggests which negotiating route organizations should consider based on the degree (size) of the contractual changes contemplated and the relative age of the outsourcing contract.



1. Renewals of outsourcing contracts are usually brought about by the impending expiration of an existing contract. More often than not a renewal will require a completely refreshed contract as many of the original features are likely to be outdated. Renewals in most cases, though not all, involve incumbent service providers retaining some or all of the existing scope, however this can be an opportunity to introduce additional service providers.

2. Renegotiations usually involve working with an incumbent service provider and renegotiating specific parts of the contract that need addressing. In general, large contracts are often subject to some form of renegotiation in the first 2-3 years.

3. Restructuring involve major changes to the contract and or service delivery model either to support a change in business strategy or focus on addressing a significant number of major issues, for example a change to the overall deal structure (pricing and/or SLAs) or a fundamental change to the delivery model used to deliver the services.

WHAT CHANGES ARE REQUIRED?

Determining the changes required and the motivations behind such changes within a complex client organization can be a cumbersome and elongated process, especially if not managed carefully; large contracts often have many stakeholders including the business users, central operations management, finance, sourcing management etc., often with different and varied viewpoints regarding what changes are required. It is, however, vital at the outset to ensure internal consensus is reached regarding the extent to which changes are necessary and required. As part of this internal debate, ISG suggests the following themes are explored:

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1. How good (or bad) is the overall level of service and what changes in service are required?
2. Are there any particular areas of service weakness or specific areas that require improvement?
3. Is the service provider delivering the degree of transformation which may have been identified in the current contract?
4. Does the service delivery model need to change, for instance will the organization benefit from moving location and/or deploying technology or tools to replace human effort?
5. What does the client organization need to do to improve its management of the contract?
6. Does the risk profile of the contract reflect the current modus operandi of the industry?
7. How important is price? Is the organization willing to sacrifice price changes in order to satisfy other requirements?
8. Is the pricing model/approach working for the client by incentively the correct behaviors from the service provider and client end users?
9. What specific deal structural issues need to be revised?
10. At this point in time, is it all worth the effort? Renegotiations tend to be a marathon rather than a sprint and inevitably detract management from dealing with other issues.
11. Is the level of executive sponsorship and time required to engage with senior service provider executives to underscore the belief and commitment that the client is able to drive forward the necessary changes understood and available?

CREATING NEGOTIATING LEVERAGE

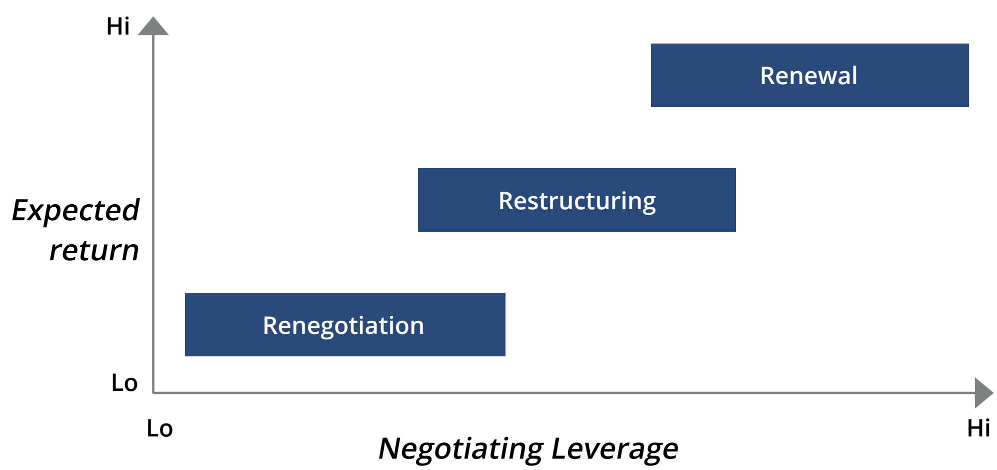
It is useful to consider how to create negotiating leverage ahead of approaching a service provider about the possibility of opening up the contract.

Irrespective of the degree of changes a client organization believes is required, service providers usually have very little desire or incentive to open up wholesale contract changes. To that end, it is useful to consider how to create negotiating leverage ahead of approaching a service provider about the possibility of opening up the contract. More often than not, clients can achieve this leverage by demonstrating to their service provider that they have, or will have plans, (however embryonic) to create viable alternatives; in other words the threat of competition and an articulated appreciation of such alternative options will demonstrate seriousness and show that you mean business. There are of course multiple sources of leverage, including the current contract and relevant performance data. To establish sources of leverage, other specific areas to explore include:

1. Establish via benchmarking whether the current pricing is above the market.
2. In the event that the organization anticipates significant growth, determine any non exclusivity provisions and rights to use other service providers.
3. Check whether there are existing obligations on the client to provide service provider references.
4. Review all SLA failures, late delivery of project deliverables and determine whether there is a case to be built for potential damages.
5. Review all cases of the service provider breaching intellectual property rights and confidential information.
6. Establish the costs of exiting the existing contract early and the ability to re-source in whole or in part.
7. Conduct a market analysis of viable alternative service providers.

Even with the threat of competition and a well thought out and viable alternative strategy, service providers can very quickly and expertly play hard-ball and put in place delay tactics. This is unsurprising as their revenue is at risk and they may consider it in their interests to slow things down. Therefore, in nearly all cases it is more effective to approach the service provider at the more senior levels of their organization to ensure they understand the degree of change required and, more importantly, to gauge senior level buy-in to the changes required and the plan to achieve them. In some circumstances, if a contract is commercially not viable for the service provider, perhaps because it is delivering lower margins than anticipated or the provider has failed to provide key deliverables on time, then the opportunity to re-contract may well be in that provider's best interests. As set out in the chart below, the degree of negotiating leverage typically required and the expected financial return can influence the negotiating approach. The chart suggests that the size of the negotiating leverage required is proportional to the expected return.

The approach taken has a direct bearing on the expected return



PREPARATION AND PLANNING

As with most major projects, preparation and planning is a key prerequisite to success. Once an organization is comfortable that they wish to change their existing outsourcing agreement, the next step is to build the case for change. Time spent on this at the outset will help client organizations think through which approach to take:

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1. A well thought out synopsis of the negotiation objectives and viable sourcing options.
2. A fair assessment of the strengths and weaknesses of the current sourcing relationship.
3. A thorough contractual review of rights, obligations and limitations under the agreement
4. A thorough assessment of exit/transition risk.
5. A cost estimate of viable alternatives, including wind down costs, termination fees, transition costs etc.
6. An holistic appreciation of where negotiating leverage exists and how realistic it is to apply such leverage.
7. An overall commitment to invest executive time.
8. Committed stakeholder buy-in, particularly from the business units.

9. An overall and realistic plan for changing the contract, including the key dependencies on the service provider.

10. A strong and committed project team.

With that said, any sort of negotiation is an imprecise science and client organizations need to be wary that, unlike first generation outsourcing organizations, they may not have access to full and detailed data records. Furthermore, technical service delivery staff may well have transferred to the service provider organization; all of which means that preparation and planning is a vital ingredient to the success of the initiative.

A FINAL WORD OF CAUTION. . .

In light of the above it is worth bearing in mind that once a service provider sees that they are likely to lose an account, they may well change their behavior in an endeavor to protect themselves. To this end, they may well start to make sure they get everything to which they are entitled under the contract, even if previously they did not do so. Therefore, the tactics and timing in the process should be carefully considered.

ABOUT THE AUTHOR

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OWEN WHEATLEY

Director

Owen has built a decorated career, serving clients across multiple industries with a special focus on enterprises in the financial services sector. Advising clients on IT strategy and the digital agenda, Owen leads high-performance advisory teams to design and implement major transformation programs, structure complex transactions, negotiate with service providers and advise on a broad range of market trends and sourcing activities. Most recently, Owen worked with a large European bank to develop a new workforce strategy that optimizes internal resources and unlocks significant savings. While at a major UK-based retail bank, he led a large advisory team to define and implement an IT sourcing strategy that led to associated savings of more than £250 million. Owen holds a BSc in economics, is a chartered accountant fellow with PwC and has been widely published in his capacity as a recognized thought leader in his field.

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ABOUT ISG

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