

Global Services Insights

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Negotiating a Global Services Outsourcing Agreement

Successful global services negotiations require complex preparation. The following three steps ensure that the negotiating teams receive consistent support across the enterprise, from corporate executives to legal and financial experts: (1) internal readiness assessment and strategy planning, (2) executive participation to guide overall direction, and (3) detailed discussions that turn strategic ideas into contractual terms.

One common mistake for negotiating teams is to skip the first steps and jump directly to tactical negotiations, leaving the internal organization without a consistent strategy or executive support when negotiating. The lack of consistent "marching orders" is a frequent cause of corporate backlash and negotiation backtracking.

Key Topics Covered

- Conducting an internal readiness assessment
- Developing a negotiation framework to create a consistent sourcing strategy
- Balancing strategic partnerships with standard procurement procedures



Introduction

Clients should begin by determining whether or not they are good candidates for globalization. Preparation includes a clear definition of the scope and delivery model. The organization should agree on pricing and cost savings objectives.

Sourcing goals should also be clearly defined and socialized across the organization. It is common for various executives to have preconceived ideas that become obstacles if not aligned. Changing objectives during negotiations causes the negotiating team to lose continuity.

Once the client has developed internal consistency, executives can communicate with service providers. The presence of executive-level relationships will become critical as the two organizations push against traditional negotiation boundaries.

Because of the complex, collaborative nature of managed services, close executive partnership between the client and service provider is required; the best time to create (and validate) this link is before any documents are signed.

Maintaining alternative service provider candidates will prevent the client from chasing a bad deal and keep the service provider competitive.

Negotiation Framework

The negotiation framework is a useful tool to ensure that important terms are not forgotten. A framework must remain a living document for the following reasons:

1. Market conditions change, sometimes quickly.
2. The capabilities and resource constraints of service providers evolve.
3. Service provider contracts with other clients may expose new insights or unexpected risks.
4. Client agreements with other service providers may stretch the boundaries of what service providers will accept.

A negotiation framework provides a playbook that client executives can refer to during the negotiation cycle. If it is continually updated, executives can

Figure 1: Contract Negotiation Process



privately review the framework to assess the company’s position on each contract term, and the overall balance across a set of related terms.

Using a framework increases the consistency in a client’s negotiating position. The company may have a single negotiator, but the transparency that the negotiation framework gives, allows senior executives to communicate directly with the service provider executives to resolve particularly difficult points.

Managed services agreements include performance incentives (currently called performance credits, earnbacks, or bonuses). This topic usually requires extensive negotiations, containing multiple terms and conditions.

Because managed services contracts extend over multiple years, performance targets should improve over time. The parties must negotiate the rate at which performance measures are made more stringent over time. To illustrate, if “time to resolution” is initially set at two hours, the improvement terms would gradually bring down that time year after year.

An agreement should also have triggers for additional resource charges (ARCs) and reduced resource charges (RRCs). As the client business requirements evolve over time, the services provided will inevitably require adjustments. The change in the volume of services provided can be minor (less than 15%) and handled within the contract scope. Volume changes beyond 15% are usually subject to renegotiations.

These are complex clauses which require both parties to collaborate and arrive at a mechanism that gives the client flexibility over time, while protecting the service provider from sudden changes in revenue. The

negotiation framework serves to document the draft understandings until the final terms are crafted.

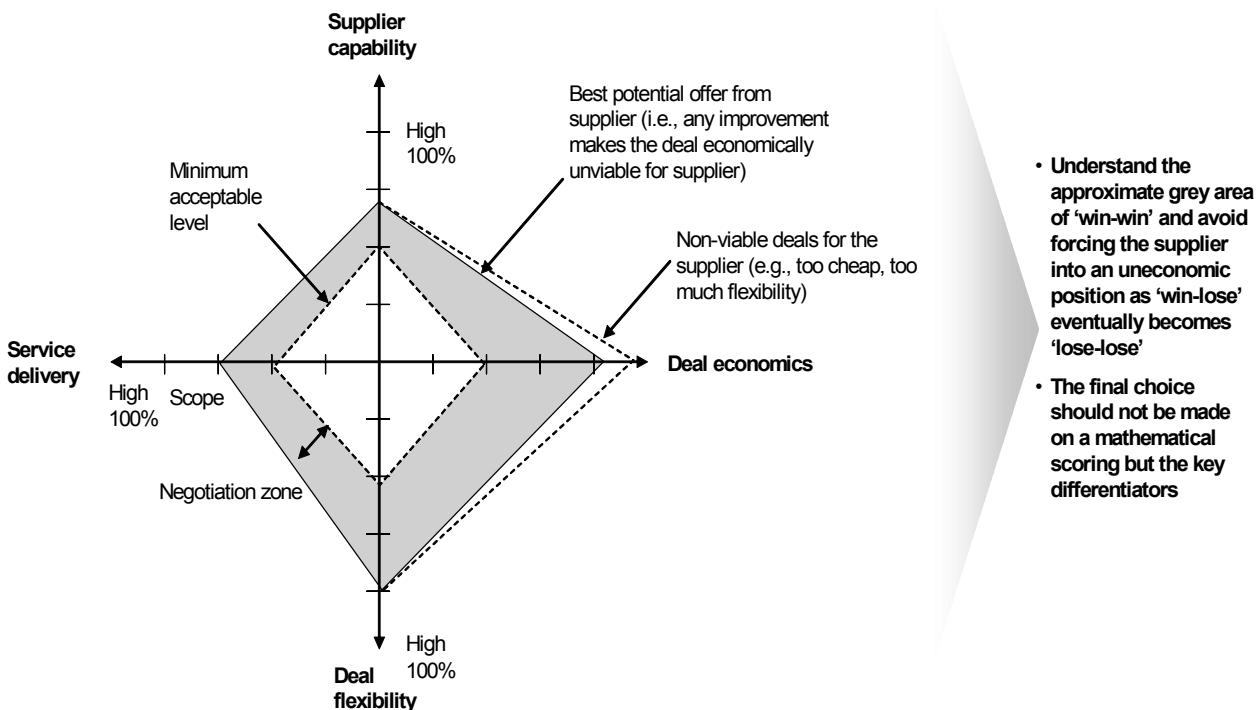
Aligning Objectives

Critical “Must-Haves”

The client should define its critical “must-haves,” including the category (e.g., price) and the threshold (e.g., \$18 per hour). Target price—or total cost of ownership savings—is frequently a key objective. Executives prefer that the negotiating team sets a target of 25% to 35% in cost reduction and often expects the service provider to innovate, so that cost savings are achieved without impacting service levels.

Some contracts may include provisions to cover inflation or exchange-rate risk for the service provider. It is important that the agreement allows the service provider to maintain a reasonable profit margin. Without the balancing mechanism, the contract becomes untenable to the service provider after some time, and service to the client deteriorates. The client must understand how the service provider will deliver and manage its cost over the life of the agreement.

Figure 2: Negotiation Dimensions



Periodically, clients use outsourcing as a catalyst to centralize control—bringing back supervision and financial management of distributed production and development units.

Service Provider Goals

An important activity is to project the service provider's reasons to engage in the contract. Clients can formulate the business case, leverage benchmark data from consultants, and derive the minimum price by estimating costs and target profit margins.

Negotiating teams can also project the non-financial objectives of the service provider. In a recent negotiation, the client realized that the near-shore subsidiary of a leading service provider wanted the engagement, not because of the size of the deal, but because the local executive wanted to grow locally-generated business. This knowledge helped the company stand firm for better resource rates.

In a different case, awareness of the service provider's need to announce significant deals, helped pull the deal negotiations through an aggressive timeline.

Since managed services agreements extend over multiple years, the insistence of a service provider on tighter clauses (e.g., limitations on termination, notice period, or termination penalty) should be negotiated. Long-term contracts, with long termination notice periods or high penalties, allow a service provider to count on recurring revenue. A client's insistence on less stringent termination terms can be traded for higher short-term margin.

Refining the Scope

It is important to properly document the scope of services in the agreement. The accurate definition of current labor and labor-related spending baseline—i.e., spending on internal personnel and external service providers—is one of the most important steps in preparing for negotiation.

The spending baseline for application work needs to be estimated. It begins with the identifiable direct

expenses for personnel working on the project. Clients should remember to include personnel scattered across business units. In most companies, there are also teams that provide only sustaining support—e.g., production support units for application-related database and system performance.

Estimates need to be made about the percentage of time that specific team members spend on sustaining support. That percentage is applied to the labor and labor-related cost of the team. The costs of these teams are directly added to the baseline.

While the internal organization can say, "We know the scope; we know what needs to be completed or delivered each day," the service providers still need sufficient details to define the boundaries and effort involved. Without such documented scope, service providers will apply a risk premium to cover areas that the client usually expects, but did not clearly state as part of requirements. The more precise the scope definition, the lower the risk premium for the deal, and the higher the client company's potential cost savings.

Enhancements

In addition to support, terms for minor and major enhancements, performance improvement projects, and new application development are in-scope for a multi-year contract. The client company should endeavor to have a reasonable estimate of future enhancements based on historical experience over a period of several years, and an executive judgment of where the business is headed—as well as work effort required for new functionality development.

Large enhancements and new application projects are generally more difficult to average out on a year-to-year basis because these can increase if the business demand is high and funding allows. The best way to project a reasonable year-to-year volume for large development projects is to align the future business views of business executives with the technology effort to support them.

One large company had a list of almost 200 applications. The list included the operating system, specific names of system utilities (e.g., databases,

language, middleware, communications, reporting tools, etc.), versions of these tools, and number of full-time equivalents (FTEs) currently supporting the specific applications.

The company defined the service level requirements and the sustaining support required. Rather than the complexity of application-by-application service level requirements (which would have been a 200 applications x 15 processes x n variations in response or resolution times, or frequency of tracking), the convenience of application categories (platinum, gold, silver, bronze) was used with response/resolution times for each process.

Before the Negotiations

A managed services agreement has multiple business and legal components that are best resolved internally before negotiations. Executive agreement on key principles can significantly reduce the terms and conditions to be negotiated.

Executive Meeting

Because a managed services arrangement requires a high degree of service provider and client partnering, a meeting between the service provider CEO and the appropriate senior client executive to discuss the critical “must-haves” will save efforts later. At the same time, when the critical terms are already agreed upon, the negotiations at the executive level will not have to involve posturing around the most important issues.

Gatekeeper Conditions

For many companies, the ideal gatekeeper condition is cost. Because cost has many variables and often cannot be determined until late in discussions, it is best to choose a component of cost that enables executives to commit. Examples of this include blended or specific resource rate or the rate of total cost of operations (TCO) savings.

An executive agreement may be on a TCO savings of 35% based on the company’s current resource mix. There will be many terms that need to be finalized, but once the 35% savings rate is agreed upon, both parties do not have to dance around this critical point (e.g., linking various terms to price, making the negotiation process unduly long and arduous at the tail-end).

Collaborative Solutions

The requirements—scope, service delivery model, and service level—are the foundation that must be defined by the client. Experts, project leaders, and operations managers must have a clear summary of the applications, platforms/versions, service areas, target and actual performance (collectively called “service levels”), how many persons and hours have historically been spent on enhancements of each application, and how many full-time-equivalents (FTEs) currently support each application. If this information is clear to the client, it will be clear to the service providers that will be asked to propose fixed prices.

The points of view of the client and service provider can be drawn out through a collaboration workshop. The objective is to understand the optimal delivery and pricing “diamond” where the service provider can deliver service levels at the best price. The client should communicate openness and flexibility to adjust its service levels to fit the service provider’s capabilities.

In a recent negotiation for a large, multi-year agreement, the active participation in a two-day workshop by executives from the service provider and the client made all the difference. The decision-makers on both sides were present throughout the day, spoke openly in various sessions, communicated what they felt the structure/delivery model should be, and listened to the alternatives that the other party suggested.

Negotiating

Even if there is executive agreement, the client should not underestimate the amount of remaining details that will need to be negotiated.

Both parties must reach explicit, operationally-implementable terms with adequate flexibility to consider special situations. In easy cases, the lawyers on both sides need to prepare the correct legal language. The more challenging cases involve situations in which the principles of the executive agreement have to be interpreted and modified.

It is human nature that both parties will try to eke out slightly better terms than what had been in principle agreed to by executives. In some cases, the leaders give guidance such as: "We had to give in on this clause, can you give us more cover, reduced risk, better margin, in the actual contract terms?" In other cases, the leaders tell their negotiating leads to "be fair, let us accept this and move forward."

Effective documentation of the requirements—scope, detailed service levels, proposed performance credits (penalties and bonuses)—will allow the client to consider another service provider quickly.

The client team should keep the negotiation framework up to date with corrections that can improve the agreement. The draft may include changes that were reluctantly decided during intense discussions. This set of materials can be adapted to an alternate service provider if need be.

The negotiating team will have an important role in selling outsourcing and the pending deal terms internally. Internal stakeholders will be aware that the

deal may still fall through and that the company has alternatives. Transparency is the best approach. Successful negotiating teams keep internal stakeholders aware of the progress of the deal, but avoid sending overly optimistic or positive messages.

Conclusion

In a good deal, the openness of company executives to communicate important principles of the deal can expedite negotiations.

With a clear understanding of these fundamental principles, the resolution of usual operational or implementation issues is made easier. Contract management leaders on both sides can talk about whether the terms of the deal principles are consistent.

For successful negotiations, particularly of complex programs, the client must have real internal and/or external alternatives. While this is traditionally done by negotiating with the top two service providers at the same time, the complexity of managed services may make it simpler to do an accelerated collaborative discussion with the initially preferred service provider.

While the client negotiating team is focused on achieving a win-win deal with the service provider, they should also regularly ask and answer the following questions: "If I have to walk away, what will I do? Who will I talk to next? Will I go to another service provider? Who will that be? Or do I go back to my internal team?"

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