

Renegotiating Your Outsourcing Contract

Executive Point of View

By Mark H. Robinson and Stan Lepeak, EquaTerra

Outsourcing agreements created ten, five, even three years ago are now being renegotiated because they were essentially conceived in another era. According to market research analysts, approximately 50 percent of outsourcing transactions have either reached a maturity date or have been in existence for more than three years.

The increasing level of sophistication in modern IT and business process outsourcing best practice produces agreements that are far more flexible and, to a greater extent, 'futureproofed.' Such agreements contain important change-management tools that allow flexibility to adjust to changing circumstances of both the client and the service provider.

Legacy agreements are generally more rigid, which creates the need for renegotiation (to accommodate changing circumstances). Both clients and service providers are then challenged to recreate their agreements into fluid, flexible and evolutionary relationships whose very nature will reduce the need for large-scale renegotiations in the future.

Renegotiation of legacy agreements is an unfortunate, but necessary, undertaking for any organization; it is critical for the valuable outsourcing relationships that organizations and their service providers have forged to be preserved. If approached and conducted properly, the renegotiation process can be a positive one that benefits both parties – building enhanced relationships and, optimally, an arrangement that maintains alignment between the client's changing needs and the service provider's operational and economic imperatives.

Renegotiations undertaken proactively are the most successful. To be proactive, a client must thoroughly analyze its needs independent of the pressure of an expiring agreement, understand all the elements of the outsourcing engagement and identify where needs are not being met.

Once complete, this data should be mapped to best practices, and the outsourcing client should document the necessary changes to the agreement to bring it into full alignment with its objectives. It should also invest real effort in researching and anticipating their service provider's ideal outcome, so that it can be prepared to make those accommodations that are fair and reasonable to create an outcome where both parties' key needs are satisfied.

The next step is to gain the consensus of the entire stakeholder community (everyone affected by the outsourcing agreement, including the executive team). That consensus should be carried into the renegotiation process by a strong team, counseled by capable, independent outside advisors and lawyers, all committed to a mutually beneficial agreement.

Renegotiation should be presented to the service provider as a positive opportunity – one that should result in an extended agreement that is better aligned with both parties' interests. This reduces and sometimes eliminates defensive posturing on the part of the service provider and helps negotiations stay fact based and outcome focused.

The ideal outcome of any renegotiation is an agreement that accommodates the client's and the service provider's needs, enhances and extends the outsourcing relationship, and facilitates future adjustments. This is accomplished through integrating the outsourcing management and governance processes with the contract change tools, enabling the relationship to continuously evolve.

The Inevitability of Change

Change is the only constant in business today. To be successful, an organization must remain fluid and flexible when it comes to adapting to any and all changes it encounters, whether those changes originate internally or externally. This is especially true in structuring long-term commitments, such as ITO or BPO arrangements.

Over the five, seven and ten-year terms that are typical of most ITO and BPO relationships, major change is inevitable. Today, well-structured contracts are specifically designed to accommodate change. They are equipped with tools that facilitate adjustments to pricing in response to technological and workforce advances and allow demand (both volumes and scope) to fluctuate. Older contracts, however, were not constructed with this type of adaptability; they were forged at a time when the outsourcing market was less mature.

Why Renegotiations are Important

In order to bring the BPO or ITO arrangement back into alignment with the client's changing needs, with evolving market practices, and with current market pricing, the client and service provider must engage in renegotiation. Historically, this has often been a painful process, although it doesn't have to be. If both client and service provider come to the negotiating table prepared for a fact-based discussion and with respect for each others' needs and economic imperatives, renegotiation can be a mutually beneficial process and positive experience for both parties.

Renegotiations are typically initiated by the client because of a belief that the service provider is underperforming relative to a set of standard or perceived metrics. They may also be driven by a client that feels the value of the services provided has drifted away from where other providers (the market) would provide them if the contract was set aside and the arrangement was reopened to competition. Additionally, clients may feel their service needs – scope and/or volume – have changed in ways that the current agreement doesn't accommodate. Or, the agreement may simply be approaching expiration or a pre-planned break point.

Typically, the triggers of renegotiation fall into five categories:

- 1. Expiration:** Because the term of the contract is looming, renegotiations are driven by the calendar.
- 2. Performance:** The client experiences or perceives performance failures, non-responsiveness from the service provider or instability in the provider's management or delivery team.
- 3. Economic:** The client or provider believes that some or all elements of pricing are out of line with the current marketplace.
- 4. Events:** A significant change on the client side impacts the client's business operations and requires contract adaptations. These include a merger, acquisition, divestiture, restructuring, bankruptcy, management change, or major volume increase or decrease.
- 5. Contractual:** Negotiations are simply built into the contract at certain dates.

If the driver for renegotiation is a perception of reduced value, this may have everything – or nothing – to do with the actual performance of the service provider. In some cases, there may be a significant disconnect on the client side regarding the high-level reason that outsourcing was undertaken. Top executives may have believed it was to achieve a best-in-class performance or part of a reallocation of resources in order to achieve high-level goals, while those on the front lines may have seen it as a way to control costs. As a result, the higher-level business case may not have been translated properly into the specifics of the outsourcing contract.

Proactive vs. Reactive

Of all of these renegotiation triggers, the most common is the approaching expiration of the agreement. However, renegotiations are far more likely to be successful if clients enter into them proactively and with enough time to prepare for them by understanding all of the business elements at hand. Being reactive keeps the client from being in proper control of the circumstances surrounding the renegotiation, in part, because of the inevitable pressure to engage in and complete the discussions before the contract expires. This reduces the likelihood of an ideal outcome from the renegotiation process, as the client will either force an outcome that leaves the service provider dissatisfied or will accept compromises that may become unpalatable.

Ideally, a renegotiation should be initiated by the client following a thorough analysis of the relevance and maturity of the current contract and the development of a detailed sourcing strategy at a time selected to ensure that the process is free of time pressures. This proactive approach, while unfortunately rare, is more likely to result in a mutually beneficial approach to the renegotiation process and an outcome that benefits both the client and the service provider.

Clients are often reluctant to begin renegotiations earlier than is required to keep the contract from expiring due to the many other demands of operating their businesses. Modern contracts (whether for new business or arising out of renegotiation) that have the tools to accommodate change, spread the burden of renegotiation over the life of the agreement, reducing the impact of future expiration dates.

Some questions that need to be asked and answered by the client in preparation for any renegotiation and realignment of a sourcing strategy are:

- What are the organization's current and future business requirements?
- How does the current contract meet those requirements?
- What current and emerging market practices affect the contract's services, and how effective is the current contract at adapting to them?
- What are current market practices in service levels, deal scope and other operating elements? How have they evolved since the deal launched?
- What is the current market pricing, how does it appear to be trending, and how does the current contract pricing diverge from that model?
- How has the service provider performed relative to service level agreements and other obligations to this point?
- How has the service provider itself changed since the original contract was written?
- What are the service provider's needs, and is the contract meeting them?
- What performance is your organization's peer group experiencing – either with or without outsourcing?
- What are the exit provisions in the current contract, and how can they be used if an agreement cannot be reached?

Because negotiations rarely deliver the ideal outcomes that either party might have anticipated – as each party's

understanding of what is possible is modified by their interaction with the other – it is important to define success not as a single objective, but to express it as a desirable range. To this end, the client should understand its relative priorities and be willing to modify positions on less critical items to achieve those priorities.

The client should also have a fully formulated fallback sourcing strategy in the event that the attempted renegotiation is unsuccessful. It should be noted that most renegotiations permit at least a short-term extension to the agreement, if not a renewal; and, if renegotiation has been approached proactively, there should still be ample time to execute on an alternative sourcing strategy.

Before initiating the process, the client needs to assemble the right team and obtain the needed executive backing. When engaging the service provider, it is critical to position the renegotiation process as an opportunity for both client and provider to realign the contract, extend it and continue their refreshed relationship to their mutual benefit. Pursuing an alternative sourcing strategy should not be considered as the primary option.

Successful Negotiation: Consensus

The two elements most critical to a successful negotiation are understanding the organization's needs for the new contract and establishing a strong team with a broad enterprise perspective. The importance of these two elements cannot be overstated.

Success hinges on obtaining the needed internal backing and sponsorship and gaining the support of a broadly defined stakeholder community. Executive support will make it clear to the service provider that the need and desire to renegotiate is real and that it has commitment at the highest levels. Support from the stakeholder community is important, because it is these individuals that interact with the service provider and will continue to do so throughout the renegotiation process.

In HR outsourcing, for instance, the stakeholder community would consist primarily of these individuals and groups:

- Corporate executive team, including the CFO – The customers of the HR executive and HR organization

- Client HR executive – Essentially the ‘buyer’ of the provider’s services
- Retained HR organization - Those people who interface directly with the service provider
- Workforce at large – The end user of the services provided by the HR organization. This could also include retired or divested employees who may still be recipients of some of the HR services in scope for the outsourcing.
- Third-party suppliers of HR services - The suppliers of services to the client or as managed by the service provider

Typically, in legacy contracts we find that such a comprehensive view of the stakeholder community was not taken at the outset, and may not automatically be top of mind in planning the renegotiation. However, if a renegotiation is to be successful in establishing a long-term, sustainable relationship, the client should help each stakeholder understand they have an interest in the outcome of the negotiations. It is important to have fact-based dialog with each constituent in the stakeholder community to understand how their needs and interests have been addressed by the current contract, how this falls short of what they would seek from any renegotiation, and what would be acceptable should this ideal outcome prove impractical. By establishing a consensus in regard to the organization’s needs, the client will come to the negotiating table with the power of unity behind it. This also prevents late barriers from arising, such as a key stakeholder’s unexpected objections becoming an obstacle to the agreement.

With internal consensus achieved, the client should map its current and future business requirements onto the elements of the desired agreement, reflected in the terms and conditions of the contract, revised scope of work and service level agreements, pricing and financial models, transition and transformation plans, and means of governance and relationship management.

As previously mentioned, while it is easy to define the ‘ideal’ solution as the prime objective, the client must view success across a range of improved outcomes. In the negotiation process, the client can’t help but be influenced by the service provider’s point of view. This is a good thing, because the objective is an agreement that meets the needs of both parties and provides a basis for partnership. However, negotiation should never lead a client to compromise its

business requirements, as such compromises set up misalignments that inevitably lead to a future round of renegotiation. In this respect, it is helpful for a client to formalize its limits of movement on every critical issue.

Successful Negotiation: The Team

An effective client negotiating team will consist of a: C-level sponsor; representative steering committee; strong and business-savvy functional executive held in high regard by the stakeholder community; credible subject matter experts for each service component; experienced outside advisors (such as EquaTerra); and, experienced outside counsel.

Actual negotiators should be those who are truly skilled and experienced in the ‘art of the deal.’ They may be internal to the organization, or they may be brought in from outside. They should be people who have successfully negotiated multiple agreements of similar scope in the past, and who will negotiate on behalf of the entire client organization rather than representing a specific interest group. Initial contacts regarding renegotiation should be between the most senior executives in the respective organizations. In these exchanges, the client should focus on setting a very positive tone, focusing on the desire to create a mutually beneficial outcome that will result in a long-term renewal for the service provider.

Most clients anticipate that the service provider will be hostile to the idea of renegotiation. Yet, a client should be cautioned that such anticipation can be a self-fulfilling prophesy. In most cases, the client’s approach determines the provider’s response, and in anticipating hostility from their service provider they adopt an aggressive posture that provokes the expected response. If, instead, the client moves to enlist the provider in solving a joint problem and delivering a mutually beneficial outcome, service providers can see renegotiation as an opportunity and will adopt a much more positive attitude.

There are other reasons why a provider should react positively to a request for renegotiation. First, it is preferable to negotiating a termination or competing with other providers for an entirely new contract. Second, it offers the provider an opportunity to extend the term of the agreement, with the potential for a longer-term revenue commitment. Finally, it gives the provider an opportunity to address any

adverse aspects of the agreement by moving to current market practices where it makes sense.

Modern (Re)negotiations: Bridging the Belief Gap

One common challenge that renegotiation must overcome can be referred to as a 'belief gap' between client and service provider. The client may have a perception of dissatisfaction in the user community or with the responsiveness or flexibility of the service provider, or may believe that the relationship has become adversarial. Often, the service provider may have a completely different perception, believing that it has performed or outperformed the requirements and the client has been making unreasonable demands and does not appreciate the provider's increasing costs.

When clients bring too much emotion to the table, they are driven to make unreasonable requests, which result in defensive and unreasonable responses from the provider.

When service providers bring too much emotion to the table, they adopt inflexible positions that are perceived by the clients as arrogant and provoke an aggressive response from the client. Operating on the basis of contradictory beliefs often drives renegotiations that are focused on the emotions of the parties, and typically engender entrenched positions that more often fail.

Successful renegotiations involve both the client and service provider approaching the discussions with the intent to first establish an agreed set of facts. If they collect and agree on the data needed for rational dialogue, they do not need to operate based on beliefs and perceptions. Traditional negotiating models involve taking positions and leveraging certain elements of the agreement to coerce the other party into accepting those positions; the outcomes from these models are characterized by compromise. In this context, compromise is unhealthy because it has been driven by a battle for control and leaves both parties essentially dissatisfied with the outcome. While most negotiations based on compromise appear initially successful, ultimately, they contain the seeds of their own destruction, having formalized inequities that will at some point lead them right back to the negotiating table.

EquaTerra's view is that modern negotiation (and renegotiation) is all about bringing the parties together

through the use of accepted facts, agreed analyses and rational dialog. The intent is to forge a common understanding of possible solutions, and then help converge an outcome that is equally acceptable, without either party feeling they gave up anything to satisfy the other.

Sourcing Advisors and Outside Counsel

In the same way that tier-one sourcing advisors and outside counsel make critical contributions to the original outsourcing agreement, any renegotiation will similarly benefit from their involvement. The sourcing advisor's contribution is to provide process discipline, tools and templates for collecting, collating and modeling data, subject matter expertise around scope, market information, service levels and performance management, specialist negotiations and renegotiations. The sourcing advisor's role is as essential in a renegotiation as it is in a first engagement.

While the specifics of the role vary slightly, the independent advice that the advisor brings to the process is important in managing the process through completion, providing market insights, delivering improved service provider executive access and participation, keeping the focus on objective data, rational dialog and the process of converging mutually acceptable outcomes. Most importantly, while the client team may include people who have been through one or more outsourcing processes, a tier-one advisor provides the skills and knowledge harvested from hundreds of outsourcing processes.

Tier-one outside counsel contributes outsourcing legal experience that parallels the commercial and functional outsourcing capabilities of the advisor. The structuring and restructuring of outsourcing agreements raises many complex and challenging legal issues that in-house counsel often cannot properly address. Outside counsel has established relationships with their counterparts in the service provider community that can smooth the process.

EquaTerra research suggests that, where clients have attempted to 'go it alone' through the renegotiation process, fewer contracts are extended, and more go to the market for a re-compete.

'Future-Proofing' the Contract

One major way that modern outsourcing agreements differ from legacy contracts is the tools used to manage and respond to change while maintaining alignment between the parties. These change-management tools, supporting a much more effective and formalized governance function, allow both client and service provider to respond to each small change trigger appropriately as it arises and reposition the relationship and the contractual documents to reflect a modified solution. A key objective of any renegotiation is to recreate the contract to include such tools and to implement the governance reforms necessary to make them effective so that full-blown renegotiation won't be needed in the future.

Conclusion

Renegotiation offers a great opportunity for the client and service provider to 'get it right' for the future. Giving the proper attention to the process – through self-examination, building stakeholder consensus, empowerment of a strong negotiating team, engaging tier-one outsourcing advisors and outside counsel, and adopting a fact-based approach to negotiations – assures that it will be done correctly. The proof will be in the long-term results, which should include a refreshed relationship where governance processes operate effectively to continuously maintain alignment between the parties on the scope, performance and price/value of the services delivered.

About EquaTerra

EquaTerra sourcing advisors help clients achieve sustainable value in their business processes. With an average of more than 20 years of industry experience in over 600 global transformation and outsourcing projects, our advisors offer unmatched industry expertise. EquaTerra has deep functional knowledge in Finance and Accounting, HR, IT, Procurement and other critical business processes with advisors throughout North America, Europe and Asia Pacific. Our people are passionate about providing objective, conflict-free advice to our clients, which has fueled our exponential growth over the past three years. We help clients achieve significant cost savings and process improvement with outsourcing, internal transformation and shared services solutions. It is all we do.

**For more information, please contact us at
1 713 669 9292 (US) or 44 207 100 7766 (Europe)**