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Outsourcing and the Economic Crises, Part II: Re-structuring Existing Outsourcings

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In our previous Morrison & Foerster update, we discussed outsourcing as a tool for significantly reducing costs as the global economy heads into what may be a prolonged recession. In this update, we turn our attention to the effect of an economic downturn on outsourcing deals entered into during better times. Companies that negotiated deals over the past five years could not have possibly anticipated economic upheaval on the scale that we are witnessing today. Accordingly, outsourcing customers should be reviewing their existing outsourcing arrangements and determining whether, in light of what experts are predicting will be at least a three-year downturn, such outsourcing arrangements need to be re-structured to reflect the realities of today's business environment.

The economic downturn provides outsourcing customers with the opportunity to re-assess the sourcing arrangements they made in different times and ask themselves:

"If we were to outsource today, would we structure the deal in the same way?" An outsourcing arrangement that was designed for more positive economic conditions – perhaps designed primarily to deliver service improvement or transformation – may not be appropriate in a downturn, where cost reduction may have become the priority. Sourcing customers should be examining whether they are getting the best out of their current outsourcing arrangements and whether they should be seeking to re-negotiate contract terms to allow for greater flexibility to deal with the changing economic climate. This update describes practical steps that can be taken to improve an existing outsourcing arrangement.

Making the most of your current contract terms

Cost cutting measures
A well-drafted outsourcing contract will include flexibility provisions that allow the contract to adapt to different customer requirements – whether these relate to service scope, volume demand or performance standards. Even if the contract does not specifically envisage and cater to changing circumstances, a robust contract change procedure should allow the customer to drive through desired changes. In the current economic conditions, a company's focus is increasingly likely to be on cost saving. The following are examples of how a company may use flexibility within its existing contract to introduce cost cutting measures:

Reduce service levels. Are those tough-to-meet service levels really required? Lowering service levels can have a significant effect on the cost of service delivery. Do you really need that 99.999% availability for an application? It has been demonstrated that each additional 9 in the availability measure can add 30% to the budget. What business benefit are you getting for that additional 30%?

Remove scope. Consider ways in which the services could be trimmed or streamlined. Are all of the service components really required? Do all of the vendor's activities provide a business benefit? The contract change procedure should provide that the on-going charges for the reduced scope of services are reduced to reflect the reduced scope. Often however, and particularly if a large portion of the services are being removed, such removal may be treated as a partial termination for convenience and, accordingly, a termination fee might be payable. But even in these circumstances there may be some scope for negotiation if the services being removed have a disproportionately high cost base. The vendor in these circumstances may be happy to lose this low margin element of the services.

Delay or postpone transformation. If the outsourcing includes some form of transformation or major development, consider whether all or part of the transformation project can be delayed or even cancelled. There may be some form of compensation due to the vendor if a short notice period for such delay or cancellation is given and the vendor cannot re-assign its staff, but the cost savings of stopping or postponing transformational activities could well outweigh such compensation.

Re-visit technology refresh cycles. Is that aggressive technology refresh cycle really required? Is it necessary to have cutting-edge technology? Now might be the time to re-evaluate the business case for your refresh strategy. Be careful, though, not to take a blanket approach to slashing IT investments – targeted investments in IT could create savings and boost sales exceeding that which you could save through swinging cuts.

Enforcing your contractual rights

It is all too common for companies to spend a long time negotiating a comprehensive outsourcing contract with various layers of protection for the customer only to file the contract away in the bottom drawer and manage the relationship on a less formal basis. Are you really getting the best out of your current terms? There are a number of areas where companies could aim to be more diligent in the application of existing contractual rights.

Service credits. Are you rigorous in the application of service credits or do you give the vendor some leeway for minor service failures. Enforcing your rights to claim service credits, however small in amount, can add up over time to give an appreciable cost saving.

Benchmarking. Have you exercised your right to benchmark the service charges and/or the service levels? Have the prices agreed upon years ago become out-of-step with the market? A benchmarking right with "teeth" to automatically reduce the charges in line with the market is an easy way to realise cost savings. Even the threat of benchmarking can be enough to bring the service provider to the table to negotiate a reduction in fees.

Audit rights. A well-drafted outsourcing contract should give the customer wide rights to audit the vendor's compliance with the agreement. Is the vendor invoicing the correct amounts? Are the volumes for service consumption correct? Are you paying for a software licence that has elapsed? Is the vendor in breach of any of its obligations? Should service credits have been paid?

Value for money. Are you benefiting from any value for money mechanisms? Do you have the right to share profit or cost savings? Is there a cap on the vendor's profit level so that any "super profits" are shared? Do you have a most favored customer clause that hasn't been exploited?

Volume related rights. Does your agreement contain provisions which allow you to re-price fixed charges if the volume of activity falls below an agreed baseline? The pricing of many outsourcing agreements contains fixed charges which may be based to some extent on transaction or headcount assumptions in the base year of the agreement. Often these amounts are to be adjusted when volumes fall below a given "band".

Opportunities for Re-negotiation

Outsourcing agreements should be periodically reviewed to assure that they are supporting the current business requirements of the organization. But a review must be done when major changes in economic circumstances affect the underlying business case for the outsourcing. As well as taking advantage of existing contractual rights, now is the time for outsourcing customers to consider whether any element of the outsourcing could or should be re-negotiated or re-structured to cater to fundamentally different economic conditions. Is the business case for an outsourcing relationship entered into years ago still valid? The following list provides some aspects where changes could be made to improve your position.

Onshore/Offshore Mix. As we discussed in our previous update, offshoring can be a significant driver for cost reduction. There may have been valid reasons at the time, however, for you to decide against offshoring any significant elements of the services at the outset. Does cost sensitivity now outweigh any potential downside? When making the decision whether to outsource services mid-term, the same considerations apply as at the start of the relationship. For more detail on these considerations, see our earlier update.

Currency risk. If there is an offshore element to your deal, consider whether the allocation of currency risk is still valid. If you are paying for offshore services in the local currency, are you prepared to accept the currency risk? Of course, the currency risk can be hedged independently of the vendor by various means, for example, by entering into a currency swap.

Dealing with mergers and divestments. In the past few months, circumstances have resulted in financial industry giants merging overnight and many other businesses being sold. In such a climate, companies should be reviewing the extent to which their existing sourcing relationships could accommodate a merger with a large competitor, or the extent to which such relationships can be terminated and transitioned to an acquiring (or acquired) entity's sourcing vendor. In this area, assignment and termination provisions are key to allow flexibility, as is a pricing mechanism that can adapt to significant volume change. If the contract does not already allow it, consider including the right for group companies to be added or removed as "services recipients". The removal of a services recipient will often be treated as a partial termination for convenience but the liability to pay a termination fee can be avoided if the divested entity enters into a replacement contract with the same vendor.

Output not input. Are your service levels and pricing mechanisms focused on measuring on the vendor's resource usage (input)? If so, consider how you can re-focus on measuring and rewarding the vendor's output. Consolidating the service levels into a smaller number of output-based service levels can be a win-win situation. For the customer, the focus is on service delivery with genuine business benefit and the vendor can save costs by not having to concentrate on delivering, measuring and reporting on a plethora of incidental service levels.

Mid-term financial re-engineering. In our last update, we discussed the strategy at the outset of a deal to spread up-front costs over the term of the agreement and therefore allow the customer to defer paying for items such as transition, asset acquisition or initial take-on costs. There is no reason why the parties could not consider a similar principle mid-term, for example, by the vendor financing mid-term price reductions in return for higher prices later in the term. This option will be viable if the vendor's cost of borrowing is less than the customers.

Dispute resolution. We are already seeing evidence of an increase in the number of sourcing-related disputes as the economy continues to sour. The dispute resolution provisions in your contracts should be reviewed carefully. Are they fit for resolution purposes? Do they meet your needs? If your vendor is based offshore, do you have any enforceability issues? Ideally, these matters should be examined and, if problems exist, cleaned up prior to having to invoke such dispute mechanisms. Often, parties to an outsourcing agreement fall into informal dispute resolution processes rather than following the contractual governance model. Get ahead of this issue by insisting that both parties return to the correct process, and that failures of the service provider to follow up on legitimate disputes are met with appropriate escalation and resolution.

Bringing the vendor to the table

It is all very well listing a number of potential improvements to your sourcing contract, but quite another getting the vendor to agree to them. So how can you bring your vendor to the table? The following list suggests some areas of potential leverage against a service provider.

Extension of term. A vendor may be prepared to offer price reductions or other concessions in return for extension of the contract term.

Right to terminate. Do you have a right to terminate the contract which you could use against the vendor? Preferably this right would be through a break-option or through a right to terminate for convenience without paying substantial compensation. But even if your right to terminate for convenience requires you to pay compensation, vendors prefer to retain existing profitable clients, rather than see them go to the competition. So, the net present value of the agreement to the vendor will likely exceed any compensation to be paid for convenience termination, and the vendor should be open to discuss compromises.

Contract breaches. Is the vendor in breach of any of its contractual terms and have you failed to exercise your strict contractual rights in respect of such breach? Taking steps to (or even threatening to) enforce contractual terms and claim damages for existing breaches may give you some leverage. Aside from the liability to pay damages, the vendor will want to avoid any negative publicity. Of course the more substantial the breach, the more success such a tactic will have. If the breach is so substantial as to allow termination of the contract, this could be the ultimate threat to the vendor.

Widen scope. Is there any opportunity to offer the vendor more scope and/or volume of services in return for a lower unit price?

Trading scope. Interestingly, there probably are elements of the services which produce negative or very little margin for the provider, and these elements are often the services which the provider is not performing very well. A joint review of the services could result in an agreement that the vendor cease performing such elements, perhaps substituting other service elements or reducing scope and providing a price deduction that serves both the customer's and the provider's economic interests.

Client reference. Are you prepared to act as a client reference site in return for some additional benefit from the vendor? Although your endorsement may seem to only offer limited leverage, the bigger or more prestigious customer you are, the more impact it will have – particularly if you remove support or threaten to actively criticize the vendor.

Conclusion

The current economic downturn is causing companies to examine every area of their operations to identify cost savings – and there is no reason why outsourcing arrangements should be exempt. Outsourcing clients should think the previously unthinkable about their outsourcing projects. There are savings to be made through careful analysis, re-structuring and re-negotiation. In some cases, it is possible that there could be a true win-win where a change to an agreement can provide both net cost savings for the customer and improved value for the vendor.