

INPUT

- REPORT - PRODUCTION QC SCHEDULE

Program: Outsourcing Program Year: 1995

Report: NEGOTIATING OUTSOURCING CONTRACTS Project Code: OSCT

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Employee No.: 683

		DATE REC.	DATE SENT	INITIAL
RESEARCH	1. Author—Write report, send to QC Officer			
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DESKTOP PUBLISHING	5. Desktop Publishing—Create/correct exhibits and formatting	8/10	9/18	Bob
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DTP	9. Desktop Publishing—Finalize report	9/28	10/2	Bob
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- REPORT - PRODUCTION QC SCHEDULE

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Cover: GBC Soft Vinyl — Soft Vinyl Window Cover
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Blinder — 3-Hole Drill Shrink Wrap

Cover Title—Exactly how it is to appear on the report cover:

Front: NEGOTIATING OUTSOURCING CONTRACTS
TERMS AND CONDITIONSSpine: (1 Line) NEGOTIATING OUTSOURCING CONTRACTS TERMS AND CONDITIONS
(more than 67 pages only)

(Binder spine may have 2 lines)

Estimated number of pages: < 32 1/16" spine

Please note: 1/16" spine is too small for title to be printed on it.

33-66 1/8" spine67-130 1/4" spine131-196 3/8" spine197-260 1/2" spine261-324 5/8" spine

Executive Overviews:

No. required for Thank-You packages: 40Program Manager Approval: J. - R. Lalla Date: 8/31/95

CENTRAL FULFILLMENT/PRINTING PLEASE COMPLETE:

1. REPORTS: Fulfillment _____	2. EXECUTIVE OVERVIEWS: Fulfillment _____
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TOTAL _____	TOTAL _____

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4. Date to print: _____

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- ① include App. A Survey Questionnaire for Disk
- ② Page #'s for TOC + Lof

1995

Negotiating Outsourcing Contracts

QC by Dan Ryan
09/27/95

Wilson:

Overall, a good, useful report.
Not any major problems. A disal
a fairly quick QC so that you could
get this published ASAP. Call me
if you have questions or concerns.

Dan

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Outsourcing Program

Negotiating Outsourcing Contracts

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Abstract

Outsourcing services have expanded in diversity and become part of options that companies, small to large, consider for the solution to both tactical and strategic business problems. Today, the growth of outsourcing activities continues at an explosive pace. Customer dissatisfaction with service level and costs can destroy the vendor-customer relationship.

Defining the contract terms that reflect customer requirements for service levels and cost containment is a critical phase in the outsourcing life cycle. This ^{report} survey examines users' evaluation of the vendor ability to negotiate contract terms and deliver services responsive to their provisions.

The report is published as part of INPUT's Outsourcing Program. The key topics explored include the following:

- Customer concerns about contract terms and the priorities placed on service delivery, technical resource availability and cost containment
- Customer evaluation of vendor ability to deliver on the performance demands and cost constraints detailed in the contract terms
- Approaches the vendor can adopt to avoid issues of non-conformance and, when ^{these} issues do arise, possible actions to ^{mitigate} ameliorate customer dissatisfaction

This report provides critical information for sales, ^{marketing} and operations specialists who work with customers to ^{determine} appropriate service and cost levels and ^{ensure} responsive and cost-effective service delivery.

The report contains 32 pages, including 13 exhibits.



Introduction

During the survey and development of INPUT's 1995 report, *Pricing and Marketing of Outsourcing Services*, concern was expressed by respondents about controlling the development of contract terms and assuring that the final contract satisfactorily reflected the actual operational cost and service effectiveness. It was from this perspective that INPUT decided to study customers' attitudes and perceptions about the development of contract terms and the manner and sufficiency with which they reflect actual service delivery and cost.

User expenditures on outsourcing services are forecast to grow, in the U.S. at ^{an} 18% compound annual growth rate (CAGR) between 1994 and 2000. INPUT forecasts the value of this expenditure to be \$42 billion by 2000. Along with the growth and heightened interest, however, press reports point to numerous customer complaints about service levels and cost. In many instances, problems are built into the contract terms because of the inability to be sufficiently specific about service expectations. In other cases, the difficulty is in the failure to remedy problems in a prompt and effective manner as they arise.

Companies, small and large, are considering and contracting for outsourcing services for business operations, network and desktop management, application and platform operations, and applications management. In each case, the service delivery expectations must be reflected in the negotiated terms and conditions. Failure to detail the service levels, service costs and potential evolution to new services in the contract can lead to dissatisfaction with services delivered and confrontation with the vendor performing on the contract.

It is important for the vendor to understand the issues arising during contract definition and, after the outsourcing service has begun, the areas in which dissatisfaction may arise in the delivery of services. Further, remedies instituted when service or price fail to meet customer

expectations or contract terms are extremely important to vendors' efforts to ensure long-term, profitable contract operations.

A

Objective and Scope

1. Objective

The objectives of this report, *Negotiating Outsourcing Contracts*, are to:

- Identify the items customers ~~identify~~ ^{identify as having} the highest priority during contract negotiation ~~ASSIGN~~
- Investigate the importance that respondents place upon key issues related to operational performance and cost considerations
- Analyze of the customer rating and ranking of performance, technology, cost and personnel issues.

This report makes
Recommendations ~~are made~~ for working with customers to develop contract terms that are responsive to requirements, prior to contract initiation.

In addition to the important issues that arise prior to the contract signing, ~~the~~ ^{the} study explores customer attitudes and evaluation of vendor performance in the light of contract and service expectations. The study identifies areas in which some vendors fail to meet expectations, whether ~~reflected~~ ^{STATED} in the contract or outside of contract specification. In addition, the relationship between vendor and customer is explored. The report discusses common areas of customer disappointment and recommends ways to avoid such situations.

The study includes assessment^s of customer expectations for vendor performance levels and service costs. The vendor-customer relationship is viewed in terms of contract provisions negotiated and vendor performance relative to these provisions. Recommendations for improving vendor responsiveness and maintaining a positive relationship with the customer are discussed.

2. Scope

The study includes customers in the United States and Canada, representing a wide spectrum of industries, annual sales and degrees of outsourcing commitment. Many have been using outsourcing providers

for more than five years. The survey respondents were from senior and middle management levels.

B

Survey Population and Characteristics

The survey includes customers that have recently begun outsourcing activities, as well as those that have had contracts for as long as five years. Many have multiple contracts for the outsourcing of numerous functions and services. None have terminated outsourcing contracts, but some have renegotiated contract terms or contracted with replacement vendors for the same service. The survey was conducted during the second quarter of 1995.

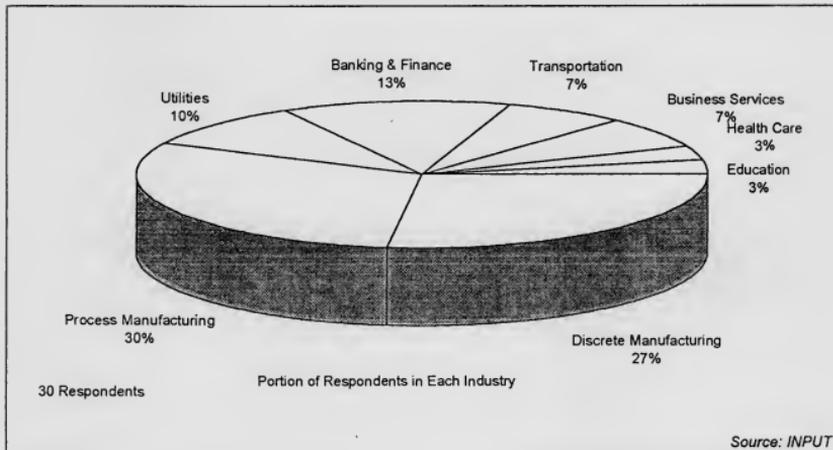
1. Industry Sectors Surveyed

The thirty companies surveyed are in a variety of industrial sectors. As shown in Exhibit I-1, the largest survey population is drawn from the manufacturing sectors.



Exhibit I-1

Distribution of Companies by Industry



Nearly 65% of the companies had annual sales in excess of \$1 billion, as shown in Exhibit I-2. The annual sales of companies in the manufacturing sector ranged between \$170 million and \$100 billion.

Exhibit I-2

Distribution of Companies by Annual Sales

Annual Sales	Portion of Respondents
< \$1 Billion	37%
\$1-20 Billion	50%
\$>\$20 Billion	13%

Source: INPUT

2. Respondent Title and Reporting Relationship

The respondents surveyed were middle-level managers involved with contract negotiation, many of whom were also involved in outsourcing activities. The distribution of survey respondent job titles is shown in Exhibit I-3. These managers reported to senior-level personnel, whose titles are shown in Exhibit I-4.

Exhibit I-3

Survey Respondent Position Titles

Title	Percentage of Respondents
Manager	37
Analyst, Administrator, Coordinator	23
Director	23
Vice President	10
Controller	7

Source: INPUT

Note that more than 50 percent of the senior personnel are corporate officers. For further discussion of the role played by CFOs in outsourcing decisions, see the INPUT report, *The Role of the CFO in Outsourcing Decisions*.

Exhibit I-4

Respondents Reporting Relationship

Respondents Reporting Relationship	Percentage of Respondents
Chief Information Officer	27
Chief Financial Officer	27
Director	12
Vice President	12
Manager	19
Controller	3

Source: INPUT

3. Types of Outsourcing Activities

The companies outsourced a broad spectrum of services and functions. The distribution of outsourcing activities is shown in Exhibit I-5. Many of the respondents outsourced numerous services or functions. However, 53 percent of the survey respondents were outsourcing a single activity. It is noteworthy that desktop services is the most frequent outsourcing activity for this survey population. The next most frequently outsourced support service is network management. Both outsourcing activities continue to take on increasing importance as client/server computing and the networks supporting business automation grow in importance.

Exhibit I-5

Outsourcing Contract Types

Type of Outsourcing Activity	Percentage of Total
Desktop Services	26
Network Management	19
All Operations and Management	17
Business Operations	12
Platform Systems	12
Application Management	9
Application Systems	5

Source: INPUT

4. Outsourcing Budget Allocation

The portion of information systems budget allocated to outsourcing by the surveyed companies averaged 19 percent of the IS budget. The allocation ranged between 1 and 100 percent of the total budget. The largest outsourcing budget allocations were found to be for entire operation outsourcing and network and platform services.

C

Report Organization

The remainder of this report is organized into the following chapters:

- Chapter II, *Executive Overview*, provides a synopsis of the study findings and recommendations.
- Chapter III, *Contract Term Negotiators*, reviews those involved in the negotiation of contract terms. In addition, the involvement of purchasing department personnel is discussed.
- Chapter IV, *Major Pre-Contract Issues*, provides a discussion of the areas of concern to customers since they are perceived as critical to the negotiation process. Recommendations are made for considerations vendors should factor into the negotiation process.
- Chapter V, *Contract Performance*, discusses the importance that customers place on various aspects of contract performance and how well the vendor conforms to the terms and expectations.

D

Related Reports

There are numerous associated INPUT reports on outsourcing to which readers can refer, including the following:

- *U.S. Outsourcing Market Analysis, 1994-1999*
- *Pricing and Marketing of Outsourcing Services*
- *The Impact of Business Process Reengineering on Outsourcing*
- *The Role of the CFO in Outsourcing Decisions*
- *Client Satisfaction with Outsourcing*
- *Business Operations in Outsourcing*

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Executive Overview

The decision to outsource operational functions and business services is complex. It requires the customer to consider multiple issues and factors and to ensure that the vendor understands the metrics against which delivery of the outsourcing service will be measured. Most important is to establish that the outsourcing activity is provided in a timely and cost-effective manner. Outsourcing projects generally are contracted for multiple years; this results in the task of definition often being complicated and stressful and requiring careful and reasoned considerations about service and cost expectations two, three, or even five years into the future.

A satisfactory relationship between vendor and customer will depend heavily upon the ability of each to fashion a contract that both parties find mutually acceptable and that appropriately reflects the reality of what the customer wants and the vendor is capable of delivering. Any failure to reflect expectations and capabilities will ultimately result in dissatisfaction, perhaps requiring mediation, renegotiation, arbitration or, at worst, litigation. ~~In all cases, avoidance of the need to resolve issues under such alternatives should be paramount.~~

A

Establishing Contract Terms

The study results reveal that the primary ^{challenge} concerns during the crafting of the outsourcing contract are ~~to define~~ the acceptable levels of service delivery while simultaneously bounding the domain of expected cost. On the basis of relative importance, the highest-rated issues are service level guarantees, commitment to delivery schedules and the availability of appropriate technical personnel.

Access to technical personnel is mentioned most frequently, but does not rank at the top of the list of concerns. Rather, issues of price and cost have the highest priority. Although, fixed pricing is a key negotiation

issue, financial incentives linked to performance are not. Warrantees are included in the list of top concerns, but linking them to incentives is not mentioned.

Respondents were questioned about which negotiating issues were resolved with ease and which with difficulty. Vendors should note that price is mentioned most frequently as an easily resolved issue while, when questioned about the most difficult negotiation issue, price and service level are ranked equally and most frequently. Almost without exception, little mention is made of major issues threatening the negotiations (i.e. "deal breakers") that arose at the time of contract signing.

The purchasing department played a key role in the contract negotiation in little more than half of the survey sample. Further, this department took the lead in negotiation in less than 15% of the cases. In light of the fact that outsourcing contracts generally are complex documents designed to define service and cost level expectations clearly, it is interesting that the purchasing department is not mentioned more frequently as taking a leading role in the negotiation process. A later portion of the survey found that several respondents indicated a desire for active purchasing department participation in the next round of outsourcing contract negotiations.

B

Contract Performance

Eighty percent of the customers surveyed have at least one year of experience operating with an outsourc^{ING} contract, and more than half have more than two years of operational experience. The second portion of the study concerned the experience of these companies regarding actual vendor performance. The survey respondents indicated that the vendors have, in general, performed within reasonable expectations. However, this is not to say that companies, across the board, are satisfied with all aspects of contractor performance and adherence to contract terms.

Items identified as being most at issue are unanticipated service costs and failure to meet service objectives. Nearly a quarter of the respondent companies are in some stage of contract renegotiation, on a formal or informal basis, to remedy problems with aspects of the above issues or due to service scope changes requested by the customer.

In spite of these problems, relations with vendors are reported as improved or little impacted. Less than 20% of the survey sample believed that the relationship with the vendor had deteriorated. In those cases where deterioration had occurred the reasons for failing relationships can be summarized as:

- problems with cost containment
- unwillingness on the part of the vendor to resolve ongoing operational problems.

Those reporting improvement in relationships generally identified the following factors as contributing to the change:

- the vendor's efforts to work through problems
- stability of key vendor personnel who stay with the contract operation
- the vendor's effort at constant improvement.

C

Conclusions

The study indicates that vendors received an above-average rating for delivering outsourcing services. However, there are still issues that create customer concerns about contract terms and vendors' ability to deliver. The most frequently mentioned issues, both pre- and post-contract signing, are assuring appropriate levels of service delivery and controlling the cost of service. Equally important, but usually not written into the contract, is concern about the vendor's willingness to assign appropriate personnel to the outsourcing contract, to work through problems as they arise and to work as a team in order to get the job done.

Vendors can shorten the process of contract term definition and negotiation by recognizing the needs of the company to appropriately define the service levels to be delivered and the cost expectations. Efforts to facilitate early agreement on these issues and vendor commitment to delivery will solidify relations with the company and offer opportunity for additional contracts for outsourcing services. Further, it becomes clear that customer pre-contract activities involve the functional business unit organizations in defining the service and cost levels, as well as IS departments. Efforts on the part of the vendor to make early, proactive efforts at working with the personnel in these organizations will hasten the process of contract agreement and, after start-up, provide a base for simplified and quick conflict resolution.

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Contract Term Negotiators

Outsourcing contract terms and conditions represent some of the most important determinants influencing satisfaction with service delivery and the relationship between vendor and customer. Contract negotiation is, indeed, a critical phase in the life cycle of outsourcing service delivery. Accordingly, it is important to understand who the lead negotiators are and who else participates in the contract negotiation process. This helps set a framework for the terms identified as being critical to the success of the outsourcing contract. *This chapter is organized into the following sections:*

- Section A, *The Lead Negotiators*, is a review of the senior personnel who are involved in the leadership and process of negotiating outsourcing contract terms. Further discussion is devoted to other key participants in the negotiation process.
- Section B, *Purchasing Department Participation*, reviews the customer's contracting or purchasing department participation in the contract negotiation process.
- Section C, *Conclusions and Recommendations*, suggests approaches that vendors can take to better understand the driving forces and initiatives that shape the contract terms.

A

The Lead Negotiators

The survey results reveal that the contract term negotiations usually are conducted by mid- to senior-level managers who have direct responsibility for the specific service or business function being outsourced. In addition to the question of negotiation leadership, the respondents also were asked if the negotiation was carried out by a committee. In only three cases (10% of the survey), were the negotiations managed by committees of senior personnel. Lead negotiating responsibility by department is shown in Exhibit III-1.

Exhibit III-1

Key Negotiators

Lead Negotiator's Department	Count	Percentage of Total
Information Systems	16	59
Non-Information Systems	11	41

Source: INPUT

It is useful to note that 41% of the senior lead negotiators are from non-information systems departments. This statistic clearly indicates the importance to be placed on thorough insight regarding not only the information systems-related requirements, but also the needs of the business and user departments. Only then is it possible to understand the driving forces that influence contract terms.

In 43% of the survey (13 companies), the negotiation of contract terms was carried out or supported by a committee of managers. The composition of these committees varied, but many had participation from staff support groups, including the legal, finance and human resource departments. This again highlights the need for the vendor to place heavy emphasis upon understanding the needs and influences of the entire organization.

B

Purchasing Department Participation

Members of the purchasing department were found to have participated in contract definition and negotiation in only 57 percent of the companies in the survey. Because the negotiation of contract terms is so closely related to the activity of the purchasing or contract department, it is unusual that this department was not mentioned more frequently as having major involvement in the negotiation process. In only four cases (13%) did the purchasing department take lead responsibility for negotiations. It is interesting to note that in two cases, companies that did not have strong purchasing department involvement would opt for such participation in future negotiations.

C

Conclusions and Recommendations

Committees and non-IS management negotiators represent another challenge to the negotiation process. Whether the customer negotiator is a committee or an individual, it is imperative that the vendor develops an appreciation for the internal user issues that are driving the decision to

outsource. Now that the reasons for outsourcing transcend the traditional issues of cost and operational convenience, understanding the secondary driving forces takes on new significance. As a result, the need to develop contacts and relationships within the customer organization at all levels and encompassing all interests in aspects of the prospective outsourcing service must be stressed. Vendors will improve their position by understanding all the requirements of the outsourcing project and being prepared to respond and shape these expectations in conformity with its ability to deliver.

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Major Pre-Contract Issues

Contract terms and conditions are designed to define the scope of services, provide for the service pricing structure, and set out appropriate methods by which the vendor or customer can pursue recourse/should disputes arise. During the recent years of outsourcing contract growth, many additional service areas (e.g. Desktop Services) have become part of the mainstream, as has the ^{VARIETY} ~~breadth~~ of companies served. At the same time, the gap between customer expectations and actual service delivered show signs of widening. There is evidence in several high-profile outsourcing contracts to suggest that vendors are sometimes unable to be responsive enough to contract terms.

The instances of disappointment with the nature, level and cost of service continue to grow. The reasons for the mismatch between expectation and reality are many. Failure of the customer to specify performance and cost expectations appropriately and the vendor's inability to manage expectations and service delivery are often at the nexus of deteriorating business relationships.

This chapter will explore the issues that are of greatest importance to the survey respondents. Vendors will benefit from developing an understanding about the factors that are important to the customer during and after contract negotiation. Although the quality of service and associated costs continue to be of primary importance to the customer, a more detailed level of requirement specification is important. The following sections explore the key contract provisions that respondents identified as having particular importance. Issues arising prior to the signing of the contract are rated, ranked and discussed. *This chapter is organized into the following sections:*

- Section A, *Key Contract Provisions*, contains the customer survey responses to key issues thought important in the contract negotiation phase.

- Section B, *Issue Resolution at Contract Time*, discusses the items that are either easy or difficult to resolve at the time of contract completion.
- Section C, *Conclusions and Recommendations*, contains suggestions for improving the process of negotiation so as to arrive at contract terms that represent the intent of the user and the capabilities of the vendor.

A

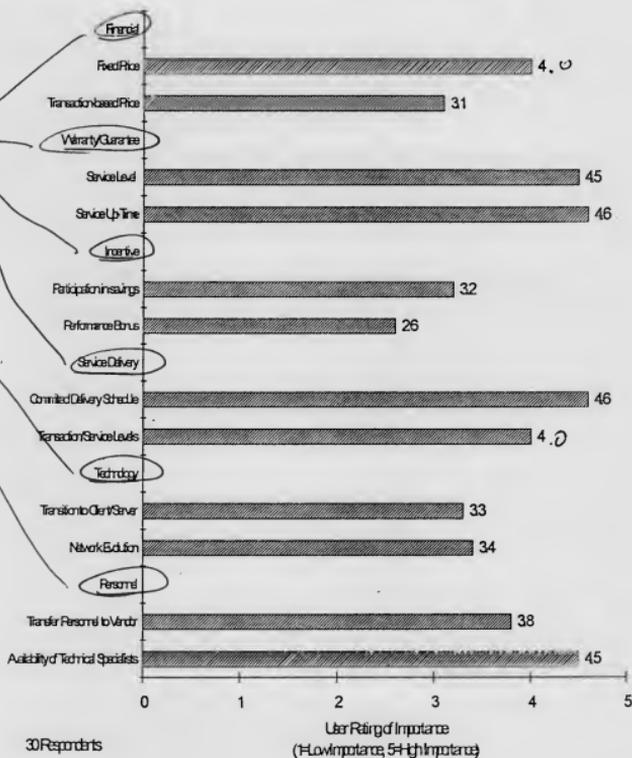
Key Contract Provisions

The traditional issues of cost, service delivery and access to technical resources weigh heavily on the minds of users. These concerns generally arise in contracts for delivering technical services. However, they become particularly problematic when the customer is faced with defining performance and cost expectations at contract initiation and, in many cases, two, five, or more years into the future.

There are six key areas of contention when contract performance terms are being defined. These were discussed in INPUT's report, *Pricing and Marketing of Outsourcing Services*. All issues were to be rated in the context of their importance when negotiating contract terms. Exhibit IV-1 shows the average rating response for each performance category.

Exhibit IV-1

Rating of Key Contract Considerations



Source: INPUT

The highest rated items (i.e., 4.5 to 4.6 rating) are guarantee of service level up-time, commitment to delivery schedule, service level guarantee and availability of technical specialists. Although service and delivery commitments and fixed pricing are important, it is interesting to note that the aggregate survey response indicated the least interest in considering incentives and bonuses for achieving specific performance levels. This indicates that vendors may gain little, or even lose, by emphasizing pricing mechanisms based on performance and/or delivery

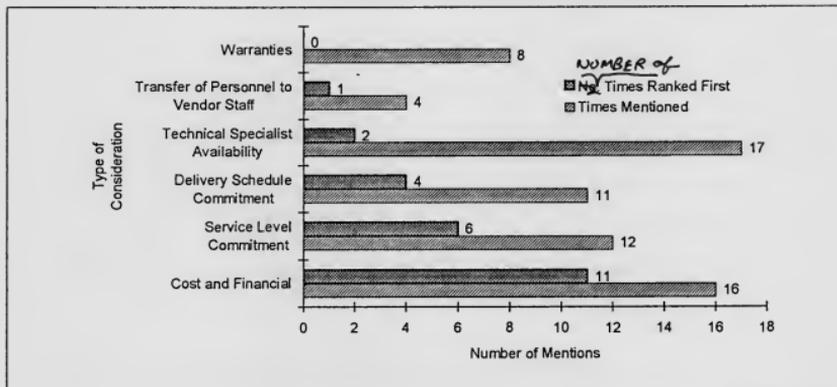
levels. It is better for vendors to take the approach that achievement of performance and delivery levels should be assumed rather than provided as a means to earn additional compensation.

In addition, the availability of technical specialists continues to be a major, persistent issue for projects such as these in which technology is evolving rapidly. This will become more even important over the next few years as the portion of client/server systems that are outsourced while also increasing in complexity. In fact, this increased technical complexity is now a driving force behind the growth of outsourcing.

Respondents also were asked to rank the items most important ~~to be~~ ^{included} in the outsourcing contract. A tabulation of the rankings is shown in Exhibit IV-2.

Exhibit IV-2

Ranking of Key Contract Considerations



Source: INPUT

Again, it is instructive to note that availability of technical specialists is the most frequently mentioned concern, although this issue did not receive the most frequent first ranking. Rather, cost and financial considerations ranked most frequently in the first position. These six issues represent 65 percent of the responses.

The consistent message here for vendors is that customers are concerned about guaranteeing specific levels of service, controlling the cost and assuring that appropriate skill levels are committed with ongoing

availability to the outsourcing project. Efforts to work collaboratively with the customer in the early stages of identifying appropriate and practical levels of performance while rationalizing achievable cost/performance objectives should represent early cornerstones for open, professional relationships with the customer. Crafting realistic expectations for performance and cost will help to ~~reduce~~ ^{MINIMIZE} disappointment with actual performance and incurred costs as issues arise.

B

Issue Resolution at Contract Time

An objective of the study is to identify the contract terms most easily negotiated at the time of contract signing, and those either most difficult to negotiate or what can best be termed "deal breakers." It was found that price and service level were the most frequently mentioned issues as either easy or difficult to resolve. The aggregate responses for these two represented 52 and 54 percent of the responses in the easy and difficult categories, respectively. See Exhibit IV-3 ^{Below} for additional detail.

Exhibit IV-3

Top Issues Easy and Difficult to Resolve

Category	Easy to resolve Percent of total	Hard to resolve Percent of total
Price	44	27
Service Level	8	27

Source: INPUT

The two issues were linked in many responses. In fact, the clear message is that cost and service level are at the root of customer concerns.

Few respondents identified any issues as being deal breakers although two users emphasize that they would not negotiate on price.

C

Conclusions and Recommendations

The key measures of service delivery to which customers expect vendors to make a commitment are:

- Outsourcing cost
- Service level
- Responsiveness

Further, the message is that users are comfortable with pricing arrangements and service level guarantees that assure limitations on cost at level of service delivery.

Joint sharing of cost savings or incentives based on performance appear to have little appeal. Vendors who choose to pursue this approach to pricing should review the way in which this is presented to prospects. The current lack of appeal may be the result of the benefits and advantages provided by performance bonuses and sharing in cost savings having been presented to the customer in an ineffective manner. This lack of marketing effectiveness is studied in INPUT's report "Pricing and Marketing of Outsourcing Services".

Users are concerned about the availability and dedication of appropriate management and technical personnel to the outsourcing project. Further, a number of the respondents expressed concern about the vendor's ability to smoothly transfer its personnel to the vendor organization. Associated with this concern ^{is} the retention of the transferred personnel ^{to} ~~to~~ ^{so they can} continue working on the customer's activities, and ^{the} assurance that transferred personnel will find the new management and benefit environment sufficiently acceptable to avoid any legal actions.

Vendors can overcome this user concern by taking time, during the negotiation process, to explain and document their procedures for integrating transferred personnel. They should also define the future role for these individuals.

Vendors can help to improve the negotiation process by understanding the service level and cost containment objectives the prospective customer is attempting to achieve. Clear and open communication about these issues is essential. The vendor will improve its negotiating position by responding openly and realistically about the customer's performance and cost demands and, in response, the vendor's ability to deliver on these objectives. In addition, issues about the availability of appropriate technical and management personnel dedicated to the project also are very important to the negotiation process.

During the contract definition phase, the vendor is in the best position to develop a close working relationship with the customer and, in the process, help to craft terms that reflect the vendor's ability to deliver. Because, in today's market, contract terms must more broadly represent the requirements not only of the information systems department, but also the user groups within the functional business units, it is important

that the vendor sales and contract negotiation team develop a clear understanding of the driving forces at all levels in each of the customer departments. This means that the vendor can improve the process by knowing which of the customer's personnel are driving the requirements definitions and working with them to ~~insure~~ ^{assure} that these requirements are realistic and achievable.

Finally, early presentation by the vendor of the technical and management personnel who are to be assigned to the outsourcing project will help to assure the customer that a competent team is ready start to the project. The more the customer gets to know these vendor personnel before the contract, the greater the probability of achieving a positive supplier-customer relationship.

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Contract Performance

This chapter provides insight into operational reality and compliance with contract terms and conditions. Of the respondent customers, 66% have been operating with outsourcing services for more than two years. Most of the respondents report successful outsourcing service operations—but not without problems, in several cases. In addition, the views of the surveyed companies regarding how they would change the emphasis of contract terms in future negotiations is discussed. *This chapter is organized into the following sections:*

- Section A, *Vendor Performance and Contract Terms*, presents users' assessment of vendors' ability to deliver expected services at acceptable cost levels. It also looks into the lessons learned and actions that the company took to resolve issues with the vendor.
- Section B, *Hindsight and Negotiating Better Contract Terms*, looks into user assessment of the actions that can be taken when negotiating outsourcing contracts in the future.
- Section C, *Conclusions and Recommendations*, makes suggestions regarding managing user expectations and positioning the vendor so as to avoid a customer's loss of confidence in the vendor's ability to deliver.

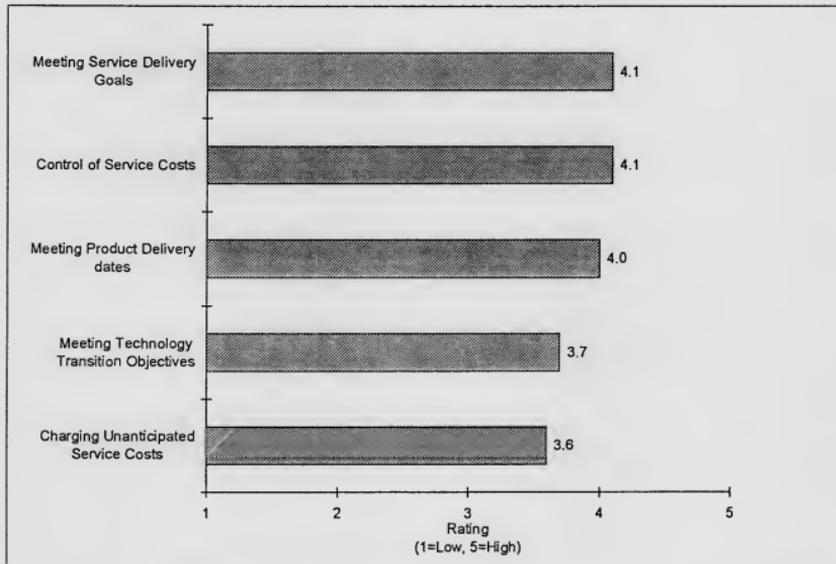
A

Vendor Performance and Contract Terms

It is important to obtain customer assessment of the vendor's performance, subsequent to contract initiation. The respondents were asked to rate how well the vendors performed in areas of cost and service level. The ratings for five specific performance areas are shown in Exhibit V-1.

Exhibit V-1

Vendor Performance Rating



Source: INPUT

The assessment indicates that, overall, users believe the vendors have performed at or above average levels of expectation. The variation in these average ratings is quite small, indicating that there is no significant disparity among the respondents' ratings. In only one case did the respondent give particularly low ratings (i.e. 1 or 2) to its vendor for the issues of meeting service goals, controlling costs and being faced with unanticipated costs. This particular outsourcing contract is in the early stages of operational delivery.

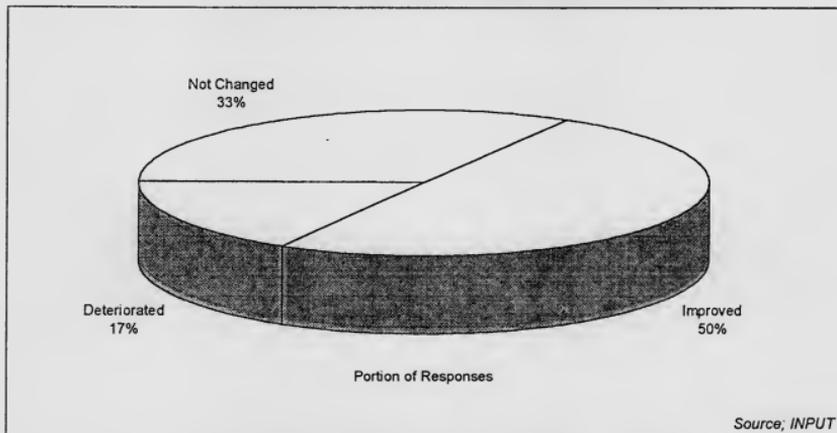
However, the unanticipated service cost item provides evidence that this area certainly could be improved, the rating being just above average performance. Three of the survey respondents indicated that unanticipated costs were a problem and that negotiations to arrive at resolutions are still in process. At the same time, several customers indicated that their vendors were very quick to arrive at resolution of problems as they arose.

Seven of the companies (23% of the survey population) responded that the outsourcing contracts were in some stage of renegotiation. Reasons for renegotiation boiled down to dissatisfaction over unanticipated costs or failure to meet service goals, or a change in project scope. Several customers indicated that through there are problems with service delivery, nothing is being done to renegotiate contract terms; apparently, the user does not consider the problem severe.

The survey asked the respondents to characterize how their relationships with vendors have evolved since initiating outsourcing activities. Ratings are shown in Exhibit V-2.

Exhibit V-2

Relationship with Vendor Since Contract Initiation



Again, this would appear to be a very positive evaluation, in that half of the companies believe that the relationship with the vendor has improved. The common themes underlying improvement are:

- Good vendor personnel who are technically matched to the need and who strive for teamwork
- The willingness on the part of the vendor to solve the problems when they arise and then to "go the extra mile" to deliver on the commitments.

The common criticisms among companies that believed the relationship had deteriorated were:

- the inability to meet service level commitments
- the difficulty with cost containment.

Once again, there is good reason to be concerned about these two issues both prior to and after contract signing.

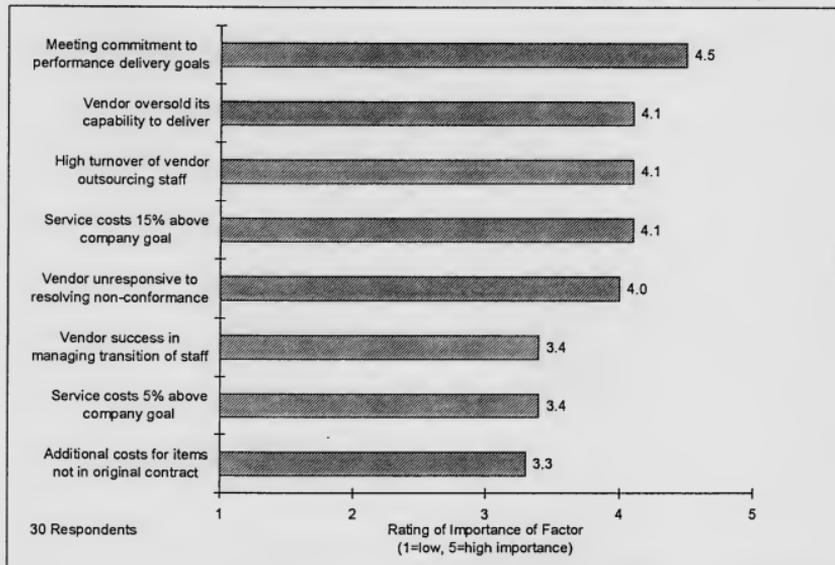
Surveyed companies were also asked to rate factors that would do the most harm to the relationship with the vendor. Examples of such factors include:

- Vendor service that was unresponsive to contract terms,
- Costs that were unanticipated or in excess of contract terms
- Issues of vendor and company personnel

The respondents' rating of these items is shown in Exhibit V-3.

Exhibit V-3

Factors that Can Most Harm Vendor-Customer Relationships



Source: INPUT

Once again, the message is that meeting the performance commitments has the greatest impact upon the vendor's relationship to the customer. The aggregate response is consistent with the responses earlier in the survey regarding the most important contract terms. Related to performance are vendors' actions to resolve non-conformance issues and overselling their ability to deliver. Both of these items are rated just below performance delivery.

Regarding service cost, it is interesting to note that the respondents indicated a concern about cost overruns in the range of 5 percent, but with less importance than a 15 percent overrun. Unanticipated or added costs were rated just below the 5 percent overrun. Although cost is of major concern, these responses seem to indicate that the customer does have some tolerance for unanticipated or excessive costs, beyond the expected levels.

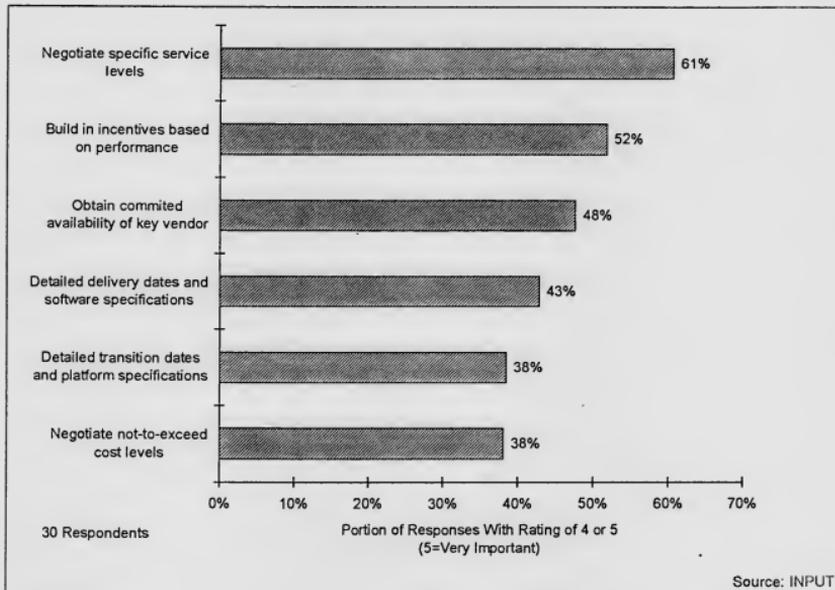
B

Hindsight and Negotiating Better Contract Terms

Respondents were asked to consider how their organization could have negotiated better contract terms. The emphasis was to take advantage of hindsight and rate actions that they could have taken to produce better contract terms. The ratings of selected actions are shown in Exhibit V-4.

Exhibit V-4

Improving the Contract Terms



Where's the chart?

If the user views of these revisions to contract terms are considered in light of the average rating then there is little differentiation. The highest rated is "Obtain committed availability of key vendor personnel" with a rating of 3.4 and the lowest is "Detail specific software specifications and delivery dates" with a rating of 2.9. This indicates a broad range of opinions regarding this area. However, by considering the portion of respondents rating each type of revision as very or most important (rating of 4 or 5) then a commonality of views emerges—in hindsight, users

would place more emphasis on negotiation of terms regarding level of performance. The relatively high portion (48%) of respondents who ranked highly the availability of key vendor personnel confirms the findings expressed in the previous chapter (see Exhibit IV-2), which indicated that the most often ranked contract consideration was that of technical specialist availability.

Other actions mentioned to ^{ensure} ~~insure~~ better contract negotiations were plans to involve a greater number of prospective vendors in the negotiation process and to obtain the involvement of the purchasing department in working out the contract terms.

C

Conclusions and Recommendations

Contract terms that address cost containment, ^{the} early surfacing of unanticipated costs, and service level guarantees are key prerequisites for a successful relationship with the customer. This study indicates that this is the primary message in all phases of the outsourcing contract life cycle. These elements are important during contract definition as well as ongoing project operation. Equally important to negotiating a contract that both sides find satisfactory is the effort keep the relationship on a positive and growing basis after the service begins.

Measures to avoid customer dissatisfaction once the outsourcing activities have begun are clear:

- The vendor must be committed to working actively to resolve contract non-conformance issues. This means that, as and when problems arise, appropriate personnel must be available to work out the technical and administrative issues requiring resolution.
- Working out the issues means that the vendor can best preserve its relationship with the customer by being up front when performance shortfalls arise, and by ^{insuring} ~~insure~~ that competent personnel who understand the customer's technical and service environment are at the customer site on a regular basis.
- Having identified incipient stages of potential problems, early resolution will help to ^{insure} ~~insure~~ a long lasting business relationship with the customer.

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Negotiating Outsourcing Contracts

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Frankfurt • London • New York • Paris • San Francisco • Tokyo • Washington, D.C.



Abstract

Outsourcing services have expanded in diversity and become part of options that companies, small to large, consider for the solution to both tactical and strategic business problems. Today, the growth of outsourcing activities continues at an explosive pace. Customer dissatisfaction with service level and costs can destroy the vendor-customer relationship.

Defining the contract terms that reflect customer requirements for service levels and cost containment is a critical phase in the outsourcing life cycle. This survey examines users' evaluation of the vendor ability to negotiate contract terms and deliver services responsive to their provisions.

The report is published as part of INPUT's Outsourcing Program. The key topics explored include the following:

- Customer concerns about contract terms and the priorities placed on service delivery, technical resource availability and cost containment
- Customer evaluation of vendor ability to deliver on the performance demands and cost constraints detailed in the contract terms
- Approaches the vendor can adopt to avoid issues of non-conformance and, when issues do arise, possible actions to ameliorate customer dissatisfaction

This report provides critical information for sales, marketing and operations specialists who work with customers to craft appropriate service and cost levels and insure responsive and cost-effective service delivery.

The report contains 32 pages , including 13 exhibits.

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Outsourcing Program

Negotiating Outsourcing Contracts

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Table of Contents

I. Introduction

- A. Objective and Scope
 - 1. Objective
 - 2. Scope
 - B. Survey Population and Statistics
 - 1. Industry Sectors Surveyed
 - 2. Respondent Title and Reporting Relationship
 - 3. Types of Outsourcing Activities
 - 4. Outsourcing Budget Allocation
 - C. Report Organization
 - D. Related Reports
-

II. Executive Overview

- A. Establishing Contract Terms
 - B. Contract Performance
 - C. Conclusions
-

III. Contract Term Negotiators

- A. The Lead Negotiators
 - B. Purchasing Department Participation
 - C. Conclusions and Recommendations
-

IV. Major Pre-Contract Issues

- A. Key Contract Provisions
 - B. Issue Resolution at Contract Time
 - C. Conclusions and Recommendations
-

V. Contract Performance

- A. Vendor Performance and Contract Terms
- B. Hindsight and Negotiating Better Contract Terms



C. Conclusions and Recommendations

Appendix

A. Survey Questionnaire



Exhibits

I

- 1 Distribution of Companies by Industry
 - 2 Distribution of Companies by Annual Sales
 - 3 Survey Respondent Position Titles
 - 4 Respondents' Reporting Relationship
 - 5 Outsourcing Contract Types
-

III

- 1 Key Negotiators
-

IV

- 1 Rating of Key Contract Considerations
 - 2 Ranking of Key Contract Considerations
 - 3 Top Issues Easy and Difficult to Resolve
-

V

- 1 Vendor Performance Rating
- 2 Relationship with Vendor Since Contract Initiation
- 3 Factor that Can Most Harm Vendor-Customer Relationships
- 4 Improving the Contract Terms



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Introduction

During the survey and development of INPUT's 1995 report, *Pricing and Marketing of Outsourcing Services*, concern was expressed by respondents about controlling the development of contract terms and assuring that the final contract satisfactorily reflected the actual operational cost and service effectiveness. It was from this perspective that INPUT decided to study customers' attitudes and perceptions about the development of contract terms and the manner and sufficiency with which they reflect actual service delivery and cost.

User expenditures on outsourcing services are forecast to grow, in the U.S. at 18% compound annual growth rate (CAGR) between 1994 and 2000. INPUT forecasts the value of this expenditure to be \$42 billion by 2000. Along with the growth and heightened interest, however, press reports point to numerous customer complaints about service levels and cost. In many instances, problems are built into the contract terms because of the inability to be sufficiently specific about service expectations. In other cases, the difficulty is in the failure to remedy problems in a prompt and effective manner as they arise.

Companies, small and large, are considering and contracting for outsourcing services for business operations, network and desktop management, application and platform operations, and applications management. In each case, the service delivery expectations must be reflected in the negotiated terms and conditions. Failure to detail the service levels, service costs and potential evolution to new services in the contract can lead to dissatisfaction with services delivered and confrontation with the vendor performing on the contract.

It is important for the vendor to understand the issues arising during contract definition and, after the outsourcing service has begun, the areas in which dissatisfaction may arise in the delivery of services. Further, remedies instituted when service or price fail to meet customer

expectations or contract terms are extremely important to vendors' efforts to ensure long-term, profitable contract operations.

A

Objective and Scope

1. Objective

The objectives of this report, *Negotiating Outsourcing Contracts*, are to:

- Identify the items customers identify as having the highest priority during contract negotiation
- Investigate the importance that respondents place upon key issues related to operational performance and cost considerations
- Analyze of the customer rating and ranking of performance, technology, cost and personnel issues.

Recommendations are made for working with customers to develop contract terms that are responsive to requirements, prior to contract initiation.

In addition to the important issues that arise prior to the contract signing, the study explores customer attitudes and evaluation of vendor performance in the light of contract and service expectations. The study identifies areas in which some vendors fail to meet expectations, whether reflected in the contract or outside of contract specification. In addition, the relationship between vendor and customer is explored. The report discusses common areas of customer disappointment and recommends ways to avoid such situations.

The study includes assessment of customer expectations for vendor performance levels and service costs. The vendor-customer relationship is viewed in terms of contract provisions negotiated and vendor performance relative to these provisions. Recommendations for improving vendor responsiveness and maintaining a positive relationship with the customer are discussed.

2. Scope

The study includes customers in the United States and Canada, representing a wide spectrum of industries, annual sales and degree of outsourcing commitment. Many have been using outsourcing providers

for more than five years. The survey respondents were from senior and middle management levels.

B

Survey Population and Characteristics

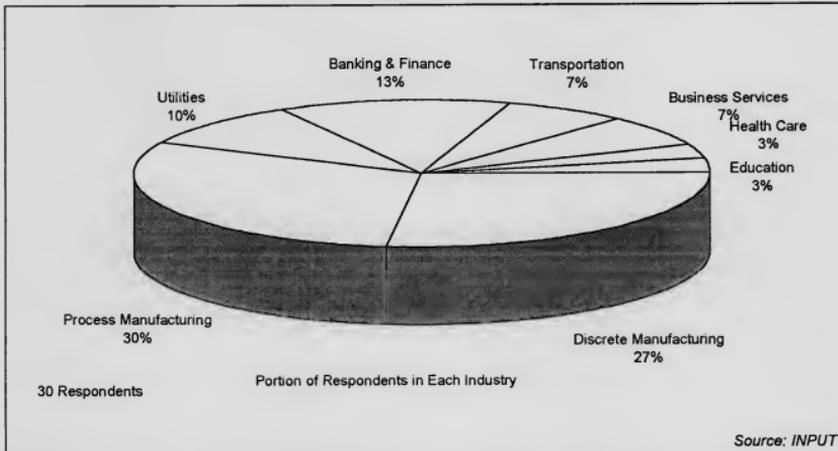
The survey includes customers that have recently begun outsourcing activities, as well as those that have had contracts for as long as five years. Many have multiple contracts for the outsourcing of numerous functions and services. None have terminated outsourcing contracts, but some have renegotiated contract terms or contracted with replacement vendors for the same service. The survey was conducted during the second quarter of 1995.

1. Industry Sectors Surveyed

The thirty companies surveyed are in a variety of industrial sectors. As shown in Exhibit I-1, the largest survey population is drawn from the manufacturing sectors.

Exhibit I-1

Distribution of Companies by Industry



Nearly 65% of the companies had annual sales in excess of \$1 billion, as shown in Exhibit I-2. The annual sales of companies in the manufacturing sector ranged between \$170 million and \$100 billion.

Exhibit I-2

Distribution of Companies by Annual Sales

Annual Sales	Portion of Respondents
< \$1 Billion	37%
\$1-20 Billion	50%
\$>\$20 Billion	13%

Source: INPUT

2. Respondent Title and Reporting Relationship

The respondents surveyed were middle-level managers involved with contract negotiation, many of whom were also involved in outsourcing activities. The distribution of survey respondent job titles is shown in Exhibit I-3. These managers reported to senior-level personnel, whose titles are shown in Exhibit I-4.

Exhibit I-3

Survey Respondent Position Titles

Title	Percentage of Respondents
Manager	37
Analyst, Administrator, Coordinator	23
Director	23
Vice President	10
Controller	7

Note that more than 50 percent of the senior personnel are corporate officers. For further discussion of the role played by CFOs in outsourcing decisions, see the INPUT report, *The Role of the CFO in Outsourcing Decisions*.

Exhibit I-4

Respondents Reporting Relationship

Respondents Reporting Relationship	Percentage of Respondents
Chief Information Officer	27
Chief Financial Officer	27
Director	12
Vice President	12
Manager	19
Controller	3

3. Types of Outsourcing Activities

The companies outsourced a broad spectrum of services and functions. The distribution of outsourcing activities is shown in Exhibit I-5. Many of the respondents outsourced numerous services or functions. However, 53 percent of the survey respondents were outsourcing a single activity. It is noteworthy that desktop services is the most frequent outsourcing activity for this survey population. The next most frequently outsourced support service is network management. Both outsourcing activities continue to take on increasing importance as client/server computing and the networks supporting business automation grow in importance.

Exhibit I-5

Outsourcing Contract Types

Type of Outsourcing Activity	Percentage of Total
Desktop Services	26
Network Management	19
All Operations and Management	17
Business Operations	12
Platform Systems	12
Application Management	9
Application Systems	5

4. Outsourcing Budget Allocation

The portion of information systems budget allocated to outsourcing by the surveyed companies averaged 19 percent of the IS budget. The allocation ranged between 1 and 100 percent of the total budget. The largest outsourcing budget allocations were found to be for entire operation outsourcing and network and platform services.

C

Report Organization

The remainder of this report is organized into the following chapters:

- Chapter II, *Executive Overview*, provides a synopsis of the study findings and recommendations.
- Chapter III, *Contract Term Negotiators*, reviews those involved in the negotiation of contract terms. In addition, the involvement of purchasing department personnel is discussed.
- Chapter IV, *Major Pre-Contract Issues*, provides a discussion of the areas of concern to customers since they are perceived as critical to the negotiation process. Recommendations are made for considerations vendors should factor into the negotiation process.
- Chapter V, *Contract Performance*, discusses the importance that customers place on various aspects of contract performance and how well the vendor conforms to the terms and expectations.

D**Related Reports**

There are numerous associated INPUT reports on outsourcing to which readers can refer, including the following:

- *U.S. Outsourcing Market Analysis, 1994-1999*
- *Pricing and Marketing of Outsourcing Services*
- *The Impact of Business Process Reengineering on Outsourcing*
- *The Role of the CFO in Outsourcing Decisions*
- *Client Satisfaction with Outsourcing*
- *Business Operations in Outsourcing*

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II

Executive Overview

The decision to outsource operational functions and business services is complex. It requires the customer to consider multiple issues and factors and to ensure that the vendor understands the metrics against which delivery of the outsourcing service will be measured. Most important is to establish that the outsourcing activity is provided in a timely and cost-effective manner. Outsourcing projects generally are contracted for multiple years, this results in the task of definition often being complicated and stressful and requiring careful and reasoned considerations about service and cost expectations two, three, or even five years into the future.

A satisfactory relationship between vendor and customer will depend heavily upon the ability of each to fashion a contract that both parties find mutually acceptable and that appropriately reflects the reality of what the customer wants and the vendor is capable of delivering. Any failure to reflect expectations and capabilities will ultimately result in dissatisfaction, perhaps requiring mediation, renegotiation, arbitration or, at worst, litigation. In all cases, avoidance of the need to resolve issues under such alternatives should be paramount.

A

Establishing Contract Terms

The study results reveal that the primary customer concerns during the crafting of the outsourcing contract are to define the acceptable levels of service delivery while simultaneously bounding the domain of expected cost. On the basis of relative importance, the highest rated issues are service level guarantees, commitment to delivery schedules and the availability of appropriate technical personnel.

Access to technical personnel is mentioned most frequently, but does not rank at the top of the list of concerns. Rather, issues of price and cost have the highest priority. Although, fixed pricing is a key negotiation

issue, financial incentives linked to performance are not. Warrantees are included in the list of top concerns, but linking them to incentives is not mentioned.

Respondents were questioned about which negotiating issues were resolved with ease and which with difficulty. Vendors should note that price is mentioned most frequently as an easily resolved issue while, when questioned about the most difficult negotiation issue, price and service level are ranked equally and most frequently. Almost without exception, little mention is made of major issues threatening the negotiations (i.e. "deal breakers") that arose at the time of contract signing.

The purchasing department played a key role in the contract negotiation in little more than half of the survey sample. Further, this department took the lead in negotiation in less than 15% of the cases. In light of the fact that outsourcing contracts generally are complex documents designed to define service and cost level expectations clearly, it is interesting that the purchasing department is not mentioned more frequently as taking a leading role in the negotiation process. A later portion of the survey found that several respondents indicated a desire for active purchasing department participation in the next round of outsourcing contract negotiations.

B

Contract Performance

Eighty percent of the customers surveyed have at least one year of experience operating with an outsource contract, and more than half have more than two years of operational experience. The second portion of the study concerned the experience of these companies regarding actual vendor performance. The survey respondents indicated that the vendors have, in general, performed within reasonable expectations. However, this is not to say that companies, across the board, are satisfied with all aspects of contractor performance and adherence to contract terms.

Items identified as being most at issue are unanticipated service costs and failure to meet service objectives. Nearly a quarter of the respondent companies are in some stage of contract renegotiation, on a formal or informal basis, to remedy problems with aspects of the above issues or due to service scope changes requested by the customer.

In spite of these problems, relations with vendors are reported as improved or little impacted. Less than 20% of the survey sample believed that the relationship with the vendor had deteriorated. In those cases where deterioration had occurred the reasons for failing relationships can be summarized as:

- problems with cost containment
- unwillingness on the part of the vendor to resolve ongoing operational problems.

Those reporting improvement in relationships generally identified the following factors as contributing to the change:

- the vendor's efforts to work through problems
- stability of key vendor personnel who stay with the contract operation
- the vendor's effort at constant improvement.

C

Conclusions

The study indicates that vendors received an above-average rating for delivering outsourcing services. However, there are still issues that create customer concerns about contract terms and vendors' ability to deliver. The most frequently mentioned issues, both pre- and post-contract signing, are assuring appropriate levels of service delivery and controlling the cost of service. Equally important, but usually not written into the contract, is concern about the vendor's willingness to assign appropriate personnel to the outsourcing contract, to work through problems as they arise and to work as a team in order to get the job done.

Vendors can shorten the process of contract term definition and negotiation by recognizing the needs of the company to appropriately define the service levels to be delivered and the cost expectations. Efforts to facilitate early agreement on these issues and vendor commitment to delivery will solidify relations with the company and offer opportunity for additional contracts for outsourcing services. Further, it becomes clear that customer pre-contract activities involve the functional business unit organizations in defining the service and cost levels as well as IS departments. Efforts on the part of the vendor to make early, proactive efforts at working with the personnel in these organizations will hasten the process of contract agreement and, after start-up, provide a base for simplified and quick conflict resolution.

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Contract Term Negotiators

Outsourcing contract terms and conditions represent some of the most important determinants influencing satisfaction with service delivery and the relationship between vendor and customer. Contract negotiation is, indeed, a critical phase in the life cycle of outsourcing service delivery. Accordingly, it is important to understand who the lead negotiators are and who else participate in the contract negotiation process. This helps set a framework for the terms identified as being critical to the success of the outsourcing contract.

- Section A, *The Lead Negotiators*, is a review of the senior personnel who are involved in the leadership and process of negotiating outsourcing contract terms. Further discussion is devoted to other key participants in the negotiation process.
- Section B, *Purchasing Department Participation*, reviews the customer's contracting or purchasing department participation in the contract negotiation process.
- Section C, *Conclusions and Recommendations*, suggests approaches that vendors can take to better understand the driving forces and initiatives that shape the contract terms.

A

The Lead Negotiators

The survey results reveal that the contract term negotiations usually are conducted by mid- to senior-level managers who have direct responsibility for the specific service or business function being outsourced. In addition to the question of negotiation leadership, the respondents also were asked if the negotiation was carried out by a committee. In only three cases (10% of the survey), were the negotiations managed by committees of senior personnel. Lead negotiating responsibility by department is shown in Exhibit III-1.

Exhibit III-1

Key Negotiators

Lead Negotiator's Department	Count	Percentage of Total
Information Systems	16	59
Non-Information Systems	11	41

Source: INPUT

It is useful to note that 41% of the senior lead negotiators are from non-information systems departments. This statistic clearly indicates the importance to be placed on thorough insight regarding not only the information systems-related requirements, but also the needs of the business and user departments. Only then is it possible to understand the driving forces that influence contract terms.

In 43% of the survey (13 companies), the negotiation of contract terms was carried out or supported by a committee of managers. The composition of these committees varied, but many had participation from staff support groups, including the legal, finance and human resource departments. This again highlights the need for the vendor to place heavy emphasis upon understanding the needs and influences of the entire organization.

B

Purchasing Department Participation

Members of the purchasing department were found to have participated in contract definition and negotiation in only 57 percent of the companies in the survey. Because the negotiation of contract terms is so closely related to the activity of the purchasing or contract department, it is unusual that this department was not mentioned more frequently as having major involvement in the negotiation process. In only four cases (13%) did the purchasing department take lead responsibility for negotiations. It is interesting to note that in two cases, companies that did not have strong purchasing department involvement would opt for such participation in future negotiations.

C

Conclusions and Recommendations

Committees and non-IS management negotiators represent another challenge to the negotiation process. Whether the customer negotiator is a committee or an individual, it is imperative that the vendor develops an appreciation for the internal user issues that are driving the decision to

outsource. Now that the reasons for outsourcing transcend the traditional issues of cost and operational convenience, understanding the secondary driving forces takes on new significance. As a result, the need to develop contacts and relationships within the customer organization at all levels and encompassing all interests in aspects of the prospective outsourcing service must be stressed. Vendors will improve their position by understanding all the requirements of the outsourcing project and being prepared to respond and shape these expectations in conformity with its ability to deliver.

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Major Pre-Contract Issues

Contract terms and conditions are designed to define the scope of services, provide for the service pricing structure, and set out appropriate methods by which the vendor or customer can pursue recourse, should disputes arise. During the recent years of outsourcing contract growth, many additional service areas (e.g. Desktop Services) have become part of the mainstream, as has the breadth of companies served. At the same time, the gap between customer expectations and actual service delivered show signs of widening. There is evidence in several high-profile outsourcing contracts to suggest that vendors are sometimes unable to be responsive enough to contract terms.

The instances of disappointment with the nature, level and cost of service continue to grow. The reasons for the mismatch between expectation and reality are many. Failure of the customer to specify performance and cost expectations appropriately and the vendor's inability to manage expectations and service delivery are often at the nexus of deteriorating business relationships.

This chapter will explore the issues that are of greatest importance to the survey respondents. Vendors will benefit from developing an understanding about the factors that are important to the customer during and after contract negotiation. Although the quality of service and associated costs continue to be of primary importance to the customer, a more detailed level of requirement specification is important. The following sections explore the key contract provisions that respondents identified as having particular importance. Issues arising prior to the signing of the contract are rated, ranked and discussed.

- Section A, *Key Contract Provisions*, contains the customer survey responses to key issues thought important in the contract negotiation phase.

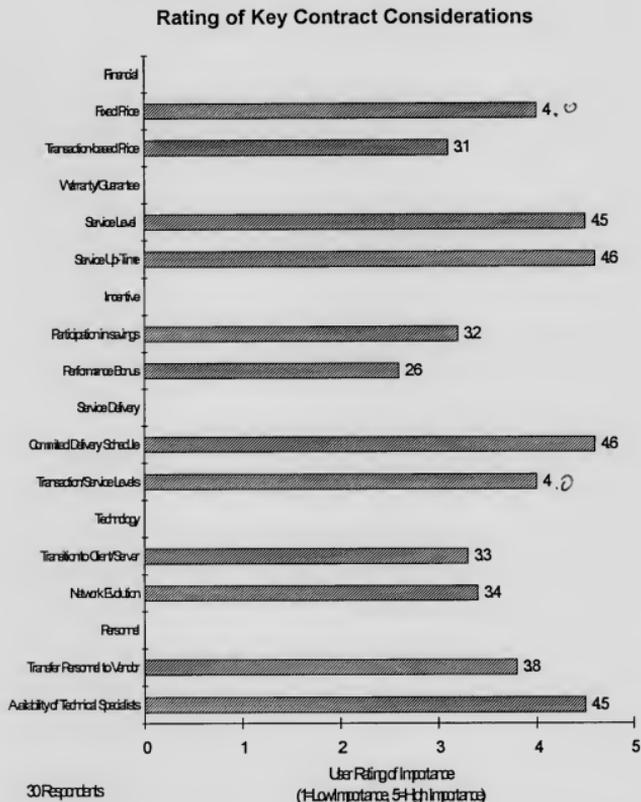
- Section B, *Issue Resolution at Contract Time*, discusses the items that are either easy or difficult to resolve at the time of contract completion.
- Section C, *Conclusions and Recommendations*, contains suggestions for improving the process of negotiation so as to arrive at contract terms that represent the intent of the user and the capabilities of the vendor.

A**Key Contract Provisions**

The traditional issues of cost, service delivery and access to technical resources weigh heavily on the minds of users. These concerns generally arise in contracts for delivering technical services. However, they become particularly problematic when the customer is faced with defining performance and cost expectations at contract initiation and, in many cases, two, five, or more years into the future.

There are six key areas of contention when contract performance terms are being defined. These were discussed in INPUT's report, *Pricing and Marketing of Outsourcing Services*. All issues were to be rated in the context of their importance when negotiating contract terms. Exhibit IV-1 shows the average rating response for each performance category.

Exhibit IV-1



Source: INPUT

The highest rated items (i.e., 4.5 to 4.6 rating) are guarantee of service level up-time, commitment to delivery schedule, service level guarantee and availability of technical specialists. Although service and delivery commitments and fixed pricing are important, it is interesting to note that the aggregate survey response indicated the least interest in considering incentives and bonuses for achieving specific performance levels. This indicates that vendors may gain little, or even lose, by emphasizing pricing mechanisms based on performance and/or delivery

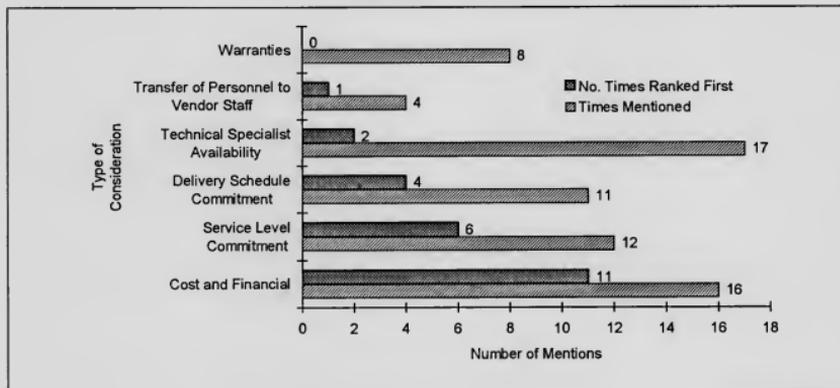
levels. It is better for vendors to take the approach that achievement of performance and delivery levels should be assumed rather than provided as a means to earn additional compensation.

In addition, the availability of technical specialists continues to be a major, persistent issue for projects such as these in which technology is evolving rapidly. This will become more even important over the next few years as the portion of client/server systems that are outsourced while also increasing in complexity. In fact, this increased technical complexity is now a driving force behind the growth of outsourcing.

Respondents also were asked to rank the items most important to be included in the outsourcing contract. A tabulation of the rankings is shown in Exhibit IV-2.

Exhibit IV-2

Ranking of Key Contract Considerations



Source: INPUT

Again, it is instructive to note that availability of technical specialists is the most frequently mentioned concern, although this issue did not receive the most frequent first ranking. Rather, cost and financial considerations ranked most frequently in the first position. These six issues represent 65 percent of the responses.

The consistent message here for vendors is that customers are concerned about guaranteeing specific levels of service, controlling the cost and assuring that appropriate skill levels are committed with ongoing

availability to the outsourcing project. Efforts to work collaboratively with the customer in the early stages of identifying appropriate and practical levels of performance while rationalizing achievable cost/performance objectives should represent early cornerstones for open, professional relationships with the customer. Crafting realistic expectations for performance and cost will help to defuse disappointment with actual performance and incurred costs as issues arise.

B

Issue Resolution at Contract Time

An objective of the study is to identify the contract terms most easily negotiated at the time of contract signing, and those either most difficult to negotiate or what can best be termed "deal breakers." It was found that price and service level were the most frequently mentioned issues as either easy or difficult to resolve. The aggregate responses for these two represented 52 and 54 percent of the responses in the easy and difficult categories, respectively. See Exhibit IV-3 for additional detail.

Exhibit IV-3

Top Issues Easy and Difficult to Resolve

Category	Easy to resolve Percent of total	Hard to resolve Percent of total
Price	44	27
Service Level	8	27

Source: INPUT

The two issues were linked in many responses. In fact, the clear message is that cost and service level are at the root of customer concerns.

Few respondents identified any issues as being deal breakers although two users emphasize that they would not negotiate on price.

C

Conclusions and Recommendations

The key measures of service delivery to which customers expect vendors to make a commitment are:

- Outsourcing cost
- Service level
- Responsiveness

Further, the message is that users are comfortable with pricing arrangements and service level guarantees that assure limitations on cost at level of service delivery.

Joint sharing of cost savings or incentives based on performance appear to have little appeal. Vendors who choose to pursue this approach to pricing should review the way in which this is presented to prospects. The current lack of appeal may be the result of the benefits and advantages provided by performance bonuses and sharing in cost savings having been presented to the customer in an ineffective manner. This lack of marketing effectiveness is studied in INPUT's report *"Pricing and Marketing of Outsourcing Services"*.

Users are concerned about the availability and dedication of appropriate management and technical personnel to the outsourcing project. Further, a number of the respondents expressed concern about the vendor's ability to smoothly transfer its personnel to the vendor organization. Associated with this concern are the retention of the transferred personnel to continue working on the customer's activities, and assurance that transferred personnel will find the new management and benefit environment sufficiently acceptable to avoid any legal actions.

Vendors can overcome this user concern by taking time, during the negotiation process, to explain and document their procedures for integrating transferred personnel. They should also define the future role for these individuals.

Vendors can help to improve the negotiation process by understanding the service level and cost containment objectives the prospective customer is attempting to achieve. Clear and open communication about these issues is essential. The vendor will improve its negotiating position by responding openly and realistically about the customer's performance and cost demands and, in response, the vendor's ability to deliver on these objectives. In addition, issues about the availability of appropriate technical and management personnel dedicated to the project also are very important to the negotiation process.

During the contract definition phase, the vendor is in the best position to develop a close working relationship with the customer and, in the process, help to craft terms that reflect the vendor's ability to deliver. Because, in today's market, contract terms must more broadly represent the requirements not only of the information systems department, but also the user groups within the functional business units, it is important

that the vendor sales and contract negotiation team develop a clear understanding of the driving forces at all levels in each of the customer departments. This means that the vendor can improve the process by knowing which of the customer's personnel are driving the requirements definitions and working with them to insure that these requirements are realistic and achievable.

Finally, early presentation by the vendor of the technical and management personnel who are to be assigned to the outsourcing project will help to assure the customer that a competent team is ready start to the project. The more the customer gets to know these vendor personnel before the contract, the greater the probability of achieving a positive supplier-customer relationship.

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Contract Performance

This chapter provides insight into operational reality and compliance with contract terms and conditions. Of the respondent customers, 66% have been operating with outsourcing services for more than two years. Most of the respondents report successful outsourcing service operations—but not without problems, in several cases. In addition, the views of the surveyed companies regarding how they would change the emphasis of contract terms in future negotiations is discussed.

- Section A, *Vendor Performance and Contract Terms*, presents users assessment of vendors' ability to deliver expected services at acceptable cost levels. It also looks into the lessons learned and actions that the company took to resolve issues with the vendor.
- Section B, *Hindsight and Negotiating Better Contract Terms*, looks into user assessment of the actions that can be taken when negotiating outsourcing contracts in the future.
- Section C, *Conclusions and Recommendations*, makes suggestions regarding managing user expectations and positioning the vendor so as to avoid a customer's loss of confidence in the vendor's ability to deliver.

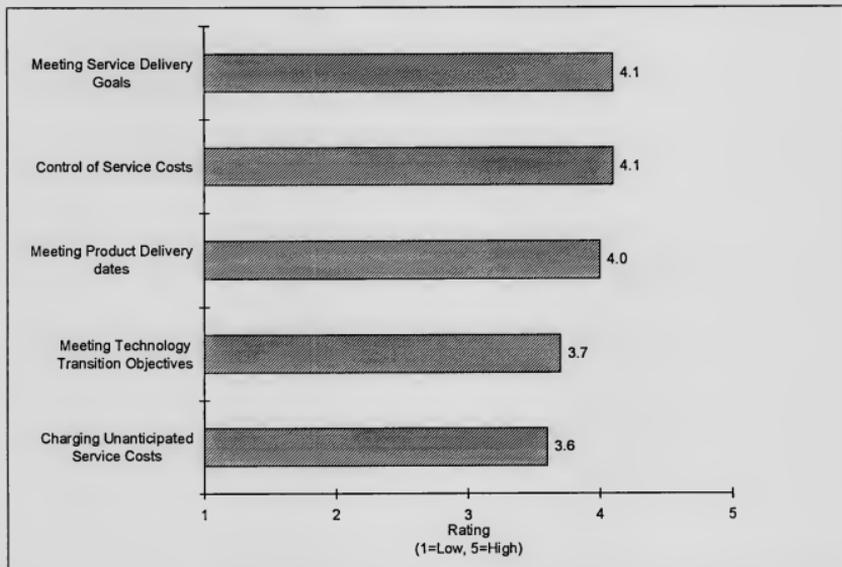
A

Vendor Performance and Contract Terms

It is important to obtain customer assessment of the vendor's performance, subsequent to contract initiation. The respondents were asked to rate how well the vendors performed in areas of cost and service level. The ratings for five specific performance areas are shown in Exhibit V-1.

Exhibit V-1

Vendor Performance Rating



Source: INPUT

The assessment indicates that, overall, users believe the vendors have performed at or above average levels of expectation. The variation in these average ratings is quite small, indicating that there is no significant disparity among the respondents' ratings. In only one case did the respondent give particularly low ratings (i.e. 1 or 2) to its vendor for the issues of meeting service goals, controlling costs and being faced with unanticipated costs. This particular outsourcing contract is in the early stages of operational delivery.

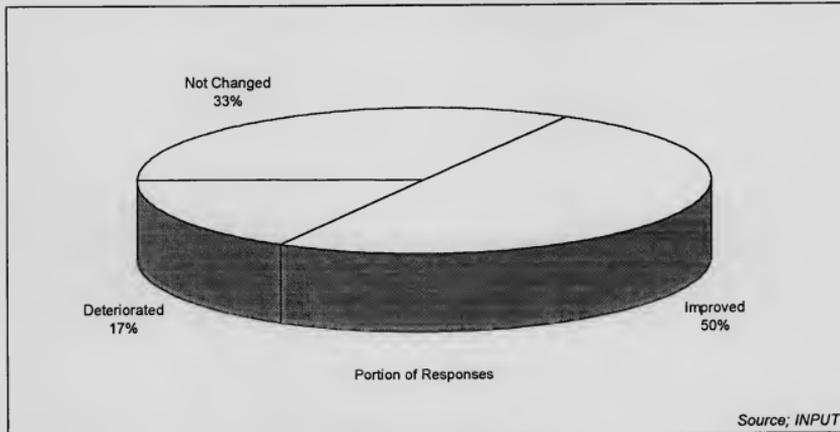
However, the unanticipated service cost item provides evidence that this area certainly could be improved, the rating being just above average performance. Three of the survey respondents indicated that unanticipated costs were a problem and that negotiations to arrive at resolutions are still in process. At the same time, several customers indicated that their vendors were very quick to arrive at resolution of problems as they arose.

Seven of the companies (23% of the survey population) responded that the outsourcing contracts were in some stage of renegotiation. Reasons for renegotiation boiled down to dissatisfaction over unanticipated costs or failure to meet service goals, or a change in project scope. Several customers indicated that through there are problems with service delivery, nothing is being done to renegotiate contract terms; apparently, the user does not consider the problem severe.

The survey asked the respondents to characterize how their relationships with vendors have evolved since initiating outsourcing activities. Ratings are shown in Exhibit V-2.

Exhibit V-2

Relationship with Vendor Since Contract Initiation



Again, this would appear to be a very positive evaluation, in that half of the companies believe that the relationship with the vendor has improved. The common themes underlying improvement are:

- Good vendor personnel who are technically matched to the need and who strive for teamwork
- The willingness on the part of the vendor to solve the problems when they arise and then to "go the extra mile" to deliver on the commitments.

The common criticisms among companies that believed the relationship had deteriorated were:

- the inability to meet service level commitments
- the difficulty with cost containment.

Once again, there is good reason to be concerned about these two issues both prior to and after contract signing.

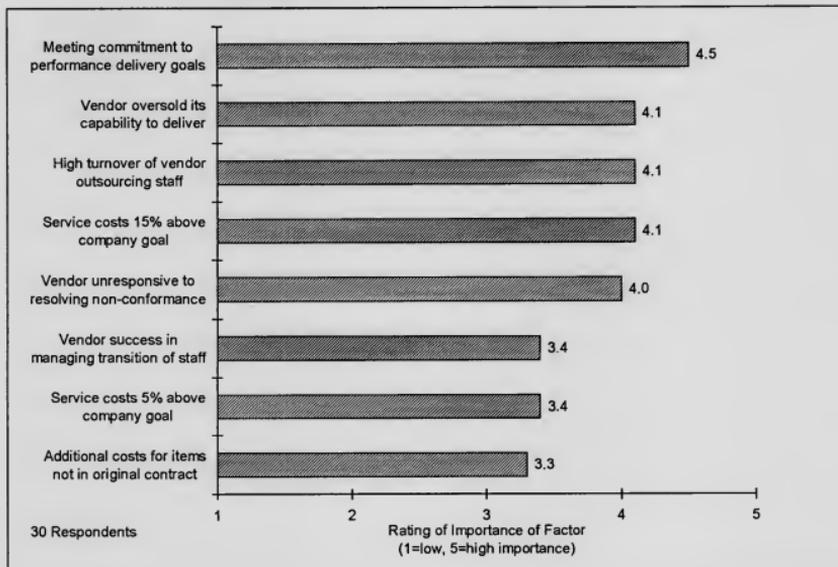
Surveyed companies were also asked to rate factors that would do the most harm to the relationship with the vendor. Examples of such factors include:

- Vendor service that was unresponsive to contract terms,
- Costs that were unanticipated or in excess of contract terms
- Issues of vendor and company personnel

The respondents' rating of these items is shown in Exhibit V-3.

Exhibit V-3

Factors that Can Most Harm Vendor-Customer Relationships



Source: INPUT

Once again, the message is that meeting the performance commitments has the greatest impact upon the vendor's relationship to the customer. The aggregate response is consistent with the responses earlier in the survey regarding the most important contract terms. Related to performance are vendors' actions to resolve non-conformance issues and overselling their ability to deliver. Both of these items are rated just below performance delivery.

Regarding service cost, it is interesting to note that the respondents indicated a concern about cost overruns in the range of 5 percent, but with less importance than a 15 percent overrun. Unanticipated or added costs were rated just below the 5 percent overrun. Although cost is of major concern, these responses seem to indicate that the customer does have some tolerance for unanticipated or excessive costs, beyond the expected levels.

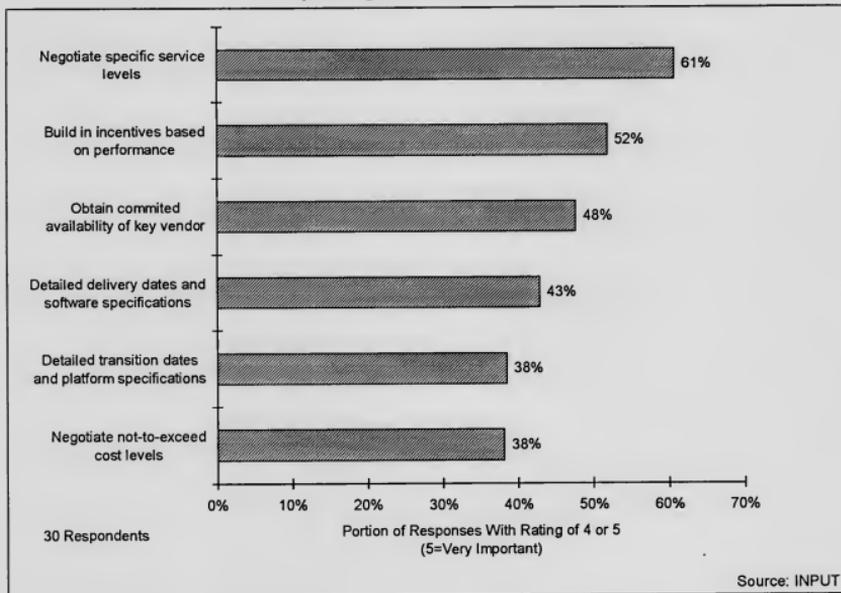
B

Hindsight and Negotiating Better Contract Terms

Respondents were asked to consider how their organization could have negotiated better contract terms. The emphasis was to take advantage of hindsight and rate actions that they could have taken to produce better contract terms. The ratings of selected actions are shown in Exhibit V-4.

Exhibit V-4

Improving the Contract Terms



If the user views of these revisions to contract terms are considered in light of the average rating then there is little differentiation. The highest rated is "Obtain committed availability of key vendor personnel" with a rating of 3.4 and the lowest is "Detail specific software specifications and delivery dates" with a rating of 2.9. This indicates a broad range of opinions regarding this area. However, by considering the portion of respondents rating each type of revision as very or most important (rating of 4 or 5) then a commonality of views emerges—in hindsight, users

would place more emphasis on negotiation of terms regarding level of performance. The relatively high portion (48%) of respondents who ranked highly the availability of key vendor personnel confirms the findings expressed in the previous chapter (see Exhibit IV-2), which indicated that the most often ranked contract consideration was that of technical specialist availability.

Other actions mentioned to insure better contract negotiations were plans to involve a greater number of prospective vendors in the negotiation process and to obtain the involvement of the purchasing department in working out the contract terms.

C

Conclusions and Recommendations

Contract terms that address cost containment, early surfacing of unanticipated costs, and service level guarantees are key prerequisites for a successful relationship with the customer. This study indicates that this is the primary message in all phases of the outsourcing contract life cycle. These elements are important during contract definition as well as ongoing project operation. Equally important to negotiating a contract that both sides find satisfactory is the effort keep the relationship on a positive and growing basis after the service begins.

Measures to avoid customer dissatisfaction once the outsourcing activities have begun are clear.

- The vendor must be committed to working actively to resolve contract non-conformance issues. This means that, as and when problems arise, appropriate personnel must be available to work out the technical and administrative issues requiring resolution.
- Working out the issues means that the vendor can best preserve its relationship with the customer by being up front when performance shortfalls arise, and by insuring that competent personnel who understand the customer's technical and service environment are at the customer site on a regular basis.
- Having identified incipient stages of potential problems, early resolution will help to insure a long lasting business relationship with the customer.

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