Developing and Negotiating 'Win-Win' Sourcing Deals

An outsourcing contract is an integral part of an outsourcing solution and should be structured for change. Success depends on developing a comprehensive agreement and negotiating the key requirements.

As the use of external service providers (ESPs) becomes more prevalent and the sourcing market matures, enterprises have many options regarding the type of services that they can secure and the type of contracts that they can sign. Enterprises must cultivate their deal development and negotiating skills, and understand the mechanisms that will ensure that ESPs deliver the expected value during the term of the contract. One of Gartner's Sourcing Core Topics is "Developing and Negotiating Service Contracts." Within this Core Topic, we address the various types of contract arrangement, and the appropriate terms and conditions that enterprises should develop to ensure the most-successful relationships with their ESPs.

It is important to note that Gartner has defined four essential phases in the sourcing life cycle (see Figure 1).

Source: Gartner Research
Developing and negotiating deals is the key step for finalizing a deal and negotiating the contract. Enterprises need to recognize that an outsourcing contract is an integral part of an outsourcing solution, and use a contract structure that accommodates change throughout the life of the agreement. Within this phase, the ESP and the enterprise finalize the scope of the engagement, and develop and approve the transition and implementation plan. The outsourcing contract is one of the keys to the success of a deal. It is the primary document between an enterprise and its ESPs, and it contains the key requirements of the agreement.

The sourcing agreement serves these primary purposes:

- Manage change and adjust the scope of the deal to business alignment
- Provide for effective, nonadversarial relationships
- Define processes for introducing innovation and continuous improvement
- Manage the allocation of risk between the enterprise and the ESP
- Establish valid service delivery throughout the duration of the agreement
- Define the measurement and monitoring processes that are used as a basis for assessing performance
- Define the conditions that could trigger changes to the contract and relationship
- Detail the information-reporting structure
- Manage and control service performance and costs

The importance of developing and negotiating deals is self-evident, but enterprises need to address two Key Issues to ensure that their sourcing deals deliver benefits to themselves and their ESPs.

**Key Issue: What are the best practices for developing and negotiating effective contracts with ESPs?**

The best practices begin with having a good, well-defined statement of work (SOW) that includes clearly defined roles and responsibilities. A well-constructed SOW is essential to a successful sourcing agreement. Although the SOW is developed early in the life cycle, there often are changes in scope that are driven by an enterprise’s needs or an ESP’s capabilities. The SOW, therefore, needs to be reviewed and finalized during the contract development phase so that it can be incorporated into the contract. As the scope of services solidifies, the roles and
responsibilities should be finalized for each service that the ESP will deliver.

A general sourcing principle is for an enterprise to tell its ESP what it wants, but not how to deliver the service. This allows the ESP to tactically manage delivery and look for improvements. However, the enterprise is responsible for delivering the services to its business units, and the ESP should present all of the strategic decisions to the enterprise for approval. For this type of arrangement to work, it is essential for the contract to define a good relationship-management process for handling business issues, strategic decisions and disputes. Issues and disputes will inevitably occur, but successful deals have processes in place to quickly resolve them.

An important step within the deal development and negotiation phase is due diligence, which is the responsibility of both parties. The enterprise must comprehensively check references to validate the ESP’s claims. If possible, visits to the ESP’s and customers’ sites are worth the effort and can provide valuable negotiating material. Conversely, ESPs must ensure that they fully understand the environment in which they will be working so they can bid for the work correctly. A contract that does not incorporate an accurate SOW, together with the required service levels and prices tied to performance, will be difficult, if not impossible, to administer.

Once the SOW has been completed, the focus shifts to the contract terms and conditions, and the final negotiations. Gartner generally recommends that an enterprise consider hiring an outside legal firm to assist with these steps. The ESP will have its own legal experts that specialize in sourcing contracts and including the unique requirements of each deal. Unless the enterprise has equivalent legal expertise, it should hire a lawyer that specializes in sourcing contracts.

Next, the terms and conditions should be carefully reviewed. There are several issues that need to be addressed, such as contract duration, benchmarking, termination clauses, transition plans at the end of the contract and the ESP’s incentive to introduce innovation to the service. The enterprise should discuss each term and condition and create a "deal sheet." This sheet lists all of the "must have" items and the items that the enterprise would be prepared to negotiate. The deal sheet becomes the primary document used by the enterprise’s negotiating team during discussions with the ESP’s team. The final contract should be "win-win" for both parties. Contracts that are biased in favor of either party lead to dissatisfaction and renegotiations, or to terminating the contract.
There is another key task at the contract development phase — to negotiate an agreement that will change to reflect changes in the enterprise’s business environment or in technology. Gartner has seen enterprises that negotiate five- or seven-year mainframe data center contracts based solely on low price without considering platform upgrades. After a year or two, they are dissatisfied because the original platform requested at the beginning of the deal has not been upgraded. The ESP is providing exactly what the client requested, even though better technology is now available. If an enterprise wants upgrades and innovation, it should include these in the initial deal. This will enable the ESP to build the cost of upgrades and innovation into the price of the deal, and will enable the enterprise to receive a service that changes as business needs and technology change.

**Key Issue: What are the best practices for structuring service levels and performance metrics?**

For most IS organizations, one of the hardest aspects of a sourcing deal is to resist the urge to tell the ESP how to deliver the services. Instead, an enterprise should tell the ESP what is needed through service-level agreements (SLAs). Service-level targets should be set to the minimum level that is acceptable to the enterprise. These targets become the focal point for all performance measurement. SLAs don’t just comprise targets; they also specify penalties for missing the targets. Without penalties, service targets are merely objectives. If the contract states that the vendor will use its “best efforts” to meet service targets, the enterprise’s only recourse for consistent nonperformance is arbitration or termination. Both of these options are costly and disruptive to the business.

SLAs should be explicitly structured to avoid this type of situation. An example is provided by the need to document not only when a service target is reported, but also when it is measured. Consider an enterprise that has a target of 99 percent availability for a server. Based on a 30-day month, this would equate to being down for 7.2 hours a month. With many applications, this may not be acceptable if the system is down for 7.2 hours at one time. However, if availability were measured weekly, then 99 percent availability equates to 1.7 hours downtime, which might be tolerable. Therefore, SLAs need to include several items, such as measurement frequency. In providing advice on this Key Issue in future research, we will identify the items that need to be included in SLAs, as well as new concepts and changing performance metrics.

**Acronym Key**

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<tr>
<th>Acronym</th>
<th>Definition</th>
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<tr>
<td>ESP</td>
<td>External service provider</td>
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<td>SLA</td>
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