Management Update: Tips on How to Negotiate Contracts With Vendors and Service Providers

Contract managers must know how to structure healthy vendor contracts and relationships. Managers should take the key steps that will ensure that a new or renewed contract will not turn out to be a “nightmare” contract.

New and Increased Challenges for Contract Managers

New challenges abound in the management of service provider relationships. Due to internal and external influences, the manner in which enterprise contracts are created, enforced and renegotiated is evolving. In this new environment, many contract relationships fail because of difficulties encountered when interpreting terms and conditions.

Adding to this challenge is the increase in the use of external providers to meet IT needs. By 2004, 75 percent of IS organizations will refocus their role on brokering resources and facilitating business-driven demands, rather than on being direct suppliers of IT services (0.8 probability). Increasingly, IT managers will be working through external organizations to fulfill the IS organization’s responsibilities. Many of those same IT managers, however, are ill-equipped to take on contract management responsibilities.

Improving Communications and Performance

Tactical Guideline: Many contracts prove ineffective because of confusion surrounding terminology, performance expectations and service content. It’s never too late to address poor communications, although much of the leverage is lost after the contract has been signed.

Efforts should be made to achieve clear communications with the service provider. Areas in which difficulties typically arise include service-level definitions and common phrases that are somewhat ambiguous, such as “good performance,” “industry standards” and “reasonable effort.” Tighten up those terms and many potential problems will be avoided.

Enterprises should review contracts against actual practices and ensure that service levels, quality, schedule and content components are clear. The following are important:
• Ensure that all parties understand terms, conditions and processes.
• Gain uniformity of understanding.
• Consider phasing in changes if significant impacts are identified.
• Note terminology issues for future contracts.
• Consider developing a glossary for high-impact terms.

Performance reporting is an area fraught with communications problems. Contractors can be very selective regarding what is reported unless the contract is very specific about what must be reported. Also, it is common for charges to be added for collecting and reporting metrics that were not identified in the contract. This “extra cost” is often just an excuse by the vendor to avoid having to report such information.

**Negotiating Customized Terms and Conditions**

**Tactical Guideline:** Enterprises that are successful in negotiating effective customized terms and conditions will achieve total-cost-of-ownership savings that far exceed any savings achieved through reducing the per-desktop fee.

For many enterprises, ongoing communications with their suppliers is minimal and often occurs only when problems arise with the delivery of the product or service defined in the contract. Such poor communication processes can cause disagreements over contract terms and conditions, and can make managing a contract extremely difficult and frustrating.

The cure? Nothing stimulates dialogue and facilitates communications with a supplier more than negotiating a new contract or a renewal. Every new contract negotiation or renewal should be viewed as an opportunity to improve communications, clarify the terms and conditions contained within the contract, and amend those that are unfavorable.

Remember that price is only one of many negotiating points — and may not be the most important one. Many enterprises spend an inordinate amount of time negotiating the price of the product or service being acquired, and very little on seeking favorable changes to the terms and conditions. In many instances, customers sign the vendor’s “boilerplate” contract with no modification. All standard contracts favor the author of those contracts. Although price is important, customers often give up more value in terms and conditions than they gain in price concessions.

Enterprises should not accept a vendor’s standard contract “as is.” They should carefully scrutinize all terms and conditions and request amendments to make the contract more equitable to both parties. Focus on the more troublesome terms and conditions, such as provisions governing definitions, entitlements, merger/acquisition/divestiture events, pricing, end of term, outsourcing and transfer rights.

**Contract Performance Metrics**

**Strategic Planning Assumption:** By 2006, contract performance metrics (whether for goods or services) will become uniform, and industrial standards will be established and commonplace in contract language (0.7 probability).
Although a contract may not contain complete service-level language, don’t let that deter a comparison of contractor or vendor performance to recognized industry standards. From productivity measures to financial ratios, a wealth of metrics can be used to calibrate a contractor’s performance.

When performance slips, consider comparisons to industry standards as a way to get the attention of your contractor or vendor. Standards can bolster the following performance management steps:

- Review service levels in light of published standards.
- Question performance slips and request a corrective plan.
- Establish a time frame for performance improvement.
- Escalate continued performance problems.

Comparisons of performance to industry peer groups are often useful to better understand the value proposition put forth by the vendor. For major outsourcing or procurement activities, Gartner recommends the inclusion of contract language to address price calibration points, to ensure opportunities for price adjustment based on market conditions.

Action Item: Calibrate service performance by using benchmark data to ensure that industry-standard service levels are being met.

Service-Level Agreements

Almost every contract that is written could be improved by including or enhancing a section on expected performance or service-level agreements (SLAs) covering the performance of the vendor and its product or service. Expectations should be quantifiable and specific, and penalties or rewards must be included to ensure effectiveness.

Too often, enterprises argue with suppliers about what type of performance was expected and whether or not the supplier agreed to certain standards within the contract. To eliminate ambiguity and provide clarity as to what is expected, it is important that this be spelled out within the contract and agreed to by both parties.

Performance expectations may take many forms, depending on the product or service being acquired. Measurement areas may include:

- Delivery schedules of the supplier for hardware or software
- Performance metrics of the particular piece of hardware or software — how should it perform?
- Service metrics, including support and maintenance for hardware and software.

Many contracts use “weasel words” such as “the product should perform substantially as follows ....” That makes any performance guarantees worthless. Care should be taken to remove such words from the contract before signing.

For each defined service level, the following components should be taken into consideration when formulating an enforceable SLA: definition, time frame, assumptions, responsibilities, service level, measurement formula, measurement reporting period, data sources, escalation, contractual exceptions, penalty and reward definition, penalty and reward formula, and notes.
Improving Financial Terms

Every contract manager wants to obtain the best possible pricing, but beware of locking in long-term rates for technologies that could experience rapid price declines. One smart way to protect your enterprise is by calibrating current pricing with industry market pricing for similar services.

Long-term contracts often end up with high comparative costs after 18 to 36 months. Volatile technologies present particularly high risks in setting price levels. What are your options after the contract is in place?

- Your No. 1 weapon is comparative pricing.
- Threaten to cut back all add-on work or additional acquisitions.
- Look for anticipated productivity gains.
- Expect add-ons to be priced at market value.

If the contract does not contain an annual or biannual price calibration clause, don’t give up hope. Favorable price adjustment may still be attainable by discussing the “facts” of the price decline with your vendor. In some cases, it may make economic sense to terminate the contract, pay the termination penalty and establish a new contract with more-aggressive rates. Don’t forget to include a price calibration clause in the new contract. Usually, your current vendor will not pass up a chance to renegotiate to avoid losing your business.

Preparing for Contract Negotiations

Tactical Guideline: Enterprises that do their “homework” before negotiation will typically obtain pricing that is 15 percent to 25 percent better than those that do not.

The challenge of obtaining favorable pricing can best be addressed when entering into a new contract or renewing an old one, and should be addressed on several fronts. Enterprises must do their homework and should seek several competitive bids, using the request for quote (RFQ) or request for proposal (RFP) process to bid on the acquisition for products or services that are in competition with one another. For example, for PCs, compare Dell against IBM against Compaq against Hewlett-Packard. That should be done even if it is clear that one product is the best technological choice. In addition, if the product or service can be acquired through value-added resellers, large-account resellers or similar third-party channels, competitively bid several resellers to gain further savings.

Before the negotiation process, gather as much price information as you can from the vendor or supplier, channel partners, business contacts, research analysts and so on. The more you know about the suppliers’ “list prices,” discount schedules and maintenance-pricing models, the better prepared you will be to leverage the information to obtain better pricing. Use outside resources, such as business contacts and research organizations, to obtain comparative prices.

Moreover, it is important to research the suppliers’ financial positions to determine if they are under significant pressure to generate revenue. When is the end of their fiscal quarter or year? Have they already made their revenue numbers for those periods? Would they be willing to offer an additional discount to close a deal and book the revenue?

Managing a Financially Troubled Vendor
**Tactical Guideline:** When the situation dictates placing a vital contract with a small firm, monitoring the vendor’s financial health is an ongoing task that may require lending additional management expertise to address a difficult problem.

Most seasoned contract managers can relate to the horrors of managing a contractor or vendor that is in financial trouble. Often, the option of quickly finding another supplier is not simple. If the contract addresses application development, a half-finished project may be of little or no value to a new contractor.

If the deliverable is not a commercial off-the-shelf software package, contract managers sometimes have to lend assistance to small providers to keep them healthy enough to finish the project. Small companies are particularly vulnerable to being undercapitalized, and thus generally at risk when faced with any significant business problems. It may be in your best interest to help rather than threaten.

When your supplier faces financial difficulties, its problem may become your problem. Before terminating a contract due to default, consider how you might work through the problem. A win-win opportunity may exist. Consider lending management and technical expertise when warranted.

**Investigating a Vendor’s Financial Health**

**Tactical Guideline:** Enterprises that take the time to investigate the financial health and viability of the vendors with which they expect to do business will minimize their own financial risks.

When using the RFP or RFQ processes, sometimes choosing the least-expensive alternative is not the prudent thing to do. That is especially true if the company receiving the award is in financial trouble or if serious concerns exist about its viability as an ongoing entity.

Before awarding a contract, taking time to research the vendor’s financial health can help to mitigate financial risks (see Figure 1). You should also investigate whether any significant litigation is pending that could be decided against the vendor and thus have an adverse impact.

**Figure 1**

**Examine the Vendor’s Financial Health — Do Your Homework, Then Protect Yourself**

- Check financial health.
  - Check vendor’s financials for the past year.
  - Establish confidence that the vendor will be viable for the near term.
  - Look for any pending litigation with significant adverse potential.

- Protect yourself.
  - Build in nonperformance clauses to mitigate risks.
  - Build in protections in case the vendor divests, is acquired or goes out of business.

Source: Gartner
However, in this time of economic uncertainty, no guarantees exist of continued financial health and viability. Therefore, it is important that enterprises build protections into their contracts in case the vendor is unable to perform as specified in the contract, divests the business unit providing the service or product, is acquired by another entity, or goes out of business. Such protections may include:

- The right to withhold future scheduled payments for nonperformance
- The right to a refund of payments already made (questionable in the case of bankruptcy)
- Guarantees of contract fulfillment if divestiture or acquisition occurs
- Contractually stated preferential treatment if the vendor ceases operations

**Improving System Integration Efforts**

**Tactical Guideline:** Contracts for outsourcing major application development projects should be structured to ensure that system integration efforts are addressed in the contract, or as a contract follow-up option.

Few, if any, application development or software installation efforts result in stand-alone systems. Unfortunately, system integration efforts can turn out to be a nightmare if contractors and vendors start blaming each other for integration difficulties. One way to offer some protection from this situation is to define in the contract the specific boundaries of responsibility, including system integration requirements, and to hold contractors and vendors accountable for progress.

Most enterprises are faced with integrating products or services from multiple sources. To avoid the “it’s not my responsibility” argument, contract managers can:

- Weigh scope vs. contract value — larger contracts or vendors should be expected to shoulder greater responsibility for integration.
- Determine who is in the best position to provide the remedy.
- Conduct a parallel contract comparison and determine which party should provide coverage.

System integration requires a firm understanding of the technical architecture and business environment. It is in the integration of systems that the big payoff takes place, as system functionality is deployed across multiple processes or business units. Often, the root of integration problems lies in a lack of understanding of the roles of each party and the needs of the business. Making assumptions about the environment is a recipe for failure.

One of the best ways to determine whether integration efforts are adequately covered is to conduct a joint review of integration responsibilities during the initial phases of the development or implementation effort.

**Integrating Problem Resolution Clauses**

Vendors sometimes engage in finger-pointing when problems arise among different vendors’ hardware or software products. It can be frustrating to get to the root of the problem and reach a resolution, especially if critical systems are down as a result.
The most effective way to eliminate finger-pointing is to address it with each vendor, as each hardware, software, service or consulting contract is being negotiated. That is the point when you will have the most leverage to introduce language into contracts or statements of work to contractually obligate vendors to resolve problems, regardless of which piece of hardware or software is ultimately determined to have caused the issue.

It is important in a multivendor environment to designate a primary vendor to have ultimate responsibility for problem resolution and contractually bind the vendor to address problems, from notification to resolution, without regard to which specific piece of hardware or software was at fault. Normally, this should be the vendor with the most contract value at stake with the enterprise.

Other vendors should not be let off the hook, however. All should have a clause specifying that they will work with the primary vendor until resolution is achieved (see Figure 2).

**Figure 2**

Use Problem Resolution Clauses in a Multivendor Environment

Integrate “no-fault” problem resolution clauses

- Contractually bind vendors to resolve problems, regardless of who may be at fault.
- Contractually select a primary vendor and require it to drive problem resolution.
- Focus on the terms and conditions of consulting or service contracts.
- Before integration projects, build a detailed statement of work for each vendor, specifying deliverables.

When negotiating service or consulting contracts with multiple vendors, many enterprises tend to focus on the costs instead of the contract terms and conditions. That may cost more in the long run if integration problems arise and chaos ensues. More value is often derived by taking the time to spell out — in detail — what deliverables are expected of each vendor.

**Proactively Avoiding Problem Relationships**

**Tactical Guideline:** Enterprises that address potential problem relationships before signing or renewing their contracts will minimize the potential for adverse impact in the future.

Problem relationships are definitely difficult to deal with, so the best way to approach them is to avoid them altogether. That can best be accomplished when negotiating new or renewal contracts. During contract negotiations, vendors wishing to book new revenue have a vested interest in eliminating any barriers to doing so. If problem relationships already exist, vendors have more incentive to fix them, or the business may go somewhere else.

If contract negotiations are imminent and relationship problems have occurred in the past, take time to clear the air before the negotiations begin. Enterprise actions include:
• Meet with account representatives and other vendor personnel that will be servicing the account, and gain confidence that working relationships will function well.

• If you are fairly certain that problem relationships will exist after the completion of contract negotiations, request that the vendor assign different personnel to service your account or look to source to a different vendor.

• For service contracts, the right project manager can make or break the project. Ask to interview the proposed project manager, and build in protections in case that project manager has to be replaced prior to completion of the contract.

• As with all good contracts, build in escalation clauses to handle unforeseen problems.

Protecting the Future

**Strategic Planning Assumption:** Contract managers that identify opportunities to “influence” the vendor toward improvement before discussing corrective measures will improve their problem resolution success rate by 30 percent to 50 percent (0.8 probability).

If every issue or approach to a problem area were spelled out in contract terms and conditions, managing contracts would be a low-level administrative function. That is obviously not the case. Successful contract managers must rely on perception and reality to be effective, and nothing is as influential for getting a problem addressed as ensuring a contract renewal.

Good products and services are sometimes difficult to find, and when contractors and vendors perform as anticipated, all parties benefit. Long-term relationships are generally beneficial to both parties in that knowledge is retained, business conditions are better understood, and the cultural norm is understood and accommodated. As problems occur, contract managers who understand the importance of contract extensions, renewals and expansions can employ tactics that imply that the relationship will be a longer-term one if current performance meets expectations.

It is becoming common practice to offer lower initial pricing for goods or services to secure the contract. This practice assumes that the vendor will benefit in the later years via contract expansion or extension. This financial-engineering approach can increase the leverage customers have, given the vendor’s incentive to improve the relationship to realize better profits down the line.

**Action Item:** Determine the leverage points in the contract and exploit these if performance goals are not being met.

Building in Future Protection

Many enterprises concentrate so heavily on the terms and conditions for the current contract period that they fail to build in protections for the next cycle of use of the products or services. That creates a major exposure whereby the vendor can significantly increase the price of products and services, including product support and maintenance at the end of the current contract term.

Many enterprises that negotiated significant discounts for products and established favorable maintenance pricing in the original contract are surprised to learn that at the end of the term, pricing reverts back to list pricing, and maintenance will then be based on list pricing, instead of net discounted pricing as before. Often, enterprises fail to negotiate for additional products or services acquired during the term of the agreement, including further price reductions for increased quantities.
For every contract negotiation, a key question to ask is: What happens on contract expiration? Enterprises should negotiate for maintenance pricing to remain flat during the term, and to base year-over-year increases after the current term at no more than the Consumer Price Index or some other mutually agreed-on percentage.

When negotiating a contract, always negotiate for the current contract term and the next one. Although vendors may not lock every item down for two terms, many will allow some concessions to be carried forward to the next term. In the case of software licenses, if rental or subscription licenses were not intended, ensure that they are perpetual and that you have the right to continue to use them at the end of the current contract.

**Recommendations**

- Recognize that many problems encountered in managing nightmare contracts are a direct result of poor communications.
- Frequently assess the strengths and weaknesses of your service provider or vendor, and consider how to maximize strengths.
- Determine the profitability of the contract, and know when to push and when to back off on pricing issues.
- Recognize the risks of contract default.
- Clarify terms for all contract modifications.
- Remember, all things are negotiable.
- Actively and aggressively pursue every new contract negotiation or renewal as a means to improve vendor relations and to amend unfavorable terms and conditions.
- Always negotiate for the current contract cycle and the next one to facilitate continuity and best-in-class contract management.
- Include a section on expected performance or service-level agreements in all new contract negotiations or renewals.
- Include specific contract language to take mergers, acquisitions and divestitures into consideration.

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