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What do suppliers think about you?

MANAGEMENT SPECIAL: SIX THINGS SUPPLIERS WOULD TELL YOU IF THEY COULD • MANAGING BIG PROJECTS • INFOSYS • HP • DOCUMENT MANAGEMENT • **CLOUD REPORT**

What suppliers would tell you if they could

Contract Negotiation

What do suppliers secretly think about you? What would they tell you if they could – and what do they hope you never find out? Professors Leslie Willcocks and Mary Lacity spoke to 1,200 of them across five continents to find out. These are their findings.

Suppliers are reluctant to share their failures publicly, or to voice complaints about clients. However, since 1989 the authors have interviewed decision-makers in over 1,200 companies of every size, in every business sector, and across five continents. This feature summarises their findings and focuses on that most problematic area: Contract negotiation – so often the root cause of success or failure in outsourcing relationships.

Suppliers talk about their clients' reasons for outsourcing, the length and accuracy of bid documents, the role of professional advisors, the unintended consequences of clients' tough or unrealistic negotiations, and the ideal contract duration. Their opinions are challenging.

But are they right? In many cases, yes, and what they say is instructive for prospective outsourcing customers. In others, the authors' research suggests not.

This, then, is what the suppliers think: What they wish that their clients knew – and what they would prefer they did not.

> **"Little of this fools the suppliers, who say there are many indicators of when a client is not serious about outsourcing or switching suppliers."**

- **"We Can Spot A Fake Bid."**

The research established that a minority of clients go through an outsourcing evaluation process with motives other than selecting an outsourcing supplier. Some client managers launch an outsourcing initiative to prevent others in the organisation from doing so, with the real aim of preserving the in-house function.

Behind all this are the office politics of the customer. For example, some middle managers hope that evaluating an outsourcing partner will demonstrate to senior management that the internal department is more cost-efficient. Indeed, the research found that some managers go through the motions of evaluating outsourcing to acquire new resources, such as new technologies or additional personnel.

Some back office managers fear that favourable media reports on business trends may seduce senior managers into outsourcing. By taking the initiative themselves, therefore, back office managers hope that outsourcing evaluations will temper those claims with real costs.

Photos: Press Association

Here's looking at you: Suppliers speak out about customers' management tactics.

Some other client companies have used outsourcing evaluations to pressure the incumbent supplier to reduce prices. Supplier-switching costs are prohibitively high, and so the clients do not have any real intention of terminating the current relationship. A request for proposal (RFP) can boost their bargaining power.

The research looked into the client's power during the outsourcing lifecycle, and established that a client's bargaining power peaks during the selection phase, and troughs during the management phase. This is particularly true when outsourcing transactions require high levels of client-specific knowledge, assets (such as IT infrastructure), or client-supplier integration.

Clients have also been known to use outsourcing evaluations to find out what their costs and service levels should be against a market benchmark. This may simply be a short-cut – and cut-price – way of obtaining useful data from informed suppliers. Alternatively, they may plan to use that data to improve the performance of an un-benchmarked in-house function.

Little of this fools the *suppliers*, however. Suppliers say there are many indicators of when a client is not serious about outsourcing or switching suppliers: for example, RFP turnarounds are too short; suppliers are not allowed inside the client organisation; they are not allowed to meet anyone but the client advisor or primary

client contact, or the incumbent supplier's name is all over the request documents.

Because supplier-switching costs are so high for the client, a *faux* bid may be a way of gaining back crucial bargaining power during contract negotiations. However, the downside of such behaviour is the potential damage to the buyer's reputation: Suppliers may refuse to respond to legitimate RFPs in future – the classic 'crying wolf' scenario.

Suppliers say that they are, in fact, happy to provide a cost and service assessment of the work, if that is what the client really wants, but it needs to be done as a paid-for consultancy assignment, or on a reciprocal basis, rather than as a thinly disguised bid process.

• "Your RFP lengths are ridiculous."

Suppliers want to know why clients request so much information from them, particularly in the early stages of the selection process. They ask: Are clients *really* reading and shortlisting potential outsourcers based on dozens of documents that are each 100+ pages long?

Some suppliers believe that clients use the length of the RFP to shortlist companies based on endurance as a proxy for capability. Some suppliers suggest that

"While macho tactics might sort out the committed from the merely interested, they can also be a root cause of project difficulties later on."

The deal: Measure your internal processes first.

documents are long because clients do not know the critical success factors, and so they request everything "in case it is useful". Suppliers complain particularly about public sector agencies, and the rigidities and frequent irrelevance of the information they request.

More positively, this has led to more framework agreements and preferred supplier arrangements being introduced in a range of countries, including the US and UK. These reduce the cost and administion burdens on suppliers, especially in the early stages of the bid process.

A complaint heard across all sectors is when a lengthy document is requested with an imminent deadline. They are right to be angry: While such macho tactics might sort out the committed from the merely interested, they can also be a root cause of project difficulties later on – suppliers may rush the analysis, arrive at unreal propositions, or be forced to recycle components from previous bids rather than tailor the proposal to the client.

The devil in the detail

In some cases, of course, the client's RFP may be highly detailed because it is genuinely indicative of what the contract terms and even the performance levels might be. If so, it forms a workable foundation for any subsequent deal. That, however, would reflect an in-house team that really knew what it was doing.

The two-decade research did uncover such cases – for example, a major chemicals company that contracted with a Dutch supplier, and an energy multinational that struck a deal with three suppliers. In these cases, suppliers did not complain about the RFP requirements and actively welcomed the amount of detail requested. The research also found short RFP timescales that translated into relatively brief contracts, with no discernible fall-off in service performance or client-supplier relationships across the outsourcing experience.

Nevertheless, the issue is a cause of contention for many outsourcing providers. One supplier CEO argued that the

commercial aspects and supplier's capabilities should be primary in the bid process, and too often he had seen these subordinated to bureaucratic concerns. In such cases, unsurprisingly, the contract was often neither consulted during the outsourcing relationship, nor really understood by either party that was operating under it.

In one global deal a client executive acknowledged that the lengthy RFP got converted into what he called "a five foot contract". This document was so forbidding that no one actively referred to it for guidance – which was fortunate, because several mistakes were made during the lengthy process of drawing it up.

Business not worth chasing

While **Professional Outsourcing** is not aware of any research that has specifically looked at the length of RFPs and their relationship to outsourcing outcomes, the authors' research established that the bidding costs, at least, for suppliers can be prohibitive. Lengthy RFPs can also contribute to suppliers deciding that the business is not worth pursuing, especially if an incumbent supplier is in the race.

However, the research did look at contract detail – the number or degree of detailed clauses in the outsourcing contract, specifying prices, service levels, benchmarking, warranties, penalties for non-performance, and so on. Because many RFPs do form the basis of subsequent contracts, a lengthy RFP may benefit the client if it helps create a detailed contract – as long as it is one that is understood by both parties. In the 13 cases where contract detail was studied during the research period, researchers found that more contract detail was associated with better outcomes in 11 of them (85%).

• "Get real with the numbers."

During the contracting process, suppliers say that clients need to be more honest and forthcoming. Suppliers want clients to be more transparent about their actual baseline service levels – and not their most optimistic guesses or their most favourable performance. Suppliers also want clients to provide more detail about process complexity, process exceptions, and process volumes. Suppliers have a difficult time assessing such issues during the due diligence process, often leaving nasty surprises for the early months after transition.

One supplier CEO said: "One thing in this business you cannot underestimate is: No matter how long you try to do due diligence from the outside, you will always get it wrong. It's only when you actually go in there and start running it that you find

Photo: Gary Eastwood

Leslie Willcocks: Sharing 20 years of research.

> **"During contracting, suppliers say that clients need to be more honest, forthcoming and transparent about actual service levels."**

out what's going on. The sooner you do that, the better it will be for everyone."

In practice, it is true that in-house service measurement and cost monitoring are often inaccurate or inadequate. One supplier told of a 2001 outsourcing bid to an Asia Pacific-based insurance company whose internal cost estimates for IT were out by 50%. This was only discovered during due diligence. It led to a radical revision in price and in the services covered by the deal.

In another case, the client and supplier drew up a contract to cover a range of services, only to discover during transition that the services that had been delivered in house were nearly one-fifth larger in scope than had been contracted for.

In a more recent case, a Canadian company and a major supplier ended up in a multimillion-dollar legal dispute over invoicing, principally due to vagueness in costs and service levels. These had been inherited from the inadequate numbers provided by the client pre-contract.

Ready to make a deal?

The research found that client outsourcing readiness – the extent to which the client is prepared to engage an outsourcing supplier by having realistic expectations, plus a clear understanding of its in-house costs, service levels and service volumes – is an important factor in achieving good outcomes. Outsourcing is unlikely to succeed where there is no detailed, meaningful comparison with internal costs and processes.

In many cases, the research found that clients did not even know the numbers of assets or people performing back office operations. For example, one C-level executive said that whenever he needed a headcount for the number of employees working in HR, it would take six weeks of investigation to get an answer.

Client companies also need to fully understand their own internal processes – including their complexity, interdependencies, and exceptions – before requesting supplier bids.

"Results corroborate suppliers' pleas for much more accurate client data before the client draws up an RFP. This may take up to three months in large-scale deals."

Overall, results from the two-decade study corroborate suppliers' pleas for more accurate client data. The research concludes that, for a deal to be successful, there needs to be an evaluation phase where the client first measures baseline services and costs, then develops evaluation criteria based on those, and finally draws up an RFP, inviting both internal and external bids. This may take up to three months in large-scale deals.

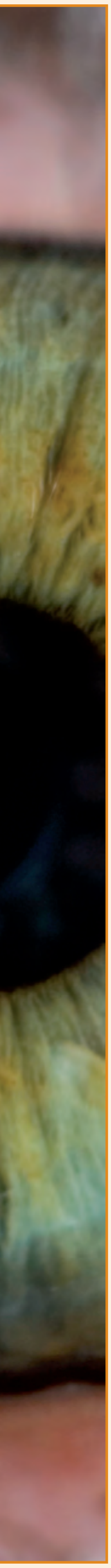
Look 'in' before going 'out'

Invariably, this process throws up a much more granular and accurate view on costs and service realities, against which supplier bids can be assessed. Once this has been made available, there should then be a negotiation phase encompassing detailed SLAs, work unit pricing, terms for contractual change, and due diligence.

Measurement needs to be constantly updated across an outsourcing relationship. However, if the early pre-contract work is skimped, then both parties will find themselves on a rocky path, leading to radical renegotiation and change later on.

How to make deals work for you

- ***Faux* bids may well be past their 'sell-by' date and are more likely to be counter-productive than useful.**
- **Lengthy RFPs with short timescales are also counter-productive, unless they are a genuine foundation for the subsequent deal. If not, they may signal client naïvety or aggression, either of which will dissuade suppliers from putting in time, effort and money.**
- **Ensure that your professional advisors have a track record of pre-screening suppliers and helping clients to send a targeted RFP to less than 10 suppliers.**
- **Also ensure that advisors can demonstrate that they can quickly and rationally shortlist three to five suppliers based on their RFPs – and get the contenders involved with the client team, particularly the senior client managers, soon afterwards.**
- **Ensure that your advisors can remain neutral and promote transparency during the contracting and engagement processes, and look for opportunities across supplier bids.**
- **Measure and analyse all in-house processes before comparing supplier bids against this baseline, and against each other.**



• "Advisors may not be helping."

Clients frequently hire advisors or consultants to assist with the entire decision-making process – including strategy formulation, RFP, supplier shortlist, supplier selection, contract negotiation, and so on.

Good advisors make the difference between a lousy deal and a good one for both client and supplier. Advisors are typically paid by the client, and so their allegiances rightly align with the client's interests. However, this can sometimes perpetuate an 'us and them' approach to contracting.

Suppliers wish that more advisors would help both clients *and* suppliers to build an outsourcing relationship, not just a contract. Suppliers want advisors to be less rigid and evangelical about their template-driven processes. As one supplier said: "Relationships are not based on templates." Suppliers also want advisors to help their clients build strategic relationships by working towards value, and less towards lowering prices and shifting risk. Suppliers also need access to client senior managers if they are to build good partnerships. Small suppliers often feel that advisors recommend "the usual suspects", while some domestic suppliers claim that advisors push clients to offshore providers straight away.

The Cloud angle

From an IT perspective, some suppliers think advisors need to be more knowledgeable about hosting and Cloud Computing services – a technology area that, some of its proponents say, negates the need for consultancy. One large supplier remarked that, invariably, he found advisors pushing for multisourcing options, and felt that this was partly because it offered them more work.

These complaints all translate into one thing for clients: make sure your advisor has deep knowledge of the breadth of supplier capabilities and how a sourcing solution might bring the most value for the client, not the advisor.

How to make deals work for you

• Never skimp on giving the winning supplier accurate cost and service information. This will be a strong foundation for SLAs, performance monitoring and invoicing.
• Do not be lulled into a false sense of security about fixed-price deals. Detailed analysis of the many hidden costs is essential, as is consideration of whether another pricing mechanism might be more appropriate.
• Long-term contracts and relationships are for mature clients to consider. The research suggests a higher disappointment rate for long-term deals. A client may mitigate risk by moving into large-scale outsourcing incrementally, if need be.
• The cost of switching out of long-term contracts can be prohibitive, and may mean staying in a poor deal.
• Start small. It is easier to ramp up your outsourcing than to scale it down from a larger deal.
• Contract on a collaborative, mutually dependent, risk-reward basis.

"One large supplier remarked that, invariably, he found advisors pushing for multisourcing options, and felt this was partly because it offered them more work."

The research into large-scale outsourcing arrangements found that the same limited pool of advisors tends to be used, and this results in similarities in best practice advice. It is important to discover whether this advice is optimal, or whether such companies are simply offering standardised or fashion-based approaches, driven by their, rather than their clients', values.

• "There is no such thing as a fixed price..."

Clients will consider a range of pricing options, all of which have strengths and weaknesses, with each being suitable for certain types of outsourced activity. These options include a lump sum fixed price, unit pricing and cost-based pricing.

Clients go for fixed prices in order to lock down cost, to render costs predictable within specified volume bands, and/or to achieve an explicit financial goal. They also see it as a mechanism for controlling suppliers' potential to be opportunistic.

Suppliers, on the other hand, will often agree to a fixed price arrangement in the hope that the client's requirements will

change, that unanticipated services and demands will materialise outside contract scope, and that these services will incur additional charges at potentially higher price levels. As a result, most suppliers are careful to define service scope meticulously, without always spelling out the full implications of what has been left out. Such circumstances occur all too frequently in outsourcing arrangements.

Fixed prices may be fine where costs, service type and service levels can be meticulously defined and are stable for long periods. However, when it is difficult to predict demand, cost changes, or even the precise *objective*, then any fixed price set will be increasingly unrealistic. The result? Both parties will have to renegotiate continuously, or, better, move to a more suitable pricing model.

The problem of scope-creep

Even with the best intentions, both parties can still run into problems – for example, through contractual ambiguities and misinterpretations of clauses concerning what is 'in' and 'out' of scope.

Clients also frequently misjudge future demand. Suppliers say that there is often a pent-up demand for IT services that gets released when the outsourcing 'white knight' appears on the scene. Subsequently, the client discovers unexpected spikes in cost. In one large aerospace deal, for example, the excess fees amounted to $500,000 in the first month of operation.

Suppliers say that clients, understandably, find it difficult to anticipate future requirements and costs, but in recent years have become better at putting the right monitoring processes in place. Nevertheless, too much faith is placed in the power of the 'fixed price' mechanism, found the research.

It also discovered that clients regularly underestimate the hidden costs of outsourcing. For example, the costs of management may be anything between four and 12% of contract value, depending on whether it is domestic or offshore outsourcing, and on the type and scale of activity, the number of vendors and contracts, and the in-house management capability. When outsourcing runs into problems, then in-house management costs rise considerably.

"The research shows that losing track of costs is the top risk for clients in their outsourcing arrangements."

Other transaction costs are easily underestimated across the lifetime of a deal. These include the cost of advisors, search costs, getting to contract, cost of termination, dispute costs, and failure to monitor performance and market prices.

Monitoring the real cost

Case studies within the research found that clients quickly lose track of the real costs of their outsourcing, whether these are fixed-price arrangements or otherwise. Over long-term contracts in particular, so much changes that initial estimates and cost controls have little relationship with, or influence over, the final outcomes.

Take the case of the Inland Revenue, whose initial estimate in 1993 was that its deal with EDS would cost £1 billion over ten years. The actual figure by 2004 was £2.4 billion.

The research established that losing track of costs is the top risk for clients in their outsourcing arrangements. This is clearly a problem when the primary objective of outsourcing continues, overwhelmingly, to be cost savings.

Opportunity knocks

Vendor opportunism is well represented in theories on outsourcing, but is less so in empirical research studies. In Transaction Cost economics theory, for example, the assumption is that suppliers will behave opportunistically unless curbed by governance mechanisms, increased competition, detailed contracts, service level agreements, regular benchmarking, and strong in-house management.

However, the research shows that the assumption of negative vendor behaviour is unfair in more favourable circumstances – for example, when the supplier is making a reasonable profit, is dealing with a prestige client, and/or sees the potential for additional work. The emerging

complementary alternative, therefore, is to set up deals on a more collaborative, mutually dependent, risk-reward basis.

• "Contracts should be 10+ years."
From the supplier's perspective, they start outsourcing engagements in a financial hole: They have spent money responding to bid documents, negotiating the contract, visiting client sites and conducting due diligence, and may also have taken on new employees or purchased client assets.

Outsourcing has transition costs that not only defer supplier profitability, but also delay outsourcing benefits for the client as well. No matter how rigorous the due diligence processes might have been, it may take six months before suppliers have a handle on daily operations.

For large deals, suppliers may need six to 18 months to apply all their transformation capabilities – such as centralisation, consolidation, standardisation, organisational redesign, and new technologies to improve client services (and to generate enough efficiencies to earn a profit margin).

From the supplier perspective, then, the longer the contract, the better. As one ex-supplier-executive-turned-CIO told the authors: "When I worked for the supplier the best deal was 10 years. As a client I would make it 18 months."

So what *is* right for the client? The research found that, in this instance, the suppliers' perspective is wrong in many cases: Short-term contracts have a higher relative frequency of success than mid-term or long-term contracts.

Contract duration was put into three categories: One to three years, four to seven years, and eight or more years. Using these categories, 85 outsourcing decisions with discernible cost outcomes were analysed: 32 outsourcing decisions were sealed with one- to three-year contracts (38%); 32 outsourcing decisions were sealed with four- to seven-year contracts (38%), and 21 outsourcing decisions were sealed with contracts of eight years or longer (25%). Among these 85 outsourcing cases, short-term contracts realised expectations more frequently than long-term contracts (88% were successful).

One reason for the success of short-term contracts is that participants only outsourced for the time in which their requirements were stable, and so participants could adequately analyse the cost implications of their decisions.

Another is that some participants noted that short-term contracts motivated supplier performance, because the suppliers realised that customers could switch partners when the contract expired. As the IS director of an aviation company commented: "The closer we get to contract renewal, it's amazing what service we can get."

Other academic studies have examined the effects of contract duration on outcomes. The preponderance of evidence (57%) suggests that shorter contracts are associated with better ITO outcomes. Taking all of this into consideration, there seems good evidence to suggest that contracts in the three- to five-year range experience successful outcomes more frequently than contracts of greater than five years' duration.

In conclusion, outsourcing suppliers can be very insightful about clients. What they would tell clients if they could is a mix of observation and advice, which ranges from the objective to the self-interested. Nevertheless, the findings suggest clear guidelines for strong contract negotiation. But the ultimate lessons for buyers must be: Measure and cost your internal processes first, and be realistic about how things will change over time. ■

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Former vendor executive

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