



# Cost-saving strategies for contracts

When was the last time you reviewed your outsourcing agreements? Taking a fresh look at those contracts can help you cut costs in tough economic times.

**THE GLOBAL RECESSION** is forcing every company to consider new ways of cutting costs. This can be a challenge for supply chain managers who are saddled with long-term outsourcing relationships entered into in better times, and which may no longer be as favorable as they once were.

It's possible to cut some of the costs associated with these relationships, but it is not easy. In this article, we discuss four areas that offer opportunities to revise and improve your long-term outsourcing contracts.

## 1. Make the most of flexibility

A well-drafted outsourcing contract includes provisions that allow the contract to adapt to the customer's changing requirements. Many agreements contain fixed charges that are based to some extent on transaction or headcount assumptions in the initial year of the agreement. Often these amounts can be adjusted when conditions change. For example, a contract may allow adjustments to fixed charges if the volume of activity falls below an agreed baseline,

or if the service provider achieves additional cost savings.

Even if a contract does not specifically envisage and make pricing allowances for changing circumstances, you often can make other changes that will save you money. For example, your agreement may have been negotiated at a time when stringent service levels were a priority. Service excellence, however, comes at a price, and reducing service levels can significantly lower the cost of delivery. Do you really need that 99.999 percent availability of a product or service? Studies indicate that each additional "9" in the availability measure can add 30 percent to costs. What business benefits are you getting for that additional 30 percent?

Or consider whether you could trim back or streamline services. Do you really require all of the service components in the original contract? Do all of the vendor's activities provide a business benefit? If not, ask your vendor to drop or scale back those services and amend the contract accordingly.

The procedure you establish for making changes in the contract should require the vendor to reduce its charges in line with the reduced scope of service. An important caveat: In many contracts, if a certain portion of the services are removed, that removal will be treated as a partial "termination for convenience," and a termination fee might be payable. Even in these circumstances, there may be some scope for negotiation. If the services you want to eliminate are disproportionately costly for the vendor to provide, the vendor may be willing to discontinue that piece of the business and waive the penalty.

Flexibility in a contract may allow you to reduce costs by delaying or canceling some or all scheduled process transformations (for example, automating manual processes) or technology upgrades. If the outsourcing agreement includes some form of process transformation, consider whether all or part of that project could be delayed or canceled. If you give short notice of the delay or cancellation, however, you may be required to compensate the vendor, but the cost savings from eliminating the project could well outweigh that penalty. And take a close look at any provision concerning information technology (IT). Does the agreement provide for unnecessarily aggressive technology upgrades? If so, now might be the time to re-evaluate your strategy for refreshing technology. But be careful not to indiscriminately cut IT spending: Targeted technology investments could

help to boost sales and even save more money than you could through cost cutting.

## 2. Enforce your contractual rights

Too often, companies spend a long time negotiating a comprehensive outsourcing agreement, only to file away the executed contract in a drawer and manage the day-to-day relationship on an informal basis. Tough economic times, however, demand a return to more formal and controlled management. To get the full benefit of the terms in your existing agreement, review its service-level and pricing mechanisms, and then enforce the rights you already have.

Failing to enforce existing contract provisions inevitably leads to missed opportunities. For example, companies frequently fail to demand credits for "minor" service failures, preferring to give the provider some leeway for the sake of "the relationship." However valuable this trade-off may be in better times, even small service credits can add up. Exercising your right to claim them can produce appreciable cost savings.

Another example involves the right to benchmark service charges. Prices you agreed on years ago may be out of step with the market. A benchmarking right that will automatically reduce service charges in line with market pricing offers an easy way to realize cost savings. Even the threat of benchmarking can be enough to bring a vendor to the table to negotiate a reduction in fees.

Consider also whether to utilize the auditing rights in your agreement. By doing so, you can verify whether the vendor is invoicing the correct amounts. Audits can also determine whether you are being invoiced for the volume and type of services you actually use. Are you paying for a software license that has elapsed? Is the vendor in breach of any of its obligations?

Finally, make use of the dispute-resolution provisions in your outsourcing agreements. Check to make sure that they meet your needs. If your service provider is based offshore, will you have any enforceability issues? Ideally, you want to review and address these matters before you ever have to invoke dispute mechanisms. On a related note, parties to outsourcing agreements often fall into informal dispute-resolution processes rather than follow the steps laid out in their contractual agreements. Avoid potential problems by insisting that your vendor use the correct process, and if it fails to follow up on legitimate disputes, use the appropriate escalation and resolution mechanisms.

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### 3. Find opportunities for renegotiation

It's wise to periodically review outsourcing agreements to assure that they are supporting your current business requirements. But when economic circumstances affect the business case for a particular deal, a review is not just a good idea, it's essential. That's why now is the time to consider whether any element of your outsourcing agreement should be renegotiated to reflect fundamentally different economic conditions.

One area where you may want to renegotiate is offshoring. If you decided to restrict a service provider from offshoring certain service elements when you first struck the agreement, there probably were valid reasons for doing so. Now, however, cost sensitivity may outweigh any potential downside of offshoring, and you may wish to change the terms to allow it. If your deal already includes offshore operations, then it's time to consider whether the allocation of currency risk is still valid. If you are paying for offshore services in the local currency, are you prepared to accept the currency risk? Or should your company hedge the currency risk on its own, without involving the vendor?

Provisions for dealing with corporate mergers, divestments, and other changes of control are prime candidates for renegotiation. Review the extent to which your existing relationships could accommodate a merger with a competitor—or the extent to which those relationships could be terminated and transitioned to an acquiring (or acquired) entity's vendor. Accordingly, you will need to review your agreement's assignment, termination, and pricing provisions to determine what your rights are when there is a change of control. If the contract does not already allow it, consider including the right for related companies to be added or removed as "services recipients." Outsourcing contracts often will treat the removal of a services recipient as a partial termination for convenience, but you can avoid the liability to pay a termination fee if the divested entity enters into a replacement contract with the same vendor.

If the provider's cost of borrowing is less than yours, consider mid-term renegotiation of pricing. Many outsourcing relationships spread recovery of the provider's up-front costs over the full term of the agreement, and therefore they allow the customer to defer payment for such items as transition, asset-acquisition, and initial start-up costs. There is no reason why you could not consider a similar principle mid-term. For example, the vendor might finance mid-term price reductions in return for higher prices later on.

### 4. Use your leverage

It is all very well to come up with a list of potential improvements to your outsourcing contract, but it's quite another thing to get the service provider's atten-

tion so that you can implement those improvements. To bring your service provider to the table, you must consider areas that you can leverage as well as changes that may offer value to your provider. Here's an example of the latter. Suppose you are satisfied with your provider's services but wish to receive price concessions. To make those concessions worthwhile for the provider, you could offer to extend the contract.

An example of using leverage would be exercising your right to terminate for convenience. Vendors prefer to retain existing, profitable clients rather than see them go to the competition. If you threaten a convenience termination, the vendor may therefore be open to discussing compromises. This is more likely if the net value of the agreement exceeds any compensation you would be obligated to pay to the vendor for the termination.

Here's another possibility. If the vendor is in breach of any of its contractual terms, then you can use the threat of termination on those grounds. Taking steps to (or even threatening to) enforce contractual terms and claim damages may give you some leverage. Of course, the more material the breach, the more successful such a tactic will be. If the breach is so material as to allow termination of the contract, it could threaten the vendor's reputation, and the vendor will want to avoid any negative publicity.

You could offer the provider additional business in return for a lower unit price. Sometimes reducing the scope in exchange for a price reduction serves both parties' economic interests. For example, you might offer to drop a poorly performed service that produces very little or negative margins for the provider.

Finally, if you are satisfied with the provider's services, consider offering to act as a reference in return for some additional benefits. If you are a large, prestigious customer, your recommendation could help your vendor get new clients. That might not sound like a lot of leverage, but in a tight market it could lead the provider to offer substantial benefits in return for your public endorsement.

Managing outsourcing agreements in difficult economic times requires thoughtful review in light of your organization's current goals. By conducting this type of review, you are likely to find many opportunities to gain additional cost savings or other advantages. So pick up your contract and look it over with care. There's no better time to do so than the present. △

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