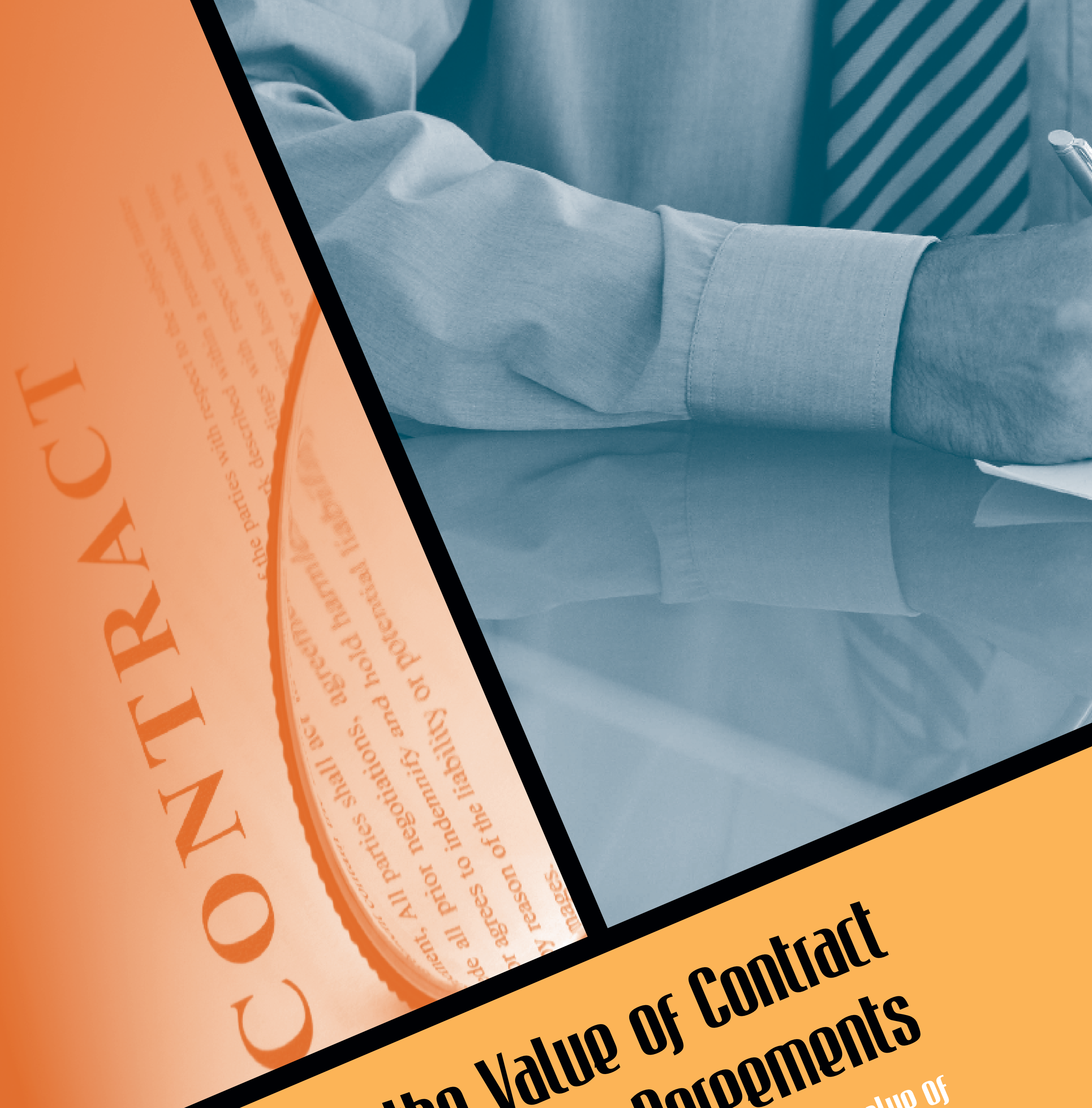
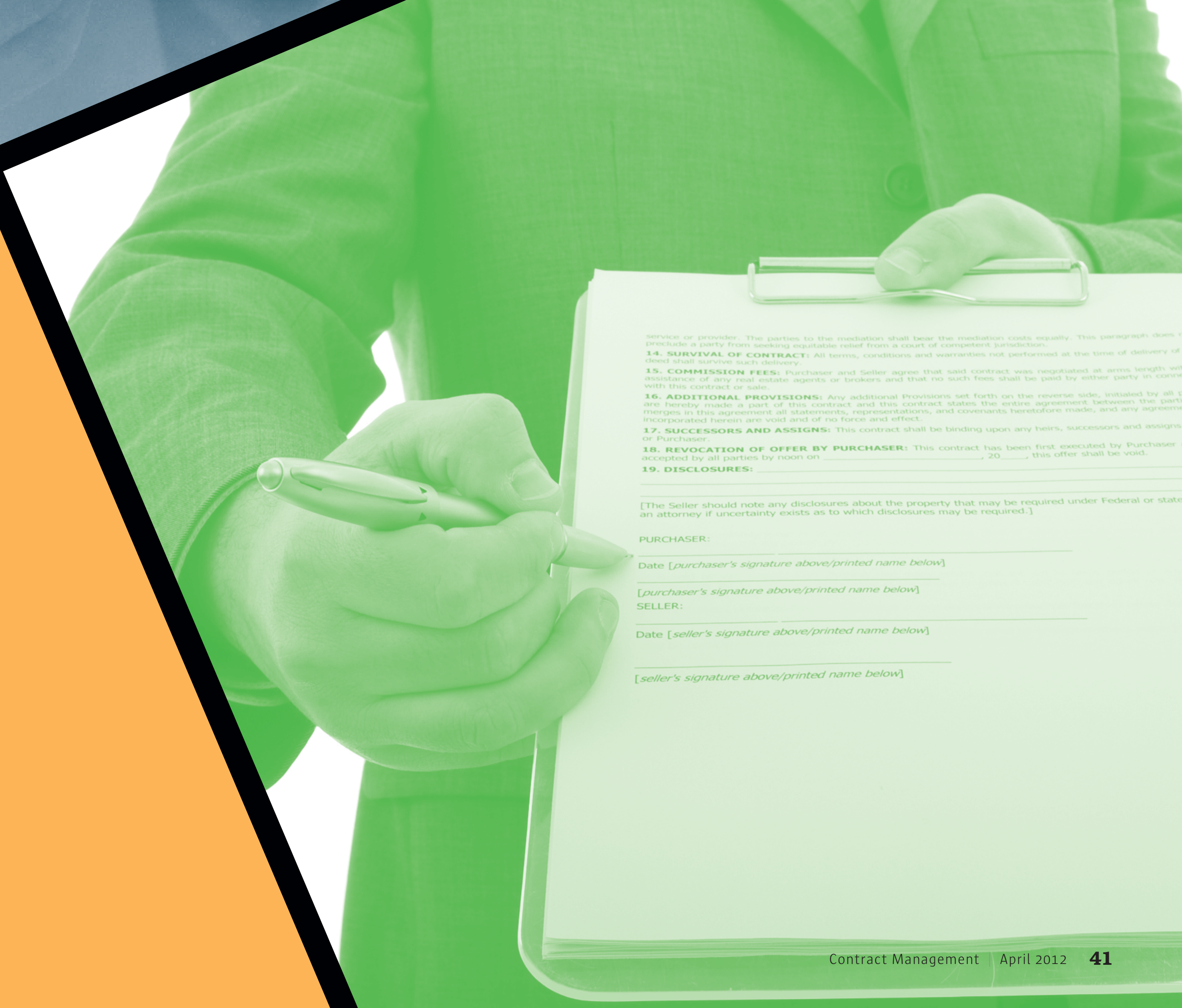


Estimating the Value of Contract Terms in Sourcing Agreements

The benefit of estimating the economic value of contract terms and approaches to doing so.

By Brad Peterson


14. SURVIVAL OF CONTRACT:
15. COMMISSION FEES:
16. ADDITIONAL PROVISIONS:
17. SUCCESSORS AND ASSIGNS:
18. REVOCATION OF OFFER BY PURCHASER:
19. DISCLOSURES:
PURCHASER:
Date [purchaser's signature above/printed name below]
[purchaser's signature above/printed name below]
SELLER:
Date [seller's signature above/printed name below]
[seller's signature above/printed name below]

Although estimates of economic value in sourcing agreements generally focus on the pricing schedule and the products or services to be delivered, sourcing agreements also provide value by securing commitments, obtaining options, aligning incentives, and supporting a successful relationship.

Those commitments, options, incentives, and support for a successful relationship—referred to in this article as "contract terms"—clearly have economic value. However, customers generally do not make formal estimates of the economic value of contract terms. Instead, customers generally rely on impressions of the importance of "risks" or "key terms."

The Benefit of Estimating the Value of Contract Terms

Estimating the economic value of the contract terms in a sourcing agreement allows customers to:

- Make smarter choices between lower prices and better contract terms,
- Balance the desire to "get it done now" against the value of "doing it right,"
- Invest appropriate time and resources in drafting and negotiating contract terms,
- Focus negotiating energy on the high-value contract issues,
- Recognize contracting teams and sourcing professionals for the value they create by crafting and negotiating superior contract terms, and
- Achieve desired business outcomes.

Estimating the Economic Value of Commitments

Contract terms can help to secure a commitment to provide specified products and services at firm prices. That commitment may include contract terms such as:

- Sweep clauses,
- Service warranties,
- Rights to make immaterial changes without additional charges,
- Continuous improvement obligations,
- "All-in" pricing,
- First-priority access to scarce resources,
- Reliable disaster recovery commitments,
- Audit rights,
- Defined direct damages,
- Reasonable amounts at risk, and
- A clear and complete definition of scope.

To estimate how much a contract commitment is worth, you can estimate the additional cost of the likely outcome without the commitment. If the likely outcome is incurring additional charges, you could estimate the value of that commitment based on the likely additional amount the supplier would charge absent that commitment.

If the likely outcome is alternative sourcing, you could estimate the value of that commitment based on the cost of the best alternative available without that commitment. For example, if the contract in essence exchanges a long-term commitment for a 10-percent reduction in cost compared to spot market prices, that 10 percent could be the estimate of the value of failing to secure the commitment. In situations where there may not be comparable products or services available on the spot market, the best estimate might be the expected cost of a workaround or supply interruption.

Estimating the Economic Value of Options

Contract terms can provide options to the customer, such as:

- Obtaining out-of-scope services at reasonable prices,
- Insourcing or re-sourcing,
- Changing technical or operational requirements,
- Imposing reasonable rules and restrictions,
- Relocating customer facilities,
- Changing customer technology,
- Adjusting prices through benchmarking,
- Having services provided to related companies (including divested companies),
- Terminating the agreement, or
- Obtaining additional services such as mergers and acquisitions support or termination assistance services.

Options such as these are valuable because they reduce the amount and likelihood of change-related charges. Customers' financial models tend to overlook the value of options because they assume that all will go as planned—an increasingly unrealistic assumption in our fast-changing world.

A straightforward approach for calculating the direct economic benefit of an option is to estimate the probability of exercising the option and to multiply that figure by an estimate of the economic benefit achieved by exercising the option. For example, if the supplier agrees that a termination-for-convenience charge will be reduced by $1 million if related to a change of control, and if you estimate a 5 percent probability that the customer will terminate related to a change of control, you could estimate the value of that provision as 0.05 × $1,000,000 = $50,000. If you can obtain that provision for less than $50,000, then it will add value to the contract.

This is, of course, a straightforward example. You may need to use more judgment to estimate the value of options that provide agility, flexibility, and adaptability in achieving desired business goals. These are undeniably important. Even though the value of these options cannot be estimated with precision, an estimate based on the collected best judgment of your team will be superior to ignoring their value.

Estimating the Economic Value of Aligning Incentives

Contract terms can increase incentives for the supplier to act in the customer's best interest. Contract terms such as service level credits, deliverable credits, holdbacks, gain sharing, obligations for the supplier to correct its errors at its cost, and indemnities against harm caused by the supplier support a successful relationship by helping to align the interests of the supplier and the customer. These incentive provisions can also mitigate potential customer risk by requiring the supplier to pay some of the customer's losses. These incentives can balance the perverse incentives created by the primary pricing structure, such as the incentive to do only what is required at minimum cost created by a fixed-price arrangement.

You can estimate the value of an incentive clause by subtracting the economic value you expect to derive without the incentive from the economic value you expect to derive if you have the incentive. The value you place on incentives depends on your estimates of the following:

- The value of achieving your desired business outcome,
- The supplier's ability to help to achieve that outcome, and
- The strength of the incentive.

The strength of the incentive depends on its size relative to the supplier's cost of achieving the desired result. Like the customer, the supplier is looking at the cost-versus-risk calculation. For every dollar that the customer wants the supplier to invest in reducing a risk by 1 percent, the supplier should have at least $100 at risk. Any smaller sum at risk would make the potential liability more of a cost of doing business than an incentive.

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Estimating the Economic Value of Supporting a Successful Relationship

Contract terms can also support a successful outsourcing relationship by achieving the following two outcomes.

Building Trust

Trust increases when companies are willing to translate their communications into enforceable legal obligations. It is further increased when the contract terms make the two companies, to a degree, accountable to each other as "partners" in sharing the risks and rewards of operating the outsourced scope. Trust allows companies to work together seamlessly.

Creating Alignment

Sourcing contracts create complex, multifaceted relationships. Agreeing on how to work together allows these relationships to succeed across company boundaries. For example, specifying reporting, governance, and information rights simplifies the communication process, agreeing on how work will be added or removed reduces friction at important points in the relationship, and issue management and escalation provisions make it easier to resolve disputes.

The purpose of these provisions is to make the contract easier and less expensive to govern. Thus, customers might estimate the value of these provisions based on the amount of additional spending that will be required to make up for not having them. In addition, the customer might consider the additional value created by a well-functioning relationship, such as innovative ideas and rapid response to needs for change.

Importance of Data

The accuracy of the estimate of course relies on the quality of the data. Customers often gather or create useful data as part of analyzing the overall business case. For example, if the value of the desired business outcome is estimated, that estimate can be used to value any change in the probability of achieving that desired business outcome. Deciding how the value of contract terms will be estimated generally allows a customer to more easily identify the key data and gather it during the initial due diligence phase and save it for future reference after a contract is complete.

The contract terms are a key data point and require careful analysis. First, the strength of individual contract terms depends on the limitations, exclusions, and other precise language of those contract terms. Second, just as a chain is only as strong as its weakest link, an individual contract term may only be effective if related contract terms are also effective. For example, a strong commitment is of little value without an adequate remedy for breach. Thus, the value of contract terms should be estimated based on their effect on desired business results, taken as a whole, not as individual terms.

However, even a simple estimate based on rough data can provide better guidance for economic decisions than ignoring the economic effect of contract terms in financial analyses or merely listing contract terms or risks. Ignoring the contract terms is equivalent to valuing them at zero, yielding a more wrong answer than a simple estimate on rough data. Valuing contract terms at zero will result in agreeing to poor contract terms with results such as surprise charges, lack of control, inability to exit, compliance failures, and responsibility for the supplier's failures. Merely listing contract terms or risks forces the decision-makers to guess at the terms' importance in maximizing shareholder value.

Summary

Contract terms provide value by securing the supplier's commitment to defined services for a fixed price, providing options, aligning incentives, and supporting a successful relationship. Customers can estimate the economic value of contract terms. Although an uncertain future makes that value difficult to estimate accurately, customers can make better decisions and achieve better business outcomes by working with available data to derive their best estimates of the value created by contract terms. **CM**

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