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Negotiating Indirect Procurement Outsourcing Agreements:
Differences You Should Know

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Indirect procurement outsourcing deals may seem like other standard business process outsourcing deals, but don't be fooled by the similarities. Indirect procurement is different and requires certain contract terms that are unique from those used in other outsourcing deals. This article explains some of the key differences and important considerations in structuring an indirect procurement services contract. But first, a little background.

Indirect procurement outsourcing is expanding by roughly 30% per year, according to Everest Research Institute. The number of standalone procurement deals is increasing, and many other outsourcing deals — including finance and accounting and IT outsourcing — contain some aspect of indirect procurement. Indirect procurement functions are transactional activities such as converting requisitions into purchase orders, managing vendor catalog information and accounts payable services. Other indirect procurement activities can be non-transactional, strategic functions, such as vendor management and category sourcing. The term "indirect" means goods and services that are not directly used in creating or providing a product or service. For example, for a financial institution, office supplies for bank branches and travel services for bank employees are indirect goods and services, while checks and check printing services are direct goods and services.

Indirect procurement outsourcing deals share many common business and legal issues with other outsourcing transactions. There are, however, some unique differences critical to drafting indirect procurement contracts and executing this type of outsourcing activity. Pricing, savings commitments, remedies, warranties, responsibility for third party performance and concern about intellectual property rights are just a few areas to better understand in

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relation to indirect procurement outsourcing. This article examines these key issues and suggests how to address them when negotiating a contract for indirect procurement functions.

1. **Pricing Structures.** Outsourcing services are often priced according to baselines (units of service for a baseline price), with a unit charge or credit for increases or decreases in volumes. Some types of indirect procurement functions may lend themselves to baseline pricing as well, such as activities that are repetitive or transactional in nature — for example, the number of purchase orders handled.

   However, many procurement deals are structured to compensate the provider based on "spend under management." The service provider may receive a fee based on the percentage of the total in-scope amount that the customer spends with third parties for indirect goods and services. If the customer's spend grows, the fee may increase, perhaps subject to a cap. If the provider manages to reduce the spend, then the provider may receive negotiated incentive compensation. Occasionally procurement functions will contain both types of compensation structures — volume-based pricing for transactions and fixed fee payments for spend-under management by the provider. Alternative pricing structures, such as cost-plus models, may also apply.

2. **Benefits.** In other outsourcing deals, most customers expect to receive the same or better services while saving on costs. Cost savings are measured by the amount that the customer pays the provider for the services. This is often not the case for indirect procurement outsourcing. While an indirect procurement service provider may in fact save the customer money for procurement services, often the customer is more concerned about reducing third-party spend. In fact, some customers are willing to pay slightly more in provider fees in exchange for the promise of reducing third-party spend. Such a counterintuitive approach to cost savings is critical to keep in mind when planning for indirect procurement outsourcing.

3. **What Counts Toward Cost Savings.** Cost savings based on volume consumption models are relatively easy to track. If you spend $100 to turn 1,000 requisitions into purchase orders, and the procurement service provider can do the same work for $85, you save 15%. Tracking, measuring and reporting cost savings on the customer's overall third party spend can be challenging. The methods to track, measure and report cost savings must be well-negotiated and documented in the agreement. For example, the customer and provider should negotiate the extent to which savings generated from the following areas will count toward the provider's savings commitment: 1) *provider productivity improvements* (e.g., an ability to get to just-in-time procurement); 2) *provider investments* (e.g., better spend management software); 3) *cost avoidance* (e.g., better pricing) and 4) *one-time benefits* (e.g., rebates, refunds). It is important for the customer to educate the provider regarding the customer's own internal cost savings and productivity programs, and to integrate them into the agreement with the provider.

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4. **The Promise (and Commitment) of Cost Savings.** Unlike other outsourcing deals, the potential of cost savings on third party spend in indirect procurement outsourcing deals far exceeds the value of the procurement services purchased. Cost savings on third party spend can run in the millions to hundreds of millions of dollars. Since most providers will not guarantee those savings dollar for dollar, it is important to structure

the agreement so that the provider has incentives to achieve cost savings. Service levels and credits are one way to do this. Guarantees of a portion of savings are another. Gain sharing —where both parties benefit from reductions in third party spend — is another commonly used method in procurement outsourcing. The rules for calculating and providing gain sharing require careful negotiations and documentation in the agreement.

5. **Remedies for Failed Expectations.** What happens if cost savings do not materialize? The customer and provider need to address this topic, and set reasonable rights and remedies in the agreement. When defined expectations are not met, the customer may want to consider terminating the deal. In other outsourcing deals, termination rights are often linked to the quality of service. For example, a customer may be able to terminate for repeated service level failures, in addition to general material breaches. In an indirect procurement deal, achieving cost savings is one of the key quality and service measures. A well-constructed agreement will contain key measurements around the delivery of cost savings, and rights to terminate based on the provider's failure to achieve those key measurements.

6. **Warranties.** With most outsourced services, the most important warranties on services and deliverables come directly from the provider — the one with whom the customer has the contract. In indirect procurement outsourcing, providers sometimes buy goods and services for the customer under the provider's own volume buying arrangements. Such arrangements can yield important cost savings, but they create issues regarding warranties, liability and indemnities for such goods and services. If the provider will use its own contracts to purchase goods and services on behalf of the customer, the customer must understand the extent to which the provider can pass through warranties and other contractual protections.

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7. **Responsibility for Third Party Vendor Performance.** Mistakes, errors and disputes are common occurrences in managing third party vendors. The contract must clearly address the extent to which the provider will be liable — from payment disputes to late or defective shipments. For example, a procurement provider may be responsible for placing an incorrect order, but may not be responsible for failure by the third party vendor to ship properly ordered items (unless the provider somehow caused this problem). Determining these lines of demarcation — that is, what the provider will and will not be responsible for — requires negotiation and careful drafting.

8. **Intellectual Property (IP) Rights.** Determining intellectual property rights of the customer and the provider is not the first thing that comes to mind in structuring a procurement outsourcing relationship. However, it should not be the last. Success in outsourcing indirect procurement activities requires consideration all of the competitively sensitive buying data to which the provider will have access to and (in some cases) control. The agreement should cover appropriate confidentiality and use rights (including addressing whether the provider may use customer data on an aggregated, no-name basis). If the provider is also using its systems, the agreement should cover customer license and use rights, including post-termination rights. Finally, most outsourcing deals include development of a procedures manual. This manual captures business processes used by the customer to run its business, and describes how the

services are provided. The customer should clearly define what rights it has to use this manual after the deal is terminated.

Like other outsourcing deals, indirect procurement outsourcing can contribute significantly to a company's cost savings. Structuring the deal with care will increase the chances that those savings do indeed drop to the bottom line.