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How To Negotiate Outsourcing Deals That Reduce Costs

By **Brad Peterson** (August 31, 2022, 5:53 PM EDT)


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Market and technology changes have created opportunities for companies to generate substantial cost reductions by negotiating and renegotiating their managed services agreements and other outsourcing services agreements.

As we all know, technology has enabled work-from-home arrangements and companies have invested in facilitating remote work. In addition, there have been substantial advances in various forms of artificial intelligence, from robotic process automation to various forms of machine learning.

Those advances have allowed outsourcing suppliers to go beyond the traditional model of providing from lower-cost locations to a new model of generating equal or better services with far fewer people.

Often, suppliers also leverage cloud-based software as a service, or SaaS, technologies for artificial intelligence, robotic process automation and machine learning — AI, RPA and ML — and for delivering functionality at lower cost.

Here are 10 ways you can help clients seize those opportunities with present and future outsourcing suppliers:

1. Reduce supplier cost.

If the company reduces the costs that it imposes on a supplier, the supplier can lower its price while preserving its profit. Complying with contract requirements is a cost.

Thus, consider whether each contract requirement adds more cost or more value in the specific deal, particularly if the contract requirement prevents the supplier from using technology that it uses to serve most of its customers.

For example, having suppliers follow the company's policies and standards is likely better for the company. But, the company may be able to reduce the supplier's cost, perhaps substantially, by checking whether the supplier's policies are adequate already or adequate with changes that might be options in the supplier's systems.

Similarly, instead of using the traditional outsourcing approach of documenting what the company does today, focus on what is needed to drive value.

2. Reduce risk premiums.

The supplier's bid will include a risk premium. Thus, a company may reduce its cost by reducing risk for the supplier. Some risks can be reduced in contracting, for example, by drafting service obligations clearly and thus reducing the supplier's risk of unanticipated demands from the company.

Other risks can be reduced by allowing the supplier to use technology that it knows well, allowing due diligence or providing reliable information. The remaining risk might be allocated more to the company.

For example, the company might agree to bear more of the risk of changes, such as inflation, that would affect the company if it were running the function itself.

In accepting more risk, companies should consider not only cost reduction under the contract, but also the effect on the supplier's incentives to avoid damage and the cost that the company will incur because it bears the risk.

3. Allow suppliers to make transformative changes to outsourced operations.

Suppliers today are offering tremendous cost savings — 30% or even 50% — if allowed to standardize and automate manual processes and deliver using RPA, AI, SaaS and other third-party technologies.

If done well, this can advance the company's own digital transformation agenda. If done poorly, the supplier might transform processes and technologies in ways that reduce its own costs while imposing costs and risk on the company that exceed the benefit of the cost savings under the contract.

Doing this well requires more than waiving typical control rights. To do this well, the company must secure commitments to maximize value and avoid costly pitfalls in both the transformation process and future model of operations.

4. Commit to more collaboration by the company with its suppliers.

Instead of asking a supplier to take full responsibility for delivering in-scope business functions, companies can commit to help the supplier perform. The help might, for example, include technical support, rapid decisions and changes to company systems.

For example, the supplier may be able to save considerable amounts if the company modifies its systems to interface better with the supplier's systems or run supplier software as part of company systems.

Committing to collaborate can reduce costs if helping the supplier costs the company less than it saves the supplier. The precise contract drafting is important.

Overly narrow drafting provides little comfort to bidders, and thus fails to lower bids and generate savings. Overly broad drafting can result in the company both paying a fixed price to have work done and doing that work itself.

5. Leverage competition.

Competitive and sole-source processes both provide the opportunity to generate value through win-win negotiations. However, competitive processes give companies both the across-the-table value found in negotiations and the same-side-of-the-table competitive pressure found in auctions.

So, in competitive processes, each bidder will seek to offer pricing not only lower than the company's base case, but also lower than it expects that other bidders are offering. Effective multisourcing can continue this competitive pressure while reducing risk. Notably, however, achieving those benefits requires better and more sophisticated planning and execution, including by the legal team.

Leveraging competition is particularly valuable for a company that believes that substantial savings are available by using technology. A company that is sourcing from various suppliers of human labor can evaluate prices based on local compensation rates and other costs, which are well known. A company looking for a technology solution may not know what is possible at the time of the deal or through subsequent improvement.

6. Partner with the supplier in its technology development.

The company may be able to obtain discounts by helping the supplier increase its profits from other customers.

For example, the company could allow the supplier to use company data to train its ML platforms, to use innovations developed under the contract for other customers, or to use the company's name in its marketing.

The company could agree to act as a pilot or beta user for new supplier products, or perhaps co-develop products with the supplier, reducing the company's own development costs. Some companies help suppliers in their marketing, including acting as reference clients or granting awards to suppliers subject to trademark and other restrictions.

This kind of partnering can also lead to long-term cost savings. Technology tends to have high fixed costs but low operating costs.

Thus, the larger number of companies that help to fund the development of a technology, the lower the cost per user. Similarly, prevailing platforms tend to accumulate useful features, lowering the cost for companies that help a platform prevail.

7. Pay in future years.

For some companies, the issue is less the total cost than the initial cost. Outsourcing contracts can help, for example, by spreading one-time costs over the contract term, selling in-scope assets to the supplier for credits against first-year charges, or committing more strongly to pay the set price for more years.

Termination charges will go up and there will be an implied interest rate on the deferred payments. However, there are years — and this may be one of them — when those might be small prices to pay.

A longer term can help to fund a digital transformation. If, for example, a digital transformation would lower the supplier's annual ongoing costs by a third of the initial investment, the supplier could implement the transformation at no additional charge to the customer with a four-year term and could profitably bid a lower price — even in the first year — for any longer committed period.

8. Address total cost, not just price.

To help the bottom line, the deal must reduce total cost, not just the contract cost.

Total costs to identify and estimate include:

- The cost of consents required from third parties;
- Employee severance costs;
- Break fees on facilities no longer in use;
- Taxes on invoiced amounts; and
- Loss of tax incentives due to reducing employment at facilities.

Also crucial are the likelihood and magnitude of possible costs of risks accepted, collaboration agreed to, noncash compensation and future payments.

9. Make the contract more complete and binding.

During negotiations, it can be tempting to just get the deal done and sort out the details later. Unfortunately, sorting out details after signing with a cost-pressured supplier generally means that value leaks to the supplier. Never sorting out the details means that the contract has gaps and ambiguities that the supplier can use to increase its charges during the term.

This is particularly true on technology commitments, where small clauses can have pervasive impacts. Thus, invest the time and resources required to get a well-crafted contract that secures a clear commitment to the needed services, at acceptable performance and compliance levels, with the right technology and for a reasonably firm price.

10. Contract for options, incentives and alignment.

The company may not know what commitments it will need over the term of the outsourcing contract, which is often three, five or even more years. Thus, instead of paying for commitments that may not provide value to the company, negotiate for options to address possible needs, incentives to solve possible future problems and alignment to avoid unnecessary friction.

For example, a company may be comfortable with its data security policy today, but remain concerned about threats emerging over a five-year term. The company could obtain an option to change its policy or obtain hourly services from data security specialists, each at preset exercise prices.

The company could give the supplier an incentive to stay ahead of threats by having the supplier bear financial risk for actual data security breaches, even if the supplier followed the company's policy.

The company could also align its data security efforts with the supplier's efforts by setting up a joint security team that meets regularly, perhaps doing annual desktop simulations.

These are just some of the ways to lower operational costs for companies in contracting for outsourcing deals.

Contracting is only one path to cost savings, and the best way to lower costs might be to provide the contractual foundation for sourcing, financial, operational, technical and other cost-saving approaches.

There are risks to consider, and outsourcing contracts can be novel and complex, and more so when intertwined with technology commitments.

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