Best Practice Insight

Bargaining Power

The honeymoon ends all too quick in outsourcing relationships, after the power shift begins. Here's why and how to prevent it.

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Clients that put in more effort up front in the lifecycle of a contract consistently have better results. The key reason for this is that they do all the critical actions while they have bargaining power with providers, not after they lose it. Bargaining power is the relative ability of a party to leverage influence over the other party. This power has a general flow, with the client holding power initially, then losing it over time. Many times, this loss of power is quick and catches the client off guard. But in all cases, power can be maximized and its loss managed.

This briefing is written for the client/purchaser/customer, known as the 'buy side' of a contract (opposed to the 'sell side', which is the provider/ supplier/vendor). We've observed that providers tend to know the power curve better, and use it better. Clients, on the other hand, may have never heard of it, and rarely manage it well.

We begin this briefing on bargaining power, not at the beginning of the journey (when a client builds power), but in the middle (when the client begins to lose it).

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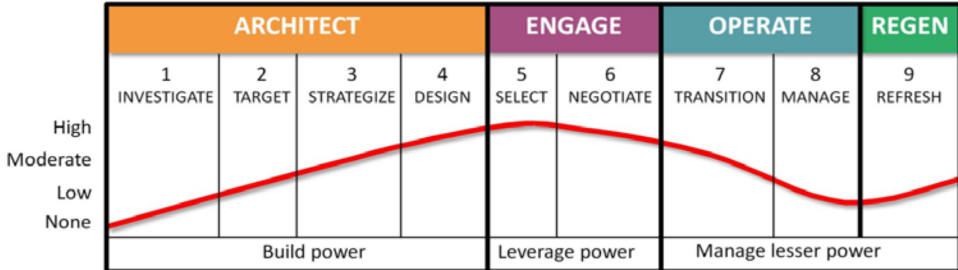

Client Bargaining Power

The lifecycle consists of four phases, divided into nine building blocks (BB1 to BB9).

The power curve begins its downward tilt away from you, and in favor of the preferred provider, once a provider believes they have won the deal in the Engage Phase of the lifecycle (as you move out of BB5 and into BB6). This is because competition has been eliminated and you are now effectively entering into a monopolistic situation regarding the scope of the contract. This is the case even if other bidders are 'on call' in the event negotiations fall through.

You will rarely be in a genuine position to throw out the preferred provider and start negotiating with the second place bidder (even if you have retained the right to do so). You will be under time and cost constraints to execute the arrangement. Also, remember that second place was awarded to them for a reason and that reason has not changed. Moreover, the next in line will probably know that you have walked away from your preferred provider (there are very few secrets that can be kept from the market), and are running out of options, which lessens your negotiating power even further.

Naturally enough, providers know all this, and many clients have experienced their preferred providers beginning to change tack once negotiations begin. It is the end of the courtship and the beginning of the (outsourcing) marriage. You will no longer hear the unconditional promises made, that the provider believed was necessary to win, during the bidding process.

Promises will now be qualified, and you will start to hear things like, "*what we meant in the bid was not quite how you've interpreted it*", or "*our lawyers can't really accept what you have put in the contract*", "*we can certainly do that, would you like us to add it to the scope*?", and so on.

While frustrating to clients, this is not a poor reflection on providers, just a natural occurrence as the power shifts. Then begins the long power slide - after you have signed the contract and during the Operate Phase comprising BB7: Transition and BB8: Manage.

BB7 is where the mobilization activities take place. Your bargaining power erodes here now that the contract has been signed.

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This is because of the switching costs. Outsourcing deals are normally prohibitively expensive to renegotiate, terminate and either backsource (bring back inhouse) or transfer to another provider.

Besides, the deal is just getting started and most clients do not want to repeat the lengthy process it took to get it in place so soon after it has begun. It takes a great deal of economic and political will to exit at this stage, and so the dominating strategy tends to be optimism about the deal improving in the future.

Once the deal has been transitioned and is in place during BB8, your power is at the lowest point. A monopolistic situation is now in full effect due to the increased switching barriers that prevents easy changing of providers. These barriers include time and cost mentioned earlier, but now that the contract has been in effect for a while, obstacles that were not as serious during the transition, now become much more significant. These include poor disengagement clauses and plans, poor intellectual property ownership and license clauses and recording processes, and inadequate asset purchase and transfer clauses (and related identification and valuation processes), to name just a few.

Your power does begin to build back up slightly during the Refresh Phase (BB9). The contract is nearing its end and the provider will want to gain an extension or renew the contract.

As one CEO told us, "*It is amazing the level of attention and service you get when contract renewal is close*."

You experience only a slight increase in power here and not the full power you had during the Architect Phase. This is because, from a number of our studies, the majority of next generation decisions result in the incumbent provider retaining most of the original scope; whether it was put to retender or not. And most providers know this. Thus, the fear of losing the contract does not motivate them as much as you would like.

In the first four building blocks, you have optimal influence over the deal and getting what you want. The most important work must take place while you are in a position of power before the curve begins its slide away from you. Unfortunately, many clients start their outsourcing preparations at BB5 by drafting a tender document in which the market is to respond (typically using a template with onerous conditions, but a loose specification).

But skipping the Architect Phase and beginning at BB5 is equivalent to starting to build a house before you have designed it and hoping everything will turn out right in the end.

Note that this power curve does not apply if you are the only, or a very large, buyer and there are many sellers who all want your money. You will always have power if you can easily switch between providers. Conversely, if there are many buyers and only one seller, the provider will be in power no matter what you do. If you want their product, you need to do it on their terms, their way.

But these are not normal situations for most outsourcing deals. There are many buyers and sellers of outsourcing

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services. Buyers have choices with whom to buy, and under what conditions. And sellers are free to choose their clients, and what to charge. However, once a contract is signed, your choices become quite limited, thus you want to ensure you have built up your power to the highest possible point, in the Architect Phase, before it begins to erode.

It is in the Architect Phase that you gather the expertise and deep knowledge required to outsource successfully, do the long-term strategic thinking, and carefully craft the deal that will work.

The Architect Phase consists of the first four building blocks:

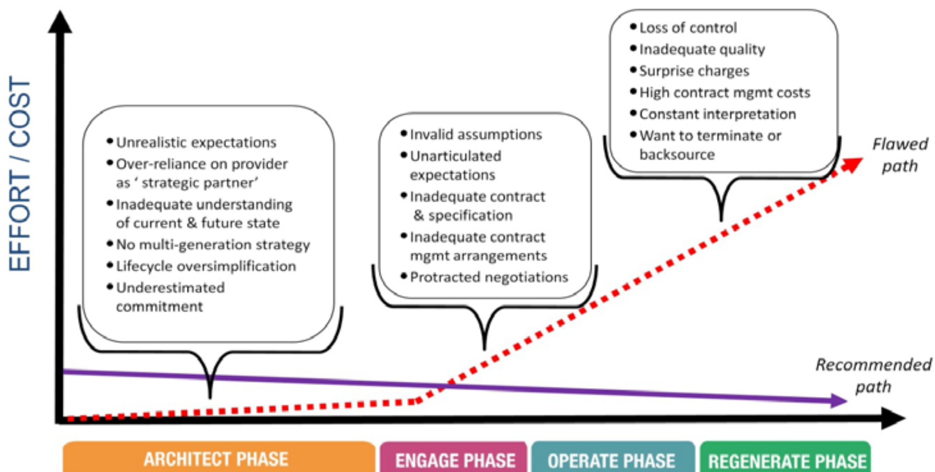
- BB1: Investigate - you acquire acumen,
- BB2: Target - you get focused,
- BB3: Strategize - you craft long-term solutions, and
- BB4: Design - you build clear and sharp commercial documents.

You collect, analyze, and prepare information so that your stakeholders can make rational and informed decisions while they have the greatest leverage with the prospective providers.

> At the end of this phase, you are able go to the market in a highly professional and focused manner, demonstrating equal knowledge to providers, with fair and practical contractual documents that focus on real, sustainable solutions.

This requires an upfront investment to ensure that later, when power declines, costs are contained and quality is maintained. Those who avoid making the necessary early investment end up spending at least as much, and often quite a bit more, to manage the resultant problems.

There is a recommended investment path and a flawed path. The difference is what is invested at what time. The recommended path invests in success (e.g. knowledge, strategies, contracts) while you are in power. The flawed path invests in managing failure (e.g. service failures, surprise charges, renegotiations) after you lose power.



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Fundamentally, if you do not put resources and effort into deals up-front, then you run the risk of being one of the many who have disappointing results, no cost savings, and lower than expected quality. The cost of contract (invoices paid to the provider plus the client's cost of managing the arrangements) can get way out of control if shortcuts are taken early in the lifecycle to try to get a deal done fast.

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Best Practice Insight

Behind the Iron Triangle: the Winner's Curse

While it is almost a cliché to talk of win-win outsourcing deals, be sure not to sign win-lose ones, otherwise known as the Winner's Curse.

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The Winner's Curse was first used to describe buyer's remorse at an auction when, in the heat of bidding, a buyer overbids for an asset. It is now also used to describe when a vendor underbids for a contract. The net effect is the same; the 'winner' loses money.

The difference when the curse is for a contract is that the provider must try to recoup the lost profit, by increasing prices or reducing cost. And thus, the curse encases the purchaser as well.

A study of 85 outsourcing contracts found two disturbing facts.[1] Firstly, the winner’s curse existed in nearly 20% of them (i.e. it is a much more common phenomenon than one would actually credit). Secondly, in over 75% of those cursed contracts, the winner’s curse was also visited on the client.

[1] Kern, T. and Willcocks, L. and Van Heck, E. (2002) The Winners Curse in IT Outsourcing: Strategies for Avoiding Relational Trauma. *California Management Review,* 44, 2, 47-69.

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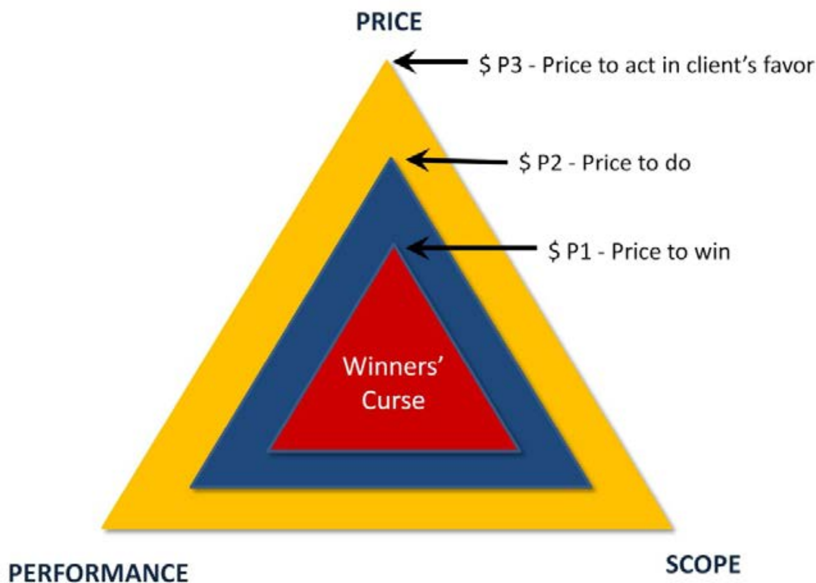
The Iron Triangle and the Winner's Curse



Source: Cullen, S., Lacity, M. and Willcocks, L. (2014) *Outsourcing: All You Need to Know.* White Plume Publishing.

The Winner's Curse has, at its core, a provider pitching a price it believes necessary to win a contract ($P1 in the figure, a modified version of the **Iron Triangle**[2]), rather that the higher price required to do the work at a reasonable margin ($P2 in the figure); and far from not the highest price of all - the one required deliver the highest quality and client satisfaction by acting in the client's favour ($P3).

What the figure shows is that these pricing decisions do not yield the same outcomes in terms of actual work performed (scope) and the quality (performance).

Let's first look at why a provider would under quote.

Sometimes, low quotes are a straightforward matter of miscalculations and errors. We've seen zeros misplaced, entire areas of scope overlooked, and in some cases just bad math.

Sometimes the inhouse costs that the provider had to bid against were in fact grossly (though unintentionally) understated by the client. In one major deal, we found such inhouse costs understated by 50%. Fortunately, this was discovered during the due diligence period, otherwise the provider would have been contractually committed to making a large loss each year for five years.

[2] The 'Iron Triangle' depicting project management constraints was first described by Dr Martin Barnes in 1969.

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Sometimes the provider is desperate for business and will undercut all other competitive bids, in the hope that once the work is secured, the money can be recovered by additional services, and reinterpreting or exploiting loopholes and ambiguities in the contract. Whatever the cause, the loss can rarely be sustained.

> To obtain cost recovery under the Winner's Curse (or possibly make a profit), the provider must cut corners,. be aggressive in how it interprets scope and performance as specified in the contract (resulting in the smallest triangle), or attempt extract more money from the client. Or all the above.

The effects of the winner's curse for a provider, and its client, can be devastating. Below is just such a case.

Case: A global manufacturer gets a good deal that goes bad

A well-known global equipment company had a successful outsourcing business in Europe and wanted to enter the Asia-Pacific market. It cut a deal with a local industrial manufacturer to outsource the clients IT function. The provider created a new wholly owned subsidiary for the region, and the deal was to be the first of many.

In order to get that first critical deal, the provider's sales team bid a price that was under cost. The team did not know that at the time however, since it was the first client and the team had no idea as to what the cost would actually be. It bid a price it deemed crucial to win, without having a firm grasp of what price was needed to have a reasonable profit.

The client knew the provider could not be making money. Management took comfort in the strength of the well-known brand and, perhaps more telling, believed themselves worthy candidates as a loss leader.

After 18 months, the provider still did not win any further clients. A review of the subsidiary by its parent entity showed that it was making an unacceptable loss with little potential for a turnaround. It had to start making money off its one client.

The provider put in a new account manager, a lawyer. His mission was to reinterpret the contract and reclaim any possible money that he could. This was possible because the contract had no date limitations over when work could be billed or reimbursements claimed.

Nine months of intensive dispute ensued. Invoices were raised for previous work now deemed out of scope and a number of additional charges and reimbursements were claimed dating back to day one of the contract.

The parties eventually reached a settlement through an intermediary. The subsidiary was wound-up and the client had to find a new provider.

The common effect on the client of the winner's curse is that variations become the norm, disagreements become frequent, and constant vigilance in monitoring the provider is required. This results in an adversarial relationship and it raises the total cost of contract far beyond

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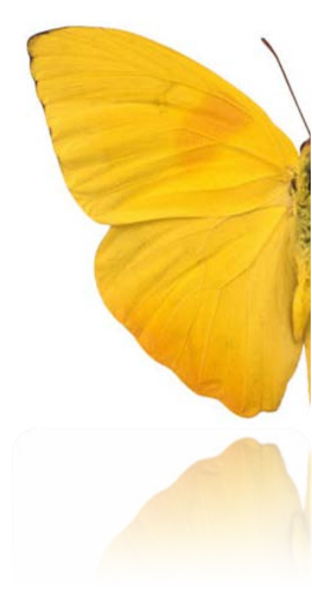
what is necessary to obtain the scope and performance.

> The cost of greater oversight, out-of-scope charges, constant renegotiation, dispute resolution, rework, backsourcing, or step-in all can make the original price immaterial.

And it is completely avoidable.

Successful outsourcing is not about getting the lowest price at any cost. It is about getting the lowest accurate price with a superior provider offering sustainable solutions under a fair contract. It is not a single, isolated economic transaction that automatically executes itself after the parties sign an agreement, but an ongoing commercial relationship with economic and strategic consequences that depend upon how the parties conduct themselves. If the client selects wisely, these consequences can be good; if not, they can be very bad.



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Research Insight

High Performance Outsourcing: The Learning Curve

Only one in five outsourcing deals is considered high performing. The difference is management and how quickly it moves up the learning curve.

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Research has established that 20% of outsourcing deals were high performing, 25% were good, 40% were doing okay, and 15% were poor.[1]

> Why such a mixed set of experiences? The common denominator was management, which made up to a 47% difference in performance.

'Management' here refers to the right mix of skills, attitudes, experiences, and behaviors amongst influential players across both parties, leading to the adoption and application of effective outsourcing practices.

High performance outsourcing requires, just for starters:

- much closer relationships between the parties,
- strong leadership, and management capabilities, in both parties,

[1] Cullen, S., Lacity, M. and Willcocks, L. (2014) *Outsourcing: All You Need to Know*. White Plume Publishing.

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- strong formal and informal governance processes,
- contracts that promote innovation, adapt to change, and deliver on business strategic and operational requirements,
- metrics that ensure quality, financial, strategic and relationship goals are tracked and managed,
- an evolving reliance on trust-based relationships more than contract stipulations, and
- bi-party teaming across client and provider staff.

But when it comes to outsourcing, clients and providers alike are still on the learning curve.

What does this learning curve look like? We capture the main parameters in the figure below, developed originally by Lacity and Rottman in 2006.

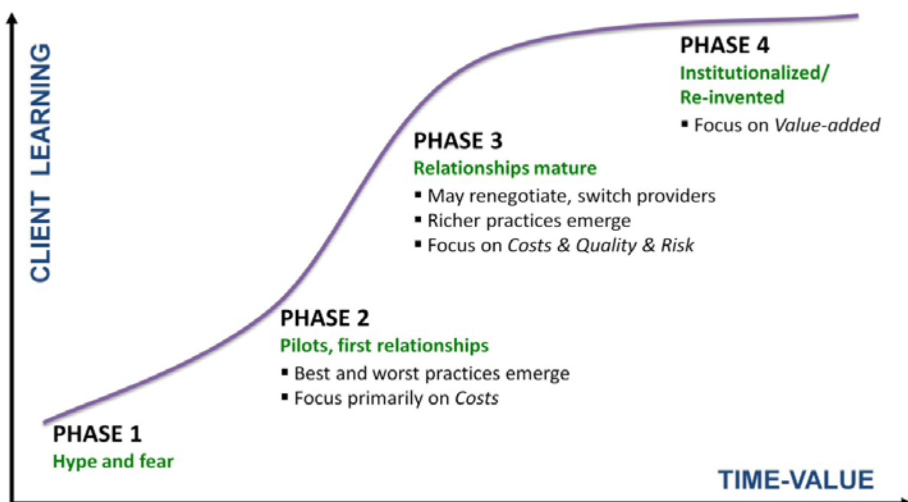
A client contemplating its first generation outsourcing arrangement (that is, it is its first time outsourcing) will typically be at Phase 1. Such clients either believe far too much of what they read in marketing brochures and hear from providers pitching for work, or far too skeptical of what to expect. Either approach has not proven to be a sound basis for entering into an outsourcing relationship.

In Phase 2, clients tend to focus mainly on cost, and usually pass through a baptism of hard learning. In all outsourcing arrangements, at any time in a client's evolution, risk mitigation is central.

Interestingly, these deals have been relatively, if quietly, successful. The characteristics of these deals are:

- limited objectives, usually just related to cost and service,

Figure: The Outsourcing Learning Curve



Source: Rottman, J. and Lacity, M. (2006) "Proven Practices for Effectively Offshoring IT Work," *Sloan Management Review*, Vol. 47, 3, 56-63.

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- reflect only 20-30% of the area's budget, thus retaining most of the existing inhouse capability,
- comprised stable, discrete activities that the clients could write complete contracts for,
- with contract durations of three to five years, and
- using multiple providers rather than sole sourcing.

This remains a good starting point for clients wishing to build their learning incrementally through the actual experience of outsourcing. Once requisite organizational capability has been built, much more scale, complexity, and sophistication becomes possible.

A client will learn much from its first generation outsourcing deal, and this can be put to good use for the second generation. We have found most clients sticking with incumbent providers (though sometimes bringing some work back inhouse), building up more retained capability, getting smarter on contracts, and about what was realistically attainable through outsourcing.

Ironically though, some clients did not build on their learning. Scarred by their first outsourcing encounter, they did something completely different in their second, and sometimes different again in their third generation deals.

Clients that have reached Phase 3 are older and wiser, and are able to get the balance of contract and relationship management right, have secured the right internal capabilities to keep control of their outsourcing destiny, and focus on leveraging the relationship with their providers.

By 2014, we found up to 20% of clients had reached Phase 4 of their journey.

And some never develop the management maturity needed to obtain high performance outsourcing, no matter how many years the organization has been outsourcing.

If your organization isn't there yet, it is not alone. There are multiple reasons why so many clients have progressed quite slowly, often painfully up the learning curve. Key people learn, and then they leave. Organizational learning is not institutionalized. Nor is learning on one type of outsourcing routinely transferred and applied to another. Objectives change and new forms of outsourcing and contracts are entered into with new providers, and a client moves down the learning curve once more.

Moreover, clients seem to prefer what we call ‘hard learning’. Unless they have experienced it themselves, they never quite believe, let alone enact, the advice they get.

There is one thing to remember. No one is making new mistakes. But it appears that clients have to go through a period of hard-earned maturity when it comes to outsourcing to be able to harness real and significant benefits and escape idealized (and often counterproductive) notions.

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