

## Outsourcing

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### The Cost of Cost Cutting in Outsourcing Contracts

The sudden, sharp change in market conditions in the last six months of 2008 paralysed activity in the outsourcing sector. No-one wanted to incur any capital expenditure or commit to long term arrangements. The market was just too unpredictable, says Allan Wardhaugh, a partner in the UK law firm Dundas & Wilson.

Things are changing. Our clients are again talking to us about outsourcing. In the new economic climate, however, these conversations are all about cost cutting, cost cutting, cost cutting. If suppliers want new business or even to retain current business, the reality is they are going to have to offer significant cost savings and offer them now.

#### Efficiency v. Risk Transfer

To meet these cost cutting challenges without an unacceptable margin reduction, suppliers will need either to become more efficient and/or pass more contract risk on to their customers.

In the immediate future at least, outsourcing deals are likely to be smaller in scale, shorter in term and characterised by generating a faster return on investment for customers. One of the obvious reasons for this is that large, high value outsourcing deals take many months to negotiate. This would delay any cost cutting benefits. These benefits are, however, needed now. Similarly, deals struck in recessionary times are likely not to be suitable for the challenges of an upturn. By the time any such deal is finalised and implemented, the recession, we all hope, will be over.

Shorter term contracts, falling volumes, smaller deal values and lack of available credit will inevitably lessen the ability of suppliers to invest in the new technologies - such as cloud computing and virtualisation - to make their operations more efficient. Currency value fluctuations also are reducing the attractiveness of offshoring for cost cutting. Even if investment is made in the new technologies or offshoring implemented, there is also the time lag before these cost savings are realised by the supplier. Customers want these cost savings now.

#### Risk Transfer

How, therefore, are suppliers going to offer significant cost savings to their customers in the short/medium term?

One of the ways a supplier can immediately offer cost savings (without unacceptable margin erosion), is to shift more of the risk in their contracts to customers. We are already seeing this in contract negotiations - although it may be a while before the trend becomes one reported on by the likes of Gartner.

When deciding on its level of charges, suppliers price both their costs and the level of contractual risk they are accepting. Then they add their margin.

For example, if a supplier has to rent a building to provide services to a customer, it will need to make sure the lease costs are recovered in the charges for that customer. That is an obvious cost, 100% of which a supplier will need to recover from that customer.

#### Risk Pricing

"Risk" in the contract is priced differently. A risk may never crystallise. However, if a supplier is to bear a risk, the cost of that risk still has to be priced. A margin is then added and the combined risk cost and margin added to the level of the customer's charges.

For example, contracts often currently provide that a supplier is liable on an “uncapped” basis to its customer for breach of confidentiality/data security obligations. A supplier will price for that risk according to its standard risk pricing methodology/model and add its margin. If a supplier instead agrees with its customer that its liability for such breaches is to be capped, or limited to circumstances where the supplier is in wilful default or is negligent, then the supplier can remove or reduce that risk price (and related margin) from its charges.

Similarly, suppliers in many situations may agree to bear at least some of the cost risk associated with legal/statutory changes that take place during the term of a contract, especially if it affects suppliers generally in its sector. This is usually viewed by suppliers as part of its own cost of business risk. Again, if this cost risk is removed from a supplier's contract, its charges will be reduced.

There are many other examples of where a supplier may seek to remove risk from its contracts to reduce charges for its customers e.g.: by increasing the parameters around what constitutes contract change and excluding/reducing by indemnity its TUPE liability risk on termination.

### Price Reduction

Taken together, these transfers of risk to the customer, on the face of it, will allow a supplier significantly to reduce a customer's charges even where the supplier has not been able to implement cost saving efficiencies via new technologies or offshoring.

### Changed Dynamic?

However, the transfer of these risks to the customer will change the dynamic between the customer and the supplier. Customers will increasingly see contractual Change Control procedures being used by suppliers to recover costs which previously customers had assumed should be borne by suppliers. This will challenge customers' budget constraints and procedures. There will also be an increasing risk of the supplier/customer relationship breaking down as a result of the increased use of Change Control procedures as a mechanism for cost recovery.

Again, if there is a breach of confidentiality / data security breach where a supplier's liability is limited or excluded save where there has been wilful default or negligence, this may lead to significant strains on the customer/supplier relationship.

What does the above mean for outsourcing contracts?

Customers are looking for cost cutting now. As the recession and credit crunch bite, capital investment in new technology will either be delayed or shelved, at least in the short to medium term. Exchange rate fluctuations will also reduce the attractiveness of offshoring as a supplier cost cutting measure. A supplier's room for manoeuvre for its own cost reductions will be limited. To avoid unacceptable margin erosion but still offer the significant cost cutting demanded now by their customers, suppliers will seek to allocate certain contractual risks to their customers which otherwise they currently bear.

We are beginning to see this trend in the deals we are involved in. However, this risk reallocation will lead to significant challenges for the supplier/customer relationship which will need actively to be managed by suppliers. Customers, too, will need to be prepared to pay more to the supplier if any of these risks actually crystallise. This will be the real cost of receiving a cheaper service. You only get what you pay for but in the short to medium term, this may be the only way to go.

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This Article is correct to the best of our knowledge and belief at the time of going to press. It is however written as a general guide, so it is recommended that specific professional advice is sought before any action is taken. We are required by law to protect personal data.

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