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Common Problems in Technology Sourcing Transactions: How to Recognize and Avoid Them

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Presented by ACC’s Nonprofit Organizations Committee and Pillsbury Winthrop Shaw Pittman LLP
The Problem

- Technology is the infrastructure that enables business to happen.
- Technology providers are experts in what they do (most of the time).
  - This includes being experts in negotiating the deals for their products/services.
    - They design their contracts.
    - They look at allocation of risk.
    - They are willing to use their leverage and your need to get what they want out of a deal.
    - This doesn’t make them bad people. This is what you would do in their situation.
- Unfortunately, lopsided negotiations produce unhappy relationships.
  - Roughly 50% of outsourcing deals fail.
  - Virtually all technology implementation/customization projects run late/are over budget/do not provide all of the functionality the customer expected.
- Unhappy relationships mean wasted money and effort.
- The purpose of this talk is to help you understand the issues/risks associated with technology sourcing deals and avoid them.

Where the Problems Begin in Outsourcing

- You’re an organization executive who is under pressure to do “SOMETHING” and to do it with a lower budget.
- A salesperson from a well-known services provider tells you that his company can provide the services that your IT group provides:
  - As well or better than you do it yourself
  - Using “global best practices”
  - At a lower cost.
- Wouldn’t you say yes?
Why Is This a Problem?

Timing.
- Salesperson wants the deal done quickly (by month end, quarter end or year end).
- Organization executive wants the deal done quickly to book the savings promised by the salesperson.

Leads to:
- Poorly defined scope.
- Loss of negotiating leverage.

Outsourcing Problem 2 - Differing Expectations

Customer perspective:
The vendor should perform the services in the same way that the in-house personnel would have. That means staying late, doing extra work, etc. without additional cost.

Vendor perspective:
The vendor has priced a fixed scope of work. Additional work should result in a change order.
Outsourcing Problem 3
Perceived Poor Customer Service

- IT culture is to do whatever it takes to solve the problem. As long as resources are a fixed cost, that isn’t a problem.
- Customers may decide to scale back “extra” services provided to end users to save cost on outsourcing.
- Customers may not accurately communicate the decreased services to end users - resulting in end user dissatisfaction with the vendor.
- Example - Level 1.5 desktop support.

Outsourcing Problem Summary

Rushed negotiations/SOW development
+ Differing expectations
+ Poor communication with end users
\[\downarrow\]
An unhappy relationship
Causes of Failure

Foremost Causes of Partnership Failure

- Poor or Damaged Relationship: 64%
- Poor Strategy and Business Planning: 30%
- Bad Legal and Financial Terms: 6%

Source – Vantage Partners

Avoiding/Minimizing Problems

Treat an outsourcing deal like buying a used car.

- Recognize that doing a deal properly takes time -
  - For outsourcing deals frequently as much as 6-9 months.
- Compete the deal.
  - Talk to multiple vendors.
  - Maintain the competition for as long as possible.
- Hold the vendor accountable for promises in their proposal/marketing materials.
Avoiding/Minimizing Problems (cont)

Don’t do other things that undercut your negotiating leverage.

- Be careful about vendor “end-run” contact with senior executives
- Talk to the person with the authority to make the deal.
  - Don’t accept a negotiator who tells you that any change you want to make to the deal needs to be taken back for approval.
  - Avoid the “I want to help, but my manager just won’t let me” approach from the vendor salesperson
- Recognize that this is business – it’s not personal.

Avoiding/Minimizing Problems (cont)

- Recognize that doing a large outsourcing deal can be a full time job for the people involved.
- Signing the deal ends the process
  - Vendor should complete all due diligence before the agreement is signed.
- Avoid “Assumptions” and “Dependencies” where the consequences are not clearly specified.
- Typical examples of “Pricing Assumptions”:
  - “This SOW is based on the information provided by [customer] to date. Any changes will be handled through the change management process. Changes will be identified and agreed to during the Program Planning and Test Installation Phase and/or through project Change Control as described in this document.”
  - “While the program is designed to be executed globally, certain regions including, but not limited to, the emerging markets may require mutually agreed upon additional considerations and adjustments to processes, responsibilities, and costs.”
Still more typical examples of “Pricing Assumptions”:
- The following came from a desktop implementation agreement:

  “[Customer] estimates approximately 1200 assets will be involved in the program for the three years.”

<table>
<thead>
<tr>
<th>Estimated Types</th>
<th>Estimated Time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated time for “Site Readiness activities”</td>
<td>15 minutes each</td>
</tr>
<tr>
<td>Estimated time for NEW PCs to be installed</td>
<td>45 minutes each</td>
</tr>
<tr>
<td>Estimated time for PCs to be de-installed</td>
<td>15 minutes each</td>
</tr>
<tr>
<td>Estimated time for PCs for data backup</td>
<td>15 minutes each</td>
</tr>
<tr>
<td>Estimated time for PCs for data restoration</td>
<td>15 minutes each</td>
</tr>
<tr>
<td>Estimated time for OLD printers to be de-installed</td>
<td>15 minutes each</td>
</tr>
<tr>
<td>Custom/site specific application installs (Avg.10)</td>
<td>30 minutes each</td>
</tr>
<tr>
<td>Estimated time for optional “Late disposal of PC’s” tasks</td>
<td>15 minutes each</td>
</tr>
</tbody>
</table>

Obviously the vendor has thought through the required steps. Would you feel comfortable signing up to this?

If this service were being provided to you, how would you be able to tell what would happen to your price if any of these “pricing assumptions” changed?

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**The Significance of Scope**

- Services within the scope of the contract are within the contract's pricing terms
- Services outside the scope of the contract will be priced as new or additional services
- The objective is to avoid paying twice for a service -- once because you thought it was in the base charge, and a second time when you have to pay extra
- Identifying scope: The factors of production
  - People
  - Facilities (space & related services)
  - Equipment
  - Software
  - Third-party contracts (services)
Significance of Scope (cont)

Specify the Scope in the Contract

- Understand the consequences of things that are not in scope.
- Understand how scope (and what’s not in scope) relates to your price.

Vendors rarely actually make the scope vague on purpose, but the SOW frequently ends up being the proposal they submitted

- Which was written before they talked to your technical people
- And frequently includes services you’ve decided not to take.
Use Service Levels to Manage Performance

- What is a Service Level
  - Objective measurement of performance of a key activity.
  - The SLA measures HOW WELL the vendor does the required services.
  - SLAs contemplate some element of failure.
    - Doing something 100% of the time is simply a requirement for a service NOT an SLA
    - Example:
      - Requirement: The mainframe will be available 24x7x52.
      - SLA: The mainframe will have an availability of 99.7%.
  - Vendors give you credits for failing to meet SLAs
    - This is not a penalty.
    - You are contracting for and willing to pay for service at a specific level.
    - If you don’t get service at that level, you shouldn’t have to pay as much for the poorer service.
  - Credits are generally a percentage of monthly fees for ongoing services.
    - Range from low of 5-7% up to 25%

Avoiding Problems in Outsourcing Deals

Summary - Avoid Buying a “Lemon”
- Take the time.
- Maximize your leverage by competing the deal.
- Avoid “re-opening” the deal after signing.
- Clearly understand what you want and what it costs you now.
- Clearly understand and document what you are getting.
- Clearly understand the price and how it might change.
- Use Service Levels and Credits to manage vendor performance.
Other Types of Deals Have Problems, Too

It’s not just outsourcing...

- Hardware Leases
- Software
  - Licensing
  - Development
  - Implementation
- Services
- Pretty much everything other than hardware purchases...
  ...and even those sometimes.
- Everything we discuss in this section is also relevant to outsourcing/services deals.

What Kind of Problems Could Happen with a Hardware Lease?

- Leasing equipment tends to be within the spending authority of many executives.
  - May involve non-standard equipment/software.
  - May create security issues.
- Like any lease, most of the problems come at the end.
- Returns
  - Leasing companies base their financials on the assumption that hardware will be lost, damaged or just inconvenient to return.
  - Most organizations are TERRIBLE at tracking leased assets (particularly desktops).
  - Most organizations are EVEN WORSE at returning them to the lessor.
- Data Erasure
  - Meaningful data erasure is hard to do and expensive.
    - Destroying the hard drive may be the only practical option, but then you have to pay for the hard drive.
    - Most leases do not provide for meaningful data erasure.
How Can You Avoid Lease Related Problems?

- All IT equipment acquisition should be coordinated through IT and/or Procurement.
  - SOP should be that IT will provide technology solutions.
  - Challenge is that IT has to be able to do that in a timely manner.
- Procurement (and possibly Legal if large enough) should review all leases and identify end-of-lease requirements.
  - Develop plan for complying with requirements before receiving the equipment
  - Be honest - Can your asset tracking system (including policies and procedures) live up to the requirements? Do people move things without your knowing it?
- Data erasure should be in accordance with your organization’s data erasure policy

Software Licensing

What is a Software License?

- Legal contract between software author/distributor and the user
- More like a rental agreement
  - You agree to pay the specified fees and comply with other restrictions
  - They allow you to use the software
- Why should you read your software licenses carefully?
  - If you violate the terms of the license, you’ve breached the contract and might have violated certain laws (DMCA, “No Electronic Theft” Act, etc.)
Software License Structure and Analysis

What a license says (and doesn’t say) is important to both sides

Software License should cover:
- Software included in the license
- Scope of use for the software and any restrictions on its use, as well as any different restrictions on the use of the documentation
- Duration of the license
- Any related services (e.g. consulting, enhancement, help desk support, etc.) that will be provided, and the terms under which those services will be provided

Software License Structure and Analysis

Software License Should Cover (cont.)
- Pricing and payment terms
- Confidentiality provisions
- Warranties and indemnities
- Limitations on liability
- Termination of the license and/or the services; and
- Any other legal terms that are relevant (e.g. rights of publicity, choice of law, etc.).
Software Modification/Customization, Development and Implementation

What if the software you’ve bought is complicated or doesn’t do exactly what you need?

Someone has to -
- Modify/Customize it
- Build interfaces to other applications
- Roll it out
- Test it

Potential candidates -
- Your IT group
- The software vendor
- A 3rd party consulting firm

Modifications vs. Customizations

Customizations
- Changes to the base functionality of software
- Involve access to source code (frequently more expensive license)
- RARELY necessary
- Risky, because they can take you out of the upgrade path and many vendors will not support customized software
  
BUT - May be the only way not to make changes to your business processes if you want to use the software.

Modifications do not involve re-coding the base software
- Do not involve access to source code
- Generally involve use of pre-defined “exits” in the software (APIs) combined with third party- or or custom-developed applications (“bolt-ons”).
- Third party developed applications are supported by the third party, who works with the software vendor to keep their applications in upgrade path
Project Management

Implementation/Customization/Modification projects

- ALWAYS take longer than planned
- ALWAYS run over budget

Ways to manage vendors:

- Percentage holdback - just like a construction contract.
- Credit for late delivery - percentage that increases as project is not completed on schedule
- Discount on rates as price exceeds budget
- Cost sharing as price exceeds budget
- Clear, defined acceptance criteria.

Things to Watch Out For

- “Joint” responsibilities. Your people will need to do some things, but the vendor should still be responsible for the project as a whole.
  - Project plan should clearly specify what you are responsible for and when
  - Vendor must inform you if any failure by you threatens the schedule
  - Otherwise, vendor does not get schedule adjustment
- Vendors frequently try to stage acceptance, and once a deliverable is accepted, it’s your problem. The vendor should be responsible for making the whole solution work, regardless of whether the problem is with an early component you “accepted.”
Negotiating Deals

Negotiating a technology sourcing deal is a skill that requires training and practice.

- Vendors have experienced, skilled negotiators who understand the details of the deal they want you to sign.
- Vendors use their entire organization in a coordinated manner.
- Create the right negotiating team and support the team members from the top of your organization down.

Summary

- Take the time to do any deal right.
- Maximize your leverage by competing the deal.
- Avoid “re-opening” the deal after signing.
- Use Service Levels and Credits to manage vendor performance.
- Create the right negotiating team – include legal.
- Clearly understand
  - What you want and what it costs you now.
  - And clearly document what you are getting.
  - The price and how it might change.
  - How the agreement can end and what happens when it does.
Questions & Comments

Thank you for listening.