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Contracting for Change

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Whatever the current trend in information technology and business processing outsourcing, the key issue confronting lawyers representing customers remains the same—how to allocate the costs and benefits that will result from changes to the outsourcing relationship over time.

Broad Principles Yield Better Contracts

Few outsourcing customers realize the potentially sweeping impact of change on an outsourcing relationship. In reality, many factors affect the scope of the services the customer seeks and the volume of the services the customer consumes, including:

- Changes in the customer's product lines or market focus
- Changes in demand for the customer's product or service
- Changes in the technology or business processes the customer uses
- Changes to the regulatory environment in which the customer operates
- Changes to the customer's operations resulting from one-time events such as the purchase or sale by the customer of a line of business
- Changes to the technology used by the provider
- Changes to the provider's service delivery model

Each of these changes has the potential to impact the provider's costs. Some changes will cause the provider to incur additional costs, while others may enable the provider to reduce the amount it spends to provide the services. Moreover, changes that impact the provider's costs often give rise to controversy as the provider typically wants to be compensated for the additional costs while the customer typically wants to realize the benefit of the provider's savings.

This issue is especially challenging because at the time the parties are negotiating the outsourcing agreement, the nature, timing, and magnitude of the changes that will occur are unpredictable. Given these circumstances, it is futile for the parties to attempt to anticipate the specific changes they will confront during the life of the agreement, estimate the costs or benefits arising from such changes, or allocate such estimated costs or benefits. To the contrary, well-represented parties should instead develop broad principles for inclusion in the outsourcing agreement that they can apply to allocate the costs and benefits when change occurs. I describe five of these broad principles below.

Principle 1: Non-Material Changes Should Not Generate Additional Charges

The first principle upon which the parties should agree is that, no matter the cause, non-material changes to the services should not give rise to additional charges, a reduction in charges, or a renegotiation of the charges. There are several reasons for deploying this principle. Primarily, it could be debilitating for the parties and their relationship if they are required to negotiate every change no matter how insignificant. Moreover, if the customer had not outsourced and was instead managing the environment itself, it is likely that it could implement non-material changes by managing existing resources without incurring additional costs for personnel or other resources. From the customer's perspective, the result in an outsourced environment should be no less favorable.

The agreement can easily reflect this principle by stating that the services to be provided without additional charge include the described functions and responsibilities as they may evolve over time. At the same time, the agreement should state that performance of functions and the assumption of responsibilities that are materially different from those described in the agreement will require an adjustment to pricing.

Principle 2: Determine Increases in Price on a Net Basis

Any additional provider charges should be determined on a net basis. In other words, any increase in price should reflect the additional costs incurred by the provider, net of any costs the provider may reasonably be able to eliminate by virtue of the change. For example, the provision of a new function may render another function unnecessary. The provider should reduce the additional charges to reflect the costs the provider can eliminate by no longer performing that unnecessary function.

The rationale behind this approach is simple: for a services arrangement to survive on a long-term basis, each party must believe that the other is dealing with it on a fair and equitable basis. If a provider is earning a windfall, the customer is unlikely to view circumstances as fair and equitable. Moreover, to preserve the health of the relationship, the pricing must not put the customer at a competitive disadvantage. If new services are priced on a gross (rather than incremental) basis, the pricing for the deal may create such a disadvantage for the customer.

The agreement can reflect this principle by requiring that provider quotes for new services equal the sum of: (the provider's best estimate of the additional costs it will incur to provide the new service) + (a reasonable margin thereon) minus (the provider's best estimate of the costs it will be able to eliminate by virtue of the change + a reasonable margin thereon).

To give effect to this language, customer counsel sometimes seeks language requiring the provider to share the basis for its cost estimates with the customer. This can be very difficult to negotiate since the estimate is likely to be based at least in part on actual historical costs. Providers generally are loathe to share information about their costs notwithstanding the customer's view that an open and transparent relationship is more likely to "withstand the test of time" than one based on a "black box."

Principle 3: Price Adjustments, Not Price Increases

Adjustments to pricing should not be a "one-way street." If a change results in a reduction in the provider's costs, a reduction in the provider's charges may be appropriate. In other words, price adjustments may be in the provider's or the customer's favor.

The rationale behind this principle is the same as the rationale behind principle 2; that is, if the provider is earning a windfall, the customer can be expected to lose confidence in the provider, the customer-provider relationship, and the contract, which together will undermine the outsourcing arrangement. In addition, customer counsel will face the same challenge when implementing this principle as they do when implementing principle 2—providers generally are loathe to share information about their costs.

Principle 4: Develop Consumption-Based Unit Pricing

The parties should develop and agree upon pricing algorithms that will accommodate changes in the volume of services consumed by the customer. While the provider should be compensated for the fixed cost of any infrastructure the provider deploys to provide the services in all events, the provider should be compensated for variable costs only as the services are consumed by the customer. Providers can implement this principle by providing a fixed monthly charge that reflects its fixed costs and monthly unit charges for each unit of service the buyer consumes. Providers should reflect economies of scale, if any, in the unit rates. Actual algorithms may be more complicated if additional fixed infrastructure is required to support higher volumes of service.

Principle 5: Plan for Significant One-Time Events

In the case of a significant non-recurring event, the parties should review and, if appropriate, adjust pricing. For this purpose, the term "significant non-recurring event" refers to an event in the lifecycle of the customer that is generally not part of the ordinary course of the customer's business (*e.g.*, an acquisition or disposition of a major line of business) that gives rise to a significant (for example, more than a 25 percent) change in the volume of services consumed by the customer under circumstances in which such change in consumption is expected to last indefinitely.

The rationale behind this rule is simple. Following a significant non-recurring event, the pricing model reflected in the agreement may no longer serve to provide fair and equitable pricing. Moreover, while it is possible to anticipate that the pricing model may no longer work, it is impossible to predict which party will be disadvantaged. Accordingly, a pricing review is appropriate.

The contract provision reflecting this principle should provide that if there is a significant non-recurring event, the parties will meet to review the provider's charges and to consider appropriate changes. The provision should further provide that if those discussions do not produce agreement between the parties, the pricing will be equitably adjusted.

The "equitable adjustment" standard is intended to be an objective standard that can be applied by a judge or an arbitrator. The rationale behind this approach is that both parties are placed at risk when pricing is put into the hands of a third party. Under these circumstances the parties have a strong incentive to make the decisions and compromises required to reach agreement.

Lessons from the Outsourcing Journal:

- The key issue confronting lawyers representing outsourcing customers in long-term information technology or business process outsourcing transactions is how to allocate the costs and benefits that will result from changes to the outsourcing relationship over time, under circumstances in which the nature, timing, and magnitude of the changes are unpredictable.

- Specific contractual rules that respond to specific changes, estimate the costs or benefits arising from such changes, and allocate such estimated costs or benefits are unlikely to be helpful.
- The outsourcing contract should reflect a series of broad principles that will enable the parties to address the issues that arise from change over time.

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