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Is Now a Smart Time to Relook at Outsourcing Contracts?

May be Opportunity for Shippers and Manufacturers to Reduce Costs, but Meat Cleaver Won't Work, Says Tyndall

SCDigest Editorial Staff

In a slumping economy in which companies are looking to cut costs in many areas, especially the supply chain, are existing outsourcing contracts in manufacturing and logistics a smart place to look?

Likely so, according to several outsourcing experts. But they also say you can also cause other problems if the approach is taken too far or not executed smartly.

Writing in the most recent edition of CSCMP's Supply Chain Quarterly, **Julian Millstein** and **Tim Roughton** of law firm Morrison & Foerster say. "It's possible to cut some of the costs associated with these relationships, but it is not easy."

They outline four areas where savings may be found by rethinking about contractual terms:

Look for Areas that Offer Flexibility: Often, manufacturing or logistics outsourcing agreements contain fixed charges that are based to some extent on transaction or headcount assumptions in the initial year of the agreement. "Often these amounts can be adjusted when conditions change," Millstein and Roughton say. "For example, a contract may allow adjustments to fixed charges if the volume of activity falls below an agreed baseline, or if the service provider achieves additional cost savings." The agreement may also include service level commitments that add a lot of cost. In this economy, does it make sense to reduce service level commitments just a bit to drive down the outsourcer's costs? The last few percents or even decimals in service level agreements can add substantial cost. Ditto with all of the services being performed – could

Many contracts allow the buyer to periodically "benchmark" service prices and make adjustments – rights rarely executed in good times. Now, however, companies may find such a benchmark will show market rates have declined significantly – and that these can be enforced via contract terms.

some of them be scaled back or eliminated right now?

Enforce Your Rights: While many outsourcing experts say that if an outsourcing agreement is managed on a day-to-day basis by the terms in the contract, it is likely to be an unsuccessful relationship, nonetheless in these times "a return to more formal and controlled management" might make sense, Millstein and Roughton say. "To get the full benefit of the terms in your existing agreement, review its service-level and pricing mechanisms, and then enforce the rights you already have.

For example, while there can be "chargeback" provisions in the contract for minor service failures, they are often ignored for the sake of the relationship. But Millstein and Roughton say pursuing such action now may result in "appreciable cost savings."

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Look for Renegotiation Opportunities: Outsourcing agreements are made at a certain time, under certain conditions and expectations, to support a given business and supply chain strategy. However, "when economic circumstances affect the business case for a particular deal, a review is not just a good idea, it's essential," Millstein and Roughton say. "That's why now is the time to consider whether any element of your outsourcing agreement should be renegotiated to reflect fundamentally different economic conditions."

For example, there might be restrictions on how and where a outsourced manufacturer can source parts that can be redone to allow additional savings in this environment. There generally are many terms related to mergers and acquisitions – now may be a great time to renegotiate those terms – before such a deal is actually announced or completed.

Find Leverage Points: Outsourcers may understandably not be wild about coming to the table to change an existing contract. However, there are leverage points that can be used.

For example, it may be easier to get the outsourcer to accept price reductions if the "carrot" is an extension of the existing contract.

Using more of the "stick" approach, it is often the case that outsourcers have violated some contract term that could allow contract termination, but would routinely be overlooked in normal times. Now, however, threat of invoking that clause could be used to win concessions.

Edicts can Backfire

Companies have to be careful they don't use such leverage too hard, says **Gene Tyndall** of Tompkins Associates, an SCDigest contributing editor.

He cited a recent example in which one company in effect "ordered" its LSPs to reduce their prices by as much as 20% while retaining service levels, under the threat of losing the business when any current contract expired.

"This is simply bad business," says Tyndall. "It makes as much sense as saying you are going to layoff 15% of your own workforce and get the same level of work done."

Tyndall agrees though it is often possible to reduce outsourcing costs. He recommends looking at three primary areas:

- The pricing mechanism a company is using with its outsourcers
- How outsourcers are being used – are the outsourcing strategy, locations and supply chain flows optimal?
- Performance – are the right metrics and analysis really being used?

Like others though, Tyndall says in the end, collaboration is key.

"Good LSPs and CMs are partners, and should be collaborating with key customers to reduce costs smartly," he says. "That almost always works better than the heavy-handed approach."