3 Critical Tools for the Contract Negotiators Toolbox!

NYDEN ON NEGOTIATION

Introduction

I start each and every training session with my personal philosophy: ***You cannot change the way someone else chooses to negotiate with you. You can, however, choose to change the way you negotiate with them. By enhancing your skill set, you can dramatically improve your negotiated outcomes.*** And, that is true. I've seen people make small, but important changes to their skill set and change the course of the negotiations. This eBook offers you a glimpse at three tools that could be an important change to your skills set that will change the course of your negotiations.

Re-Thinking the "Best Deal" for Your Organization

People negotiate because everyone involved wants something from the deal. And each stands to benefit from the negotiated outcomes. In other words, the parties see immediate advantages or potential gains in the future if they reach an agreement today. How did customers and their suppliers forget that?

To re-think getting the "best" deal for your organization, you need to understand that getting the "best" deal means defining "best" more expansively than negotiating aggressively on price. Note that I did not say, cheapest, least costly or even the best value. I said best deal, which can mean many things depending on the organization's goals and the circumstances at hand.

Only you and your organization can define what's "best". This eBook will help you help your organization define the "best" deal in the context of three tools all contract negotiators ought to be comfortable with:

- Using Total Cost of Ownership and Activity Based Cost Analysis,
- Developing Metrics and SLA's (when standard metrics are not enough), and
- Structuring Advanced Governance Systems.

> According to Keld Jensen, one of the leading authors on negotiating partnerships: *"Poor negotiation skills are probably the biggest single cause of major costs and lost opportunities to any organization. And what´s more –most companies do not even see it!"*

So this is not just theory, I've provided you with examples of all three tools.

Here's to your negotiation success!

Jeanette Nyden

Jeanette Nyden, Negotiation expert training leaders to negotiate complex contracts with nuance, accuracy and confidence!

Tool #1: Total Cost of Ownership/Activity Based Costing

Developing a TCO?

A solid Total Cost of Ownership (TCO) provides the buying company with a more holistic approach to evaluating price. It doesn't matter if procurement or sales (or a combination of those two functions) develop the TCO. All that matters is that the buying company has and uses TCO data to make holistic buying decisions.

There are three advantages to performing a TCO, whether the TCO is performed on the procurement or sales side of the negotiations.

1. The buying company makes price decisions based on holistic cost analysis and long-term relationships versus one-time material cost differences (savings).
2. Both the buying company and the service provider or vendor keeps the buying company's operations at the forefront of the decision. In other words, both companies understand the risk factors associated with supplier performance to the company's operations.
3. Both organizations can make more effective tradeoffs that take many factors (in addition to material costs) into consideration.

Buy-side:

Manufacturers Alliance for Productivity and Innovation (MAPI), regularly conducts studies. One study found that companies with a TCO methodology, are twice as likely to enter into pay-for-performance agreements with suppliers, nearly twice as likely to realize 90% or more of savings promised by a supplier, and more than seven times as likely to receive supplier offers with a TCO component. Furthermore, companies with a TCO methodology were more likely to gather data, for example, on warranty costs and on operating costs.

Sell-side:

Buy-side organizations ***want*** the data from their suppliers to prove that they are making a value based decision. It is very likely that suppliers and service providers have many of the relevant data points. When sales organizations provide their own data about the total cost of ownership of their product, it helps their customers make better cost-benefit analysis. And, those organizations that provide TCO data sell their value – not just the price of something. I work with sales-side contracting teams and preserving value while negotiating contractual terms is a critical factor for those teams. If customer's buy on TCO, all parties will – in my opinion– better understand the value of the terms and conditions they are discussing.

[3] Source: Manufacturers Alliance for Productivity and Innovation

TCO Is a Cost Benefit Analysis

The purpose is to understand the ***trade-offs*** between material savings (actual item or service), other operational costs associated with the item or service, and the risk criteria (i.e. delayed shipment or deployment) to make strategic supplier selections. A proper TCO analysis uncovers a discrepancy between different suppliers' purchase prices and the total life cycle costs for their products.

The **goal** is to establish the "cradle to grave" costs of an item over the life of the item. Ownership brings purchase costs (included in the price), of course, but ownership can also bring substantial costs for installing, deploying, operating, upgrading, maintaining and decommissioning the same asset.

Who Should Be On the Team?

It takes a cross-functional team to develop a complete TCO. A team might include:

- Supply chain manager --procurement ***OR*** VP Sales -- sales
- Accounting/finance for analysis
- Senior management (P&L responsibility)
- Engineering
- Planning/Project Management
- Daily Management

TCO Example

Premise: A Baseline TCO Analysis

A baseline TCO analysis includes the costs under the current scenario ***as well as the projected costs based on a set of assumptions***. This is critical– no matter if you are customers or sales, it is important to understand the assumptions. In this example for simplicity, I have four categories.

1. Direct - These are the Cost of Goods Sold or full purchase price of a good or service.
2. Operational - These are sometimes called overhead. In this example I added +1 in Year 2 to factor in the increase in operating costs.

3. Indirect/Other—Indirect costs can be the costs of sales for manufacturers who buy machines to fabricate the items they are selling. Maintenance and repairs might be in the category or in operating costs. It depends on the company to categorize costs.
4. The last category is very important to include– that is the cost to remove or decommission the item. I am speaking particularly of the costs and recovered costs (such as scrap metal sales) of removing an item from operations.

Current Scenario

Costs	Y1	Y2	Total
Direct	$X	$X+1	$Y
Operational	$X	$X+1	$Y
Indirect/ Other	$X	$X+1	$Y
Decommissioning		$X+1	$Y

Projected Scenario

Costs	Y1	Y2	Total
Direct	$X+2	$X	$Z $Z
Operational	$X-2	$X-2	
Indirect/ Other	$X-1	$X-1	$Z
Decommissioning		$X	$Z

X = Dollar; Z = Total Dollar

These tables form the procurement "business case" to compare supplier's costs. In sales, you might calculate or help procurement calculate the projected scenario in your response to your company's proposal submittal. The preferred approach is always transparency, where the total costs to own a product over time is factored into the price.

Sales TCO or Value Selling

To really negotiate on value – have that back and forth conversation aimed at reaching an agreement -- you have to demonstrate the math. The procurement professional will need to go back to their organization to negotiate internally with his or her stakeholders. It is the sales person's job to educate the procurement professional in a way that helps them get the decision maker to buy on TCO and not on a less expensive price (with higher operational costs).

This is a very high level copy of a spreadsheet that my client developed to demonstrate how their premium product reduced their customer's costs and risks.

Value Statement	Calculation	Savings
Rejects Best in Class (Compared to Average Alternate Supplier)	See Cost of Quality Sheet	$35,000
Standardization and Consistency	3% of Purchases	$12,000
Better Grades and Readability	2% of Purchases	$8,000
On-Time Delivery Best in Class (Compared to Average Alternate Supplier)	27 x $1000/each	$27,000
		Sub-Total $150,000
		-37.50%
ABC	300 Shipments x $250 = $75,000	**Total $225,000**
		-56%

Activity Based Costing

Activity Based Costing

Activity Based Costing has two goals. First, it seeks to capture "cradle to grave" costs of a **service**. Second, it helps business units compare the cost of working with a supplier versus doing the work in-house. Activity Based Costing is similar to a TCO for activities, such as call centers.

Example Activity Based Costing

In this scenario, I was hired as a consultant to help negotiate a 350M outsourcing deal awarded to the incumbent supplier of services. The customer wanted to know if it was economical to shift some internal work to the supplier, thus broadening the supplier's scope of work. Here is our process. And, it is critical to set out that both the customer and the incumbent supplier worked together after the decision was made to re-award the work to the incumbent supplier.

Step 1– Sort out the work to be analyzed

Taxonomy of Processes (what the customer did and what the supplier did). By way of example, the supplier was an integrated service supplier. That means that it was paying the third party invoices for sub-tier suppliers and passing the costs along to the buying company. The buying company wanted to understand what it did with all the processes and what the supplier did. We were looking at how the "baton" was passed back and forth:

- Role Misalignment
- Opportunity for Changes

Step 2 – Establish some time measures

We interviewed the buy-side (customer's) people to get an idea of how much time each person spent on processes that could be transferred to the supplier. This was difficult for a number of reasons, ranging from, people had literally no idea, to they did not want to tell us for fear they'd lose their job if too much went to the supplier.

Step 3 – Calculate the estimated savings if the work went to the supplier

The customer then priced out--placed a value on--their own work. Then the customer decided what can be transferred to the supplier and why. Maybe because the supplier was already doing the job or something similar. Maybe because the supplier had better processes in place.

Finally, the customer asked the supplier to price the services. The accounting departments for both the customer and the supplier worked together after the customer had their value and the supplier had their price on a per hour time estimates. This is a critical point. They worked together at this point so the customer could make a verifiable cost-benefit analysis.

Step 4 – Decide what will transfer to the supplier and provide financial proof

This is the last step. The customer's team (procurement, line of business and accounting) made a decision as to what would be transferred to the supplier based on financial proof of anticipated savings.

Tool #2: Metrics, SLAs and KPIs

What Are You Driving At?

Service level agreements (SLA) drive behaviors. Behaviors drive performance. So, if you measure safety, the supplier will adopt behaviors that emphasize safe interactions. If you measure savings, then the supplier will adopt behaviors that will emphasize saving money. SLAs are neutral. They can drive positive or negative behaviors.

Why SLA's fail to deliver

There are three significant reasons that SLA's fail to deliver.

First, companies set the wrong metric (unit of measurement) to support the SLA.

Companies use what they have in place already, but not needed for this relationship. Or companies use what some other company said they used (borrow an idea an executive brings from a prior employer). Or companies use what someone thinks is a good idea (but the company cannot collect the right data).

Companies often collect the wrong data. Or a company might collect the correct data to support the metric, but it is insufficient to draw a conclusion that can be validated.

Companies use the metric for the wrong purpose, in other words, the metric is not tied to a business objective. Some companies inadvertently measure a task and/or processes that is completely outside of the supplier's or service provider's control (but the information is used for/against the supplier or service provider).

Finally, some buying organizations and suppliers or service providers have different definitions for the metric. In other words, what does "actual to budget comparison" *really* mean if each company has different ways to account for the same item?

Second, companies set the wrong target.

For example in a call center setting, a target might be the number of calls per representative per hour. The target was set to 20 calls per representative hour. The problem is that—for this particular customer, no one asked these questions...

- *Why 20 calls per representative per hour? Is it for Efficiency? But then how does it affect thoroughness of call, or the quality of help provided?*
- *What is the other side of the coin? I.e. the downside of this target?*

In one instance, 20 calls per representative hour met the goal of efficiency at the expense of call quality, thereby decreasing customer satisfaction. The buying company was left to determine, after the fact, which was more important; efficiency or quality? Frankly, this ought to be sorted out before engaging the service provider.

Three, companies over use penalties while failing to properly align incentives that go along with the SLA

- *Too many* companies tend to over emphasize liquidated damages to “recover” for small deviations in supplier performance trends over a short period of time. For example, a company may penalize for small monthly deviations, rather than looking at quarterly or semi-annual trends. There are often legitimate business fluctuations that need to be factored into SLA performance when looking at a monthly timeframe that are not reflected in a quarterly or semi-annual timeframe.
- *Too few* companies use incentives to reward behavior that helps the customer meet its business objectives. For example, customer retention is far more important than rewarding the supplier for an average of 20 calls per representative hour. While a company might have liquidated damages for 18 calls per representative hour, very few actually issue a bonus check for retaining customer loyalty through call centers.

Best Practices in developing SLA’s

Studies show that there are three best practices that—in my personal experience—many companies rarely follow.

First, start from the business objectives, not the template.

I do understand how busy people are, but some other company’s scorecard may not meet your company’s line of business’ needs. To have a valuable metric it must contribute directly to the assessment of the service’s ability to achieve the buying company’s desired business objectives. For instance, if the goal is to streamline operations, the metrics should measure the service’s improvements to streamline operations.

Second, establish the SLA, metric or performance standard before working with the other party

Try to establish the performance standard, corresponding SLA, and corresponding metric (unit of measurement) before you start to negotiate with the supplier. This means looking at the:

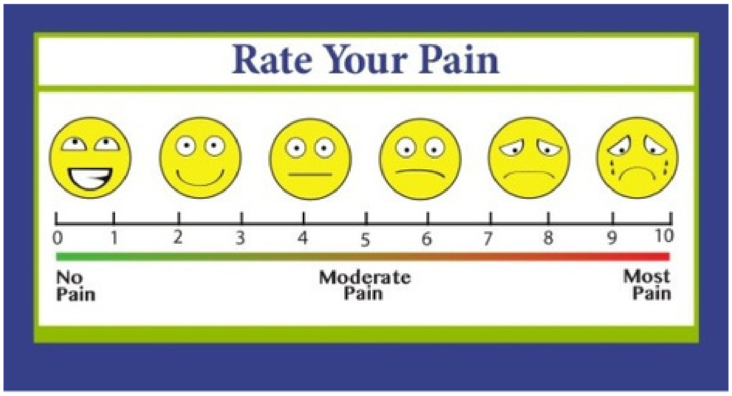
- Business case
- Technical specifications or delivery specifications
- And talking to the internal customer about what they really need from the supplier.

Third, plan to renegotiate, SLA’s, metrics and KPI’s as people gain experience

Set up a contract mechanism to allow for renegotiation of, SLAs and metrics as people gain experience working in the relationship. This best practice ties directly into the need to modify long-term contracts and have a non-legal dispute resolution process in place. In some outsourcing relationships, customer’s and their provider’s re-evaluate the SLAs and corresponding metrics annually.

Developing a Joint Scorecard

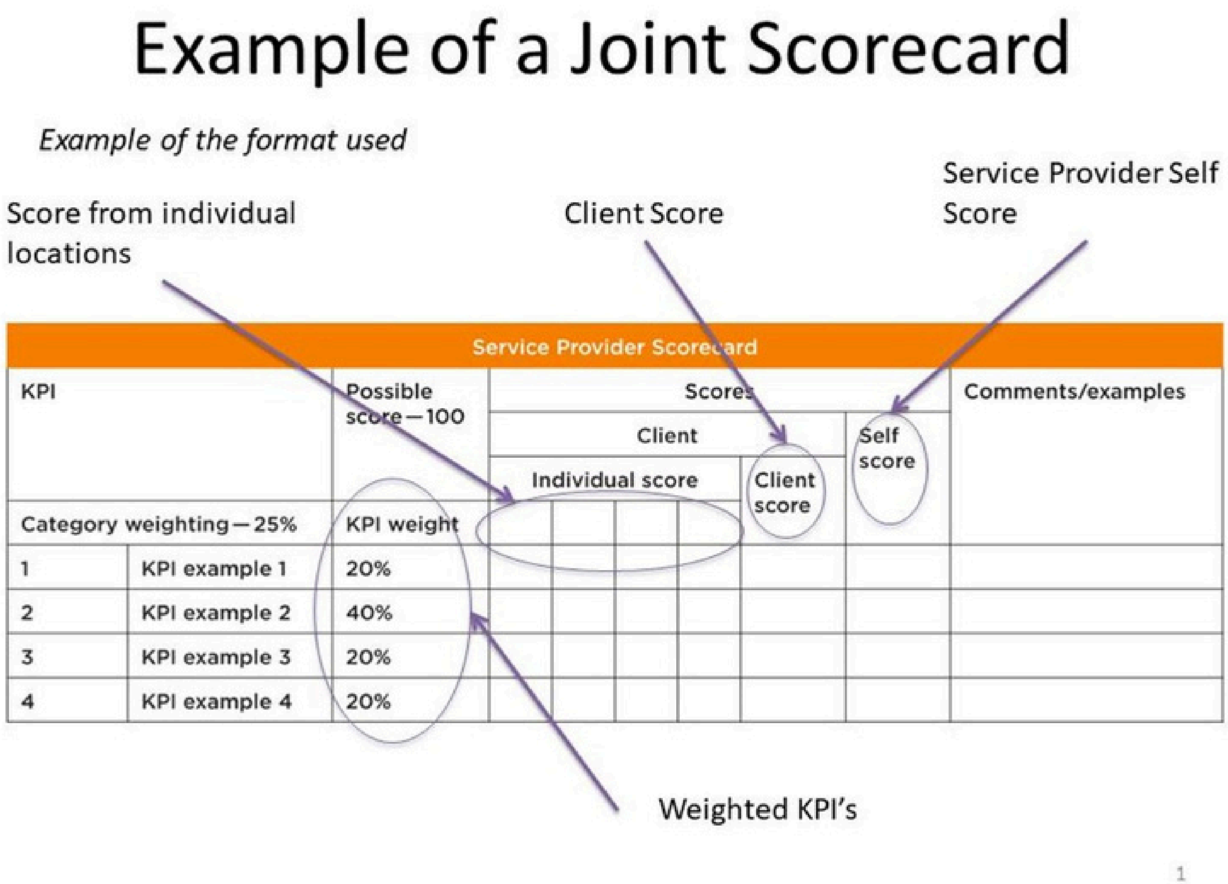
Should Your Organization Establish a Joint Scorecard?



Joint and Balanced Scorecards are strategic performance tools. The customer and supplier measure mutually agreed to business objectives, and usually also measure each other's performance as it relates to the business objective. When developed and deployed properly, joint scorecards deliver previously unidentified opportunities for positive and tangible financial outcomes.

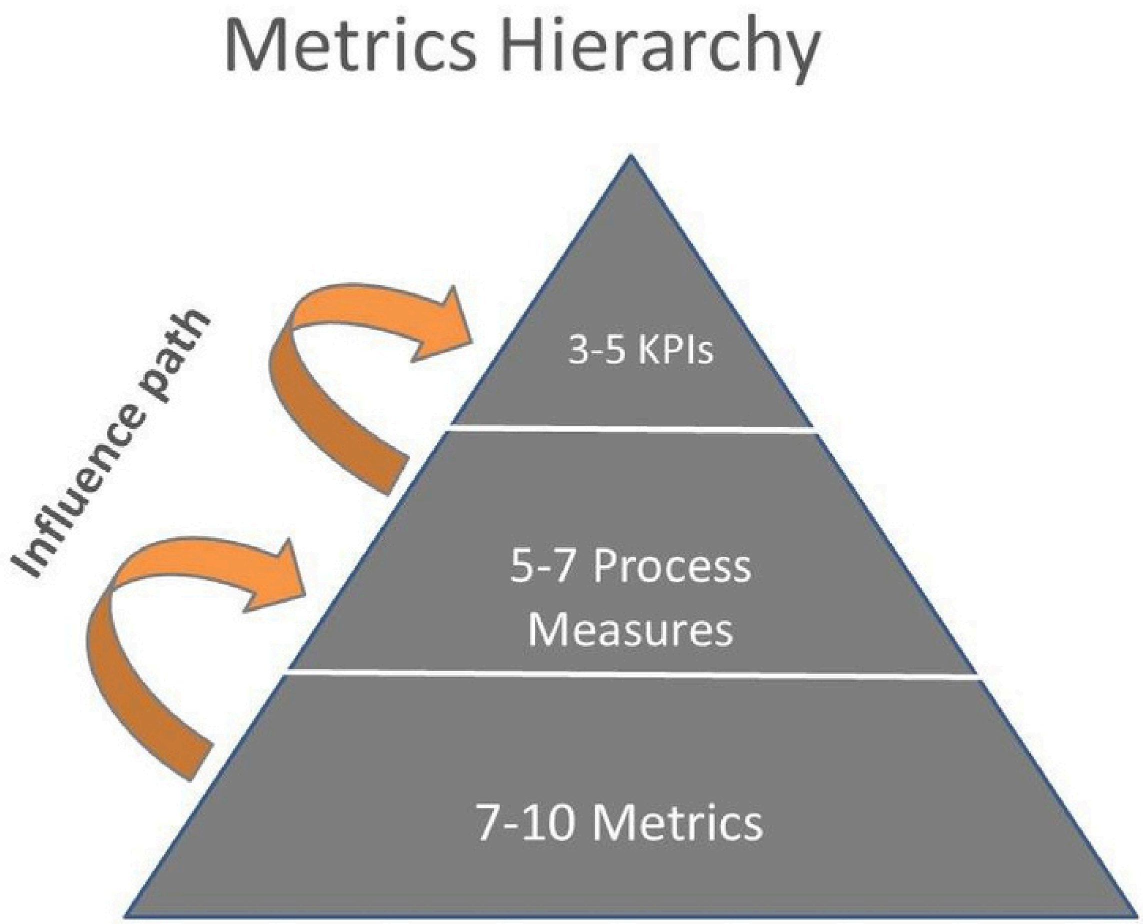
The most critical component of the Joint and Balanced Scorecard are the Key Performance Indicators (KPIs) – the set of mutually agreed to metrics in order to measure performance. These KPIs should be a mixture of financial and non-financial measures that align to existing business objectives that help the customer and supplier gain greater market share. They should be fact-based and actionable, as well as drive ongoing collaboration between the customer and supplier.

For example, some industries use Collaborative Planning Forecasting and Replenishment (CPFR). Early adopters are already deploying CPFR as a way of developing one shared sell through forecast. CPFR focuses on joint metrics to improve the planning, forecasts, as well as replenishment of stock. If a customer is not prepared for a full on CPFR, the customer and its suppliers can pinpoint key elements of the business objectives for fulfillment, then establish a metric, before finally looking at process improvement metrics.



This is an example from my work with Kate Vitasek and Vested Outsourcing™. When the buying organization originally shifted outsourced services to a new supplier, it used a joint measurement approach where both parties provided a score for 4 key metrics. As you can see there are four KPI's. We recommend only 3-5 KPIs for a joint scorecard. More than 5 KPIs becomes truly unmanageable. The first column reading from left to right is the weighting. The scores are weighted to a total of 100%. In this scenario, there were four leaders who would give the supplier a score of the customer from 1-5 (1 being low and 5 high). Then in the next column, the aggregate score was totaled. Finally in the second to the last column, the supplier scored itself on a scale from 1-5.

Metrics Hierarchy



Here are some things to consider when developing a joint scorecard. Use an end to end KPI, not just a supplier service level agreement. For example, in the call center world answering 90% of all calls within 2 minutes (picking up the line and talking to the customer) might be the service level agreement. But the joint scorecard KPI might be customer satisfaction score of 4 or better after the call is completed. The customer (in my case the bank) and the service provider both had a hand in satisfying the customer when he or she called. There were several end to end processes that were measured. The process metric measures the ease of access to the phone number on the website, the ease of use of the phone system, the answer time, the quality of the answer and/or transferring the call for additional technical support. That is an end-to-end process measurement—some within the customer's control; some within the supplier's control.

We (the authors of the *Vested Outsourcing Manual*) have an entire chapter on this topic in our book so please feel free to pick up a copy if you want a much more detailed discussion than what I am able to provide today.

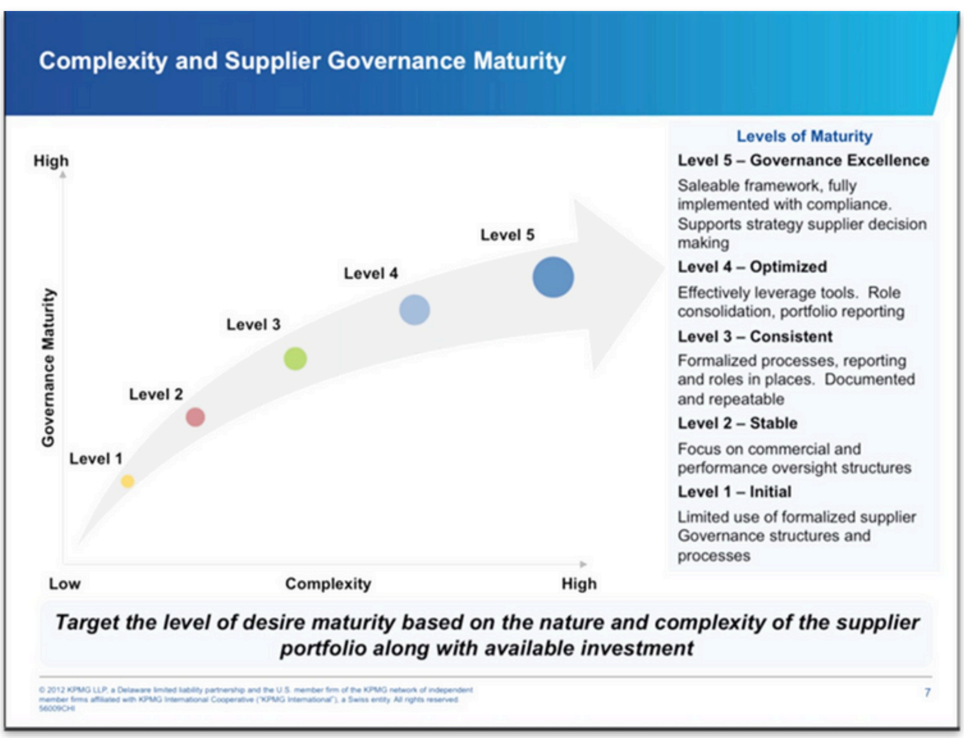
Tool #3 Advanced Governance Mechanisms

When I talk about advanced governance mechanisms I mean three things. First, the governance itself will operate despite changes in personnel. For larger interdependent customer-supplier agreements, governance cannot depend on one champion. Second, there is an outlined structure that is documented in an easy to read format. And, finally, that the meetings themselves move from analyzing the past performance of the supplier, to how the relationship will meet challenges in the future.

Level 3 Governance

I like this model because it is closely aligned to the Sourcing Continuum. In other words, as the customer-supplier relationship becomes more interdependent and contractually complex, so increases the need for a more mature (advanced) governance model. Once I outline the Level 3 Governance, I will show you how to move your organization to level five.

Supplier Governance Maturity



This slide is used with permission from KPMG and was presented at a conference a few years ago.

Why establish Level 3 Governance?

The Goal

The goal is to design and ***institutionalize*** an effective governance structure to deliver strategic insight. People unfamiliar with working in highly collaborative relationship find it easy to fall into the familiar tug-of-war mentality. A sound governance structure provides a set of cohesive policies, processes and decision- making rights that encourage collaboration. By institutionalize, I mean have a system in place that works despite the fact that key individuals leave the organization and despite the fact that the champion is on to other initiatives.

The "New Sheriff In Town" Ailment Is Real

The "New Sheriff in Town" often occurs when a new leader joins the buying company and wants to shake things up. In 2012, GM and its then newly minted CIO Randy Mott made the decision to in-source 90% of the IT work. At the time he made this decision, H.P. had that work as an outsource service provider. H.P., which won GM's Supplier of the Year award in 2010 and 2011 for its "dedication and loyalty", was ousted. H.P lost approximately $1 billion in revenue and let go of hundreds of employees. While this is an extreme example, I am sure all of you can tell me a story about a new leader wanting to shake things up with an established—and working—supplier relationship. Those shake ups often do not go well for either the customer or the supplier.

Level 3 Governance can help put structures in place that will help stabilize the relationship when a new sheriff arrives in town. For more information on this ailment, please visit http://www.vestedway.com/ailment-11-new-sheriff-in-town-syndrome/

A Structured Approach Prevents "Strategic Drift"

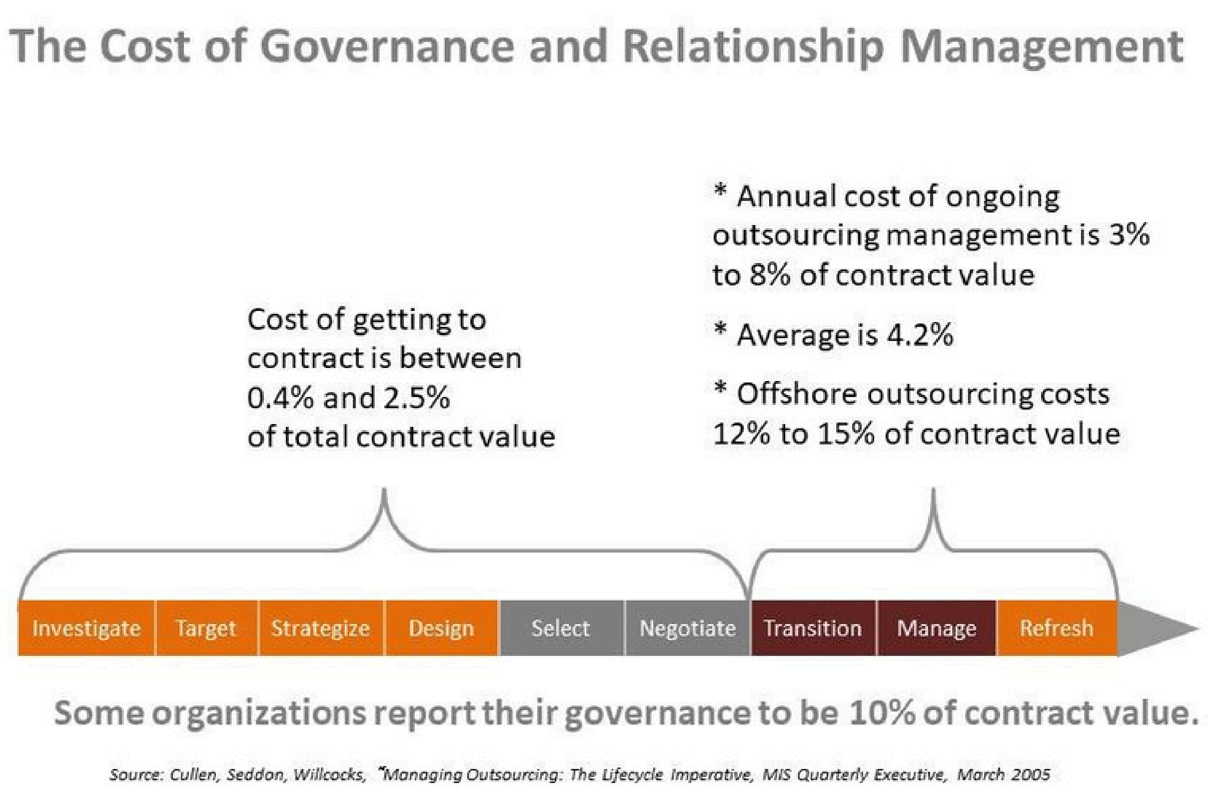
Level 3 Governance also prevents strategic drift. Strategic drift occurs when buyers and service providers don't work to maintain their relationship and/or work to update strategic priorities. This typically happens after a first generation contract has been successful and senior management "checks out", moves on to other initiatives and leaves this successful relationship to manage on its own. In fact, relationships can manage on their own if you—AT THE TIME OF NEGOTIATION—put a governance structure in place.

Strategic drift means, QBRs are not scheduled as frequently or at all. Or the topics begin to slip to anecdotal past behaviors void of data to support conclusions. Service providers lose sight of priorities and are more reactive than proactive in driving solutions to problems or connecting new solutions to new priorities. These issues typically result in the buying company thinking the service provider is not proactive – not doing their job (remember the problems with metrics measuring the wrong things). Then the buying company wants a new service provider when in reality they already have a good one.

Governance costs money – so budget for it.

Governance is not free; you must devote the right resources not only to achieve service excellence but also to help drive strategic outcomes for both companies. Some companies have an initial thought of "My gosh, we can't put that kind of overhead on our project!" However, research tells us that without proper governance, companies experience up to a 90% erosion of deal value and savings leakage.

The cost of getting to contract is between typically 0.4% and 2.5% of total contract value. The annual cost of ongoing outsourcing management is typically between 3% to 8% of contract value. The average is 4.2%. Offshore outsourcing costs even more ranging from 12% to 15% of contract value.



When I speak of Level 3 Governance in the context of cost of governance, I am talking about transitioning the work (to a new supplier, or new work to an existing supplier), managing the work so the buying company meets its business objectives from the relationship, and refreshing the work, metrics, KPIs etc. throughout the duration of the relationship. And, it is usual to plan to spend 3%-5% of contract value just on governance.

Example: Governance Costs

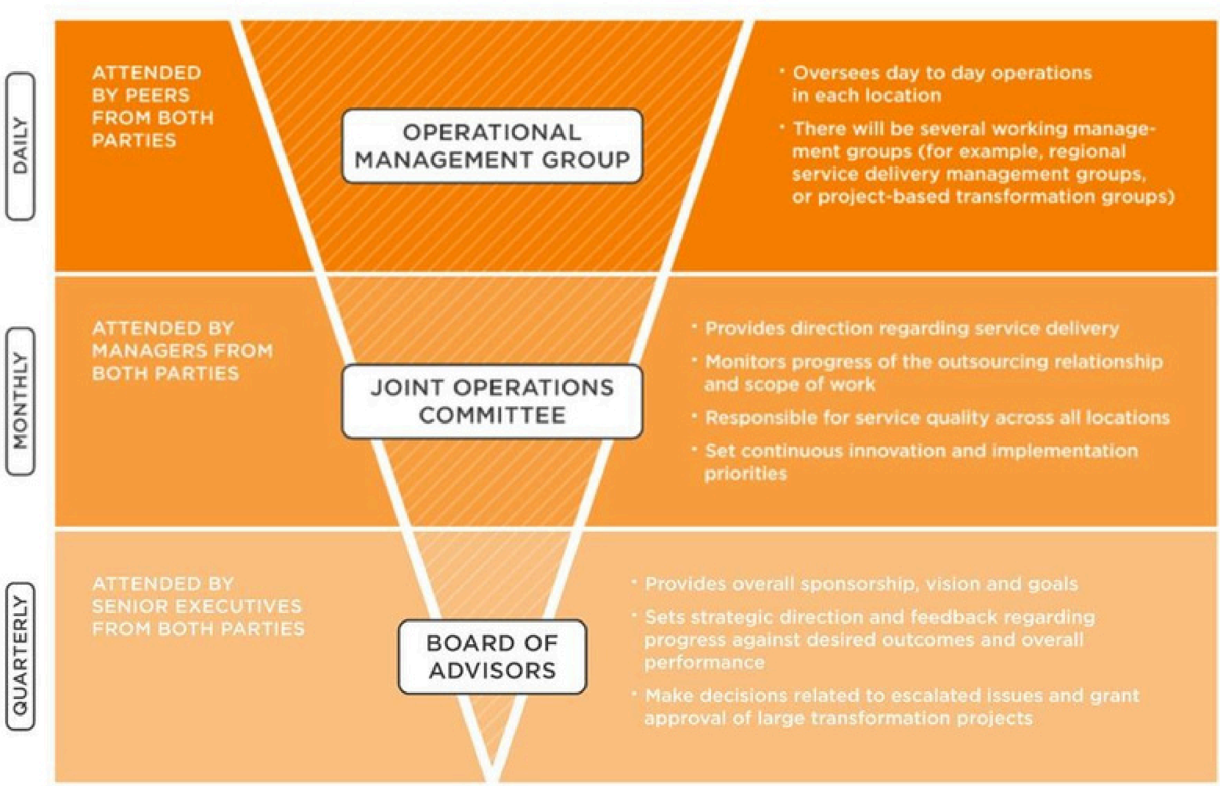
This is an actual example from one of my clients proposing one net new employee on the customer side and paying for net new two employees on the supplier side, with one net new shared employee as an assistant. The totals below are per anum.

Customer	Supplier	Cost (approx.)
Transformation Manager	Transformation Manager	$250,000
	Customer/Vendor Manager	$125,000
Governance Administrator (shared)		$50,000
	TOTAL PER ANUM	**$425,000**

My client made the following note when presenting the costs of governance. "The following roles are net new & required roles to implement the Governance Framework indicated in this document and the current customer Vendor Management team will be leveraged. They will be charged (to the P&L) as FTE costs for the 4 FTE required."

Best Practices in developing Level 3 Governance (with examples)

Three Layered Structure



At the top—the biggest "v"– sits the Operational Management Group(s). These groups oversee day-to-day operations in each location. This group may meet weekly or monthly.

Next, in the middle, sits the Management or Joint Operations Committee. These are typically division leaders and account managers. This committee provides direction regarding ***implementing*** strategic service delivery. It also monitors overall strength of the relationship. It can also set continuous innovation priorities.

The board of advisors provides overall sponsorship and develops strategic direction for the buying company. That strategic direction is then augmented with the supplier's resources. In other words, how can this service provider help this customer meet a strategic target? The board of advisors also approves large transformation projects (larger than a small improvement in a process).

The board should meet at least quarterly for the first two years of the agreement and after that semiannually. Only senior executives from both parties sit on the board; in other words, someone from each company with the authority to make strategic decisions. This is usually more than an account executive at the service provider.

This is What You Would Produce

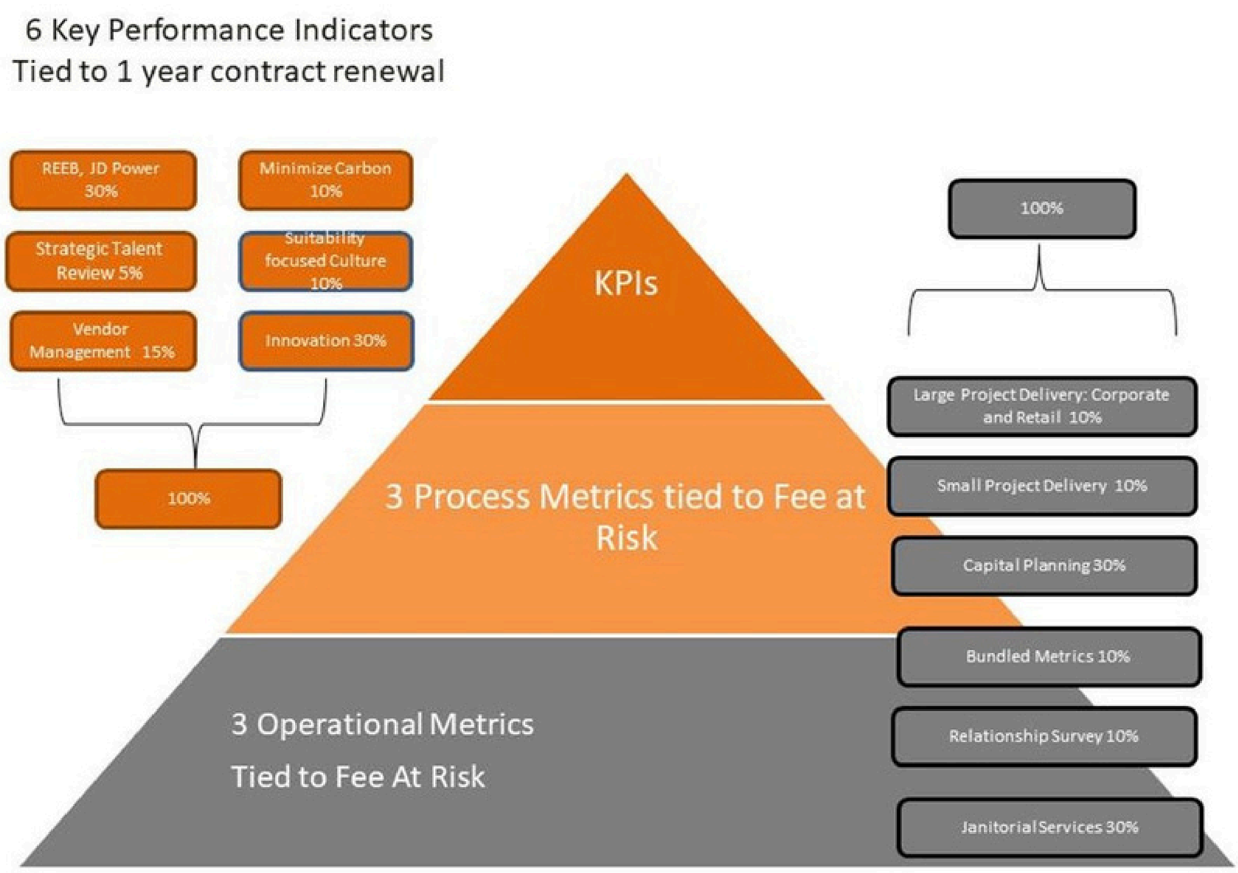
Committee	Customer Members	Supplier Members	Role	Reporting
Operations	Sally Abe Michelle Randy	JoBob Peter Alice Astrid	Daily FM Operations	• Peer Pair Abe/Alice (etc.) • KPI 1,2,3, • Report to Management Committee
Joint Mgmt.	MaryAnn	Lori	National FM management	• Peer Pair MaryAnn/Lori • All FM KPIs • Report to Board
Board of Advisors	Taylor	Gary	*Head of N. American Real Estate *President of Supplier FM division	• Peer Pair Taylor/Gary • Responsible for all strategic decisions.

Note that the “contract professional” for the customer sits on the Joint Management Committee as well as the supplier’s own vendor manager for 3rd party vendors to the relationship. This allows for “flow through” of contract terms and scope of work initiatives from the customer to the supplier and to the supplier’s sub-contractors.

To move from supplier oversight to business insight, the companies must tie the governance structure to a solid joint scorecard and a clear understanding of the Total Cost of Ownership. Once the structure is in place (the names, the meeting frequency, the roles and reporting structure) the goal shifts to developing strategic insight (Level 5 Governance). That means placing an emphasis on looking ahead. Each committee looks ahead to ask themselves, “what business challenges are looming, both internally and externally?” “What economic challenges are looming?”

3 Critical Tools for the Contract Negotiators Toolbox!

Tying SLAs to Governance



This model demonstrates how governance teams move to insight by tracking the metrics noted above. By monitoring these metrics weekly, monthly and quarterly, the relationship functions as a system on its own, and not at the whim and will of a charismatic leader.

Conclusion

People negotiate because everyone involved wants something from the deal. And each stands to benefit from the negotiated outcomes. Using the three tools in this eBook, you will help your organization and your counterpart's organization re-think "best" in getting the "best deal".

Using these tools both organizations will redefine define what's "best":

- Using Total Cost of Ownership and Activity Based Cost Analysis,
- Developing Metrics and SLA's (when standard metrics are not enough) and
- Structuring Advanced Governance Systems.

Now that you have these tools in your toolbox, how will you use them?

About the Author

Jeanette Nyden, J.D.

Negotiation expert training contract professionals to negotiate complex contracts with nuance, accuracy and confidence!

Since 2003 I've been helping non-lawyer contract professionals to negotiate complex contracts with nuance, accuracy and confidence. I offer a range of online and in-person training programs. I have a valuable skill set that most organizations desperately need. I am a lawyer who understands business operation needs to form a high performing customer/supplier relationship, and a business consultant who understands the legal terms and conditions. I've personally been involved in deals as small as a preferred vendor agreement for a privately held manufacturer and as large as re-negotiating two outsourcing deals worth hundreds of millions of dollars each.

I am a recognized expert in the contracting field having authored and/or co-authored four books:

- ***The Contract Professional's Playbook, The Definitive Guide to Maximizing Value through Mastery of Performance- and Outcome-Based Contracting (with Lawrence Kane)***
- ***Getting to We: Negotiating Agreement's for Highly Collaborative Relationships, (with Kate Vitasek and David Frydlinger)***
- ***The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Relationships (with Kate Vitasek, Jacqui Archer, and Katherine Kawamoto)***
- ***Negotiation Rules! A Practical Approach to Big Deal Negotiations***

I have worked with organizations such as PG&E, Esterline, KLX, TD Bank, CIBC Bank, Brookfield Johnson Controls, H2MHill, T-Mobile, Jones Lang LaSalle, and Microsoft. I also was an adjunct professor at Seattle University and have taught courses at the University of Tennessee's Center for Executive Education.

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