Maintaining Market Pricing in Technology Agreements

Jim Steinberg and Lance McCord

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Long-term technology service arrangements are dynamic by their nature. The buyer's business needs evolve, services are moved in and out of scope, and the market conditions that form the context for the service agreement can change before the ink is dry.

As a result, the pricing described in any contract is rarely more than a snapshot. The cumulative effect of pricing changes can drain your project of the value that once made it appealing.

It is possible to mitigate this risk by negotiating initial pricing that reflects your actual present and future business needs, obtaining commitments from the supplier regarding pricing and productivity, requiring committed price reductions to reflect the results of benchmarking, and leveraging your ability to shift the services away from the supplier.

A buyer must understand its true cost for the services before the buyer can effectively assess the supplier's proposed pricing. This understanding comes from the buyer's careful development of a detailed base case describing the buyer's current direct and indirect cost for the services, together with a clear understanding of which of those costs will be retained by the buyer after the services are transitioned to the supplier.

At a stage of negotiations where both parties are understandably focused on the desired upsides to the project, the base case provides an opportunity for a cold, hard look at the true cost of the project. The base case will necessarily rely on assumptions about how the transition will affect each business group involved in the delivery or use of the services.

By documenting and testing these assumptions, the buyer can hone the base case and potentially identify unexpected costs that will result from the transition.

The volume of services required by the buyer is unlikely to remain steady over the term of a contract. Accordingly, the supplier should provide pricing proposals that address all foreseeable contingencies (such as changes to the scope of services and changes to service volume). The buyer must carefully review the supplier's pricing proposals, calculating the fees in a variety of scenarios, to ensure that the pricing mechanisms yield predictable and desired results.

The contract should contain clear pricing terms that provide committed pricing for additional or reduced service volume. If the buyer is acquiring or licensing products from a supplier who also offers related products, consider including committed pricing on all products that the buyer may wish to acquire. Pricing commitments for volume changes or new products must be accompanied by the supplier's commitment to fulfill requests for volume changes or new products. If the supplier is free to reject such requests, then the supplier is free to condition its acceptance of such requests on the buyer's acceptance of new pricing, circumventing the agreed-upon pricing.

Buyers may also require the supplier to commit to improve productivity and to share with the buyer the cost savings that result from those improvements. For most services, it is reasonable to assume that the supplier's efficiency will improve over time. The supplier's personnel will become more experienced in the performance of the services.

At the same time, the account team will learn and integrate with the buyer's processes and personnel. Improvements in hardware, software, and network tools will also allow the supplier to be more efficient. The benefit of these improvements will flow entirely to the supplier unless the buyer contracts for both the supplier's active participation in improving productivity and the sharing of cost reductions arising from those improvements.

The supplier's desire to keep the buyer's business also plays an important role in maintaining market pricing. But the buyer cannot fully benefit from this desire without the flexibility to in-source or re-source the services (in other words, to resume performing the services using the buyer's own organization or to engage another service provider to perform the services). The contract should clearly include the buyer's right to increase or decrease the volume of services that fall within the supplier's scope, even to the point of removing some or all categories of services from the contract.

In addition, the buyer should contract for the supplier's cooperation with the buyer and third party service providers who are performing services removed from the supplier's scope. These contractual protections create an ongoing incentive for the supplier to maintain competitive market pricing.

Buyers can also address the risk posed by market changes by negotiating for a mandatory price reduction when the contract prices exceed a benchmark based on market prices.

In a typical benchmarking, an outside consultant analyses the services that are being performed by the supplier and identifies a group of customers receiving comparable services. The benchmarker then normalizes the prices that those other customers are paying to account for differences among the comparators. The result is a report that allows the customer to assess how its pricing compares with market pricing.

Suppliers will understandably wish to document the benchmarking process to ensure that the survey is limited to similar supplier-buyer relationships and that the data is normalized in a way that protects the supplier against unfair comparisons. But a prescriptive benchmarking contract clause creates risks for the buyer. For example, too many restrictions on what constitutes a similar customer will make it difficult to locate comparators.

Ideally, the experienced third-party benchmarking consultant should be allowed to use its own skills and experience to identify comparators and normalize the prices paid by those comparators.

Of course, benchmarking results are not binding unless the contract makes them so. From the buyer's perspective, it is essential that the contract impose mandatory fee reductions to bring the supplier's prices within the range of the market prices identified by the benchmarking report. The contract should clearly state the conditions under which a reduction is triggered, and how and when the reduction will become effective. The buyer should beware of terms that condition price changes upon the supplier's approval of benchmarking results.

A buyer can benefit from strong benchmarking protections without ever exercising the right to benchmark. The cost of engaging a respected benchmarking firm (which is typically borne by the supplier) can be substantial. Moreover, suppliers generally prefer negotiated discounts to pricing changes imposed by facts outside the supplier's control. For these reasons, the threat of exercising a benchmarking right is often enough to drive price concessions.

Buyers may attempt to go a step further by requiring suppliers to take the initiative on giving the buyer the best possible prices. In some cases, it may be possible to obtain a supplier's promise not to provide any in-scope services to a third party at a better price without giving the buyer the benefit of the improved pricing. (This commitment is often referred to as a "most favored nation" or "MFN" clause.)

The buyer's ability to obtain a strong MFN commitment will depend in part upon the amount of leverage the buyer wields in negotiation. Suppliers often seek to qualify the MFN so that the supplier is only required to provide the best pricing that it provides in circumstances that are similar in terms of service scope, service volume, geography, industry, or other factors.

Finally, the buyer's position in any pricing discussion will be strengthened by a right to terminate the agreement for convenience. (In a previous article, we discussed circumstances in which it may be reasonable for the buyer to pay a termination for convenience fee that is limited to making the supplier whole for investments and wind-down costs; a termination for convenience penalty would be any amount that exceeds such a reasonable fee ["Terminating Long-Term Technology Agreements," Daily Report, May 1, 2015].)

The possible outcomes of any negotiation are framed by the alternatives each party has to reaching agreement. The right to terminate for convenience gives the buyer a clear alternative to overpaying for the services.

The buyer's leverage is greatest when the buyer has the right to terminate the services piecemeal, as opposed to being limited to terminating the contract or any statement of work in its entirety. This flexibility should be explicit in the contract language that gives the buyer the right to terminate for convenience.

Jim Steinberg, a partner at Kilpatrick Townsend & Stockton, focuses his practice on complex commercial transactions and general corporate matters for telecommunications, financial institutions, health care providers, technology and other companies. Lance McCord is an associate at Kilpatrick Townsend & Stockton, where his practice focuses on outsourcing and commercial agreements, technology licensing, advertising data and targeting agreements, joint ventures and strategic alliances.