Beware the winner's curse

Stuart van Rij

Could your outsourcing deal be subject to the winner's curse?

■ AFTER MANY LATE evenings and long negotiations, you finally inked the outsourcing deal that was "your baby" for more than a year. However, nine months later the expectation and relief shared over the celebratory bubbly has long since evaporated. The deal was "best practice" but for one problem: The supplier isn't making any money. Now, the supplier's difficult to deal with, performance has dropped and a raft of unexpected costs have crept out of the woodwork. You may have encountered the "winner's curse".

A recent London School of Economics (LSE) paper, *The Outsourcing Enterprise: The CEO guide to selecting effective suppliers*, describes the winner's curse as "...deals which excessively favour the client at the expense of the supplier..."

The paper explains that such deals do not work to the client's advantage in the long run. It quotes a 2002 study of 85 contracts that found the winner's curse in nearly 20 per cent of cases. In over three-quarters of those cases, the winner's curse was felt by the clients.

Ominous words. In practice, the impact on the customer is likely to be found in an uncooperative supplier that focuses on the letter of the contract and not its spirit, making the most of every ambiguity. So, while it may be tempting to let the supplier deal with the problems it signed up to, that approach may backfire in the long-term.

The LSE paper highlights the issue with a case study describing the not uncommon scenario of a supplier bidding the price they thought necessary to win the contract, without fully understanding what was needed to make a reasonable profit. The deal was to be a "loss leader" for the region. However, after 18 months, the supplier had not won any further business and was under pressure due to unacceptable losses and little prospect of profit.

The supplier's solution was to engage a lawyer as the account manager to go over the contract with a fine tooth comb to discover whether the company could reclaim any money. What followed was nine months of disputes. The supplier stopped work it deemed to be out of scope and raised invoices for out of scope work that went back to the start of the contract. Not a recipe for happy families.

But what can a customer do? Although fairly obvious, the following considerations can help prevent the winner's curse from torpedoing your deal. We often see shortfalls in these areas in the outsourcing deals we advise on.

Design for due diligence

The supplier needs to know what it's getting itself into. This normally means providing ample opportunity for adequate due diligence throughout the procurement process. And not just by the exchange of paper – the LSE rightly recommends a high level of interaction throughout the bidding process (site visits, workshops etc) so the supplier can get to grips with how the customer's business really operates. Suppliers say they try to get this detail at proposal stage, to no avail. It's a big gripe for them.

Walk a mile in the supplier's shoes

The more you can understand the supplier's business model the better. Work through the kind of behaviour the deal might extract from your supplier and when and how the supplier expects to make a profit. Misunderstand this and your service credit regime may be the straw that breaks the camel's back.

Cater for change

Unexpected changes can lead to unexpected costs. It's well worth investing time at the start to identify anticipated changes, and pricing structures and other mechanisms to cater for those changes.

Be ready to renegotiate

Renegotiation will often be the preferred option when faced with potential costs of disengagement and maintaining the status quo. Better to confront the issues and look for lateral solutions than let the problem fester. ■

Stuart van Rij is a solicitor at Wigley & Company, a law firm specialising in ICT. He advises on deals for both the private and public sector with projects ranging from software development and SLAs to outsourcing and ERP implementations. He can be reached at (04) 499 1842 or stuart.vanrij@wigleylaw.com

If there are any questions you would like Stuart to answer in relation to IT issues, please forward these to divinap@fairfaxbm.com