

User's Guide to Outsourcing



Pinsent Masons

A User's Guide to Outsourcing

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Acknowledgement

Thanks to Data Monitor for use of their data. Data Monitor's IT services contract database tracks every deal signed by major services vendors.

G01 What is outsourcing?

This is section G01 of A User's Guide to Outsourcing. It contains a brief introduction, a diagram illustrating the outsourcing process and a glossary of commonly used terms.

Introduction

Outsourcing in the UK has expanded enormously over the last decade and a half – both in the number and value of outsourcing transactions and in the variety of services which are outsourced.

The pressures which lead organisations to outsource show no signs of slackening. In the private sector, global competition requires businesses to continually look at ways of increasing efficiency and reducing cost. In the public sector, the pressure of a new spending settlement compels local and central government to consider new ways of increasing efficiency such as the shared services initiative. Both sectors turn to outsourcing as one means of achieving their aims.

But cost saving is not the only motivation for outsourcing. In many cases, access to innovation, increased speed to market, and improved service quality are as important as cost in influencing the outsourcing decision. As the aggregate value of transactions has increased (see Table 1), the range of outsourced services has also expanded. Most non-core services which organisations have traditionally provided internally – IT, financial administration, HR, property management, catering and security – are now commonly outsourced. And the locations from which services have been provided have also multiplied. While services were previously outsourced to service providers in the UK or Ireland they are now increasingly outsourced to overseas locations – with India in the lead and Eastern Europe and China increasing in importance.

IT and BPO Spend

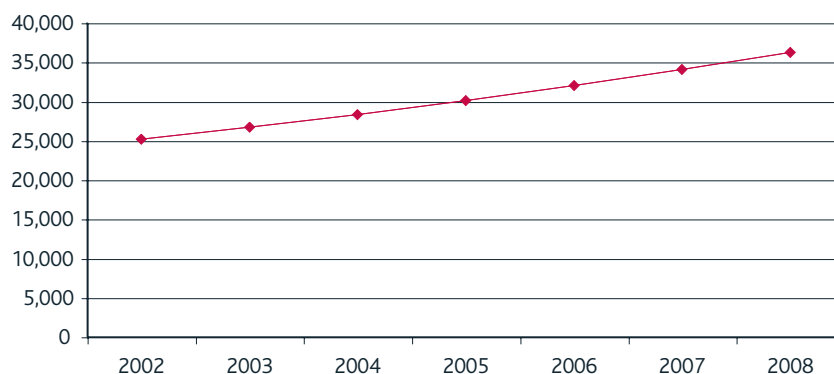


Table 1 – Source: Datamonitor IT Services Contracts Database

This Guide is a brief introduction to the subject. It looks at outsourcing in the round, picking out some of the areas that are of particular interest to a company considering outsourcing for the first time or planning to re-procure an outsourced service.

The Guide assumes that the reader will be interested in a discussion of the commercial aspects of outsourcing rather than the legal and technical detail of an outsourcing contract and, while it inevitably considers some contractual matters, it does not purport to give legal advice or to deal with 'technical' issues such as intellectual property, liability or detailed service levels. As it is occasionally rather opinionated it should also be pointed out that the views expressed are those of the group within Pinsent Masons that were responsible for the guide's production and are not to be attributed to Pinsent Masons generally.

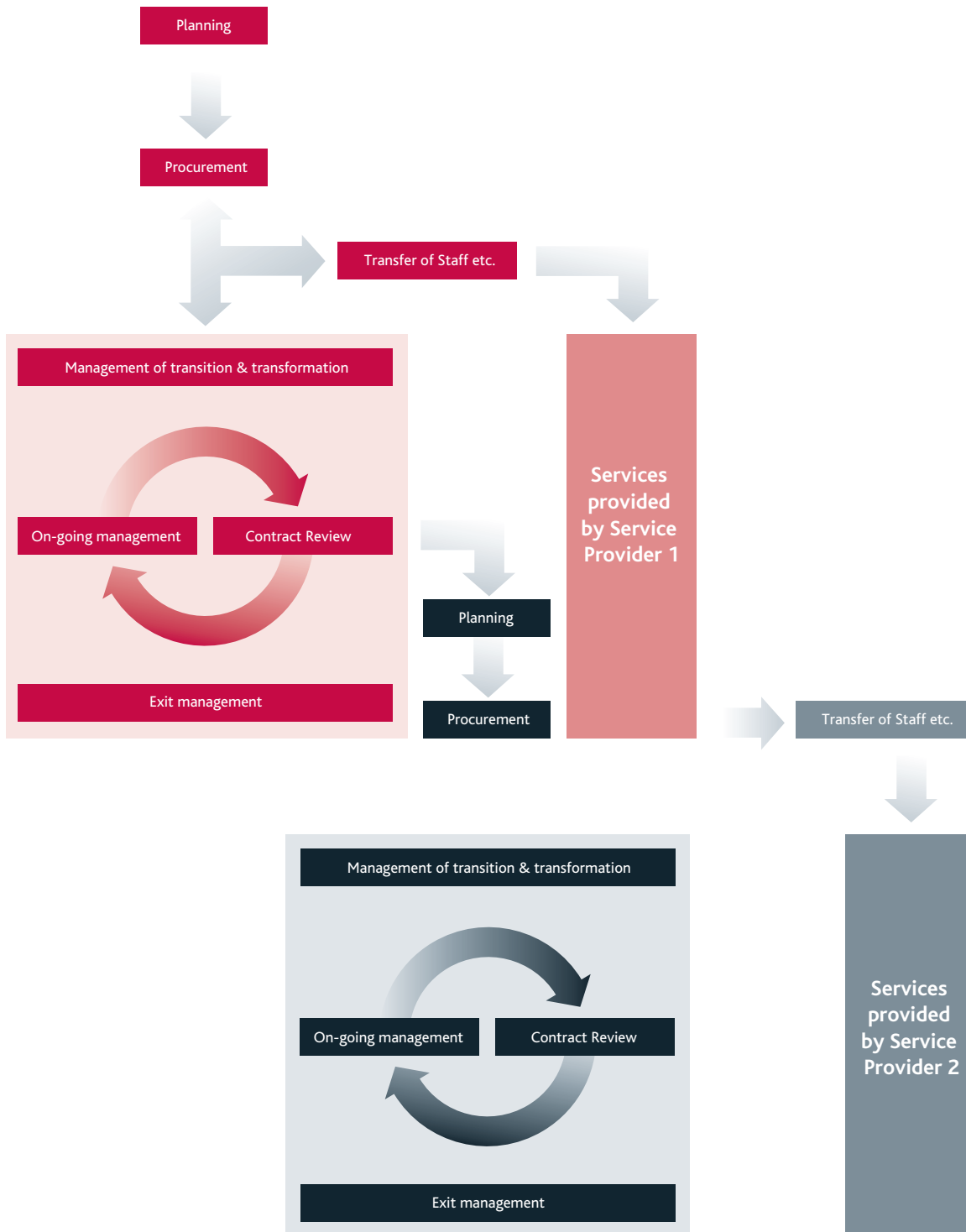
What is outsourcing?

Outsourcing occurs when a customer organisation transfers the ownership and operation of a business process previously performed in-house to a service provider in return for the service provider supplying services back to the customer on agreed terms. The transfer of the business process to the service provider normally involves the transfer of some or all of the staff, assets and contracts used to run that business process from the customer to the service provider.

When a business process is first outsourced by a customer we refer to the transaction as a first generation outsourcing. When the contract for a first generation outsourcing comes to an end, the services, staff, assets and contracts may transfer back to the customer but more commonly the customer will re-engage the original service provider or appoint another service provider in its place. Such a transaction is called a second generation outsourcing (and subsequent outsourcings are referred to as third, fourth, etc. generation). Where an outsourcing contract is replaced by a next-generation outsourcing contract, staff, assets and contracts often transfer from the out-going service provider to the in-coming service provider. This potential for a recurring transfer of ownership is one of the features that differentiates outsourcing from other service arrangements and relationships.

While outsourcing began with IT (a term we use to cover all forms of information technology, communications and networks), it has expanded inexorably into other areas such as HR, finance, and procurement. Outsourcing in many of these areas (business process outsourcing or BPO) is now growing at a faster rate, although from a smaller base, than IT outsourcing. In addition, facilities management, which has its own independent origins, has many features in common with outsourcing and transactions described as 'property outsourcing' combine elements of facilities management with elements drawn from more generic business process outsourcing. (See What is outsourced?, another section of this Guide.)

First generation	Customer	Service provider
Second generation	Customer	Service provider

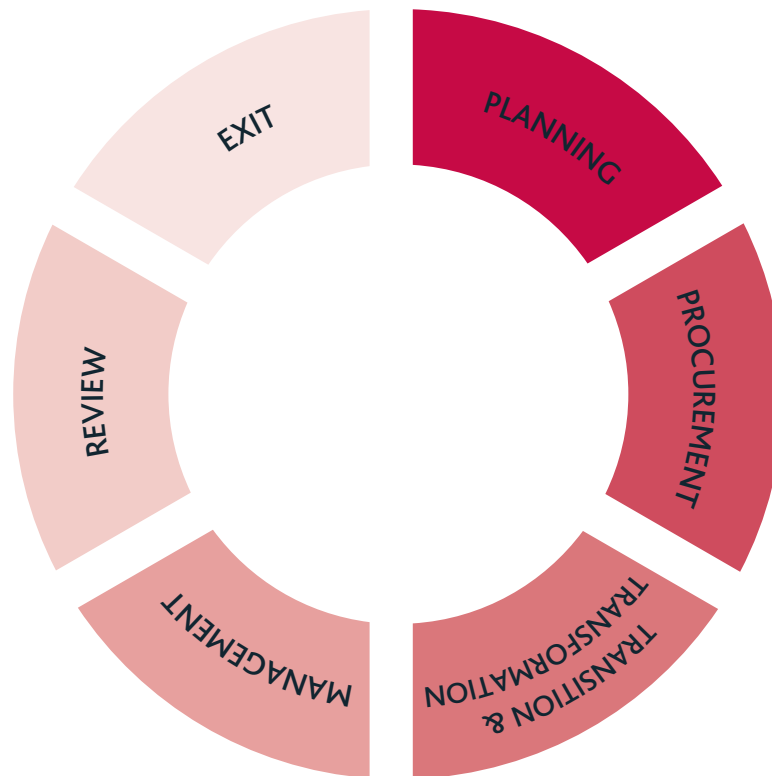


Process

The diagram on the previous page shows the outsourcing process across two generations. There are two points particularly to note:

- the overlap between the two generations - at some point in any outsourcing, the customer has to start planning and procuring its replacement
- the transfer of staff, assets and contracts - a customer task in a first generation outsourcing but a service provider task in second and subsequent generations

The diagram divides the customer's activities into a number of stages (planning, procurement, etc.) and in the remainder of this Guide we use a simplified form of diagram to refer to those stages:



We discuss each of the stages in detail in separate sections of this Guide but we also describe them briefly in the following glossary.

Glossary

There are no terms of art in outsourcing and expressions change their meaning over time. In this Guide terms are used in the following way:

Types of outsourcing

outsourcing occurs where a customer sources, from a third party, services that it previously provided in-house

business process outsourcing (or BPO) is the outsourcing of functions or business processes other than IT (whether or not those processes are computerised) – for example, the outsourcing of all of a business's HR functions is a business process outsourcing, even though one of those functions may be running a personnel database

facilities management involves the supply of management services relating to property (security, ground management and the like)

a second (third, fourth, etc.) generation outsourcing occurs when a customer who has previously entered into an outsourcing agreement renews that agreement with the same service provider or procures similar services from one or more alternative service providers

transformational outsourcing is an outsourcing transaction which requires, for its success, a degree of change in the customer's organisation and/or processes that is fairly described as transformational.

Stages of outsourcing

planning – the process by which a customer determines its requirements and the most appropriate means of satisfying them. The planning phase may include some preliminary market testing, a discussion of possible procurement approaches and contractual structures, and the preparation of a procurement pack.

procurement – the process of seeking bids and agreeing a contract. The procurement process may be straightforward or may go through several phases – for example, there may be a request for proposals, a downselection to a short list of potential service providers, an invitation to tender, and competitive negotiations before the preferred service provider is finally chosen.

transition – a period after cut-over when responsibility for the services has been transferred to the new service provider but it is not subject to the full contractual regime. Some contracts contain no transition period (for example, one would not expect one where a new contract was being granted to the same service provider) but most will allow a short period during which, for example, the service credit regime is slightly relaxed in order to give the new service provider some breathing space.

transformation – a period during which the service provider transforms the existing services into something different – for example, upgrading a network from frame relay to IP MPLS or from one hardware/software platform to another. To count as transformation (in our usage of the term) the transformation must amount to a substantial project in its own right. The fact that a service provider is obliged to make incremental increases in efficiency does not constitute transformation. Many (probably most) outsourcing contracts do not contain a requirement for transformation but when they do the success of the relationship will often depend on the success of the transformation process.

management – however large the scope of an outsourcing agreement, the customer is always left with a significant management burden: managing the relationship with the supplier. The contract will contain various management and review mechanisms – service reports, audits, benchmarking, governance reviews – and the customer will also wish to keep an eye on market developments that might affect the contract and, where possible, maintain relationships with other potential service providers. Management begins on cut-over and, where there is a significant transformation process, customers may retain a separate, or enhanced, management team to oversee the transformation process. Review and exit are functions of management but we treat them as separate stages because of their functional importance.

review – all contracts will be affected by change from time to time. However, it is increasingly common for large outsourcing contracts to undergo formal review, and often substantial renegotiation, at some point during the term. Review is an essential part of the management process but review that leads to renegotiation may be the result of dissatisfaction with the supplier's performance or a major change within the customer's organisation. Or it may be, less dramatically, that the market or the relationship between the parties has evolved in a manner not anticipated when the contract was drafted.

exit – the process under which responsibility for the services is handed over from the outgoing service provider to the new service provider (or back to the customer). Although the transfer will take place at cut-over, the outgoing service provider will normally be obliged to provide further assistance, if required, during the new service provider's transition period.

Some other useful terms

benchmarking – the evaluation of outsourced services, most commonly in relation to their value for money. Many outsourcing contracts contain a mechanism allowing the customer to benchmark the outsourced services on a regular basis and, where deficiencies are found, requiring the outcome of that exercise to be reflected in price and/or service improvements.

benefit sharing – is a term often used in outsourcing contracts to describe a mechanism for clawing back a proportion of any 'excess' profit made by the service provider above an agreed percentage or to describe an arrangement for rewarding the service provider for delivering business value to the customer.

break clause – a clause giving a party to an agreement the option to terminate the agreement before its expiry.

COTS (or commercial off the shelf) – a hardware or software product that is ready-made and available for purchase by the general public (usually under the supplier's standard terms of sale).

cut-over – is the day on which the employees, assets and contracts transfer to the service provider and the service provider starts delivering services to the customer.

downselect – selecting one or more potential service providers from a larger group of bidders through an evaluation and elimination process.

exit management – the tasks and activities to be carried out by the service provider on expiry, or early termination, of the outsourcing agreement to enable the service to be taken back in-house or to be transferred to an alternative service provider.

governance – a term often used in outsourcing contracts to refer to the process of contract management, often defining the mechanisms to be used by customer and service provider in relation to decision-making, reporting and reviewing. Governance may also include issue escalation and dispute resolution procedures.

liquidated damages – fixed or determined sums that are payable by the service provider in certain circumstances on the basis of a prior calculation of the loss that might be suffered by the customer in those circumstances.

multi-sourcing – a term used to refer to the sourcing of the individual customer requirements from different service providers – for example, some large, some smaller niche providers and some off-shore. The customer may retain the role of overall management of the various service providers or appoint one of the service providers as service integrator.

off-shoring – describes the process of sourcing services from another country, from which were spawned the terms "nearshoring", indicating that the country is nearby (for example Canada is a common "nearshore" location for a US customer) and "onshore/offshore", indicating that the service is delivered using a mixture of onshore resources (in the same country as the customer) and offshore resources.

partnering – an arrangement under which the customer and service provider share a commitment to the success of their relationship, sometimes including provisions which link the service provider's remuneration to the achievement of the customer's broader business goals.

service credits – reductions in the service charges that are triggered by the service provider's failure to achieve specified levels of service.

service levels – levels of service that are defined within the agreement, usually limited to the most important parts of the services, that are capable of objective measurement.

single sourcing – occurs when a customer sources services from a single provider.

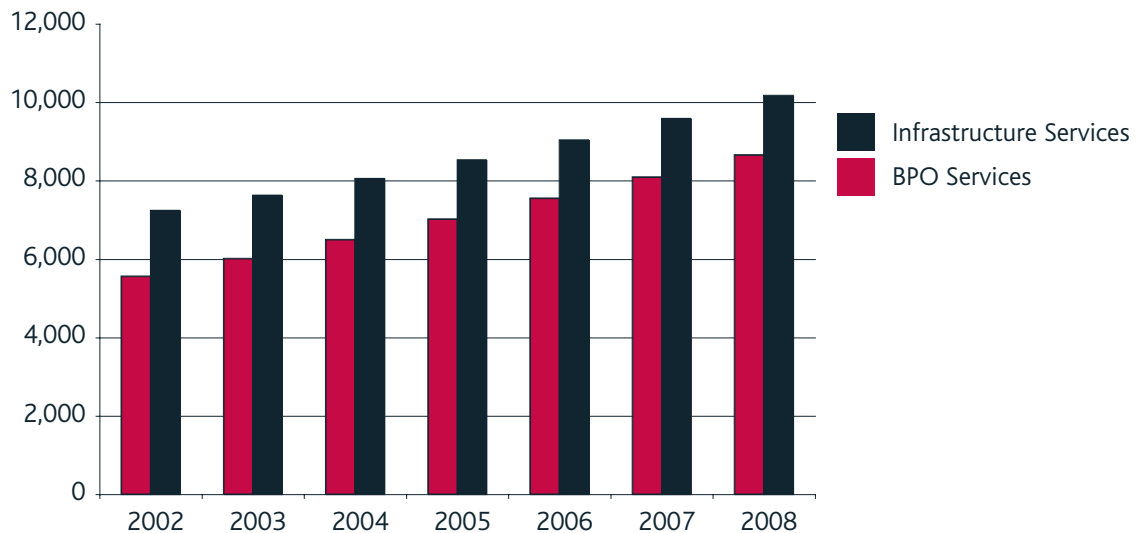
G02 What is outsourced?

G02

This is section G02 of A User's Guide to Outsourcing. It looks at the functions and processes that are commonly subject to outsourcing.

Outsourcing began with IT but in recent years some of the fastest growth in outsourcing has been in other areas of business.

IT and BPO Expenditure



Source: Datamonitor Knowledge Center

The diagram on page GO2-3 indicates some of the services that are outsourced by companies. It does not cover all the services that companies buy from suppliers but concentrates on those areas where companies have, in recent years, moved from an in-house capacity to an outsourced capacity.

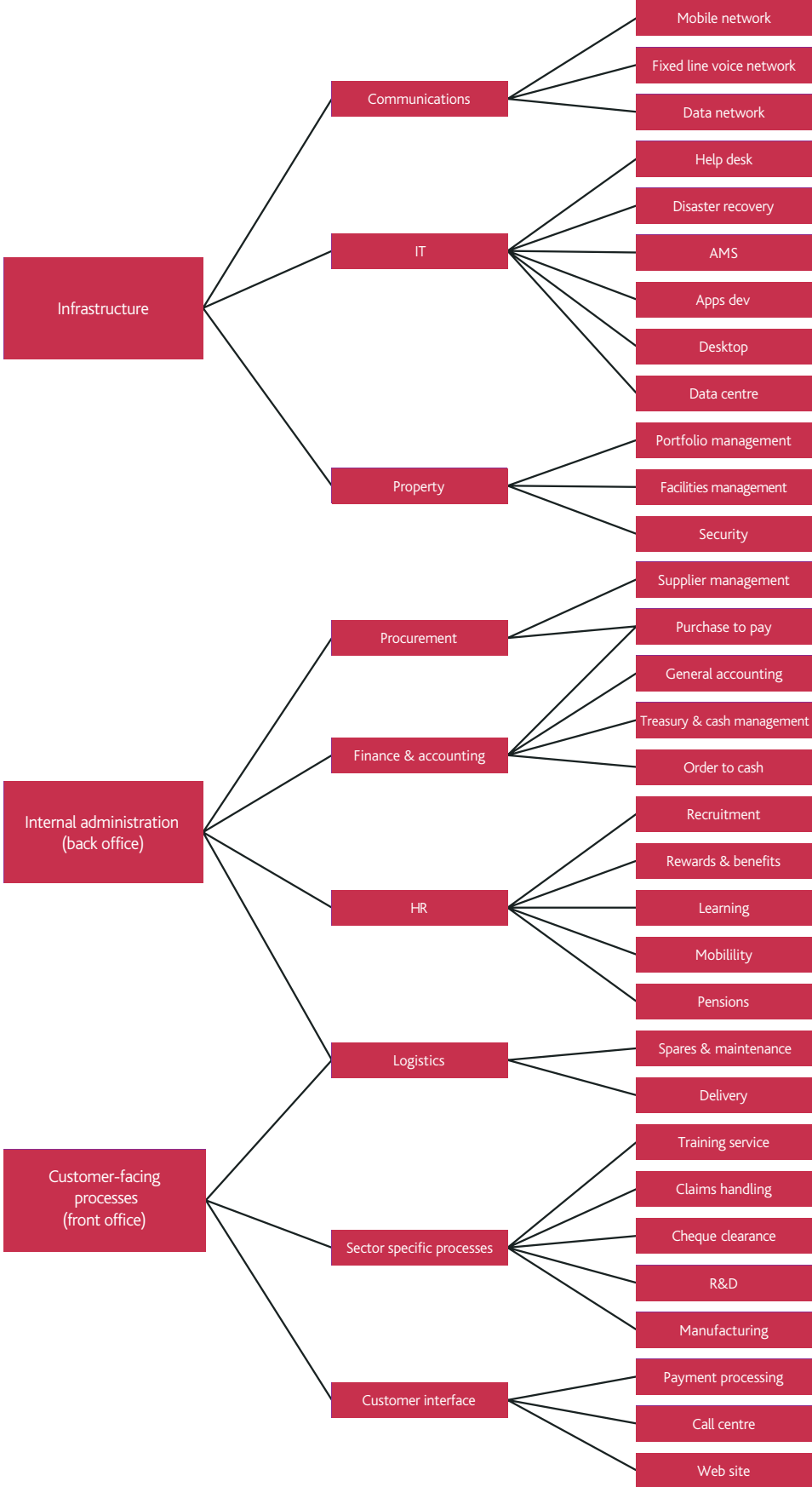
The diagram distinguishes three main business areas: infrastructure, internal administration (back office) and customer-facing processes (front office).

By infrastructure we mean premises, IT and communications. Outsourcing of infrastructure is well established and we have given some examples of the packages in which infrastructure services are often supplied.

By internal administration we mean the back-office processes and support services that support a company's business: procurement, finance & accounting, HR and logistics. (Logistics also falls into the next category.) Outsourcing of internal administration is an established feature of the outsourcing market - although less widespread than outsourcing of infrastructure. Discussion of business process outsourcing, or BPO, often centres on the outsourcing of internal administration.

Finally, there are those customer-facing processes that distinguish one company's business from another's. Most of these are sector-specific and the processes we show in the diagram are simply examples – the sector-specific processes outsourced by a bank will be very different from those outsourced by a manufacturing company.

The stages of outsourcing that we discuss in other sections of the Guide apply equally to all three business areas. The main differences between areas lie in the descriptions of the services that are outsourced, the service levels that are applied to those services, and the extent to which the market has begun to impose standardised solutions. Pinsent Masons has experience of transactions that fall within each of the boxes shown in the diagram.



G03 Stages of outsourcing: Planning

G03

This is section G03 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the first of those stages: Planning*



Planning

Of all the stages in the outsourcing lifecycle, planning has strong claims to be the most important – so we make no apology for this section of the guide being one of the longest.

Determining objectives

Customers who have a clear idea of their strategic and tactical objectives in approaching an outsourcing have a better chance of ensuring that the outsourcing meets those objectives. They have the ability to communicate those objectives to the service provider and to use them as the contractual basis of their relationship. They can also use the objectives as a management tool to ensure that both parties to the relationship stay on track.

While the objectives of outsourcing will vary from business to business, the most frequently cited include the following:

- an increase in the customer's ability to focus on strategic issues and the delivery of value added services to its clients
- an increase in the customer's flexibility to plan workloads and to focus management efforts
- the possibility of business re-organisation – whether in the form of decentralisation, downsizing or simply better resource control
- a reduction in the number of competencies which the customer has to sustain
- increased cost control – in the form of greater costs predictability and the conversion of overheads and other previously fixed costs into variable costs
- cost reduction through efficiencies and economies of scale on the part of the service provider

Non-financial objectives are often stated to be as important as financial objectives in the decision to outsource (although our experience suggests that financial objectives often assume a higher profile as negotiations proceed).



Assessing risks

Objectives are not always met (for example, a survey by Templeton College Oxford reported that half of 63 United Kingdom and 38 United States outsourcing deals considered by the survey team had failed to produce significant cost savings) and consideration of outsourcing should also include consideration of the risks and the alternatives.

As each customer has its own collection of objectives, so each customer will have its own collection of risks, but in our experience these are common problem areas:

- failure to obtain commitment to the customer's vision or culture from the service provider
- the distraction of having to manage the relationship with the service provider – an organisation with its own goals and a different culture
- a perceived loss of control and a feeling of over-dependence on service providers – which can be particularly acute where there is a single, large service provider and few retained staff
- a feeling on the part of retained management staff that they have less influence on the development of strategy and policy and on the part of retained technical staff that they have become less skilled in their specialist field
- unanticipated expenditure – services that were assumed to be included in the service provider's package appear as extras in its invoices and/or promised cost savings turn out to be dependent on a high level of capital investment in new projects on the part of the customer



Considering alternatives

A consideration of objectives and of risks should also include consideration of alternatives to outsourcing. Some customer organisations give existing in-house departments the opportunity to put forward a competing bid and others conclude that the benefits available from outsourcing could be obtained more economically by changes in internal processes, such as increased standardisation. Even when it is decided that outsourcing is an essential component of the solution, there may be steps that the customer could take prior to approaching the market that would put it in a better negotiating position. For example, if standardisation is implemented prior to outsourcing, the services for which bids are sought are more likely to be priced on a commodity basis.

Testing the market

Having determined the objectives sought from an outsourcing, it is prudent to test whether those objectives are achievable in the marketplace. To do this, customers may use advisers to tell them what is available or approach the market directly – or a combination of the two. A direct approach gives the customer an opportunity to test assumptions and refine objectives.

Market feedback is particularly important in view of customers' increased willingness to consider 'off-the-shelf' solutions (sometimes called COTS (or commercial off the shelf) solutions). In contrast with the attitude prevalent a few years ago, when the service provider was commissioned to automate the customers' existing internal processes, customers are now more likely to consider amending their internal processes to match a solution that is available in the market.



Planning internal change

This introduces another key theme in planning for outsourcing: outsourcing always requires a degree of process change on the part of the customer. The degree of change can be modest or very significant. For example, where a group whose members have each run their own bespoke HR processes decides that all HR will be sourced from a single service provider, each company will have to amend its processes to conform to those of the service provider. Outsourcing transactions that involve this degree of change are often referred to as transformational and one of the key lessons of transformational outsourcings is that internal change within the customer requires as much, or more, planning and effort as negotiation with the service provider. Several studies of projects in the public and private sectors have shown the danger of trying to implement an ambitious new IT system when the users who are to operate that system are not organised in the way that was assumed by its designers. A key element in any planning is an assessment of the degree of change required and the resources required to manage that change.

Understanding the starting point

At the risk of stating the obvious, any customer wishing to outsource an internal function needs to understand that function. At the least, this means having a clear idea of the extent and capabilities of the internal function, the services that it supplies, the standards to which those services are supplied, the resources (people, assets, contracts) it uses to produce the service and its running costs. Assembling this information can often be one of the most difficult tasks in an outsourcing project, particularly where the internal function is widely distributed across the customer organisation. (In a second-generation outsourcing there is a similar problem as regards information about the incumbent service provider's establishment). It is therefore important that the customer focuses on these issues during the planning period.

In assessing its starting position it is particularly important for the customer to take a view as to the optimum treatment of employees, assets and third party contracts.



Employees

Introduction

Considerable fears exist that outsourcing arrangements mean job losses for in-house personnel. Within Europe, however, it is usually the case that the transfer of responsibility for providing services will transfer all in-house personnel to the service provider by operation of law together with all attendant liabilities. Depending on whether the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) apply, the staff in question may become service provider staff, and the incoming service provider inherits a workforce and historical liabilities. The employment aspects of any outsourcing transaction therefore require very careful attention. This is an area of law which can cause much confusion and there are many pitfalls for the unwary.

Does TUPE apply?

The uncertainties surrounding whether TUPE applies to an outsourcing have largely been swept away by the introduction of specific provisions within TUPE which expressly bring service provision changes within scope. Some uncertainty remains about the application of TUPE to offshoring and it is worth bearing in mind, in respect of transactions which involve other EEA countries, that the scope of local laws in relation to service provision changes will not be as wide as in the UK.

Implications of a TUPE transfer

If TUPE applies to an outsourcing:

- those employees working immediately before the transfer in the provision of the services will become employees of the incoming service provider
- the terms and conditions of employment for those employees will transfer to the service provider, save in respect of certain aspects of membership of an occupational pension scheme
- liabilities relating to the transferring employees will transfer to the service provider
- dismissals connected with the transfer will be automatically unfair unless they have been made for an economic, technical or organisational reason
- collective agreements and trade union recognition in respect of the transferring employees will transfer to the service provider



- an obligation arises to inform employee representatives about the transfer and, in certain circumstances, to consult with them
- the customer has obligations to the incoming service provider in respect of the delivery of information concerning the transferring employees

By contrast, if TUPE does not apply, the employees previously engaged in the provision of the services will remain employees of the customer. They will either be redeployed or made redundant.

Some key issues to be considered in the context of whether TUPE applies include the following:

- will the service provider be able to perform the services – in the context of an IT outsourcing perhaps in a more innovative way, possibly with a much higher level of technology – with the continued involvement of the existing workforce?
- will the service provider be able to provide the services at the agreed price within the constraints of the existing terms and conditions of the transferring workforce (because TUPE does not permit a change to those terms and conditions in connection with the transfer)?
- if personnel who are to transfer are in possession of valuable know-how or confidential information, to what extent will the customer be protected after the transfer?

While TUPE issues tend to occupy the foreground in outsourcing, other employment issues normally arise: usually relating to specific employee warranties and indemnities; pricing and funding issues.



Pensions

Pensions are often a significant issue on outsourcing projects. The issues will differ, depending on whether the employees are employed in the public or the private sector before transfer.

Public Sector

If the employees are transferring from the public sector, the service provider will be required to provide them with a high level of pension protection following the transfer. This usually means that the service provider must offer the employees membership of a pension scheme which is, in the opinion of the Government Actuary's Department, broadly comparable to their pre-transfer, public sector pension scheme. As this is a substantially higher level of pension provision than is standard in the private sector, there will inevitably be a considerable amount of negotiation between the contracting parties over the cost of providing these pension benefits.

The service provider will also be required to allow the employees to transfer the pension benefits that they have earned prior to transfer into the service provider's scheme. This ensures that the employees' pre-transfer benefits remain linked to salary after transfer. The public sector outsourcer will try to set the basis on which this transfer is to be calculated, and this is usually the subject of fairly intense negotiation between the parties as the service provider may consider the transfer value to be insufficient.

Special provisions on local government transfers

On transfers from local government, the service provider will be able to participate in the Local Government Pension Scheme, as an alternative to setting up a broadly comparable pension scheme as described above. This is generally the preferred route for both outsourcing authority and service provider, although the service provider will want to impose a number of limits on its liability where doing this.

Private Sector

The requirements that apply on employee transfers in the private sector are less onerous than those in the public sector.

Where TUPE applies to the transfer, the service provider must offer the transferring employees one of the following:

- membership of a final salary pension scheme providing a minimum level of benefits; or



- membership of a defined contribution or stakeholder scheme where the service provider matches the employees' contributions up to 6% of salary.

Unsurprisingly, most service providers will usually choose the latter, rather than the former.

However, whilst these are the strict legal requirements, some outsourcing employers will require a service provider to provide a higher level of pension provision, especially where the employees are in a final salary scheme before transfer. This will be a matter for negotiation between the parties.

Due diligence

Whether the transfer is from the private sector or the public sector, it is vitally important that a prospective service provider carries out a thorough review of the pension arrangements of the transferring employees.

Arguably, due diligence is more important on a private sector transfer, as the service provider is unlikely to be replicating the employees' pre-transfer benefits. In particular, if the employees are members of a final salary scheme before transfer, they may have a right to certain benefits on early retirement or redundancy. There is a risk that the right to these benefits may transfer to the service provider under TUPE, which may be an issue if the service provider intends to provide the minimum level of pension benefit for the employees after transfer. This could potentially lead to a significant cost for the service provider, and indemnity protection may be sought.

The importance of properly considering the HR implications of an outsourcing for those employees who are to transfer to the service provider should not be underestimated. In one recent outsourcing, there were last minute complications when the service provider confirmed that it was unable to offer the same levels of permanent health insurance for an affected employee who, prior to the transfer, had been on long term sick leave. Happily the matter was resolved but only after a month's delay to the scheduled outsourcing programme.



Assets and property

It is likely that an outsourcing will result in the customer having no further use for equipment and property that has been used to provide the in-house services. The customer may therefore seek to transfer assets and property to the service provider on the basis of market or book value – or at a nominal value or premium. Not all outsourcings include the transfer of equipment and property– it may be retained by the customer on terms that it may be used by the service provider (with or without payment). This is an area that requires careful consideration. As costs incurred by the service provider will often be reflected in increased service charges, it is in both parties' interest that the incidence of property-related taxation (primarily VAT and SDLT) is avoided or mitigated when property interests are granted. On the other hand, security of supply of services may well depend on secure occupation of the premises from which those services are to be supplied, so both parties will wish to ensure that the final property arrangement is secure from attack by landlords or other interested parties.

Third party contracts

As with equipment and property, the customer is likely to have had a number of contracts with third parties that will be surplus to its requirements once the services are provided by the service provider. Taking IT outsourcing arrangements as an example, there are likely to be some or all of the following: software licences, hardware and software maintenance and support agreements, equipment leasing agreements and agreements with network providers. Most of these third party contracts are likely to be incapable of assignment without consent and even providing full details to potential service providers may involve a breach of confidentiality provisions. It is therefore necessary to plan a strategy for dealing with third party contracts very early in the process.

Third party software licences can be especially problematic. In the case of hardware agreements, the parties normally have the option of leaving the contract with the customer and requiring the service provider to manage its terms. In the case of licences, not only will the licence often be unassignable without the consent of the licensor, but the terms of the licence will usually be subject to an express obligation of confidentiality, and the use of the underlying software may be restricted to the customer. If this is the case, leaving the licence with the customer is not a long-term option (because use by the service provider will cause a breach) so the customer therefore has little choice but to notify the licensor of its wish to assign. This is often



a prelude to negotiations in which the licensor will seek payment of a fee for the granting of its consent and any necessary amendments to the licence. The main commercial issue - which must be dealt with in the contract – is who will bear this cost of obtaining the licensor's consent.

Where the customer is retaining elements of its IT delivery, or other third party suppliers may continue to supply IT services directly to the customer once the outsourcing contract is let, care needs to be taken to determine whether the range of services under each third party contract is fully within the scope of the outsourced services. If not, decisions will need to be taken as to whether the contracts should be retained by the customer, renegotiated or appropriate rights of use negotiated with the outsourcing service provider. Reviewing third party contracts (and indeed locating full copies of third party contracts!) and negotiating with the relevant third party suppliers to secure the required rights is a time consuming exercise and must be started early. Regrettably we have seen clients start the third party contracts process late which created unnecessary pressure on the outsourcing timetable and ultimately lead to the client accepting additional risk.

The form of procurement

The customer should also consider what type of service provider is best placed to meet its objectives. As well as considering questions of capability, cultural fit etc, would its objectives best be met by using a single provider or seeking multiple providers for specialist services (multi-sourcing). Should it require multiple providers to form a joint venture or consortium or retain the integration function itself? Is there any benefit to the customer in itself entering into a joint venture with a service provider – for example, because it will minimise VAT exposure or create the opportunity to service other third parties?

Where the customer is a public body bound by the EU procurement regulations, it will have to determine what form of procurement procedure is appropriate: open, restricted, competitive dialogue or negotiated.



Planning the procurement

We have already indicated that gathering information, determining policies and managing the transition of employees, assets and third party contracts are time-consuming tasks. As will be seen from the next section, the procurement phase also contains tasks, such as service definition and contract negotiation, that impose a heavy workload on the procurement team and are often difficult to reconcile with business-as-usual. One of the important planning tasks, therefore, is to consider the way in which the procurement will be managed, determine the balance of internal and external resources and set a budget and project plan.

G04 Stages of outsourcing: Procurement

This is section G04 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the second of those stages: Procurement*

G04



Introduction

Equipped with the information gathered in the planning phase, the next step is for the customer to procure the desired services in the market.

Negotiations may be commenced with a single, preferred supplier (particularly on a renewal) but the more common practice is to issue a form of invitation to tender to a group of potential service providers.

Some customer organisations include the internal function itself in the invitation; others prepare an internal bid for purposes of comparison (but using a separate bid team for its preparation); others rely on the market alone.

As will be obvious from earlier sections, given the potential pitfalls involved in any outsourcing, there is a clear need for the terms of the relationship between the parties to be as well defined as possible. While flexibility is important, no relationship will be successful without each party having a clear understanding of what is expected of it. Within the various strands that make up the usual procurement process our experience suggests that three factors are particularly critical to achieving a successful outcome in the outsourcing context:

- keeping the potential for misunderstanding (and change requests) to a minimum by providing as much information as possible at an early stage and establishing the service providers' responsibility for verifying that information
- ensuring all the technical and commercial strands remain closely interwoven, so that it is clear at all times what is in scope and therefore covered by the quoted price



- establishing the service providers' position on all the key commercial areas before the preferred bidder is selected – preferably by ensuring that draft terms covering these areas are set out clearly in the invitation to tender and that discussions on them are concluded before selection

In the remainder of this procurement section we concentrate on three of the key commercial areas that are likely to be discussed in any outsourcing: service definition, service levels and charges. (Other areas are discussed in other sections: the transfer of employees, assets and contracts in the planning section; management in the management section; benchmarking, term and termination in the review section; and exit in the exit section.)

Service definition

One of the risks that we mentioned in GO3 – Planning was unexpected charges. As the service provider will calculate its price based on its internal understanding of the scope of its obligations, the protection against unexpected charges is a clear mutual understanding of the services that are included in, or excluded from, scope. This is achieved through service definition.

There are different approaches to service definition. What might be called the inclusive approach seeks to describe all services (and all service-related customer obligations) in detail so that neither side can be in any doubt as to what is required of it. By contrast, what might be called the exclusive approach describes the service providers' obligations at a higher level of generality, using detail only to describe those elements that would have been caught within the general description had it not been agreed that they were out of scope.

The inclusive approach



The exclusive approach





Both approaches have their advantages and disadvantages. If the inclusive approach results in an exhaustive list of obligations it gives a greater degree of certainty. However, in practice obtaining the necessary level of detail can prove difficult and a non-exhaustive list is less than helpful. The exclusive approach gives a better indication of spheres of responsibility but because it is drafted in more general terms it allows greater room for subsequent arguments about what is and is not 'in scope'. It is therefore not unusual to find hybrid service definitions which attempt to blend the inclusive and exclusive approaches.

The importance of the service definition should not be underestimated – it sets out the nature and scope of the services that the customer will receive from the service provider and is the touchstone to which other important terms, such as the service level standards and the pricing regime, will refer. If the customer has not previously had to describe its internal services in any detail, preparing a detailed definition of the services will often be a complex and time consuming task.

For this reason, many customers will try to pass the responsibility for service definition onto the service provider. This rarely (if ever) achieves a satisfactory result for either party. Any service definition that is produced by the service provider will be written to suit its own interests rather than those of the customer....and the customer often ends up having to spend more time and effort in reviewing and amending the service definition than it would have done had it taken the responsibility in the first place and written the service definition to meet its own requirements.

Distinguishing those services which are to be delivered by the service provider from those activities which are to remain the responsibility of the customer (or a third party supplier) is essential to defining the boundaries of responsibility in the event of service problems. The ideal from the customers' point of view is that one person – the service provider or, if more than one, the key service provider – should have end-to-end responsibility for ensuring that all the services are delivered in the agreed manner. However it is rare for the service provider not to be reliant, at least in part, on performance of certain tasks by the customer – for example, the provision of information or the conduct of tests – so if the service provider is to undertake end-to-end responsibility there needs to be a mechanism for granting some measure of relief if the customer fails to deliver.



The participation of third party suppliers raises similar issues. Where the service provider introduces new third parties as its subcontractors then it will normally accept that it retains full responsibility for their actions. But the position is less straightforward when the service provider is asked to take over existing contracts between the customer and third parties or to interface with third parties who are providing complementary services. Uncertainty can be reduced by transferring the responsibility for managing relevant third party suppliers to the service provider – either by requiring the service provider to assume the role of prime contractor or by appointing the service provider as the customers' managing agent (leaving the underlying contractual relationship between the customer and the third party supplier). Either arrangement transfers the responsibility for identifying and resolving problems to the service provider and lessens the risk of service attrition during any dispute period.

Managing and reporting service performance

All customers require a service that is reliable and that consistently meets pre-agreed standards. But at the same time services should not be static. In most outsourcing deals, the customer will expect two contrary movements to occur simultaneously: the quality of services delivered by the service provider to improve and the charges payable for those services to decrease. The challenge is to devise a mechanism which adequately specifies and measures current performance while allowing for that performance to improve over time.

Service levels exist to give the parties a means of measuring performance. Ultimately, the performance that matters to the customer is the performance of its business so the closer the correlation between the service provider's measured service performance and the impact of that performance upon the customers' business, the more useful the measurement. However, there is a balance to be struck between the closeness of the correlation and the cost of implementing the system required to measure that correlation. Certain service levels will probably be measured by the service provider for its own management purposes and they can be provided to the customer without additional cost. Others - particularly those that are business-centric – may require a complex new measurement algorithm to be put into place. Such an algorithm is unlikely to be developed without additional charges.



In our experience, customers are increasingly adopting service levels or performance indicators which measure performance from the end-user's perspective. For example, availability of the network (based on weekly or monthly measurement) is of more use to the customer than assurance that individual elements of the network are functioning in accordance with certain technical measures. Many contracts also now include "customer satisfaction" as a measure driving payment or the award of bonuses. On one global outsourcing where we advised the customer, the service provider agreed that its quarterly charges would be reduced by an agreed percentage if customer satisfaction surveys indicated low end-user satisfaction with the service. Ultimately, after escalation, the service provider risked losing the right to manage its own services if the situation did not improve.

Speed of response is another factor to be taken into account. One of the benefits of measuring and reporting service performance is to allow preventive or remedial action to be taken if the reports indicate an adverse trend. If the calculation is too complex, the root cause of the adverse trends may be hidden from view and by the time it is discovered, the opportunity to take early preventive action may have passed.

Setting service levels is therefore a difficult balancing act. It is not made any easier by the fact that a failure to achieve service levels normally leads to an adverse financial consequence for the service provider in the form of service credits (a proportionate reduction in the fee that would otherwise have been paid for the defective service) or, in the case of more severe failure, damages linked to the loss which the customer suffers (or could potentially have suffered) by reason of the failure.

Our experience shows that with a tight timetable for completion of the outsourcing contract, and where information relevant to the setting of service levels is not readily available, it might not be possible for all the required information to be assessed prior to contract signature. If that is the case, the parties may agree that some or all of the service levels will be set during the transition period. From the customer's perspective this may appear to have advantages in that it allows the customer to take a fully informed view of its requirements. However, it is important to avoid leaving agreement of critical service issues until after contract signature: the customer's negotiating position will be weaker once the contract has been signed and the service provider will be fully occupied in implementing transition. Actions deferred until after contract signature are often subject to lengthy additional deferral in the post-contract period.



We have already suggested that the correlation between service performance and business impact is often complicated and in our view it is misleading to view service credits as compensation for business loss. Service credits are better considered as price adjustments: they are a reduction in the charges made because the service provider has failed to deliver what it agreed to deliver and, as such, they are normally calculated on a scale that increases the reduction by reference to the extent of the shortfall in delivery.

However, it is undeniable that certain service failures will cause a business impact. To take an ICT example, it may not be clear that a reduction in the percentage availability of a server has an impact on the user's productivity but if a call centre operator is unable to answer calls because the communications networks are down or the customer data is unavailable on the screen then there is no doubt that the business will be affected. If the outage continues for any length of time, or if similar outages occur over a period, then the customer will seek remedies that are proportionate to the loss it suffers.

Establishing a proportionate response to service failure requires a consideration of the options. A claim for damages is a possibility but damages take time and effort to establish and the customer is rarely keen to incur additional expense on top of the loss it has already incurred. Termination of the relationship in whole or in part (for example, by withdrawing an independent element of the service) may be appropriate if the failure is particularly severe, or is repeated, but it is a remedy that can only be exercised once and it plunges the customer into a new (and expensive) procurement process. Liquidated damages – fixed sums that are payable in certain circumstances on the basis of a prior calculation of the loss that might be suffered in those circumstance – have the advantage of certainty and simplicity but cannot cater for every eventuality. Which mixture of these remedies best suits the transaction in question is a subject of lengthy discussion in most outsourcing projects.

One of our clients had concerns over the service provider's ability to provide support relating to a business critical element of the services. As it did not have any concerns over the rest of service delivery it exercised its right to terminate the contract in respect of the support element of the services. This involved a variation to the charges to reflect the scope and process of exit management to ensure that knowledge, data, licences, documentation and other relevant information were transferred back to the client to enable the support function to be run internally again.



At this point the reader may feel that the discussion has taken a negative turn and ask why the parties concentrate on punishing failure rather than rewarding success. The answer is that parties do try to find 'win:win' solutions and that they are dealt with in the next paragraph.

Charges and benefit sharing

Charging is too complex a subject for a guide of this nature. There are many different formulae applied to the pricing of outsourcing contracts. Some use a fixed price basis – normally where the scope and likely volume of the service is well-defined at the outset. A few are proposed to be on a time and materials basis (with the customer paying only for the resources it consumes). The recent trend in favour of utility pricing applies the time and materials concept to the consumption of defined types of resource.

Benefit sharing is a term often used in outsourcing contracts. In some contexts it describes a mechanism for measuring the profit which the service provider derives from the contract and clawing back a proportion of any 'excess' profit above an agreed percentage. In others it describes a more positive arrangement for rewarding the service provider for delivering real business value to the customer. Such an arrangement, if properly structured, can encourage the service provider to approach the relationship as a business partner and to accept that part of its remuneration should be dependent upon the achievement of certain pre-agreed targets. These targets may refer to service-related outcomes, such as innovation in the introduction of new services, or to outcomes which are only consequentially affected by the way in which the services are provided – for example, the achievement of internal profitability targets by the supported customer business. The essential requirements are that the targets are relevant to the customers' success and that achievement of the targets can be measured in a meaningful way. This can be done through a variety of financial and legal structures in which the risk and reward mentioned above, can be shared by both parties. However, while Morgan Chambers' study of 250 FTSE Business Process and IT and Telecoms Outsourcings revealed an "increasing acceptance and implementation of the risk/reward principle", our experience indicates that acceptance of the principle is running in advance of meaningful implementation and that this is an area which requires careful consideration and negotiation if both parties are to achieve a fair result.



Some customers have negotiated satisfactory benefit sharing provisions with service providers. One of our clients in the construction industry put in place contractual benefit sharing options in its agreement with the service provider under which the service provider was incentivised to propose cost-saving IT projects which had a business benefit for the client (e.g. infrastructure standardisation measures). Once the client had an approved business case for the proposal, terms were agreed with the service provider for the measurement and sharing of the savings (if any) that arose initially set at a default rate of 50/50. Note that the customer's business case was approved in this instance. We have seen other examples where budgetary restraints prevented the customer from proceeding with the proposal, leading to a degree of dissatisfaction on the part of the service provider.

G05 Stages of outsourcing: Transition & Transformation

This is section G05 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the third of those stages: Transition & Transformation*

G05



Introduction

Once the procurement has concluded and the customer has signed a contract with the service provider, 'cut-over' takes place. Cut-over (also known as hand-over or the service commencement date) is the day on which the employees, assets and contracts transfer to the service provider and the service provider starts delivering services to the customer.

Transition

Where an existing outsourcing contract is being renewed with the same service provider or the services being outsourced are of a type, and to a standard, that is customarily offered in the market, there may be no need for any period of transition; the service provider may be able to take over the running of the services from cut-over without the need for any bedding-in period. In many cases, however, the customer is prepared to allow the service provider a short 'grace period' during which the service provider is not subject to the full rigour of the contract – for example, service credits may be charged at a lower rate while the service provider puts a new service infrastructure in place or while new services are introduced to replace third party contracts that have been terminated. We refer to any such period as transition.

Our reason for suggesting that transition is considered as a separate phase is to emphasise that it should be time-bound and should have a clear beginning and end. Outsourcing contracts require a number of important issues – technical, legal and commercial – to be resolved. It is only too common for the outsourcing contract to be signed, and cut-over to take place, with certain issues left unresolved and no plan in place for their resolution. The ideal is that all such issues should be resolved before signature: if that is not possible, a transition plan that includes a timetable for the resolution of outstanding issues (as well as any agreed grace period) has the advantage of keeping them in each party's contemplation – particularly if financial consequences result from delay in their resolution.



Transformation

Transformation is something different. As mentioned above, transformation takes place when one of the main objectives of the outsourcing is to make a fundamental change in the services that are provided to the customer or the way in which those services are provided. For example in an HR outsourcing, the contract may involve the service provider in managing existing personnel processes while at the same time developing and installing a new personnel system to which all existing personnel records will be migrated. Once migration has taken place, the service provider will provide personnel services using the new system.

Such a contract can best be considered by dividing it into two. One part of the contract is a services agreement under which the service provider provides personnel services, first using the old processes and then using the new system. There may be a change in service descriptions or service levels when the new system replaces the old, and there will probably be a reduction in the charges, but the emphasis of the services agreement will be on continuity – on the provision of a service that meets the customers' requirements, whatever the underlying technology. The second part of the contract is a project agreement for the design, installation, and commissioning of the new personnel system and the migration of existing records onto that system. If the new system will remain the property of the service provider and will require little or no input from the customer, then the project part of the contract may be largely silent: the customer will be sufficiently protected if the provisions of the service part of the contract guarantee consistent service levels and the integrity of migrated data. However, if the customer will inherit the new system on termination or if (as is often the case) delivery of the new system depends to a material extent upon successful completion of certain activities on the part of the customer – for example, specification of requirements, cleansing of existing data, training in new processes compatible with the new system –the project part of the contract assumes a higher profile. In these circumstances, the customer becomes interested in ensuring that the new system complies with its requirements after termination and the service provider points out that the savings it has promised in the services agreement are dependent on the customer performing its project-related activities promptly. Where the project element of the agreement assumes importance, the contract will have to deal with such matters as the timetable for development of the new system and migration of data; acceptance testing of the new system; and the effect of delay or failure by either party.

G06 Stages of outsourcing: Management

This is section G06 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the fourth of those stages: Management*



Introduction

Surveys suggest that roughly 70% of all outsourcing deals are re-negotiated within two years of the contract being signed. Common reasons given for renegotiation are:

- dissatisfaction with pricing
- business change and
- unsatisfactory service performance

Our own experience is that the success or failure of an outsourcing arrangement is often determined by:

- the quality of the customers' planning and preparation for the outsourcing
- the ability of the contract to handle change
- the customers' dedication to post-contract management

These two lists are not in conflict. For example, in our experience dissatisfaction with pricing often arises from a failure sufficiently to test assumptions during planning and procurement. Two common sources of complaint are disagreements over scope and volumes. As regards scope, a frequent complaint is not that Service 1 (for which a price was agreed in the contract) is costing more than expected but that the customer is being charged for Service 2, which it thought was included within the price for Service 1. As regards volumes, we have seen several situations in which (whether through a failure of forecasting or an over-optimistic timetable for transformation) the customer is still paying for an expensive legacy service at a time when the business plan anticipated that the legacy service would have been replaced by a newer, less expensive alternative. Sound planning and preparation are needed to ensure that service definitions are clear, volume assumptions are tested and pricing is inclusive.



The effect of business change is never easy to predict. The best manner of handling change will depend upon the particular circumstances of the contract. Many of the consequences of change may be able to be dealt with through flexible pricing structures (structures which anticipate the pricing effects of increased or decreased demand). In addition, the contract should contain provisions to handle common occurrences such as the acquisition by the customer of a new subsidiary or its disposal of an existing business. However, there will always be changes which fall outside those which the parties can anticipate at the date of signature. Outsourcing contracts must therefore contain detailed change control procedures, listing the steps that have to be taken in order to agree a change to the contract. A well drafted contract will distinguish between those changes which are a matter of day-to-day service management and those which have an impact on key elements of the relationship between the parties and will ensure that all change is subject to consultation and agreement, taking account, where appropriate, of the proposed change's effect on all aspects of the relationship including its impact on other parts of the services, the price and working arrangements.

Public sector clients will need to make special provision for machinery of government changes which cannot always be anticipated in advance. This is mirrored in the private sector by the need for provisions relating to divestiture and acquisition activity within the customer group. We have negotiated and seen in operation provisions which enable businesses which have been divested from the customer group to be transitioned out of the outsourcing service in an orderly way using the relevant provisions of an exit management plan to deal with the transfer of employees and assets. Provisions of this kind should be sufficiently flexible to allow for all of the following: continued outsourced service provision under the outsourcing agreement for a hand over period; a phased transition by way of an insourcing to the divested entity or its purchaser; or a transition of the services to an existing service provider of the purchasing company.

Deficient service performance is an inherent risk of outsourcing but contractual protections can be put in place. We have talked about the importance of clear and measurable service levels. In addition, any well drafted contract will set out a clear, and escalating, set of remedies for service deficiencies.

But, however well drafted the contract, there is no substitute for dedicated contract management. Pinsent Masons has been involved in rescuing many large IT contracts which have run into difficulty and on many occasions the problems which have given rise to the dispute have been aggravated by the failure of the parties to attend to



contract management issues. It is remarkable how often a customer who complains of the service provider's performance has not taken advantage of the contractual provisions that were inserted for the specific purpose of keeping performance on track or has allowed the parties' behaviour to depart so far from what was contemplated in the contract (without the changes being recorded through the agreed change control procedure) that it is difficult to assess exactly what terms currently govern the relationship between the parties.

The fundamental point is this: any outsourcing arrangement, irrespective of the nature of the activity being outsourced, requires dedicated and intensive management. Responsibility for managing the outsourcing arrangement for the benefit of the customer cannot be handed over to the service provider. If the customer has not retained sufficient resources to manage the contract itself it is better to outsource the management task to a third party than to allow it to fall into abeyance.

Resources pose a particular problem. Resources are key to effective management and in an outsourcing, a customer typically loses most, if not all, of the employees who were involved in delivering the in-house function to the incoming service provider. To run and manage an outsourcing contract effectively itself, a customer will need to retain (or hire) a core team of employees with sufficient skills and business (and technical) knowledge to monitor the service provider. It is common for an organisation which has outsourced to appoint a service manager or contract manager to manage the overall outsourcing. But is this sufficient? To manage an outsourcing a customer is required to deal with a range of matters including contract monitoring, building and developing a relationship with the service provider and (often the most difficult of all) managing the relationship with the internal business community. Depending on the size of the outsourcing, one contract manager (or one country manager) may not be able to perform all these activities. Many companies which have outsourced have unfortunately learned to their cost that they need to factor into their outsourcing budget sufficient management time and resources to monitor the on-going outsourcing relationship. Some customers have suggested that at least 5% of any outsourcing budget should be set aside for internal management costs.



The more strategically important the outsourcing, the more management engagement will be required from the customer. For example, the customer who insists that the service provider signs up to partnering principles owes it to the supplier and to itself to ensure that the supplier receives the information and executive involvement which are necessary to make partnering a reality. Both parties must ensure that appropriate levels of governance are set in place and that regular meetings are held at the operational, management and executive level so that issues and problems are identified early and dealt with promptly.

One final management-related point: often the parties spend weeks negotiating the contract only for the negotiating teams to depart as soon as the contract has been signed and to be replaced by a set of managers who have only the sketchiest knowledge of the contractual provisions and the purpose behind them. This is particularly a risk for the customer as, in those circumstances, the service provider's management will usually fall back on standard company procedures which are often at variance with the provisions agreed in the contract. It is therefore in the interests of the customer to ensure that there is continuity of management post-contract – if only for a transitional period.

G07 Stages of outsourcing: Review

This is section G07 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the fifth of those stages: Review*



Introduction

We describe management and review as separate stages only to emphasise two different aspects of the customer's contract management role. Reviewing the service provider's performance in the light of its contractual obligations, the customer's business changes and changes in the marketplace is an integral part of the customer's on-going contract management role. However, there are moments at which the customer stands back to consider these matters more formally – either because the contract provides for a formal review to take place from time to time or because performance or change issues force the customer to consider its options. It is this more formal review that we discuss in this section.

Continuous improvement and benchmarking

As we have seen, continuous improvement in service quality and pricing is usually a key customer requirement. But how is the required standard of improvement to be judged? In most outsourcing arrangements it is now common to include a right for the customer to benchmark the services provided against comparable services in the market – normally by commissioning an independent third party (a benchmarker) to compare the service provider's performance against industry norms.



Benchmarking is used in two different ways. Occasionally the parties build benchmarking into the fabric of the relationship, using the benchmarker to establish a starting position on day 1 and then regularly monitoring the evolution of performance against that starting position. This is arguably the ideal as it removes benchmarking from the contentious arena. More commonly, benchmarking is used on an occasional basis – often when the customer believes, but the service provider does not accept, that the service provider's performance is falling behind the norm.

Undertaking a benchmarking exercise, particularly on an occasional basis, can be costly and time consuming. Two areas cause particular difficulty: finding an appropriate basis of comparison and agreeing the treatment of the results. The problems associated with benchmarking often centre on the ability of the appointed benchmarker to conduct a benchmarking exercise that is genuinely comparative. For certain activities (for example, data centre management) there is a large bank of industry knowledge available to benchmarkers and it is not difficult to find operations which are similar in configuration and scale to any given customer's operations. The benchmarker therefore has an industry norm against which it can report. For other activities there may either be too few players in the market, or too great a variation in the services they provide, for any meaningful norm to be deduced. In those circumstances the benchmarker's conclusions are likely to contain a greater degree of subjectivity and therefore to be more open to challenge by the service provider.

Even where plentiful comparators are available, a benchmarking exercise rarely results in a simple recommendation. It usually lists 'opportunities for improvement' which the parties might consider, rather than stating, for example, that percentage availability should be increased by 0.02% or the price of installing a PC should be reduced by £5. The parties to an outsourcing therefore need to agree how benchmarking results are to be handled. Service providers will naturally be reluctant to accept a contractual obligation automatically to reduce their prices or to improve their services. Conversely customers will be unwilling to make the introduction of change dependent on the service provider's agreement. This is an area which needs careful handling.

Other subjects for debate are the identity of the benchmarker and what, and how often, individual services should be benchmarked.



Outsourcing deals with a relatively short duration (say 3 to 5 years) are often felt to be sufficiently "future proofed" to render complex benchmarking provisions unnecessary or overly expensive. However, in longer deals, value for money tests (which may include benchmarking) are considered essential for the customer. The following are some examples of different benchmarking features we have experienced in longer term outsourcing relationships:

- a "hard" benchmarking regime requiring the service provider to adjust its prices in line with specific recommendations made by a trusted third party benchmarking adviser. The regime included a dispute resolution mechanism specific to the benchmarking provisions which in certain circumstances allowed the service provider to challenge the recommendations and implement alternative adjustments where appropriate*
- a "softer" regime which provided for a shared benchmarking exercise to be undertaken (with costs and responsibility for appointing the benchmarker being shared) and the right for the customer to terminate services which are shown to be poor value for money and in respect of which the service provider has not offered improved terms within a defined timescale*
- terms allowing the customer to renegotiate the pricing provisions (including an obligation on the service provider to justify its price build in the light of market comparators) where value for money concerns arise*



Renegotiation

We have already mentioned a survey which suggested that roughly 70% of all outsourcing deals are re-negotiated within two years of the contract being signed. Re-negotiation may take place because of customer dissatisfaction with the service provider's performance, whether or not the source of dissatisfaction would entitle the customer to terminate the contract for breach. However, it can also be triggered by other factors such as a change in the profile of the customer (through acquisition or disposal), a change in the management priorities of the customer, the results of a benchmarking or broader changes in market conditions. Each of these developments might represent a departure from the fundamental premise upon which the original arrangement was based. We have already mentioned the importance of robust change control procedures. However, such procedures tend to function within the confines of the original arrangement. A change so significant that it creates the need for a fundamental re-assessment of the contract normally falls outside the ambit of change control. What protections against such a change can a customer secure?

The two most common protections are a break clause and a right of termination for convenience. Both have the advantage that they allow the customer to exit from a contract that no longer meets its needs. However, both come at a cost. A unilateral break clause (a clause allowing the customer to terminate on a particular date – normally an anniversary of contract commencement falling half or two-thirds of the way through the term) may not require the customer to pay compensation for exercise of the option to terminate but will often result in the service provider (at least initially) pricing the contract on the assumption that the option will be exercised: so a seven year contract with a break clause at the end of the fourth year will be priced as though it were a four year contract. Termination for convenience usually involves the customer paying compensation to the service provider in respect of unrecoverable investment and breakage costs but may involve other elements as well (for example, loss of profit). However, there are circumstances where the price is worth paying.

As we will discuss in the section on Exit, considering and agreeing in advance the consequences of termination allows the customer to assess its options with more confidence. While termination may not be the customer's preferred result – it may prefer to continue with the existing service provider on revised terms – it is helpful to negotiations if it is a realistic and affordable option. It will not be either if the consequences of termination are unclear. With this in mind, customers should be cautious about agreeing to any term which might restrict their ability to renegotiate. For example, some service providers include standard clauses in their terms and



conditions which entitle the service provider to extend the contract by serving a notice before the end of the existing term. This may sound innocuous – after a long and successful relationship it may in practice be inconvenient to move to a different service provider – but the customer should always have the ability to consider other options, even if only to provide some form of benchmarking exercise.

Re-negotiation should not be taken as a sign of an unsuccessful relationship. As mentioned above, even the most robust change control procedure is unlikely to be able to cope with fundamental changes in the customer's underlying business or strategic direction. We have known second and third-generation outsourcing contracts, entered into between the same parties each time (often before the existing contract has expired), but differing significantly from each other in their basic contractual terms. In some of these cases the existing service provider has had to re-bid against internal and external competition: in all of these cases, the service provider has had to show an ability to adapt to the customer's changing requirements. However, changes in the customer's requirements were not the only source of variation in the contractual terms. Equally as important was the development of the relationship between the customer and the service provider.

In cases where policy changes occur or where unforeseen developments arise the parties may wish to vary the terms of the deal, building on the existing relationship and success of the arrangements. We have seen examples of a range of scope changes which include those arising due to divestitures, group company re-organisation and restructuring of central government departments and policy. In those circumstances the parties were able to negotiate deals which provided the customer with the flexibility it required in the particular circumstances but which enabled the service provider to retain a sufficient revenue stream.

Similarly we have known successful outsourcing relationships where, at the end of the contract, the customer has nevertheless decided to organise its affairs in a different manner in the future: to move from a single-source to multiple-source outsourcing or vice versa – even to bring the outsourced operation back in house. Needs evolve, relationships mature, management styles change. The important thing is to ensure that the customer's strategy dictates the form of the outsourcing contract rather than vice versa.

G08 Stages of outsourcing: Exit

This is section G08 of A User's Guide to Outsourcing.

*We divide the customer's experience of the outsourcing process into six stages.
This section deals with the last of those stages: Exit*



Term and exit management

Outsourcing contracts run for varying lengths of time. Templeton College found that relatively short term contracts achieved success more often than longer term contracts – partly because customers cannot realistically predict their requirements far in advance – and, on the basis of that research, it has been suggested that a three-year term is normally appropriate, particularly where the agreement represents a new departure for the customer.

Clearly each business must make its own decision on the basis of its own needs and the service provider's financial proposals. However, where the service provider is expected to transform the manner in which services are provided, investing in new infrastructure and retraining large areas of the workforce, the customer will rarely be willing to pay the whole cost of transformation at the time it is incurred – it will expect the service provider to recover the investment through the service charges over time. This is unlikely to be possible in a short period. Also, negotiating an outsourcing transaction is expensive both in terms of time and resource and a customer who opts for a shorter contract must factor into the financial equation the cost of re-letting the contract at regular intervals. These factors may explain why, particularly in larger outsourcings, contracts of five, seven and ten years are far from uncommon.

Exit planning

On expiry or earlier termination, a customer must always be able to rely on the service provider's co-operation and assistance to enable the services to be taken back in-house or to be transferred to an alternative service provider with minimum disruption to its business. When negotiating the outsourcing contract both parties will naturally be more eager to talk about the prospective new relationship and ongoing services rather than dwell on issues typically associated with ending the



relationship. However, it is essential to agree the terms of the exit management arrangements at the outset of any contract. An outsourcing contract will typically contain the following provisions:

- an obligation on the service provider to develop and maintain an exit management plan and to implement it at the appropriate time
- an obligation on the service provider to provide information required for the purpose of obtaining tenders from replacement service providers and to assist in the hand-over
- the transfer of ownership of, or grant of rights to the customer and/or the new service provider to use, the service provider's intellectual property rights, assets and contracts (to the extent previously used in the provision of the services)
- provisions governing the treatment of staff used by the service provider to provide the services (essentially a mirror image of the provisions which applied on the original transfer)
- a right for the customer to extend the exit period to cope with unforeseen delays in the commencement of the replacement service

These provisions will apply not only upon the expiry of the term but also in the event of termination for breach (where the parties may not be on the best of terms) or on removal of services.

It is an unfortunate fact of commercial life that relationships sometimes do, for whatever reason, deteriorate or break down. When this happens in an outsourcing arrangement, having a detailed exit management plan in place will significantly ease the pain of the separation for both parties. Despite this, we have seen many instances in which neither the customer nor the service provider wishes to devote any more than minimal effort in undertaking this task prior to commencement of the outsourcing. It goes without saying that this is storing up and compounding problems for the future.

A compromise is sometimes to agree that the outsourcing agreement will contain only an outline of the plan and that the parties will 'flesh out' the detail of the plan within, say, six months. Even this approach can give rise to problems because once the contract is underway the parties are often too busy to sit down and talk in detail about possible exit arrangements. The moral of the story remains...don't put off until tomorrow (when an exit is being contemplated) what you can do today (preferably before the outsourcing contract has been signed).



Some of these provisions are considered in more detail below.

Intellectual property rights (IPR)

Intellectual property rights and know-how are likely to be created or used during the term of the outsourcing contract. This might take the form of bespoke software or the development of new business processes. The issues regarding IPR ownership after the end of the outsourcing contract are likely to be minimal if the customer has successfully negotiated that all IPR created in the provision of the services is to be owned by the customer.

However it is more likely that at least some of the IPR will be owned by the service provider or used by the service provider under licence. If service continuity after the end of the contract is reliant on this IPR, the customer should ensure that the outsourcing contract sets out a process for identifying the materials concerned and contains a sufficiently wide licence to permit the customer or its nominated replacement service provider to use the materials in the future. Where the IPR concerned is proprietary to the service provider, perhaps containing cutting edge material, the service provider is likely to resist provisions which do not provide satisfactory commercial protection. In this case, the customer could consider narrowing the scope of the IPR to be transferred or licensed on exit to material that is genuinely essential for service continuity or limiting the period of access so that it covers the transition of services to the new service provider only.

Given the potential tension between the interests of the customer and service provider, there is often a need for compromise in this area.

Assets

It may be desirable for certain service-related assets to be transferred to the new service provider, or if the service is to be brought back in house to the customer, to enable the services to continue with minimal interruption throughout the exit period. It is common for customers to require an option to purchase back these assets at the end of the term on an agreed commercial basis. However, where the outgoing service provider has provided a leveraged service, spreading the cost of service provision across a wide customer base, there may be a limited number of assets that are exclusively used for the customer's services – and are therefore readily able to be transferred with the services. In most cases, the increasing commoditisation of outsourced services means that this is an acceptable risk since the services can be replaced on the market without undue difficulty.



In relation to the assets which are agreed to be available to the customer or its replacement service provider at the end of the term, it is prudent to ensure that the contract provides a robust process for identifying what they are (sometimes a difficult task) and determining how their purchase price is to be set.

To ensure that the process of identifying and transferring assets works smoothly in practice, it is sensible from the customer's perspective to require the service provider to maintain a register of assets throughout the term.

Third party contracts

The service provider may have a range of service or supply contracts in place with third parties in relation to the services. In an IT outsourcing, for example, these may include software licences, hardware and software maintenance contracts and disaster recovery contracts.

The customer's exit strategy should include consideration as to how these contracts should be managed at the end of the term and whether they will be needed in the future. It is therefore important for the contract to:

- identify the contracts the customer wishes to take back at the end of the term (bearing in mind that, as for leveraged assets, some of these contracts may not be specific to the customer but may be used for the service provider's customers generally)
- identify how those contracts should be transferred, with a mechanism for reconciling payments made in advance or in arrears and provisions that allocate responsibility for any actions or omissions (which could give rise to claims under the contracts concerned) taking place before or after the date of their transfer.

Customers will commonly require the service provider to ensure that its contracts with third parties can be transferred to the customer or a replacement service provider without restriction and at no cost. However, the customer should be aware that in some cases the service provider may be unable to secure these arrangements or the cost of doing so may be prohibitive. Whatever the case, the customer should ensure that there is adequate transparency and consultation on these matters to ensure that the viability of the exit strategy is maintained.



Personnel

Just as the treatment of service personnel is a key issue for the handover of services to the service provider at the start of the outsourcing, similar issues arise in connection with the end of the term.

In many cases, the customer will want to ensure that key personnel will be available to transfer to the new service provider to ensure that in-depth knowledge about its services and processes is not lost. Equally it may wish to ensure, to the extent that it is lawful to do so and within the constraints of TUPE (where applicable – see the section on employees in G03), that the service provider retains the cost of personnel not needed to provide the replacement services.

The contract should provide for an appropriate allocation of cost and risk in this area – particularly to protect the customer or its replacement service provider from inheriting liabilities that relate to transferring employees' employment by the service provider.

Exit assistance

It is usual for the outsourcing contract to define a set of exit assistance activities that are to be provided in the period leading up to the termination of the outsourcing contract, commonly called an exit period.

The customer will want to ensure that it has access to relevant information to facilitate the re-tendering of the contract in good time before it comes to an end. (Similar assistance can also be useful during the term, especially in non-exclusive arrangements, to test whether particular services should be moved to a new service provider.) In addition, at a more detailed level, there are normally a range of tasks which will need to be undertaken to effect a smooth handover of services to the replacement service provider. The specifics of such tasks depend upon the particular circumstances but examples of the assistance that a customer may require include:

- information provision at regular, defined intervals
- planning activity
- segregation of the service provider's equipment and data from that of the customer and data migration.



Financial matters

To avoid dispute, it is essential to be clear in the contract about which party pays the costs of exiting the outsourcing relationship. These costs generally fall into two categories, dealt with briefly in turn below:

- the costs of preparing for the termination and transitioning to the new service provider
- the cost of terminating the services.

In relation to the first category, there are no hard and fast rules as to how these should be dealt with, though many customers require exit assistance to be provided at no additional cost. Service providers will naturally seek to scope exit assistance very tightly in order to ensure its pricing holds firm to allow for this – and may seek to exclude from its prices the cost of providing exit assistance in respect of partial terminations during the term. Where the customer agrees to fund exit assistance as an additional charge, the service provider (arguably) is incentivised to perform well throughout the exit period without diverting resource from the day to day services.

In relation to the second category, the service provider will commonly expect to be financially compensated for the "loss" of the services at the end of the term. This usually applies only where the customer has terminated the outsourcing contract for convenience, but may also be conceded where the service provider has made unique investments for the customer which will not be able to be deployed for its other customers after the contract is at an end. The compensation may cover any outstanding investment costs that have not been recovered through the charges and specified one-off costs such as early termination charges incurred in respect of sub-contracts. Service providers will sometimes seek an element of compensation for its lost profits, though this is often resisted.



Conclusions

Many customers have learned to their cost the need to be comprehensive and precise about the assistance they may require from an incumbent service provider on expiry or termination. Our experience of advising on second and subsequent generation outsourcing teaches some harsh lessons about the adequacy of the exit provisions within the outsourcing contracts of the outgoing service providers – often negotiated many years previously and lacking the best practice approaches that have been developed over the last few years.

Customers will often have to work very hard to encourage a genuine competition upon a first or subsequent renewal of an outsourcing contract because competitors may be unwilling to bid against the incumbent service provider. Careful scoping of the exit assistance obligations within the contract can facilitate a genuinely competitive tendering exercise to mitigate these risks.

Further advice

At Pinsent Masons we have a team of more than 80 lawyers dedicated to providing legal advice in relation to all aspects of outsourcing. This guide identifies some of the areas which experience tells us are important to the success of any outsourcing. We are happy to meet with organisations to discuss their outsourcing requirements. For further information please call your usual contact at Pinsent Masons:

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