IT OUTSOURCING

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MID-TERM BLUES IN IT SYSTEMS OUTSOURCING
TERMINATION

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Introduction

In the first edition of Global Technology News we focused on cloud computing and the risks associated with this relatively new way of outsourcing all or part of a customer’s IT operations. Cloud computing was largely born out of the more traditional IT outsourcing in which it is common to outsource the whole of the IT operation to a third-party who agrees to run it for a long period in return for a monthly fee.

It therefore seemed timely to dedicate our second edition to IT outsourcing. Many readers will have first hand experience of IT outsourcing and will understand the effort involved in preparing for the initial transfer of the operation to the supplier (or more commonly multiple suppliers), the many operational difficulties that usually arise after the handover, the impact that problems can have on staff morale and productivity, and the resulting push back from the end users.

Of course, not all IT outsourcing is a negative experience. We have therefore invited experts from the UK and France, in the form of consultants and lawyers, to provide their own views on the key risks and recommended best practices that help to ensure that the transfer and subsequent IT operation is a successful one.

Our three writers cover (1) getting it right at the start (2) managing the mid-contract blues and (3) termination.

As our writers report, the undertaking to transfer an entire IT operation to a third-party is such a complex matter that there is no substitute for exceptional care and attention in the initial preparation. As one writer puts it “an ounce of prevention is certainly worth a pound of cure”.

We hope you find it useful.

Jim Whetstone
01: Groundwork, process and risk; the keys to successful outsourcing contract negotiations

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The key objective for the customer during the pre-contract phase of an outsourcing deal is to sign up to a value for money solution that will deliver their requirements. For the supplier the key objective is to win a profitable piece of work. Sadly, this phase does not always deliver these outcomes, despite the huge efforts that are put in corporately and individually. Failures can have significant and costly ramifications for both sides, one of the most recent high profile examples is EDS vs BskyB.
01: GETTING IT RIGHT AT THE START
So what can the customer and supplier do, pre contract, to mitigate the risk of a deal failing to deliver value?

A clear business case is the foundation of a successful deal. A solid business case, including both costs and benefits, can provide comfort to both parties and should be maintained throughout the life of the deal. It is also important that the supplier maintains their own business case, which should go beyond just giving the delivery manager a budget and a revenue target and address similar strategic areas as those covered in the customer’s business case.

Customers also need to understand who the true key stakeholders are in their organisation, ensuring their views have been considered in putting together the business case and requirements. Doing so will mitigate the risk that, in spite of the requirements being met, the users do not like the service.

However, business cases at the pre-deal stage do not need to be a detailed pre-emption of the likely solution.

Everyone needs to understand how the value will be delivered. Both sides need to think about how value will be delivered in the deal and agree on this. If the customer thinks the value derives from economies of scale or platform, but the supplier thinks it is about driving up resource utilisation, this is likely to cause continued problems through the life of the deal.
There are very few ways in which a supplier of outsourced services can deliver performance and cost improvements, these include:

- moving labour from higher to lower cost locations
- process or technology improvement and innovation – either of the technologies, the processes themselves or through simplification and consolidation
- economies of scale or platform, for example moving work into shared service centres/shared platforms
- improving the cost/quality equation for resources or assets - typically through improving the skill sets and capabilities of teams or driving up utilisation
- aligning services more closely with actual required service levels – i.e. doing less of the not so important things.

Both sides need to be realistic about these sources of value.

Having established clear business cases, what can be done during the procurement/sales cycle to mitigate risk?

Develop a list of suppliers who you are confident can deliver the work. Customers need to engage the market prior to the deal process – both in terms of the supplier community, peer companies and industry analysis. This will help to get the right people around the table and the right mix of suppliers to provide choice and differentiation.

Suppliers need to be sure they have a strong value proposition for the deal.

“There are two good reasons not to set timelines which are too aggressive. First, they are almost never met and second it is a false economy to reduce solution creation and clarification times.”

Set out a pragmatic timetable and process. There are two good reasons not to set timelines which are too aggressive. First, they are almost never met and second it is a false economy to reduce solution creation and clarification times. You either pay in final negotiations, or during the life of the deal. This is not to say that deals cannot be done quickly, especially if the customer really understands their needs and can communicate them clearly.
Suppliers will also often view an accelerated, or quick process, as one that has been designed to see an incumbent appointed, but being able to tell the board that a competition was run. They are right to question this and customers should be open on what incumbents are operating already (not least because whoever the winner is will have to integrate).

**Work hard to ensure business, technical and commercial requirements are consistent.** The business case should be clear whether the customer is looking for inputs, outputs or outcomes. These days, best practice is output or outcome based where appropriate. Most suppliers are comfortable working to these requirements, provided the commercial model is right and the customer can deliver their obligations.

Whatever a customer’s preferred procurement and commercial strategy, it is vital that all the different types of requirement are consistent.

Care needs to be taken to manage the customer’s expectations on the trade off between more outcome and output based regimes, and the amount of control over inputs that a customer can and should expect.

**Monitoring and incentivising performance through SLAs, service credits and bonuses.** Both parties need to avoid agreeing service levels and performance regimes where: ‘the lights are all green but the users hate the service’. Server availability or answer within ten seconds on the helpdesk does not necessarily equal a happy customer. So they should seek to align service levels and credits with the pain points identified with the business and set out in the business case.

One area to explore is correlation between service levels. Do not have three SLAs when one will deliver the same results. Move the others to KPIs if necessary, by which we mean, measure them, but don’t apply as high a level of performance management.

Service credit regimes, where a proportion of the supplier’s money is at risk to performance, are intended to incentivise suppliers to focus on delivering on the promised benefits. However, poorly designed service credit regimes can lead to poor outcomes. PA worked with a telecommunications company that incentivised a supplier on the number of roles moved offshore, however, as there was no related incentive to remove onshore numbers, there was no benefit realised in the business.

So while customers do not want to pay for 99.9% performance when 99% will do, if there are areas where improved performance can be demonstrated to align to increased business benefits, then bonuses can be used to drive value from the deal.

**Information and clarification.** To finalise the deal satisfactorily there will be a need for detailed data and it is better to have it available as early as possible, organised clearly and shared as appropriate.
Where information is not available suppliers should discuss in detail the assumptions they will have to make to derive solutions and estimates. This should show the effect on the price/timeframes/performance of changing the assumptions and show the customer where it is really important to clarify information or requirements. In doing this, the clarification will work both ways.

In PA’s experience, the clarification stages can change the value and risk of a deal more than any other transaction phase. It is here that a shortlist of vendors can really understand the drivers for change, desired outcomes and current situation. It is also here that sometimes small misunderstandings or changes to requirements or process can lead to large changes in solution, risk or price, prior to formal, final negotiations.

**Evaluation, selection and BAFO (Best And Final Offer).**

The business case is key for this stage. Customers need to be able to answer the questions: Are we selecting on headline price? Best solution? Who impressed us most personally? All are valid criteria provided the reasoning in each case is sound.

However, conflating ‘technical’ and ‘price’ scores into one overall percentage score can lead to bizarre decisions. It is much better to hold both scores separately. Clients often find it useful to chart quality versus risk adjusted price for each vendor and see how this changes through the deal life.

Customers also need to be alert to low-balling (offering an unrealistically low price). As a customer, if a supplier is offering a price significantly below what the rest of the market is offering and well under the business case, this should prompt questions. Both parties need to understand that techniques such as low-balling or over-pushing on price through multiple BAFOs, stretching the deal’s commercial viability to the limit, can lead to poor and ingrained relationships and behaviours. There are examples of deals where suppliers refuse to turn up to management discussion meetings without a purchase order or charge code. This is not a good place to be.

**Negotiation – talk about risk and build a rich contract.** The parties need to get the contract to a place where the price and scope are agreed and commercial issues such as liability are clear. In addition, the contract and, in particular, the contract schedules such as change...

“The clarification stages can change the value and risk of a deal more than any other transaction phase.”
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control and governance, should contain clear, business-focussed and usable processes.

The negotiation process should be driven by the teams who will be receiving and delivering the service, supported by procurement and sales functions, rather than the other way around. Having these teams driving the negotiation should also mean it focuses on value and delivery risks in the deal, rather than over-concentrating on price. If the deal is not clearly a good one for both parties by reasonably early in final negotiations, neither side is going to make it a good one by furious late night rounds of horse trading and redrafting.

Throughout the process – focus on talking about, reducing, documenting and managing risk. Throughout the discussions, channels need to be open and there needs to be transparent discussion on risk. Risk (and therefore price) can only be materially reduced if it is clarified and discussed in an open manner. Neither side is going to reduce risk in the deal by trying to hide things, or surprising the other during the process.

Small changes in requirements or acceptable solutions can bring big reductions in the amount of risk faced by both the supplier (and so reduce the price of a deal) and the customer (and therefore increase the chance of realisation of benefits).

The business case should be the bible of the deal. It should include the transaction phase, show what, where, who, how and importantly why.

The biggest impact on the overall value and risk of an outsourcing transaction is felt at the requirements, clarification and supplier selection stages. Large improvements cannot be made during final negotiations. If it is not working for either party, then they should go back and look at the earlier stages and ask:

- Are we asking for the right thing?
- Have we offered the best solution?
- Do we know how the value is being delivered in this deal?

Figuring out the answers to these questions will then be vital in ensuring both parties can come to a deal with manageable risk levels and appropriate returns.

“Risk (and therefore price) can only be materially reduced if it is clarified and discussed in an open manner.”
What isn’t important pre-deal?
Throughout the process both sides should be looking to concentrate on the 20% of activities which affect 80% of the value. Two common mistakes are:

- ‘boiling the ocean’ - collecting vast amounts of (not always reliable) data and analysing it to within an inch of its life - on the business case and options analysis can often lead to paralysed decision making as too much choice and information is given to senior decision makers

- trying to win each and every line and clause in the negotiation. This behaviour is most likely a sign that one of the parties is worried about the value and benefits of the deal.
Conclusion:
All of these recommendations are based on the principles of good planning and clear communication. Yet, these are often not followed because small reductions in trust soon lead to parties retreating and adopting defensive behaviour. This in turn causes the breakdown of the free exchange of information and entrenches positions, thereby further increasing the risk.

All of the suggestions outlined here can only work if trust is maintained. This requires energetic and positive management of both sets of teams throughout the process. However, if customers and suppliers can get this right they can deliver a deal which reduces risks and delivers clear value for both sides.
IT systems outsourcing involves a massive initial project to transfer ownership and control of the systems to the supplier. This is followed by a longer period in which the new outsourced arrangement needs to bed in and both customer and supplier get used to working together. The initial set up phase undoubtedly is one of the most challenging in terms of the time and effort required to get everything transferred across into the ownership of the supplier without too much disruption to the business. However, to imagine that the risks and difficulties end there would be foolish. There are indeed many risks associated with the smooth operation of an outsourced arrangement. Many of these risks are common to all IT projects but the long duration of most outsourcing agreements increases the risks and therefore demands greater care. This article looks at some of these key risks and suggests ways to manage them.

“An all-too-common phrase heard at the outset of any major IT contract is “We can’t expect to foresee all eventualities.”"
Requirements

Difficulties throughout the life of the outsourcing agreement regularly stem from poorly defined customer and supplier requirements.

An all-too-common phrase heard at the start of any major IT contract is “We can’t expect to foresee all eventualities” and “We will deal with problems as they arise”. Although flexibility is a key requirement in customer/supplier relationships, this cannot be a substitute for carefully analysing the customer and supplier requirements and negotiating strict contractual terms that would meet these. Three key documents must be drafted carefully and be consistent:

- the requirements
- roles and responsibilities
- service levels.

Successful completion of the initial transfer and set up phase depends also on clear instructions on what is to be done, by whom and when. The contract should clearly state what the outsourced solution must look like and how it must perform, the resources needed to achieve this and a mechanism to monitor progress and verify successful delivery.
The project and operational teams need to be specified in the contract with regard to the skills and numbers of resources needed to deliver a successful transition and to run the operation smoothly. The contract should state the degree of skill for key roles, what their availability should be and make provision for the orderly replacement of key people who leave.

Key performance targets should be integrated into the contract in the form of precise and exhaustive compliance criteria, a service level agreement and a clause detailing the ability of the system to be upgraded in the future.

The customer’s requirements need to be very detailed. When a customer has not precisely defined its requirements and expectations or does not have a clear idea of the resources it will need to commit in view of the size and complexity of the project, this will lead to a lack of common understanding with the increased tension that this brings.

Roles and responsibilities

Operating an enterprise-wide IT system usually requires the joint action of numerous teams, such as a team to run the help desk, a team to manage new software development or hardware upgrade projects, and a team for application maintenance, etc. To complicate matters, these teams can often be different service providers.

Ideally, each task should correspond to a single person whose responsibility can be clearly identified from the task. In practice, the management of the different parts can be so interwoven that it is sometimes hard to pinpoint who should take ownership for a task. Therefore, when a problem arises there is rarely a single person involved and this can lead to tension as the customer is passed from pillar to post when, for example, presenting a technology change request that could be viewed as either a new project or a repair, where different suppliers have responsibility.

The contract alone cannot remove all of this risk but if it includes a well-drafted statement of roles and responsibilities of each party, it can be a great help in managing the risk.

Contract monitoring

“A good contract is a contract you never have to look at again”. This idea, which is often at the back of people’s minds, is an illusion where IT contracts are concerned. IT outsourcing contracts always change during their lifecycle and when a contract has not been updated the parties always
regret the waste of time in negotiating a
document which in the end did little to
assist in the resolution of the problem.

A contract reflects a situation at a given
date. It should not be considered as a
pile of paper to be filed after signature,
but as a structured reference document
reflecting the functional and technical
evolution of the project and relationship.
Any potential evolution of requirements,
and the resulting change in scope,
must be assessed and provided for in
the contract to prevent this reference
document from becoming obsolete.

To manage a contract effectively, it must
be continuously monitored and updated.
However, this simple principle seems to
present many practical difficulties for the
parties given the frequency with which
changes are not properly logged in large
scale contracts. Without being overly
prescriptive, two key features should
be present for good change control
management.

**Supervisory committee**

A dedicated supervisory committee
must be set up to provide the parties
with a safe means of challenging each
other on things such as customer’s
obligation to work collaboratively and
the service provider’s duty to advise the
customer. The purpose of the supervisory
commitee is to arbitrate and compromise
between the practical everyday issues
that arise in all long-term contracts.

Supervisory committees are generally
organised on two levels. At one level, their
purpose is to monitor the performance

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of the contract from an operational
viewpoint and to arbitrate any non-
essential operational issues. At the other
level, they are more focused on resolving
any conflicts between the parties and
reviewing any decisions that may affect
the general structure and viability of the
project.

In practice, controlled evolution of the
contract requires the proposed changes
to be assessed and understood in terms
of the commercial impact, any delay and
each party’s responsibilities.

Assessing the consequences of an
operational change therefore requires
financial and legal experience as well
as technical and functional expertise.
Committee members should be
encouraged to request the presence of
a specialist when the need so requires.

The frequency with which meetings
are held can reduce the risk of minor
operational difficulties becoming bigger
problems and the frequency should
therefore be consistent with the contract duration, complexity and degree of anticipated change at any given time in the life cycle of the contract. Time limits for arbitrating operational decisions should be short to maintain the smooth running of the contract. The contract should always allow for the possibility of requesting extra committee meetings if the circumstances require it.

Legalising the changes
Changes to the contract should always be vetted by suitable lawyers to advise on issues that may arise from the changes and to help assess responsibilities in the event of scope creep or delay. Unstructured contract changes need to be avoided at all costs as this inevitably leads to confusion and recrimination if things go wrong later.

The parties need to have a mechanism for incorporating technical agreements and decisions into the contract. Where a meeting between the technical teams results in a technical document recording an agreed change, the change needs to be integrated into the initial contract in the form of an addendum. Similarly, notifications issued by a party should be taken as an opportunity to review the contractual impact thereof and to formalise this. Rather than viewing these notifications as a means of enforcement, they should be used as an opportunity to engage the other party in order to avoid future conflict.

Although the contract contributes towards managing the parties’ responsibilities in the event of changes, it cannot deal with all the issues potentially leading to problems and it is imperative that there is a robust non-contractual mechanism to manage risks effectively.

Avoiding disputes
Despite the foregoing precautions, it is impossible to fully eradicate the risk of scope creep, questions of responsibilities or delay in a long term contract. It is therefore essential to set up tools for managing problems when they arise.

The most common way is to create a suitable escalation process that adequately deals with problems encountered. When a problem is identified or anticipated, project managers tend to be too close to the detail to be the best judge of who is responsible and what needs to be done to resolve it. They often react adversely to bad news or disagreements. Yet this is precisely the time they should respond in a calm and controlled manner in view of the importance of the contract to both parties.

It is therefore important to provide in the contracts for various levels of discussion and, if relevant, for an arbitration procedure. In addition, this escalation process must be understood as a mandatory requirement so that all parties are bound to follow it. Even if this process can often be seen as a constraint, history shows that it is viewed retrospectively as being a positive influence on the early resolution of disputes.

In some cases, the involvement of a third-party may be helpful. Far too often,
in France at least, the parties tend to consider that this third-party can only be a court judge. Yet in almost all cases, the parties become increasingly angry as the proceedings progress.

Deciding between who is right and wrong in any long-term contract is rarely a black and white matter. Arbitrating the parties’ responsibilities can then be a perilous task and frequently results in faults and responsibilities being equally shared between the parties. In the end the parties often find themselves back at square one without either of them having found a satisfactory solution.

In such a case, alternative dispute resolution experts and mediators can be of huge assistance to the parties in identifying solutions and, where relevant, helping them to understand the weaknesses of their position. It is often difficult for the parties to agree on this type of procedure once the dispute has taken hold and positions have become entrenched. It is therefore advisable to provide for them in the initial contract.

Conclusion:
By anticipating not only the risk of dispute, but also the means of resolving dispute, the parties effectively manage their contractual relationship and mitigate the common risks that exist in all long term contracts.

‘Mid-term blues’ is fortunately not an incurable disease but an ounce of prevention is certainly worth a pound of cure.
03: Exit from outsourcing contracts: it’s inevitable, so be positive!

David Barker, Partner and Technology Lawyer, Pinsent Masons, London
This article requires the reader to make a leap of faith: to accept that all IT outsourcing contracts will, sooner or later, come to an end. This simple statement may seem to be so obvious as to go without saying, yet empirical evidence suggests that it does not. Both customers and suppliers are frequently guilty of ignoring the issue of termination and exit until some time after it has become ‘the elephant in the room’. Messy termination and exit is rarely in the interests of either party, so here are some pointers for getting it right, right from the start.

1. Understand that an exit is a project in itself. Most IT outsourcing begins with a transition phase, often followed by a transformation phase which promises to deliver long term business benefits and cost savings. Transition is often complex and described in detail, with its own governance structure, often a modified service level regime, dependencies on the customer and so on. Transition back to the customer or a replacement supplier at the end of the term will be a project of similar complexity and magnitude. Recognition of this fact must guide the contractual regime in relation to exit. In short, all the complex issues which had to be resolved on entry will ultimately have to be resolved on exit too.

2. The time to tackle all of these issues is on entry into the contract. If they are left until after contract signature they are likely to be neglected. Initially they will be left to one side as unimportant, and time will pass. As the reality of exit approaches, what was unimportant will become too difficult. Experience shows that agreeing exit terms in the process of exit can be almost impossible. The default position on either side is usually to apply to Court for an order determining what some quite vague contractual provisions mean in practice. This is far from satisfactory.

3. Having an exit schedule doesn’t get you off the hook. Many contracts have an empty space where the exit schedule should appear: “[to be agreed within three months of contract signature]”.

“All IT outsourcing contracts will, sooner or later, come to an end.”
Of course, this is a simple illustration of the neglect of exit. Consider, however, that populating that exit schedule is probably just creating a comfort blanket. In reality, the range of issues relating to exit will need to be dealt with through a range of contractual provisions. First, there are the high level commercial issues which may best be dealt with in the agreement itself: who will own intellectual property rights, what will happen to the assets, will any money change hands as a payment for either, what will happen to the employees in the context of employment protection regulations (in the UK, these are the TUPE regulations), and so on. Second, there are the high level principles of what will happen on exit: what the supplier will do to hand the services back, what third party contracts and licences will be assigned or novated, how the processes will be documented, and so on. This will provide a framework for the type of high level exit plan which can be included in the agreement. Finally, there is the detailed day-by-day, even hour-by-hour, plan which will describe the precise activities leading up to the hand back. Realistically, the detail of this can only be worked up in the weeks before handback of the services takes place, so the exit plan will need to provide that the parties will work together to create this plan.

4. Who will pay for exit? For the supplier to perform exit services diligently will take resources in addition to the ‘business as usual’ team. This means there will be a cost to the supplier. Whether that cost is passed on to the customer is another matter for negotiation, but experience of smooth and bumpy exits suggest that it may be in both parties’ interests for the supplier to be paid. Often the supplier will be obliged to provide exit services at no charge if the contract is terminated early due to the supplier’s default. In theory this seems fair: why should the customer pay if it has been forced to end the contract early due to the supplier’s inability to perform? In practice, suppliers and customers never agree that termination for fault is justified. So in this scenario the basis on which exit services are being provided (and responsibility to pay for them) is in dispute. The line to take for suppliers in negotiations is that exit will happen sooner or later, and so it is appropriate for the customer to pay.
5. IT outsourcing contracts will typically have a regime for fault based termination based on persistent failure to meet service levels, material breach of contract and so on. How to approach these provisions is beyond the scope of this article. What can be considered here is termination for convenience. Usually this is a right which operates in favour of the customer only. Great care needs to be taken when quantifying termination for convenience payments to be made by the customer, to avoid unexpected consequences. The ideal approach is to quantify the payment applicable in each contract year, usually on a reducing basis. This gives certainty. Problems can arise where the payment is to be calculated by reference to a formula which draws on other sources. For example, the formula may refer to a financial model which may have become out of date by the time of termination or it may refer to the supplier’s accounting treatment of various assets. This can bring about unexpected results.

6. Having recognised that the approach to exit needs to be agreed and detailed on contract signature, it is important to remember that as the services evolve over the life of the agreement, so will the likely requirements for exit. Preparedness for exit will ultimately be a function of good contract management practices: documenting processes and standards, maintaining asset registers, software licensing arrangements, third-party contracts, and so on.

“An exit is a project in itself… all the complex issues which had to be resolved on entry will ultimately have to be resolved on exit too.”
“Exit is too often a painful process on both sides.”
Conclusion:
All good things come to an end. Exit is too often a painful process on both sides. Getting the preparation right should lead to a smooth exit, and a reputation for smooth exit will enhance a supplier’s market reputation. Time invested in this area early on will pay dividends later.
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