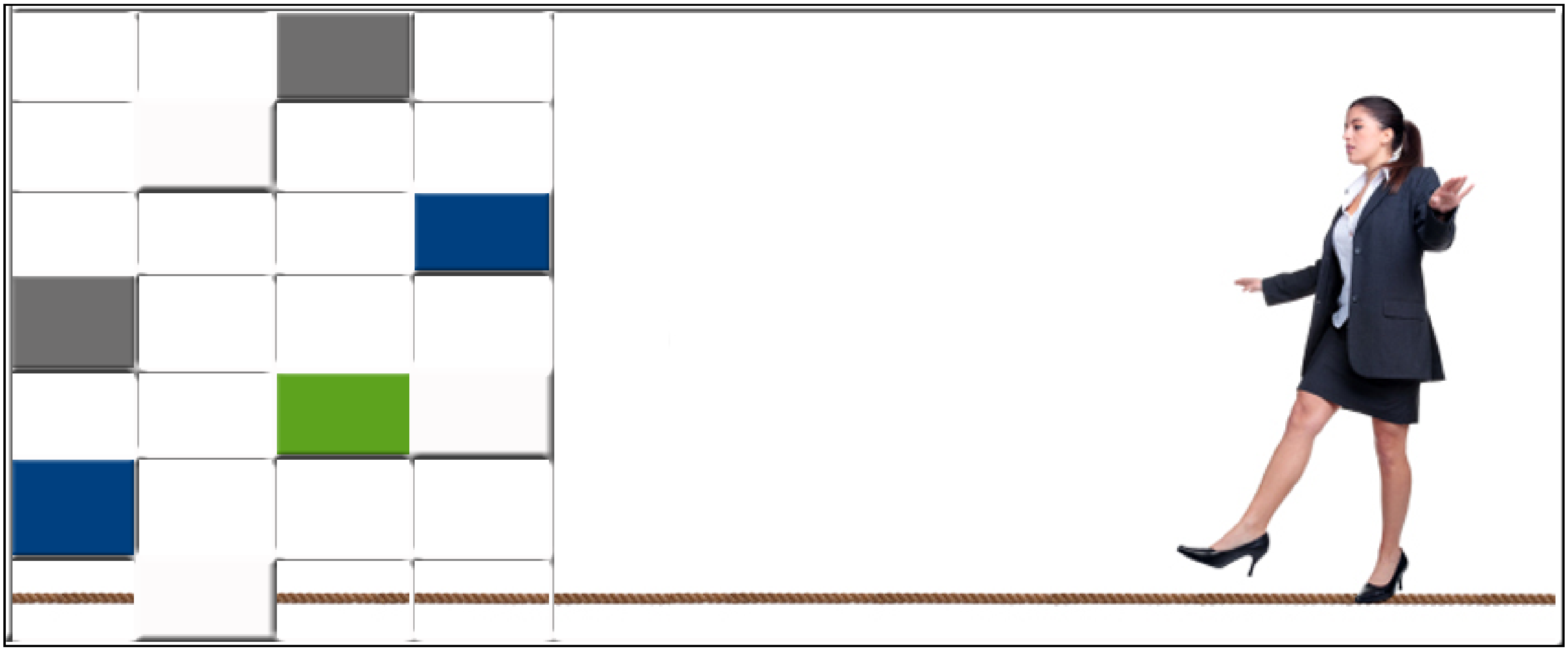

Balancing the Risk and Reward of Outsourcing Contracts

Introduction

There are many paths that can lead an organization to determine that outsourcing is the right strategy for improving the long-term viability of its IT operations. For some, it is primarily a cost decision. For others, cost is an important factor, but there are other pressing needs, such as dramatically improving day-to-day delivery or transforming the environment in response to changing business priorities. Depending on the organization's unique circumstances, their IT sourcing strategy may encompass one or more delivery towers, include one or multiple providers, and require a short or a long transition period. Culturally, you may need to also consider how much control to retain.

The best outsourcing agreement for your organization is not necessarily the one with the lowest price. Your primary goal when negotiating and structuring an outsourcing contract is to develop an agreement that achieves your business objectives not just on day one but throughout the entire term. To do this well, you must understand the overall construct of a good outsourcing contract and make certain you balance the overall risks and rewards in order to receive the services you need at the levels you require and within your price constraints.

Pushing hard to maximize the returns in one area can negatively impact other areas, finding the "right" mix is the art of successful outsourcing. As you think through the various sourcing scenarios, use the following guidelines to help clarify your requirements and establish the right point on the continuum for each. By looking at your options this way, you will be able to better align your outsourcing agreement with your strategy and requirements.

Contract Terms

An outsourcing contract is a complex legal document, as such, it will be important to fully understand the terms and conditions you will live with for many years to come. In addition to your own personal experience and your internal counsel, you will most likely want to engage external counsel and/or an outsourcing advisory firm to ensure you get an agreement that is legally sound and well-positioned to provide you with the required services at a reasonable price. That being said, there are a couple of areas you should explicitly focus on to ensure the agreement is flexible and manageable.

Governance

Governance is a critical factor for successfully managing an outsourcing agreement. It defines the roles and responsibilities of both parties related to the management and delivery of outsourced services, and it provides the framework for working together to support strategy, innovation, business planning, contract changes, and dispute resolution.

Delivery Locations

In return for hitting your price point, a provider may want to include the freedom to deliver from whatever location they see fit. There are enough risks associated with movement of work from one team to another, imagine the risks associated with movement of from one country to another. Because of the potential impact to your business, you want to make certain you have some sort of approval authority prior to the movement of support functions. The provider may counter that they are accepting the risk because they are signing up for service levels. However, the potential business impact to you is much greater than their risk of incurring service level credits for missing a couple of metrics.

Termination

It can be hard to focus on termination language and termination charges at the beginning of an outsourcing relationship. Termination language is analogous to a prenuptial agreement – it is there just in case things do not work out as originally intended. As the final negotiations occur, you may be tempted to give a bit on the termination language in order to get to the price point you want. Depending on your starting point, some "give" might be acceptable but you first need to understand the ramifications if you need or want to get out of the agreement (or pieces of the agreement) in the future. Once the contract is signed, it can be especially difficult and costly to get out of it if the termination provisions are favorable to the provider.

> "Your primary goal is to develop an agreement that allows you to achieve your business objectives not only on day one but throughout the term."

Statement(s) of Work

The Statement of Work (SOW), also known as the Statement of Services (SOS), describes in great detail (typically 100+ pages for a full information technology outsourcing agreement) the services to be performed by the provider and also clarifies certain client responsibilities. The SOW describes WHAT will be done for the price. Because the SOW is the “meat” of what the provider will do for you, you need to ensure it fully describes the services you expect from the provider.

Alignment to Market-Based Towers

There are several benefits to organizing the SOW to market-based towers, such as Server Management, Contact Center Management, Applications Development, and so forth. First, alignment to market-based towers allows for easier “apples-to-apples” comparison of competing providers and makes it easier to benchmark the price of services periodically over the term of the contract. Second, by ensuring your pricing, SOW and Service Levels are aligned by tower, you can structure the agreement so that you can terminate specific towers without terminating the whole agreement. Lastly, organizing the SOW by tower helps both parties understand how work will be performed and how it will be managed.

Process Standards

As you develop the SOW, make sure you include, in very specific terms, the process standards you expect. For example, if you expect Capability Maturity Model Integration (CMMi) Level 5 performance, make sure that is clearly stated, along with how both parties will assess and certify a certain level of process maturity. You also need to clearly state your expectations related to process documentation in the form of policies and procedure manuals, operations manuals, checklists and so forth.

Technology Management

It is important that you document your expectations related to the provider’s management of your IT environment. You need to clearly describe how you expect the provider to keep your technology current, how they bring you industry and market insight as to next-generation technology, and how they manage and track assets and changes.

Audit Compliance & Security Management

Clarify each party's role in audit compliance and security management activities, as this can be an area with overlap and conflict between your company and the provider. If you have corporate security standards then make sure you point to those in the contract and ensure that the provider takes the appropriate responsibility for adhering to your requirements. Also clearly describe how the provider will be required to support your internal and external audit activities, including any remediation required to achieve audit compliance.

Service Levels

Service levels work in conjunction with the SOW to scope the services that the provider will deliver. They describe HOW MUCH and TO WHAT EXTENT the services described in the SOW are delivered. You need to realize that costs will go up exponentially as you get closer to a 100% performance target. Outside consultants with market information can help you determine a fair price for the service levels you require. Additionally, there are important service level terms that should be included to allow you the freedom to add and change service levels and to re-allocate service level credits as your business needs change.

Measure the Right Things

An important aspect of an outsourcing agreement is to ensure that the right things are being measured. Service levels should be aligned by tower, should be relatively few in number (dozens, not hundreds), and should align to your business objectives as much as possible. Implementing the right set of metrics incents the right behaviors and objectively measures how well the provider is meeting your needs.

At Risk Amount (include reallocation)

As you develop the SLA, it is imperative to set up a methodology by which the provider will provide you with significant service level credits in the event that minimum target levels are not achieved. Obviously, you should not try to use this as a profit center – the goal should be that the services are provided as promised and all service levels are consistently met. However, in the event of problems, you want to ensure that the credit is large enough to capture the attention of the provider's management team so that they fully focus on permanently resolving the issue. Frequently, the concept of escalation is used to double or triple the credit in the event of consecutive failures.

Continuous Improvement and Flexibility

As your outsourcing agreement will be several years in length, you want to make sure that the service levels and associated targets remain relevant. Service Levels and Targets that are appropriate for today may not remain appropriate three, five or seven years down the road. By articulating the process for adding or removing service levels and adjusting target levels now, you eliminate the need for future negotiation and increase the flexibility of the outsourcing agreement.

Pricing

There are a number of factors to consider regarding pricing. On the whole, you should expect your IT costs to go down over time due to improvements in hardware and software functionality and pricing, labor arbitrage, automation, and so forth. Because each situation is different, there are no easy “rules of thumb” to apply, but pay close attention to these specific areas:

Pricing Structure

You should structure your pricing to be aligned to market towers and to be built based on base fees plus a variable fee component known as Additional Resource Charges / Reduced Resourced Charges (ARCs/RRCs). The concept is simple, but you need to watch for how that will work for you based on your future growth assumptions. For example, if a provider expects that your business will grow over time, they may propose a lower base price to meet your initial price point, but then have a relatively high additional resource charge, or ARC rate, for additional volume. You should expect the pricing for most towers (possibly excluding applications due to its labor-centric nature) to go down each year, with the provider accepting the risk of continuously improving and streamlining its operations to achieve lower price points each year.

Market-Based Pricing

Probably one of the best ways to ensure the long-term success of your outsourcing agreement is to start with an agreement based on market prices. This means that you are starting the relationship in the right place, and any future pricing adjustments (such as benchmark adjustments) will not be as extreme or emotional as they otherwise might be. Using the services of a well-respected benchmarking firm such as ProBenchmark can shorten the negotiation cycle because the conversations are fact-based, and not driven by how much one party can squeeze out of the other.

COLA

From your perspective, it would be ideal to not have a COLA, but the reality is that most providers will require it in order to give some risk protection in the out years. Any sort of cost of living increases should be tied to a well-known government index. Each tower should have a "COLA index" that indicates the portion of the unit pricing that can be affected by a COLA index. They should be country-specific if you will be receiving labor from an offshore location, and they should be capped to reduce your risk.

Transition and Transformation

Providers will want to transform your IT operations as quickly as possible to modernize and standardize the environment to achieve their service level commitments within forecasted costs. In a typical outsourcing cycle the transition (initial transfer of employees and technical set up in order to start providing services) is completed within 3-6 months of the contract date. After transition, transformation (the re-engineering of the environment for long-term benefit) is typically a 12-18 month initiative. Providers will have a set of transformation initiatives they want to pursue, some will be more visible and/or beneficial to you than others. You need to understand and help prioritize those transformation initiatives (they will enable lower recurring costs for you), but also make sure to include other initiatives that are important from a business perspective. By documenting your transformation needs early in the process, you will be in a good position to ensure the business value of the transformation.

Defined Milestones

A key component of a quality transition/ transformation is for the provider to contractually commit to specific high-level milestones. These milestones should be easy to understand and measure (such as "all identified employees transitioned to provider," "all in-scope servers moved to provider data center" and so forth). Your payment for transition and transformation activities should be tied to the successful completion of each milestone, so that you don't end up paying for transition/ transformation services that haven't accomplished the desired objectives.

> "Achieving optimum balance between risk versus reward requires a combination of experience, knowledge, skill, effort and determination."

Defined Scope

Expect the provider to clearly document the scope of the transition and transformation, even though detailed work plans typically are developed 30 days or so after the contract is signed. The scope should address things such as transition/transformation management, objectives, methodology, high-level schedule, roles and responsibilities of each party, the content of the forthcoming detailed project plan, third-party transitions, security transition, procedures manual development, personnel transitions, a description of how cross-tower services will be implemented (such as change management, incident management, problem management, configuration management and service level reporting), and a description by tower of the changes that will be implemented.

Conclusion

In conclusion, you achieve the "best" outsourcing agreement not by solely focusing on price but by optimizing the overall risks and rewards in several areas including: Contract Terms, Statements of Work, Service Levels, Pricing and Transition Transformation. Doing this effectively requires a combination of experience, knowledge, skill, effort and determination. These guidelines will help you articulate your requirements and steer you towards an agreement that is built for long-term success.

"Alignment to market-based towers allows for easier 'apples-to-apples' comparison of competing providers and also makes it much easier to benchmark the price of services periodically over the life of the contract."