

Managing risks in outsourcing | BY IAN FERGUSON AND STEPHEN NEWTON

Outsourcings can offer significant commercial benefits but they also present challenges and risks throughout the outsourcing life-cycle whether during supplier selection, contract negotiations, implementation and day to day operation, or on exit.

Supplier selection

Key risks associated with supplier selection include delays leading to increased deal costs, disruption to day-to-day business and buying a solution which does not support your needs and meet your objectives.

Successful supplier selection is dependent on undertaking sufficient due diligence, preparation and planning. You should conduct a baseline review to identify and assess current services and systems and the current costs of providing them. This analysis will not only form benchmarks for performance and service levels but can also be used to confirm that your outsourcing business case is robust.

You should identify your business requirements and what you would like to achieve through outsourcing and investigate the market to understand the price you would be likely to pay for the deal you need, and which suppliers are able to offer it. You may send out a request for information, setting out the services you are considering outsourcing and requesting information about suppliers' capabilities and experience in respect of those services.

In some cases a tender is not the best option. The most appropriate strategy will depend upon your needs and objectives. You may consider retaining your existing supplier: an advantage is that your relationship with the supplier is already established and transition risks are significantly reduced. However the supplier has little incentive to price its offering competitively and you may be tied to that supplier, who controls a critical business function or holds critical software or data.

If you choose a tender, you can mitigate risk by preparing a detailed RFP including much of the internal analysis information obtained during your baseline review. You should ensure your RFP contains all information which may be relevant to enable suppliers to submit their best bids, including an accurate and full description of your business, the services you require and the outcomes you would like to achieve.

Sufficient time should be allocated for due diligence to permit suppliers to prepare a comprehensive solution. You should also stipulate that the suppliers' proposals are not conditional on further due diligence after the evaluation process is complete. This will help to ensure that the selection process is not prolonged or compromised by 'indicative pricing' which is subject to further review.

You should develop and communicate clear and specific criteria for evaluating the responses received from bidders, and do due diligence into each potential supplier (including interviews of supplier personnel and on-site visits, checking references and financials).

The use of multiple suppliers can limit the risks of an outsourcing deal, force suppliers to be competitive and provide a fallback strategy if one supplier withdraws. However, managing multiple suppliers is more complex and time consuming.

Negotiations

Common risks which you may face during negotiations include costly

delays, damage to your reputation, and long term damage to the relationship with your supplier if an adversarial approach is adopted. A well-managed negotiation offers you an opportunity to build a good relationship with your supplier and will improve the overall chances of a successful outsourcing deal which supports your needs and objectives.

The key elements of the commercial deal should be agreed before focusing on a contract. If this is not done there could be significant delays, frustrations, miscommunications and wasted internal and advisory costs. It is important that you and your supplier understand and agree, prior to detailed negotiations, your, and the supplier's, key business objectives, the scope of services and associated responsibilities, and the pricing model.

An outsourcing arrangement is a long-term relationship and the parties' experience at the negotiating table will colour the nature of their ongoing relationship. Therefore a cooperative, non-adversarial, approach is more likely to succeed in the long term. The negotiation timetable should be agreed, be realistic and ensure 'buy-in' and focus from all members of the negotiating team.

Commercial decisions must precede legal drafting. Key commercial negotiators must be able to take decisions. It is a mistake to 'leave it to the lawyers to sort out', as there is no such thing as a purely legal issue as every issue has a commercial consequence. The parties should also ensure that the outsourcing contract is not more complex than it is required to be – clarity is critical.

Relationship management

Successful outsourcing requires effective contract management. While you can mitigate the risks associated with outsourcing through having a robust outsourcing contract, it is the day to day management of the relationship with your supplier which is critical to the overall success of the deal. Problems will always arise: an inadequate specification of requirements, delays, cost overruns and poor performance are not uncommon. Underlying most of these issues is a single recurrent theme – poor management and communication between the parties. If an effective management framework is established early and applied consistently throughout the deal, the risk of an outsourcing deal failing is significantly reduced.

Contract management and governance structures should be given sufficient consideration during negotiations. There should be multiple layers of interaction between you and the supplier with different reporting and governance structures to address operational, financial and strategic requirements. These processes should run in parallel and strategic relationship meetings should be distinguished from the escalation of operational issues.

Workable change control procedures should be included in the outsourcing contract and used. Change control procedures are often detailed in the contract but not applied in practice. When disputes arise it can be difficult to find a comprehensive audit trail of change control notices, resulting in considerable uncertainty around the supplier's obligations and the scope of services.

You should ensure there is rapid escalation of problems as part of a dispute resolution procedure. There may be a concern that the use ▶▶

of dispute resolution is an admission of failure by the delivery team, this may be correct in certain circumstances but as outsourcing deals increasingly involve key business activities, problems do require senior management engagement for resolution, and the greater danger is the reluctance to escalate urgent problems to an appropriate level. It is important to ensure that any resolution of problems during the course of the outsourcing is documented properly.

There are often significant cross-dependencies between your activities and the supplier's. This is especially the case in a multi-vendor outsourcing environment. You should ensure that cross-dependencies are identified early before the outsourcing contract is executed and that responsibility for delivering on those dependencies is clearly assigned.

In many contracts suppliers are penalised for poor performance but not incentivised to achieve good or superior performance. While poor performance should be penalised it should be done in a balanced manner which also incentivises good performance.

Exit

The exit from an outsourcing deal gives rise to a variety of different risks for a customer, particularly an exit following the termination due to supplier default or termination for convenience by the customer.

Common risks which you may face on exiting an outsourcing contract include disruptions or discontinuity in the supply of the services, significant and unplanned costs, loss of critical assets, software, know-how or other intellectual property, delays in the exit process, damage to your reputation, unauthorised disclosures of confidential or commercially sensitive information or data, being locked into specific but inflexible exit arrangements, loss of critical staff, and poor or insufficient termination assistance being provided by the exiting supplier.

You should address the risks associated with the termination as part of the general planning for the outsourcing deal. This should not be left until exit, as suppliers will have little motivation or desire to reach a deal at that point, particularly if the relationship has deteriorated.

Although a detailed exit plan is usually produced after the entry into of the outsourcing contract as it is often not practicable to prepare the exit plan in detail at the outset, the principles and content of the plan should be specified in the outsourcing contract.

You should ensure that the exit plan, once agreed, is reviewed regularly and updated to reflect any changes to the services provided or any applicable service levels which occur during the course of the outsourcing contract.

The most contentious area of exit is cost. The different types of costs, when they will be payable and whether these costs are factored into the agreed pricing model should be identified to avoid disputes and surprises arising on termination. There is usually a discussion on whether costs should relate to the reason for termination, for example, if the outsourcing contract is terminated for the supplier's breach, the supplier should bear all its own cost.

An outsourcing deal can be a complex transaction to negotiate. Risks will arise but they can be avoided or mitigated. You should seek appropriate advice early from experienced sourcing advisers to ensure that you have identified all key risks and considered all relevant options to ensure a successful outcome. ■

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