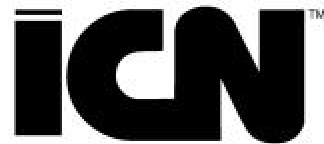
An Outsourcing White Paper

Considerations in Structuring an IT Outsourcing Contract



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Introduction

As IT outsourcing has become an increasingly important and common procurement project over the past 15 years, it also has evolved through a number of contract structures. These structures relate to such variables as length of contract term, flexibility in scope of services, accountability, service levels, ownership of intellectual property, ability to advance the deployed technology, uniformity of services provided to business units, accommodation of business units bought or sold, price adjustments and so forth. The driving force in the evolution of outsourcing contracts has been the accumulation of experience and the lessons learned from those who lead the efforts in early deals. Significant contributions have been made by many organizations—those that have replaced an original outsourcer or renegotiated old contracts, others that have taken their outsourcer to court or elected to bring the IT function back in-house.

Does Contract Structure Match Deal Goals?

A prime factor affecting the contract structure is the true underling purpose or goal of outsourcing. In other words, is the intention to update technology? to concentrate on core business competencies? to reduce operational cost? to provide skilled resources not available locally? to implement a financial restructuring? As an example, an outsourcing deal for which the real purpose is financial, i.e., to restructure a company's balance sheet or generate needed cash, will involve selling IT assets to the outsourcer. Those assets will have a high book value and low market value. Thus, the contract will generally have a longer term (in excess of five years) in order for the outsourcer to recover its investment. In addition, there will be little consideration of operational cost efficiencies.

Another important consideration in structuring outsourcing contracts is the diversity of business units to be supported as well as their geographic location. The contract for an outsourcing deal intended to support an organization with diverse business entities, each with different IT requirements, must describe the exact services to be provided and/or the service levels necessary to meet their individual business objectives.

Having observed numerous outsourcing transactions over the last several years, it has been demonstrated that the one-size-fits-all approach doesn't work. The individual, detailed description of services and service levels is often what will make or break large outsourcing transactions.

Determining the Most Important Objectives

As mentioned earlier, organizations enter into IT outsourcing relationships for a variety of reasons and to meet diverse objectives. Generally, an organization is attempting to achieve multiple objectives. There is, however, one overriding consideration that will determine the project's success or failure. For each objective, there must be an associated contract structure, one that best suits that objective.

Again, in the case where the primary objective is to achieve a financial goal, i.e., reducing operating cost, restructuring the balance sheet or gaining a cash infusion, then a contract structure which dictates all variables of the outsourcing deal (a top-down approach) is ideal. It provides the corporate office with the ability to control the types of service offered, the service levels by which that service will be delivered and, most importantly, the cost at which the service will be provided. In other words, the ability to craft a deal at the business unit level is removed, eliminating the possibility of placing the main objective in jeopardy.

If the main objective is not financial, it may fall into one of the following categories—to improve efficiency, to respond to customers' needs, to offer new business methodologies, to overcome skill shortages, to move to new technologies and so forth. In the case of a non-financial objective, a different contract structure than the one described above is necessary. It may well require a structure that allows each business unit, with corporate governance, to solve its specific problems and achieve its individual objectives. A top-down approach will not satisfy the objectives of individual business units, particularly those with diverse core functions.

As a note of emphasis, a non-financial primary objective does not preclude the achievement of financial benefits. When business units update technology, thereby gaining efficiencies in support of current infrastructure and increasing the amount of business, there can be a dramatic, positive effect on profits.

Structuring a Nonfinancial-objective Contract

The Multi-tiered Contract Approach

The multi-tiered contract approach recognizes that certain aspects of the outsourcing relationship are better defined and controlled at the group or corporate level while other aspects are more appropriate to the business or operational unit. In this approach, the group office controls the relationship between itself and the outsourcer across all business units. The individual business unit crafts solutions that best address its particular operating characteristics.

Master Agreement

Under the multi-tiered structure, the outsourcing provider enters into a Master Agreement with the group office and a series of Transaction Agreements with each business unit. The contents of the Master Agreement are listed in Exhibit A, attached.

In reviewing the Exhibit, it is important to note that the Master Agreement does NOT contain a detailed description of the services to be provided by the outsourcer, does NOT describe the service levels at which the services will be provided and does NOT describe the pricing of the services. These items are detailed in the Transaction Agreement, also referred to as the Statement Of Work.

Transaction Agreement

The Transaction Agreement is specific to each business unit or even to a further breakdown to a business unit's operating entities, perhaps to address geographic or technology differences. The Transaction Agreement specifically addresses the IT operational requirements that the business unit has determined are necessary to achieve the mission statement.

The Transaction Agreement typically incorporates, by reference, the following Exhibits.

Exhibit 1	Designated Services or Service Requirements (Detailed description of services to be provided by outsourcer for this business unit; generally 20 – 200 pages)
Exhibit 2	Service Levels (Detailed description of what components of the services will be measured, how and when they will be measured and remedies when service levels are not achieved; generally 30-50 pages)
Exhibit 3	Sample Reports
Exhibit 4	Infrastructure (Description of the IT hardware and software used to provide services)
Exhibit 5	Critical Systems
Exhibit 6	Supplemental Glossary of Terms
Exhibit 7	Customer Sites

Exhibit 8	Third-party Agreements
Exhibit 9	Customer's Responsibilities
Exhibit 10	Detailed Transition Plan, including methodology and other requirements
Exhibit 11	Detailed Readiness Review and Pilot Test
Exhibit 12	Key Employees (Specific outsourcer individuals key to the project's success)
Exhibit 13	Detailed Pricing, Baselines, Pricing and Pricing Methodology
Exhibit 14	Invoicing Requirements
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Important Elements

It is important to note a few key considerations with respect to the Transaction Agreement.

1. Exhibit 1. The Designated Services Requirements are specifically written for the services an individual business unit expects the outsourcer to perform. This document is not a shopping list of services that can be provided; it describes, in detail, each of the services to be provided. In an outsourcing transaction, this is the most difficult and time-consuming document to develop; it also is the most important. Unfortunately, many times clients believe that a well-written Master Agreement protects them. The client ignores the fact that the Master Agreement generally points to the Description of Services as the means for determining if the outsourcer is providing the services expected. If this document is not written with clarity and reflective of the business unit's requirements, the contract is seriously compromised.

2. Exhibit 2. Service Levels specifically address those components of the service that are important to the business unit and can be measured and reported. Service levels are a means of ensuring the outsourcer continues to focus on the things the business unit believes are important. Again, this is a time-consuming task, requiring a great deal of thought because most organizations do not have existing written service levels, do not track performance and, therefore, have no performance history. The service levels should be set in accordance with the business *requirements* of the unit, **not** at "best practices." There is a cost to the target level of services levels, i.e., an organization should expect to pay for 24 by 7, 100% up time. The cost of outsourcing, if every component were provided at "best practice" service levels, would be unimaginable.

3. In developing the Designated Services and Service Level documents, consideration must be given to laws, customs and practices existing in the countries where services will be provided. International organizations that outsource do not have one set of services and one set of service levels to be applied around the world.

4. Both the Designated Services and Service Level documents are developed and made part of the contract at execution of the Transaction Agreement. They are not developed after the contract is signed. Those who have conducted outsourcing negotiations can attest to

the difficulty of gaining agreement relative to these documents. The difficulty in gaining agreement supports the importance of having the documents completed before contract signing while the client's negotiating power is strongest.

5. Realizing that an outsourcer's charges are a function of the exact services to be provided and the service levels at which they will be provided, it is difficult for the outsourcer to determine the price of services unless those factors have been agreed upon.

6. Exhibit 10. The Transition Plan provides a comprehensive and detailed list of events necessary to migrate the services to the outsourcer. This plan is not a general list of items to consider; it is a specific plan, written to address the unique issues facing the business unit. The Transition Plan is developed after the outsourcer has preformed due diligence of the client's IT infrastructure. The Transition Plan assigns specific task responsibility with scheduled completion dates. The Transition Plan often is incorporated in the Service Level Agreement as a set of deliverables, with associated remedies if the deliverables do not occur when or as scheduled. Further, the Transaction Agreement should be clear as to whether the transition activities are included in the term of the agreement or if the term is to start upon successful transition. Also of particular importance is determining the date on which invoicing for services will begin and when any service level credits apply. Transition is usually considered completed when the readiness review and pilot test have successfully met acceptance criteria.

Concepts to Avoid in Outsourcing Agreements

Best Practices

Best Practices is a term that many outsourcers and clients use in place of developing a detailed description of the services to be provided or determining the service levels necessary. This has resulted from concern on the client's part that something will be omitted or not adequately described—the description of the service or proposed service levels, current industry trends or, perhaps, the service level bar. If you ask for the bes—as in *best practices*—what more could you require?

The question remains, however, what are *best practices*? Is the client's vision of *best practices* the same as the outsourcer's? Who decides what are *best practices*? Where does one go to get a description of *best practices*? Is there a *best practice* for every IT service? Is there only one set of *best practices*—regardless of industry, country, custom and so forth? What is the additional cost if **everything** must be done according to *best practices*? Can the client afford *best practices* for everything? When *best practices* change, must the outsourcer change and, if so, within what timeframe? And, will there be an additional cost?

Benchmarking

Benchmarking is a concept whereby the level of service or the price of the services is adjusted to reflect current market conditions. The service levels or pricing may be adjusted up or down. This practice is most often proposed by the outsourcer to address the client's concern that they may be paying too much for the services in the out years of the contract.

Benchmarking has been used successfully in simple outsourcing transactions such as desktop help desk support. However, there are a number of problems with benchmarking in complex outsourcing transactions. For example, in describing the benchmarking practice, the contract usually requires that the outsourcer's services, service levels and pricing be compared to those provided of other organizations. It further requires that the comparison be with organizations in the same industry, of similar size (employees, MIPS, etc.), similar geographic location and/or similar technology. This requirement to compare creates the first problem—which organizations should be used for comparison?

Additionally, the benchmarking process usually requires consideration of the capital investment, labor investment, transition effort, risk and other factors made by the outsourcer to establish the services. This creates the second problem—consideration of the financial investment made by the outsourcer: Was the outsourcer required to purchase the assets of the client? …assume the client's existing leases? …offer employment to client's IT staff at similar pay and benefits? …invest in new technology on behalf of the client to provide services? …operate from the client's existing facilities? These and many other factors have considerable impact on the investment required and, ultimately, the cost basis upon which the outsourcer determines the services' pricing in order to earn a fair return on capital.

Once the investment has been made, is it reasonable to expect the outsourcer to lower the price of services because of suggested benchmark data? As a result of questions such as this, additional conditions are usually provided in benchmarking procedures, i.e., charging the client for any investment or additional resources required to comply with changes in service or service levels, as indicated in the benchmarking. Therefore, the true risk and cost of benchmarking is clearly on the client, not the outsourcer. Experience has shown that the only effective method to ensure that the services, services levels and price are balanced in favor of the client is to re-compete the outsourcing services with several vendors every 42 to 60 months.

Guaranteed Savings

Guaranteed Savings is a phrase used to secure senior management's acceptance of outsourcing. Just as it is difficult to take a position against the concept of *best practices*, it is equally difficult to oppose the provision of IT services at a lower than current cost. However, once again, the difficulty is turning the concept into reality.

As we have discussed, the price an outsourcer charges is primarily a function of the services provided, the service levels stipulated and the investment required. Determining the exact services and service levels to be provided should be controlled by the business unit through the execution of a Transaction Agreement. If the factors used to determine the outsourcer's price have not been established at the time the Master Agreement is signed, how can the outsourcer guarantee real savings?

While the outsourcer will appear to commit to guaranteed savings, in fact it knows that any one of several events, should they occur, will make an actual calculation of savings impossible. Therefore, the outsourcer realizes that any proposed remedy for not achieving the saving has little chance of being enforced.

Following is a partial list of the events that can prevent the calculation of guaranteed savings. First, in many cases it is difficult to measure current cost—the client and the outsourcer simply never actually agree on the current actual cost (base line cost).

A second stumbling block is that the services are delivered at services levels other than those upon which the base line cost was established. Since most units do not have formal service levels, merely establishing service levels will change the base line assumptions. When the assumptions change, the outsourcer will claim that an apples-to-apples comparison is no longer possible. Then, naturally, the promised savings cannot be delivered.

And, the exceptions continue. Additional services are added during the term—the base line is not valid. Existing services will be eliminated during the term—the base line is not valid. The composition of the services will change during the term, requiring different skill sets for the outsourcer to support the client—the base line is no longer valid.

The number of client users changes, because the client has sold/divested a business unit. This changes the economies of scale envisioned by the outsourcer; the unit cost may be higher. No surprise—the base line has changed and is no longer valid.

The experienced outsourcer knows that the one constant in outsourcing is change. Change brings the opportunity to effectively avoid prior commitments.

Existing Service Levels

Existing Service Levels are, for the most part, not formalized, tracked or reported, nor are remedies paid, if the IT services are provided by in-house staff. In some cases, this is unnecessary because individuals understand that their employment and future promotion depends on how their performance is perceived. An extra effort in solving problems is expected, but not a part of their written job description. When moving to an outsourced delivery mode, service levels become the metric by which to measure the supplier's performance. As a result, significant care must be taken in drafting service levels.

When the outsourcer suggests that it select a period of time in which to measure existing service levels that will be used to set formal service levels, the business unit is deprived of the opportunity to raise the expectation level. This process makes service levels only as good as they are today. The better course of action would be to develop each service level metric in such a manner that it directs the outsourcer's attention to those components of the service most important to the business unit.

Diverse business units typically have different operational requirements. Therefore, one set of service levels applied across different businesses is not appropriate. For one business unit, online data availability for customer use may be key to the unit's success. For another unit, help desk support may be the key. Setting service levels the same across business units has the effect of depriving a unit of levels it needs or, perhaps, forcing it to pay for levels not needed.

Concepts to Include in Outsourcing Agreements

Control of Strategic IT Direction

Control of Strategic IT Direction is the means by which organizations design IT solutions to foster business objectives, create market differentiators and/or control delivery costs. The current trend is for an organization to retain control of the strategic direction and have the outsourcer execute the strategy. By retaining control of strategic direction, the client assumes responsibility for transforming IT services in the direction that best serves its business interest. If this position is to be adopted, it must be clearly articulated in the contract.

Control of strategic direction has several implications in structuring outsourcing deals. When the organization is to retain control of strategic direction, the current senior IT management should remain with the organization and not be a part of any personnel transfer to the outsourcer.

Secondly, the infrastructure (hardware/software) required to support the organization is determined by who controls the strategic direction. Therefore, if the client retains control and then changes direction, requiring a different infrastructure, it will be at the financial expense of the client, regardless of who owns the assets. The mechanics of how the change is to occur and who is responsible for which elements is defined in the Change Control Procedure section of the Master Agreement.

Asset Ownership

Asset Ownership provides the client with increased ability to resource the provision of outsourcing services, should it desire to do so. One of the criteria influencing *asset ownership* is whether the services will be provided from the client's facilities or from the outsourcer's facility. In a case in which services are provided at the client's facility, it is preferred that the client owns both the hardware and software assets. When services are provided from the outsourcer's facility, it is important that the client own the software assets.

The importance of asset ownership is related to termination charges. If the outsourcer owns the assets, then the termination charges are generally higher. Additionally, the term of the deal may have been extended in order to recoup the outsourcer's capital investment, while still maintaining affordable monthly service fees. Similarly, if the client owns the assets, the outsourcer's main role is one of providing personnel and technical expertise. This allows the client to resource the work internally or to a different outsourcer; neither then has to make a large capital investment. The contract should specifically address this issue. If the outsourcer is to procure assets in the name of the client, a separate contract section should describe the roles, duties and responsibilities of each party.

A third issue in asset ownership is the "way out" of the contract. If asset ownership is retained, it becomes much easier to re-source or in-source the services at a later time.

Pricing Tables

Pricing Tables provide an easy means to reconcile the outsourcer's billing with the services provided. Tables should be constructed for each business unit, for each location and for each service provided. The tables should include pricing for each year of the contract term. By constructing the pricing table per business unit, per location, the client can determine the impact on the total corporate IT outsourcing charge should a unit be divested. In addition, an estimate could be made of the cost if the divested unit wanted to retain the outsourcer's services. Pricing per business unit allows the outsourcer to set the price of services and incorporate the service levels established by the business unit. In this manner, as a result of different service level requirements, two different business units may pay disparate amounts for the same type service.

The pricing table should include a separate price for each of the services provided, i.e., help desk, hardware maintenance, software support per major application and so forth. This allows the client to calculate the cost of each service. It is important to include with each table the assumptions upon which the price was determined. The assumptions include volume metrics such as number of employees, number of transactions per system and so forth. Also included with each metric is the associated cost to adjust the price upward or downward as that metric changes. Constructed in this manner, the table allows the client to know the impact on the cost if, for example, another 150 employees were to be supported by the help desk.

Termination Tables

Termination Tables provide the client with a pre-negotiated cost to terminate for convenience some or all of the services. Again, this table is structured per business unit, per service and should reflect a decreasing cost obligation as the client moves through the term of the contract.

No one likes to think about termination when putting forth the great effort required in structuring an outsourcing deal. Nevertheless, the client's ability to negotiate a reasonable termination fee is greatest before the contract is signed.

Continuing Obligation of the Parties to Perform

Continuing Obligation of the Parties to Perform provides assurances to the client that should disputes, particularly fee disputes, occur, the outsourcer is obligated to continue to perform all of the services, at agreed service levels, until the dispute is resolved. This eliminates a situation in which the client must pay disputed amounts or perform actions that they believe are not required in order for service to continue. While it is correct and

important that the outsourcer receive all monies due, in the short term, it is not as important as the client receiving the services necessary for the business to function.

Reporting Requirement

Reporting Requirement (Rolling Estoppel) is an effective tool for the client to control the outsourcer's performance, particularly in software development projects. Everyone has either experienced or has heard of a development project that is considerably late and over estimate. In many if not most instances, it is at the scheduled delivery date that the client first learns of the problem. How does the Reporting Requirement tool work?

A key to the progress report or *reporting requirement* is the concept of rolling estoppel. Specifically, when the outsourcer is reporting on the status of the project, it is to report anything that is putting the success of the project at risk, that is, meeting the completion date. Therefore, it is the duty of the outsourcer to notify the client of any task for which it has responsibility that is not completed as scheduled.

Under the rolling estoppel concept, the client is entitled to assume that no problems have occurred unless identified in a progress report. This concept is important because the outsourcer is prevented from claiming that a problem has arisen, causing delay or additional expense, if it had knowledge of the problem and failed to identify it in the current report. The rolling estoppel concept is important in preventing the outsourcer from claiming delay or additional compensation because of an action or inaction on the part of the client.

Conclusion

Over the years, the structure of outsourcing deals has changed. Outsourcing deals have evolved from those that placed a heavy reliance on the outsourcer to provide a total solution, including determination of a strategic IT direction, to those in which the client maintains control of it own destiny. The new outsourcing environment is one in which the client does not accept vague promises from the supplier. Instead, it is one in which the client holds the supplier responsible and accountable for achieving defined, measurable targets.

Major IT outsourcing transactions are complex deals. They require a great deal of effort on the part of both the outsourcer and the client to define the details of the transaction. Clients realize that the definition process always occurs. The difference is that today's client requires the definition before the Transaction Agreement is signed. They require the definition to protect themselves, to ensure that they fully understand the exact services to be provided, the service levels at which the services will be provided and the real cost of those services.

With good contracting practices and proper contract structure, followed by careful management of the contract after it's signed, today's outsourcing client is in a better position than at any previous time to receive value for its efforts and the services for which it paid.

Exhibit A

Master Agreement

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