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Embedding Improvements and Innovation into Outsourcing Arrangements

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by Alistair Maughan, Susan McLean

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Business decisions to outsource often focus on the need to improve service performance and drive innovation. At the outset of an outsource process, most service providers enthusiastically promote their “transformational” outsourcing services and the resulting improvements and innovation. But companies mostly find that, once a contract is signed, much-promised performance improvements and innovation rarely materialise. So, how can an outsourcing relationship be structured to drive the desired service provider behaviour and deliver service improvements or innovation?

Service Levels

Regardless of the amount of due diligence carried out, service providers are instinctively reluctant to agree to improved future service levels in excess of those historically achieved, especially where the service provider is taking over customer facilities, assets and employees. But companies may be entitled reasonably to expect higher levels of service than if a service is provided in-house because for example:

- the service provider is an expert in delivering the outsourced services, the customer is not
- one of the business case justifications for outsourcing is to gain improvements/service efficiencies
- customer personnel may feel disaffected by the outsourcing of the services they provide, and that related staff concerns could have affected recent service performance (and therefore achievement of service levels).

Typically, a company should not necessarily adhere strictly to the historic service levels in any case - nor those proposed by the service provider or so-called industry standard service levels. Rather, the company should take the opportunity to consider the business impacts that are of key concern and assess whether the service levels need to be more outcome-focused than is traditionally the case, building-in those specific service levels the business requires.

Most outsourcing negotiation processes, however, tend to deal with the past and present – while ignoring the future. In fact, whatever service levels are agreed at Day 1, the contract should incorporate a mechanism to improve those service levels during the contract term, preferably by way of an up-front programme of service level improvement. For example, the customer may agree to a level of [***x***] per cent, provided that the service provider improves this to [***y***] per cent by the end of year 1.

Companies should also consider a ratcheting or re-baselining mechanism to ensure that the service levels are challenging yet achievable throughout the contract term. For example, if a target service level is 95% but, over the course of a year, average performance actually meets 97%, then the service improvement mechanism should automatically increasing the target service level (either to 97% - or at least a level which almost closes the gap) for the following year.

An outsourcing customer should also consider whether it is prepared to incentivise the service provider to improve performance beyond the originally agreed service levels. For example, is there a business benefit to paying pre-agreed service bonuses if the service provider achieves higher performance levels or is there no material benefit to the business as a result of such over-achievement?

Whatever approach is taken, the parties should agree governance mechanisms that include regular meetings to review service performance and improvement.

Productivity

Productivity improvements can be measured in different ways. For example, for application development, they can be linked to increased function points achieved per man-day. The parties can measure the customer's staff's pre-outsourcing historical productivity and review whether improvements have been made against that historical position. If the improvements are not achieved against the forecast baseline, the customer could require a credit of the cost of the additional man-days required due to the fact that productivity improvements have not been achieved.

Alternatively, agreed productivity improvements could be built into the service charges – with the risk borne by the service provider if these are not achieved. Whatever measure is used, it should be carefully thought through and clearly constructed. In 2006, Sprint sued IBM claiming that IBM had not achieved the contractually agreed productivity improvements, had failed to comply with the agreed productivity measurement methodology and had not provided the contractually agreed data to support its productivity claims. IBM on the other hand claimed that the productivity formula was incomplete. The case settled out of Court, but it highlights the importance of getting the mechanism right from the outset.

Continuous Improvements

Over time, technology and outsourcing solutions will develop, allowing outsourced activities to be undertaken more efficiently. The service provider should be under an obligation to inform the customer of such improvements, together with details of opportunities to increase the customer's revenue or reduce its cost base, whether this is done at a regularly scheduled improvements meeting or on an ad-hoc basis.

To incentivise the service provider to propose actual and realistic improvements, the customer could require a certain number of improvement proposals per year or require the service provider to build a certain number of improvement man-days into the services charges. Lastly, it could consider including a form of gainsharing mechanism to address how reductions in costs or increases in revenues can be apportioned between the parties. If both parties derive some benefit from improvements, the service provider may be more likely to suggest them.

Innovation

Customers often want, and expect, a service provider to bring innovation to the services. But that can be no more than a general expectation or desire and it may be difficult (if not impossible) to specify in advance what that innovation should be, and when in the contractual lifetime it should be delivered.

If innovation is key to the company's objectives for the outsourcing, the customer should consider the service provider's track record, take references and speak to its existing customers to evaluate the service provider's innovation in practice (rather than taking at face value the sales material that service providers include in tender responses or proposals).

The customer may even consider giving each service provider a small project during evaluation to test the service provider's capacity for innovation.

Successful innovation doesn't happen by itself; it needs an engine to drive it. Companies should examine critically how what they think constitutes their "innovation engine". For example, in the contract itself the customer should include mechanisms to ensure that innovation is regularly proposed, considered and tracked. As with continuous improvement, the customer could consider requiring the service provider to build into the services charges a certain level of innovation resource or projects per year.

Softer Methods

The customer could also consider softer methods of incentivising improvements, for example, by requiring that a proportion of the service provider's key account managers' bonuses are linked to the results of an improvements-focused customer satisfaction survey.

Conclusion

It is often assumed that outsourcing will deliver performance improvements and innovation. However, to ensure real business benefits are delivered to it, a customer needs to ensure that its outsourcing relationship incorporates the right improvement mechanisms. In addition, it will need to manage the service provider pro-actively to drive the right behaviour. As with all outsourcing success, firm contract and relationship management is key.

Ultimately, a customer has to be realistic. If it truly wants a service provider to deliver improvement and innovation, it will need to invest in that improvement and innovation - be that financially, or by contributing efforts towards that improvement and innovation. Although achieving improvements and innovation may not always be impossible, it is still no easy feat.