Outsourcing Governance

Part 1 — Analysis of Contract Tools

1. Introduction

Successfully managing an outsourcing contract requires customers both to include the right governance tools and mechanisms in their contracts and then to use those tools appropriately.

Outsourcing contracts are not all created equal — the relationships they create can range from that of a customer purchasing a service from a supplier to something more akin to a partnership. The governance tools that the customer should include in its contract will vary significantly, depending on the type of relationship being created (see section 3). Even where governance tools are included, the extent to which the contract needs to deal with each tool, either in particular detail or relatively short-form, will also vary depending on the tool's relevance to the relationship type. Section 4 of this whitepaper describes the types of issues that will be addressed in the short- and long-form of each contract term.

While these contract tools provide the customer with leverage in managing the contract, they should be used knowingly, with a view to their potential impact on the relationship. Part 2 of this whitepaper (to be provided in the next edition of Middle East & Africa Technology, IP and Sourcing Focus) will analyse the potential impact on the relationship of actually using the tools.

2. Types of Relationships

In Section 3, we have divided the outsourcing relationships into three categories:

- **Transactional**

  Transactions involving interchangeable products, priced on a commodity basis, with highly specified deliverables. Typically, these will be standard (or close to standard) supplier offerings.

- **Enhanced**

  Transactions involving greater flexibility on the part of the supplier, with the supplier needing special knowledge of the customer's business. The transaction will involve customisation of the supplier's standard solution to meet the customer's specific requirements as they change over time.
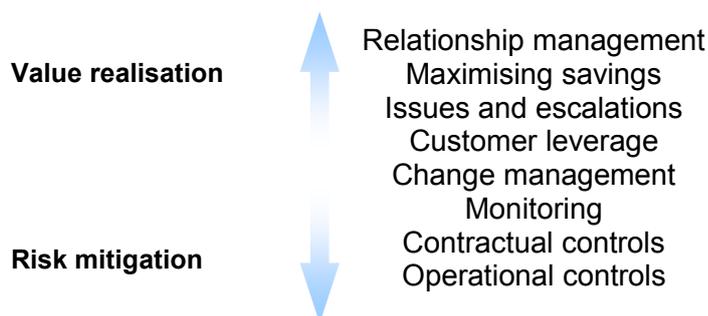
- **Collaborative**

  Transactions involving a transformation of the customer's IT environment or business processes. These transactions involve a highly customised solution where the supplier works within the customer's environment to transform it. These transactions are solutions orientated, often with shared rewards and a high level of integration between the supplier's and customer's teams.

Importantly, customers should recognise that most Enhanced outsourcing relationships include commodity components and that most Collaborative outsourcing relationships include Commodity and Enhanced components.

Range of Functionality

The table in section 3 also groups the tools vertically by functionality (colour coded) and these are arranged in a continuum from top to bottom, showing whether and the degree to which the tool enhances value realisation or risk mitigation:

Value realisation

Relationship management
Maximising savings
Issues and escalations
Customer leverage
Change management
Monitoring
Contractual controls
Operational controls

Risk mitigation

3. Analysis of Contract Tools

Which contract tools are essential to the transaction (and the extent to which the contract should focus on each) depends on whether the relationship will be transactional, enhanced or collaborative:

Contract Tool	Transactional	Enhanced	Collaborative	Tool Functionality
	● High focus ◖ Medium focus ○ Lower focus			
Committees	○	◖	●	Relationship management
Representatives	○	◖	●	
Key personnel	◖	●	●	
Reviews	◖	●	●	
Risk/reward (*e.g.*, gain-sharing)		○	●	Maximising savings
Price/service review (*e.g.*, benchmarking or market testing)	●	●	○	
Issues resolution	◖	●	●	Handling issues and escalations
Dispute resolution	●	◖	○	
Service levels and service credits	●	●	◖	Customer leverage
Withhold payment	●	●	●	
Non-exclusivity and flexibility	●	●	◖	
Payment and liquidated damages on transition milestones	●	●	◖	
Termination assistance	◖	●	◖	
Contractual change management	○	●	●	Unexpected change
Reports	●	●	◖	Monitoring
Information requests	○	○	●	
Audits	○	●	●	
Approvals	◖	●	●	Maintaining contractual control
Subcontracting	○	●	●	
Retention and removal of personnel	○	◖	●	
Operational requirements	●	●	●	Maintaining operational
Operational change management	●	●	◖	

Contract Tool	Transactional	Enhanced	Collaborative	Tool Functionality
Procedures manual	●	◖	○	control
Working with third parties	○	●	●	External facing

Note: legend for the focus symbols — ● High focus, ◖ Medium focus, ○ Lower focus

4. Summary of Contract Tools

The following table describes the different types of governance tools, both in their basic form as well as the more detailed versions that should be covered if they are central to managing the particular type of agreement.

Contract Tool	Basic Requirement	Additional Focus
Committees	Committee structure, regularity of meetings, membership.	• Typically, do not have the authority to amend the Agreement whether formally or informally. • Define charters and guiding principles. • Specify rules for the meetings (*e.g.*, which party prepares agenda and minutes). • Refine structure of organisation. • Consider the extent to which supplier will participate in customer's internal forums.
Representatives	Each party to appoint a relationship executive and a contract executive. Identify further key representatives for specified areas of approvals and management.	• Supplier contract executive to have the authority to apply resources or make other changes as required to ensure customer satisfaction. Customer contract executive is the key customer contact for the supplier. • Link to governance structure.
Key personnel	Identify key personnel positions (to include the supplier customer executive), with customer's right to approve, and restrictions on removal of, relevant personnel.	• Obtain ability to change designated positions. • Require linkage (subject to legal restrictions) between account performance and recompense for these personnel.
Reviews	Annual review of contract.	• Include contract walkthrough with supplier to confirm that obligations are being met. • Institute internal customer monitoring programme to regularly confirm that supplier obligations are being met. • Differentiate between types of reviews (technological, strategic etc.). • Regular production of conformed version of contract showing cumulative changes.

Contract Tool	Basic Requirement	Additional Focus
Risk/reward (*e.g.,* gain-sharing)	Identify in the agreement circumstances where the parties expect to collaborate on a risk/reward basis.	Include detailed mechanisms for implementing the methodology.
Price/service review (*e.g.,* benchmarking or market testing)	Always consider the extent needed (is it required for a short term deal?). If it is required, all aspects of the mechanism need to be locked down with an independent and objective process for the provision to have any real effect.	• Because litigation or arbitration can take a long-time, supplier appeal rights significantly reduce the value of the provision to the Customer. • Refine process (*e.g.,* consider whether a top down or a bottom up benchmark is appropriate for the type of services). • Consider alternative or supporting mechanisms such as market testing in integrator deals. Note: Most-favoured customer provisions often come up, but these provisions tend to be heavily resisted during negotiations and difficult to enforce in practice due to confidentiality restrictions.
Issues resolution	Ensure that the relationship management structure has the appropriate committee and escalation structure to address issues before they become disputes.	Identify specific processes to address any expected contentious issues.
Dispute resolution	Specify an escalation process for addressing disputes.	• Integrate the dispute resolution process with the issue resolution process to head off disputes. • Consider appropriateness of alternative dispute resolution mechanisms.
Service levels and service credits	Service credits applicable on failure to meet key service levels.	• Flexibility to change service credit weightings, add and delete service levels and promote/demote service levels and key performance indicators. • Introduce advanced mechanisms to incentivise ongoing improvement. • Consider whether and how service levels should increase over term.
Withhold payment	Customer right to withhold payment of disputed charges.	• Specify circumstances (and any limits) on when customer can withhold payment of disputed charges.
Non-exclusivity and flexibility	Maximise flexibility under the contract (to the extent economically viable) to allow removal of services and minimise any volume floors.	Identify the combination of commitments that maximise supplier protection (and allows competitive pricing, with reduced risk premiums) and customer flexibility. This will typically include the play-off between the following (not all will be appropriate for each

Contract Tool	Basic Requirement	Additional Focus
		deal): • Term; • Fixed v. variable charges; • Non-exclusivity; • Minimum revenue commitments; • Restrictions on the rate of removal; • Termination for convenience charges; and • Volume bands.
Payment and liquidated damages on transition milestones	Transition Fees payable on a milestone basis.	• Identify key initial transition tasks that should be triggers for liquidated damages. • For transformation and/or major transition projects, use detailed mechanism for acceptance testing and allocation of financial responsibility for any delay. • Consider other implications of non-performance such as right to terminate.
Termination Rights	Customer to have broad termination rights (for cause, for convenience upon payment of a fee) and others.	• A viable right to walk away from the supplier is required for customer to the leverage during the term that is required to manage the supplier.
Termination assistance	Supplier required to provide termination/expiration assistance including: • Termination assistance planning. • Termination assistance management. • Knowledge transfers. • Transition of personnel. • Right to acquire equipment and software.	• Depending on the types of services, consider whether any further rights or assets are needed to ensure self-sufficiency. • Consider interim licence arrangements for a transition period.

Contractual change management	• Require that supplier make changes to the environment in which it provides the services, or processes it uses to provide the services, according to governing requirements, including requiring customer approval for any change that reasonably can be expected to have an adverse impact on customer.	• Include a detailed change management procedure.
		• Specify the types of changes that will lead to a pricing impact, including:
		  o Materiality criteria;
		  o Key aspects of procedure;
		  o Objective mechanisms to govern how charges will be adjusted; and
		  o The supporting information to be provided by the supplier (including to

Contract Tool	Basic Requirement	Additional Focus
		support changes to charges)
Reports	Specify types of reports, regularity and recipients	• Consider whether a database approach is more appropriate. • Refine and reduce list. • Focus on ability to change report types.
Information requests	Obligation on supplier to answer questions and provide information about the services	Agree in advance the limited restrictions on the information that will be provided (*e.g.*, supplier cost information, although there are exceptions) and how to address any required third party consents.
Audits	• Ensure you meet full requirements of the internal audit department (including for customer audits, external audits and regulatory audits). • Obtain rights to perform SAS 70 audits if customer is regulated under Sarbanes-Oxley.	Specify key controls and control objectives to be met.
Approvals	Specify key control points in statement of work that are subject to customer approval.	• Specify categories of change that need to be approved in advance. • Use flexible process to delegate and change approval authority.
Subcontracting	Reserve right to approve material subcontractors and right to force termination of subcontractors in specified circumstances.	• Focus on the materiality definition to ensure that important subcontractors are captured, while minimising unnecessary controls. • Identify provisions that should be flowed down to subcontracts. • List pre-approved material subcontractors.
Retention and removal of personnel	• Require reasonably low turnover of supplier personnel. • Include right to require removal of supplier personnel.	Consider requiring, during initial post-transition stabilisation stage, that overall personnel levels and key individuals are maintained on account, with appropriate milestones.
Operational requirements	Restrictions on how supplier will perform the services (*e.g.*, areas where the supplier is interfacing with the customer, security requirements and customer policies).	Ensure that the controls are kept to the minimum and that they do not create tensions with other obligations on the supplier. On the other hand, do not overlook operational requirements, where the supplier's "how" gives rise to customer risk.

Contract Tool	Basic Requirement	Additional Focus
Operational change management	• Specify the standards that the supplier will meet in performing operational change to the services and systems (*e.g.*, changes performed in a controlled manner with back-out plans etc.). • Distinguish from contractual change management (see above).	
Procedures manual	• Define the process for developing the procedures manual with customer retaining approval rights. • Specify the key topics that will be covered by the manual. • Specify the minimum update cycle for the manual.	Integrate aspects of contract which are likely to need regular updating with the procedures manual so that they are kept current in practice.
Working with third parties	Obligations on supplier to cooperate with third parties, including providing information and access to interfaces.	• Specify the standards that will apply if services are facing external customers or where interacting with multiple supplier environments. • Where there is a danger of finger-pointing, consider multi-party side agreements or charters specifying how disputes will be resolved. • Standardise requirements across contracts with third parties ensuring that a consistent governance approach is taken with all parties. • Introduce priming relationships where appropriate and evaluate whether splitting of processes and functional areas between third parties is appropriate. • Document touch-points between the different parties.

5. Using the Contract Tools

As stated above, while these contract tools provide the customer with leverage in managing the contract, they should be used knowingly, with a view to their potential impact on the relationship. Part 2 of this whitepaper (to be provided in the next edition of Middle East & Africa Technology, IP and Sourcing Focus) will analyse the potential impact on the relationship of actually using the tools.

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