

The Challenge of Outsourcing in the Current Economic Climate

Peter Mulligan and Carrie Neal discuss recent developments in outsourcing and some considerations that should be taken into account in outsourcing agreements.

It has been an interesting year for the outsourcing industry. With the economy slowing, there were predictions that demand for outsourcing would decrease as customers directed spending to other areas. However, recent announcements regarding new outsourcing arrangements between Qantas and IBM,¹ Fosters and Wipro,² as well as Optus and EDS,³ suggest that outsourcing has not lost its popularity. In addition, a Gartner study (Gartner on Outsourcing, 2008-2009) forecasted that outsourcing would continue to grow as organisations seek to generate cost savings and efficiencies.

The Gartner report shows that the global economic slump has meant that customers are re-evaluating their contracts to improve efficiency and costs. Customers are considering more closely the selection and retention of suppliers, how services are or will be delivered, the delivery location and contract pricing.⁴

IDC has also recently reported on the state of the outsourcing market in Australia. According to IDC, the Australian spend on outsourcing in 2008 was \$6.4 billion and is growing at 4% per annum. Despite this growth, IDC has predicted that to succeed in the current market, suppliers will need to differentiate their outsourcing strategies and demonstrate value for money.⁵

Why outsource?

Outsourcing is the transfer to a third party of the operation of a service or function which would otherwise have been fulfilled internally by an organisation. This could be an IT function or a business process, such as human resources, document management, asset management, procurement, customer care or collection of accounts receivable. Alternatively, an organisation may engage a supplier to conduct only part of the service or function and have the other part performed in-house or by another supplier or suppliers (commonly known as 'multi-sourcing').

In addition to cost savings, organisations choose to outsource for a variety of reasons. This may include gaining access to specialist resources, ensuring that work is performed more efficiently or effectively, increasing flexibility and reducing the amount of time and resources spent in-house on non-core activities.

Commercial issues to consider

Customers seeking to outsource services or a business process need to consider a range of issues. These include:

- whom to choose as the supplier;
- how to maintain control;

- how to ensure flexibility; and
- how to manage risks (such as the risk of poor performance by the supplier), including by transferring risk to the supplier or using an external measure such as insurance.

The significance of the first point should not be understated. The Satyam scandal from earlier this year is a good example of the importance of paying careful attention to supplier selection.

Satyam is one of India's largest IT outsourcing providers. In early January, its founder, B Ramalinga Raju, revealed that the company had been falsifying its accounts for years, overstating revenues and inflating profits by at least US\$1 billion. The Indian government sacked the board and took control of Satyam as the fraud threatened to affect confidence in India's multi-billion dollar outsourcing industry. Since then, Satyam has been sold to a third party and India's Central Bureau of Investigation has filed charges against Raju. Satyam customers have had to endure disruption and uncertainty as the scandal played out.

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Shortly after the Satyam scandal, the World Bank announced that it had barred two Indian outsourcing firms, Wipro Technologies and Megasoft Consulting, from doing business with the bank. The bank said that Wipro had been banned for four years for "providing improper benefits to bank staff".⁶ Megasoft was also banned for four years for "participating in a joint venture with bank staff while also conducting business with the bank".⁷ In this environment, it may be some time before the Indian outsourcing industry regains the confidence of customers.

Negotiating an outsourcing contract in the current environment

The types of services that are outsourced are usually either strategically important or a core function within a customer's business. In the wake of the Satyam scandal and in today's context of economic uncertainty, it is particularly important that the parties negotiate a robust yet flexible outsourcing contract.

Some of the key ways of achieving such a contract are set out below.

1 Qantas has signed an agreement to outsource its project delivery function to IBM. See www.itnews.com.au/News/155428,ibm-qantas-ink-seven-year-outsourcing-deal.aspx.

2 Reports suggest that Fosters will outsource part of its internal IT function to Wipro. See www.zdnet.com.au/news/software/soa/Foster-s-confirms-Wipro-deal-job-losses/0,130061733,339298159,00.htm.

3 It has been announced that Accenture and EDS will provide application development and maintenance outsourcing services to Optus. See www.zdnet.com.au/news/communications/soa/EDS-Accenture-win-Optus-app-deal/0,130061791,339298126,00.htm.

4 See www.gartner.com and www.gartner.com/it/page.jsp?id=856713.

5 See IDC, "Australia Outsourcing Services Market 2009-2013 Forecast and Analysis" (2009).

6 See <http://online.wsj.com/article/SB123178764486274231.html>.

7 As above.

A. Services and service levels

It is essential that the outsourcing contract sets out the services to be performed in as much detail as possible. This will typically be in either a service schedule or specification attached to the contract. A detailed services description benefits both parties as the expectations of both parties will be clear from the outset.

Additionally, the risk of poor performance by the supplier may be reduced by including in the contract appropriate service levels and remedies should the service levels not be met. This may include an obligation on the supplier to pay service credits. Service credits are often an amount calculated to deprive the supplier of its profit, and thus to provide an incentive to perform. Customers should be careful to ensure that any service credit regime is not penal in nature and so void under the law of penalties.

An alternative approach, which is increasing in popularity, is to use an outcomes-based contract. Rather than prescribing in detail the services which the supplier must provide, this type of contract focuses on the outcomes a customer is seeking to achieve.

B. Liability

The types of services that customers outsource are usually critical to the operation of their business. In many cases, should the supplier fail to perform, the losses that a customer may suffer are likely to be significant. Customers, therefore, often seek to transfer some or all of this risk to suppliers through a robust liability clause.

The amount of risk that a supplier is prepared to assume is generally dependant upon the value of the contract to the supplier. However, in the current economic climate, suppliers may be willing to take on a greater amount of risk for lower value contracts.

C. Change control

It is essential to build flexibility into the outsourcing contract. In longer term deals, it is rare that a customer's requirements throughout the term of a contract remain static, especially as the economy contracts and expands. Accordingly, the ability to add or remove services from scope is an essential tool to enable a customer to tailor the services to its needs.

It is in both parties' interests to specify a detailed change control procedure as well as a mechanism for costing agreed changes. This will ensure that introducing changes to the services only results in minimal disruptions and that this occurs in a cost effective manner.

D. Term and termination

Other risks with longer term contracts derive from the pace of technology change and changing business requirements. For example, the economic downturn may have reduced the services required by many customers. Under an inflexible long-term agreement, a customer may still be paying for an outsourcer to support functions that are no longer in use due to downsizing of staff.⁸

In order to reduce this risk, a customer should seek to avoid a lengthy contractual term. According to Gartner, today's best practice is a base term of 3 to 5 years, with extension clauses of 1 to 2 years.⁹

In addition, a customer should include in its outsourcing contract the right to suspend the contract for a period (if the customer so requires) and the right to terminate for a maximum range of reasons. It is particularly important in the current economic climate that customers include extensive rights to terminate for supplier insolvency or on the first signs of financial distress. There have been a number of high profile casualties of the global economic

slowdown, including international consulting firm BearingPoint and telecommunications equipment manufacturer Nortel. Both of these organisations filed for Chapter 11 bankruptcy protection in the United States earlier this year and have since had parts of their business sold off to competitors.

The Satyam scandal has also exposed the need for customers to include an ability to terminate for supplier fraud or impropriety. A right of termination for convenience should also be considered, although this will typically be subject to the payment by the customer of certain costs, or the lost profit-margin, of the supplier.

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Concluding remarks

There has been a rise in the number of outsourcing deals reported in recent months. This may be due in part to the global economic conditions and the cost-cutting and efficiency gains that outsourcing offers. However, outsourcing is not always the best commercial solution as it throws open a range of legal risks that should be considered. In the current landscape, it is essential that organisations seeking to outsource structure a contract that is flexible enough to accommodate the many changes that might occur in their requirements as the economy enters a recovery phase.

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⁸ See www.crn.com.au/News/151572,cios-warned-against-long-outsourcing-contracts.aspx/2.

⁹ Mike Lafford, Group Vice President at Gartner, quoted in www.crn.com.au/News/151572,cios-warned-against-long-outsourcing-contracts.aspx/2.