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Drive Your Business

Five Ways to Develop a Successful Outsourcing Contract

Introduction

A few key aspects of an outsourcing contract typically drive its projected savings and return on investment (ROI). You must carefully consider all of these areas to avoid mixed financial results on your outsourcing project. Strategizing the following five areas can help you develop a successful outsourcing contract:

- **Contract components**

- **Unit pricing**

- **Resource volume**

- **Dead bands**

- **Renegotiation bands**

Contract components

A large outsourcing contract typically contains many components. This section provides an overview of the contract components that are most important in developing a successful contract.

Scope of service

The first step in developing an outsourcing contract is to define its scope of service. The scope typically describes the responsibilities and rights of all parties to the contract, but it also should define the contract's requirements. You can begin this process by attaching the request for proposal (RFP) and corresponding vendor's response to the contract. These documents should provide an accurate description of the contract's requirements and how the vendor plans to meet those requirements, provided the procurement process has been performed properly.

The incorporation of sales language into the contract usually troubles outsourcing service providers, since the RFP often describes a scope of service that's different from the final scope that's priced in the contract. The RFP also contains much more information than is useful for the contract. It's therefore important to use the RFP as just a guideline for writing the contract's requirements section.

▶▶ RFPs should provide an accurate description of the contract's requirements – and how the vendor plans to meet those requirements.

Service level agreements

Service level agreements (SLAs) are typically attached to the contract or treated as exhibits. These formal documents describe the service levels required by the contract, as indicated by key metrics. SLAs often determine the success of an outsourcing contract and their use has become more widespread in recent years. Clients have traditionally used SLAs to request service guarantees from vendors such as outsourcers. However, enterprises also use SLAs to obtain service guarantees from their own business units and IT departments. A significant majority of enterprises use both internal and external SLAs, and only a small minority have no SLAs in place at all. The extensive use of both types of SLAs can be effective in motivating enterprises to deliver the same level of service to their internal clients as they receive from their vendors.

The key to creating SLAs for effective outsourcing contracts is to tie the SLAs to business outcomes rather than just technical or transactional measures. Vendors' key performance indicators and day-to-day operations should be aligned directly with the organization's own business metrics. For example, while measures of system availability have been common for decades, what actually matters to the business is "end user perceived availability", i.e. the availability of applications and data to the people who actually use them in their work. And while service desk SLAs have included such conventional measures as response time and time-to-answer, the measures that mean the most to the business itself are things like customer satisfaction (end users' surveyed opinions on their satisfaction with service desk performance) and first call resolution percentage.

The collection of baseline data is a key step in the development of SLAs, since it allows you to set appropriate performance standards. The majority of enterprises are able to collect baseline data for the SLA, although a small minority may be unable to collect this data due to inadequate capabilities or insufficient time. These limitations place an enterprise in the position of creating SLAs without knowing their baseline performance, which is a clear path to undesirable results in an outsourcing contract.

A poorly structured SLA also can lead to unintended consequences in a contract. Many enterprises create too many SLAs in effort to guarantee service levels for all services described in the contract. However, this practice can be a mistake, since it reduces the value of the critical services that have the greatest impact on business. A better practice is to focus on just a few critical services and align those measures directly with business outcomes. Focus and business alignment are two ways to avoid "seeing green but feeling red" when reviewing outsourcing performance.

The service levels described in an outsourcing contract fall into three categories: critical service levels, key service levels, and metrics.

Critical service levels drive the business and generally have financial implications when these service levels are missed. These service levels must be under the complete control of the service provider to qualify as a critical service levels under the term of the outsourcing contract.

Key service levels are less important than critical service levels, since they have no financial implications for the client as described in the SLAs. However, these service levels are still important to the client and may be designated as critical services under specific conditions. The service provider also must have full control over key service levels since they can become critical service levels.

Metrics are service levels that the service provider can measure, although they don't have full control over them. Metrics, therefore, can't become critical service levels or key service levels.
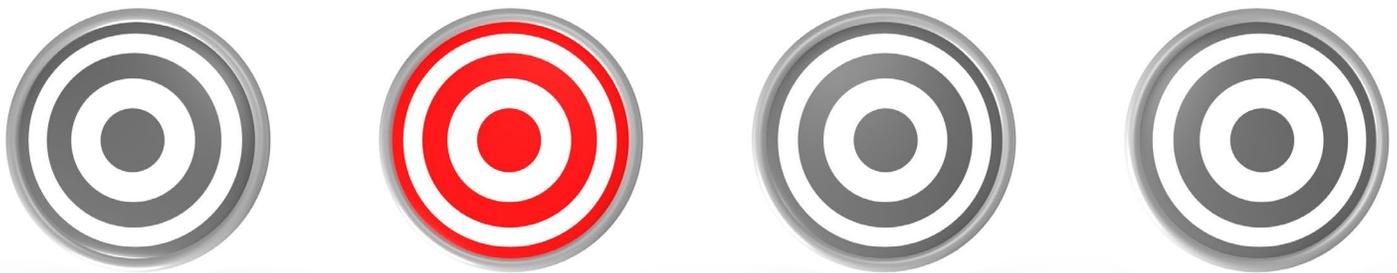
Pricing

The pricing section of an outsourcing contract describes the fees for services. It's essential for this section to include the costs for development, implementation, and conversion. All parties to the contract must clearly understand these terms for the contract to succeed. The pricing section may also describe the cost of de-conversion, which may occur when the contract is terminated. This section should define the conditions under which costs may change, including inflation and changes in activity levels. This section also should place limits on price increases in the event the prices are variable.

Obtaining the best price requires the contract to contain fixed and variable pricing components. The resource volumes should provide a set of volumes that ultimately charge for services on a monthly basis for the lifetime of the contract. The most cost-effective pricing solution on an outsourcing contract is typically a fixed monthly charge for the projected baseline of the resource volume. This strategy allows the contract to reduce the pricing risk to the vendor and increase the client's leverage. It also creates a close correlation between cost and revenue, as well as simplifying invoicing for most contract services.

The fixed-price portion of the contract should retain sufficient visibility to adequately describe its major service components. Assume for this example that the purpose of the contract is to provide IT infrastructure.

The fixed-price portion of this contract should include major hardware, such as mainframes, networks and servers. Components of this hardware may require fixed pricing to identify the resources that are driving your service prices. Additional reasons for using fixed prices include the ability to compare contract services with similar services in the marketplace.

The variable-price portion of the contract allows the client to adjust the fixed portion in response to unexpected volume changes. No one can accurately predict the changes in economy and business environment that can drive the demand for enterprise's goods and services. These changes in demand also impact the IT resources that an enterprise requires, which must be managed effectively.

Finally, the organization should expect continual price reduction to be built into the contract. With a number of factors - Moores' Law, dropping costs of disk storage, cheaper bandwidth, and new automation -- conspiring to continually reduce costs of computing and networking, the vendor's cost to deliver service in Year 3 will be less than in Year 1. The outsourcing contract should reflect this and allow both the vendor and the company to share in those cost reductions.

Ownership

The ownership section of an outsourcing contract specifies the ownership of physical property, including tools and equipment as well as intellectual property such as data, trademarks and work output. It's crucial for the client to retain ownership of existing intellectual property, although equipment ownership depends on the relationship between client and service provider. Either party may retain ownership of intellectual property created as a result of the contract, which primarily includes software in the case of an IT outsourcing contract. The client generally will retain ownership of created software when the client defines the specifications, and the software is an extension of existing systems owned by the client. However, the client and service provider may share ownership of software when it customizes or extends a service provider's product.

Security and controls

The security and controls portion of the contract specifies the safe handling and confidentiality of the client's data, in addition to the vendor practices needed to meet those requirements. These practices may include the controls that determine how vendor staff member will access physical areas of the client's facility or data. Access controls typically require vendors to have non-disclosure agreements (NDAs) with staff members and report security breaches. Some contracts may define additional controls, such as approval of assigned personnel, notification of personnel changes, insurance requirements, and maintenance timeframes. Some clients may need to include compliance regulations in the security and controls section, especially in certain industries like healthcare and finance.

Dispute resolution

An outsourcing contract may contain a dispute resolution section that defines the process for escalating and resolving conflicts. This section typically specifies the escalation time frame for both the client and service provider, in addition to the use of arbitration as a means of resolution instead of civil litigation. An indemnification clause generally requires the service provider to take responsibility for its negligent actions. A limitation of liability clause places limits on the service provider's liability, which is typically equal to the fees paid. The termination clause specifies the conditions under which the contract may be terminated before its normal expiration and usually includes any termination notices and fees.

Audit

An outsourcing contract may contain an audit section for various audit types, including internal control, financial, and security. This section specifies the audit frequency, the party that pays for the audits, and the types of reporting available. It also may define the documentation and timeframes of audit deficiencies and their resolutions.

Performance standards

The performance standards section of the contract defines the SLAs, including the minimum service-level requirements. It also describes the remedies and penalties for failure to meet those standards.

Unit pricing

Unit pricing in a contract includes additional resource charges (ARCs) and reduced resource charges (RRCs). These pricing vehicles apply to each type of resource identified in the baseline volumes and allow both the customer and service provider to adjust the charges of the contract. ARCs and RRCs should represent the variable component of unit pricing, which is the cost of delivering additional services. Fixed charges recover the costs of infrastructure, management and tools, so they should offer enough bandwidth to accommodate reasonable fluctuations in resource usage.

Different variations from the baseline resources may incur different unit pricing, provided the dead bands are broad enough to adequately represent the benefit and risk to the contract. ARC or RRC unit prices generally remain constant, although broader dead bands provide greater justification for cost variations. IT costs decrease as volume increases, provided the additional volume doesn't require more investment in infrastructure. These costs increase when volume decreases to the point that it eats into fixed costs. ARC and RRC pricing comes into play when the service volumes fall outside the dead band specified in the contract on a particular month. These unit rates allow the service provider to recover the additional costs incurred in providing the supplemental services.

Assume for this example that the baseline volume for help desk calls is 10,000 calls per month, and the contract specifies a +/- 5 percent dead band. The help desk receives 11,000 calls in a particular month, meaning that 500 calls fall above the dead band. The service provider would invoice the client for an additional 500 calls, based on the assumption that the existing infrastructure does not support these calls. These 500 additional calls would therefore be covered under the variable-price portion of the contract.

Conversely, the client would receive a credit for 500 calls in a month where the help desk only received 9,000 calls. In this case, the call volume fell 500 calls below the dead band minimum of 9,500 calls. The rationale for this credit is that the service provider's variable cost is less due to the lower number of calls that were supported.

The client should ensure that the unit prices specified in the contract have the desired impact on business behavior. Assume, for example, that the client had an initiative to migrate from paper processing to electronic processing. A misalignment in the prices specified in the outsourcing contract could remove any financial incentive to change this business process.

Resource volume

The client should strive to ensure that the contract specifies base volumes that will remain as accurate as possible for the life of the contract. This strategy will minimize the pricing adjustments that must be made due to changes in service volume. It's important to anticipate future changes that could affect resource volume, which is often the most important factor in driving variances in financial planning. An outsourcing client therefore needs to take enough time during the pre-RFP stage to get the resource volumes right. In particular, the initial resource volumes need to accurately reflect the service levels currently supported in the business environment.

It's also important to consider how those resource volumes will change over the life of the contract. The baseline resource volumes will form the basis for pricing in the contract, which should also represent future volume changes. These baselines need to reflect future growth, so that your enterprise doesn't have to renegotiate the contract to avoid continually paying ARCs.

The most common method of establishing a baseline resource volume is to measure it over the course of a year to account for any seasonal fluctuations in business. Divide this annual volume by 12 to establish the average monthly volume. This methodology works well for most businesses, although a longer time period may be needed for businesses with large changes in annual service volume. Some businesses may use average quarterly volumes to minimize potential credits and debits due to large differences in monthly volume.

The unit of measure is another key aspect of resource volumes. You need to structure your resource units so that you can assess an equitable charge back of services to the end users. The correct units of measure for resource followings will minimize the cost to the end users for services they didn't consume.

The structuring of resource units becomes somewhat more complex in cases involving different types of servers, since each category must have its own set of resource units. For example, a contract may have servers made by different manufacturers, or with different levels of complexity. Resource unit structures also become more challenging to develop when your business strategy changes the mix and volumes of services. Common reasons for this occurrence include migrating from physical servers to virtual servers or moving from paper to electronic processing.

It's especially important in these cases to ensure that the service volume specified in the contract reflect these anticipated changes in resource volume. Failure to account for these volume changes can result in extra charges when they reach the limits of the dead bands and renegotiation bands.

Dead bands

Outsourcing contracts nearly always contain a large amount of hidden scope. Common reasons for this problem include employees who are unclear about what they're doing, as well as work that's budgeted or performed outside the process area. These situations often result in disagreements over who should perform the work or bear the cost.

Major service providers like Pricewaterhouse Coopers address the issue of hidden scope by including a "dead band" in the contract. This section identifies the baseline of services in addition to a small number of other services that the vendor will provide without incremental charges. A contract with a dead band should be written so that the customer can add additional services with rates that are easily understood.

Dead bands require the customer to have a clear understanding of baseline service levels. Otherwise, the service provider may have difficulty in anticipating the customer's needs, even when the provider attempts to perform due diligence. Uncertainty over baseline standards can thus lead to the customer's disappointment over the vendor's service levels, which may require renegotiation of that portion of the contract. No customer can precisely predict the baseline resources that it will require each month, so a dead band minimizes billing complexities due to minor variances in consumed resources. A contract typically expresses a dead band as a variance percentage from the baseline volume.

Assume for this example that you're trying to outsource IT services. Your baseline volume for help desk calls is 10,000 calls per month, but the help desk receives 10,500 calls in one particular month. A dead band of +/- 5 percent will prevent you from paying an additional fee. By the same token, you wouldn't pay less if the help desk only received 9,500 calls. The rationale behind a dead band in this case is that the service provider's costs aren't directly tied to call volume. Furthermore, the dead band provides the help desk with some flexibility on capacity.

A dead band should generally be as close to the baseline volume as possible, while still being greater than the typical fluctuation in resource usage. The service provider will incorporate the additional costs into the fixed or variable prices if the dead band becomes too wide.

Uncertainty over baseline standards can lead to customer dissapointment.

Renegotiation bands

Resource volumes may still fluctuate beyond the limits indicated by the dead band, despite all efforts to prevent this occurrence. This change in resource volume can cause service charges to change so much that it impacts the original purpose of the contract, resulting in a need to re-price the contract. Renegotiation is especially desirable when the change in service volume is likely to become the normal service level. This situation is most likely to occur when the variable and fixed prices in the contract are based on specific resource volumes. A renegotiation band describes the minimum change in service volume needed to trigger a renegotiation.

Both parties in an outsourcing contract typically become interested in renegotiating prices when the service volume changes by at least 25 percent from the baseline level, and renegotiation is almost always necessary before the fluctuation exceeds 50 percent. The current pricing model begins to fall apart when the volume change reaches this level because the increasing use of RRCs makes the costs in the fixed portion of the contract less likely to be recovered. A 25 percent increase in resource volume also means that ARCs may no longer represent the incremental service costs, since the growth in service volume generates greater leverage to reduce unit costs.
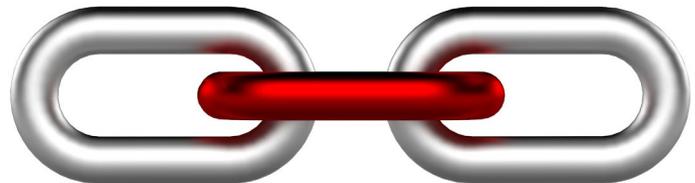
The specific type of service being provided may cause some exceptions to this general rule. For example, some services require additional infrastructure and may not be completely utilized until the service volume increases further. Service volume growth may actually increase unit prices in these cases, rather than reducing them.

Renegotiation bands should be wide enough to accommodate corporate strategy. This process generally involves running scenarios with the proposed fixed and variable prices to reflect possible changes in service volume. These scenarios often explore possibilities such as using past purchase types or divesting parts of the business. Businesses that are expecting significant changes may require wider renegotiation bands to accommodate multiple rates for ARCs and RRCs. For example, a renegotiation band could specify an ARC rate of $10 for each helpdesk call up to a 25 percent change in volume from the baseline level. This renegotiation band could also specify a second rate of eight dollars per call for volume changes between 25 and 50 percent.

An accurate baseline volume is especially critical when developing renegotiation bands. Consider a contract that involves 1,000 servers, including 300 Intel servers and 700 UNIX servers. UNIX servers are generally more expensive than Intel servers, so a business may have an IT strategy that involves shifting from UNIX servers to Intel servers over the life of the contract. A failure to account for this anticipated change in resource volume could result in a scenario in which one of these resource units reaches the renegotiation point before the other one.

An accurate baseline is especially critical when developing renegotiation bands.

Assume for this example that the renegotiation band is +/- 25 percent and 150 Unix servers are replaced by Intel servers over the life of the contract. The volume change for the Unix servers is only 150/700, or about 21 percent. This change falls below the renegotiation band, so the RRC rates can adjust the fixed price of the contract for the Unix servers. However, the volume change for the Intel servers is 150/300, or 50 percent. This volume change falls outside the renegotiation band, which forces a contract renegotiation.

A renegotiation in this scenario provides the client with limited leverage in obtaining a more favorable price. The client is already locked into a multiyear contract with liabilities for early termination, placing the service provider in control of the renegotiation. This example

further illustrates the importance of analyzing resource volumes carefully to ensure that the baseline volume in the contract will adequately represent current and future service volumes. Another key concern when developing renegotiation bands is the need for a methodology that will predict the effect of changes in business environment upon service volumes.

A renegotiation band must clearly state the actions that will occur when service volumes fall outside the indicated range. The RRC adjustment may represent a greater cost than that needed to support the resource volumes if the service provider adjusts the fixed rate. On the other hand, the service provider may not be able to recover sufficient costs to be profitable if the service provider continues to charge the fixed rate plus ARCs.

It's therefore essential that provisions continue to use the existing ARC/RRC rates for volume changes outside the renegotiation band until the renegotiation adjusts the contract prices. The new rates can then be reconciled with the existing rate after renegotiation is complete. The renegotiation band also should describe a period of time during which prices can be adjusted. For example, the renegotiation band could specify that prices can be renegotiated when the resource volume has remained stable for at least three months.
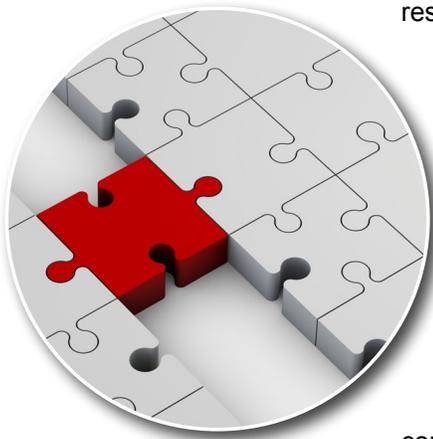
The potential for renegotiating the contract emphasizes the requirement for flexibility in the original contract. The frequency of change in modern business operations is the primary reason that contracts with major service providers often describe two levels of change. The first level is for clients that are growing at a predictable rate, typically less than 15 percent per year. The other level is for clients that change dramatically, usually as the result of an unexpected acquisition or divesture.

An outsourcing contract must be properly structured and provide accurate resource volumes to minimize the probability of invoking the renegotiation band. The primary driver for success is ensuring the resource volumes account for volume changes over the life of the contract. The variable pricing portion of the contract also must be accurate to ensure that price changes align with volume changes. These actions will help to ensure the contract is properly managed to provide the expected benefits for both parties.

Summary

An outsourcing contract's projected savings and ROI are typically driven by a few key features. The development of these features requires careful thought to avoid compromising the expected benefits of the contract. One of the most important considerations is ensuring that the baseline service volume in the contract accurately reflects the current resource volumes and anticipates future volume fluctuations due to changes in the business environment. An accurate estimation of resource volumes ensures a fair price for the services the client consumes each month throughout the life of the contract. The ARCs and RRCs in the contract are composed of unit prices that allow both client and service provider to adjust charges in the contract.

Outsourcing contracts should always include fixed and variable pricing components to obtain the best overall prices for the client. A cost-effective pricing solution generally requires the service provider to include a fixed monthly charge to cover the baseline resource volume. The variable pricing component of the contract allows a client to adjust the fixed component to account for volume changes that are unaccounted for by the baseline levels. Proper structuring of the variable component requires price changes to reflect volume changes.

A dead band minimizes billing complexities due to relatively minor fluctuations in resource volume. The rationale behind including a dead band in the contract is that the service provider's costs usually aren't significantly affected by modest changes in service volume. A properly structured dead band also builds some capacity and flexibility into the contract for the service provider.

A renegotiation band should describe the point at which a deviation from the baseline resource volume has become large enough to impact the contract's original purpose. A properly structured contract and accurate baseline volumes are especially important for developing renegotiation bands, since the client is often at a disadvantage in a renegotiation. These features are also essential for the effective management and business approval of the contract.

Founded in 1995, **WGroup** is a boutique management consulting firm that provides Strategy, Management and Execution Services to optimize business performance, minimize cost and create value. Our consultants have years of experience both as industry executives and trusted advisors to help clients think through complicated and pressing challenges to drive their business forward.

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