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EVERSHEDS

Delivering contracts with teeth

The dilemma…

All too often, businesses are faced with bold promises about the services they will receive from their outsource providers; they are drawn in by the "ideals" pitched to them, and ultimately find themselves disappointed with the outcome as those services fail to live up to expectations.

This is a dilemma that arises time and time again for organisations that procure outsourced services. Outsourcing is undoubtedly a powerful tool for improving performance, driving business change and achieving efficiencies within an organisation. However, it should not be forgotten that any deal requires significant up-front investment from the buy-side organisation, including the costs of undertaking transition and transformation, the need to reconfigure the retained organisation and other deal costs. What happens if the outsourced services just aren't cutting the mustard?

Added complications…

To make matters worse, buyers with long term outsourcing arrangements in place are often shackled by a situation in which service delivery is not acceptable, but performance is not at a level that permits termination. Termination is, in any event, unattractive for the buyer with the upheaval this would result in, and also because of the knowledge of the time and money invested to date.

The survey

In light of this, it is paramount for the buy-side organisation that any major outsourcing contract includes sufficient levers to incentivise good supplier performance. Deal teams spend a huge amount of time forming, negotiating and then drafting outsourcing contracts. Where is this time best spent?

The aim of this survey was to collate data on those contractual provisions in outsourcing agreements which are actually being used by customers at the coalface, to ensure that their suppliers perform. Which terms are being included and which are actually making a difference?

Respondents to the survey covered all sectors, including financial services, energy and utilities, manufacturing, TMT, public sector customers and a range of professional services. The majority represented organisations with a turnover of £50m plus per annum, though a significant percentage also fell into the £10m - £50m per annum bracket. The majority of responses were from buyers of outsourced services, with a small number from support organisations, such as advisory or consultancy. Two types of outsourcing (ITO and BPO) dominated the respondents' current areas of focus (BPO - 30% and ITO - 28%), with finance and accounting, human resources, LPO and analytics/KPO deals all seemingly having a lower level of focus at present.

What we found

It is clearly a topic that generates interest, and respondents were keen to provide real-life examples of outsource relationships where particular contractual provisions have been used to great effect, and equally those that have not had the value that organisations expected when the contract was signed.

Service credits have become a staple ingredient of any outsource contract, and remain in favour and well-used in practice. As one respondent stated, "anything which offers an immediate remedy which hits the supplier's bottom line" is an obvious form of encouragement. Another added that "it is the threat of implementing service credits when performance slips below SLA levels that arrests poor performance". However, many other remedies and contractual provisions, that are similarly "stick" rather than "carrot" approaches to incentivising the right results, are also seen as important to delivering robust supplier performance, such as an ability to terminate in part, a right to remove exclusivity, audit rights to deal with poor performance and imposing remediation planning processes. Perhaps, not surprisingly, step-in rights were viewed as having limited value, along with a right to recover damages for breach from a poorly performing supplier.

What is also clear, however, is that the contract terms are an important baseline to establish and maintain a strong business relationship between the parties. This is particularly clear from the additional commentary that respondents provided, where "effective partnership management" is a common theme. The contract must have the relationship at its heart, through a strong governance structure, constant senior engagement from both sides, a reporting structure that delivers an understanding of whether business requirements are being met, and also an ability to reward good performance where there is a tangible upside for the customer's business.

Continuing with this theme, the survey also demonstrates an openness on the part of the buyer community to revisit the contract terms, if deemed necessary to improve performance and embed confidence in the buyer's organisation. This is only where there was a genuine belief that revisiting the contract would ensure the supplier would start to meet its contractual obligations. The types of changes being considered include renegotiating the charges, adjusting the charging mechanism to better compensate for fixed costs, rebaselining, pushing out certain SLAs, amending the scope of the services being provided and also extending the transition period. Nevertheless, these steps were still seen as "unwelcome" and "rare", and there "needs to be a benefit for both sides in the new terms", with perhaps "a marginal increase in rate, subject to increased contract performances".

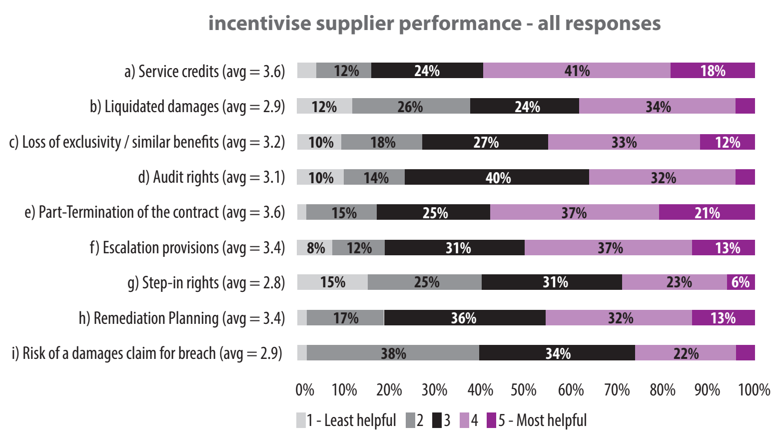
The push factors

Service credits, as well as a right to terminate in part, are both viewed as very helpful tools to deliver performance.

The tool that the highest percentage (21%) of respondents concluded was the "most helpful" tool was termination in part; an interesting statistic. It is a right that is often considered and may be included in outsourcing contracts but often without full thought being given to the consequences. For this to be a right that works in practice, it is essential that the contract clearly identifies what parts of the contract can be terminated, and crucially that it is clear what the impact is on the charges and wider terms that are relevant for the retained services. Without this, the right does little more than trigger a change control discussion.

Step-in rights, liquidated damages and the risk of a damages claim for breach of contract were seen as the least helpful tools. This is not a surprise for step-in (which has become much less useful as a model, with supplier outsource operations less dedicated to particular customers), or for damages claims. However, it is interesting that "liquidated damages" appears lower down the list; perhaps it is seen as too blunt a tool to deal with delays in transition, given the difficulty of identifying that purely the supplier is to blame.

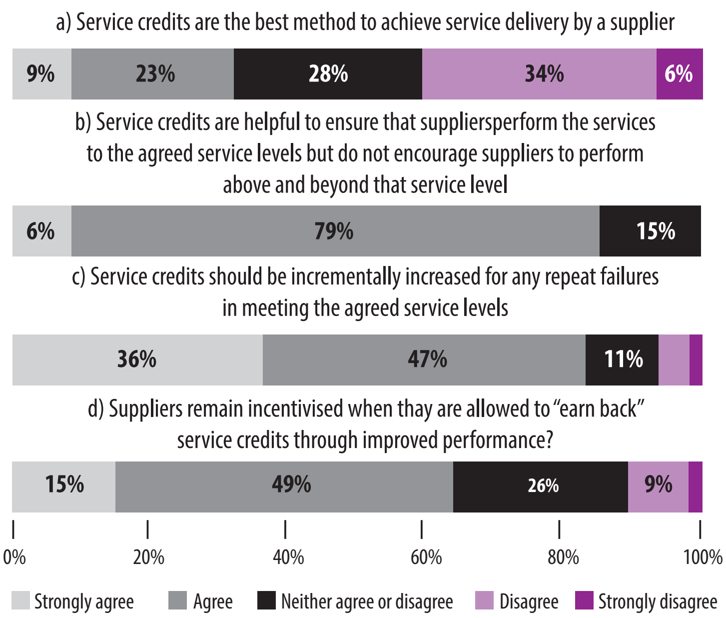
In your view, how useful are the tools listed below in a contract to incentivise a supplier to perform? Please rank each option with "1" being the "least helpful" and "5" being the "most helpful".



Service credit regimes

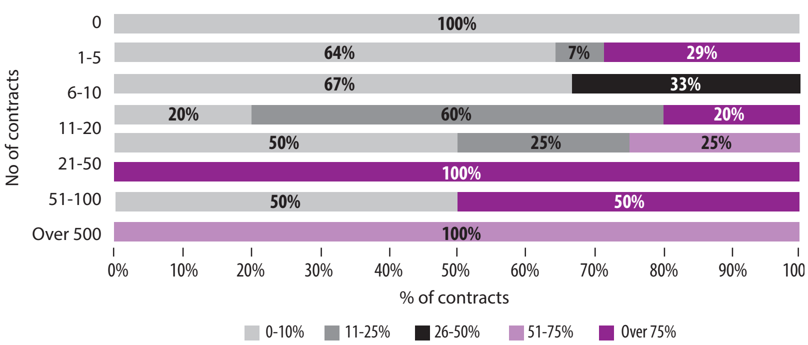
In the additional commentary provided by respondents, service credits come up time and time again as a helpful way to push supplier performance. Despite this, they are not seen as the perfect solution. 85 per cent of respondents agreed that service credits are helpful, but crucially they do not encourage suppliers to perform above and beyond the relevant service level. The mechanism also needs to be thought through: for example, 83 per cent agreed the service credits should, for example, be incrementally increased for repeat failures in meeting service levels. In addition, there is a risk that suppliers are not focused where they should be where there are "badly aligned SLAs" that "drive wrong behaviours". An earn-back element of a service credit mechanism was also seen as attractive, as only 11 per cent of respondents did not agree that suppliers remain incentivised when they are allowed to "earn-back" service credits through improved performance.

Service credit regime - all responses



The chart below provides further detail on how service credits have been used by respondents. 29 per cent of those with 1-5 contracts including service credits (the largest group) have implemented service credits in over three-quarters of those contracts.

In the last three years, on approximately what percentage of those contracts has your organisation exercised its contractural right to obtain service credits for supplier poor performance or for repeated failures to meet the agreed service levels?



Remediation planning, audit reviews and the use of third party experts

11 per cent of respondents regularly use the contract remediation planning process to tackle supplier under-performance, and over 50 per cent apply the process from time to time. A number of respondents noted the importance of being able to deal with under-performance via a "root cause analysis" from the supplier.

***Remediation planning:** There are often contractual provisions in outsourcing agreements which require the supplier to correct/remedy any poor performance within a short time period, with a formal process to put in place and then implement a rectification plan. Which one of the below is most applicable to you?*

	Buyer	Support organisation, etc.	Grand Total
We regularly tackle supplier under-performance by applying the contract remediation planning process.	9%	18%	11%
We apply the contract remediation planning process sometimes to tackle supplier under-performance.	58%	45%	55%
Our contracts include rectification provisions but we rarely, if ever, use them.	33%	36%	34%

Overall, over half of the respondents regularly conduct audits of their suppliers and a number of respondents separately identified that an "ability to increase oversight" where a supplier is not delivering had proved to be helpful.

***Audit reviews:** In the last 3 years, has your organisation conducted an audit of your outsourcing suppliers?*

	Buyer	Support organisation, etc.	Grand Total
Regularly	60%	31%	51%
Only if the supplier is in breach, or we have been required to do so by a third party (i.e. a regulator)	23%	38%	28%
Never	17%	31%	21%

Third party experts are not as popular, with only 8 per cent of respondents continually or frequently using them. 48 per cent use them occasionally and 45 per cent of respondents do not use them.

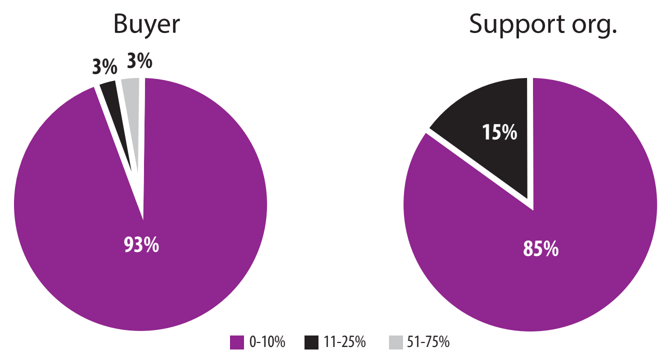
***Third party expert**: Has your organisation ever instructed a third party expert to review poor supplier performance?*

	Buyer	Support organisation, etc.	Grand Total
Yes - continually	0%	15%	5%
Yes - frequently	4%	0%	3%
Yes - occasionally	44%	54%	48%
No	52%	31%	45%

Step-in rights

Step-in rights are not very popular. This is understandable as, in many cases, the skills do not exist to do this, or the outsourcing operating model is not one that lends itself to a third party taking over the running of it. Over 90 per cent of respondents stated that they have used step-in rights on less than 10 per cent of their contracts.

***Step-in rights:** In the last 3 years what proportion of your outsourcing contracts has your organisation used step-in rights to deal with supplier's poor performance?*



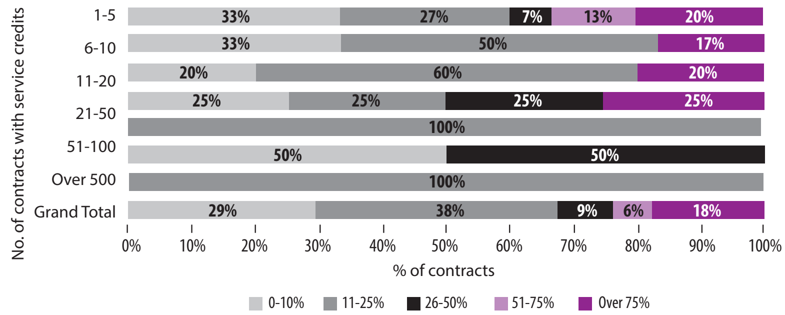
The pull factors

Senior escalation

The chart below shows how escalation has been used by respondents. Feedback from the survey respondents stresses the importance of using the contract escalation processes, with a common message being that it is key to "work closely with the supplier at a senior level" and "senior level escalates", "senior management escalation" and "escalating the issue to a director within the supplier organisation" all being the ways in which respondents identified they had resolved a recent problem with supplier poor performance. However, what is also clear is that "senior management had to be really engaged in the issues and could not just have a superficial understanding".

Over 70 per cent of respondents indicated that they have employed some form of escalation in over 10 per cent of their contracts.

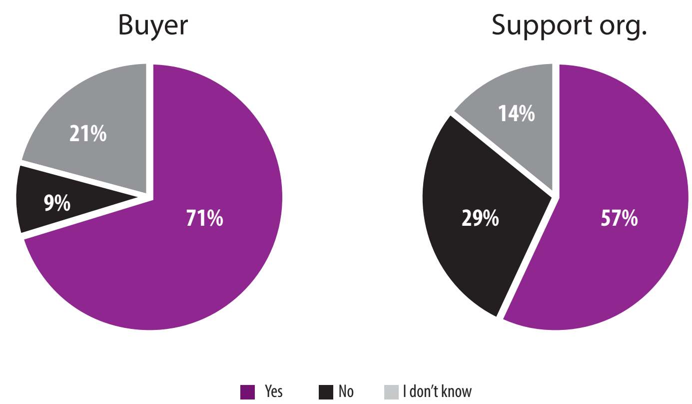
Senior escalation. In the last three years, on approximately what percentage of your outsourcing contracts has your organisation used the contractual escalation provisions in an outsourcing agreement to tackle supplier poor performance?



Amending contract terms

67 per cent of respondents would agree to amend terms for a supplier in order to improve performance, though the additional commentary indicated that this option perhaps only came into real consideration when other options had been exhausted, and where there was a genuine belief within the buyer organisation that the supplier was not able to conduct its business in a profitable way.

Payment incentives: Would your organisation ever agree to amend terms for a supplier for a service in order to improve supplier performance (on the basis that the supplier claims it has struck a bad deal and is unable to turn profit)?



Additional commentary

Many respondents were vocal around the importance for a contract to recognise the relationship element of an outsourcing arrangement, such as:

"Continual working together and review of performance, using relationship and communication as opposed to contractual remedies."

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"By close and continuous contract management, regular reviews, a careful use of change control and constant senior engagement in reviewing performance."

"Close working relationship that recognises the supplier's and client's needs and ability to conduct business in a profitable way."

"More to do with supplier relationship management than contractual stick and carrot – if relationships are good, this fosters a better working environment and improved performance."

Conclusion

It remains the case that having a number of levers in an outsourcing contract to incentivise good performance from your suppliers is paramount. Although it is accurate to say this survey demonstrates that certain provisions are more favoured by the buyer community, what is also clear is that having a range of options available to an organisation at any given time is very beneficial; the solution is very much dependent on the particular facts at the time and there is no particular contract tool that will be sure to fix all problems. There must be sufficient tailoring to a particular transaction, and the contract must be able to deal with the multitude of types of breaches or poor performance issues that can arise in an outsource relationship.

Secondly, building and maintaining a strong relationship with your outsourced supplier is equally as important, and the contract must provide a strong framework for doing that.

Finally, buyers can of course look outside of the immediate contract terms to drive better performance. A number of respondents pointed out the benefit of having alternative suppliers in place, holding back on (or not giving) further work to a supplier that is not delivering on the existing contract, and also not being as open as it could be to providing support to a supplier where that supplier is hoping to win work from other potential clients. Of course, it is important that buyers consider these levers as part of their wider vendor management strategy, which needs to sit alongside the approach taken on each outsource contract.