Best Practices in Outsourcing Governance

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What is Governance?

- “the structure for determining organizational objectives and monitoring performance to ensure that objectives are obtained” (OECD Principles for Corporate Governance)
- “specifying the decision rights and accountability framework to encourage desirable behaviour” (Weill, IT Governance)
- “the buzzword for the most effective strategies for resolving issues that seem endemic to outsourcing transactions” (Hogan & Hartson)
What is Governance?

- Governance can be thought of as a set of structures, mechanisms and protocols for communication, monitoring, and decision making that foster predictability and trust.
Importance of Governance

- Relationship problems and associated governance failures are a leading cause of unsatisfactory outsourcing outcomes
- Effective governance is key to obtaining value from outsourcing transactions
- Growing requirements for flexibility and control require increasingly sophisticated governance
- Governance is the “top challenge” for outsourcing professionals and must be institutionalized as an important component of the outsourcing relationship
Theme: End-to-End Governance

- Effective governance requires a good transaction structure and well-managed processes.
- Internal and inter-party governance must be integrated throughout the process.
- Internal governance will apply throughout the initial review, development of the RFP, assessment of proposals, change management, etc.
- Negotiation governance: provides negotiating team with escalation path to executive sponsors.
- Transition project management.
- Operational governance requires information flow and transparency, governance SLAs, reporting, monitoring, regularly scheduled meetings: good process around these requirements is critical.
- Dispute resolution mechanism, with escalation powers from working team to senior executives.
Stages in the Outsourcing Deal Cycle

1. Internal Assessment / RFP
2. RFP Response
3. Negotiation
4. Transition-in
5. Operational Stage
6. Transition-out

Governance issues arise at each stage in the outsourcing deal life cycle
Stage #1: Internal Assessment / RFP

- Good internal deal governance begins during assessment of opportunity and development of the RFP
- Ensure there are structures within the company to effectively manage the outsourcing transaction and relationship
- RFEI or RFP is the first point of engagement with the service provider
  - it sets the rules of engagement and interaction
  - it sets the tone for the relationship
Stage #1: Internal Assessment / RFP

Assess and understand the opportunity:

- Document the current “as is” base case (including governance structures and processes)
- Consider making changes prior to outsourcing (fix problems and internal governance processes before outsourcing the services)
- Clearly identify and demark the scope of work that could benefit from outsourcing
- Consider which procurement model is best suited to the opportunity (RFI, RFP, RFQ, dual track, sole source, etc.)
- Establish clear governance processes to ensure appropriate communication and procedural fairness throughout the RFP process
Stage #1: Internal Assessment / RFP

Good Governance and Executive Support:

- Outsourcing may be used to advance a number of different objectives (cost savings, etc.)
- Good governance requires clear executive alignment on the objectives of the outsourcing transaction
- Executive sponsorship, ownership and support of the transaction and governance process is critical
- Commitment of management, subject matter experts, legal and other resources is required for timely and successful completion of the transaction and the effective longer term governance of the outsourcing relationship
Governance and the transaction team:

- At the outset, identify the expertise and skills required to successfully complete the outsourcing transaction.
- Assess available internal resources and expertise (management team, subject matter experts, legal, negotiating team members, etc.)
- Early in the process, select and retain outside outsourcing expertise (legal, consultants, technical, etc.) as required to fill gaps but ensure that governance functions are staffed for the long term.
- Integrate internal and external resources to form an effective and cohesive team (operating within clearly defined governance structures).
Stage #1: Internal Assessment / RFP

Tailoring the RFP:

• Customer needs to have (and to communicate through the RFP) a clear and coherent understanding of its key objectives and value drivers
• Lack of internal coherence and a common vision is particularly damaging to mid-size sourcing projects
• Senior management focus and support is critical
• The RFP needs to communicate the Customer’s governance expectations and objectives and also to set forth the rules of engagement around the RFP (and governance structures applicable during this stage)
• Customer should try to view the opportunity from the perspective of the service providers and to build in clear governance interface points
Stage #1: Internal Assessment / RFP

RFP Outsourcing Contract:

- Inclusion of an excessively one-sided draft model contract in the RFP is likely to give rise to a number of governance problems from the outset:
  - Deter potential service providers from vigorously pursuing the outsourcing opportunity
  - More difficult and contentious negotiations resulting in missed deadlines, delayed implementation and loss of credibility with stakeholders, etc.
  - Additional process costs
  - Harm to the relationship (which may prevent the parties from arriving at an optimal outsourcing solution)
Stage #2: RFP Response

• The evaluation criteria and processes for communicating with the service providers should be established prior to issuing the RFP, and should be reflected in the RFP

• Customer needs to consider the key factors that will drive the selection of the successful service provider, including:
  – Objective factors such as price, service levels, response times, alignment of governance structures, etc.
  – Subjective factors such as reputation, culture, quality of the response, location of facilities, depth of operational team, relationship personnel, etc.
Stage #2: RFP Response

- Customer must determine the weight to be assigned to each factor, and how to effectively quantify each factor.
- Other factors, such as culture, working relationship and information gathered from site visits with other customers frequently play an important role in the down select decision.
- It is critical that customer and service provider be able to work effectively together through compatible governance structures in a collaborative relationship in order for the outsourcing to succeed.
Stage #3: Negotiation

Governance and Preparations for Negotiations:

• The parties should agree to rules of engagement and governance protocols for the negotiations at the outset
• Customer should try to reduce the number of issues arising from the procurement by starting with a reasonably balanced contract
• The RFP should ask service providers to identify in an issues list significant concerns with draft contract
• The parties’ counsel should try to resolve and clarify issues prior to the full team negotiating meetings
Stage #3: Negotiation

- As part of the preparation for the negotiations the parties should:
  - Agree as to the make up of negotiating team and ensure that members of the negotiating team are dedicated, and are available to participate throughout the negotiations
  - Arrange to have subject matter experts available to participate in the negotiating meetings as required
  - Prepare a list of principal issues to be negotiated during the meetings and, prior to the negotiations, each party is to clarify its views on each issue
  - Empower its negotiating team to negotiate reasonable solutions to the issues at the table
Stage #3: Negotiation

Selecting the Negotiating Team:

- The negotiating team should have the skills, knowledge, availability and seniority to successfully lead the negotiation process
- Avoid use of soon-to-be-outsourced personnel on the negotiation team
- Coordination and regular updates among negotiating team members is essential
- There should be general parity, in terms of seniority, between the corresponding members of each team
Stage #3: Negotiation

Negotiation Governance:

- The governance rules for the negotiation should include the following:
  - The negotiations are to be interest-based, and are to avoid the adoption of positional approaches.
  - The negotiating team should be empowered to address and resolve (in a fashion that the party believes to be reasonable) all issues, but the negotiating team is not to negotiate to a deadlock (rather the negotiating teams are to clearly identify the interests which each party believes should govern with respect to each unresolved matter).
  - Unresolved issues (and interests) should then be escalated to a senior executive steering committee for resolution.
Stage #3: Negotiation

Establishing the Rules of Engagement:

- Negotiation is first step in the development of a close multi-year relationship and should foster rather than harm the development of team spirit.
- Negotiation is to be conducted in a principled manner that is always respectful of the individual participants.
Stage #3: Negotiation

Negotiation Strategies:

- Use issues list to identify issues, facilitate an exchange of views about such issues, prioritize issues and facilitate resolution
- Impose “per issue” time limitations on initial discussions to facilitate an efficient canvas of all outstanding issues
- To avoid the need for escalation, the parties should try to develop creative options to reframe the discussion and break the logjam
- As issues are resolved, the Parties may wish to jointly revise key elements of the draft contract to reflect the agreed resolution
Stage #4: Transition-in

- Transition-in should be managed as significant project: the usual project management skills and governance processes should be brought to bear
- Transition provisions in the outsourcing agreement should clarify:
  - Communications protocols and processes
  - Rules of engagement
  - Orderly and efficient transition steps
  - Allocation of responsibility
  - Timetable
  - Milestones
  - Consequences of delay
  - Dispute escalation and resolution
Stage #5: Operational Stage

- Governance applies to decisions relating to:
  - Technology, strategy, planning
  - The evolution of the environment within which services are provided

- The governance structures that have been built into the relationship through the negotiations must be fully implemented to drive value at this stage
  - Ongoing need to maintain commitment and discipline
  - Good processes and engagement can assist in the achievement of synergies and mutual success
Stage #5: Operational Stage

Governance: The Role of Service Levels and Remedies

- When will service levels start?
  - Initial grace period?
- How are service levels being set/measured?
  - Service level guarantees?
  - Reference to existing, third party, or industry standard service levels
- Verification of performance:
  - Periodic reports, internal or third party audits
- Designing the incentive structure: bonuses/penalties, alternatives?
Stage #5: Operational Stage

Governance mechanisms that may be used to ensure that pricing, technology, and service levels remain current throughout the life of the deal:

- re-pricing mechanisms
- benchmarking
- “most favoured customer” provisions
- automatic price productivity improvement numbers
- automatic technology refresh
  - requirements that technology be current versions
  - requirements that service levels evolve to reflect evolution of technology
Stage #5: Operational Stage

Benchmarking:

- Quality of service
  - Unique transactions or commodity-like service
- Price
  - Price benchmarking: comparison against other organizations that are outsourced.
  - Cost benchmarking: comparison against insourced organizations.
Stage #5: Operational Stage

Change Management and Decision Making Structures:
• The organization’s needs will evolve over the life of the outsourcing agreement
• Flexible and effective change management process is essential
• Recognize the tension between low costs and greater flexibility
• Who has the right or the authority to approve changes?
• How are change requests evaluated?
• Planning: who is responsible for strategic planning to ensure continued alignment of services with organization’s needs and business objectives?
Stage #5: Operational Stage

Communications:

- Regular, comprehensive reporting and ability of customer to require ad hoc reporting
- Importance of regular, scheduled meetings at operational through to the executive level ensure that the lines of communication are kept open
- Clarify the roles, responsibilities and membership of committees
- Appoint a full-time Relationship Manager
- Foster trust through gain sharing and similar mechanisms
Stage #5: Operational Stage

Governance Obligations and Service Levels:

- Good governance should be supported by service metrics applicable to the relationship, with defined activities and corresponding SLAs
- Performance of governance activities should be audited and performance failures should have serious consequences:
  - mandatory reporting of failures to the Executive Committee
  - provider failure can give rise to conventional service level remedies (credits, etc.)
  - customer failure can give rise to loss of SLA credits (or suspensions of other rights)
Stage #5: Operational Stage

Dispute Resolution:

- Resolution prior to litigation
  - Escalation levels for grievances
  - Alternative dispute resolution mechanisms

- International agreements
  - Choice of law
  - Choice of jurisdiction
Stage #5: Operational Stage

Governance Warning Signs – Problems Ahead:

• Meetings are regularly re-scheduled or cancelled
• Members of committees regularly send delegates
• Bad news is concealed and is not reported
• Planning is not performed jointly
• Problems are not solved jointly
Stage #5: Operational Stage

Governance Warning Signs – Problems Ahead (cont’d):

- A focus on assigning blame, rather than on fixing the problem
- Lack of trust
- Development of partisan positioning
- Questioning of each other’s motives
- Festering, unresolved conflicts
Stage #5: Operational Stage

Avoiding traps:

• Trap: poor communication
  – develop protocols for communication and information-sharing
  – ensure committee membership and charters are clearly defined
  – maintain regular meetings

• Trap: key personnel coming on and off the project team, resulting in lost knowledge
  – provide for customer input into key personnel and commitments for minimum periods of availability
Avoiding traps, cont’d:

- **Trap: Change process**
  - provide customer with rights to approve significant changes

- **Trap: Relationship breakdown: lack of trust, unaddressed conflicts, retaliatory behaviours, interpersonal issues, sense of resignation**
  - can be fixed through direct engagements if parties are motivated to identify and resolve issues
  - consider a change in personnel
  - may require assistance from outside consultants
  - if can’t be fixed, need to consider termination and transition out
Stage #6: Transition-out

Context of transition out:
- Term of agreement and extension options
- Effects of change of control of vendor/customer
- Vendor/Customer termination provisions
  - Cause
  - Change of Control
  - Force Majeure
  - Convenience
- Notice period
Stage #6: Transition-out

Transition governance issues:

- Cooperation, knowledge transfer and the provision of assistance in transfer activities
- Coordination of communications with stakeholders
- Facilitate assignment of licenses and agreements
- Solicitation of key employees
- Division of costs associated with transition
- Privacy and confidentiality
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Questions?

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