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Information Technology

Outsourcing Transition Issues - Minimising Risk on Transition and Transition-out

Introduction

Transition-in is one of those tasks often left to Project Managers to determine among themselves - it is sometimes viewed as a pre-cursor to the commencement of the "real" services.

However, a well organised and well planned transition is essential to provide a stable platform for the customer's business not only while the responsibility for the services is passing to the supplier from the customer, but also to provide the stable platform once the services are being performed by the supplier.

Transition-out is an area where even more emphasis needs to be placed on ensuring a structured approach is in place to mitigate the risks to the customer's business on exit.

Transition In

Apart from the obvious operational concerns and planning that has to occur to effect a smooth and seamless transfer of the outsourced services from the customer to the supplier, the following are the areas where problems usually arise.

Due Diligence and "True-up"

Prior to entering into the outsourcing arrangement, the supplier will have conducted its own verification and assessment of the prospective services and customer environment. This is usually done with the full co-operation of the customer.

The supplier uses this information partly to assist in designing how it will perform the services, but also for estimating areas of savings, assessing risk and being a factor in its pricing model.

But to what extent should the supplier then accept an informed risk, and fix the pricing? If the supplier has been able (or at least given the opportunity) to conduct a full due diligence and has been provided or had access to any relevant information it requires, then surely the customer is justified in insisting on a pricing model that will not vary.

However, the supplier usually will insist on a "true-up" ability after a period of time from commencement of service. This enables the supplier to re-visit its price if either its pricing assumptions do not hold true, or where "unforeseen" circumstances exist that the supplier did not price for. The effect on a customer's base case for outsourcing of this retrospective change can be significant.

This theme is also evidenced when suppliers seek a service credit holiday for a period of time (say 6 months), while the supplier "beds down" the services. No service or performance credits will be payable for a breach of Service Levels during this period, but the Service Levels will continue to be measured for reporting purposes only.

A further extension to the service credit holiday is for the supplier after that period of time to be able to adjust the agreed service levels depending on the operational experience during that "transitional" period. The rationale for this approach is usually that as nothing has essentially changed on day one of service commencement, if in six months the service levels can not be reached then they are either too high or based on incorrect measures.

All of these three approaches are at odds with the supplier's ability to verify the situation for themselves prior to contract. Depending on the outsourcing project, a customer may wish to insist the supplier conducts a full due diligence at the outset as no retrospective adjustment will be available.

Definition of Services

Frequently, the precise details of the services to be performed by the supplier for the customer are not able to be fully defined prior to signing the outsourcing agreement. This can be for a variety of reasons, but usually it is because there is not a current written description of the services within the customer's business and there is not enough time to produce one prior to the required commencement of the outsourcing.

If this approach is taken, it is vital that during the transition phase (and preferably prior to actually commencing the services) the supplier completes an accurate and complete description of the services to be performed under the outsourcing arrangement. This gives the customer comfort that services they did expect to continue receiving are clearly with-in scope, and will not be charged as additional services after the supplier commences the provision of the services.

Third Party Contracts

Usually, suppliers will be taking on the customer's responsibilities and rights under certain existing customer contracts with third parties under the outsourcing arrangement, as these often are directly related to the provision of the outsourced services going forward (for example maintenance of third party software by that third party). Other third party contracts will be retained by the customer.

Major risks in the process of transitioning third party contracts to the supplier include that:

– frequently they are not able to be legally transferred to the supplier by the customer;
– if they are to be novated, the third party must consent;
– the customer will usually be in breach of the third party contract if the supplier simply assumes the customer's rights for itself; and
– the third party is often able to demand a large payment for allowing the contract to be transferred to the supplier (this is known as "stiffing" in the industry).

To address these issues, the transition of third party contracts needs to be carefully managed. Some suggestions are:

– notify all third parties early on that the outsource may occur (this helps to identify problem third parties sooner), but stress that it is "business as usual" (depending on supplier's intentions to retain the contract);
– both the supplier and the customer need to negotiate with the third party over the novation to the supplier (either party may have additional commercial or relationship leverage over the third party);
– for crucial contracts that will not be able to be novated in time, the supplier may be able to act as the agent of the customer without breaching the contract (the parties need to ensure this is the case under the contract's terms, and customer needs to watch the billing - is it a straight pass-through to the customer or to be marked-up by the supplier?);
– the parties need to agree who pays if a fee is demanded. If it is the customer, then it must be capped, and some incentive must exist on the supplier to keep such payments low. Alternatively,

the supplier should pay (though this cost is usually reflected in its pricing matrix). A joint approach may be best.

Contracts that are retained by the customer should still be managed by the supplier which may include making payment on behalf of the customer (with or without an additional mark-up by the supplier).

Business Processes

After transition, on day one the supplier will normally continue to provide the outsourced services to the customer in the same manner as before. Only over time would the supplier be able to effect real change.

Accordingly, the supplier will have to follow the customer's previous business process and procedures. These may be contained in business process manuals, operating instructions or operational policies.

As part of transition, the supplier should be supplied or made available all these processes and procedures to ensure the services continue in the manner expected by the customer's business. The supplier should also commit to following these processes until they are amended through agreed change control. Often they are not all documented, so the supplier will have to liaise with identified key staff.

While this should assist with a smooth transition, it is important for the customer that the supplier then does have the responsibility to document and update all operational, business processes and procedures as the method of delivery changes over time.

Transition-Out

Whether the contract expires or is terminated, the customer requires the same orderly hand-over of the services to either a new service provider or back to itself.

The essential feature of any successful transition-out will be a good exit plan. An exit plan needs to deal with the relationships, responsibilities and obligations of the parties - setting out exactly what is required from the supplier by way of assistance or specific termination services for the customer.

When an exit plan is produced is important. If it is not created until termination, if there has been a break-down in the supplier/customer relationship, then this will be reflected in the plan - the supplier will only want to do the absolute minimum. A plan prepared and updated during the life of the relationship, and then finally updated on termination, will tend to be more balanced and provide for the real business needs of the customer.

Fees under the exit plan are also an issue. Will the supplier be paid for all transitional services, or just those that are in addition to a "hand-back" obligation? Will it be different if the supplier has breached the outsourcing agreement, causing the termination? Again, these issues can all be pre-planned for and agreed in an exit plan.

Some issues to consider in an exit plan are:

– **hand-over of documentation** - all business process and procedures currently being used by the supplier need to be correctly recorded. Are there any proprietary claims by the supplier to documents or methodologies? If so, a royalty-free, flexible, perpetual licence should be granted for use with the services to the customer.

- **transfer of assets** - what should the value be for the customer purchase? Should it be lower of nett book value or market? How to deal with assets in a shared supplier facility? If assets are leased, should the leases be assigned (if that is even possible)? Are they operating or finance leases (tax and accounting treatment)?
- **transfer of software** - can the software licences be novated? Is there a fee to any third party? Are new licences required (was the software covered under supplier's global sourcing arrangements?), and if so what role will the supplier play in assisting the customer to obtain them?
- **supplier's subcontractors** - can these be transferred to the customer? Are there any prohibitions or conditions?
- **supplier intellectual property** (software, tools, methodologies etc) - what on-going use is required by the customer? A transitional use right should be granted to the customer if necessary. The length of time and cost (if any) need to be addressed. In addition, any conditions (eg confidentiality obligations for other service providers using that intellectual property) need to be agreed and set out. A distinction between embedded material (that the supplier can not easily remove) or stand-alone material (which can be easily taken out) may be required. A permanent licence for embedded material in customer systems is not unusual.
- **transfer of personnel** - what will the requirements be? Who will bear any redundancy risk - this should be a mirror of principles for initial transition in.

Conclusion

Transition - both at the start of the relationship and on exit at any stage are vital to ensure a stable continuation of the customer's business - paving the way for the ability to achieve the benefits of the outsourcing relationship in the long term.

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