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OUTSOURCING: A RECIPE FOR CONFLICT?

By Andrew Legg, Rani Mina and Miles Robinson

A recent report commissioned by the Business Services Association estimated that the outsourcing sector in the UK generates turnover in the region of £207 billion a year, just short of the estimated turnover from the financial services sector. It is further estimated that £125 billion arises from private sector outsourcing – indicating that despite the recent high profile of public sector outsourcing contracts, the private sector is the larger market. However the spend breaks down, there is no doubt that this is a significant sector for the UK's economy, employing a large number of people (the report estimates 3.1 million) and it is one that has grown rapidly over the past few years. Financial service businesses (in common with many organisations) are heavily reliant on outsourcing, whether for business critical services such as back office functions and IT, through to such services as property maintenance, security, catering and waste services.

There are well known benefits to outsourcing: it can drive substantial costs savings, and can allow businesses to keep pace with innovation without needing to make significant investment internally. However, as the sector has grown, and the large scale outsourcing projects entered into within the last 4 to 5 years mature, we are now seeing how they stand the test of time and where problems are likely to occur. The difficult economic circumstances have exacerbated the stresses in these relationships as businesses look to maximise value across all areas.

We have seen a substantial rise over the past two years in problems associated with these arrangements. There have been some high profile examples of this: the NHS IT outsourcing debacle, the dispute between BSkyB and EDS/HP in January 2010 (where EDS/HP paid a reported £318 million in damages) and the more recent Boeing 787 Dreamliner project where commentators blame the massive delays and cost overruns on a wholesale outsourcing of manufacturing and design. Our experience, however, is that for every dispute that hits the headlines, there are numerous others being dealt with under the radar.

There are good reasons for this "*behind the scenes*" approach, other than a healthy fear of litigation:

- reputation is key for suppliers: other than in extreme circumstances, it is not desirable to be seen to be in dispute with customers;
- there are strong business drivers on both sides to continue the arrangement: for the supplier, this can often be a high value, long term arrangement, and for the customer it can drive substantial costs savings;
- particularly where the supplier is embedded in the business, it can be very difficult to disentangle the arrangements without risking significant business disruption;
- where staff have transferred across to the supplier, there is the risk that the customer will have lost its knowledge base so that taking the outsourced service in-house, or setting up new arrangements, could be extremely challenging;

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- the complexity of many outsourcing relationships, and the inputs required from both parties to make it work, means that establishing where fault lies is often extremely costly and challenging.

These factors mean that resolving ongoing disputes by way of a private renegotiation of the arrangement is generally the best commercial option.

The key to avoiding this situation is a clear understanding of the reasons why outsourcing relationships run into difficulties, and a realistic assessment by businesses of the benefits and risks of entering into a large scale, long term outsourcing arrangements. Our experience of outsourcing disputes across a wide range of sectors and industries suggests that there are some common root causes:

- there is a tension between the desire of the customer to generate cost savings, and do so quickly, and the desire of the supplier to "win the deal" and protect profitability over the life of the deal. Pushing too hard at the outset on price may be attractive but counterproductive;
- failure to define the scope of services. Vagueness in this area, or an agreement to agree the details later, is often a recipe for later disputes;
- failure to allow for market developments in areas (such as IT outsourcing) where technology can develop rapidly over the course of an agreement spanning several years. This can leave a customer with no option but to pay for additional or different services in order to maintain efficiencies.
- The complex nature of many outsourcing deals means that even in the best drafted agreements it is impossible to anticipate every situation that may occur in a contract that could last for many years.

Regulatory issues are an additional consideration for financial services businesses, in areas such as data security and long term access to records. For instance, where IT services have been outsourced, a financial services organisation must satisfy itself that adequate procedures are in place to meet its regulatory obligations.

It cannot simply assume that its outsourcing provider will perform as required – it must make regular checks to ensure that systems are robust and secure. It is key to identify those services and activities which are so core to the business that the risk of outsourcing them is too high to take, and where services can be outsourced, to manage those relationships pro-actively.

The reality is that outsourcing makes sense for most businesses, and particularly those that require sophisticated and state of the art technology. Maintaining the resource and expertise in-house is often impractical. Done well, outsourcing can benefit all stakeholders, particularly where flexibility is maintained by, for instance, a multi-source solution, but to achieve this needs a rational analysis of the risk factors - in particular whether dependence on a particular supplier for a critical business function is a healthy and manageable situation for the business to accept - and proper investment in translating the current and future requirements of the business into a suitably detailed contractual framework.

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