SOURCE OF TROUBLE

OUTSOURCING MAY SEEM A QUICK COST REDUCTION FIX, BUT THERE ARE OFTEN HIDDEN RISKS, WARN RANI MINA, MILES ROBINSON AND ANDREW LEGG

The trend towards outsourcing has picked up real pace as the financial crisis of the past few years has focused minds on cost reduction. A recent report commissioned by the Business Services Association valued the outsourcing industry at £207bn a year in the UK, second only to the behemoth that is the financial services sector.

In this climate, it is increasingly important for companies and their finance directors to make sure that the cost/benefit analysis for any outsourcing proposal is robust and that the arrangement is managed effectively to ensure the programme's long-term success.

When entering into an outsourcing arrangement, the key issue for the customer should be whether the value of the deal is greater than the value of alternative arrangements. It is common for customers and their FDs to undertake financial modelling when making these value assessments, but they will not properly understand the real value of the deal unless risk is considered and factored into their assessments. Not doing so makes it easy for the upfront financial value to be eroded quickly. It is also important to manage such risks carefully throughout the life of the deal, to avoid the longer-term financial and reputational impact of a significant outsourcing deal that collapses.

Outsourcing was a growing trend even before the financial crisis hit, and with contract terms historically ranging in length from five to 10 years, the industry has reached a point where there are more than a few examples of high-profile failures (in both the public and private sectors), and the hidden risks and causes of failure can be identified and assessed more easily.

Recent examples of cases that have ended up in court include a dispute between Ericsson and H3G (arising from H3G's termination of a network and IT outsourcing contract, see box) and the case between BSkyB and EDS/HP (where EDS/HP paid a reported £318m in damages).

But for every example of a failed outsourcing deal that is taken to court, there will be several more where the issues are resolved between the parties behind closed doors.

OFFSHORE JURISDICTIONS

One of the key areas of risk for a customer arises in deciding whether to outsource to an offshore jurisdiction. At first glance, the financial benefits of offshoring are compelling, given the comparatively low average salaries in countries such as India and elsewhere in Asia, and a workforce that tends to be both well educated and highly motivated.

The financial modelling for this type of proposition is, however, more complex than it might appear. As well as factoring in transition costs, including UK redundancies, the ongoing expense of having a management team travelling regularly to and from the relevant country and communications with an offshore operation, not to mention exit costs (which will be higher than if the operation was being moved within the UK), there are other, less obvious risks that should not be overlooked.

These risks include inflation and foreign exchange fluctuations that can eat into cost savings, business continuity issues caused by geo-politics and the significant risk that the customer will be left without a

LEGAL WRANGLE: ERICSSON AND H3G

Ericsson Ltd v Hutchison 3G UK Ltd (H3G) [2010] EWHC 2525 (TCC)

In 2005, H3G outsourced the provision of certain IT services for its 3G mobile network to Ericsson. The contract was to last a minimum of seven years and a party had to give at least one year's notice of termination, if termination were for reasons other than contractual breach. The contract contained certain exit provisions designed to ensure a smooth handover of services to H3G or another service provider.

In May 2010, H3G gave notice of termination, specifying a termination date of December 2012. A dispute arose as to whether Ericsson was obliged to provide exit services during the entire period from the date H3G gave notice, or whether this obligation was limited to one year pursuant to the exit provisions. Ericsson argued that if it were required to provide such services over the entire period it would suffer unreasonable additional expense. H3G argued that the extended exit period was required to ensure an orderly handover.

The Court found that this was an issue of interpretation and that the contract distinguished between termination for convenience (for which one year's notice was required) and termination for cause. In this case, termination was for convenience and the court ruled that properly interpreted, the exit period was limited to one year and that this would be sufficient time to achieve an orderly exit. If the exit plan was not satisfactorily implemented in one year, the contract allowed for an extension to the exit period.

legal remedy if problems develop due to the difficulty of taking legal action against a foreign entity and in a foreign jurisdiction.

The clearest way to mitigate this risk is to insist that the contract is governed by English law and that there is an exclusive jurisdiction clause in favour of the English courts. That does not, however, cure all of the potential problems, particularly with respect to enforcing any court order that might be obtained against a foreign entity with no real presence and few or no assets in this jurisdiction. The alternative is to try to enforce the order against the foreign entity in its home jurisdiction, but this is expensive and often just as difficult. It would be unusual for a foreign supplier under an outsourcing arrangement to provide any security to cover risks such as these. It may be possible for the customer to obtain appropriate insurance, but such an additional cost must be factored into the financial modelling at the outset.

BEWARE THE MEGA DEAL

Customers are increasingly focusing on rapid cost reduction, and the trend has been towards outsourcing 'mega deals': high-volume and high-value contracts. This approach on the customer side does not sit well with the supply side perspective, in which poor economic conditions force suppliers to make aggressive bids (with up to a 50% difference between the first and second round) in order to win deals. This can mean that suppliers suffer a cash negative position during the early stages of a deal when the highest set-up costs are incurred. This is one reason for the historically long-term nature of outsourcing contracts, with suppliers also insisting on limited exit rights.

Alongside this commercial context is the traditional mindset of negotiating a contract for a fixed price over a set term, with little flexibility to adjust the pricing mechanism, the scope of services provided and to allow for market developments or rapid advances in technology or to enable the relationship to be easily brought to an end if necessary. There is a growing realisation that contracts negotiated in this context frequently fail.

START SMALL

The more successful types of outsourcing projects tend to start out small, initially over a shorter term, and are grown and extended over time as the relationship between the parties develops, and trust and confidence are built. This also provides the opportunity to make adjustments for changes in strategic thinking and to re-negotiate at regular intervals the scope of the services and the way in which they are delivered, giving the ability to recognise and implement innovations along the way. Flexibility can also be achieved by introducing regular benchmarking, which allows the customer to compare prices and service levels over the term of the contract against other suppliers in the market, with the contract providing an agreed method of price or service adjustment depending on the outcome of the benchmarking exercise.

The success of outsourcing depends on meeting both the customer's and supplier's needs. Smaller contracts over a shorter term may not achieve the rapid level of cost reduction the customer expects, but this may represent a false economy once the risks and hidden costs of this approach are factored in properly.

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