THE NOTION OF „ACTIVE CUSTOMER" IN IT OUTSOURCING CONTRACTS

Bogdan Pilawski

Bank Zachodni WBK, Strzegomska 8-10, 53-611 Wrocław, Poland
e-mail: bogdan.pilawski@bzwbk.pl

Abstract
From time to time media and professional papers bring up examples of spectacular failures of IT outsourcing agreements. The multi-million contracts break off and giant international companies are bringing their IT services back home (e.g. General Motors recently).

One of the main reasons leading to such disastrous failures are poorly prepared or makeshift contracts, seeking quick and easy cost savings.

This paper presents the concept of the so called "Active Client" (also known as "intelligent customer"), which, when included into outsourcing contract, should prevent most of the common failures found in many agreements of that kind. The concept in question is based on an assumption, that it is the client who should control the execution of the outsourcing contract, and should have to his disposal the proper and strong means to perform these controls.

This paper does not insist the concept of Active Client will make every outsourcing contract a success, instead it says the contracts without this concept included are more prone to failure. The paper also says many other numerous requirements are also to be met, to bring the outsourcing contract as a whole to the level desired.

The additional effort spent on including the concept of Active Client into outsourcing contract would bring multiple benefits while executing such a contract, and running it smoothly to the satisfaction of all parties involved. However, should those parties fail to exploit this concept in practice, most of the effort put to include it into the contract in the first place, will simply be wasted.

1. Introduction

For some time now in the economy there is a distinct trend of various businesses trying to transfer most of their activities regarded as non-core to some outside companies. In most cases this is accompanied by expectation to gain clear and unquestionable benefits almost automatically. These are not limited to lowering of costs, but they embrace also expectations of getting rid of all the possible problems resulting from the area of activity to be handed over to the outside organisation. The practice shows however, that in the course of this process the transferring organisation is not only not freed of control and supervision and of co-ordination activities, but more to that it is also and out of the sudden required to show totally distinct and little known abilities.

Handing the IT services over to the outside service provider constitutes a decision of serious consequences. Even relatively minor errors committed on that occasion could impact in a negative way the fortune of the whole organisation involved. Cost cutting and service improvement effects expected to result from such a decision are not always fully achieved, if at all.

On the practical side one can see numerous and spectacular cases of withdrawals from sometimes long-term outsourcing contracts. Until recently the case of Middland Electricity in United Kingdom was regarded as the most significant example of that kind.[1] Now it has been deposed by the case of General Motors, which – having outsourced all its IT services – had the highest IT costs in the US motor industry reaching 2.5% of its sales. Now, after they backed up from all their IT outsourcing contracts and have re-build their own IT services from the outset, their IT expenditure is of ca. 1% of sales value and is the lowest in the industry [Riley_2002]. Also the opinions of almost 200 IT bosses of financial institutions surveyed by *Datamonitor* question some economic results of outsourced IT services [Sim_2002].

The examples above do not mean the outsourcing of IT services is by its nature of poor economic results. They only tell that not every single outsourcing deal brings the expected financial benefits. One of the main reasons for that is the expectation that having outsourced the IT, the organisation is absolved from its responsibilities in that area.

To bring the economic outsourcing results any nearer the outsourcing party (client) is required to perform numerous preparatory activities which should precede the formal conclusion of the outsourcing contract. The client should also engage into how the outsourcing agreement is executed. This kind of client's activity is called in this paper "*the position of active client*" [2]. It is one of the major factors which, if applied, could significantly increase the chances for success of the whole outsourcing exercise.

In this paper various aspects of IT outsourcing contracts resulting from inclusion of the *position of active client* are presented and discussed.

2. The weaknesses of outsourcing contracts

The outsourcing contracts are in many cases the main reason of their execution failures.[3] Lack of experience required to coin such agreements and similar inexperience in contract execution results in signing agreements on supplier terms, since only the supplier is capable of drawing it up. For obvious reasons agreement of that kind defends supplier's interest before anything else and minimises his risks.

As shown in a paper [Scard_2002a] the main reason for failures in this area are the tactics applied by outside consultants, hired to ensure quick cost savings are achieved. Those savings, as a principal short term target, dominate any long term objectives the organisation in question might have. The usual practice in these circumstances is to bypass in the decision

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[1] One of big British electricity companies – East Midlands Electricity – entered, in 1994, a 12-year outsourcing contract for IT services, valued 150 mln pounds, with Perot Systems Europe. This agreement was terminated by Electricity company after 5 years, when they re-created their IT division and took aboard some 200 IT professionals, earlier moved to Perot Systems. The only reason of the break off was the lack of significant savings. [Pil_2001]

[2] this term is the author's proposal to replace the English notion of „intelligent client", which could lead to association with its opposite (non-intelligent client) in those outsourcing agreements where this notion has not been included

[3] the list of most common errors committed by clients and service organisations are presented in [Rosen_2000]

making process the IT authorities, if only they do not support the risky way to proceed proposed by the said consultants.

All that results in a poorly prepared Request For Proposal being sent to potential suppliers, where the requirements are not precisely stated, and there are no statements related to changes and innovations, and there is no harmony between business and technical requirements, and - first of all - there is a groundless assumption, that all the operational risk is to be taken over by the supplier of outsourcing services.

The potential supplier is forced into ensuring the expected cost savings are achieved, what usually results in the wording of contract (which itself is compiled on supplier's conditions anyway) to be put the way to fulfil customer expectations in the initial phase and to recompense to the supplier the concessions he made, in the following years.

According to the [Scard_2002a] paper, such quickly drawn and signed contract agreement for outsourcing of IT services, expected to bring fast and significant cost savings already after the initial year of contract execution, leads to the situation, where:

- The contract becomes the source of continuous argument between parties, and the relations between them are far from proper,
- The supplier concludes the contract conditions are even worse for him than it was initially expected,
- The supplier explores the avenues to charge the customer for services which he claims are beyond the scope of the contract,
- On the customer side the costs are on the continuous rise,
- The supplier, in an attempt to bring his costs down uses lower grade (and lower paid) personnel to perform his tasks resulting from the contract,
- The new IT manager on the customer side attempts to correct errors made during the (non distant) past.

Gartner research, the organisation from where the quoted paper originated, insists the scenarios like the one above, are still taking their place and take their tall. According to Gartner, one should prepare long term strategic IT outsourcing plans preceded with a thorough balance between the own sources of the organisation and the chance to reach for outside sources. Reaching the business goals of the organisation at the lowest risk level should be the basics of any such a plan. According to Gartner, outsourcing with the quick cost cuts as the only goal is to risky and - in the long term - instead of becoming the source of savings, brings significant losses.

During the recent IT conference in Stanford Gartner has come with the conclusion that year 2002 was the year of bad outsourcing contracts, which are poorly drawn up with the sole expectation of gaining quick savings. As stated by Gartner, many executives, and especially in big organisations, do put their signatures under such unfavourable contracts pictured as success because of significant cost savings promised. Such a "success" results in quick promotion of those executives and the unavoidable problems to execute such an agreement, are no longer their responsibility.

3. Drawing up of outsourcing contracts

To reach significant effects (including cost savings) of outsourcing contracts requires not only for the contract to be well prepared, since this is only the crowning of the whole process, but also for proper and detail preparation of all execution procedures concerned, and of methods, measures and tools to evaluate potential suppliers (and - during the contract execution stage - to evaluate the performance of the selected supplier). The outsourcing agreement should also be flexible enough to allow for innovations and stay abreast of changes.

The whole outsourcing process can be divided into four stages:

- Strategy set-up
- Evaluation and selection of the supplier
- Preparation and sign-off of the agreement
- Management of the contract execution process [Scard_2001]

All those stages are tightly connected and the strategy assumed at the very beginning has the decisive influence on effects likely to be achieved in stages following it. This is to be felt mostly during the execution phase of such a contract, when the business units of the organisation (and in a growing number of cases - also its customers) are expecting the service level agreed to be kept.

One of the most common failures made during strategy stage is planning to get rid of possibly high number of existing employees, by transferring them to the outside organisation or terminating their jobs. That brings some short term cost cutting effect, however brings also a serious blow to the intellectual and managerial level of the organisation itself. That in turn makes impossible the proper supervision of execution of the outsourcing contract. This is often called "outsourcing of everything and for any price" [Amb_2002].

The supplier of outsourcing services is usually eager to offer all those managerial and supervisory functions (for additional salary), since in effect this gives him control not only over the execution of the contract, but also over the contract declared partnership relation between the parties.

The outsourcing contracts are distinct from all other service contracts, because they:

- Embrace the wide scope of operations,
- Transfer to the partner a significant scope of the operational risk,
- Cover long periods (usually 5 to 15 years),
- Result in numerous, new co-operation channels to be set-up on various levels,
- The exit from such a contract is more difficult, complex, costly and risky, than the initial engagement in it.

During the preparatory stage the matter of contract termination seams to be something very remote and hypothetical. In practice however - it is one of the most important parts, and the lack of it could have serious and costly consequences [Paq_2002]. It is obvious that it is only before the contract is drawn up and signed, when there is a chance to decide on the way the contract can be terminated, and not by last moment attempts to modify it, when first symptoms of execution difficulties begin to appear.

In any outsourcing contract the customer should have three basic termination options to his disposal and sole discretion to use any of them:

- As a result of contract breach by supplier,
- After the period for which the contract was signed expires,
- By an autonomous client's decision (also known as "by convenience").

Exit from such a contract or its breaking has serious consequences for both its parties, however for the supplier it means only the loss of income (what may also mean lack of return on investments made to fulfil contractual obligations), while on customer side it results in the must of quick finding of a new supplier with the immediate ability to provide similar (if not the same) services, or taking over its role. This enforces the customer into maintaining a continuous readiness for taking such a step, what requires him to prepare and to maintain appropriate plans during the whole period of contract execution. The decision to terminate an outsourcing contract prematurely usually becomes the source of numerous and difficult to foresee problems, even if the proper and up to date plans for that were maintained. This could be:

- The ownership of software, documentation and data,
- The co-operation between the existing and new outsourcing partner, necessary during the transition period,
- Contract limitations.

As an alternative to contract termination one can see its re-negotiation. This is a process similarly difficult as initial negotiations and usually it takes the same amount of time [Maur_2002]. One needs to take this into account while planning such re-negotiations, especially when the agreement is to undergo this process not far from its termination date.

4. The stance of the Active Client

As it was already mentioned here - the outsourcing agreement concluded can not be regarded as static and requires the ordering party to look after it in the following regard:

- To maintain the service level agreed,
- To minimise the operational risk,
- To ensure the security level agreed,
- To control changes in the scope and direction of change of services covered by the contract,
- To evaluate continuously the co-operation between the parties of the contract and to remove early any possible sources of conflict,
- To resolve contentious issues.

In practice however it turns up that the ordering party is usually not prepared to carry with such a supervisory function, and the lack of appropriate contract clauses makes it impossible to formalise appropriate requests in that respect.

It is possible to avoid disappointments and failures when the IT outsourcing contract execution stage, if the contract in question is properly prepared and carefully executed. One of the means available to ensure this is achieved is to put the *stance of the active client* into the contract [see also Scard_2002b].

The outsourcing contracts with relation to the stance of the active client contain usually a number of special clauses and conclusions, which relate this stance to the matter and scope of a given contract. These are among others:

- The so called Service Level Agreements are the integral part of the contract agreement,
- The supplier has no monopolistic position to provide services named in the agreement - the ordering party has the freedom to pass part of this service to other suppliers,

- The supplier is obliged to co-operate with all third parties indicated by client, on the stated level of service,
- The parties of the agreement set-up a contract management committee, to supervise the execution of the contract and to do the strategic level planning,
- Client has the upper hand in the contract management committee,
- The parties regard themselves as partners,
- The supplier is obliged to present the client with plans, documents and registers related to the agreement, and to maintain them up to date,
- In agreed periods the supplier reports to the contract management committee on contract execution, its own development plans and planned changes to the contract covered services,
- The services named in the contract are covered by supplier's business continuity plans, which are synchronised with similar plan of the client,
- The supplier will inform the client about all facts likely to affect the execution of the agreement,
- The client has the right to control the execution of the services,

The Service Level Agreements constitute usually the attachments to the outsourcing contract agreement. This facilitates adding of new services and changing of conditions related to the services already included in that agreement. The Service Level Agreement should precisely define - possibly in some measurable form - the obligations of the parties and penalties for not meeting their terms [McKeef_2001]. Service Level Agreement should embrace among others:

- The purpose and period of being in force,
- The definition of the service covered and guaranteed levels of efficiency and performance,
- Time schedules,
- Performance measures and rules to calculate availability indices,
- Rates, payment conditions and penalties,
- Warranties, responsibility limitations and termination conditions.

Similarly important is the manner in which changes are introduced to the contract and its Service Level Agreements. Every such a change, regardless of whether it results from client initiative or by the action of the supplier, it needs to undergo the proper approval procedure. The rules of such a procedure should be also included in the contract. The reason for having that procedure included is to allow for thorough analysis and evaluation of possible consequences of proposed changes even before they are introduced. This prevents the potential conflicts and protects against uncontrolled effects of actions taken by parties in areas other than those controlled by contract. The growing scope of co-operation and data exchange agreements entered by nowadays organisations result in their increased vulnerability to ad-hoc introduced changes, which might have wide and serious consequences.

An outsourcing contract with a single supplier results in doubled risk: it gives the privileged position to that supplier and brings a significant threat to continuity of operation, which might be effected by e.g. bankruptcy or a serious slip-up of a supplier. For this reason alone the contract should contain the clause giving the client the right to employ other service providers, and that this right, when executed, will not influence the level and quality of service with the initial supplier[4].

A separate contract clause is also needed to force the supplier to co-operate with all other parties hired by the client to perform services on its behalf. In some exceptional cases this obligation might embrace also client's business partners, with which the supplier will e.g. exchange data on behalf of the client, or will provide them with reports and defined scope of services. The kind of co-operation required, its scope, quality and performance regimes etc. should be detailed in a Service Level Agreement, constituting an attachment to the original contract.

Every outsourcing contract should be managed on two levels: on operational level and on strategic level. The former of the two allows for current management of operational activity, executed by co-ordinators nominated by the parties [see Salv_2002];

Strategic management should be carried by the Contract Management Committee, the line-up of which, its scope of activity and its rules should be stated in the contract itself. The Committee should consists of delegates of both contract parties, the right to preside over it should be contractually reserved for a representative of the client.

In some outsourcing contracts one can also find the clause stating the client has the right to require at its will for the supplier representative in the Committee to be replaced. In practice this might result in controversies, since it is to the contrary to the partnership rule, which should preside over all other rules of such a contract. This would deepen the asymmetry of relations between client and supplier, which is introduced anyway by presiding of the former over the Contract Management Committee.

The Contract Management Committee does not manage the current co-operation of the parties (provided there no issues which cannot be resolved on lower management levels). The Committee performs periodic evaluation of contract execution and sets up future plans. This evaluation is based on client's data and reports presented by the supplier. The frequency and contents of those reports should be defined in the contract.

The Committee should also evaluate the development plans and changes and innovations, proposed by the client, and also those resulting from supplier's intensions [see also Law_2002]. The changes to the way the contract is executed, and the new quality and performance abilities planned by the supplier and accepted by the Committee, should be analysed according to change control procedures contained in the contract itself. The action of the Committee (and of its temporary subject orientated work teams) in this respect should be limited to coming up with change proposals and recommendation for this to be endorsed by client organisation management.

The outside service organisation along with taking over the part of another organisation's operations also takes aboard its business risks related to this scope of operations. The responsibility for the whole process of which these operations are part however, still belongs to the management of client. For this reason it is important for the supplier to have proper

[4] in case of IT services, and especially those relating to a single IT application, it would be impossible to split it up, and to have more than one supplier of the service

business continuity plans in case of any circumstances likely to hamper or otherwise adversely affect the services to be provided.

The plans in question should be synchronised with client's own plans and those of the other partners of both - the client and the supplier. The business continuity plans should be kept up to date and presented to the Contract Management Committee from time to time. The Committee should also receive reports on how those plans are executed.

Beside this the contract should contain the clause calling for the client to be informed immediately in case of any circumstances resulting in any procedure of business continuity plan to be executed. The client should be also informed by the supplier about appearance of any circumstances likely to affect the execution of the contract.

The outsourcing contract should provide the client with the right to control the execution of such a contract. The contract should state explicitly in what circumstances and in what manner such a control should be exercised. The contract should also decide whether the right to control applies to the client employees only, or it can be extended by client also to representatives of third party of its choice. If the latter option is included in the contract, it is reserved to the supplier's endorsement any time such a control is to performed.

5. Conclusion

The task to prepare, to set-up and to negotiate the IT outsourcing contract is a difficult, complex and time consuming process. The whole future co-operation of parties of such a contract depends on how well this task is carried out. The results of that will most of all affect also the business processes performed by client's organisation.

But even when most of clauses of such a hundreds of pages contract will never be used in practice, it does not mean they are unnecessary, and the effort to coin them is simply wasted. It is thanks to those clauses it is possible to execute the contract in a way expected by client and also beneficial to the supplier. That means also the effort put to prepare the IT outsourcing contract which might seem to be excessive, is in fact disproportionate when put against possible losses likely to be experienced by contract parties, when their mutual relations would be based on an agreement containing mostly general statements, imprecise and based first of all on their good will. The likely effects of agreements of that nature are discussed in the opening part of this paper.
The notion of active client discussed in this paper requires for the parties of the agreement to stay active also during the contract execution stage. If that will not turn true, the notion in question will remain only the useless matter of contractual conditions and clauses, and the effort put to develop them will be wasted.

As indicated by multiple examples - outsourcing can become beneficial to all participating parties. The condition for success however is to have a good and solid base, a part of which is a contract agreement, presenting answers to simple traditional questions: who, what, when, how an why?

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