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Managing Outsourcing Relationships to Maximize Value

Evolving Relationship Management Practices, 2010 Edition

Danny Ertel
Sara Enlow
Ben Siddall

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Foreword — About the Study

With greater automation, companies have gotten better at applying and integrating technology into business processes, helping to fuel further growth in the outsourcing industry. As the industry has matured, it continues to grow and extend into ever more complex business processes. And the good news is, even with growth in new types of outsourcing, we see fewer headlines about deals failing outright. Companies are getting better at negotiating agreements that work for both sides and improving their ability to manage these complex, often lengthy, relationships.

The bad news is that many deals continue to disappoint in terms of the business value and innovation they are able to generate. And with the intense focus on cost savings in our current economy, the use of outsourcing is only expected to grow more quickly in years to come. With more companies jumping in with both feet faster, there is a danger that some of the mistakes of the past will be repeated.

Top causes of outsourcing failure (over 70% of total)[1]

- Buyer's expectations unclear up front
- Interests become misaligned over time
- Poor governance
- Poor communication
- Not mutually beneficial

Figure 1

In 2004-2005, in conjunction with Cutter Consortium, BT's Vital Vision Program, and EquaTerra, Vantage Partners surveyed both buyers and providers of outsourcing services to better analyze the link between realizing business value in outsourcing and effective relationship management. In a study we published in early 2006, we combined the results and analysis of three separate surveys with client case studies, input from leading attorneys who advise the parties to outsourcing deals, and interviews with some of the most experienced outsourcing executives around the world.

In 2009-2010, together with the Outsourcing Institute, we took another look at what is happening in the industry when it comes to relationship management. We surveyed buyers and providers to understand what has changed over the last five years, how the industry has matured, and where there is still room to improve. In this updated study, we again present a look at the problems (business and financial value lost) associated with poor relationship management, the benefits (potential value gained) of good relationship management, and some practices companies are employing to more effectively manage their relationships. We also provide our perspective on what more buyers and providers can do to ensure success, and share some leading-edge practices employed by a handful of companies. And we add new perspective on innovation in outsourcing — what it takes to achieve the sometimes-elusive "value add" so many organizations are seeking.

The study is organized by outsourcing lifecycle phases — from RFP and Selection to Ongoing Management, with a special section on Driving Innovation. For each phase, we review the critical relationship management-related challenges of that phase, share survey findings on what buyers and providers are currently doing in that phase, and offer some advice — for buyers, providers, and the parties jointly — on what additional steps could be taken to ensure effective relationship management and therefore greater value realization.

[1] Everest Group, "Leading Causes of Outsourcing Failures" (August 2004).

Critical relationship dynamics across the outsourcing lifecycle

RFP and Selection	Negotiation	Transition	Ongoing Management	Driving Innovation
■ Getting clear on objectives for outsourcing and the nature of the desired relationship	■ Getting a good deal and a good relationship ■ Setting the stage for successful implementation	■ Ensuring "speed to governance" ■ Managing change	■ Responding to relationship problems ■ Managing the relationship and maintaining momentum	■ Use value discovery sessions to uncover opportunities ■ Define metrics for innovation

Figure 2

About the 2010 Study

The contents of this updated and extended study were informed by:

- Survey of Experienced Outsourcing Buyers by Vantage Partners and the Outsourcing Institute
  - Global perspective (47% North America, 4% South America, 21% Europe, 2% Australia/Pacific, 17% Asia or India, 9% Other)
  - Over 200 respondents
- Survey of Outsourcing Providers (ITO and BPO) by Vantage Partners and the Outsourcing Institute
  - Over 350 respondents
- Input from attorneys at the leading firms advising buyers and providers in outsourcing deals
- Interviews with some of the most experienced outsourcing executives around the world
- Various secondary sources (credited directly in the text or footnotes) that we relied on for context, industry trends and additional real examples

understanding the value of relationship management in outsourcing

Introduction — The Value of Relationship Management in Outsourcing

What Value do Organizations Seek in Outsourcing?

Outsourcing holds the promise of a number of significant benefits. For buyers, outsourcing offers the prospect of reduced cost, a movement of fixed costs to variable, an ability to focus resources and management attention on critical areas, and access to world-class expertise from a provider whose business it is to manage specific processes effectively. For providers, meeting those needs offers scalable, rapid growth with a predictable financial model and often a very defensible market niche. According to Vaughn Hovey, who has managed outsourcing relationships for Nationwide Insurance, Kodak, BankOne, and IBM Global Services, and is currently an independent consultant and lecturer at The Fisher School of Business (Ohio State University), "In the main, outsourcing is a business relationship. The value the customer is seeking should be the foundation by which [the parties] come together." In order to assess the impact of relationship management in outsourcing, then, let's first start with the "foundation" by examining how the parties look at value.

The outsourcing buyers we surveyed indicated several different drivers for outsourcing (see Figure 3). We asked for their organizations' top three reasons for outsourcing, and the most commonly-cited purpose for the buyers was to **cut costs** (74%, up from 63% in 2004). The buyers we surveyed also stated that they outsource because they seek many types of value in addition to, or rather than, financial value. The next most commonly-cited purpose for outsourcing was to allow re-trained staff to focus on **core competencies** (58%), followed by making up for a **lack of in-house resources** to complete the work (34%) or because a provider would bring **better expertise than in-house** (34%, down from 60% in 2004).

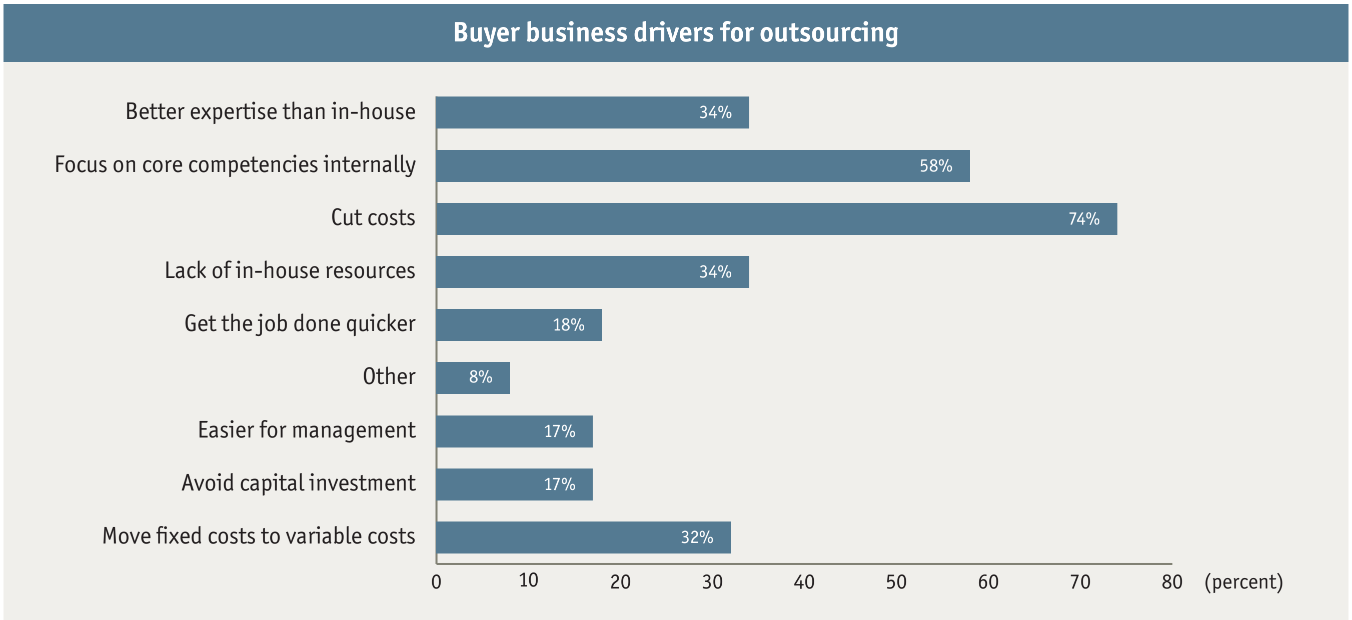

Figure 3

> *Those organizations that outsource only to achieve cost savings miss out on the benefits sought by half of all organizations that outsource.*
>
> — Michael F. Corbett, founder of the International Association of Outsourcing Professionals

It should be noted that this survey update occurred during a challenging time in the world economy. Late 2008 and early 2009 was a hard time for almost everyone, buyers and providers alike. It is quite possible (if not likely) that the overall economic environment contributed to the increased focus on cost savings in our survey results. Research by Duke's Offshoring Research Network (ORN) in 2008 supports this theory, showing that for nearly three quarters of companies surveyed (74%), labor cost savings was an even more important driver for offshore outsourcing than it had been in the past, largely driven by concerns about the overall economy[1]. Given the economic environment, many buyers have seen their budgets cut. As a result, several have begun to outsource more routine tasks to lower-cost resources, freeing up their lean internal staffs to focus on higher-value activities.

Beyond the Business Case

Part of understanding the impact of relationship management in outsourcing involves looking at what the parties mean by "value" and understanding that value is not all financial. Just as there are reasons to outsource beyond cost savings, there are indicators of value beyond the business case. Buyers tend to measure or describe their deals, whatever their strategic purpose, by the savings they can project in their business case. Providers tend to describe them externally on the basis of top-line revenue; internally they also add some measure of profitability. But that's not the only value of outsourcing. Regardless of why you outsource, you will experience some other benefits and incur other costs or burdens. In many cases, if you don't pay attention to and cultivate these benefits, you may waste them or otherwise destroy a lot of potential value. Often, buyers group many of these non-financial benefits under the banner of 'innovation' and increasingly are describing that bundle of benefits as a key focus of outsourcing agreements. Responding to this development in the market, we've added a section on Driving Innovation in this version of the study, beginning on page 73.

In our research, we found that buyers and providers were both aware, to varying degrees, of value beyond direct savings achieved or margin earned. While buyers said that one of their top drivers for outsourcing was cost savings, many respondents said that they sought other, non-financial value through outsourcing as well (see Figure 4). Many respondents (59% of buyers, 47% of providers) identified specific types of 'innovation' or 'added value' that are expected in an outsourcing deal. Examples provided include proposing process improvement, working together to improve business planning, and identifying new business models and platforms.

For buyers, the value potential of outsourcing above and beyond cost savings depends on the primary drivers for outsourcing, and therefore the goals implicit in the arrangement. For example, some buyers outsource to effect dramatic change in a particular function or process very quickly. A buyer in this kind of scenario might seek speed of transformation, focusing on measures of speed or response time and thought leadership. In a facilities management outsourcing deal, non-financial value of this type can include such benefits as quickly lowering the number of workplace accidents and rapidly increasing security. In a "transformational" software development arrangement, buyers may seek dramatically faster software development cycles with significant improvement in software quality.

1 Arie Lewin, Silvia Massini, Nidthida Perm-Ajchariyawong, Derek Sappenfield, and Jeff Walker: Getting Serious About Offshoring in a Struggling Economy; Shared Services News, February 2009.

Measuring value beyond cost savings

Increasingly, organizations are seeking additional value through outsourcing in addition to cost savings, and they are getting ever-more savvy at measuring that value. Some companies are using a balanced scorecard approach to measure various categories of value — from financial value (e.g., return on physical assets, avoidance of capital expenditure) to operational value (e.g., process efficiency, service levels, quality, and on-time delivery of products and services), to strategic value (e.g., expansion into new geographic areas or markets, brand recognition/exposure, new products/services). Cutting across operational and strategic value, many buyers are seeking innovation from their providers, facilitated by increased collaboration or brought primarily by the provider based on their industry knowledge. A handful of progressive organizations are also beginning to measure the quality of their supply relationships as a leading indicator of the other kinds of value they will achieve, using qualitative metrics such as cultural compatibility, level of trust, and quality of communication.

Beyond revenue, the kinds of value providers seek in their arrangements with buyers focus primarily on client satisfaction, retention, and growth. From a service provider perspective, most outsourcing deals are structured such that the provider invests in change and improvement in the early years, and potentially even loses money in the first year or two. Slowly, as improvements are implemented, however, margins begin to increase. This business model makes base retention critical; deals that are terminated before the provider can turn the corner on margins can be incredibly costly.

Also, outsourcing deals often take many months of time and effort to close, making cost of sales very high. Reducing these costs through higher client renewal rates can save millions in sales efforts for providers. Finally, providers' ability to work with their buyers to identify new ways to add value and new services to deliver is critical to their ability to grow their arrangements and attract additional customers. Client satisfaction and/or willingness to recommend, depending on how a provider measures it, can also be an early indicator of the buyer's receptivity to new processes (which may deliver efficiencies for the provider), new services (which may mean top and bottom line improvements), or even joint exploration of innovative techniques and services.

Beyond the business case: Non-financial value for buyers and providers

Buyers	Providers
Better Service	Client Renewal
Higher Quality	Customer Satisfaction
Greater End-User Satisfaction	Customer Referencability
Innovation and Thought Leadership	
Resources Freed Internally to do Other Work	

Figure 4

Achieving the Value

As we did in 2004, we asked our survey respondents, both buyers and providers, what steps they take to ensure that they achieve the value they desire through their relationships. They pointed to a number of different means, including obtaining the best possible price at the outset of the deal, implementing new tools and processes to increase productiv-

> *Buyers and providers agree — investing in a quality working relationship is the most critical step to ensuring that outsourcing value is realized, even more important than obtaining the best possible price at the outset of the deal.*

ity, and selecting a provider with the greatest expertise. However, for both buyers and providers, the most critical step to ensuring that the value of outsourcing is realized is investing in a quality working relationship, even more important than obtaining the best possible price at the outset of the deal (see Figure 5). Eighty per cent of providers identified investing in the relationship as a key to achieving value; among buyers, it was the factor rated highest by respondents; 83% identified such investment as being of maximum importance. This finding may be somewhat surprising, given that nearly three-quarters of the buyers said that one of their primary drivers for outsourcing was cost savings. It also certainly begs the important question — how does investing in a quality working relationship lead to value realization?

There are two distinct ways relationship management contributes to the value equation — first, by creating value when the relationship is managed well, and second, by destroying value when the relationship is managed poorly.

Creative, Value-Maximizing Solutions

On the positive side of the equation, parties with a stronger working relationship enjoy benefits beyond what they would have otherwise achieved. When buyer and service provider have an effective working relationship, they have greater trust, and therefore tend to share with one another more information about their needs and priorities and in a more robust way. Consequently, providers are able to more effectively propose and implement creative, innovative solutions that meet the other party's needs as well as their own. They can also make best use of their resources by focusing improvement efforts on those areas with the greatest potential impact.

Employee, End-user, and Customer Satisfaction

Almost all of the providers and many of the buyers we surveyed cited employee, end-user, or customer satisfaction as one of the primary non-financial sources of value they seek through outsourcing. Stronger working relationships open doors for greater creativity and business value, which in turn, lead to greater customer satisfaction. For example, a strong working relationship allows for efficient and effective communication, which contributes to faster response times to problems and requests (and ultimately to greater customer satisfaction). Effective communication and conflict management, both of which are critical to a strong working relationship, also foster a healthy working environment, which contributes to employee satisfaction.

What matters most in achieving outsourcing value

Buyers

- Investing in a quality working relationship (83%)
- Stringently monitoring and enforcing SLAs (51%)
- Obtaining the best price possible at the outset (50%)
- Selecting a provider with the greatest expertise (61%)

Providers

- Investing in a quality working relationship (80%)
- Making/strengthening relationships with individuals at the most senior levels of the customer organization (77%)
- Demonstrating quality service by documenting/reporting on achievement against SLAs or other contractual targets (71%)

Figure 5

Resources Freed Internally to Do Other Work

Buyers also note that another key source of value they seek through outsourcing is an ability to shift focus onto internal core competencies. As buyer and provider work better together and solve problems, trust increases; the buyer believes that the provider will be able to meet their critical needs because they have a strong understanding of those needs and are willing to act on them. Greater trust then allows the buyer to free up for higher-value work resources that might otherwise be used to shadow or audit provider activity.

Sometimes the value is even simpler: over one-third of buyers said that they outsourced to compensate for a lack of available in-house resources. For these buyers, an effectively managed relationship allows the provider to fill in these gaps effectively.

Resource Waste

Conversely, on the value-destroying side of the equation, poor working relationships leak value in three primary ways: resource waste, suboptimal results, and lost innovation opportunities. More than 60% of buyers said that resources are wasted through an inability to trust or delegate; a similar percentage said resources were wasted by creating a greater need to monitor/audit. Challenges in the working relationship cause buyers to feel the need for more involvement, undercutting savings.

Our survey showed a number of sources of this waste of resource. Nearly 60% of both buyers and providers said that a poor working relationship also results in loss of value due to duplication of effort. Because the parties lack trust, they often duplicate efforts or require significant documentation of work performed. In extreme cases, this takes shape as redundancy in staffing, “shadow organizations,” and excessive supervision and documentation requirements at the task level. The more resources that are expended on redundant activities, the harder it is to meet deadlines and achieve cost savings.

Though not as widespread, the survey identified another significant source of resource waste as well: 30% of buyers and 35% of providers said that a poor working relationship resulted in overinvestment in alternatives or contingencies. Since the parties are not communicating effectively, each party must plan for a variety of possible future scenarios, rather than jointly discuss possibilities and agree on the right preparations to take. This results in significant time and money invested in possibilities that do not come to fruition and that do not generate value for either party.

Widespread, Poorly-Managed Conflict

Additionally, more than half of buyers and providers note that poor working relationships are often characterized by rampant and poorly-managed conflict which leads to frequent (and otherwise unnecessary) escalation. When every problem must be escalated beyond its source, progress is delayed while parties wait for resolution. Individuals end up spending their time in issue-resolution meetings instead of getting work done. Interestingly, several buyers say they addressed major problems by escalating issues on both sides. Given the amount of resources required to escalate and the delays in progress it creates, regular escalation is generally not a sustainable solution.

The majority of buyers and providers say that poor working relationships lead to wasted time and money through an inability to trust or delegate, and a greater need to monitor/audit.

> *Providers say that poor working relationships lead to poor decisions and solutions to problems, and buyers agree — they say that poor relationships lead to decision making based on limited information, which can result in suboptimal outcomes.*

Bad Business Results

Ineffective relationships not only waste resources, they also produce bad business results. In troubled outsourcing relationships, buyers' number one complaint was lower-than-expected quality (48%), with missed deadlines/delays a close second (46%). While a number of different factors can and do affect service levels and the quality of a provider's performance, the working relationship plays a prominent role. When asked how poor working relationships lead to diminished business results, nearly 60% cited lack of clarity about roles and responsibilities as a primary cause of poor results. Fifty-five percent of buyers also cited ineffective execution and follow-through from the provider as a significant cause. When parties communicate poorly and do not trust one another, it is unclear who is responsible for particular actives. This results in some efforts being duplicated, while other necessary activities slip through the cracks.

Buyers' other principal complaint was that the outsourcing suppliers delivered at higher-than-expected costs (38%). As described above, a poor working relationship often leads to inefficiency, duplication of effort, and missed deadlines, all of which raise costs. Costs also go up when buyer and provider make bad decisions; just over half of providers said poor relationships between buyer and provider lead to poor decisions and solutions to problems (51%).

Another complaint buyers have is that their suppliers don't fully understand their business, identified by 31% of buyers. When trust is low and parties do not communicate well or sufficiently often, information flow is severely restricted. By diminishing trust and restricting information flow, the parties find themselves continually confirming their worst fears about their counterparts. What may appear to be a quality problem, a deadline problem, or a cost problem often springs from one or more complex relationship problems. Interestingly, more buyers cited this problem in our 2004 survey (38%), which may suggest that buyer and provider are getting better at communicating about the buyer's business needs.

Lost Opportunity for Innovation

Not only are costs often increased by a poor relationship, but additional sources of value can be lost. More than half of buyers and nearly 45% of providers said that a significant impact of a poor relationship is less innovative or creative solutions being developed. This is not surprising; when there is less trust, weaker communication, and greater fear, it is more difficult for the parties to imagine new ways of working together more creatively, and also harder for providers to take a chance on suggesting new ways to solve problems. As outsourcing evolves, expectations for innovation or "value-add" will surely continue to increase. This evolution emphasizes the connection between a strong working relationship and generating innovation through outsourcing.

Value at Stake

Just How Much Value is at Stake When it Comes to Getting Relationship Management Right?

Quantifying the financial return on efforts to improve outsourcing relationship management is very challenging, but we asked our survey respondents to perform a thought experiment to help us gauge the value at stake when it comes to outsourcing relationship management. We asked them to compare a "worst-case" scenario — an outsourcing deal in which the buyer and provider have a very poor or acrimonious working relationship — to a "best case," highly-collaborative relationship characterized by strong mutual trust and effective management of conflict. We then asked respondents what percentage of the annual contract value of outsourcing deals they thought was at stake between the best and worst case scenarios. Virtually all respondents (94% of buyers and over 95% of providers) agreed that at least 10% of the annual contract value of outsourcing deals is at stake when it comes to effective relationship management (see Figure 6).

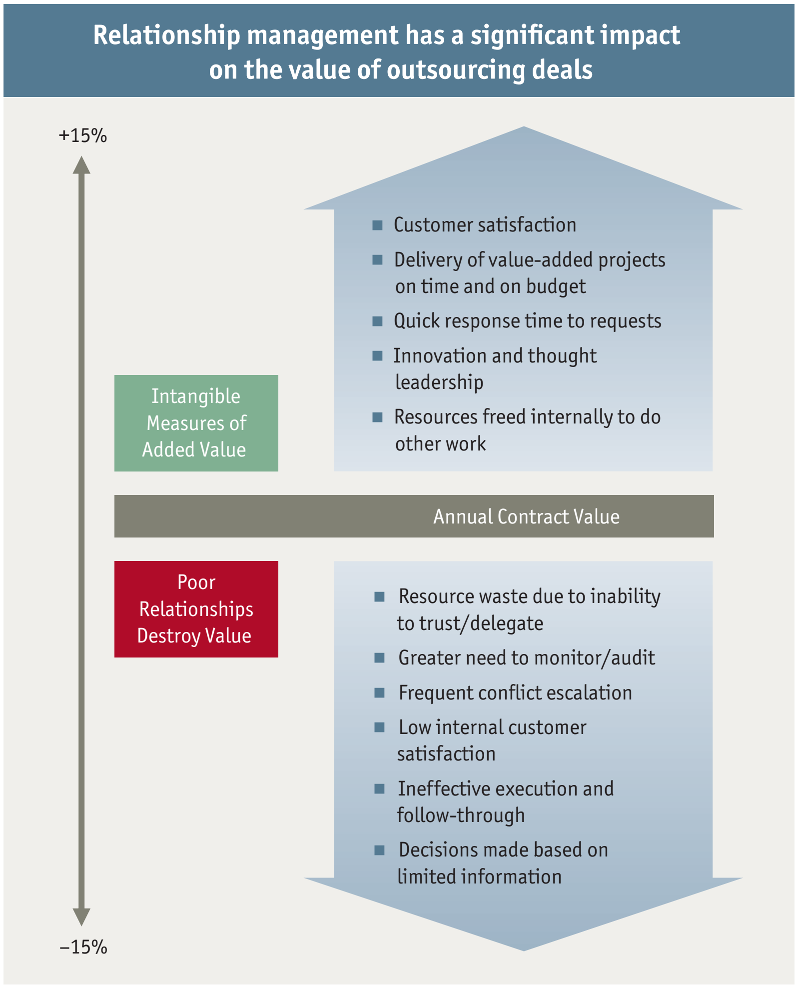

Figure 6

Many thought the stakes were even higher — over 55% of buyers, and over 60% of providers said that at least 30% of the annual contract value for their outsourcing arrangements is at stake when it comes to effective relationship management.

We do see a change in how buyers responded to this question between our 2004 surveys and the 2009 survey; in 2004, over 80% of buyers said that at least 30% of annual contract value is at stake when it comes to effective relationship management (compared to 55% who said at least 30% of value is at stake in our most recent survey). Provider responses did not change significantly. This difference could be interpreted in a few ways — perhaps buyers and providers are getting more rigorous about the way they manage their outsourcing arrangements; consequently, buyers may feel less is at risk simply based on how the relationship is managed. Another hypothesis is that the number of competitive service providers has grown considerably in recent years; with so much competition, and improvements in technology, more processes can be outsourced more quickly and at lower costs. Perhaps buyers feel that with more qualified choices, they don't have to rely as much as they once did on strong relationships. In any case, one thing hasn't changed — buyers and providers agree that how they manage relationships does matter — a lot.

Other research supports this finding — EquaTerra's study, *Outsourcing Management and Governance: Building a Foundation for Outsourcing Success*[2], found that organizations with more outsourcing experience tend to invest more in outsourcing governance, and these organizations are more satisfied with their outsourcing arrangements.

[2] Equaterra (2007)

> *What else that is within a buyer's ability to influence directly is worth more than 10% of contract value?*

Also, according to the Corporate Executive Board, the stakes may be even higher in comprehensive HR outsourcing arrangements. Their study reveals that ineffective relationship management can reduce returns by as much as 75%[3]. Estimates of the value at stake vary, but the picture that emerges is clear: there's very little else in an outsourcing arrangement, over which buyers and providers can assert some control, that matters more. Interestingly, most buyers reported that the negative financial impact of an adversarial working relationship cost them significantly more than the amount they reported spending on governance and oversight of their outsourcing relationships: The average relationship management function was only 6% of deal value. Given the value at stake in outsourcing relationships, greater relationship management investment may be needed.

The increasing importance of SLAs and measurement

An interesting change between our 2004 and 2009 survey results is the significant increase in provider focus on demonstrating quality service against SLAs or other contract targets. In our 2004 survey, such reporting was identified as being among the most important ways to achieve value by only 38% of providers; in the current survey, 71% selected it as among the most important. This likely reflects a combination of factors: increased buyer focus on quantifiable, measurable evidence of success in the outsourcing relationship; increased provider focus on marketing based on demonstrated success in meeting contractual requirements; and a maturing of the market and increased expectations among buyers and providers.

[3] Corporate Executive Board, "Maximizing Return on HR Outsourcing Investment" (2004)

getting clear on outsourcing objectives and the nature of the desired relationship

RFP and Selection

Critical Relationship-Related Challenges

Selecting a service provider is a complex and difficult decision, perhaps even more so than the initial decision to outsource. No single service provider/buyer relationship will be a perfect fit. Different providers bring different combinations of capabilities and working styles, each of which can be appealing for different reasons. Selecting a provider means making trade-offs. For example, which is more important — the total cost savings over the life of the deal, or the timing of savings? More flexibility in pricing or a lower base price? Deep expertise in one or two areas or general expertise across all functions being outsourced? An ability to drive innovation, or consistent, solid performance? The critical relationship challenge during the RFP/Selection phase is, therefore, getting clear on the objectives for outsourcing and the type of relationship necessary to achieve those objectives.

Current Practices

While most outsourcing buyers evaluate potential providers on a number of different criteria, often selection decisions are ultimately carried by criteria that are easy to assess and compare, but perhaps not most important. This happens for a couple of reasons. First, some metrics that are important are just not conducive to apples-to-apples comparison. For example, if a provider has greater presence in a critical geographic area, but less expertise in one of the processes being outsourced, should presence be traded off for expertise? How should these interests be evaluated and balanced relative to each other? If a provider demonstrates that they are able to work with you more effectively, is it worth it to pay a higher rate for that capability? Many organizations, out of an instinct for the comfort and perceived fairness of "purely objective" comparisons, fail to grapple with the challenge of discussing these trade offs and default to making decisions based on less important but easier to quantify criteria.

Four types of relationships and distribution of responses across them

	Transactional	Type 2	Type 3	Strategic
Provider	3%	40%	33%	23%
Private Sector Buyers*	31%	30%	28%	10%
Public Sector Buyers	28%	16%	24%	28%

Transactional

- Primary driver is cutting costs through economies of scale
- Little/no innovation expected
- Commodity services
- No real integration required between buyer and provider

Type 2

- Primary driver is getting work done more efficiently or effectively
- Small degree of customization of services
- Provider has some specialized knowledge regularly accessed by the buyer

Type 3

- Great degree of flexibility and customization of services
- Significant level of integration between buyer and provider required
- Provider has high degree of knowledge about the buyer's business

Strategic

- Full integration and shared responsibility required
- Innovation is core
- Shared risks and rewards involved

*Source: Cutter Consortium 2004, www.cutter.com

Figure 7

Second, many buyers, often due to political reasons, are understandably tempted to keep the outsourcing decision under wraps until it is final, which ultimately results in the exclusion of some critical stakeholders in the decision making process. While excluding additional perspectives may make decision making quicker in the beginning, it ultimately means that important information or criteria may be missed or glossed over, since important knowledge about requirements for the outsourcing is often distributed quite widely in a buying organization. The end result is a mismatch between the service provider's capabilities (and perceptions of what is important to the buyer) and the needs of the buyer organization.

Our practice and our research suggest that different kinds of relationships are necessary to achieve different objectives; therefore, different selection criteria should be used to help the parties assess the factors most important to establishing the kind of deal they desire. Several years ago, many in the industry characterized outsourcing relationships on a spectrum, from "transactional" at one end, to "strategic" at the other, with a couple of stops along the way. In our earlier surveys, we asked buyers and providers how they would describe their arrangements on this scale and got some interesting results (see Figure 7). Generally, providers said their buyer relationships were anything but "transactional," that they were much more heavily weighted to the "strategic" end of the spectrum; whereas most buyers said their relationships were anything but "strategic," being much more weighted toward the "transactional" end of the spectrum.

The disconnect between buyer and provider views about the nature of their relationships may not be surprising. Many buyers aspire to keep their providers toward the "lower price/less integration" end of the spectrum to decrease their reliance on an outside party, making it easier to withdraw from the relationship should circumstances change. Providers, on the other hand, often aim to integrate further, thereby becoming more entrenched and enhancing their margins. Such divergent viewpoints over the type of relationship each side wants creates tension over time, as the provider pushes to deepen and strengthen the relationship while the buyer simultaneously struggles to keep the provider at arm's length.

Also, it could just be that the single-dimension view of outsourcing arrangements is simply unhelpful. The majority of buyers and providers said their relationships were somewhere between "transactional" and "strategic," but this spectrum doesn't say much about what being in the middle means. We have found that it is more useful to describe relationships along two dimensions, rather than a linear relationship along a single continuum, since the distinction between the middle types on a continuum is often unclear (see Figure 8).

On the vertical dimension, a relationship is characterized in terms of its complexity, which is a function of the number of in-scope processes, the number of geographies involved, and the complexity of the organizational structure (e.g., number of business units). It can be tempered, in part, by prior outsourcing or in-sourcing of the functional area. This is because having previous centralization of service and outsourcing experience would presumably remove some of the complexity inherent in a decentralized environment, as well as some of the difficulty in managing expectations and making decisions across different business units or geographies in a distributed environment.

On the horizontal axis, relationships are characterized according to the type of goal, or the overall business objective to be achieved. Those deals that are more "transformational" and/or require greater innovation move further out on the x-axis. For example, some outsourcing arrangements simply involve "picking up" a business process or function and transferring it to another organization that can perform essentially the same function less expensively or more effectively — a fairly straightforward goal. Others, however, entail taking advantage of unique provider

Four types of outsourcing relationships and their characteristics

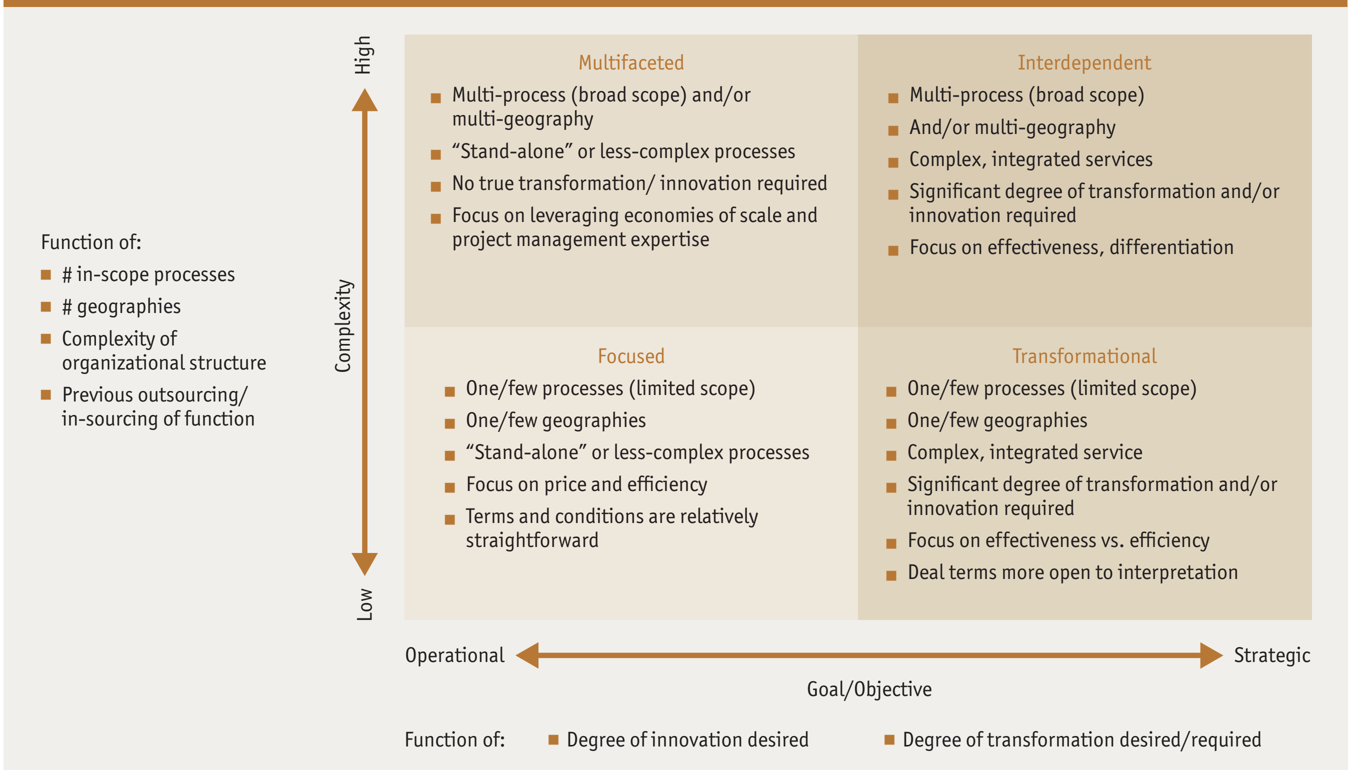

Figure 8

competencies to create a wholly new way of performing a function or creating a new form of end-customer value. This situation involves considerably more complex kinds of goals.

Each type of relationship entails a different kind of challenge, lends itself to creating different kinds of value, and therefore requires that different capabilities and factors have more weight in the selection decision than others. In "Focused" relationships, for example, stand-alone or less-complex processes are outsourced, so drawing scope boundaries is relatively straightforward. The focus is on leveraging a provider's economies of scale, and the value to be gained is mostly cost savings and greater efficiency of process. Outsourcing of payroll operations in a single geographic area, mainframe computing, and data center management often fall into this category of relationships. Approximately 13% of providers and 19% of buyers in our 2009 survey said their relationships could be characterized as "Focused."

In these relatively straightforward types of relationships, the focus on economies of scale and cost reduction often requires standardization of what once were varying processes and tightening of service levels. As a result, the end user experience and satisfaction is sometimes traded off in favor of cost savings, so setting appropriate end user expectations is important. In these relationships, therefore, likely critical selection criteria include low cost (generally as a result of scale), and demonstrated acceptable levels of services (but not necessarily the highest levels of service).

Unique value, likely issues, and sample critical selection criteria by relationship type				
	Focused	Multifaceted	Transformational	Interdependent
Unique Value	■ Cost Savings ■ Process Efficiency	■ Smoother implementation ■ Decreased cost of coordination	■ Faster transformation	■ Innovation ■ Differentiation
Likely Challenges	■ Managing end-user expectations and satisfaction	■ Managing multiple geographies or complex organizational structure	■ Defining and managing scope boundaries	■ Continual innovation
Sample Critical Selection Criteria	■ Cost ■ Acceptable (though not highest) service levels/capability	■ Project management expertise ■ Change management expertise	■ Deep functional or process expertise ■ Desire to grow and invest in a particular area ■ Ability to work intimately and effectively with the buyer	■ Functional expertise ■ Partnering capability

Figure 9

The second type, “Multifaceted” relationships, include multi-process (and therefore, broader scope) and/or multi-geography outsourcing arrangements. Processes are relatively less complex, and no true transformation or innovation is required. Almost 27% of buyers and 25% of providers in our 2009 survey said their relationships were like the “Multifaceted” type. The true challenge in this type of relationship is managing the multiple geographies or complex organizational structure involved (as opposed to effecting transformational change). The value potential, therefore, is about smoother implementation and decreased cost of coordination. Examples of this kind of relationship include a multinational corporation outsourcing its worldwide employee data administration, or a manufacturing company outsourcing (and standardizing processes for) facilities management, including health and safety administration, security, cafeteria and janitorial services, to a single provider across multiple sites. In this type of relationship, therefore, a provider’s project management and change management expertise should be important selection criteria.

In the “Transformational” type of relationship, scope is limited to one or a few processes in a limited number of geographies, but the processes themselves are very complex. A significant degree of transformation and/or innovation is required, and therefore, the focus is on effectiveness and quality, as opposed to efficiency. The value to be derived in these relationships is the potential for faster transformation than a buyer could achieve on their own. For example, imagine an auto maker outsourcing its software development function to achieve radical change in both the quality of the operating systems used by their cars, and also the cycle times for software development.

In these relationships that involve significant change, it is nearly impossible during contract negotiations to predict the most effective path to get to the desired end state. Due to process complexity and the degree of transformation involved, scope boundaries are more difficult to draw clearly, both at the outset and over the life of the relationship. In these types of relationships, therefore, an emphasis on selecting a provider with deep expertise in a particular function or process, a desire to grow and invest in that area, and an ability to work intimately and effectively with the buyer over time are critically important.

Interestingly, almost 30% of providers in our 2009 survey said their relationships were relatively less complex, but required significant transformation, whereas only about 13% of buyers characterized their relationships in this way. This finding may have several causes — some buyers are looking for dramatically improved results in their outsourced processes (like better quality, faster cycle times, and an ability to change more rapidly), but perhaps aren't as aware as their providers are of the transformation required to achieve those results. Perhaps some providers view an operational transformation as more significantly transformational than a buyer would.

An "Interdependent" relationship combines the multi-process/multi-geography challenge of a "Multifaceted" relationship with the innovative goals of a "Transformational" relationship. In "Interdependent" relationships, the potential value to be gained focuses on innovation and differentiation, and often involves some shared reward. In this sense, "Interdependent" relationships can be thought of more as alliances than outsourcing relationships because of the mutual risk and reward involved. For example, in 2006 American Airlines teamed with their provider, IBM, to develop a new outsourced HR platform. By 2009, this platform had successfully delivered the immediate objective of matching the service delivery quality of the old in-house solution… and had also delivered new services and a significant strategic benefit. American benefitted from a centralized call center, online learning tools, and broader talent management capabilities. The outsourced platform also had a strategic benefit: it made American far more able to respond to the HR challenges presented by the 2008-9 global economic downturn[4].

"Interdependent" relationships involve the creation of new value sources for both buyer and provider. Proactive information sharing about business needs and strategy and perspectives on industry direction are therefore

A word on "Partnership"

Particularly during the sales process, buyers and providers alike tend to frequently use the word "partnership." Buyers seek "partners" to help them solve their business problems, while providers do their best to play up their capability to be a good "partner." According to Vaughn Hovey, the word "partnership" is sometimes "a lot of marketing hype." Underneath the hype, buyers and providers have very different definitions of what "partnership" means. For providers, "partnership" generally implies some sense of shared risk and reward and drive to achieve common goals — at the bottom line, further integration and longer-term relationships. For buyers, however, the word "partnership" is more likely to imply a situation where the provider is willing to go the extra mile (beyond the letter of the contract) to solve the buyer's problems and help further the buyer's business goals, and as a result, be rewarded with more business. Buyers' and providers' differing perspectives on the nature of their relationships are, in part, a product of these differing definitions. Unfortunately, these different definitions and perspectives often play out as unmet expectations on both sides. A provider may act in a way that they think is consistent with "partnering" by initiating conversations with their customer about joint contribution to problems and challenges — conversations that the buyer experiences as an attempt to abdicate responsibility. The buyer therefore refuses to engage and holds their provider even further away. The provider, in turn, perceives this behavior as very "un-partner-like."

[4] For more information, see http://www-01.ibm.com/software/success/cssdb.nsf/cs/JSTS-7UYQ84?OpenDocument&Site=gicss67trav&cty=en_us

required to continually innovate and avoid stagnation. In addition to functional expertise, a provider's ability to effectively manage and bring value to partnerships is especially critical in these types of relationships. In our 2009 survey, 41% of buyers and 33% of providers characterized their relationships in this way.

These four types of relationships can be used as a model for analyzing the goals and objectives of the arrangement, and therefore help the parties determine what selection criteria are important. Because it is unlikely that any single provider can meet every possible selection criteria perfectly, generally some trade-offs are required in the selection process. These relationship types can be used to determine the relative importance of various aspects of the deal and the desired relationship, and to ascertain where trade-offs can be made without compromising intended outcomes. They can also be used as a means for communicating and aligning on potential challenges and desired goals, both within the buyer organization and between buyer and provider.

General Recommendations

In the last several years, the survey data (and our own work with clients) suggests that buyers are seeking to outsource ever-more complex tasks, and look to their providers to deliver increasing degrees of transformation. This reflects several realities: many buyers have more experience with outsourcing and thus, their comfort level with entrusting important processes to a provider has increased; buyers are increasingly under pressure to reduce costs and focus on core competencies, which has led to a greater desire to utilize outsourcing providers to drive non-core activities; and finally, there may be a recognition on the part of buyers that many providers are now more experienced and skilled at assessing and driving transformation than the buyer organizations themselves.

That said, there remain differences in viewpoints over the type of relationship buyers and providers seek. Buyers are more likely to view a transaction as 'highly complex' than providers, potentially leading to a different view of staffing and seniority required for completion. Buyers also see more transactions as requiring minimal transformation, creating the potential for disconnect between a buyer's view of the cost and ease of delivery and that of the provider. These differing perspectives are problematic because they lead to a different understanding of the ultimate objectives the parties hope to achieve, as well as the complexity of achieving those objectives, and therefore the degree of closeness required and the relationship management and governance mechanisms necessary to ensure success. So a first step is for buyer and provider to align on the level of complexity inherent in the deal, and the degree of transformation expected.

Advice for Buyers

Build Alignment Internally Around the Decision to Outsource

Many buyers, in their haste to outsource and their desire to keep outsourcing decisions quiet, leave critical stakeholders out of the decision-making process. As a result, internal alignment around the decision to outsource and the selection of the provider are not achieved prior to outsourcing. Frequently, those left out of the process are those who are most likely to see their jobs or those of their colleagues change dramatically. It is also these individuals who can make effective implementation of new systems or processes difficult, if not impossible. "We have had our best change-management outcomes when we have communicated early on, during the assessment phase of the lifecycle," says Kurt

> *We have had our best change-management outcomes when we have communicated early on.*
>
> — Kurt Kohorst, VP, Liberty Mutual Insurance

How much is relationship management capability worth?

Our recent survey asked buyers to assess to what degree a provider's better relationship management capability should offset a competitor's price advantage. A vast majority (86%) said that a provider's ability to manage relationships effectively was worth at least 5% of the overall price, and just over half said it was worth 10% or more. Perhaps most surprising, almost one-third of respondents said that a provider's better relationship management capability should offset a competitor's price advantage by 20% or more. While these numbers may seem large, they are using the mid-point of each range to estimate exact percentage, our data suggests that superior relationship management capability should offset 13% of price. This data is consistent with our other findings that the difference between an effective and a troubled relationship can amount to 46% of annual contract value.

Another way to look at the value of relationship management capability is to evaluate its impact on the probability of closing the deal. Our survey indicated that a strong customer reference made a deal 34% more likely to close than when there is not such a reference. Considering the significant impact on deal value from good relationship management, it is reasonable to consider the probability of closing additional work a significant ancillary benefit of relationship management as well.

Kohorst, a Certified Outsourcing Professional (COP) and Vice President of Business Process Management with Liberty Mutual Insurance. "While there is not always a lot of detail to be shared, impacted employees want to understand the assessment approach and potential outcomes early on. This builds credibility and lays the groundwork for receptivity to challenging messaging that may need to occur during the implementation and transition phases of the project."

Building internal alignment around the outsourcing decision requires several components: a well-defined process, appropriate stakeholder involvement, and clear communication. First, you need to put in place a well-defined process for making a decision around what to outsource and the objectives of outsourcing. A good process means having transparent criteria, clearly articulated decision-making roles and responsibilities, and a prescribed timeline. A series of rigorous formal assessments and discussions are likely required to figure out what specific functions should be in scope for outsourcing, the intended cost savings or improved service levels, and long-term goals.

Second, you must identify all of the relevant stakeholders and agree with them on their involvement. Stakeholders include not just senior executives, but also people who may be instrumental to implementing the deal once it is signed. It is often assumed that if an individual is considered a stakeholder, he/she must be a decision maker. In reality, stakeholders can have different levels of involvement depending on their role within the organization and their areas of expertise or knowledge. The extra time and effort required to engage stakeholders early will pay off later with smoother implementation and less resistance.

Finally, once a decision to outsource is made, you must communicate it to the entire organization clearly and consistently. A comprehensive communication plan should include general content, messages tailored to specific audiences, and communication mechanisms. Common topics include the rationale behind the decision, the decision-making process employed, and organizational impact. Customized messages should focus on how outsourcing is going to impact each stakeholder group and what they should expect in the short and long term. Remember that people often do not think about the implications right away and pay little attention until these initiatives begin to impact them personally.

Consider Relationship Management Capability in Selection

As the outsourcing industry has matured, more and more service providers have developed comparable delivery capabilities. Differentiating among top tier providers on things like number of service centers, industry experience, or functional knowledge is increasingly difficult. One criterion that historically was left out — intentionally or because of difficulties involved in evaluating it — is relationship management capability. Over time, outsourcing buyers have increasingly begun asking providers to describe their governance and relationship management models, and a greater number of selection debates are revolving around the question, "What will it be like to work with this provider day-in and day-out?" As our 2009 survey results show, more than 95% of buyers agree that the provider's ability to be a good partner influences provider selection, and nearly half include a formal evaluation and weighting criteria in their process (see Figure 10).

How does a provider's ability to act as a good partner influence your organization's provider selection process today?

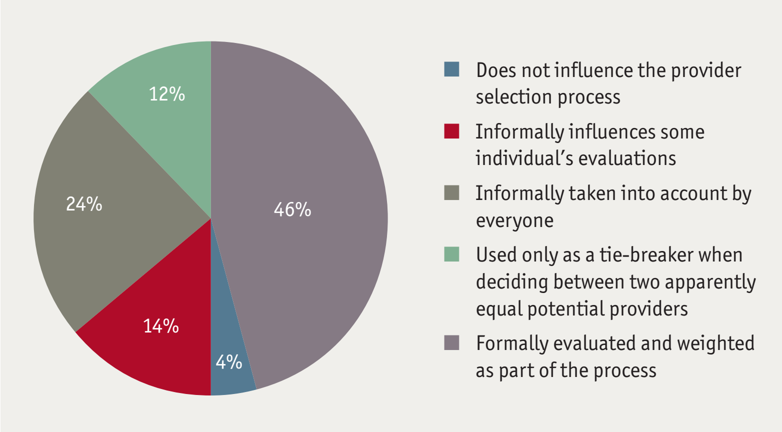

Figure 10

Assessing a service provider's relationship management capability is not the same as making sure the two organizations have a compatible culture. Different cultures can work well together, as long as the two parties can openly discuss and manage the challenges resulting from those differences. Ask potential providers for references and concrete examples of investments they've made in their relationship management capability (e.g., skills training, process development, etc.). Be clear with the provider on what your objectives are for outsourcing, and based on these objectives, the type of relationship you are aiming for in the outsourcing arrangement. This will enable the provider to select appropriate references and to tailor the information they provide to you regarding their relationship management capability. In general, the more complex and transformational the deal, the more important the service provider's governance and relationship management capability is going to be in driving value during implementation.

Make Sure You Know How the Provider Plans to Deliver to Your Goals

Any provider will need your assistance in order to be successful. For any goal you hope to achieve through outsourcing, there are activities you need to undertake, and ones the provider must perform. For example, if you want to reduce cost, a provider might deliver with less expensive, offshore resources; they may automate some processes, and/or they might implement best practice process improvements. But doing any one of those things requires your support — you have to be willing to transfer knowledge and communicate effectively with offshore team members for labor arbitrage to work; you must be willing to accept some degree of standardization in order to automate; and you have to be willing to change your processes to implement best practices. If, during the selection process, you don't clarify how the provider plans to make good on its promises to deliver value to you, you won't know what will be needed from your organization. And unfortunately, when a provider isn't able to deliver the results you expected in implementation, it's not just "their problem," it's yours too.

Advice for Providers

Focus on Relationship Management Capability as a Differentiator

We asked providers how they typically aim to differentiate themselves during the sales process. On average, providers put quality and/or reliability at the top of the list, followed closely by technical or functional expertise and ease of working with the provider. While your organization likely sees a clear distinction between your delivery capabilities and those of your competitors, many buyers actually have a hard time discerning the meaningful differences. Additionally, certain aspects of capability that are very important to some buyers may be less compelling to others.

Increasingly, technical capability or expertise will only get you into the game. Winning requires an ability to prove how the overall experience of entering into a deal with you would be different from doing so with competitors. From the buyer's perspective, it often comes down to what it would be like to work with you day-to-day, and sophisticated buyers (often with the help of advisors) are beginning to ask more detailed questions of potential providers regarding the steps they take to ensure effective management of relationships. The trend between 2004 and today suggests that demonstrating the provider is easy to work with is increasing in importance as a differentiator and thus, providers should seek to 'win' this criteria with a clear and documented story.

Providers' assessment of how they aim to differentiate themselves

	Today	2004	Change from 2004 to Today
Quality/reliability	4.28	4.06	+0.22
Technical/functional expertise	3.76	3.89	-0.13
Ease of working with provider	3.47	3.02	+0.45
Price	2.37	2.13	+0.24
Global presence	2.15	1.91	+0.24
(All data on 5 point scale, 1=low, 5= high)			

Figure 11

It is also interesting to note that the sales challenge for providers appears to be getting more competitive — providers indicated they are increasing their differentiation on four of the five criteria we surveyed, with only technical/functional expertise decreasing slightly in focus. With this increased focus, a "smoke and mirrors" approach to governance and relationship management during the sales process no longer works. Providers increasingly must demonstrate true relationship management capability (that is, an effective, repeatable process for managing relationships) up front to continue winning deals. That means describing a well-thought-out governance and relationship management structure in RFP responses, and citing specific examples of when the structure has been implemented. It also means sharing which formal skills training programs are in place for provider account and relationship managers to ensure they can perform their roles effectively and describing what weight relationship

No longer does a "smoke and mirrors" approach to relationship management work during the sales process. Providers increasingly must demonstrate true relationship management capability (that is, an effective, repeatable process for managing relationships) up front to continue winning deals.

management ability is given in these managers' performance reviews. It also means investing in and demonstrating the software tools providers use to assess performance to service levels and providing references from other customers in similar situations.

Being able to clarify (in a concrete way) your understanding of the buyer's objectives for outsourcing, the appropriate relationship needed to meet those objectives, and the way you can help to create and maintain that relationship will go a long way towards differentiating you from competitors during the selection process.

setting the stage for successful implementation

Negotiation

Critical Relationship-Related Challenges

Outsourcing deals are the result of high stakes negotiations, and buyers and providers commonly assume that a good deal can only be achieved at the cost of a good relationship (i.e., extracting concessions by making threats, withholding information, or otherwise being hard on the relationship) or vice versa (i.e., attempting to protect a strong working relationship by offering concessions on price or terms). In reality, getting a good deal and having a good relationship is not only possible (albeit difficult), but also critical to achieving value in an outsourcing deal so that both parties can work together to attain their business goals.

Moreover, many outsourcing deals are not set up to be effectively implemented because those negotiating the deal are often so focused on getting the deal signed that they don’t discuss how implementation is actually going to work at an operational level. In addition, those who have to live with the deal (i.e., implementers and end users) are not involved early enough (if at all) during the negotiations. Those involved in negotiating outsourcing deals therefore need to look beyond contract signing to ensure that negotiations set the stage for successful implementation.

Current Practices

Forcing Oversimplified or Narrowly-Defined Comparisons

Many of the things buyers and providers have traditionally done during outsourcing negotiations have actually set the stage for deal failure rather than success. For example, although outsourcing consultants/advisors and procurement staff can certainly play an important role in negotiations, their potential to add value is significantly limited when their stated mission is to create a wall between buyer and provider and to commoditize providers’ offers. Given the complexity of outsourcing bids, many buyers understandably prefer “apples-to-apples” comparison shopping, rather than making “apples-to-oranges” comparisons between various provider offerings.

Unfortunately, however, the result has been deal structures that are easy to compare, but do not create the most value for the parties. Different providers offer unique capabilities and potential value that will be missed or squeezed out if the provider is forced into a narrowly-defined, over-simplified comparison on a limited set of factors. This forced “commoditization” of provider bids also leads some providers to fall prey to the “winner’s curse”: the provider that is most optimistic about risk bids most aggressively wins; but the most optimistic provider is rarely right, which can lead to a host of problems as the deal is implemented.

As more and more outsourcing transactions focus on complex and transformational tasks, the need to realistically assess and compare different types of activities will only increase. The most effective approach to negotiating these complex transactions will be one that properly balances the business needs of buyers and of providers and recognizes that relationship and business value do not need to be in opposition.

Excluding Important Stakeholders

Additionally, both buyers and providers have traditionally excluded or significantly limited the involvement of end users and implementers/delivery personnel in negotiations in favor of leaving the detailed back and forth to a core group of professionals often in Procurement (buyers) and Sales (providers). Buy-side negotiators lament that involving business units and end users in negotiations is often time-consuming and frustrating, as individuals not entirely bought into the process create roadblocks and articulate difficult challenges that take some time to sort through and address. Provider-side negotiators fear that delivery personnel, more concerned about implementation than closing the deal, will be overly risk-averse or conservative at the negotiation table.

Regardless of the reason, by leaving out those who will have to live with the deal once it is written (both on the buy- and deliver-side), buyer and provider are increasing the odds that negotiation teams will lack important data and perspectives, and those who need to live with the deal will not be "bought in." Important ongoing business objectives, such as continuous improvement and innovation, are likely to be lost or given too little weight, creating a long-term challenge for the outsourcing relationship. As a result, their arrangement is less likely to meet all critical needs, and implementation is more likely to be rocky and prolonged.

Giving Governance Short-Shrift

Without a framework within which to manage the relationship, with established governance structures, processes, and protocols, our experience shows that both buyer and provider have a significantly more difficult time sustaining a strong working relationship. Unfortunately, governance often receives little attention during contract negotiations — it is either hastily conceived in a manner not aligned with the goals of the deal, or consists merely of a contract boilerplate that has been pulled from a generic contract template or previous deal. In some cases, governance provisions are not included in the contract at all due to time constraints or perceived insignificance. It is therefore not surprising that implementation of governance provisions occurs broadly in less than 55% of relationships and in less than 35% for some critical, specific items.

When the foundation for an effective working relationship is not established while the deal is being negotiated, buyers and providers find that it is very difficult to create this foundation as the focus turns to the operational details of implementing the deal. They also find that it is much more difficult to try to build a framework for an effective working relationship once a slew of unanticipated problems have already arisen due to lack of clarity around decision-making, communication, and problem solving, all of which could have been preemptively discussed at the time of negotiation. The reality is that the formal negotiation period is a key opportunity to learn about the other company and what it might be like to work with them. The foundational trust between individuals and organizations built at this time can dictate the development of a healthy working relationship.

Many leading-edge companies and their advisors are starting to change the game, however. As described in the previous section of this study, more and more buyers are inviting early discussions about governance and relationship management, and some are even formally evaluating potential providers on their relationship management capability as part of the selection process.

Additionally, some buyers and providers are taking steps to ensure that "implementability" has a voice in negotiations. They are accomplishing this by inviting delivery personnel to review potential solutions and to assess the feasibility of various options, and looking to buyer business unit leads and other key executives to express their most critical needs and concerns that need to be addressed in any potential arrangement.

The latest survey responses on governance suggest that there are some areas that are important to a good agreement, but which no longer represent differentiators since the great majority of transactions already envisage an approach to managing them. The data also suggests a few valuable opportunities for providers to differentiate themselves in areas regarded as critical to success, but which are also not regularly implemented. Two of these are joint training and guidelines for a 'handoff' between the negotiation and implementation team. Perhaps because of expense, joint training appears to be oft-neglected but is regarded as equally important to a number of often-implemented governance provisions. The concept of a 'handoff' is recognized as valuable, but executing a handoff plan requires involvement from not only the negotiating team but also the delivery team, complicating the organizational challenge of implementing such a provision.

General Recommendations

Negotiate Governance Structure

Today, most providers regularly include some sort of governance committee structures in their outsourcing contracts. However, very frequently, boilerplate language on governance is simply dropped into contracts. During complex outsourcing negotiations about scope, pricing, and SLAs, it is tempting for both buyers and providers to overlook discussions about the governance of an outsourcing relationship. Pushing off defining and adapting a governance model to the particulars of the deal might save time during upfront negotiation. However, it will also likely result in even greater time wasted as the deal is implemented without proper oversight and processes for communication, decision making, and issue resolution.

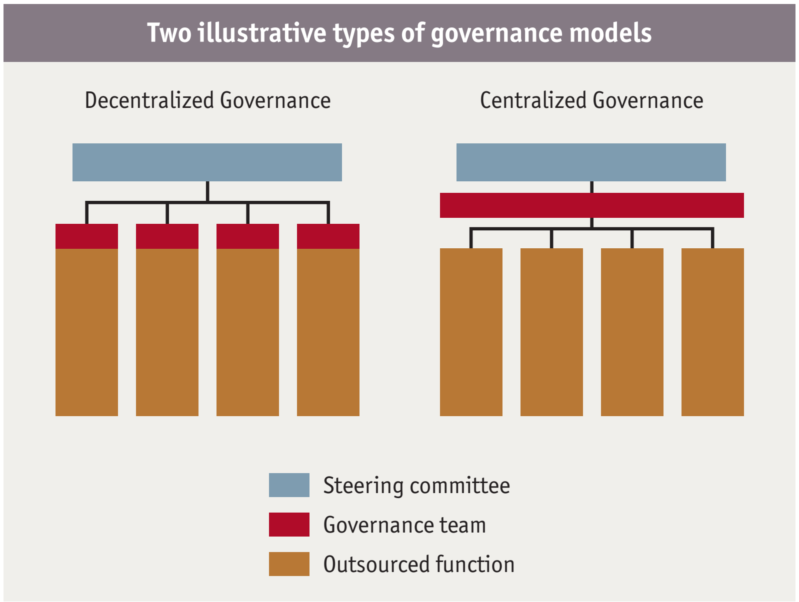

Figure 12

No single governance model is appropriate for all deals. Rather than dropping a "one size fits all" governance model into the contract, buyer and provider should spend some time negotiating what their deal's governance structure will be. Defining these structures helps determine which decisions are made by whom, which individuals and groups interact, and how responsibilities are divided.

For example, a defining characteristic of governance structures is the degree of centralization — where governance resources live and how they are linked to the outsourced functions (see Figure 12). A centralized governance organization (on the right in the figure) includes both functional experts from outsourced areas and those performing specific governance functions, like contract administration or financial monitoring, and sets them apart from each outsourced function. A decentralized governance organization (on the left in the figure) places governance team members — both functional experts and those performing governance functions — closer to the actual outsourced areas for more hands-on involvement.

For relatively straightforward "Focused" relationships, which involve stand-alone or less complex functions, a simple, centralized structure is generally appropriate. (See pages 21-24 for a description of these different types of outsourcing relationships.) “Multifaceted” relationships, which are more complex but not especially transformational, require a governance structure that incorporates a significant degree of input and participation from key stakeholders in different functions or geographies, as well as some higher-level view that brings those functional or geographic views together into a cohesive picture, which points to some combination of centralized and decentralized governance.

“Transformational” relationships, which involve one or few very complex and evolving processes within a limited number of geographies, require a governance model that allows for close interaction between buyer and provider to ensure effective transformation; this requirement might lend toward a more decentralized model that takes into account an “on the ground” view of the process that has been outsourced. “Interdependent” relationships are most complex, requiring regular communication at multiple levels, as well as significant high-level oversight. These kinds of relationships therefore also lend themselves to some combination of centralized and decentralized governance.

Adapting the governance model to the reality of a particular deal is just the first step. It is just as important for buyer and provider to agree upon how the model will actually work on a day-to-day basis. If no one is made accountable for putting the governance structures and processes into place, then the model will consist of nothing more than empty words in the contract. Building and implementing the governance model should be assigned as an official role to one person or a group of individuals, and all involved should understand the purpose and importance of implementing the governance model and have specific incentives to do so.

Negotiate the Deal with the End Game in Mind

Negotiators of outsourcing arrangements often go into negotiations with a short-term attitude and mindset: get the deal done. Negotiators can get so mired in the details of SLAs and cost projections that they often don’t step back and look at the negotiation (either in advance or while “at the table”) from a more strategic perspective. The kind of relationship you want (based on the degree of complexity implicit in the deal and the desired degree of transformation) should drive the negotiation process. “Focused” relationships might be best suited to a simple auction-like negotiation process, making use of a straightforward comparison of services, with the primary topic of negotiation being price. However, as the relationship moves out the complexity and transformational axes towards “Interdependent,” negotiating the deal with more complex forms of value at the forefront (like one would negotiate an alliance) will maximize value in the deal for both buyer and provider.

Some key questions to think about when preparing for and actually negotiating a deal strategically include: “What are both parties’ key interests and concerns (including those of important, but reluctant, stakeholders who are critical to implementation)? What are some creative options that satisfy those interests well? What are some standards of legitimacy, such as benchmarks and terms and conditions consistent with industry practice, which will allow both parties to select among various options in a way that each believes is fair? What are the most relevant governance structures and processes for the targeted type of relationship between buyer and provider? How will the buyer inform the provider regularly about evolving business needs? How will the provider share with the buyer information about relevant new processes, technologies and innovative ideas on an ongoing basis? How much flexibility is required in the agreement to account for uncertainties? Using this kind of strategic approach to negotiations (when relevant) leads to more creativity and greater value creation in the deal-making process.

Advice for Buyers

Set the Deal up for Successful Implementation

Instead of just signing an outsourcing contract and expecting implementation will follow as outlined in the contract, there are a few things that you can do to ensure that your outsourcing deal is set up for success. First, make sure that business unit leads and other key stakeholders are not only involved in initial discussions around in-scope functions, intended cost savings or service levels, and long-terms goals, but that they are kept in the loop as negotiations proceed and decisions or trade-offs need to be made that will have a material impact on end users. Time spent consulting or informing key stakeholders as appropriate throughout the negotiation process will pay off in greater buy-in (and therefore reduced resistance) after the deal has been signed.

Second, work with the provider to create SLAs that matter, not just those that are easy to measure. Some buyers have said that, even when SLAs are being met, they don't feel they are achieving the full value they hoped to get from outsourcing. Instead of simply collecting the performance data that is easiest to gather, think systematically about the business outcomes you want to achieve, and work backward to identify metrics that reveal whether or not those targets are being met. This approach requires you to carefully assess and align internally around your desired business outcomes. It also means working with your provider to consider possible ways to assess progress against those outcomes. You can contribute to the success of this approach by sharing your changing business needs with the provider and asking for the provider's input on ways to shape or hone metrics that will create an up-to-date view of success in the relationship over time.

Third, discuss with the provider how implementation is actually going to work. How often will the SLAs be measured, jointly discussed, and adjusted? What are the roles and responsibilities of joint governance team members and how often will the joint governance committees meet? What are the protocols for communication, decision making, and issue resolution? How will project milestones be monitored and adjusted? How will change orders be sent and processed? How will employees be transferred to the provider? These are just some of the important implementation-related questions that should be discussed and agreed upon before the contract with the provider is signed in order to increase the likelihood of a smoother transition and ongoing implementation of the deal.

Create a Negotiation Process that Maximizes Value

The creation of additional value in negotiations is often treated as an afterthought and thus doesn't get very much traction. For example, if you ask providers to fill out detailed line item pricing on huge spreadsheet forms, and then throw in a question inviting them to propose creative solutions, it is highly unlikely that they will take such invitations seriously or spend much time on brainstorming creative solutions; they know you will barely read these solutions, much less score them.

Particularly if your intended relationship is "Focused," "Multifaceted," or "Transformational," having a process that puts the creation of value upfront in negotiations will make it more likely that providers will take you seriously and engage in a discussion about possible creative solutions for the outsourcing deal. Consider engaging in a discussion (which could be structured or facilitated by an outsourcing advisor) with interested providers so that they can better understand your goals, interests, and priorities in order to come up with possible creative solutions that create greater value for both parties in a particular outsourcing deal. Challenge yourself and your advisors to make real assessments and comparisons of dissimilar value propositions. It will be your first opportunity to examine how well a provider understands your needs and can craft an appropriate solution.

Advice for Providers

Respect the Role that Advisors Play in Negotiations[5]

External advisors who help develop baselines, draft RFPs, and manage selection processes have become an integral part of today's outsourcing negotiations. Outsourcing advisors offer buyers significant market knowledge and negotiation experience that most wouldn't otherwise have (and therefore would be disadvantaged by during negotiations). They also play an important role by saving time for buyer executives. Part of what appears to be filtered or excluded during the sales process is the advisor protecting their client's time and attention — most clients prefer not to spend hours of their time meeting with many potential providers.

Tempting though it may be, do not expend a lot of energy on trying to get around advisors. Recognize that they offer an important service to buyers, and in some ways, to you, by educating their clients about the realities of outsourcing, preparing them to manage a relationship, helping them get a grip on their true current state and reality-testing their baselines. If there is a specific need to communicate directly with the buyer (make sure it is a real need), create a request that speaks to the advisor's interests (i.e., wanting to look like they're doing their job, respecting the buyer's interests of not being overly involved in the negotiations, etc.). Present data to the advisor that shows how communicating directly with the buyer would be beneficial to both parties (i.e., digging deeper into the buyer's interests to capture value that may be available through redesigned processes, more innovative solutions, or simply more efficient transitions). If the advisor still is not convinced, provide examples of how this kind of direct communication has been beneficial in the past. Some advisors will create limited, structured time for you to communicate directly with the buyer; respect the allotted time and structure that the advisor creates for this interaction.

Some advisors still might not agree that you should be allowed to speak with the buyer directly. These advisors often try to create simplified selection criteria so that the buyer is able to do "apples-to-apples" comparison shopping, and they also create a tightly controlled negotiation process in order to save time and push the provider hard on price. If the deal being considered is mostly a commodity offering, then you might just have to play this game. However, if the deal is not a commodity offering, and you don't get the access to the buyer that you need to create a solution that truly meets their needs, then you might need to consider walking away from the deal, otherwise you could fall prey to the "winner's curse": if multiple providers bid on a potential deal with inadequate information, and if the buyer is going to make a decision based mainly on price, then the provider who is the most optimistic about all of the uncertainties is the one who will win the bid. However, the chances that the most optimistic provider was accurate are quite low, hence if you win in this situation, you actually lose by having to deal with all of the problems (e.g., delivery issues, low/non-existent margins) caused by underestimating the time and resources required to implement the deal.

Involve Implementers Early

Without involving implementers early in negotiations, there is a higher risk of having a deal that looks good on paper but cannot be operationalized easily. There are a few reasons why implementers are often not involved in negotiations: negotiators are normally rewarded for getting a deal done, they are not responsible for implementation, and they

[5] Note: In the more mature outsourcing markets (including BPO, ITO, and HRO) Vantage Partners does not provide advice on development of baselines, drafting RFPs, and managing selection processes. Vantage does advise clients in specific, developing outsourcing markets such as LPO and KPO on RFP and selection processes where such work does not conflict with existing provider relationships.

often see implementers as being risk averse and thus a hindrance to negotiations. It is also sometimes difficult for a provider to staff the actual implementers who will be involved in a particular deal until later in negotiations. It is rare to see incentives for negotiators to walk away from a deal, build a good relationship with the service provider, or craft an agreement that is value-maximizing for both parties. This translates into behaviors such as making last-minute concessions to meet deadlines or agreeing on terms without clear rationale. The assumption that those responsible for governance will “figure it out” frequently turns out to be a poor one because more often than not, those implementing the deal are left confused about parts of the agreement. Deal-makers are not always around to see the outsourcing arrangement materialize and explain the contract to those implementing it.

Negotiation teams should include those who will stay around to implement the deal. Knowing they will have to implement something will cause people to behave differently than if they could simply walk away from it. In other words, they will be less likely to agree to a term that sounds good conceptually but may be challenging to operationalize. Negotiators will need to have proper incentives to include implementers, and you will have to make sure that the appropriate implementers are selected and available early enough in the negotiation.

managing change

and achieving

speed to governance

Transition

Critical Relationship-Related Challenges

Most outsourcing buyers and providers have resigned themselves to suffer through a “valley of despair,” a period shortly after go-live where productivity and relationships suffer badly before slowly recovering. During this awkward transition phase, a new provider delivery team is getting up to speed on the buyer’s business, their existing capabilities and processes, their expectations, and their organizational culture. Simultaneously, this new team is trying to integrate transferred employees and assets, begin the process of driving out costs, and keep the trains running and the lights on. It is a bit chaotic, to say the least.

During this transition period, there is a flurry of activity on the buyer side, executives are looking around for their promised gains, business line managers are panicking about the sudden loss of internal support and considering whether they need to hire their own people to take care of their needs, and individuals who have stayed with the buyer as part of a retained organization are trying to figure out what their new role should be and how to do it (a challenge for many who are used to getting things done directly, and now have to get things done through their relationship with the delivery team). Furthermore, many, if not all, of those who negotiated the deal have moved on, leaving buyers with a huge gap in institutional knowledge.

Looking to the contract to determine how to manage the chaos of transition is fruitless; while outsourcing contracts serve many useful purposes, they fall short on informing the buyer and service provider exactly how they will work together to manage all of the changes outsourcing requires. Contracts are written in legal language and focus on what the parties will do, but little on how they will operate together. For example, pricing-related portions of contracts likely contain detailed costs for various services, but not a description of how the parties will resolve invoice discrepancies and disputes. “Relationship management doesn’t just happen on its own; you need to work on it…. Buyers really need to think carefully about how to develop a good governance model,” says Hugh MacDonald, owner of HR MacDonald Training & Development, Inc. As former VP of Operations and Knowledge Management, Central Services, HR Division for Canadian Imperial Bank of Commerce (CIBC), he can relate to the critical importance of robust governance. In March 2001, CIBC signed a 7-year HRO deal (TCV of CDN $230M) with EDS. Based on prior experience, expert advice and an eye to what would work in the bank’s culture, CIBC created a robust governance structure with multiple levels of strategic and operational committees and councils.

To effectively manage all of the transitions and change required in an outsourcing arrangement, it is critical that the parties work together to

The valley of despair

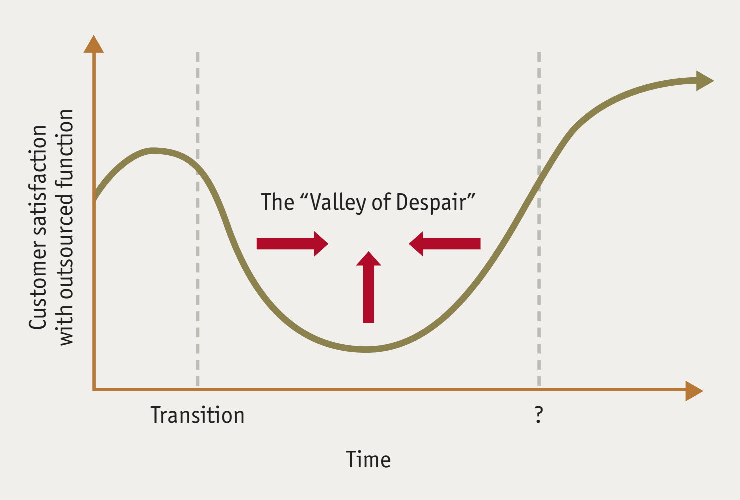

Figure 13

create a relationship management infrastructure that will guide how they will work together, focusing on multiple levels, including governance structure, skills, processes, and metrics.

Current Practices

Structure[6]

As mentioned in the previous section on Negotiation, provisions for committees or other decision-making bodies are often the governance-related provisions most frequently written into outsourcing contracts, along with escalation paths. Common components of a governance structure include a joint steering committee responsible for setting the business direction of the relationship, and a management committee that develops plans to meet the goals set by the steering committee and reviews performance regularly. Most governance structures also provide for one or more operationally-focused committees that manage regular delivery of work and troubleshoot problems or issues.

Staffing and Skills

Governance is about more than structure, it is also about those individuals who are charged with managing the engagement and their relationships with one another. The best-designed governance structure will crumble without appropriate staffing of individuals with the right kinds of skills. To meet this need, the largest proportion of providers (38%) said they have separate staff dedicated specifically to governing and managing each outsourcing engagement, while about a fifth of them (20%) have designated their delivery personnel responsible for governance on accounts. An additional 15% charge individuals within the sales or business development function with relationship management responsibilities, and a similar portion of providers (14%) have a single account manager or relationship manager support multiple clients. Only a handful (just under 10%) say their relationship managers by practice sit within specific functional areas, rather than centrally. On the buy side, two-thirds of buyers said they had governance staff in place for some or all outsourced functions.

> *Relationship management doesn't just happen on its own; you need to work on it…. Buyers really need to think carefully about how to develop a good governance model.*
>
> — Hugh MacDonald, former VP of HR, Canadian Imperial Bank of Commerce

Those responsible for managing outsourcing relationships are faced with a daunting task. On the buy-side, individuals in governance roles and retained organizations frequently must transition from accomplishing results by directly managing the team doing the work to accomplishing those results by managing the relationship with the provider. For many, that transition will be complicated by the fact that the individuals with whom they work day-to-day and on whom they rely to accomplish critical results are former colleagues who now work for the vendor. Many organizations staff their retained and governance organizations with functional experts from the outsourced function. While some subject-matter expertise may be helpful background for governance teams, increasingly organizations are finding that skills for collaboration and managing relationships are even more critical for those charged with managing outsourcing arrangements. For example, research from Leslie Willcocks and Catherine Griffiths at the London School of Economics reveals that the skills of middle managers can make or break an outsourcing arrangement, citing the importance of skills such as facilitation and problem solving and relationship development that individuals in these roles so infrequently have[7].

[6] For more on governance structure, see page 35 of this study.

[7] Stephanie Overby, Outsourcing Problems? Your Middle Management May Be to Blame; CIO.com, 2010. http://www.cio.com/article/527156/Outsourcing_Problems_Your_Middle_Management_May_Be_to_Blame?page=2

Process

Effective relationship management and governance require much more than just specification of committee structures and skilled individuals. Developing processes and protocols for how various aspects of the relationship will be managed, including communication and conflict management processes, is critical as well (see Figure 14).

Our current survey results are largely consistent with the 2004 results on the ranking of which governance processes are most critical. However, on average, providers rated fewer governance processes as ‘critical’ in the current survey, resulting in slightly lower percentages for many of the processes in Figure 14 compared to 2004. The importance attached to three governance provisions dropped materially in the new survey, each by approximately 15%: conflict management/problem-solving processes; guidelines/methods for handing off between negotiation and implementation teams; and joint training for buyer and provider. It is likely that a combination of budgetary pressure and resource limitation is part of the explanation — with fewer individuals left in retained organizations, and fewer funds available, things that once felt critical might seem to be more of a luxury. Also, while more improvement is needed, we have seen some organizations begin to improve the way they hand off from negotiation to implementation over time, more frequently including individuals who are responsible for delivery as part of the negotiation team. As a result, some may feel that the handoff process is less critical now than it once was, since fewer problems are resulting from that process. In many ways, developing organizational governance capabilities requires experience as well as putting in place the proper structure. As Director of Sourcing Management Office, Nancy Gustine manages a multi-year, multi-million-dollar ITO and BPO arrangement for Williams, Inc. Since signing its original deal in 2004, Nancy says the organization has learned a lot about governance. “It takes work on the front end and discipline ongoing to build out and maintain effective governance. Having a strong framework in place is critical, as is having people who understand the ultimate goal isn’t about winning and losing,” she says. “We needed some discipline and structure; just documenting and following our processes has helped a lot to take some of the emotion out. It makes a tremendous difference.”

Metrics

Measurement of ongoing performance in outsourcing relationships is still evolving. Most buyers currently rely on service levels as their primary means for gauging outsourcing success. Typically service level agreements or objectives (SLAs or SLOs) focus primarily on operational performance — call resolution rates, application availability, network response times. As with other kinds of processes, you get what you measure. As buyers increasingly use outsourcing as a means to achieve value beyond cost savings, they will have to seek new measures that drive the additional kinds of value they seek. For example, a buyer seeking innovation and transformation cannot rely on operational measures alone to assess progress. Any innovation or transformation requires significant change (process change, technology change, etc.). If the buyer focuses solely on operational metrics that emphasize minimal disruption to operations, their provider will take the hint and emphasize operational stability rather than transformation, despite the words they hear from buyer executives. Ultimately, the result is that the buyer will not achieve the strategic value they want. Additional discussion of the challenges associated with innovation in outsourcing deals is contained on page 73 of this report. Metrics must be used to emphasize and assess the kind of value the buyer wants, as they send a loud and clear message “this is what we care about.”

Providers' perspectives on inclusion of governance provisions in contracts		
Governance provisions	**Description**	**% ranking as critical or very important**
Communication processes	■ What information needs to be communicated to whom and when? ■ How will information be shared?	88%
Conflict management/ problem-solving processes	■ How will conflicts be handled? ■ What are the appropriate escalation paths? ■ How will we deal with systemic conflicts?	70%
Scope management protocols/ tools	■ How will both parties deal with scope changes? ■ What steps will be taken to manage scope?	60%
Guidelines/methods for handing off between negotiation and implementation teams	■ How will lessons learned through negotiations (about working together, about organizational priorities, etc.) be transferred to those implementing the deal? ■ How will we ensure open issues not resolved during negotiations will be resolved at a later time?	57%
Change management processes/tools	■ What levers can we use to drive new, appropriate behavior? ■ How can we communicate effectively about change?	60%
Escalation paths	■ How will issues not resolvable at their source be resolved?	56%
Relationship audit/adjustment processes and structures	■ What steps will we take together to proactively manage demand? ■ What metrics are useful for measuring the health of the relationship? ■ How often and with what method will relationship health data be captured?	57%
Joint training for buyer and provider (e.g., on understanding the deal or one another's business, effective communication, scope/change management, conflict management)	■ For example, what are some means we can use for understanding the deal or one another's business? ■ How can we effectively communicate? ■ What methods can we use to effectively manage scope, change, and conflict together?	56%
Demand management processes/guidelines	■ How will we balance demand from end users or business units with financial constraints and requirements?	48%
Committees/decision-making bodies	■ What will the parties do with the data? ■ What structures will we use to make different decisions? ■ What is the scope and purview of each committee? ■ How will each of the decision-making bodies relate to one another?	38%

Figure 14

Means for achieving value across relationship types			
Focused	Multifaceted	Transformational	Interdependent
■ Obtaining the best price at the outset of the deal ■ Investing in a quality working relationship ■ Stringently monitoring/ enforcing service-level agreements (SLAs)	■ Selecting provider with greatest expertise ■ Investing in a quality working relationship ■ Obtaining the best price at the outset of the deal	■ Investing in a quality working relationship ■ Stringently monitoring/ enforcing SLAs ■ Selecting provider with greatest expertise	■ Investing in a quality working relationship ■ Selecting provider with greatest expertise ■ Obtaining the best price at the outset of the deal

Figure 15

Implementing Governance

Identifying key governance processes is only half the battle; the buyer and provider still need to implement these processes in order to gain value from them. Many of the key processes identified by buyers and providers were, unfortunately, implemented in less than half of outsourcing deals. In our experience, this is a direct result of treating governance as boilerplate to be pasted in from a reference manual or the last deal someone worked on. All too often, such processes and structures fail to fit the current deal, or are so insufficiently defined that they are useless in practice. When process design is left behind in the flurry of operational transition activities, instead of being discussed, adapted, and actively negotiated as something that really matters, the result is entirely predictable.

Even when both parties intend to follow through with implementation, they often underestimate the work required to define, enable, and execute on a structure. Implementing governance structures and processes effectively can add up to significant investment; of those buyers we surveyed, the average expenditure on outsourcing governance was 6.6% of annual contract value. Admittedly, organizations account differently for spending on governance, and it may be difficult to compare across contexts, but some commonly-included categories of spend include dedicated governance resources, senior management attention, tools and systems, and training. Anecdotal evidence from other outsourcing industry sources indicates that most companies spend between 3% and 7% of the annual contract value of the deal on governance each year, consistent with our study.

A simple rule of thumb is that the more transformational and complex the outsourcing deal, the more effort and resource it takes to manage it well. In our research, expenditure varied somewhat by relationship type (see pages 21-24 for a detailed description of these relationship types).

Regardless of the type of relationship, effective governance and relationship management are important for achieving the value sought in outsourcing. What “good relationship management” means, though, will differ across different types of relationships. For example, performance management processes for straightforward “Focused” relationships should be designed to regularly monitor performance to service levels, benchmark regularly to reassess baselines, and make use of penalties when appropriate. “Multifaceted” relationships, because of their broad, multi-process or geographic scope (and therefore complexity), require performance management processes that focus on root cause analysis of complex problems. Performance management processes focusing on incremental improvement and joint problem solving are most appropriate for “Transformational” relationships, where innovation and transformation are the goal. Finally, for complex “Interdependent” relationships where significant change is required, focus on delivery excellence and quick, joint resolution of problems are critical to good performance management.

Means for achieving value across relationship types					
	Relationship Category	Focused	Multifaceted	Transformational	Interdependent
Implication	Characteristics	Straightforward	Complex challenge	Innovation and transformation	Innovation and transformation with a complex challenge
	Key relationship management challenge	Performance management	Gaining alignment	Jointly managing scope/demand	Building trust
	Value potential	Increasing efficiency	Coordinated execution	Innovation and transformation	Strategic leverage
	Presumed duration	Short to medium term	Medium to long term	Long term	Long term
	Key governance attribute	Operational	Decentralized	Change management focused	Strategic
	Communication focus	Transaction	Customization	Change	Business strategy
	Performance management	Monitor SLAs and leverage penalties, benchmarking	Focus on root cause analysis; leverage penalties	Joint focus on continuous incremental improvement, joint problem solving	Joint focus on delivery excellence, quick joint resolution of problems
	Joint planning	Annual; narrow in scope	Regular, but limited in scope	Joint and frequent, long term focused	Integrated, frequent, and long term focused
	Management resource required	Low	Medium to low	Medium to high	High

Figure 16

General Recommendations

Conduct a Joint Launch

Implementing governance is hard work, but organizations do not have to resign themselves to a "valley of despair," as described in the beginning of this section. There are steps organizations can take to get their relationships off on the right foot and ensure "speed to governance" that will put the relationship on a path to success from the beginning.

We recommend that buyers and providers undertake joint launch activities early on to position themselves for managing the challenges of transition in a way that sets a good precedent for the ongoing relationship. A joint relationship launch helps the parties manage expectations and solve problems more effectively together, making the “valley of despair” shallower and shortening its duration. Launch activities are segmented into three critical components, each with specific purposes and different audiences[8].

1. Team Briefing and Relationship Planning

To ensure smooth transition, this segment involves one or more formal briefing sessions between negotiators and those who are charged with implementing the deal. In such sessions, key members of the provider and buyer negotiation team brief transition managers, delivery managers, and functional managers from both sides on the key terms of the deal and the underlying intentions behind them, as well as critical scope boundaries, highlighting any issues that were deferred or not fully resolved. Before or after such sessions are conducted, negotiation teams, in concert with delivery/implementation teams, may be better equipped to create plain language summaries of key terms that can be more easily understood by key stakeholders who were not involved directly in negotiations.

In addition to contract reviews, buyer and provider might conduct relationship planning activities to mitigate problems arising out of goal misalignment. As part of relationship planning, the parties share their organization’s critical success factors and develop a prioritized set of joint critical success factors, based on the high-level goals each side hopes to achieve. Clarity around joint priorities early in the relationship will enable smoother implementation as well as increased efficiency and focus during transition — a period where project plans are literally hundreds of line items long and conflict can easily erupt over what needs to happen when. To ensure continued relevance, the buyer governance organization and provider delivery team can also determine a method for periodically refreshing these goals and success factors over time.

2. Joint Risk Management and Applied Governance

In this segment of the launch the provider delivery team and the buyer governance team, as well as appropriate buyer business unit or functional representatives, review potential pitfalls. They also develop a risk management plan containing both strategies to prevent disasters from occurring and strategies to mitigate the impact of challenges if they do arise. Additionally, they draft joint operating principles to guide their day-to-day interactions and outline how they will handle exceptional issues. They also articulate specific protocols and processes for more effective management of the relationship, such as specific decision-making roles and processes, conflict management mechanisms, and escalation paths for issues.

3. Communication and Change Management

In this segment of the launch, governance and delivery team leads work together to identify important constituent groups and their needs, considering the change required by different profiles of constituents. The teams then develop a targeted plan for systematically driving desired behavior from each group of constituents both during transition, and at key points after implementation, choosing among the most appropriate levers. For example, business unit leaders, who are often rewarded on savings to their bottom line, might consider buying in to the

[8] For more detail, see Ertel, Danny, and Sara Parker Enlow, “Enabling Outsourcing Success: The Relationship Launch.” Complimentary copies are available at www.vantagepartners.com.

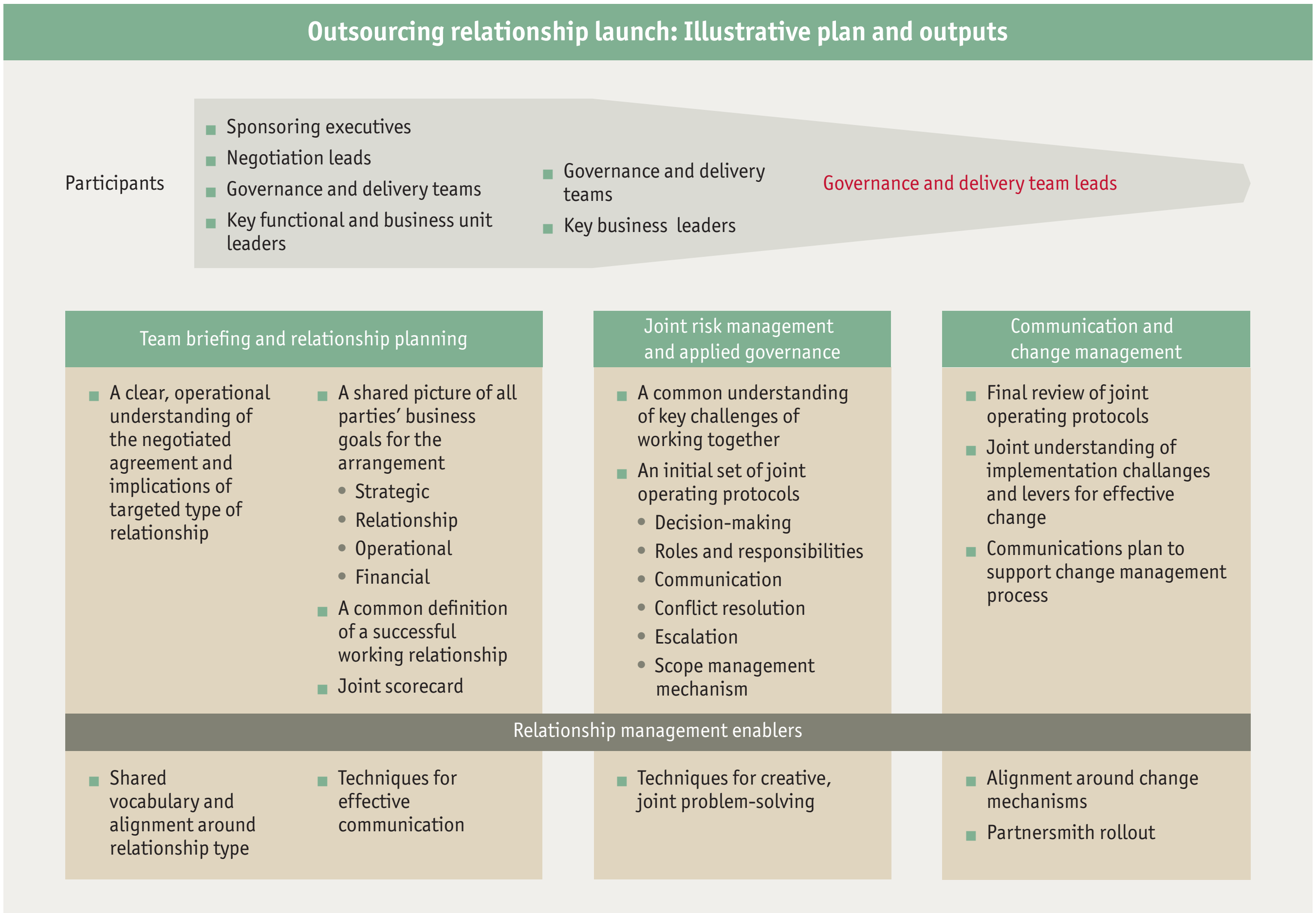

Figure 17

outsourcing concept more quickly when a positive impact on their operating cost can be demonstrated. End users may be less driven by decreases in operating cost; they are more likely to change their behavior (e.g., call a central technology support center) when the "new way of doing things" is much less cumbersome or more efficient than the "old way" and if organizational leaders make a point of using the "new way" themselves.

During the launch, buyer and provider also develop key messages for important constituencies and design communication procedures and protocols to ensure those messages are sent and received most effectively. Early components of a communication plan often involve efforts to better share the deal's intent and reasoning behind new processes that require a behavioral change from end users. This kind of communication is important for ensuring compliance with new processes and procedures that will enable buyers to achieve cost-cutting targets and productivity improvements. Later components of the plan focus on two-way communication between the governance teams and key stakeholders from both sides to determine what is working well, which areas require improvement, and where change can be anticipated.

Each of these three components is also enabled by targeted skill building and technology.

Advice for Buyers

Outsourcing can be highly traumatic to an organization. Frequently it involves the movement of employees who must adapt to a new organization's processes, tools, and ways of conducting business. Even retained employees can feel the impact as they see their roles change and long-time colleagues re-badged and working for another company. During the throes of transition, buyers often emphasize (with good reason) things like getting employment agreements, signing over assets, and conducting due diligence. During this chaotic time, change management unfortunately often gets short shrift, resulting in organizational confusion and resistance.

While committees and processes are important structural components of proper outsourcing governance, they alone are not enough to ensure success. You need people with the right behavioral skills to manage the complex web of relationships and interactions that comprise outsourcing arrangements. To ensure that such skills are institutionalized, senior management needs to send the right messages, use good metrics, and have a proper incentive system. More specifically, an effective change management program should avail itself of several key organizational levers:

- **Skills training and coaching:** Asking individuals to take on new roles in a new context or environment is a recipe for failure if they are not provided with appropriate training and coaching to help them learn those behaviors. In general, individuals working closely with the provider on the interface between the provider and the business stakeholders should receive the training necessary to round out their repertoires in negotiation and influence, joint problem solving, facilitation and alignment, and managing difficult conversations. This kind of training tends to be most effective as live classroom training with lots of role plays and realistic case studies. The most forward-looking organizations are actually undertaking this training jointly with key individuals from the provider delivery and account management teams, to ensure that they share a vocabulary and approach to working together.
- **Communications planning:** Providing skills training without a well orchestrated communications plan that lets those individuals and others around them know not only what is expected of them, but why, often results in wasted time and money. A communications plan need not be large or complex. It does require having management think hard about the messages they should send and how they might reinforce those messages with their own behaviors. For example, messages about the need to work together with the provider to achieve key savings should be reinforced by recognizing joint achievements and milestones.
- **Incentive systems:** How important it is to pay individuals for taking on new roles and exhibiting particular behaviors depends on the culture of the organization and even on the particular function. What is clear is that in order for any desired new behaviors to take root in an organization, it is critical to remove any disincentives surrounding the desired behaviors. If individuals are paid, for example, on the basis of the penalties applied to a provider for missing an SLA, (or on the flipside, if provider staff are compensated for generating change orders), it is going to be that much harder to get individuals to engage in good problem-solving behaviors.
- **Metrics:** Individuals are very good at noticing what the organization measures and cares about, even when those metrics do not directly affect their compensation plan. Letting individuals know that non-financial and non-performance attributes of the relationship will be measured and reported on joint balanced scorecards, and that management will have fairly granular visibility into the health of the partnership, tends to help individuals focus on those aspects of their interactions with the provider. There need not be many metrics, and

they could include subjective, self-reported items; but their presence on scorecards speaks volumes about their importance. Some examples of such metrics include the number and types of issues that require escalation, the amount of voluntary turnover on the team, and responses to survey questions about how often they are consulted on key topics, whether they feel respected, and whether they are learning from their counterparts.

Buyers should resist the urge to put off change management activities until the fires of transition are extinguished. Effective management of change is just what you will need to ensure those fires (or new ones created while trying to put them out) don't continue to smolder years into the relationship.

Advice for Providers

In most professional service arrangements, scope management is viewed in an adversarial way — providers are expected to police scope boundaries (noting what is out of scope, and will therefore "cost extra"), while buyers are expected to continually test them. On the other side, demand management is generally seen as the buyer's problem. The stereotyped perception of the role of the provider relative to demand management is to try to seek out and encourage additional demand. This troubling dynamic pits buyer against provider in a competition of who can most effectively push the other in their desired direction, ultimately creating unnecessary conflict and tension in the relationship.

Particularly in a large-scale outsourcing arrangement, aligning with your buyer on expectations about scope boundaries (and adjustments to fees based on changes in scope) is challenging. Many organizations outsource to minimize the administrative burden they experience in a particular function, and, right or wrong, have the initial expectation that fees are "fixed" and that the quoted fee is for a complete solution, regardless of how much the work changes or grows over time. As scope expands, the buyer laments being "ARC'd" (incurring Additional Resource Charges), and the customer experience is negatively affected.

Adding to the complexity of this dynamic, outsourcing contracts are often written before thorough due diligence is conducted with the expectation that more accurate estimates will be gathered during the transition period. While most providers and buyers write clauses into their contracts indicating that specified fees are based on estimates that must be verified over the course of several weeks or months of due diligence, they often do not specify the conditions under which fees will vary, or articulate a process for updating estimates, thereby undermining any assertion that fees might need to be adjusted. Leaving these details ambiguous may make signing a deal easier, but it makes generating ongoing value together more difficult.

Another major scope management challenge is that often out-of-scope work has already been completed before it is reported to the customer, or even to provider management. This problem arises particularly in "lift and shift" outsourcing arrangements where buy-side employees are re-badged as provider employees. These individuals are generally used to "getting the job done" and frequently have not been expected to monitor or even be aware of scope boundaries prior to outsourcing. Additionally, re-badged employees who are asked for "favors" by former colleagues often have a hard time pushing back. They often prefer to just perform the additional work because they are used to doing it, or they want to maintain working relationships with their colleagues. Unfortunately, if problems are not resolved or work is done before being reported, then providers run the risk of bearing the cost of scope changes.

Managing scope effectively means starting early. The earlier you begin to discuss expectations and processes for future scope and/or fee change negotiations, the more likely you are to have successful conversations, maintain strong client relationships, and avoid hits to your margins. When expectations are set and processes are agreed upon during negotiation or transition, and then those processes are followed, it is much more likely that scope changes (and therefore "ARCs") that occur will be funded in a fair manner. As many of us have experienced, it is often extremely difficult to convince a client to pay after-the-fact, when they have already received the service and really only have to pay at their discretion.

An effective way to view scope and demand management is as a linked set of challenges you have to manage together with your buyers. Implementing scope management processes that allow you to effectively identify scope boundaries and make appropriate trade-offs jointly with your buyer when those boundaries are tested alleviates the tension of the traditional "us vs. them" view of scope and demand management. Such processes also provide a means by which to recognize when scope boundaries need to be changed, and a forum for making legitimate decisions about scope that both sides can support.

managing the relationship and maintaining momentum

Ongoing Management

Critical Relationship-Related Challenges

As the chaos of transition eases its way into a more stable pattern of interaction, buyers and providers begin to cement some more predictable ways of working together for the remaining years of their engagement. Generally basic operational issues are under control and the parties shift from fighting day-to-day fires to managing the relationship on an ongoing basis. As deals stabilize, two critical challenges tend to arise. First, buyers and providers who find themselves emerging from transition into sub-optimal relationships need to manage their way to a more value-creating place. Second, even when deal partners are satisfied with their working relationships, they need to manage them effectively on a day-to-day basis, and ensure that the momentum they gained early in the deal is not lost as time goes on.

Mid-Course Correcting

When outsourcing deals are signed and press releases issued, deal partners have high hopes, both for the financial and service benefits expected, and for their working relationship. After operations begin to stabilize (often twelve to eighteen months into the deal), however, many buyers and providers find themselves in lackluster relationships that are not delivering expected results. They see their once-promising arrangement fall into a cycle characterized by mistrust and frustration — a pattern that, once established, can be very challenging to escape.

The impact of a poor relationship goes well beyond “not getting along.” Organizations that find themselves in sub-optimal relationships after transition experience the effects of those poor working relationships in a number of different ways. Providers indicated that they feel the pain of poor working relationships through low customer satisfaction, wasted time and resource, and poor decisions or solutions to problems.

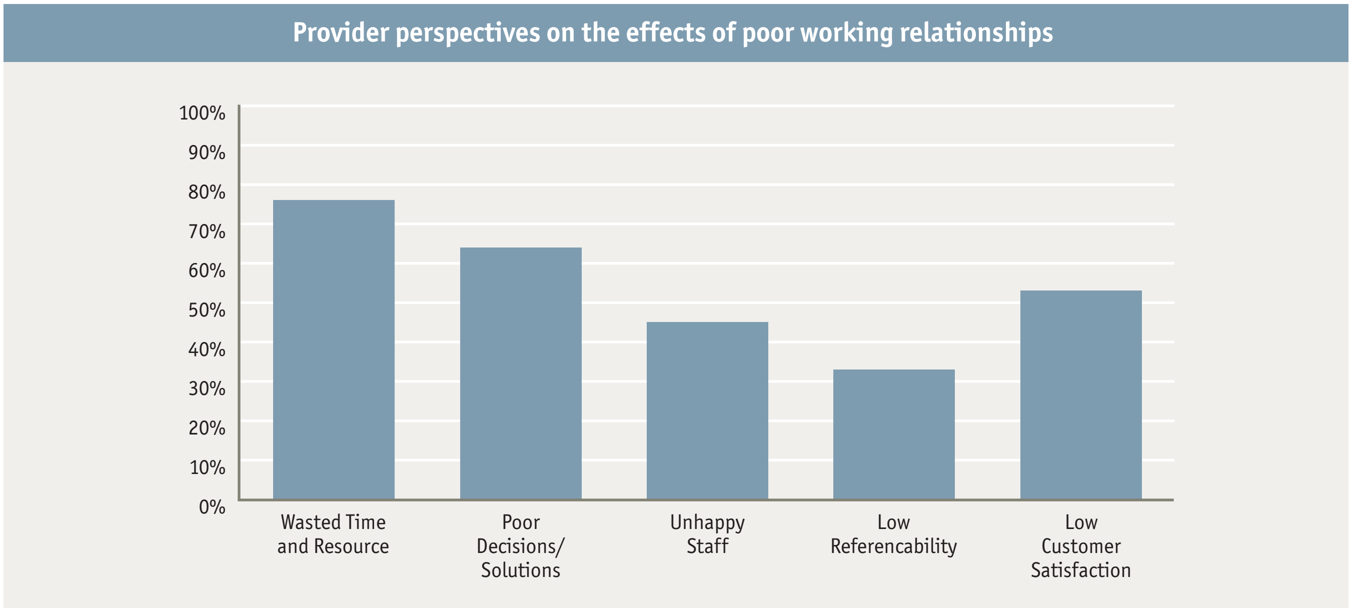

Figure 18

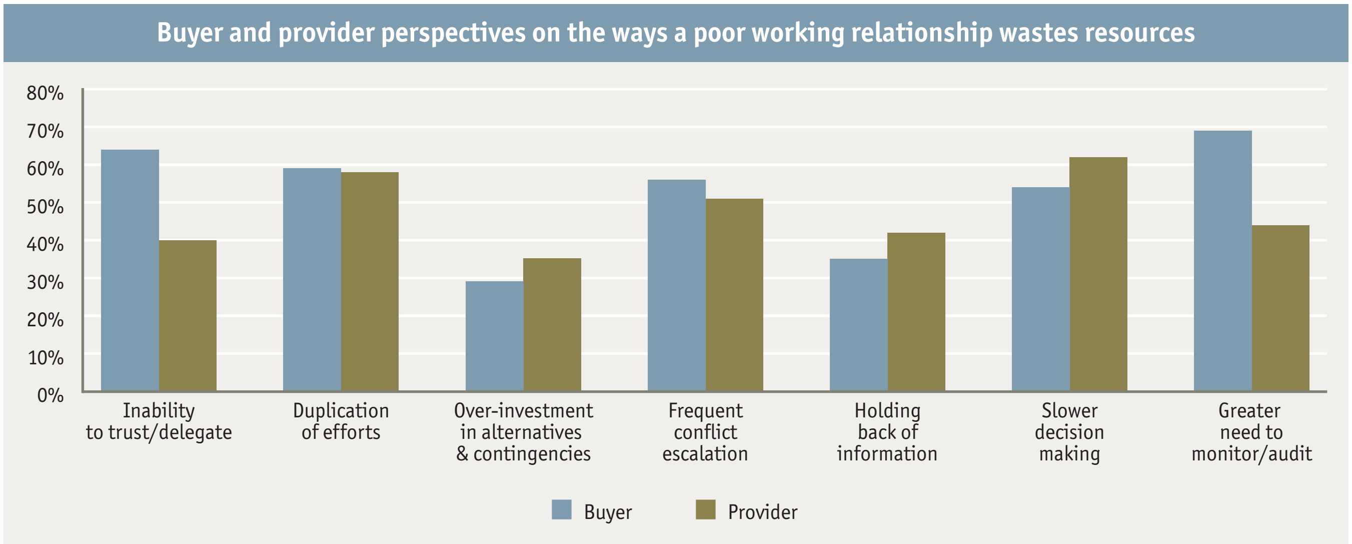

Figure 19

Low customer satisfaction was the most often cited consequence of a poor working relationship, by 77% of buyers and 53% of providers. There tend to be more problems in a troubled relationship than in a healthy one — some that break into open conflict, others that simmer beneath the surface. When conflict is managed poorly, issues are escalated frequently, decisions take too long to make, and execution is often surrounded by reluctance once a decision is made; these troubled interactions undoubtedly become evident to internal customers. As a result, the service provider often appears rigid and inflexible, and end users complain about poor service quality.

Over half of respondents (both buyers and providers) who experienced poor working relationships also said that these relationships lead to wasted time and money. Because the parties lack trust, they often duplicate efforts or require significant documentation of work performed. In extreme cases this situation can result in redundancy in staffing, "shadow organizations," and/or excessive supervision and documentation requirements at the task level. Additionally, when every problem must be escalated beyond its source, progress is delayed while parties wait for resolution. Already over-stretched individuals end up spending their time in issue-resolution meetings instead of getting work done. The more resources that go into such redundant or unproductive activities, the harder it is to meet deadlines and achieve cost savings.

Once relationships have started into this downward spiral, recovery can be difficult and costly. Of the providers we surveyed, the vast majority (84%) said repairing a damaged outsourcing relationship would cost at least 10% of annual contract value. Over half said that undoing the damage done would cost more than 20% of annual contract value (see Figure 20).

Managing the Day-to-Day Relationship and Maintaining Momentum

Even when the relationship is functioning and the parties are dealing effectively with problems as they arise, buyers and providers encounter different kinds of challenges as they work together on day-to-day activities, including:

- Tracking contracts as they are modified and ensuring ongoing common understanding of contractual obligations

- Verifying invoices and resolving discrepancies collaboratively
- Accounting for incremental costs and projected savings
- Tracking performance to service levels, taking remedial action where necessary, and modifying or adjusting service levels as appropriate
- Monitoring issues and ensuring timely resolution

Providers in your experience, how much does fixing a damaged outsourcing relationship typically cost, as a percentage of the annual contract value?

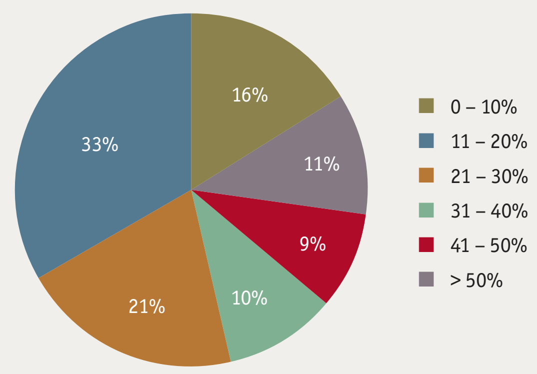

Figure 20

Additionally, those parties that have invested in creating the structures, processes, skills, and metrics necessary for building a strong working relationship up front may still find that keeping the deal relevant as the business environment changes, organizational leaders come and go, and strategies shift is also a tough post-transition challenge to manage.

Beyond ensuring continued deal relevance, demonstrating ongoing improvement over the life of the deal (such as additional cost savings, service enhancements, or innovation) is also critical to maintaining momentum and satisfaction. While ongoing improvement is important, determining what service enhancements or innovations are most important (where to focus the effort to improve) can be challenging, particularly if the parties do not have some form of joint business planning or means for monitoring and adjusting the relationship together over time. This topic is covered in greater detail in the section Driving Innovation, begining on page 73.

Current Practices

"A Little Bit of Madness"

When faced with an underperforming relationship, many buyers' first instinct is to get out. However, termination can be difficult and costly, and often it doesn't address the underlying causes of underperformance. In those troubled outsourcing relationships where the parties did not ultimately decide to go their separate ways, buyers and providers tried a number of different approaches to improve results. From what we have been able to discern from both our practice and the research described here, a great many buyers and providers seem to have forgotten Benjamin Franklin's oft-cited definition of insanity: "doing the same thing over and over and expecting different results" (see Figures 21-22).

If the root causes of the problem remain unaffected, vowing to try harder, swapping out personnel, meeting more frequently or producing more reports will not change the outcome. "While some providers might just not be living up to their end of the contract, usually there is something that both sides have contributed when there are problems in an outsourcing arrangement," says Cathy Hyatt, Vice President of Enterprise Vendor Management for Franklin Templeton. "There needs to be a much deeper level of diagnosis and cure. If the same approaches are taken with a new provider, you can almost guarantee that the same types of problems will show up again."

Changing Personnel/Account Managers

Approximately 9% of providers said they rely on changing Account Managers or other personnel to combat a poor relationship. Indeed, while few will admit to it publicly, some providers make a practice of rotating out relationship managers after a couple of years. They do this on the assumption that after a limited amount of time, anyone in the relationship manager role will have had to say "no" too many times and will have to be replaced to keep the relationship amiable. While replacing a relationship manager or senior member of the delivery team might be part of an effective solution in some cases (e.g., because of a lack of necessary skills or experience, or an irremediable personality clash), making scapegoats of provider personnel and switching them out is too often seen as an easy fix. The reality is that other problems exist that, if left unresolved, will likely resurface regardless of who manages the deal.

Top buyer responses to relationship problems	
Responses (buyer could give multiple responses)	% Respondents
Improve relationship management	28%
Closer monitoring and enforcement of SLAs	19%
Improve communication	17%
Renegotiate/offer discount/dispute resolution	8%
No action	6%
Terminate	6%
Create Action plan	6%
Other (Education and Training, QA/Root cause analysis	10%

Figure 21

Top provider responses to relationship problems	
Responses (provider could give multiple responses)	% Respondents
Escalate/bring in executive to remediate	18%
Improve communication	18%
Renegotiate/offer discount/dispute resolution	12%
Improve relationship management	12%
QA/Root cause Analysis	11%
Change customer-facing team	9%
None	5%
Add resource to delivery team	4%
Create action plan	4%
Other (Bring in third-party advisor, terminate, closer monitoring and enforcement of SLAs, Education & Training)	7%

Figure 22

Moreover, changing personnel can be very disruptive because the replacement will be expected to hit the ground running with minimal knowledge of the contract and the buyer organization. Consider the loss of tacit knowledge (about how things really work, how decisions are made, and what is important) that accompanies unanticipated staff turnover. Now multiply that by a factor of ten or more in recognition that the person being replaced is a key member of the team who has visibility into more aspects of the relationship and who touches more people than anyone else.

When both companies move their relationship managers to other critical positions, their replacements don't have relevant historical data, and frequently don't invest as much as the first group in learning about and managing the deal. If the root cause of the problem is not the individual, buyer and provider should be aware of the advantages of keeping experienced individuals in place, and should make sure that they benefit from the knowledge of these people. And when indeed a provider and buyer determine that the real cause of a poor working relationship is a specific individual (or individuals), then they need to make sure that this conflict does not interfere with the development of the relationship between buyer and provider.

Better Monitoring

Some buyers (19%) turn to more rigorous monitoring or enforcement of service-level agreements (SLAs) as a way to fix problematic outsourcing relationships. Perhaps unsurprisingly, this is not a preferred solution for providers; only 2% of providers said they respond with more rigorous monitoring. When the problem is that the provider is not certain about what service levels the buyer is expecting, or whether they are meeting them, clarifying SLAs can be helpful. Whether this approach is effective depends on the nature of the underlying problem. When the problem is that the service level objectives are set too low, and even if the provider meets them, but the buyer's business is still negatively affected by the services delivered, raising the bar on service levels may help solve the problem. When the problem is that the provider is not providing sufficient resources or working hard enough to meet the buyer's service level expectations, greater monitoring or more rigorous application of penalties may help focus attention on the problem. But raising the bar on service levels or monitoring them more frequently does not solve a service level problem caused by a lack of sharing of information or of effective collaboration, and it does not necessarily improve communication or creativity. In fact, when SLAs measure what is easy to track, rather than what is most important to the buyer's business, raising thresholds and unnecessary monitoring can be counterproductive, further distracting both parties from the activities which can truly drive value.

> *If the root causes of a problem remain unaffected, vowing to try harder, swapping out personnel, meeting more frequently or producing more reports will not change the outcome.*

Many providers reasonably interpret a greater emphasis on SLAs and their enforcement as a clear signal from the buyer that what's in the SLA is what matters. It tends to lead them to focus their resources on either meeting SLAs or having defensible reasons for not doing so, and also to expect that so long as they meet those obligations the buyer has no cause to complain. Indeed, an overemphasis on SLA monitoring and the use of penalties can cause provider personnel to duplicate some tasks, be overly risk-averse and afraid to innovate, and focus more on avoiding blame than working toward improving the buyer's business performance.

Achieving real value from SLA monitoring requires rethinking what the SLAs are actually measuring as well as how the data is interpreted. Many a provider has lamented to us over the years, "I'm meeting all my SLAs, and my customer is still unhappy." Moreover, simply imposing penalties for missed SLAs will not help service providers improve performance. As one buyer noted, "We are not in the penalties collection business. We just want the provider to deliver what they said they would so that our company is able to function more efficiently." In other words, the real business cost of poor provider performance is always greater than any financial penalty the buyer might receive.

Renegotiation and Contract Revisions

One reality of the current environment is that more contracts are renegotiated than not, with reports ranging from 50% to 80% of deals going through some degree of adjustment. For example, a 2007 study by Addleshaw Goddard found that 60% of companies had renegotiated or changed their IT outsourcing arrangements[9]. A TPI study found that contract renegotiation typically occurs about three to six years into a deal, but that many renegotiations occur in

[9] Statistics Related to Offshore Outsourcing. (RTTS, 2010) http://www.rttsweb.com/outsourcing/statistics/

as little as 18-24 months into the deal, often prompted by changes in the business. The study also claims that most outsourcing agreements will experience significant restructuring before they're completed, the majority of which will happen in the first three to four years, and that about 75% of the restructuring will occur with the incumbent service provider, while the other 25% will be re-sourced[10].

Sometimes renegotiation is driven by changing business requirements, other times as part of a cost-reduction plan. But when it is done because a relationship is in trouble, the "cure" is short-sighted at best. While changing the terms of a contract may address issues related to pricing, services, or service levels in the short term, the problems that led to renegotiations in the first place are likely to resurface if relationship issues are not resolved. In a worst-case scenario, acrimonious renegotiations may actually worsen the problems and eventually lead to difficult terminations that hurt both the buyer and provider.

> *We are not in the penalties collection business. We just want the provider to deliver what they said they would so that our company is able to function more efficiently.*
>
> — An experienced IT outsourcing buyer

We were encouraged to see that only a small percentage of buyers in our study (8%) indicated that when faced with a troubled relationship, they had renegotiated the contract or made significant revisions. Slightly more providers (12%) indicated they had renegotiated or made significant revisions, indicating they had given rebates or future discounted pricing as a response to relationship challenges. Nonetheless, these numbers suggest that seeking solutions, rather than an exit or a different form of agreement, remains the focus for most providers *and* buyers.

Better Ways Out

Faced with growing evidence that addressing the symptoms alone does not work, a number of leading edge buyers and providers are trying to get to the heart of relationship problems. The results are more effective approaches to resolving relationship challenges.

Managing the Relationship and Maintaining Momentum

Aside from managing through difficult dynamics and responding to problems, managing outsourcing relationships from a purely day-to-day perspective is a data-intensive job requiring significant coordination and thorough documentation. As such, a great deal of administrative burden is placed on those charged with governance. For example, performance monitoring processes produce reams of data each reporting period, and operational areas can document several pages of issues, each with lengthy descriptions of business impact and action items. In the absence of tools, organizations risk inadequate monitoring and require greater numbers of staff. They also lack the data they need to determine how best to evolve and adjust the relationship over time.

Loosely defined, tools are things that aid in performing governance and management activities. Examples include an electronic workflow for getting approvals, a database for tracking operational issues, and a system that gathers performance data from various sources and presents them in a dashboard format. For the purposes of our research, we asked participants about software tools. There are several software tools on the market today that help organizations

[10] Restructuring Outsourcing Agreements: An Indication of Failure, or a Tool to Increase Value? (TPI, 2007) http://www.tpi.net/pdf/researchreports/Restructuring_ResearchReport%20Jan_24_07.pdf

monitor performance, manage documents, and collect and analyze financial data. We found overall tool usage on the buy-side to be significant and much higher than in our 2004 survey; 58% of buyer respondents use some software for monitoring provider performance (up from just 18% in 2004), 57% for document and contract management (up from 13%), and 33% for cost/revenue validation (up from only 7%). Today, usage of software tools by providers is roughly equal to that of buyers; providers were significantly larger users of these tools in 2004. In fact, provider usage of software tools was down slightly from 2004. Of those providers we surveyed, 67% indicated they use tools for performance monitoring (down from 75%), and 42% of them use tools for cost/revenue validation and document or contract management (down from just over 50%).

Improved relationship management and governance

Encouragingly, an increasing number of buyers (28%, up from just 10% in 2004) have focused on improving internal governance and relationship management capabilities in the face of a poor relationship. Providers were, somewhat surprisingly, less focused on internal governance and relationship management capabilities, with only 12% identifying upgrades in these areas, further distracting both parties from the activities that can truly drive value. Some of the ways in which buyers and providers have worked to improve internally include creating Vendor Management organizations or roles, instituting improved change management, driving more executive support, and encouraging better collaboration.

Most buyers today (67% in our survey) have some form of governance or relationship management function in place to manage their provider relationships. For providers, the number is even higher — 79% have some personnel outside of their delivery staff who are responsible for relationship management, while most of the others task their delivery teams with that work.

For some organizations, investing in internal governance capability at a time when relationships are already under-performing can feel like throwing good money after bad. Indeed, staffing these functions is fairly resource-intensive; for example, providers reported that their relationship management activities typically cost just under 10% of annual contract value. However, unlike closer monitoring or swapping out personnel, a true investment in capability should help get to the core of systemic issues and prevent problem recurrence. Certainly, the earlier these organizations can be in place, and the more effective they are, the more problems can be avoided.

For providers, there is another important benefit a strong relationship management function provides, improved sales and retention rates. Recall that buyers surveyed reported that, on average, superior relationship management capability should offset over 13% of a competitor's price, which is somewhat higher than providers typically spend on building the capability. Additionally, it makes sense that better relationships lead to increased retention, which should greatly reduce sales costs upon contract expiration. Providers reported that their average cost of sales was just over 9% of total contract value. While the cost of a contract renewal with a satisfied customer is not zero, it is doubtless significantly less than that incurred in making a new sale.

More robust communication

Buyers' third most commonly-noted response to problems was improving communication — co-locating team members, instituting regular meetings, and encouraging informal, direct communication between the parties. Often, one of the first things buyers and providers do when conflict arises or results are not achieved as expected is to retreat to their own sides and limit communication. Problems are then exacerbated by an "us and them" dynamic. The more communication can be encouraged, especially in the face of challenges and issues, the better the buyer and provider can understand one another, and begin to work together (vs. against one another) to get to creative solutions.

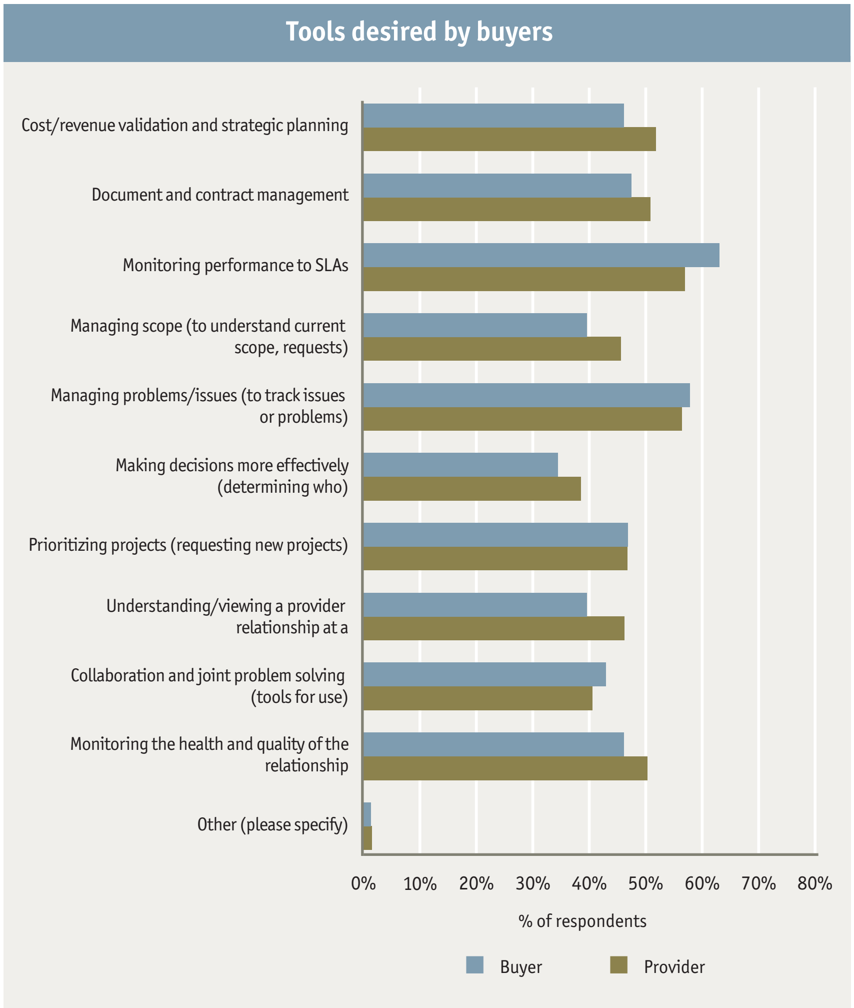

Figure 23

Our survey indicates that there is also demand for additional software tools to help with governance tasks (see Figure 23). The most pressing areas appear to be monitoring performance to SLAs, managing problems/issues, document & contract management, and cost/revenue validation. Interestingly, the most desired tools were virtually identical for buyers and providers, suggesting an opportunity for software providers.

General Recommendations

Invest Early in Creating the Relationship You Want

While a renewed focus on governance and relationship management, improved communication, and ongoing assessments and adjustments can help to improve a troubled relationship, significant time and resources (on average, as much as 25% of annual deal value, according to providers) must be invested into reforming a poor working relationship. Depending on the extent of the relationship problems, the buyer and provider might always feel burdened by the "baggage" of their history. Without question, it is less expensive and more effective to cultivate a strong relationship at the outset, and monitor and adjust that relationship over time, than it is to respond reactively after problems have occurred.

One way to build the right relationship, as we described in the previous section on transition, is for buyers and providers undertake joint launch activities[11]. Investing the time and attention needed to conduct contract briefings and relationship planning activities, to develop governance mechanisms and protocols, and plan for effective change management pays off significantly in the long run by helping the parties lay the foundation they need to build a solid working relationship.

[11] For more detail, see Ertel, Danny, and Sara Parker Enlow, "Enabling Outsourcing Success: The Relationship Launch." Complimentary copies are available at www.vantagepartners.com.

Institute a Systematic Health Check Process

Though a number of organizations at regular intervals benchmark their outsourcing deals against other similar arrangements to assess whether their pricing for service and scope continue to be in line with market pricing, not many go beyond a look at price to regularly assess the health and quality of their relationships on multiple, important dimensions. A more robust assessment of outsourcing relationships can go deeper to uncover the true roots of challenges and ways to capitalize on lessons learned and key opportunities. Key dimensions for a robust health check process include:

- Governance structure
- Metrics
- Stakeholder engagement
- Decision making
- Mindset
- Skills
- Processes and working protocols
- Personal and institutional relationships

Far beyond a standard customer satisfaction survey, a robust health check relies on input from a broad cross-section of sources — at the executive and operational levels across both the buyer and provider organization — and usually multiple collection methods, such as surveys, interviews with key stakeholders, contract reviews, and performance and governance data. The result is a clearer and more detailed picture of the relationship from multiple angles; as a result, it provides even greater input to the parties regarding how to continue to improve the arrangement and its value over time.

Manage and Maintain Relationships More Easily with Transparency

Reaping the benefits of a good working relationship requires coordination between buyer and provider — effective governance processes, supported by relevant and timely data. It also requires collaboration — the ability of the parties to execute those processes in a manner that is consistent with and supports the kind of relationship they want to have. Effective coordination and collaboration go hand in hand. Without robust processes for monitoring performance, managing scope and demand, keeping the contract up-to-date and relevant, and managing financials, the parties do not have a strong basis for collaboration. For example, how can buyer and provider have good conversations about performance if they lack any real performance data? By the same token, putting in place even the most robust performance management tool does not ensure that buyers and providers focus on problem solving and take appropriate action toward getting the best performance in areas that matter most.

Tools can enable both effective coordination and effective collaboration. They are most helpful when used by organizations to address the real drivers of governance challenges, rather than simply to automate poorly-designed or adversarial processes and bad behaviors. Used collaboratively, tools can make governance processes operational and dynamic. They also improve transparency. Take an issue management process, for example. Absent some means for jointly tracking and managing issues, one side often ends up escalating before the other; buyer or provider executives think they’ve made a decision and resolved the matter, only to find out that another executive on the other side has made a different decision at the same time about how to solve the problem.

Issue tracking tools provide visibility into the overall process of issue management, including how long it takes to resolve issues and patterns in the kinds of issues that keep cropping up. An automated issue tracking tool provides some visibility into both sides' views on each issue and where the issue is in the process of being resolved. In addition, the tool allows for continual reengineering or fine tuning of processes (to avoid recurring issues), and provides data that allows parties to recommend improvements in how they allocate resources and make trade offs. The additional transparency tools also allow executives to hold people more accountable for fixing the problems they said they would fix.

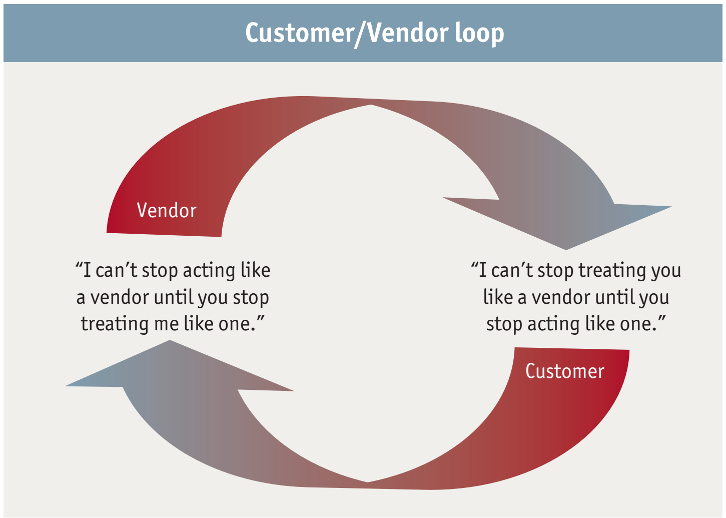

Figure 24

Transparency also enables individuals to have more productive conversations, particularly about performance and scope, by providing a shared set of data upon which both organizations can rely. Shared data on performance to service levels is necessary for organizations to assess performance objectively. While perceptions of performance are important, they are sometimes skewed by individuals' personal feelings about outsourcing, by their memories of "the good old days" of personalized service and so on. Objective performance data against agreed-upon measures is critical to managing those varying perceptions and creating a shared sense of what is working well and what needs to be improved.

For example, one IT provider described their experience working with their customer, a major retailer. After their first quarter working with the retailer, the IT provider improved overall system availability significantly over availability prior to outsourcing. At their quarter-end performance review, however, the IT provider was shocked to learn that most end users thought performance had declined a great deal since outsourcing, and their customer deal sponsor was livid. Fortunately, by jointly reviewing detailed performance data, they were able to get to the heart of the disconnect. While overall availability was much better than it had been previously, there was a several-hour system outage on a Saturday during the holiday season (the busiest time of the year for the retailer), during which time credit card transactions could not be processed. An outage at such a critical time naturally had a strong impact on perceptions of availability and performance overall.

Without that detailed information on availability, buyer and provider would likely have been arguing about their conclusions without progress ("Availability is worse than it has ever been" vs. "It's obviously a whole lot better than it ever was"). Fortunately, through their conversations about performance (supported by adequate data), the parties were able to focus on the most important areas. They modified service level objectives to include both overall availability targets, and some specific availability targets for critical business times. The parties also shared the performance data gathered with end users to manage their perceptions, acknowledging the outage and describing the action plan for ensuring it would not happen again, while also recognizing that overall performance was much better than it had been previously.

Don't Give Up — It's Never Too Late

When either side becomes dissatisfied with the way the relationship is functioning, the initial tendency is almost always to apply blame — to list in detail all of the examples of the other side "not acting like a partner." Unfortunately, as relationship problems progress, it becomes more and more difficult for either party to make the first move toward changing the dynamic to a healthier one.

This tendency leaves buyer and provider stuck in a predictable loop (see Figure 24). Both sides make rational sense — on one side, the buyer is saying things like, "If I see you trying to upcharge me, or selling more scope, or sending in the 'B' team now that you've got my business, you don't deserve to be more integrated into our process. I'm going to hold you to the contract and not give you the benefit of the doubt." And the provider, equally rationally, is saying things like, "If I see you not listening to my suggestions for ways we can improve processes or be more productive, or not sharing important information with me, or taking my suggestions for improvement and putting the work out for bids, then my hands are tied. I'm going to hold you to our agreement, worry first about my own profitability, and not go the extra mile." And the loop just feeds on itself. Getting into this dynamic is easy — it's just a matter of who gets into the loop first. The other party, almost inevitably, will respond in kind. Getting out once you are there is what is difficult.

When confronted with a chronically underperforming outsourcing relationship, the reality is that lasting change rarely comes from applying greater pressure on the service provider or simply working harder and running faster to try to fix the problems. Instead, a deeper level of diagnosis is required to uncover the root causes of performance issues, and to identify the self-perpetuating loops partners often fall into that impede effective execution and hinder collaboration. Transforming an underperforming outsourcing relationship into one that yields significant value requires that both parties engage in a structured and collaborative problem-solving process. Such a process is necessary to diagnose causes of underperformance, and to brainstorm strategies to overcome challenges and effectively exploit new potential sources of value.

Rather than purely assessing blame and applying penalties, we recommend that buyers and providers explicitly "re-launch" their relationship to address the issues that have led to the primary challenges over time. A re-launch process consists of a series of activities to enable both parties to identify and share perceived symptoms of problem, and explore the root causes of underperformance. These activities also provide opportunities to revisit the original objectives for the relationship and make adjustments as needed, to develop strategies for overcoming current and future challenges, and to establish milestones for meeting business objectives and metrics for assessing performance. Re-launching relationships also involves equipping both sides with skills, tools, techniques, and common vocabulary for more effective collaboration so they can more effectively build mutual understanding of expectations and commitments going forward. These offsite, teambuilding kinds of events can also help foster greater trust and camaraderie between the buyer team and the provider team.

Advice for Buyers

Insist on a Joint Planning Process Early On

Many outsourcing deals go sour because they become disconnected from true business needs and requirements. It is not uncommon to see an outsourcing arrangement where the service provider is meeting all of the contractually-specified service levels but the overall deal objectives are not achieved; the service provider is doing the wrong

> In 2008, Vantage Partners and the Outsourcing Institute created the Outsourcing Relationship Management Awards (RMMYs) to recognize the investment many service providers have made in building organizational capability to manage outsourcing relationships more effectively. The RMMYs provide an opportunity for buyers to nominate providers for recognition for exceptional relationship management. Separate awards are given for different categories, including "*Best Enabled Relationship/Account Managers*," "*Best Performance Management Process*," *Best Transition Process*," *Most Innovative Relationship Management Practice in a Downturn*," *Best Partnership*," and "*Best Overall Relationship Management Capability*" Additional information on the RMMYs, including information on nominating a provider, is available at www.vantagepartners.com and www.outsourcing.com.

things right. The more complex and transformational the deal, the greater the risk this could happen, and the more likely it is that you will not recognize the transformational benefits sought.

It is inevitable that business needs will change as company or business unit strategies and objectives evolve over time. Without some formal processes and mechanisms to monitor, plan for, and communicate evolving business needs (both internally and externally), outsourcing arrangements eventually become less relevant. While providers know what types of work are attractive to them (because of the margin they generate, or because they are somehow strategic to their business), they do not know what is most important to buyers. Buyers know which initiatives and projects are important, but may not always know the level of effort required to accomplish those objectives (and whether that effort fits within contracted scope). Regular dialogue is therefore required so that you can learn about the creative ways providers can help meet your needs and priorities, and providers can prioritize their efforts to deliver the highest possible value.

To ensure that the deal stays relevant and that your needs are continually front and center, insist early in the relationship on putting in place a process for joint planning with providers. Such a process could be as simple as briefing one another on relevant business strategy changes and evolving objectives at regular intervals, and as complex as true joint business planning where each organization briefs the other on its strategy, imperatives, and direction, and they jointly identify key goals, activities, and success metrics for the coming period. One effective way to ensure this occurs is to conduct 'value discovery sessions' on a regular basis. These are described in greater detail in the next section, Driving Innovation, beginning on page 73.

Lead the Way Out of a Difficult or Poor Dynamic

If a relationship has gone sour, though it may be tempting to point fingers and sit back and wait for the provider to fix the mess your relationship has become, doing so rarely leads to better results. Even if penalties are involved, they will never make up for the loss buyers suffer (in terms of time and attention wasted on escalation and poor problem resolution, or even litigation, ill-informed decisions, and unrecognized potential) as a result of a poor working relationship. Providers take their cues from buyers and will follow their lead. To change a troublesome relationship dynamic, take responsibility and insist on taking healthy steps toward resolution.

For example, move toward joint root cause analysis to assess performance problems and away from one-way assessment. Revisit decision making roles and responsibilities to determine whether individuals and organizations broadly are playing appropriate parts. Invite providers to make demand and scope management a shared responsibility, asking for their advice on how to manage internal demand, and offering to help them police scope boundaries internally. If business unit leads or end users are resisting new processes, going around the provider, or generally pushing back, use the governance team to build alignment and be facilitators of good communication and planning — not barriers to it.

Advice for Providers

Make Good Governance and Relationship Management Repeatable

An IT provider would hardly seek to create a new process for consolidating data centers or managing a PC refresh with each successive deal, just as an HR provider would not endeavor to create a new employee data management process and system for every new client. Yet many providers leave relationship management activities up to each individual delivery executive. Providers fortunately have the advantage of managing multiple relationships and learning from each deal. Don't let all of the lessons about what it takes to govern and manage a relationship effectively go to waste by starting with a blank slate for each new client. Make good governance a repeatable process, as integral as processes and mechanisms for executing the functions you perform (IT, HR, Procurement, F&A, or otherwise).

Buyers, particularly those new to outsourcing, look to your experience and expertise (along with that of their advisors) to help them determine how these relationships should be managed. Lead the way by bringing a template set of processes and mechanisms to the relationship that can be appropriately modified to the circumstances of the deal. This leadership will not only offer you more continuity across deals, but it will show potential clients (who are ever-more demanding) that a well-functioning relationship is as critical to you as it is to them and that you have invested in building expertise in relationship management.

Bring Tools

While many buyers would like to have tools for more effectively tracking contracts and financials, assessing performance, and supporting governance, they often find that the business case for investing in creating or buying a robust tool is not there for them. They may manage one or more relationships, but those relationships are small enough that tools are simply cost-prohibitive. Providers, on the other hand, have the ability to leverage software tools across accounts, making the cost case for them more attractive. Additionally, you know your own systems and processes, and can select (or create) tools complimentary to those systems.

Leveraging software tools for managing relationships across accounts not only enables effective management of a particular relationship, but it also provides for cross-customer views — the ability to spot challenges across multiple relationships and share unique and effective solutions. Expertise and learning are not siloed within client relationships, but are sharable among different arrangements.

Do Your Part to Improve Broken Relationships

If your customer takes steps toward improving a relationship that has gone off track by insisting on working more closely together to assess problems, going through joint training, or re-thinking how the relationship is governed, do not let them regret taking that step. Accept their invitation and follow their lead. Instead of dwelling on who is to blame, provide necessary resources to perform joint root cause analysis to get at the key contributions of both sides to problems and take corrective action. Attend (and share the cost of) joint training efforts aimed at providing both sides with a common vocabulary and set of skills and frameworks for communicating effectively and addressing issues collaboratively. Participate in joint planning activities. You will learn more about what your customer cares about, and you will be better positioned to continuously improve in areas that really matter. You will also be better able to propose solutions that address their most critical problems.

Creating additional value and jointly innovating

Driving Innovation

Critical Relationship-Related Challenges

Companies decide to outsource for a wide variety of reasons: cost reduction, improved service levels, access to new technology, increased efficiency, and to shift fixed costs to variable ones, among other reasons. Outsourcing providers have become increasingly effective at delivering these types of benefits during the early days of the outsourcing arrangement. However, whatever the primary motivation for outsourcing may be for a particular buyer, once the transition period concludes and service delivery stabilizes, many buyers begin to wonder, "What have you done for me lately?" or "What about innovation and continuous improvement?" Even when the primary motivation isn't innovation, buyers tend to expect it anyway, and tend to be dissatisfied when they don't receive it. Fifty-nine percent of buyers in our survey indicated they would like to see such innovation occurring.

A common occurrence for many companies is that they may initially make the decision to outsource to lower costs (at least a bit) and to have some predictability in spend. Over time, buyers see some centralization and standardization of service, and expect costs to continue to go down, in part because of Moore's Law — the notion that technology should get less and less expensive. Buyers also expect that providers are continually competing in the market, and as a result, they should see continuous improvement (and therefore cost reduction) over time, even when the initial deal may have called for stable costs.

Unfortunately, whether defined as 'continuous improvement' or 'breakthrough ideas,' many buyers don't receive the level of innovation they want from their provider. Part of the explanation for this is that few providers have a structured, repeatable approach to delivering innovation; another part is that buyers' expectations and behaviors often are not consistent with provider expectations and requirements to deliver innovation. Bridging this gap between buyer expectations and provider capability to deliver innovation is a key challenge, especially in a maturing relationship. Most of the time, no one systematically plans for how to bring about innovation. After the deal is signed, there is a big push to achieve some cost savings and reach stability in ongoing operations, and, while many contracts do specify year-over-year price reductions, no one really plans for how cost will be driven out, how operations will be continuously improved, or how great new ideas will be brought to fruition. Once arrangements reach steady-state, expectations for continued savings and additional value are still there, but because no one has planned for how the additional value will be generated, the arrangement stagnates.

Current Practices

Many buyers and providers today recognize that innovation is a source of value in an outsourcing relationship; however, they often have different understandings of what "innovation" actually means. Is it efficiency? New ideas? Cost reduction over time? Does it mean inventing something no one has ever done before, or bringing "best practices" to the buyer, or perhaps suggesting ways the buyer can change their own processes? The answer is that each of these can represent "innovation" within the context of a particular relationship. We surveyed both buyers and providers about what they think buyers mean when they ask for "innovation" or "added value" and there is both good news and bad news in the responses.

The good news is that buyers and providers appear, in the aggregate, to have a relatively similar understanding of what buyers are seeking when they ask for "innovation." The bad news is that in any given relationship, the parties may

Top five buyer descriptions of innovation	
Deliver services more efficiently	18.3%
Reduce costs	14.9%
Bring industry best practices to customer	12.4%
Suggest new processes for customer	12.0%
Suggest new ideas	9.5%

Figure 25

Top five provider descriptions of buyer definition of innovation	
Deliver services more efficiently	20.7%
Reduce costs	20.2%
Suggest new ideas	11.9%
Suggest new processes for customer	10.2%
Bring industry best practices to customer	9.1%

Figure 26

not have the same understanding of how that value will look within the particular engagement. This gap emphasizes the need for both buyers and providers to go beyond stating that "innovation" is expected in an outsourcing agreement, and to have a genuine discussion of what they each believe "innovation" will look like over the course of the relationship.

What is "Innovation" or "Value Add?"

Added value can take many different forms, from bottom-line savings, top-line value through new ideas and access to information on the competitive market, and operating efficiencies.

As these lists demonstrate, there are many ways that buyer and provider can generate different types of value even beyond those specified in common contract terms. A key first step is getting clear on which of these types of improvements or value constitutes "innovation" in the minds of buyer or provider.

Collaborating to Drive Innovation

Generating innovation in an outsourcing relationship requires collaboration — there are only so many things a provider can do by itself, and in a sustainable way, to deliver the types of value listed above to a buyer, and indeed many buyers expect more (and more broadly defined) value than the provider can generate alone. One aspect of this collaboration is generating ideas through joint brainstorming. More than half of buyers and providers in our survey identified such brainstorming sessions as a way to create innovation in their outsourcing relationships. However, in our experience, the level of deep collaboration required to generate innovation on a consistent basis is best enabled by formal structures designed to ensure that collaboration between the outsourcing partners occurs.

A common challenge is that once good ideas are generated they are not pursued. This can happen for a number of reasons: there may not be a process in place to decide which of the many ideas should be implemented, there may not be alignment on how to invest in these ideas, and even if there is a way to sort the ideas and some resource to make them 'real,' a lack of clear processes for implementing the ideas may keep their potential value from being realized. Ensuring that a structure and key processes are in place to bring these ideas to fruition and properly reward providers is required to sustain innovation in an outsourcing relationship. One aspect of this is ensuring that proper tools and technology are in place to facilitate exploration of innovative ideas. The absence of such tools is part of the explanation for why so many outsourcing relationships flounder over lack of innovation. In our survey, only about 30% of buyers and providers said that such processes and tools were in place.

Good ideas that are properly nurtured still face another relatively common challenge in outsourcing relationships: 'not invented here' syndrome, which may discourage the buyer from supporting solutions or approaches viewed as coming

Bottom-line savings	Top-line value	Operating efficiencies
■ Elimination of redundant assets and processes through centralization or shared-service approaches ■ Joint (re-)design of processes for more efficient service delivery ■ Reduction in headcount through more efficient processes and/or movement to self-service or greater reliance on technology ■ Reduction in capital expenditures by shifting them to, or sharing them with, providers	■ Faster development cycles; faster time to market ■ Access to new insights about customers and the marketplace ■ Increased market share and margin through quality improvement ■ New product/service development ■ Joint marketing ■ Access to, or penetration of, new markets ■ Balance of trade arrangements with providers as customers and /or channels	■ Improved value-chain forecasting and response ■ Improved quality and speed of decision-making ■ Reduced time and effort in scope management ■ Enhanced service quality, responsiveness, and flexibility ■ Reduction in errors and conflicts ■ Streamlined management of order fulfilment, rebates, etc. ■ Reduced time spent on provider selection and contract negotiation

Figure 27

from outside its organization. One approach that often helps avoid this barrier is separating the process of brainstorming potential value-generating ideas from the process of evaluating them; our clients often find that this encourages individuals to think creatively about possibilities because it removes the fear of being criticized for the resulting ideas.

Once a good list of possibilities is developed, it often helps to sort them in a structured manner as well. One approach we recommend is to map each of the ideas listed on a 2x2 grid reflecting the level of effort and the expected value of the idea if fully implemented; doing so generates a clear picture of possible innovations to pursue as well as the difficulty of attaining them and the potential value for each idea generated. An example of this is below:

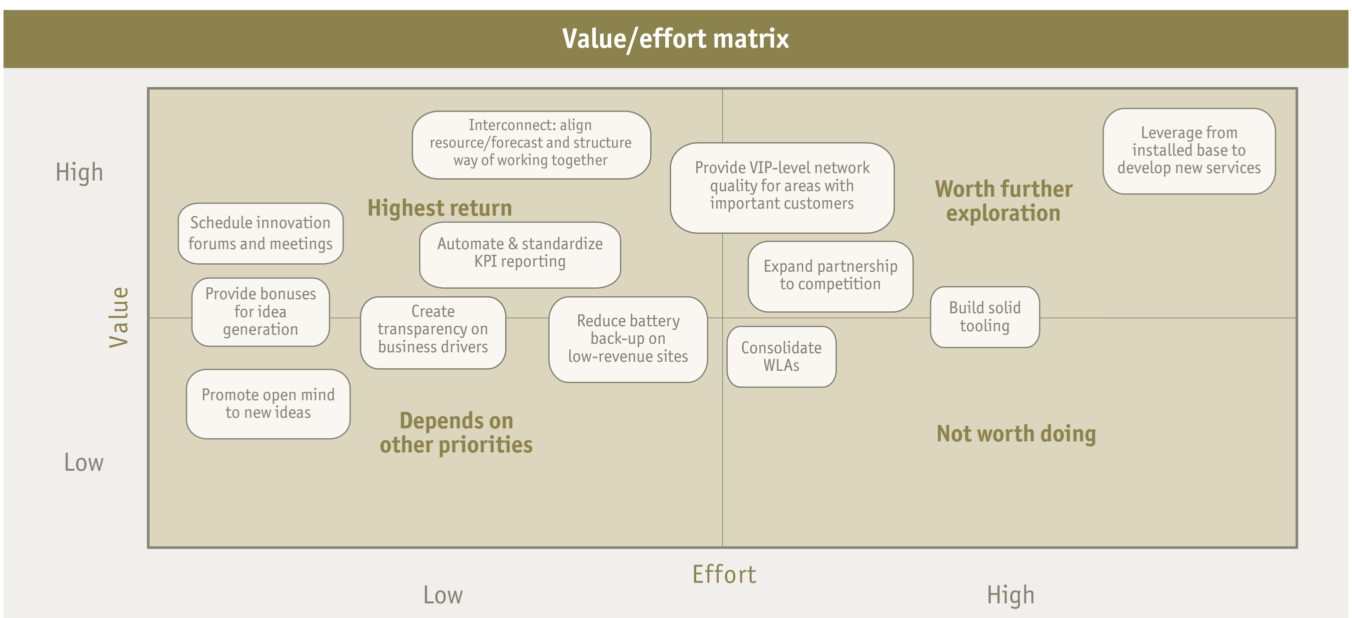

Figure 28

Another aspect of ensuring that innovative ideas are fully developed is creating appropriate incentives for innovation. It is nearly unheard of to have an outsourcing agreement that doesn't measure quality, but our survey suggests that it is quite common to have one that doesn't measure efforts to innovate — 74% of both buyers and providers said that there were not regular targets or metrics for innovation in their agreements. Absent this monitoring and the ever-present time pressures today, it is not surprising that many outsourcing relationships fail to explore the possibilities of innovation.

How customers say they work with their provider to create innovation		How providers say customers work with them to create innovation	
We share business objectives and priorities	60%	Customer shares their business objectives and priorities	72%
We help brainstorm solutions/new ideas	57%	Customer helps brainstorm solutions/new ideas	58%
We help make solutions operational	48%	Customer approves or rejects our proposals for innovation	47%
We build internal support for the necessary changes	44%	Customer comes up with new ideas and we provide advice on the feasibility of implementing those ideas	47%
We come up with new ideas and providers give advice on the feasibility of implementing those ideas	43%	Customer helps make solutions operational	45%
We approve or reject proposals for innovation	38%	Customer invests resources or time in co-developing new processes, products, technology, etc. together with our staff	44%
We invest resources or time in co-developing new processes, products, technology, etc. together with our staff	35%	Customer builds internal support for the necessary changes	43%
We set regular targets or metrics for innovation that our providers are obliged to meet	26%	Customer sets regular targets or metrics for innovation that we are obliged to meet	26%
We "innovate" on our own and we implement the changes we want	19%	Customer "innovates" on their own and we implement the changes they want	24%
Not applicable/we are not involved in helping create innovation	8%	Not applicable/customer is not involved in helping create innovation	5%

Figure 29

General Recommendations

Use Value Discovery Sessions to Uncover Opportunities for Innovation

One way to build the environment for innovation is to schedule regular value discovery sessions to facilitate identifying and planning for innovation. In our survey, buyers said that utilizing such meetings was the most common way that providers enabled innovation; providers mentioned it third most frequently, after 'increasing communication and information sharing' and 'developing processes and tools focused on innovation.' (It may be that providers view such sessions as but one means for increasing communication and information sharing, or just one example of a process focused on innovation.)

Such sessions are most effective when they include individuals who understand the buyer's and provider's business objectives, who understand the current state of service delivery, and who can help think creatively about a future state that better meets these priorities. The sessions are often best facilitated by a neutral party to ensure that all potential aspects of innovation are explored and, once possible opportunities are identified, to ensure that these opportunities are evaluated and sorted in an objective manner. These sessions often focus initially on building an understanding of what sources of value are important to both organizations, so that the parties can then address questions such as "How can we transform service delivery?" or "What new products can we create together?" with those end goals in mind.

Once some ideas are generated, the combined team will often sort the ideas based on value and complexity of implementation. A few ideas rise to the top as high-value and low to moderate complexity; for these, key contributors may be identified to help move these ideas forward after the session concludes. Parties may go as far as sketching out a rough project plan during the session for one or more ideas. The output of these sessions can be medium or long-term changes in approach, or they can also generate quick-win opportunities that build momentum for additional, ongoing collaboration.

Determine Metrics for Innovation

In all outsourcing relationships, organizations decide what to measure in part based on what they think is important; yet, three-quarters of both buyers and providers in our survey said there were no metrics for innovation in their outsourcing relationships. Considering the constant pressure to perform and meet basic KPIs and SLAs, this lack of measurement of innovation carries a grave risk of pushing the pursuit of innovation to the side. As we've all seen, generating value from innovation is too difficult (not to mention too important) to expect it to be done well unless it is at least a part of people's 'day job' and is monitored on a consistent basis.

While implementing metrics will help ensure that innovation occurs, what makes sense to measure depends on the specific function being outsourced as well as the type of innovation expected. In some relationships, and with some innovation targets, the measurement may be focused on the extent to which particular outputs occur. For example, if the provider and buyer agree that process efficiency is a target for innovation, then specific parameters can be defined around this, or there might be quarterly reporting of 'reductions in cycle time' or 'calls per transaction'.

> Is this part of my 'day job? ' With the pressure today on providers to stay lean and for buyers to manage outsourcing relationships with a lean retained organization, it is perhaps not surprising that a major barrier to achieving innovation is lack of time available for collaboration. Establishing formal structures such as value discovery sessions and ensuring that processes and metrics are in place to focus both organizations on the need for innovation helps ensure that searching for breakthrough ideas receives the time it requires.

Sometimes it may not initially be clear precisely what type of innovation is sought, or what the results of that innovation ought to be. This might be because the expectations for innovation aren't fully formed when the contract is signed, or because there is uncertainty about what should (or can) be delivered. Even when there is clarity on what form the parties would like innovation to take, there may still be uncertainty about how best to measure and report progress towards that innovation. For example, even if buyer and provider agree that innovation in a particular arrangement will focus on developing new product ideas, defining a metric for this might be difficult. Should units of new product sold be measured? Profitability of new products? A simple count of new product ideas that reach a certain point in the development cycle? All might make sense, depending on what ideas are developed, but it is very difficult to prospectively assess which of these will make the most sense.

In situations like these, where there is ambiguity about how innovation might be measured, measurement shouldn't be ignored. Instead, we recommend that rather than setting an output-based metric, a different approach is to focus on measuring success in adhering to the process instead. Such a measurement might be as simple as ensuring that value discovery sessions happen regularly, that they are attended by key representatives from both sides, and that action items are completed. These types of metrics enable innovation, even if they don't directly measure the outputs of innovation.

Ideally, and when appropriate for the context, there should be a balance of output-focused metrics and enabling measures so that both the process and the substance are being tracked. However, what is most important is not that a specific form of metric is included in the agreement (since the appropriate metric will vary) but instead ensuring that pursuit of innovation is reflected in the agreement and that the parties align on how they will jointly monitor how that pursuit is occurring.

Advice for Buyers

Clarify Internally what Innovation is Sought from this Provider in this Relationship

There is little hope that a provider will meet your expectations for innovation and value add if those expectations are not clear to both you *and* to them. Ensuring this clarity first requires some internal consultation, since different business units might have very different needs, or a different perspective on what a provider should bring in terms of innovation. Some buyers let the 'deal team' drive these assessments, and while the deal team is well-situated to coordinate the process and ensure that information is collected, they often lack detailed knowledge of key aspects of the business that may impact the innovation sought.

We recommend that key internal stakeholders be consulted about potential areas of innovation broadly and early in the exploration of innovation with the provider. This exploration should include some background on the provider, the services in scope, any expectations about other activities that may come into scope during the agreement, and a sharing of the provider's overall strategic objectives. Key internal stakeholders should be asked about their 'pain points' relating to the in scope services, and this information should be recorded and organized by department, process, or business unit. This should be a periodic dialogue not only during the initial exploration, but also as the relationship launches.

The purpose of these consultations is not only to gather perspective on where the most valuable opportunities for innovation may reside; it is also to ensure alignment across internal stakeholders on expectations of what the provider may be able to bring forward and when they may realistically be able to do so. This process takes some time, and some buyers will choose not to pursue it; however, our experience is that buyers who invest in gathering the most information and sharing that information over time with internal stakeholders, will maintain the strongest internal alignment and support for innovation.

Negotiate and Manage the Agreement in a Way that Allows for, and Properly Rewards, Provider Innovation

Providers recognize that not only is innovation an expectation of many buyers, but also that providing it is an excellent means to strengthen buyer relationships and demonstrate value. However, they also are under the same pressure to manage costs that buyers are, and, given the wrong contract structures and governance messages, this tension can drive providers away from focusing on innovation. To prevent this, buyers should do three things; encourage provider investment in pursuing innovation, enable broad sharing of information, and recognize provider business requirements.

As we've discussed above, innovation requires knowledge of buyer strategy, markets, and current-state processes, and these take time and a high level of communication. Sometimes, buyers under internal pressure to manage scope, increase volume of outputs, or reduce cycle times can feel that some of these activities aren't the best use of provider efforts. "We need to save money first, then we can look for new ideas," they say. Our experience is that this is a debilitating mindset overall, but especially when it comes to driving innovation in the relationship. It might feel like innovation is a switch that can be flipped in year two or three, but in fact the provider needs to be gathering information and exploring possibilities almost immediately.

Similarly, and especially in the transition phase of a relationship when internal pressure to reach a steady state of delivery is particularly intense, there can be a feeling that there simply isn't time to share critical non-delivery information with the provider. While this is understandable, it is also misplaced; not only is sharing information on strategy, objectives, and potential internal changes important to the provider's efforts to generate innovation, in many cases it allows them to better plan for delivery of services as well. Committing to sharing information early and consistently has another benefit; it creates a precedent of openness that provides a good basis for future collaboration.

Finally, there is a common tension around innovation relating to the idea of continuous improvement. Many buyers expect that there will be efficiency gains over time, whether or not that improvement is actually described in the contract. Thus, these buyers may view year-on-year improvements as being "part of the contract" rather than innovation. In some cases this may be quite fair, and it might be something the provider agrees with as an expectation. However, in other cases, this assumption of cost reduction undercuts the provider's business model.

In some outsourcing agreements, providers will price an engagement 'low' in the initial year or two, perhaps even below cost of delivery, based on an assumption that delivery efficiencies will be generated and that they will be able to make a margin once these efficiencies occur. The challenge arises around year two, when the provider has achieved delivery efficiencies and starts to earn a reasonable margin, and the buyer wants the provider to lower costs, which certainly the provider resists, as they are just beginning to recoup the losses of the first couple of years of the contract. If the provider does agree to lower cost, they have to find ways to take their own costs down and continue to earn a margin. One way this can occur is through elimination of resource, and when resource is lost, so is the provider's ability to engage in additional exploration of innovative opportunities. By year three of an engagement with this dynamic the provider feels that they have been prevented from making a fair return and the buyer is left asking where their 'new ideas' have gone.

While it is easy to say this should have been prevented during the negotiation and contracting, consider the perspective of the provider in such a situation. Once they conclude a buyer will take any form of improvement as "theirs," the incentive to generate such improvements is greatly reduced. This is not to say that innovation shouldn't benefit buyers, or that some agreements won't spell out specifics about what some expectations for improvement might be; rather, it is to note that how the buyer and provider discuss innovation initially will drive how they handle innovation which occurs during the contract. A buyer mindset that seeks to claim all improvements as "theirs" is most likely to reduce the number of improvements generated — and that benefits neither party.

Be Open to New Ideas and Approaches from Your Provider

Even in successful outsourcing relationships there can be tension between the retained organization and the provider organization, especially around provider suggestions for changes to the buyer operations or processes. In some outsourcing relationships this may also have a cultural aspect; if the provider's cultural expectation is for directness and the buyer's is for guarded commentary, it is quite easy for well-intentioned options for change to be interpreted as criticism. Unfortunately, this dynamic can result in good ideas being rejected for reasons unrelated to their value or path to implementation.

Customer description of provider actions which have engaged the customer in innovation	
Build governance structures to facilitate innovation	29%
Develop processes or tools focused on innovation	24%
Increase communication & information sharing	24%
Proactively demonstrate innovative ideas	11%
Develop technology to facilitate innovation	7%
Ensure alignment and clarity of objectives for innovation	4%
Engage customer actively in seeking innovation	2%
Improve relationship	0%

Figure 30

To help avoid these situations, buyers need to adopt a mindset which is open to new ideas and to avoid the 'not invented here' mentality. In many buyer organizations (as in many provider organizations) there are processes that work well and others that can be improved. Many times, it's hard for the buyer to fully recognize whether a process is working optimally, since they may lack real knowledge of how others in their industry perform those tasks. Providers often have a broader perspective, working in similar situations across a number of buyer companies. We recommend that buyers view suggestions from their providers as opportunities to learn what other companies are doing and to recognize that sometimes change in their organization may be needed. Examples of some provider actions that buyers have found effective in facilitating innovation are shown in Figure 30.

This is not to say the provider is always right, of course. In some situations the provider will misunderstand the purpose of a process, or be unaware of the flow-through implications of a proposed change. Buyers can take such opportunities to further educate the provider about the buyer organization and build a deeper level of understanding… or they can simply discard the suggestion. Our experience is that organizations that do the former reap the rewards of doing so while those that do the latter tend to end up asking themselves why they can't seem to get any provider to give them innovative ideas.

Advice for Providers

Ensure Alignment and Realistic Expectations for Innovation

Buyers bring very different expectations for innovation to each outsourcing relationship. These expectations have varied sources, prior experience with providers in the same or different service areas; internal innovation guidelines; or just a sense of 'what should be there' given the size of the relationship. From the provider perspective, these assumptions are worrisome — unless these expectations are uncovered and discussed, they can easily lead to buyer dissatisfaction. To avoid this, providers should ensure during the negotiations (and certainly once delivery begins) that they understand what the buyer expectations around innovation are. Truly understanding the buyer's expectations has three different aspects to consider:

1. Understanding what the buyer believes innovation might look like in this relationship and pushing back on those expectations where appropriate
2. Understanding what the buyer needs to do in order for the provider to deliver innovation
3. Aligning strategy and priorities on when innovation should begin to occur in the relationship

As we saw in Figure 25 buyers' expectations for innovation vary widely. This is quite understandable, since there is no single accepted definition for innovation. For a provider, what's most important isn't designing an approach that creates the most accepted definition of innovation — what's most important is understanding which of the broad list of possible meanings of the term 'innovation' this particular buyer expects during this outsourcing relationship. Gaining this understanding can be as easy as asking the buyer during negotiations, or may involve several interactions with a number of buyer stakeholders. While the complexity of answering the question will vary for providers and across relationships, it is always important.

Another aspect of aligning on expectations for innovation is ensuring that the buyer knows what you need from them in order to succeed. Each buyer (and provider) will have different requirements in order to drive innovation in the relationship; the key requirement might be funding, information sharing, or simply a willingness to change, but if there isn't a clear understanding of what is needed, great ideas may never become reality. Many providers struggle to ask for help from a buyer, especially in some cultural contexts, and this tendency can be very counterproductive. Telling a buyer you can do it on your own, without their help, unless you are sure you truly have everything you need to succeed, is a recipe for failure.

Especially with buyers that a provider hasn't worked with previously, there can be significant differences in expectations about when innovation will occur. Depending on the buyer's understanding of the term 'innovation,' they may believe a provider should be able to offer the value sought right away. For example, if a buyer feels that access to industry best practices is 'innovation' within the relationship, they may believe this should be available just about immediately, whereas if significant process reengineering and optimization is the buyer's expectation,

Making it real

What does such a contract mechanism look like? Why isn't simply stating that innovation should occur enough?

A client of ours negotiated an agreement with a provider seeking relatively standard benefits from innovation: cost savings, access to best practices, and a shift from fixed to variable costs. A key element of the outsourcing agreement was that a fixed number of FTEs would initially be employed by the provider to complete the set of tasks that were being outsourced. The buyer reasonably assumed that over time, they would get additional 'value from these FTEs as efficiency increased; the provider reasonably assumed that they would make their margin by completing the set of tasks with fewer FTEs over time. Within the first two years of the agreement, it became clear to both parties that their expectations were in conflict: either the FTEs remained stable or they did not, and it was unresolved who should benefit from innovation and efficiency gains over time. The parties each thought they had provided for innovation in the agreement, but not in a way that clarified expectations or effectively enabled innovation over the length of the contract.

they may not expect innovation for a year or two after steady-state is reached. Whatever the outcome of the exploration of what innovation is expected, providers should also ensure that they understand (and manage) the buyer's expectations about timeframe for this added value to begin to appear.

Ensure Mechanisms for Identifying and Implementing Innovation are Negotiated into Agreements

At the beginning of contract negotiations, buyers may or may not realize that innovation results from collaboration and requires time and appropriate structures and processes. Sometimes, buyers assume that providers have the capability to generate innovation on their own, or they may believe that the processes required to reliably drive innovation are a poor use of resource. Providers will be held responsible by their buyers for delivering innovation, and thus need to ensure that the requirements for enabling innovation are properly identified in their outsourcing agreements. Not only does this provide contractual protection, it also ensures that a productive discussion of the objectives for innovation will occur. We surveyed providers about approaches to gaining customer engagement that have succeeded. Developing the right tools and facilitating a high level of communications and information sharing are areas that can be discussed and aligned during contract negotiations.

Conduct Internal Reviews to Identify Opportunities for Innovation

Once the contract is signed and delivery begins, ideas for potential innovation are likely to exist throughout the delivery team. An internal process should be instituted to regularly gather such ideas. For some providers, this will be a simple email, sent periodically, asking for suggestions; for others, it might be regular small-group meetings where managers collect ideas and pass them along in the organization.

Some types of innovation require more collaboration within the delivery team, though. For example, opportunities to consolidate resources and deliver more efficiently often exist, but frequently require multiple elements of the delivery team to compare processes, locations, and staffing levels in order to recognize the potential. Enabling these types of innovation requires cross-functional team discussions. One effective approach is to create an agenda item for weekly or monthly delivery manager meetings to brainstorm possible areas of innovation.

Provider description of provider actions which have engaged the customer in innovation	
Increase communication & information sharing	27%
Develop processes or tools focused on innovation	20%
Build governance structures to facilitate innovation	14%
Develop technology to facilitate innovation	11%
Engage customer actively in seeking innovation	8%
Ensure alignment and clarity of objectives for innovation	8%
Improve relationship	7%
Proactively demonstrate innovative ideas	6%

Figure 31

the continuing challenge to improve outsourcing management

A Look Ahead

The outsourcing industry has matured significantly in the last few years as more players have entered the market, and providers have expanded their offerings, improved operating methods, and enhanced their relationship management capabilities. As the industry continues to mature, companies will continue to outsource more and more processes to many different geographies, making both sourcing and managing these relationships ever-more complex. While cost savings will still be a key driver, companies will focus more and more on value-add and innovation, making relationship management even more important. In the years to come, value will increasingly be driven by the ability of providers and buyers to collaborate effectively and jointly drive better results.

Repairing the damage of responses to the financial crisis

A significant short-term challenge for both buyers and providers will be rebuilding the relationships damaged during the financial crisis of 2008-2009. Faced with challenging conditions, many buyers pushed hard for discounts and rate adjustments in their existing outsourcing arrangements. Providers were faced with either losing deals or slicing their margins, and for many relationships, the resulting tough fights over scope and fees have left lingering bitterness and mistrust on both sides. Beyond damage to working relationships, the slashing of fees and headcount left both buyers and providers under-resourced and ill-equipped to deal effectively with the increased scrutiny and greater expectations placed on their outsourcing arrangements. Many arrangements will require a whole new foundation for the parties to move forward together effectively — a means for both sides to come together to determine root causes of past problems and the best ways to address them, and new ways for working together and communicating effectively that help them rebuild trusting working relationships.

Focusing on optimization, beyond basic service delivery

One measure of success for the outsourcing industry is that today, fewer deals are failing outright. This is a credit to providers (who have implemented higher quality, more effective processes, and more robust ways of engaging with their buyers) as well as buyers (who have learned from earlier generations of outsourcing engagements what they need to have in place internally to help their providers drive the results buyers need and expect). However, as experience and capability have grown, expectations have also evolved. Where some cost savings and a basic level of service quality were once acceptable, today most organizations are looking for much more from their outsourcing arrangements. Increasingly, innovation and “value add” have become a baseline expectation as well, and that’s where deals currently tend to let both sides down. Going forward, what will set apart the deals that delight (both sides) from the ones that disappoint will be the ability of the parties to effectively collaborate to drive innovation. Both sides must be willing and able to share information about their needs and strategies, brainstorm creative approaches jointly, and prioritize and manage to a set of concrete plans for delivering beyond the basics. This requires that buyer and provider executives be willing to commit resources and help one another, and that there be incentives in place for both sides to do so on an ongoing basis.

Enabling organizations through Centers of Excellence

Centers of Excellence have long been used by organizations to bring together expertise and capability (of different types) and make them available across the organization. As organizations have begun to undertake a multi-vendor approach, breaking apart various pieces of different functions and parsing them out to providers who specialize in different areas to outsource ever-more complex processes, and simply to outsource more functions to more different geographies, many are finding that Centers of Excellence are critical resources. More and more organizations will rely on Centers of Excellence as a means to leverage knowledge across their organizations, bring management discipline and rigor to the outsourcing process, and continue to learn from experience, so that lessons gained in one part of the organization aren't learned again the hard way by others.

Managing new needs and demands driven by cloud computing

As companies continue to access different software, services, storage, and development platforms via the "cloud" (Internet), and indeed to look to the cloud for significant savings in other IT-enabled services, new ways of interacting between buyers and providers (and a host of new challenges) will emerge. Though cloud computing will be disruptive of some outsourcing business models, it will raise the bar in terms of a need for strong relationship management. Cloud computing is meant at least in part to allow buyers to treat some aspects of their IT-enabled services as a utility, which should imply more standardization and less hands-on involvement. But providers, to close the deal, still promise significant customization and lots of flexibility and innovation; business users have also shown themselves notoriously unwilling to accept true commodity services. Balancing buyers' needs for flexibility, and their expectations of provider agility in response to their changing needs, with the provider's need to inexpensively, effectively, and securely manage its cloud environment requires the ability to have robust conversations about creative solutions. It will require paying greater attention to decision rights and responsibilities, to change management, and to developing joint planning and problem solving capabilities.

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About Vantage Partners

Vantage Partners, a spin-off of the Harvard Negotiation Project, helps companies realize and maximize value from their most important business relationships — with suppliers, customers, and alliance partners. With more than 20 years of experience consulting to the Fortune 500/Global 1000, Vantage helps leading organizations around the world create and capture greater value by more effectively negotiating and managing their key relationships. Vantage Partners' Directors and Consultants are recognized thought leaders, speakers, and writers on the subject of negotiation and the management of critical business relationships. Collectively, their work includes such books as:

- *Getting to YES: Negotiating Agreement Without Giving In*
- *Getting Ready to Negotiate: The Getting to YES Workbook*
- *The Point of the Deal: How to Negotiate When Yes Is Not Enough*
- *Difficult Conversations: How to Discuss What Matters Most*
- *Making Partnerships Work: A Relationship Management Handbook*
- *Negociación 2000: La Colección de Conflict Management*

In addition, members of our firm have also published numerous articles in the *Harvard Business Review* and the *Sloan Management Review*, a number of studies, and numerous white papers on negotiating and managing relationships.

Outside of the corporate arena, the Directors of Vantage have also worked over the last 25 years to address some of the world's most divisive conflicts in the Middle East, South Africa, Kosovo, Nicaragua, and Rwanda.

To learn more about Vantage Partners and our work, we invite you to visit our website at www.vantagepartners.com, or to call 617-354-6090.

To contact the authors of this study directly, please e-mail us:

Danny Ertel

Mr. Ertel is a Founder and Director of Vantage Partners.
dertel@vantagepartners.com

Sara Enlow

Ms. Enlow is a Principal at Vantage Partners.
senlow@vantagepartners.com

Ben Siddall

Mr. Siddall is a Consultant at Vantage Partners.
bsiddall@vantagepartners.com




Brighton Landing West   10 Guest Street   Boston, MA USA 02135   **T** +1 617 354 6090   **F** +1 617 354 4685

www.vantagepartners.com