

OUTSOURCING

The sourcing column

Denis A. Chamberland
Gowling Lafleur Henderson LLP

The growth of the outsourcing market in the last few years has been spectacular, globally and in Canada, and all indications are that the pace will continue for years to come. A few months ago, the Sourcing Interest Group (a leading forum for the exchange of information between those involved in the sourcing of information technology, business processes and shared services) pegged the global outsourcing market at \$72 billion USD for 2002 and predicted that that figure would rise to \$100 billion USD in 2005. What's more, McKinsey, a leading consulting company that advises clients on the merits and value of outsourcing, estimates that what is currently outsourced amounts to only about 10 per cent of what can be outsourced. Clearly then, there is a huge untapped market in this area, with many companies just now beginning to realize the potential benefits that outsourcing can bring.

This is the first of what will be a regular column on outsourcing and other forms of sourcing arrangements, such as insourcing, netsourcing and shared services relationships. In the next few columns, we will provide an overview of the why, what and the how of outsourcing. We will answer such questions as: what is the value proposition behind outsourcing?; what does a company want to outsource (and what not?); how does a company go about making a decision about whether to outsource?; and, how does it go about selecting a service provider? Subsequent columns will probe various aspects of sourcing transactions, but with a primary focus on outsourcing. We invite readers to submit comments.

What is outsourcing?

Outsourcing involves the transfer of an organization's regular business activities (functions and processes)

Denis Chamberland is a partner with Gowling Lafleur Henderson LLP, where he is a member of the firm's Strategic Sourcing Group. Gowlings (www.gowlings.com) is a member of the Sourcing Interest Group, a leading forum for the exchange of information between those involved in the sourcing of information technology, business processes and shared services. This column is intended to convey only general information and does not constitute legal advice.

to an outside service provider that provides the services back to the organization, as defined in a (typically) long-term contract. The core of an outsourcing arrangement is that the control and ownership of the business activities are put into the hands of the service provider. The service provider then owns and manages the business processes, including the resources that are used to provide the services to that organization. In a typical outsourcing, the people, the facilities, the equipment and the technology are transferred to the service provider. Given the magnitude and complexity involved, outsourcing relationships tend to be long-term propositions, usually in the 5 to 10 year range, and sometimes longer.

The transfer of ownership of the business activities being outsourced is really what differentiates outsourcing from other business relationships. As a rule of thumb, if the buyer of services owns the process, it is usually a services relationship. The buyer is purchasing time. On the other hand, if the service provider owns the process, chances are the buyer is outsourcing. For example, a utility company that brings in outside help to fix a computer bug is not outsourcing. But a utility company that transfers several of its business processes to an outside service provider that will provide billing and customer care services back to the company for a 10-year period is outsourcing. As we will see below, the nature of the relationship will take on a very different character according to whether the relationship is contracting or outsourcing.

Types of outsourcings

There are many typologies of outsourcing. There is a distinction between "conventional" and "greenfield" outsourcing. In a "conventional" outsourcing, the people, the facilities, the equipment and the technology are transferred to the service provider. In a "greenfield" outsourcing, the company buys new services from a service provider that it would normally have performed in-house (this is the 'make vs. buy' decision). For example, a company just getting into wireless remote computing might buy the services from a third party rather than build the infrastructure resources internally. The outsourced service will cost less and be better.

There is also a distinction between "tactical" and "strategic" outsourcing. "Tactical" outsourcing is typically driven by a problem-solving mentality. For

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example, a company finds that its payroll clerk is not able to process payroll changes, cheques, tax returns and make the required accounting entries on time. The company concludes that the payroll clerk is competent, but that there is too much work for a single person. So the company outsources the payroll process (including the clerk), and ends up with all of the payroll work done on time and at a lower cost, therefore achieving a net gain in operational efficiency.

“Strategic” outsourcing is more ambitious. Here, the outsourcing initiative is not designed just to fix a problem, but is structured so that it is aligned with the company’s long-term strategies. In this type of arrangement, the benefits that are expected from the outsourcing often do not materialize for many years, but when they, do they are significant. A sub-set of “strategic” outsourcing is “transformational” outsourcing. As its name implies, it promises to transform the company profoundly. In a “transformational” outsourcing, the end game is nothing less than redefining the way the company conducts business, but in a way that results in dramatic gains in share price, market position, and return on capital. These tend to be the true “mega-deals”. An example of such a deal involves U.K. food retailer J. Sainsbury plc. In 2001, the company was facing large operational problems and was losing market share, so it launched into a seven-year transformational outsourcing with Accenture. The company has outsourced all of its IT infrastructure — resulting in immediate savings of \$50 million USD per year — and is now working on a programme to re-platform the entire company, including its email system, supply chain and financial systems. Several hundred employees have transferred to the service provider. One of the main objectives of the outsourcing for the company is to free itself so it can focus on ways to develop a deeper relationship with its customers.

There are many types and sizes of outsourcing relationships, but in all cases, it is the transfer of ownership of a business process to a service provider that defines the core of the outsourcing relationship. As a general rule, the larger and more strategic the outsourcing, the more the relationship between the company and the service provider will be re-defined (if one pre-existed the outsourcing). The service provider will start to look less like a service provider and more like joint-venture/strategic partner. This is not surprising. Given the mounting layers of complexity and the significant investments on both sides, the parties realize that if they are to succeed, they will need to deal with each other in a way that qualitatively improves on the classic buyer-supplier mindset.

The many varieties of outsourcings also means that a standard-form outsourcing template will be inappropriate for all outsourcing relationships. In fact, the one-size-fit-all approach to documenting an outsourcing arrangement is positively risky. While a good template might be a helpful starting point — it can cut down a lot of drafting time and save your client some money — lawyers should be especially careful that the document they are working from is the right one. And they should have a clear understanding of their company’s or client’s brand of outsourcing (which in many cases will be a moving target, as the business team struggles to come to grips with the business and legal complexities of outsourcing).

Recent outsourcing announcement

An example of a large outsourcing deal in Canada is the recently-announced \$1.45 billion (Cdn.) BC Hydro outsourcing arrangement where the utility will outsource its customer services, IT services, network computing services, human resources services, financial systems, purchasing and building and office services to Accenture. More than 1,500 of the utility’s employees will become employees of an Accenture subsidiary that will be formed to provide the services back to BC Hydro and to other utilities across North America. This outsourcing is intended to save BC Hydro \$250 million over a 10-year period, and the service provider will be contractually bound to deliver the same or better quality services back to BC Hydro. Not a bad proposition for BC Hydro!

How can an outsourcing service provider promise all that, and still make a profit? This is where the economics of outsourcing become all-important. For a lawyer negotiating an outsourcing arrangement, it is essential that that he/she have a thorough grasp of the business model that frames the deal because that will drive the negotiations, and the drafting process. In the next column, we’ll look at some of the business drivers of outsourcing and at the types of activities that companies like to outsource. ■