

LEVELLING THE PLAYING FIELD - A FOCUS ON SECOND GENERATION OUTSOURCING

Customers contemplating a second generation outsourcing re-tender are faced with an enlarged set of complexities and considerations compared with those that arose the first time around.

INTRODUCTION

As the wave of outsourcing contracts signed in the mid 1990s begin to expire, the focus of the outsourcing industry is shifting increasingly to what happens in a second generation situation. An issue that arises in almost all second generation outsourcing re-tenders is how can a Customer "level the playing field" and ensure a fair competition between its incumbent supplier and other suppliers invited to bid to take over the service? If the non-incumbent bidders believe that the competition is, or is likely to be, unfair and that they stand little or no chance of displacing the incumbent supplier, they are unlikely to invest the considerable time and money necessary to put up a viable bid.

Levelling the playing field is something the Customer needs to continually do throughout the bid process until contract award. The nightmare scenario would be if the non-incumbent supplier withdrew mid-way through the bid process because it felt the bid process favoured the incumbent supplier. If this happened, the incumbent supplier would have maximum negotiation leverage over the Customer for the remainder of the negotiations.

A robust "market making" exercise by the Customer is almost certainly necessary to avoid becoming "locked-in" to single tender contract renegotiations with its incumbent supplier. Customers will appreciate that a strongly positioned incumbent is unlikely to be sufficiently incentivised to deliver a new solution which offers best value for money in the market place.

What is Second Generation Outsourcing?

- Second generation outsourcing involves the re-tender of an already outsourced service.
- Second generation outsourcing transactions differ from the first round of outsourcing in a number of ways, one of the most significant being that, should a non-incumbent bidder succeed, they will likely involve the transfer of staff from the incumbent supplier to the successor supplier.

- This transfer of staff will be governed, in the UK, by the Transfer of Undertaking (Protection of Employment) Regulations (TUPE) and presents complex legal and industrial relations issues.
- Recent examples of high profile second generation contracts in the public sector include the DVLA's PACT partnering agreement with PWC Consulting (now IBM) in 2002, the Inland Revenue's ASPIRE IT project in 2003, and the Police Information Technology Organisation's (PITO) IDENT1 national fingerprint database and identification services project in 2004.

BACKGROUND

Research published by Ovum Holway, the IT consultancy, has shown that 97% of project renewals are awarded to the incumbent supplier. With bid costs on large UK Government procurements (of which there has been a spate in recent months) approaching the region of £10 million, it is not surprising that the market often perceives little or no chance of a real competition.

New Issues require New Techniques:

A re-tender situation throws up new issues and market perceptions which do not appear in first round outsourcing. Legal and sourcing advisers need to respond to these issues with new techniques and methodologies.

Such techniques may include:

- imposition of Chinese Wall;
- "end of contract" re-negotiations with the incumbent;
- payment of Unique Transition Costs;
- use of a Should Cost Model; and
- payment of bid costs.

CHINESE WALL POLICIES

It has become increasingly common to require the incumbent supplier to implement 'Chinese Walls' between its operational team (the service delivery team responsible for "business as usual" live services under the existing contract) and its bid team. This can be done by the Customer requiring a 'Chinese Wall Policy' to be implemented by the incumbent supplier early on in the re-tender process, as a condition of the incumbent being invited to bid.

A Chinese Wall is a physical and logical barrier which is raised to prevent the incumbent supplier's bid team from acquiring information beyond that which is officially provided through "official channels" (*i.e.*, the Customer's ITT or RFP). This reassures non-incumbent bidders that the Customer intends to play fair with all the bidders, and that the whole process is not just a pointless exercise undertaken by the Customer to comply with internal policies or the statutory requirements of any applicable competition or public procurement laws.

The exact form of the Chinese Wall may depend on the corporate structure of the incumbent supplier and the vehicle it uses for its bid. Although there is some scepticism as to whether these policies are, in practice, adhered to by suppliers, the use of a robust and auditable Chinese Wall Policy sends a strong and positive message to the non-incumbent bidders.

END OF CONTRACT RENEGOTIATIONS

One of the things that non-incumbents will be looking for is a sign that the Customer genuinely believes it is possible to transition the services away from the incumbent supplier and has taken steps to ensure that the incumbent cannot sabotage the procurement process or subsequent transition by, for example, "hiding" information or running the services down prior to transition.

Accordingly, a Customer is advised to review, as early in the re-tender process as possible, the existing "End of Contract" or exit arrangements in place with the incumbent supplier. If these arrangements (and associated exit plans) are robust, up-to-date (so as to reflect new services or other changes implemented under the contract with the incumbent supplier) and can be implemented in such a way as to ensure a smooth transition to a successor supplier, preserving business continuity for the Customer and minimising operational and transitional risk, then this will send a strong message to the non-incumbent supplier from the outset that the Customer is genuinely intent on "leveling the playing field" throughout the bid process.

Where the arrangements are lacking (which is often the case where "older" contracts come up to be re-procured), a Customer should leverage its negotiating advantage with the incumbent supplier prior to the commencement of the re-tender process by seeking to amend the original contract. The Customer will need to propose and negotiate an "End of Contract Addendum", or similar, in order to (retrospectively) put into place provisions which require the incumbent supplier to:

- support the re-procurement process (*e.g.*, by releasing relevant information for the Customer's ITT or RFP);
- support any subsequent transition to a successor supplier; and
- provide post-termination assistance as required.

Such renegotiations are likely to focus on the above key phases, and the Customer should put in place appropriate and executable exit plans that address specific topics such as:

- performance-related and other information;
- HR data and employees;
- third party contracts; and
- IPRs and assets.

UNIQUE TRANSITION COSTS

Unique transition costs are the costs of transition that are unique to a successful non-incumbent. Their very nature means that they will not be incurred if the contract is re-let to the incumbent supplier. Their existence has the potential to place incumbent suppliers at a considerable advantage in relation to the non-incumbent bidders.

In the public sector environment, where complex UK and European rules apply, the government contracting authority risks a challenge being made to its procurement process on the grounds of discriminatory treatment of the non-incumbents unless the issue of unique transition costs is addressed. These costs do represent a hidden positive discrimination in favour of the incumbent supplier which the Customer may often treat separately for evaluation/down-selection purposes and which, in some cases, contracting public authorities, of late, have begun to redress by meeting some of the costs involved.

At present this technique is probably unique, at least in the UK, to the public sector. Government contracting authorities which adopt this technique typically implement tight rules to determine the amount of such transition costs which can be reimbursed to a successful non-incumbent as public sector IT contracts come under intense scrutiny from, amongst others, the National Audit Office, and must deliver value for money.

The Inland Revenue's ASPIRE Project:

- Shaw Pittman advised the Inland Revenue on its ASPIRE project, at the time the largest government IT project, worth an estimated £4-6 billion over its 10 year term.
- The ASPIRE contract, which was signed at the beginning of January 2004, established Cap Gemini and Fujitsu as the Inland Revenue's new technology partners in place of EDS and Accenture.
- This was against a background of hostile media and industry comment which considered the non-incumbent bid teams to be severely disadvantaged - a perceived "shoe-in" for the incumbents, with both IBM and Lockheed Martin refusing to bid for the contract.
- The Inland Revenue used the best practice techniques outlined in this Alert to overcome these issues in order to:
 - level the playing field;
 - ensure a fair competition between incumbent and non-incumbent bid teams; and
 - stimulate a (successful) market challenge to the incumbent suppliers.

SHOULD COST MODELS

One of the great disappointments of outsourcing is that costs may not actually go down-they may go up. The price/as-is cost model seems a simple and obvious way for Customers to determine whether an outsourcing will save money. If a supplier's bid is lower than the 'current' or 'as-is' cost, outsourcing appears to make financial sense. However, unless there is proper competition between bidders, this approach is unlikely to yield the best price.

The Should Cost Model allows the Customer to compare the bid price with what the Customer's cost should be; enables direct comparisons with a bidder's estimated costs; and provides a basis for challenging those costs. In a second generation outsourcing, access to the incumbent supplier's financial model may be necessary to develop the Should Cost Model.

Although more difficult to determine than as-is cost, and requiring a baseline, low-level inventory of existing operations as well as a cost and quality analysis, the use of a Should Cost Model puts the Customer in a better position to negotiate with its suppliers.

PAYMENT OF BID COSTS

Probably the most controversial of all techniques, and one that remains relatively rare, is for non-incumbent bidders to have all or part of their bid costs met by Customers. As bid costs (particularly in large scale and complex public and private sector procurements) spiral ever higher, payment of bid costs (under tightly defined rules and stringent requirements) may become more common.

CONCLUSION

Different Customers will, naturally, place a different emphasis on the level playing field issue. It is important that the project team and its advisers establish, at an early stage, the desired approach to dealing with this issue to enable the right messages to be communicated to the market and the production of appropriate documentation, such as Chinese Wall policies and Rules of Engagement, at or about the time of the ITT or RFP.

SHAW PITTMAN

Shaw Pittman has extensive experience working with public and private sector purchasers of outsourcing services and are experts on the issues that arise when undertaking a second generation procurement exercise. For further details on Shaw Pittman's expertise in the fields of outsourcing or technology in relation to the issues raised in this Alert, please contact Tim Wright (Email: tim.wright@shawpittman.com; tel: 020 7847 9505). Tim is a Partner in Shaw Pittman's Global Sourcing Practice Group. More information about the group is available at <http://www.shawpittman.com>

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