Impact of disruptive technologies on sourcing and outsourcing transactions

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ABSTRACT

The sourcing and outsourcing markets are being challenged by the simultaneous impacts of a number of new technologies and delivery mechanisms; this article addresses the impacts being felt by the market participants and the contractual structures they seek to put in place as a result.

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1. Introduction

There is a story (or a theory, albeit not one that I would suggest be tested!) which works by comparing us to frogs. Supposedly, if a frog is placed into a saucepan of water and the water is then placed on a hob, the frog does not notice the gradual change in water temperature as it goes on around it, to the point where it becomes soporific and then (unfortunately) boils to death. By contrast - and again I am not suggesting that you ever try this! - if a frog is taken directly from a saucepan of cold water and dropped into one full of boiling water, it will jump straight out.

Now, I do not recount this theory out of any particular antipathy towards amphibians. Rather, it is because it is a metaphor for change, and the fact that it sometimes occurs so swiftly that those of us who are caught up in the middle of it can struggle to appreciate the seismic nature of the adjustments being made.

It is my belief that the global sourcing and outsourcing market (and particularly - but not exclusively - the markets fo-

cussed upon IT services) is caught up in precisely this kind of rapid change, which if not quite pushing outsourcing into terminal or irreversible decline, will nonetheless have profound ramifications for the kinds of deals being done (and the contractual terms being negotiated in relation to them), and the fates of many of the current players in the global outsourcing market, in particular.

In this commentary, therefore, I will summarise what I see as being the key disruptive factors, how they are affecting the scope and nature of the contractual agreements being negotiated, and how they may be addressed going forward.

2. Digital transformation

At the outset, it is important to stress that digital transformation - which has become a buzzword much beloved of consultants and commentators - is more than simply spending more on IT services or products, or making products or services available online. Instead, it is about either transforming an existing process or procedure so as to undertake it in

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a fundamentally different way (enabled by IT), or looking at an existing form of business endeavour and challenging it by means of undertaking the same or similar base service, by technologically driven means. An example of the former would be those banks who are seeking to enable their customers to take out a mortgage via their smartphone; sounds simple enough, but actually is something which requires a re-thinking of a process which can take 30 + individual steps and involve face to face contact with mortgage advisors as well as the filling in of multiple detailed forms. In the case of the latter, one need only look to the likes of Uber or Air BnB; companies who revolutionised their respective market sectors (taxi driving and hotel accommodation respectively) without either of them ever owning a single asset of the type that you would associate with such services.

So what does this have to do with sourcing? Might it not be argued that with such technologically dependent programmes, outsourcing in particular might be bolstered rather than undermined? The answer is - in theory yes, but in practice less so. Across nearly all of the digital transformation projects I have been personally involved with, the key imperatives are speed and flexibility; services need to be developed and rolled out iteratively and with maximum alacrity, often for fear that, if the market is not grabbed quickly, someone else will be able to seize first mover advantage. This leads in many cases to the adoption of less familiar approaches, such as the Agile methodology for application development (which works on a more iterative process of fully designing, building and testing bite sized chunks of the overall solution, rather than the more traditional "waterfall" approach of having an end to end design created first, which is then subsequently developed in full before being made subject to a complete user acceptance test). Such flexibility and willingness to embrace change is not usually seen as being a common feature of a typical outsourcing arrangement…!

Even for development contracts, lawyers need to recognize the contractual changes, which are necessitated by a shift to an Agile approach. Under the more traditional waterfall methodology, it will be far easier for the contract to assign contractual responsibility to the supplier, should the solution ultimately fail to pass user acceptance tests. There will have been a signed off specification for the entirety of the solution, and so it should be factually possible to establish as to whether or not the code as then finally delivered by the supplier meets that specification or not. With the Agile approach, however, the supplier and customer will have been working in joint teams (often called "scrums"), such that assigning responsibility for defects becomes difficult, if not impossible. Equally, customers may have in the past become used to having the budgetary certainty of a fixed price from their suppliers for the completion of particular IT developments (at least as from the point where the relevant design had been fully signed off); such certainty is far less likely to be achieved using the Agile approach.

I do not mean in this regard to be acting as an opponent of the use of the Agile methodology; far from it. When used in appropriate circumstances, it can result in developments, which proceed faster, and with reduced rework, and often with lower overall cost. However, the point is that the adoption of such approaches - when intended to support the "fast track"

imperatives of digital transformation initiatives - create contractual challenges, which must be fully understood by those involved.

3. The cloud

Now, there is of course nothing "new" about the cloud. Even before someone thought to give it the new identity as "cloud computing" or the "X as a service" family, the concept of remotely hosted IT services has been around for a long time, ever since telecoms links evolved to the stage of being able to handle bulk data transfers at commercially acceptable download speeds.

What is different - and disruptive - however, is the growing maturity of the cloud services market. Even as short a time ago as 12 months back, it would be relatively rare to see commercial organisations doing much more than utilising the cloud for what might be termed commodity or non business critical services (such as marketing or HR systems, data storage and the like). In heavily regulated sectors such as financial services, there was (and to an extent still is) a healthy degree of scepticism as to whether truly public cloud services could ever meet the stringent contracting and procurement related standards of the relevant regulators.

Within the more recent months, however, there has been a noticeable shift in gears. Deal values are going up (with one major UK bank being reported to have signed a cloud transformation agreement worth in the region of £1.3 billion), and at the same time the functions being entrusted to the cloud are increasingly including those which are truly core and/or critical to the customer entity.

The implications of this are manifold. For lawyers who are advising clients in this area, the primary challenges come in relation to the negotiation of the contract clauses for the cloud services agreements. When deals were smaller/less critical, it would not be unusual for the relevant suppliers simply to present their standard contracting terms on a "take it or leave it" basis. The logic here would be that the cloud services were being offered as a form of commodity or utility, and as such the contract terms for them had to be considered to be part of the overall package (in the same way that the consumer of a household water supply would not expect to be able to negotiate a variation to his or her water supply contract with the local utility company so as to individually vary the level of fluoride being added to their water). However, customers are far less likely to accept such a position when their level of spend upon the services and/or their level of reliance upon them is much higher. To take but one example of a contract that I was recently involved with on behalf of a well-known retailer, the cloud solution in question was to underpin the operation of their main merchandise purchase and supply functions. Put simply, if the solution failed to work or was to be simply unavailable for lengthy periods of time, their existence as a company would be at risk. Having a standard form contract which provided that in such an event, the supplier's liability would be close to zero was therefore never going to be a palatable outcome!

Therefore, there is more pressure for negotiation of cloud related contracts. At one end of the spectrum, cloud service