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J. Grigg

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Commentary

IT Services Contracts — Risk Analysis Framework

Service contracts should delineate the frameworks that parties will use to analyze risks surrounding their operational, legal and financial relationships, how the risks might be mitigated, and when they are unacceptable.

An inherent structural conflict exists in external service relationships where the service recipient (SR) looks to transfer as much risk as it can to the service provider (SP), while the SP focuses on minimizing its level of risk assumption. This effort of risk shifting drives price and scope, and directly affects client satisfaction. Gartner recommends that enterprises incorporate a shared methodology for assessing and managing the risks associated with service delivery into the contracts between the SP and SR. This methodology should illuminate each party's assessment of acceptable risk and should be accompanied by mitigation processes for identified risks.

Purpose

A risk analysis framework is a detailed exposition of the key risk identification, analysis, mitigation and reporting principles the parties will use when examining policy issues related to the deal. The framework:

- Describes the methodologies, processes and timelines for analyzing risks
- Establishes guidelines for reviewing those risks
- Identifies processes to minimize and manage risks

Importance

In an external service relationship, the risk assumptions that drove pricing and due diligence at the start of the contract become increasingly inaccurate and inapplicable to the SR's evolving business environment over time. Changing circumstances and delivery requirements for new scope additions may generate risks that extend beyond those contemplated by the SP during its detailed and tightly costed due diligence at bid time.

When this happens, the SP's internal risk analysis can lead to difficult discussions with the SR about changing prices and repricing scopes of work, for which the SR may be completely unprepared. Additionally, bids on new work can be delayed while the SP gathers the information it needs to assess its risk. Therefore, the SR will often face unexpectedly high prices when the bid is finally submitted. SRs tend to feel exploited when this occurs, reasoning that the prices for delivering new services should be comparable with those for services already being delivered, and that repricing existing services is an unspeakable heresy. This disjunction occurs primarily because the parties do not share the same understanding of what risks exist and how they should be incorporated into service pricing. When SPs and SRs share the same framework and processes for assessing risk, they can deal with these potential problems before they become crises, and can work together to mitigate the risks — and therefore the costs — associated with the programs and projects in question.

Risk identification, analysis and management are skills that exist primarily within SP organizations, particularly as part of the bid process. By agreeing upon standard risk methodologies and periodic risk analysis processes, and communicating clearly when such risks arise, the likelihood of adverse unforeseen business disruptions for either party stemming from or affecting the deal should be minimized.

Structure

Within the contract document, a risk analysis framework consists of a detailed exposition of the key risk identification, analysis, mitigation and reporting principles the parties will use to examine policy issues related to the deal. More specifically, the following items should be included:

- A statement of key risk assessment and management methodologies
- A definition of the risk threshold points for action (e.g., communication and contract amendment)
- A definition of the risk reporting frameworks into SR and SP organizations
- A definition of the processes to periodically identify likely future risks that may affect the deal or derive from the deal
- A definition of high-level risk management and mitigation processes

Example

A major U.S.-based manufacturer entered into a long-term outsourcing relationship for application development with a Tier 1 service provider (see "An IS Organization Adopts an ESP Model: The Lessons of a Radical Transformation," R-14-0932). Because of vast differences in the project and risk management capabilities between the parties — the SP held Capability Maturity Model (CMM) Level 5 certification, and the SR was at CMM Level 1 — and, after numerous disagreements between the parties on how scope should be managed and expanded, the SP determined to infuse its risk analysis methodology into the manufacturer's processes to address the cause of the problems.

Reasoning that introducing the methodology would improve the viability of the deal and allow the SR to materially advance its business effectiveness, the SP invested considerably in knowledge transfer to position the methodology. In doing so, it realized its objectives of bringing the parties to consensus in managing scope variations in the deal. In addition, the manufacturer now operates at best practice, having terminated projects with unacceptable business risk. It only undertakes changes to its service portfolio when they are consistent with its enterprisewide risk objectives.

Bottom Line: A primary driver of entering into relationships with external services providers is the expectation that the scope of work will adapt to the ongoing demands of the business. To ensure that this expectation is achievable, the parties must share the same methods for assessing the risks associated with change, clearly understand each other's acceptable risk thresholds, and communicate and cooperate to mitigate identified risks.