Providers Paying the Price

Whipping a vendor into shape shouldn't require a heavy hand or heavy wallet. Consider the ultimate consequences of financial penalties. By Paul Davies

The usefulness of financial penalties in complex HRO deals goes largely unchallenged. However, while their value seems self evident and has many supporters, the effect can sometimes be counter-productive and bears careful consideration.

On one hand, buyers want "partners" in the transformation and outsourcing business: providers who will stay focused on what the business requires, be flexible over contract limitations, and not quibble over myriad tiny change requests. They want openness, goodwill, and a "go-the-extra-mile" attitude that reassures them that life will be as good as it was when the buyer's employees did the job. On the other hand, the contract is stuffed with KPIs, critical deliverables, and a hefty financial thump in the gut if a deliverable date or a performance metric is missed.

One consideration sometimes overlooked in these approaches is the extent to which performance is actually improved, mistakes uncovered, and corrective actions quickly agreed upon in an environment in which blame and liability is apportioned. At the very least, there is a risk that openness will suffer when it comes to resolving the root cause of mistakes if the objective is to assign a financial penalty.

Another facet to think about is the polarization brought about by penalties. If choices have to be made, it is easy to imagine things that don't get punished not getting done. The implication is that the buyer needs to be careful when crafting the areas of performance affected by financial penalties.

The definition of performance can also crop up as a problem. The date of completion for a critical deliverable, for example, can seem objective while disagreement over the quality of the completion lingers on. Those with a systems background often argue that this can be avoided with thought and experience. However, the successful definition of deliverables in full scope transformational HRO can prove illusive.

Even in circumstances where the quality is clearly measured, the high levels of partnership required in transformation deals can make accountability difficult to establish. The scope and structure of the contract will have an impact on how much of the deliverable is controlled by the provider or can be attributed to the buyer. In case of a penalty being applied, it is natural that there should be much dialogue about who contributed how much to the failure. While this is going on, energies are being diverted away from the main goal.

It may be worth exploring why the suspicion exists that the provider will not supply the appropriate level of service unless motivated by financial punishment. Putting aside the question of why the buyer chose the provider, it assumes different motivation patterns than those expected in an employment relationship. A buyer can be concerned about a provider's profit-quality conflict, multi-client prioritization, or simply the loss of direct control. Whatever the cause, the penalties might be improved by understanding the specific dynamic in each case.

In some circumstances the need for penalties arises because something else in the contract is out of balance; for example, if the volume of business or price mechanism is out of alignment. This is not to suggest that the price should be raised, but it may be important to understand if "buy-by-the-drink" pricing in a country with low volume is being counterbalanced by high penalties.

All in all, in case of actual financial "damage," penalties are worth the endeavor. Sometimes, the date of a deliverable is well founded in the costs a buyer will incur if the deliverable is missed—for example, the planned retirement of a system. In such circumstances, transferring the costs of continuing the system to a provider that missed the deliverable is a good example of a well-grounded penalty. Another is financial incentives regarding service performance levels, provided they are applied to proven metrics and are not punitive.

Paul Davies is an independent advisor in HR services and outsourcing. He can be reached at paul.davies@debunkhr.com.

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However, where the penalty works merely to inflict pain or claw back elements of the price because "we're not getting what we paid for," the mechanism needs re-evaluating. Where performance drivers are not wholly owned by the provider or if deliverables are the result of joint work, penalties can be more trouble than they're worth. When well-crafted, they will focus the provider's attention, but when overplayed they are distracting and destabilize partnerships and can financially damage a provider that should be investing funds into problem fixing. HRO