

The missing link to efficiency

Outsourcing allows hotels to reduce their capital exposure and streamline operations. **Richard Bursby** and **Paul Smith** of Taylor Wessing look at the legal aspect of outsourcing

COLUMNIST

The benefits of outsourcing can be numerous. By placing the responsibility for specific functions with an outsourced supplier, hotels can reduce their operating costs, streamline their operations and concentrate on their core activities. They can also reduce their capital exposure by taking advantage of a supplier's existing infrastructure and expertise without having to invest heavily themselves.

Traditionally, outsourcing has focussed on back office functions such as IT, but there is a growing trend for hotels to outsource more prominent functions such as concierge services, catering, marketing, reservation services, loyalty programmes and the operation of gyms and spas. In the current climate, as hotels try to obtain and maximise cost savings, we are likely to see both an increase in this type of activity as well as an increase in existing outsourcing arrangements being reviewed and renegotiated.

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There are a number of reasons for this, including long term deals with fixed obligations no longer being viable. Hotels and suppliers which have entered into long term deals with fixed pricing or with a lack of flexibility around pricing, or minimum purchase commitments, are likely to find that they cannot live with that lack of flexibility going forward.

KEY OUTSOURCING ISSUES

Agreeing an appropriate term for the arrangement. This will depend on the circumstances and may be driven by a number of factors, including how long the hotel can reasonably predict its needs, how much flexibility the hotel needs in terms of the services being provided, and the financial implications of having a short term deal versus a long term deal.

Other relevant factors which hotels need to consider, especially when outsourcing its back office functions or reservation systems, are the life expectancy of the key assets involved in the outsourcing, and the projected pace of technological change.

Traditionally, outsourcing agreements have been long term agreements. The main reasons for this are:

Where a supplier has to invest in assets at the start of the relationship, that cost is likely to be amortised

over the term of the agreement and reflected in the charge to the hotel. Therefore, the shorter the term the greater the unit cost is likely to be;

The hotel achieves a longer period of stabilisation after the initial transition of the outsourced business;

Suppliers are prepared to offer better prices if they have the certainty that their services will be required for a substantial term.

Defining a clear scope and description of the outsourced services and the process by which the hotel can seek redress for poor service.

The description of services is maybe the most critical area of an outsourcing agreement as it sets out what the supplier has to provide and what the hotel expects to receive. In addition to the service description, the agreement should require the supplier to perform to a set of service levels and/or KPIs. It is common for the monitoring of these service levels to be either linked to the fee that the supplier is paid or a process involving the payment of service credits to the hotel. In this way, the hotel can seek redress for poor performance by the supplier without having to terminate the agreement and recover damages. Obviously there should come a point when the service delivery is so bad that the hotel should be entitled to terminate the agreement and seek damages. Agreeing the level of exclusivity offered by



the hotel operator to the supplier, which may involve the hotel operator agreeing to minimum purchase commitments or granting the supplier “preferred supplier” status.

The difficulty with provisions dealing with exclusivity is that there needs to be a balance between (1) the supplier’s need to protect its capital investment, and (2) the hotel’s wish to retain the ability to source from an alternative supplier (most probably on cost or quality grounds). If exclusivity is granted, the hotel should seek some protection in relation to breach and unforeseen events / acts of God, so that exclusivity is suspended in these circumstances. Also, exclusivity provisions can raise competition issues and can be very hard to police in practice.

Whilst many outsourcing agreements do not provide for exclusivity for the supplier, they often contain other protections for the supplier such as:

Minimum commitments, which in practice mean that the hotel is likely to use the supplier for the majority of its services;

Preferred-supplier status, whereby the supplier has the right to receive notice and to take part in all new tenders by the hotel; or

Most-favoured customer clauses, which is a contractual undertaking from the supplier that the charges the hotel is paying for the services are at least as favourable as the charges paid by any other of the supplier’s customers receiving similar services at similar service levels and in equivalent volumes.

Structuring the pricing payable for the services in order to incentivise the supplier, for example by making the price contingent on the supplier fulfilling certain KPIs or performing

within an agreed budget.

Apportioning risk and liability. Outsourcing agreements which align the interests of the hotel and the supplier in such a way that “pain and gain” is shared by both parties, are much more likely to stand the test of time. The liability provisions should clearly set out who bears the risk (and to what extent) in the event of breaches of the agreement.

Hotels should consider whether to adopt an Open Book model for the price it pays for the outsourced services, whereby the cost of the services is passed through to the hotel with complete transparency and the supplier receives a fee based on its performance. The Open Book model can be beneficial for both parties as it increases the flexibility of the agreement and supports the partnership relationship between the parties.

If a hotel is appointing a foreign service provider, it should consider to what extent the currency fluctuation risk is allocated between them. By tackling this issue in the agreement at the start of the relationship, it is less likely to cause problems later on.

Providing for sufficient flexibility is still workable and makes economic sense regardless of the current economic climate. This can be achieved in a number of ways that, including:

Limiting the fixed commitments that are given in the outsourcing agreement – e.g. minimum revenue or minimum purchase clauses could be drafted so that they track the downturns in occupancy, and in this way both the hotel and the supplier share the risk; and

Allowing for changes to service scope and service levels.

The amount of flexibility in the outsourcing agreement will impact

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on the hotel’s bottom line as, in general, the greater flexibility allowed by the supplier, the greater the price it charges. However, there are clear benefits to having flexibility in outsourcing agreements, particularly in long-term deals, so it is something that needs to be considered.

Managing a successful transition of the outsourced function whilst maintaining the integrity of the hotel’s operation and minimising disruption for hotel guests.

If the services cannot be carried out immediately following signing of the agreement, the agreement needs to provide for a transition plan to be drafted and agreed in order to legislate for what can be a difficult period. The key points which the transition plan should deal with are (i) who is responsible for managing the transition, (ii) how long the transition will take, (iii) what service levels will apply during the transition period and (iv) what is the role of any outgoing supplier.

Monitoring employment issues and complying with employment law at all stages of the arrangement. A new outsourcing can often involve a transfer of employees from the hotel to the supplier. Similarly, on the termination or expiry of an outsourcing, employees may be transferred back to the hotel or to the replacement supplier.

The possibility of a reduction in headcount (and therefore lower operating costs) is one of the attractions of outsourcing for hotels, but often raises employment law issues (such as liability for redundancies and pensions), which need to be addressed in the outsourcing agreement at the outset.

SUMMARY

Outsourcing can deliver considerable benefits for hotels if the arrangements are properly structured, such as reduced operating costs and an improved level of service. ■

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