Outsourcing
What is it and what are the options?
EXECUTIVE SUMMARY

Since it first emerged as an option in the mid-eighties, outsourcing has been one of the most hotly debated issues in IT. These days, it’s less a question of whether or not it makes good business sense and more a discussion about which elements of a business can be outsourced to advantage, to whom and with what expectations.

Over the years, outsourcing has grown significantly among large organisations and has also become attractive to midsized operations. Services typically fall into the categories of Application, Infrastructure and Communication services.

As the market continues to mature, the face of outsourcing changes. The current trends show:

- A move towards the use of multiple service providers
- Increased use of offshore resources
- The need for effective governance of both the contract and the relationship
- A move to smaller, shorter-term arrangements

Business strategy drives outsourcing choice

Today, outsourcing services fall into two broad categories: Information Technology Outsourcing (ITO) and Business Process Outsourcing (BPO).

Business Process Outsourcing is growing at a faster rate than traditional IT Outsourcing and centres mainly around services in Finance and Administration, Human Resources, Customer Relationship Management, Procurement and Facilities Management.

In order to gain full advantage from outsourcing, it’s imperative that companies develop a detailed outsourcing strategy aligned to their business goals. This will make it easier to choose from the almost endless combination of services and providers available. Every company is different and so each outsourcing transaction must be tailored to that company’s corporate culture, maturity and business strategy.

In brief

Outsourcing offers the following advantages:

- Access to skills
- Best practices methodology
- Improved services
- Cost reductions
- Flexibility

But there are also potential downsides:

- Loss of control
- Less customisation
- Vendor management capability
- Inflexible contract terms and service level agreements (SLA)

The formidable challenges associated with operating in a global economy are forcing CEO’s and CIO’s to evaluate new ways of delivering improved results. For many organisations, outsourcing has become the solution.

“An outsourcing transaction must be tailored to that company’s corporate culture, maturity and business strategy.”
A BRIEF DEFINITION OF TERMS

The term “outsourcing” has been used in many contexts and, sometimes, the subtle but important differences between outsourcing, out-tasking and contracting-out are lost.

Outsourcing may have evolved from the idea Ross Perot had when working for IBM on selling spare mainframe cycles to multiple customers. He started Electronic Data Systems in 1962 to provide computer bureau services, where the service provider had the hardware and would run a program or suite of programs for customers. This concept evolved into the current IT outsourcing model where customers sign a contract with a service provider for a variety of clearly defined IT services, usually for a fixed term and with defined service levels.

Out-tasking has many similarities with outsourcing, but typically out-tasking is limited to a subset of services. As an example, a customer may decide to out-task the router configuration management and monitoring while retaining all other aspects of service delivery. Out-tasking can be useful to access a very specific skill-set through the use of a third party.

Contracting out usually relates to a customer buying a workforce for a specific project. This contracted team is then managed by the customer who is responsible for the deliverables. For project work, where a short term boost in people and skills is required, this is a very useful method of obtaining additional staff.

There are two areas that cannot be outsourced – risk and accountability.

THE CHANGING ROLE OF THE CIO

In today’s market, there is strong pressure to improve the efficiency and effectiveness of business operations. CEO’s are facing the challenges of continuous revenue growth and honing their organisation’s agility and flexibility to rapidly address new or changing markets. For CIO’s, this translates into having an IT operation that can quickly be aligned to and support business goals.

“IT is no longer just about technology and support. It’s about business strategies and goals.”

To help create competitive advantage, CIO’s are expected to:

• Conceive and implement strategic initiatives that will deliver the desired business benefits
• Put in place appropriate disaster recovery strategies
• Ensure compliance with any legislative requirements

These challenges find CIO’s performing a delicate balancing act to manage the compromise between:

• Maximising return on investment from past strategic initiatives
• Freeing up a constrained budget to focus on critical new business initiatives and
• Retaining and motivating a workforce whose skills relevance is eroding on a daily basis
WHAT ARE THE CURRENT DRIVERS FOR OUTSOURCING?

Today, outsourcing is driven by:

- Having access to a skilled workforce
- A predictable and controllable consumption based fee schedule
- Focus on core business

Cost containment continues to be a key driver and many CIO’s outsource their legacy environments and use the cost savings to invest in new projects that would otherwise not receive funding.

“Most major outsourcing service providers have strong graduate trainee programs and global centres of expertise where they can tap into the best skills available.”

Access to a skilled workforce

In recent surveys, CIO’s have rated access to the required skills as one of their top challenges.

Most major outsourcing service providers have strong graduate trainee programs and global centres of expertise where they can tap into the best skills available, regardless of location. Of course, retaining skilled staff is also a challenge for service providers, but this is usually managed by providing rewarding long term careers and is offset by having sufficient employees with the necessary skills. Special programs to rapidly train staff in “hot” skills are also usually in place.

Predictable costs

In outsourcing, the amount charged is the service unit price multiplied by volume, which means the costs are controlled by the customer. Where significant changes in volume are anticipated, it is possible to pre-negotiate future volume discounts. This move to a variable cost basis is very attractive to many companies as much of the risk associated with consumption change is borne by the service provider. Outsourcing service providers are able to deliver these benefits to their customers by carefully managing peaks and troughs in demand, and through economies of scale achieved by providing services for hundreds or thousands of customers.

Focus on core business

The fiercely competitive market driven by globalisation has motivated many companies to determine what their core competencies are. Core competencies are often defined as those that are at the heart of the company and cannot easily be replicated. Non-core activities, by their very definition, do not materially impact the company’s differentiation or bottom line. Outsourcing of non-core activities provides many benefits, such as using savings from the transaction to invest in core activities and removing distractions from a company’s main focus.

These examples highlight different approaches to outsourcing:

A well established German manufacturing company is faced with increasing competition from low cost companies in other countries. The CEO is looking for immediate cost savings and for IT to reduce costs across the entire operation – not just IT expenditure.
The primary drivers are reduced costs and access to skills to assist with improving overall efficiency. Outsourcing can deliver the required savings as long as all aspects of the transaction are taken into account. These include cultural alignment and acceptance of off-shore service delivery while ensuring compliance with German data privacy and HR laws.

Another example may be a three year old Asian company that has had tremendous growth in the Asia Pacific region and is looking to compete in the global market as soon as possible. For them, cost savings are not important as they already have a low cost workforce. Their primary driver is developing a deep outsourcing arrangement with a global service provider that can assist them to grow rapidly. This outsourcing deal would be structured around variable pricing based on actual consumption, agreed service levels for deployment of systems and technology, standardised technology and assistance with the outsourcer owning the assets.

### The Choice Between A Single Service Provider or Multi-Sourcing

The decision about which sourcing model to choose, single service provider or multi-sourcing, needs to be made carefully and with consideration to both current business strategy and future initiatives. There are benefits and drawbacks associated with each sourcing model, some of which are discussed below.

**Outsourcing service providers are able to deliver cost benefits to their customers by carefully managing peaks and troughs in demand, and through economies of scale.**

### Multi-Sourcing Benefits

Multi-sourcing refers to an agreement where multiple service providers are chosen to supply various elements of a company’s outsourcing requirements. Typical benefits of the multi-sourcing approach are:

**Lower cost**

Going to the market for each IT segment usually leads to lower pricing per unit of service. It also allows niche players to bid for their specialist segments. While the unit costs are lower, the customer needs to take into consideration costs associated with multiple requests for proposal and ongoing governance.

**Shared risk**

Having more than one service provider in each area provides a level of comfort should one of them have financial or other difficulties.

**Improved service**

Knowing that work and revenue may move to a competitor often motivates service providers in a multi-sourced environment to provide a high level of service.

**Retained skills**

In a multi-sourced transaction, it is important to ensure that the scope is well defined and the rules of engagement between service providers are clearly understood. The customer needs to be an astute procurer of IT services and it may require a larger retained workforce in-house which may bid for services against service providers.
MULTI-SOURCING CHALLENGES

The downsides of a multi-sourcing approach include:

The customer acting as integrator

In order to manage conflict or disputes between service providers, the customer needs to act as integrator and overall manager of end-to-end service delivery.

Seam definition

To ensure clear and accurate accountability, there must be a clear definition of the boundary conditions or seams between the service providers and various functions. Issues often arise with regard to:

- Security responsibilities
- Service levels dependent on multiple parties
- Helpdesk systems
- Disaster recovery
- Project pricing

Governance overhead

The effective management of a multi-sourced environment requires higher levels of governance and greater depth of skill in order to manage the challenges that arise when competitors are vying for a customer’s business on a daily basis. It is also important to establish the ground rules with the internal business units to avoid service providers selling to them directly, which could negate many of the benefits of a centralised IT environment.

Outsourcing Procurement team

In order to multi-source effectively, a full-time outsourcing procurement team is necessary. Outsourcing contracts and approaches are continually being refined and the procurement team needs to be aware of the latest trends in order to maximise the benefits to the company.

SINGLE SERVICE PROVIDER BENEFITS

The predominant approach to outsourcing over the past two decades has been to have only one or a small number of service providers to complement the retained IT team. The benefits of single service provider sourcing include:

Clear accountability

In the words of an outsourcing account executive to a prospective customer, “you have only one throat to choke.” While an unfortunate turn of phrase, it certainly drives home the clear accountability associated with a single service provider environment.

Definition of scope

With a single service provider supplying, for example, all infrastructure and communication services, the scope and seams do not have to be as well defined. It is up to the service provider to manage the seams between their delivery organisation and the customer. If something is within the overall scope of the deal, then it is up to the service provider to ensure it is provided.

Fewer contracts

By definition, a single service provider environment will only have a single or very limited number of providers, resulting in only one or a few contracts.
**Governance**

A single or small number of service providers dramatically reduces the governance effort with fewer contracts and only a few relationships to manage. The service providers are not in competing businesses and so tend to work very well together. This environment also fosters a situation where the service provider manages contracts on behalf of the customer.

**SINGLE SERVICE PROVIDER CHALLENGES**

**Time**

When outsourcing to a single service provider for the first time, executives and management usually analyse the options and impact very carefully. The benefit of this approach is a collective understanding of the drivers for the decision and agreement on the options and choices, resulting in a smoother transition. The downside is that it can become a protracted decision making process.

**Governance**

Single service provider environments over the years have seen many customers developing “learned helplessness” as they allow the service provider to make more and more of the decisions related to IT. This can be detrimental to the customer and allows service providers to develop a locked-in environment where it is difficult to move to another service provider or take services back in-house.

**Skills**

Long term agreements on the correct contract terms protect customers by providing defined pricing and services into the future. The downside is that these contracts are only negotiated every few years and the customer sometimes does not have the skills or knowledge to maximise the deal.

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WHAT CAN BE OUTSOURCED?

Most aspects of IT can readily be outsourced to one or a number of service providers with good track records, but it is highly recommended that customers retain the skills necessary to control their strategy and direction, especially in the areas of technology and security.

When considering outsourcing IT, it is critical to ensure that decisions are not taken in isolation – they need to be aligned to overall company strategies and business goals.

Key questions that need to be answered **before** going to the market include:

- What are the buying criteria?
- How does this project link to other outsourcing initiatives?
- Which service providers would be unacceptable to the company?
- What is in-scope and what is retained?
- Would off-shore provision of services be acceptable?
- What skills are needed to govern the contract and relationship?

So, with a clearly defined strategy, how do customers decide what to outsource and what to keep?

All companies are different and the mix and match of services outsourced, retained, off-shored, contracted out etc., will depend on the company’s culture, overall business plans, maturity and, in many instances, location.

THE COMPLEXITIES OF OUTSOURCING VS. THE BENEFITS

Outsourcing is not easy. It is a complex process and requires significant effort to accurately define the scope and contents, as well as an understanding of current service levels and costs. While a daunting task, the benefit of achieving ongoing, sustainable savings can make outsourcing very attractive.

As for IT services, some areas can be more complex to outsource than others. As a general rule of thumb, the more discrete the part is, the easier it is to outsource.

Comparing the various kinds of services available, there are clear differences between them with regard to the complexity of the sourcing, ongoing management and benefits achievable. The savings from application outsourcing, for instance, are usually significantly higher than from outsourcing PC’s.

The diagram below depicts a generalised view of complexity and benefits for various IT areas.
Based on experiences from a large number of outsourcing projects, there are two important lessons to be learned:

• The first is to do a comprehensive preparation before going to the market so that the expectations and service levels are clearly defined.
• The second is the need to communicate and engage the rest of the organisation to ensure they are part of the outsourcing journey. By knowing the reasons for the decisions and how it is likely to impact them ahead of time, they are more likely to support the initiative.

Any area considered for outsourcing must be adequately defined such that there is a very clear understanding of:

• What services are being provided by the service provider
• What services are retained
• What service levels will apply
• Who owns the licences
• How change will be managed
• What is included in the base price
• The impact of other service providers

OFFSHORE RESOURCES

Almost every day, there are references in the media to companies taking advantage of IT skills offshore and moving services to India and other low cost locations. While there are benefits to be enjoyed, there is also an increased risk profile when using offshore resources. This is an area where customers need to be very clear on what is being delivered and from where.

Challenges to consider

The use of an offshore service provider or resources involves a number of challenges, including:

• Issues of data privacy
• Knowledge transfer (especially getting it back!)
• Legal jurisdiction
• Cultural acceptance
• Political pressure
• Governance
• Service provider team structure (%offshore vs. %onshore)
• Service provider turnover rates

Many of the larger outsourcing service providers have well established, low cost centres around the world and have integrated their use into their overall delivery model.

“Comprehensive preparation and open communication with the whole organisation are key to successful outsourcing projects.”

“The benefit of achieving ongoing, sustainable savings can make outsourcing very attractive.”
RECOMMENDATIONS FOR SUCCESSFUL OUTSOURCING

Successful outsourcing transactions do not happen by accident. In order to improve the chances of success, we make the following recommendations:

Alignment with business strategy

It is important that the decision to outsource is made in the context of the entire business strategy. By aligning to business strategy, the appropriate controls and intent can be bound into the contract. As an example, if a company intends to grow through an aggressive acquisition strategy, it would be appropriate to ensure the pricing tables take the planned growth into account. Similarly, if there is an expectation that the service provider will perform significant integration projects, then a service provider with those skills should be selected along with terms and conditions around lead times, project pricing mechanisms, etc.

By aligning the outsourcing decision to the strategic plan, the executive management team become committed to the project and support it “with one voice”. Management commitment is vital to the success of outsourcing transactions.

Timeframes

Outsourcing is complex. It is essential to provide sufficient time for the project rather than choose a date and define it as a deadline that must be met. A myriad of options and challenges need to be worked through in keeping with the unique aspects and requirements of a company. A less than optimal agreement can be signed quickly, but could leave the customer severely disadvantaged.

Communication

When impacted employees hear about outsourcing for the first time, they invariably go through a range of negative emotions. In order to sustain productivity, it is important to communicate with the entire organisation and ensure they are aware of decisions as they are being made. All too often, only employees involved in the outsourcing project receive information. Without open communication, it is common for other parts of the organisation to suspect that their functions will also be outsourced in the near future. This can result in a loss of productivity and increased management effort to refute the “rumour mill”.

Culture

Outsourcing transactions typically run for several years, sometimes up to a decade. It is important the parties can work effectively together over the entire life of the contract. By selecting a single service provider or multiple providers that complement their corporate culture the chance of success is maximised. Without cultural compatibility the best outcome that can be hoped for is a strictly transactional relationship, which rarely allows customers to tap into the wealth of services and depth of skill service providers have available.

“ It is essential to provide sufficient time for the project rather than choose a date and define it as a deadline that must be met.”
The outsourcing landscape has evolved significantly over the past decades. In the early days of outsourcing, the high capital costs of the equipment made outsourcing an attractive option. Today, it’s the ability to attract and retain critical skills combined with flexibility that make the difference.

The ability to access the necessary skills when needed, coupled with a known and predictable pricing regime at agreed service levels, make outsourcing a very useful business tool.

Well executed outsourcing transactions can reduce costs, improve service levels, free up capital, offer access to critical skills and can provide the vehicle to enter global markets more quickly and with limited exposure.