# Information Technology Outsourcing

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# Executive Summary

- Outsourcing – refers to the practice of contracting with another company to purchase certain services that may ordinarily be provided in-house.
  - Advantages
    - cost savings,
    - improved efficiency and productivity,
    - fewer headaches for IT managers.
  - Drawbacks,
    - hidden costs
    - loss of control over outsourced business processes

# A little History

- IT services are among the many kinds of services being outsourced today by businesses and the government.
- Primary Drivers:
  - Initially, cost savings
  - More recently to allow companies to focus on their core competencies
  - Shortage of Skilled personnel primarily in Network and Security
- Outsourcing was first practiced in the early 1990s, but has gained significant momentum since, especially within the financial industry.

# Just How Big Is It

- J. P. Morgan Chase recently signed a seven-year $__________ deal with IBM.
- Bank of America inked a 10-year, $___________ contract with EDS.
- Canadian Imperial Bank of Commerce signed a $__________ agreement with Hewlett-Packard
- US Federal IT outsourcing should hit $15 billion annually by fiscal 2007, a 127 percent increase over the $____________ spent in 2002
- Fueled by cheaper programming labor, offshore outsourcing, estimated at $4 billion in 2000, is expected to jump to an astronomical $___________ by 2015.

# Just How Big Is It

- J. P. Morgan Chase recently signed a seven-year $ 5 billion deal with IBM.
- Bank of America inked a 10-year, $4.5 billion contract with EDS.
- Canadian Imperial Bank of Commerce signed a $2 billion agreement with Hewlett-Packard
- US Federal IT outsourcing should hit $15 billion annually by fiscal 2007, a 127 percent increase over the $6.6 billion spent in 2002
- Fueled by cheaper programming labor, offshore outsourcing, estimated at $4 billion in 2000, is expected to jump to an astronomical $136 billion by 2015.

# Types Of Outsourcing

## Out-tasking

- J.P. Morgan Chase may have captured media attention, but the practice has lent itself toward smaller, more selective outsourcing contracts. This approach toward outsourcing is called out-tasking. Out-tasking agreements reflect the frustrations among some clients with long term agreements that typically fail to account for changing market conditions or anticipated cost savings, or do not provide specific, measurable performance, such as cost of services per desktop.  In summary out-tasking agreements focus on specific, rather than a broad range of IT functions

# Types Of Outsourcing

## Co-sourcing

- On some large contracts multiple outsourcing partners work collaboratively to provide complete services. This type of outsourcing deal is called co-sourcing. The primary issues with co-sourcing are the establishment of clear, precise areas of responsibility by each of the providers.

## Gainsharing

- When an outsourcing provider shares in the client's resulting profitability it is called gainsharing. Client companies negotiating gainsharing contracts believe that outsourcing vendors with interest in the profits have more of an incentive to provide good, cost-effective service – a very difficult contract to negotiate

# Types Of Outsourcing

**Application Service Providers (ASPs)**

Application Service Providers are also changing the shape of the outsourcing market…again.

By hosting applications at remote data centers and enabling them to be accessed over the Internet or a VPN, ASPs free customers from the burdens of managing IT systems in-house.

ASP Advantages:

- Secure Facilities
- Shared Software
- Economical Data Stores
- Skilled Administration
- 7X24 Support

# Types Of Outsourcing

## Managed Services Provider (MSPs)

Instead of providing application access, the MSP assumes responsibility for critical services, such as security monitoring. MSPs are popular in those environments where skilled personnel are in short supply, or where the cost of providing services in-house would require significant capital investment.

# Issues to Consider

**Vendor Flameouts**

- If software development is part of the contract, include <u>a source code escrow provision</u> that ensures a neutral third-party has access to all software source code and updates.
- Insist on lifting any restrictions relative to hiring vendor personnel <u>if an outsourcer shutdown appears imminent</u>.
- <u>Update the organization's business continuity plan</u>, identifying a list of alternate suppliers, and developing a transition strategy that minimizes service disruption and switchover costs

# Issues to Consider

**Data Control**

- Liability cannot be outsourced. If customer data is compromised, both the outsourcing company and the outsourcing client will be held responsible.

**Personnel Policies**

- Let the employees know what is happening and communicate with them regularly. If word of a deal "leaks out," the company is likely to start hemorrhaging staff, including vital personnel.
- Develop incentives to retain key technicians and managers during the outsourcing transition period.
- Encourage staff members to reexamine their skills and abilities in light of the outsourced environment.

# Issues to Consider

**Hidden Costs**

- Finding a vendor and writing the contract is a significant cost – don’t ignore it. Average is about three percent of total outsourcing expense.
- Some transition costs are hard to quantify. It usually takes about a year for a vendor to wean itself from dependency on in-house technical staff.
- Managing the contractor costs an average of $300,000 annually.
- To help mitigate these costs, Barthelemy advises the following:
  - Do not outsource critical or idiosyncratic activities.
  - Spend a great deal of time researching vendors.
  - Hire managers with outsourcing experience.

# Issues to Consider

## Offshore Outsourcing

- Increasing in popularity (lower labor cost) but there are many warning flags
  - Diplomatic tension
  - Distance – difficult to communicate change in scope
  - Requires RIGID design specifications

## Buyer's Remorse

- Most likely the product of unrealistic expectations or unclear contract definitions
  - Outsourcer delivers disappointing results
  - both the client and the outsourcer disillusioned, often by the end of the first year.

# Analysis

To realize the benefits of IT outsourcing, it is important to define goals and strategies:

- Carefully weigh the advantages, disadvantages, and costs.
- Negotiate a fair and flexible contract.
- Establish an infrastructure and an employee team to monitor the relationship between the client and the outsourcer.

# Outsourcing Advantages

**Advantages**

- Outsourcing can offer substantial cost savings.
- Often, outsourcing contracts include the takeover of the clients' computing infrastructure and staff by the outsourcing vendor. Savings:
  - fewer staff members
  - less training,
  - Facilities and equipment reduction for ASP and MSP,
  - a more immediate value is the ability to **deduct outsourcing fees as a current business expense** rather than an expense that must be depreciated over a number of years.

# More Advantages

- Allows the remaining IT staff to concentrate on core competencies.
  - IT services that contribute to competitive leadership should not be outsourced
- Avoids large capital investments in technology that will become obsolete.
- Focuses IT efforts on strategic business objectives.
- Outsourcer has people readily available with the requisite scarce skills and knowledge.
- Outsourcer can more readily bring state-of-the-art technology to a ministry.
- Offload routine, high-cost services such as application maintenance.

# More Advantages

- Overcome inability of the internal IT organization to provide the required levels of service.
- Outsourcer is adaptable to changing market conditions.
- Outsourcer can provide services across large geographic areas, or even globally.
- Respond effectively and efficiently to an increasingly complex, distributed IT environment.
- Stabilized overhead costs.
- Shared risk through co-sourcing.

# Disadvantages

Outsourcing is not the panacea for IT shortcomings.

- Many companies have found that the projected cost savings from outsourcing were overstated, after they were already locked into an inflexible contract.
- Companies have found that they must set up an internal contract management team to oversee the agreement
    - They can focus on the agreement, avoiding oversights
    - It makes the process run more smoothly.

# Disadvantages

**Outsourcing may not be the wisest option to pursue if it:**

- Negatively affects mission-critical systems.
- Does not contribute to the ministry's objectives.
- Is not based on internal ministry and IT priorities.
- Lessens control over strategic IT services.
- Negatively influences staff performance.

# Disadvantages

Short-term outsourcing gains can become long-term liabilities.

- ❖ Declining morale of remaining staff.
- ❖ Loss of highly skilled, talented employees.
- ❖ Failure to resolve conflict among multiple vendors.
- ❖ Generation of unrealistic expectations among all parties.
- ❖ Outsourcing vendor's lack of knowledge about the ministry
- ❖ Getting locked into complex and inflexible contracts.
- ❖ Losing control of IT services to the outsourcing vendor.
- ❖ Becoming the outsourcers guinea pig for unproven technology.

# Analysis - EVA

## Economic Value Added

- One of the primary benefits of outsourcing is to defer capital investment.
  - Example: Outsourced network management functions eliminates the procurement/upgrade of expensive network management equipment.
- In evaluating the return of investment for outsourcing, some organizations are employing the Economic Value Added (EVA) method.
  - EVA subtracts the "capital charge" (the capital investment times the cost of capital) from the net financial benefits.

# Analysis – More EVA

EVA Example:

- A service generates $200,000 per year in net benefits.
- Performing the service in-house requires a $1 million capital investment for hardware and software.
- Outsourcing the service costs $80,000 per year.
- Performing the service in-house costs $60,000 per year.
- **In-house EVA** = $200,000 in net benefits - $120,000 in capital costs ($1 million x 12% cost of capital) = $80,000 EVA
- **Outsourced EVA** = $200,000 in net benefits - $0 in capital costs - $80,000 in outsourcer fees = $120,000 EVA

*Source: John Berry, "EVA shows outsourcing's payoff,"* Computerworld.

Looking strictly at the operations costs ($60,000 inside versus $80,000 outside), the service should be in-sourced.

Looking at the economic value added, however, ($80,000 inside versus $120,000 outside), it is clear the service should be outsourced.

# Recommendations

- **Five Rules**

1. Be sure to include ALL the costs of preparing the outsourcing agreement
   - the cost of an experienced, highly-skilled in-house contract management team
   - the costs accrued throughout the definition of the agreement.
2. Don't forget the value of money over time.
   - Immediate financial gains can be eroded over time due to inflation.
   - Use calculations like net present value or shareholder value analysis to determine the true payback over a specific time period.

# Recommendations

3. Do not ignore the intangible pros and cons of an outsourcing agreement.
   - ❖ Try to associate a dollar value to each one or at least factor in their impact on a "hard dollar" item.
4. Account for some incremental rise in services.
   - ❖ A well-considered risk analysis can help anticipate probable changes and their effects.
   - ❖ Avoid assuming a steady level of services.

# Recommendations

5. The single largest failure of an outsourcing agreement:  “We didn’t AND the contract”
   - Form an experienced and knowledgeable outsourcing management team to represent the interests of the organization affected by the outsourcing agreement. This will help ensure that all the major technical, operational, and business issues are accounted for in the cost/benefit analysis.

# Recommendations

5. The single largest failure of an outsourcing agreement:  "We didn't read AND understand the contract"
    - Form an experienced and knowledgeable outsourcing management team to represent the interests of the organization affected by the outsourcing agreement. This will help ensure that all the major technical, operational, and business issues are accounted for in the cost/benefit analysis.

# Recommendations

## Five Steps

- **Prepare To Outsource**
  - **Determine ministry priorities**
  - **Know what you have (infrastructure, hardware, software)**
  - **Evaluate vendor options - gather intelligence about them**
  - **Know what you want – analyze your needs then establish SLA requirements,**
- **Craft the Contract Yourself**
- **Choose an Outsourcing Partner CAREFULLY**
  - **Experience is critical (stability, technical expertise, responsiveness)**

# Recommendations

- **Lay the Groundwork**
  - Avoid inflexible contracts
  - Demand SLA's
- **Develop an Exit Strategy**
  - Insert an escape clause
  - Know where you want to go before you exit