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Research

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Avoiding Outsourcing Problems, Part 1

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Outsourcing users can minimize or avoid major outsourcing problems by adhering to some basic principles when the outsourcing contract is negotiated.

ANALYSIS

There are a few essential rules or principles that users should follow when structuring an outsourcing deal. They are critical to avoiding problems later on when services or projects have been transferred to the external services provider (ESP).

Set realistic expectations. ESPs are neither magicians nor miracle-makers. If the internally provided IS operations that are transferred to the ESP have been poorly managed and inefficiently run, it will take time for the vendor to understand and stabilize operations, and put management processes in place. In the best of circumstances, it will take the ESP about six months. For outsourcing that includes a broad array of services or many unique user sites, this process may take 12 months. If substantial change activity (e.g., migrating to Windows NT or implementing SAP) is to take place at the same time, then the time frame when one can expect a truly stable and predictable environment could take even longer.

The ESP should be able to reach the "finish line" faster than could be done on an exclusively in-house basis, but keep in mind that the ESP has the same hurdles to jump and the same distance to run to get there. Users should be wary of any ESP competing for their business that promises a quick fix to a long-term problem. If a fast and effective solution was truly available, the chances are that either the internal IS organization or other ESPs would also know about it.

Recognize that fixed prices have short life spans. Do not insist that the vendor commits to a fixed price for services in a long-term contract (three or more years). Although it may be counter to common thinking, experience has shown that the longer the price is fixed, the bigger the risk. As the environment changes and requirements change, the ESP's costs may change and pricing may need to change. Outsourcing cannot be treated as a one-time purchase. Users will depend on the vendor they select for ongoing services over a period of years.

If the vendor is locked into a contract for services at a price that can no longer return profits, users will find themselves with a very inflexible services supplier or extensive billings for work done out of the contract's scope. Conversely, the fixed price the user originally negotiated may, over time, be significantly higher than new market rates. The vendor may be reluctant to adjust the contracted price downward. Therefore, the longer the contract term, the greater the need for a contract mechanism that tracks and adjusts pricing to current market conditions.

Do not focus negotiations and the negotiators on price alone. Price and pricing methodologies can easily consume the majority of the negotiator's time and attention. Although a thorough analysis of pricing is essential (see ESP *Research Notes* SPA-OUT-241 and SPA-OUT-242, April 4, 1997), it is only one of many elements of service delivery that will determine if the relationship is a success or failure. In large outsourcing deals, the ESP's negotiators will work as a team, with each team assigned to its area of specialty (e.g., sales, financing and technology). Adapt the same approach to the internal team that is evaluating competing vendor bids. Each aspect of the potential relationship will then receive the amount of attention and depth of analysis it requires (see Note 1). Further, the vendor will be required to work a bit harder at structuring a proposal that addresses the complete scope of user requirements.

Contracts for full life cycle services should be staged to avoid lock-in to a vendor that performs poorly. Many ESPs are hired to provide the resources and skills needed to undertake large applications development projects and implement major systems transitions. A logical extension of the ESP's effort is for it to maintain those applications and systems once they are in production mode. Even if this full life cycle approach is desired by both the vendor and user, resist entering a binding contract for all phases (build and then maintain) of the work right away. If the vendor does a poor job in the development and implementation phase, it is unlikely that the user would want the vendor to continue. Build checkpoints in the contract where the deal can be reviewed, adjusted or put out for competitive bid.

Bottom Line: Many of the major and frequently nonrecoverable problems typical in ESP relationships can be minimized or avoided by taking the proper safeguards when the deal is negotiated. Enterprises are urged to be realistic about what an ESP can achieve, keep price in balance with other requirements, and gear the overall length and work phases of the contract to reasonable planning horizons.

Core Topic

IT Management: Selecting, Negotiating and Managing Outsourcers

Key Issue

What are the critical success factors in an outsourcing agreement?

Strategic Planning Assumptions

By 2000, use of ESPs for IT functions will be viewed as a routine mechanism for 80 percent of organizations wishing to stay competitive or gain access to new skills (0.9 probability).

By 2000, 80 percent of users will combine collective experience and rigorous procedures for negotiating ESP deals (0.7 probability).

Length of Outsourcing Contracts

For any ESP deal, do not commit to a longer-term contract than is necessary. It is in the vendor's interest to entice an enterprise into the longest-term contract possible. Although all contracts should provide for early termination by the enterprise, exiting a contract early can be disruptive and expensive. If business and IT requirements cannot be reasonably forecast for five, seven or 10 years from now, then what is the likelihood that a contract negotiated today will satisfy requirements that are far ahead in time? Enterprises should fit the length of the contract as closely as possible to their IT and business planning horizon.

Associated Research Note

For additional information, see ESP *Research Note* TU-OUT-264, July 17, 1997.

Note 1

Areas of Specialty for Negotiating Team

- *Evaluation of ESP*
- Interview references provided by vendor
- Assess market position and strategy of vendor
- Check external sources of expertise
- Evaluate financial position of vendor
- Interview key members of vendor's staff
- *Service Levels*
- Define performance metrics for each service

- Set baseline/minimum for each service
- Customize for different business units
- Define process for adjusting target
- Establish escalation procedures and penalties for poor performance
- Identify key components and frequency of performance reports
- *Pricing*
- Evaluate bid for competitiveness
- Determine billing practice (currency and frequency)
- Set schedules for different levels of demand or levels of service
- Establish processes for tracking/ benchmarking price
- Set procedure and boundaries for pricing adjustments
- Define escalation process for pricing disputes
- *Organizational Structure*
- Determine internal resources needed to manage ESP
- Define roles and time commitments required
- Identify internal individuals to fulfill each role
- Identify vendor counterparts
- Establish formal routine communication process and (nonroutine) escalation procedure

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