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True or False: Outsourcing Saves Money

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Outsourcing is widely perceived as a way of reducing IS costs. We investigate and derive surprising conclusions.

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ANALYSIS

Many enterprises consider outsourcing part or all of their IS department as a way of reducing IS costs. Extensive research among our clients reveals that enterprises must exercise extreme caution before making this assumption. We have uncovered five factors that challenge the theory that outsourcing saves money:

Factor 1: Benchmarking. Benchmarking studies reveal that enterprises can compete with outsourcers on a cost basis. Benchmarking firms maintain databases that compare the cost efficiency of IS departments. As outsourcing companies enter data into the benchmarking databases, it has become apparent to benchmarking professionals that the best IS departments are at least as cost-efficient as a good outsourcer. Yet, this does not mean that all IS departments can achieve the same high levels of cost efficiency. Users should take a benchmark first to see if savings are likely. The benchmarking firm may offer users tactics to reduce costs themselves, obviating the need to outsource.

Factor 2: Change. Many (perhaps the majority) of our clients report that they do not know whether they saved any money in outsourcing deals. The usual reason is that the original contract predicated savings against the budget over several years. That budget was, in turn, based on a capacity plan and other business assumptions. Accordingly, the outsourcing contractor predicated their charges on those assumptions. After 12 to 18 months, many of the assumptions have turned out to be inaccurate. In some cases, capacity has far exceeded expectations, users have wanted changes in the services, expected benefits from new technologies have not materialized, and business needs have changed. Further, the organization's IT plans may have changed dramatically, due to the vendor's suggestions. The result, in these cases, is that total actual spending is far in excess of budgeted spending. This unpleasant outcome can be avoided by structuring deals around unitary prices, such as cost per MIPS, cost per server, cost per end user and costs to be monitored independently from volume. At minimum, this will reduce unit costs, even if total costs are greater than original forecasts.

Factor 3: Experience. After a year of client feedback, we can report that approximately 20 percent of enterprises claim demonstrable cost savings have resulted from their outsourcing contracts. Enterprises that have been outsourcing for several years often report that they received other unexpected benefits from outsourcing, such as increased flexibility, better service levels, better skills and better management of end users.

Factor 4: Economies of Scale. The main source of cost savings from outsourcing is usually economies of scale. The enterprise's resources, staff and premises are added to the vendor's larger infrastructure, and savings result from rationalization of those resources, staff and premises. This does not always work. Enterprises' premises, hardware and software may have leasing or other contractual arrangements that are punitive when taken over by the vendor. These added costs make rationalization difficult or delay implementation. Occasionally the customer's demands regarding retention of existing employees makes the cost of shedding superfluous staff high or inhibits cost savings in this area. Enterprises should investigate these factors in great detail before assuming that outsourcing can save them money.

Factor 5: ESP Vendor Behaviors. An outsourcing vendor has no motivation to reduce costs unless it is clearly demanded in the contract. Its duty to shareholders is to sell more services to the user. In most cases, external services providers (ESPs) will do that zealously. After an outsourcing contract has been signed, the vendor may send salespeople into end-user departments to sell additional services, ranging from higher-quality operational support to systems integration contracts and consultant services. This is acceptable, provided the executive team is ready for it. They must ensure that new services are delivered outside of the original

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contracted budget and paid for by the end users who ordered them. If not, the contract's cost can spiral and all parties will be confused, since there is no clear definition of the services. Enterprises should employ effective change management of the contract to ensure that this spiral does not happen.

Bottom Line: Enterprises should not assume that outsourcing will save money. Savvy users should employ audits, benchmarks and effective costing techniques to determine if they are outside acceptable performance ranges. Only if they are operating at a disadvantageous cost level should they take action to investigate outsourcing if their primary goal is to reduce internal costs. They should first determine if savings can be made by independent action within their IS department. If experience shows that it is unlikely, then they should seek the assistance of an outsourcer.

Core Topic

IT Management: Selecting, Negotiating and Managing Outsourcers

Key Issue

What are the critical success factors in an outsourcing agreement?

Strategic Planning Assumption

By the end of 1997, teams comprising end users, purchasing specialists and IT staff will develop processes to enforce terms and conditions of outsourcing contracts. Service-level agreements are reinforced with benchmark data at regular intervals (0.3 probability).

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