

The ABCs of Outsourcing

A Need to Know Guide on Outsourcing.

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What is outsourcing?

There are as many definitions of outsourcing as there are ways to screw it up. But at its most basic, outsourcing is simply the farming out of services to a third party. With regards to information technology, outsourcing can include anything from outsourcing all management of IT to an IBM or EDS to outsourcing a very small and easily defined service, such as disaster recovery or data storage, and everything in between.

How is outsourcing priced?

There are various ways to structure pricing within an outsourcing contract, including:

Unit pricing: The vendor determines a set rate for a particular level of service, and the client pays based on its usage of that service. For instance, if you're outsourcing desktop maintenance, the customer might pay a fixed amount per number of desktop users supported.

Fixed pricing: The customer pays a flat rate for services no matter what. Paying a fixed price for outsourced services always looks good to customers at first because costs are predictable. And sometimes it works out well. But when market pricing goes down over time (as it often does), a fixed price stays fixed. And suddenly it doesn't look so good. Fixed pricing is also hard on the vendor, who has to meet service levels at a certain price no matter how many resources those services end up requiring.

Variable pricing: This means that the customer pays a fixed price at the low end of a supplier's provided service, but allows for some variance in pricing based on providing higher levels of services.

Cost-plus: The contract is written so that the client pays the supplier for its actual costs, plus a predetermined percentage for profit. Such a pricing plan does not allow for flexibility as business objectives or technologies change, and it provides little incentive for a supplier to perform effectively.

Performance-based pricing: At the opposite end of the spectrum from cost-plus pricing, a buyer provides financial incentives that encourage the supplier to perform optimally. Conversely, this type of pricing plan requires suppliers to pay a penalty for unsatisfactory service levels. This can be tricky to pull off successfully, but is becoming more popular among outsourcing customers, dissatisfied with performance in their previous forays into outsourcing.

Risk/reward sharing: With this kind of arrangement, the customer and vendor each have some skin in the game. Here, buyer and supplier each have an amount of money at risk, and each stands to gain a percentage of the profits if the supplier's performance is optimum and meets the buyer's objectives. The buyer will select a supplier using a pricing model that best fits the business objectives the buyer is trying to accomplish by outsourcing.

What is an SLA?

A service level agreement (SLA) is a contract between an IT services provider and a customer that specifies, usually in measurable terms, what services the vendor will furnish. Service levels are determined at the beginning of any outsourcing relationship and are used to measure and monitor a supplier's performance.

Often, a customer can charge an outsourcer vendor a penalty fee if certain SLAs are not met. Used judiciously, that's an effective way to keep a vendor on the straight and narrow. But no CIO wants to be in the business of penalty charging and collecting. Bad service from an outsourcing vendor, even at a deep discount, is still bad service, and can lead to greater problems. It's best to expend that energy on finding out why the SLAs are being missed in the first place and working to remedy the situation.

What is the best length for an outsourcing contract?

What's the best length for a skirt? While the outsourcing industry is not quite as fickle as fashion, the prevailing wisdom about the best length for an outsourcing contract has changed over the years. When outsourcing first emerged as a viable option for providing IT services and support, long contracts—as many as 10 years in length—were the norm. As some of those initial deals lost their shine, clients and vendors began to look at contracts of shorter duration.

So what is the best length for an outsourcing contract? As with most other questions about outsourcing, the answer really depends on what's being outsourced and why. A transformational outsourcing deal will require more time to reap benefits for both client and vendor and therefore must be structured as a longer-term contract. But when outsourcing desktop maintenance or data center support, a shorter relationship may work better. Generally speaking, overly long contracts (more than seven years) are frowned upon unless there is a great deal of flexibility built into the contract.

How do I decide what vendor or vendors to work with?

Selecting a service provider is a difficult decision. But start by realizing that no one outsourcer is going to be an exact fit for your needs. Trade-offs will be necessary.

To make an informed decision, you need to articulate what you want to gain from the outsourcing relationship and extract from that your most important criteria for a service provider. It's important to figure this out before soliciting any outsourcers who will undoubtedly come in with their own ideas of what's best for your organization, based largely on their own capabilities and strengths.

Some examples of the questions you'll need to consider include:

- What's more important to you: the total amount of savings an outsourcer can provide you or how quickly they can cut your costs?
- Do you want broad capabilities or expertise in a specific area?
- Do you want low, fixed costs or more variable price options?

Once you define and prioritize your needs, you'll be better able to decide what trade-offs are worth making.

What do I need to know about the transition period?

Vantage Partners calls the transition period—during which a new provider's delivery team is getting up to speed on the buyer's business, existing capabilities and processes, expectations and organizational culture—the "the valley of despair." During this period, the new team is trying to integrate transferred employees and assets, begin the process of driving out costs and inefficiencies, while still keeping the lights on. Throughout this period, which can range from several months to a couple of years, productivity very often takes a nosedive.

The problem is, this is also the time when executives on the client side are looking most avidly for the deal's promised gains; business unit heads and line managers are wondering why IT service levels aren't improving, and IT workers are wondering what their place is in this new mixed-source environment.

IT leaders looking to the outsourcing contract for help on how to deal with the awkward transition period will be disappointed. The best advice is to anticipate that the transition period will be trying and attempt to manage the business side's expectations and set up management plans and governance tools to get the organization over the hump.

How important is ongoing relationship management to outsourcing success?

The success or failure of an outsourcing deal is unknown on the day the contract is inked. Getting the contract right is necessary, but not sufficient for a good outcome. One study found that customers said at least 15 percent of their total outsourcing contract value is at stake when it comes to getting vendor management right. A highly collaborative relationship based on effective contract management and trust can add value to an outsourcing relationship. An acrimonious relationship, however, can detract significantly from the value of the arrangement, the positives degraded by the greater need for monitoring and auditing. In that environment, conflicts frequently escalate and projects don't get done.

In their book, "Multisourcing," Gartner analysts Linda Cohen and Abbie Young point out that successful outsourcing is built on "a network of relationships not transactions," and outsourcing governance is the single most important factor in determining the success of an outsourcing deal. But many companies still haven't internalized that truth. Gartner found that fewer than 30 percent of enterprises will have formal sourcing strategies and appropriate governance in place. In a 2004 survey of 130 CIOs, 42 percent said they were dissatisfied with their outsourcing relationships, according to outsourcing advisory company EquaTerra, primarily due to poorly developed, underbudgeted and undersourced governance models.