Outsourcing
(IT and anything)

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September 2004

This Session
Is about how businesses obtain and manage resources

• Background to Outsourcing:
  • Components of a Business
  • InSourced functions
  • Costing of functions and services

• Basic Rules for Outsourcing

• Outsourcing of IT
  • Rationale
  • Process
  • Saving Costs
  • Ensuring Value

Background to Outsourcing

• Definition:
The transfer of an in-house function and the associated
resources to an external service provider.

Business Functions

• What's done in-house?
• Why?
• Examples?

Costing of in-house services

Company X owns its head office, a multi-story office block in an
inner city location, and all of its staff and operations are
accommodated in the building.
The Company distributes all of its costs to its products, so that it
can assess their underlying profitability.

Questions:
What cost should be used for the cost of accommodation in the
product costing:
• Zero?
• The operational costs (rates, power, light, maintenance)?
• A nominal rental?
• The same rental rate as other nearby commercial buildings?
• The opportunity cost of capital for the value of the building?

Should X continue to own the Building?

The decision to outsource

Considerations:

– Complexity of the function
– Importance to the survival of the Business
– Is the function stable and under good management control
– Is there a change agenda for the company? For the function?
– Can the function be outsourced
  • Is there a company available to take on the task?
  • Can it be disentangled from other strategic functions?
  • Is there a competitive market?
    • Will there be price competition?
    • Will there be scale-economies?
Summary: Basic Rules

- Only Outsource functions which are:
  - Low complexity
  - Low strategic importance

- Functions must be stable, well understood
  - Under managed control
  - not subject to change

- There must be an external market for the services
  - Improved service delivery from specialist Firms
  - Scale economies
  - Price competition

?Question

- A company has decided to implement a new customer management strategy. By understanding the history of previous customer dealings, sales efforts will be targeted to the high value customers.
  - A new database of information on all past and existing customers is to be created, and data collected and loaded:
    - Customer details
    - Business name, location, contacts, personnel
    - This data will then be linked to a history of interactions
    - Sales order, services, queries
    - Billing transactions

- Should the company outsource:
  - The database technology platform?
  - The customer data collection and management?

Outsourcing IT

Why Outsource?

- Saves management effort
- Meet Market expectation for focus on core business
- Save cost
- Change culture
  - More accountability for use of services
- Convert direct, fixed costs to variable
  - transfer volume risk to Outsource provider
  - Capex to Opex

Outsource what?: Lifecycle

Outsource what?: Accountabilities
Outsourcing: impact on Lifetime Costs

Ballpark Lifecycle costs for a business IT platform
- Initial Investment: about 50%
- Lifetime Maintenance & Operations is the other half
  - Maintenance: 10-30%
    - support
    - Bug fixes
    - Technology currency
  - Operations & Facilities Management: 20-30%

Conclusions:
- Outsourcing can only impact about half of the IT lifecycle cost
- How significant?

Many operational costs are locked in by the initial system design

Typical outsource commercial process

- Stages:
  - Prepare a Tender 4 weeks min.
    - Scope
    - Service Stds
    - Financial Model
    - Survey market (Suppliers)
  - Supplier interactions 8 weeks min
    - Iterative
    - Leads to proposal
    - Shortlist
  - Due Diligence (by all parties) 6 weeks min
    - Negotiation
    - Decision process
  - Implementation 10 weeks min
    - Contract signed
    - Staff transitions
    - Asset transfers, etc
    - Client Work Ordering process

- It takes time
- A multi-function team is required

Controlling the Outsource Provider

Client will require leverage over the Provider.
- You cannot contract "happy"

Options:
- Non exclusive deal
- Term of the contract
- Technology change risk
- Business change risk
- Termination rights
- "At Risk" portion of fees
- Subject to Service levels
- Bonus structure related to business outcomes or over achievement
- Incentives to Key personnel
- Sales incentives to senior executives
- Staff churn as a Service Limit
- Control Rights
- Location of work
- Subcontracting
- Technology & Architecture
- Benchmarking
Saving Cost: the IT dilemma

- Only 3 ways to save money:
  - Do less work
  - Get cheaper resources
    - Anyone for India? China? Russia?
  - Increase productivity
    - work better & smarter
    - do the right things only

Saving Cost: Doing Less Work

- Risk of Failure
  - Less than half of IT systems projects succeed
    - (define succeed)
- Business Change costs are significant
  - For a new transforming IT system, can be about the same as the IT investment
- Lifecycle IT costs are committed in the initial design
  - Maintenance & Support is roughly 25% TLC
  - Facilities & Operations is roughly 25% TLC

Messages:
- Upfront business case work is critical
- “Do the right work”

Saving Cost: The Off Shore Rationale

- Educated middle classes in emerging economies provide cheap labour
  - India, Philippines, Russia, China etc.
- Offshore labour cost is about 20-30% of US/Aus market
  - $200/day offshore vs $900/day onshore
- Engagement model is:
  - Customer contact functions are performed onshore at local rates:
  - sales, specification, implementation
  - IT functions are performed offshore at offshore rates:
  - design, build, test, maintain & enhance
- The Offshore Business Case depends on the split of work
  - Legacy systems go offshore quite readily:
    - 80/20 Offshore Onshore delivers 50% savings
  - New systems and COTS packages have high onshore component
- Issues are:
  - Cultural differences
  - Cost of transition of poorly documented systems
  - Change to new IT Delivery Methodology for offshore delivery
Saving Cost: Lifecycle Breakdown

<table>
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<th>IT System Life Stage</th>
<th>Percent</th>
<th>Outsource</th>
<th>OffShore</th>
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<tbody>
<tr>
<td>Concept &amp; Feasibility</td>
<td>5%</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Investment Decision</td>
<td></td>
<td>No</td>
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<tr>
<td>Deliver new System Services (Labour)</td>
<td>about 25%</td>
<td>about 15%</td>
<td>about 5%</td>
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<td>Hardware</td>
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<tr>
<td>Ops &amp; Facilities Management</td>
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<tr>
<td>Application Maintenance</td>
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<tr>
<td>Total</td>
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</tr>
<tr>
<td>Decommission</td>
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<td>Yes</td>
<td>Yes</td>
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Getting Value from Outsource Providers

Basic Outsource Delivery structures

- Fixed price for all work:
  - Define scope (somewhat)
  - Have ins/outs process
  - Live with the fuzzy edges

- Time & Materials:
  - Simplest
  - Client carries ALL RISK - forces client to manage

- Output based (price per business deliverables/outcomes):
  - Flawed - can’t agree output measures

- Cost Plus:
  - Incentives based on business outcomes
  - Easy to agree: client carries all risk
  - Supplier foregoes opportunity to maximise margins

- Other more complex (eg scorecard)

Ensuring Value: Productivity

- What are we getting for our money?
  - There is no good way to ensure/measure IT work/$ (Value)
    - Only 2 measures:
      - Client satisfaction
      - Function Point measures
  - Productivity measures are deeply flawed:
    - However,...
      - For contracts longer than 2 years Client needs some mechanism eg some form of price review to capture the general Industry productivity gains
      - IT Industry general labour productivity increase averages 10-15% pa historically
      - Client options to capture this benefit are limited

Ensuring Value: Benchmarking

- Benchmarking
  - Define ‘IT work output’ in terms of ‘Function Points’
  - Function Point is a measure of complexity & quantum of systems
    - A professional activity
    - An imprecise art form
  - Process is:
    - All systems are measured & counted by (usually the Outsource provider)
    - Engage 3rd Party to audit & compare with ‘peer group’ providers
    - Outsourcer receives $ bonus, or gives refund - based on result of Benchmark.

- There are huge issues with Benchmarking
  - Supplier resistance & influence over metric process
  - Choice of peer group & comparison criteria
  - Agreement to ‘true up’ procedure is a difficult negotiation

- Market Testing is the only reliable approach
  - Can embed into the Outsourcing mechanism
    - E.g: separate “Factory” support functions from IT development functions
    - Maintain competitive tension for new work/scope

Recap: Why Outsource?

- Convert direct, fixed costs to variable
  - Transfer volume risk to Outsource provider
  - Capex to Opex

- Change culture
  - More accountability for use of services

- Meet Market expectation for focus on core business

- Saves management effort

- Save cost
That’s it!

Thanks

Any (more) Questions?