Outsourcing of IT

Bob Jacobs
July 2004

This Discussion…

Outsourcing of IT

• Rationale:
  – Outsource what?
  – Outsource why?

• Process: Outsource how
  – Project Steps
  – Operational Model

• Saving Costs

• Ensuring Value
  – Productivity & Benchmarking

Outsourcing

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

• The theory:
  - Outsource functions which are:
    - Low complexity
    - Low strategic importance
  - Must be stable, well understood
    - Under control and not subject to change
  - Improved delivery from specialist Firm
  - Scale economies
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
Outsource what?

- Enterprise Strategy
- Business/Product & Technology/Platform Strategy
- Concept & Feasibility
- Architect & Integration Planning
- Design & Project Design
- SI Prime Contractor
- Design & Implementation
- Operations Environment
- Decommission
- Outsource Provider
- Outsource Provider
- Migrate
- Enhance New
- Maintain New
- Enhance Existing
- Decommission
- Client
- Client

The $$$ impact

Recall: The Ballpark $$$ for a business IT platform

- Lifecycle Costs
  - Initial Investment: about 50%
  - Maintenance: 10-30%
    - Support
    - Bug fixes
    - Technology currency
  - Operations & Facilities Management: 40-60%

Outsourcing can only impact about half of the IT lifecycle cost

The commercial process of outsourcing
Typical outsource commercial process

- **Stages:**
  - Prepare a Tender 4 weeks min
    - Scope
    - Service Bin
    - Evaluation Model
    - Survey market (Suppliers)
  - Supplier Interactions 8 weeks min
    - Initial
    - Leads to proposal (Shortlist)
  - Due Diligence (by all parties) 6 weeks min
    - Negotiation
    - Decision process
  - Implementation 10 weeks min
    - Contract signed
    - Staff transitions
    - Asset transfer, etc
    - Client Work Ordering process

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

Outsource IT Operational Model

- **Client View**

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
  - Service additions
- Termination rights
- "At Risk" portion of fees
  - Examples: license costs
- Bonus structure related to business outcomes or over achievement
  - Incentive to key personnel
  - Salary related to contract performance
  - Staff churn as a Service Level
- Control Rights
  - Subcontracting
  - Technology & architecture
- Benchmarking
Saving Costs

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

Where are the Outsource Cost Savings?

<table>
<thead>
<tr>
<th>Staff Costs</th>
<th>Software Costs</th>
<th>Hardware Costs</th>
<th>Taxes</th>
<th>Other Overhead</th>
<th>Telecom Costs</th>
<th>Assets &amp; Deprec</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAVINGS</td>
<td>Outsourcer's Direct Costs</td>
<td>O/S Margine</td>
<td>Taxes</td>
<td>O/S Overheads</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Billed</td>
<td></td>
</tr>
</tbody>
</table>

Source: Gartner Group Research Note Oct 1998
Saving Cost: Doing Less Work

- Risk of Failure
  - Less than half of IT systems projects succeed
  - Define success

- 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:

- Uptfront business case work is critical
  - "Do the right work"

Saving Cost: The Off Shore Rationale

- IT Labour has become a commodity
  - All-inclusive standard and interchange, key packages, process standards, OIM

- Educated middle classes in emerging economies provide cheap labour
  - India, Philippines, Russia, China etc.

- Offshore labour cost is about 20-30% of US/De 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

- Business Case depends on the split of work
  - Legacy system is offshore 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

Lifecycle Cost Breakdown

<table>
<thead>
<tr>
<th>IT System Life Stage</th>
<th>Percent</th>
<th>Outsource</th>
<th>OffShore</th>
</tr>
</thead>
<tbody>
<tr>
<td>Concept &amp; Feasibility</td>
<td>5%</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Investment Decision</td>
<td></td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Define new System, Software, Labour</td>
<td>about 5%</td>
<td>small</td>
<td>Non-scope</td>
</tr>
<tr>
<td>License</td>
<td></td>
<td>about 15%</td>
<td>About 15%</td>
</tr>
<tr>
<td>Total</td>
<td>45%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operate &amp; Maintain</td>
<td></td>
<td>Yes</td>
<td>Non-scope</td>
</tr>
<tr>
<td>(Op &amp; Facilties Management)</td>
<td></td>
<td>Yes</td>
<td>Non-scope</td>
</tr>
<tr>
<td>Application Maintenance</td>
<td>about half</td>
<td>Yes</td>
<td>Non-scope</td>
</tr>
<tr>
<td>Total</td>
<td>45%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Decommission</td>
<td>5%</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Getting Value from Outsource Providers

Basic Outsource Delivery structures

• Fixed price for all work
  • Define scope (somewhere)
  • Have milestones 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 (e.g. 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 e.g.
      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’ as ‘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 Outsourcer 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 re ‘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 Outsourcer provider
  - Capex to Opex

- Change culture
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- Meet Market expectation for focus on core business

- Saves management effort

- Save cost

That’s it!

Thanks

Any (more) Questions?