Outsourcing IT (and anything)

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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

A Reference

- Suggest simply Google ‘Hirschheim’

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 inhouse?
- Why?
- Examples?

The decision to outsource

Considerations are:

- 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?
- Is the function able to be outsourced
  - 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

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Question? Cost 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:
1. What cost should be used for the cost of accommodation in the product costing:
   - Zero?
   - The operational costs (rates, power, light, maintenance)?
   - A nominal rent?
   - The same rental rate as other nearby commercial buildings?
   - The opportunity cost of capital for the value of the building?
2. Should X continue to own the building?
   - What are the benefits of outsourcing the accommodation?

Outsourcing IT

Why Outsource IT?

- 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

IT Systems Lifecycle
What Outsource?

Operations Environment
- Decommission
- Maintain
- Enhance
- Deliver New

Concept & Feasibility
- Enterprise Strategy
- Business/Product & Technology/Platform Strategy
- Architect
- & Integration Design

Design & Project Design
- Enhance New
- Maintain New
- Migrate

SI Prime Contractor
- Outsource Provider

Existing
- Outsource Provider

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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
- Reducing Risk of Project Failure
  - Less than half of IT systems projects succeed
    - (define success)
  - Business Change effort is significant
    - For a new transforming IT system, cost can be about the same as the IT investment
- “Do the right work”
  - Lifecycle IT costs are committed by the initial design
    - Maintenance & Support is roughly 25% TLC
    - Facilities & Operations is roughly 25% TLC

Saving Cost: Let’s Outsource?

Shelf Costs
Software Costs
Hardware Costs
Taxes
Other Overhead
Telecom Costs
Assets & Depreciation

Saved:
- Shelf Costs
- Software Costs
- Hardware Costs
- Taxes
- Other Overhead
- Telecom Costs
- Assets & Depreciation

Bill/Ex
Source: Gartner Group Research Note Oct 1998

Saving Costs

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Outsourcing: Impact on IT Lifetime Costs

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

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

Many operational costs are locked in by the initial system design.

Saving Cost: Cheaper Resources

Let’s go Off-shore
- Much IT has become Commodity
  - Moves to standard architectures
  - Key business functions are dominated by packages
    - SAP
    - Seibel
    - Microsoft
  - Process standards define quality: CMM

IT Labour has become a commodity.

Saving Cost: The Off Shore Rationale

- Emerging economies provide cheap labour
  - India, Philippines, Russia, China Etc

Offshore labour cost is about 20-30% of US/Oz market
- $300/day offshore vs $900/day onshore

- Not all work can be done off shore
  - 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

- It all depends on the split of work
  - Legacy systems go offshore quite readily:
    - 90/10 offshore/offshore delivers 50% savings
  - New systems and COTS packages have high onshore component:
    - 30/70 offshore/onshore delivers 20% saving

- It all depends on the split of work

Saving Cost: Increasing Productivity

- IT Industry Labour Productivity increases by 10–15% pa historically

Issue: How do we measure?
- Productivity measures are deeply flawed:
  - There is no good way to ensure/measure IT work/$ (Value)
  - Only if measures:
    - Client selection
    - Function Point measures

Issue: Who gets the benefit?
- Client? Outsource Service Provider?

Issue: How do we measure?
- Client options to capture this benefit are limited:
  - For contracts longer than 2 years Client needs some mechanism eg some form of price review to capture the general Industry productivity gains.
  - Administrative approach: Productivity Benchmarking
  - Commercial approach: Retender

Measuring Value: Benchmarking

- Benchmarking
  - Define ‘IT work output’ in terms of ‘Function Points’
  - Function Points 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
    - Outsource 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
    - IsG separation of ‘Factory’ support functions from IT development functions
    - Maintain competitive tension for new work/offshore

Recap: Why Outsource IT?

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