

Three Golden Rules of Cost and Risk Reduction in Outsourcing

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This research focuses on some of the fundamental flaws of traditional outsourcing and provides three golden rules as practical guidelines to enable business and IT managers to avoid the most common mistakes. Enterprises are also provided guidance for seriously considering new utility models for infrastructure as available means to achieving cost and risk reduction.

Key Findings

- Outsourcing is anti-cyclical in nature and tends to be leveraged in bad economic or business times. During recessive periods, clients and providers are at risk of too-quickly-made decisions or too-narrowly-focused deals.
- Outsourcers are already reporting a rise in their pipelines of client interactions from first time as well as expert clients (second-generation deals).
- First-time clients are more exposed to some of the basic mistakes that have been repeated over and over again, by different organizations, during the more than 30 years of the IT outsourcing business.

Recommendations

- The analysis and recommendations on this note go to "sourcing beginners" and also address clients that are already experienced in outsourcing deals, thanks to evolution of the outsourcers' offerings (industrialized IT services).
- Client organizations that are engaged for the first time in a large outsourcing transaction should avoid the traditional approach that providers indicate as "your mess for less."
- Client organizations (both first time and expert) should start focusing on buying services from the providers' industrialized service portfolios.
- Clients must force their providers into designing a transition phase into a long-term outsourcing relationship that is fundamentally managed as a program/project.

ANALYSIS

Overview

With the economic slowdown extending to multiple geographies, and amid a growing uncertainty, organizations are refocusing on IT cost reduction and may conclude that increasing the level of outsourcing is the best — if not the only — way to go. But is it?

IT services sourcing decisions are rarely quick fixes. It takes months to get into a well-negotiated contract, and then organizations face year-long service and operations transitions to begin achieving the actual outcomes (see Note 1). Those final outcomes often include less-than-stellar levels of satisfaction (typically 5 on a scale from 1 to 7 on Gartner outsourcing user wants and needs surveys, where 7 is the best level of satisfaction), low levels of flexibility (4.8 — the lowest satisfaction score on these surveys) and high levels of lengthy renegotiation (more than 80% of deals are somewhat renegotiated in the course of their lives).

Analysis

In the past, organizations often traded their future business flexibility for IT savings, and then suffered. In a recent Gartner survey — and also as substantiated by third-party surveys — more than 80% of CIOs and CEOs expect large or very large business structural changes in their organizations during the next three years. Therefore, organizations must determine how to achieve their short-term cost-reduction goals without hindering their ability to react to further market changes as well as rising threats and opportunities.

Having a balanced perspective is critical before the decision is made. Multisourcing best practices and awareness of new offerings, sourcing models and approaches — including alternative delivery models — are more important than ever. However, this is not enough. You also need to clearly understand what you're going to trade in exchange for the savings you want to achieve.

Rule 1: Don't Ask the Merchant If Goods Are Good and Inexpensive

There are different approaches possible to handle the initial phase of an outsourcing deal (RFIs, client/outsourcer meetings, RFPs). In most cases, the client provides the bidders an extremely detailed definition of the current state of operations (assets, configuration, tools, operational processes, service-level agreements [SLAs] and so on). The reason for the details on the current state is because of the fundamental premise of the deal — the client's in-scope service operations and the assets that deliver that service (for example, the data center, the distributed systems or the applications) will be transferred to the provider (that is, outsourced) in terms of responsibility and, in many cases, ownership.

When providing this information, the organization often explicitly or implicitly provides the vendor with:

- Enough information to judge the client inefficiencies and evaluate the current client cost (sometimes actual costs are shared openly by the client, a practice that further pushes the client into a weak position)
- A description of the expected service that is often more precise on internals (assets and tools) than on the actual outcomes (SLA, customer satisfaction, flexibility).

Based on this amount of information, the provider can offer the organization a price that is based on the client cost (price = "client cost" less a discount, usually 15% to 20%). Ironically, the client, not the provider, is setting the price in this traditional approach (see Note 2). This is, at the least,

suboptimal, and more often, it is just the first step toward several known outsourcing problems (see Note 3).

Action Item: During the preparation of the deal, the organization must create a clear representation of its current requirements (shared between client and potential providers) and a fair evaluation of the current service delivery status, as well as all associated costs (for client-only use), so the client can prepare an "apples-to-apples" comparison between different options and alternative offerings. Gartner's recommended best practice is to do so as part of the sourcing strategy preparation (Stage 1: Context and purpose; see "Best-Practice Process for Creating an IT Services Sourcing Strategy," "Use Five Steps to Make Data Center Outsourcing Decisions" and "How to Build the Sourcing Business Case").

Rule 2: Focus on Business Outcomes, and Move the Responsibility for Service Description and Technical Objectives (SLA, Terms and Conditions, Price) to the Provider

In traditional outsourcing deals, the client is implicitly asking the provider to evaluate the service to be outsourced based on the current, internal operations. In an industrializing market, providers increasingly are building very structured service portfolios that include classes of SLAs for different clients needs and requirements (see "Keiper: Adopting an Infrastructure Utility for Flexibility and Efficiency," "Case Study: Areva Gains IT Flexibility Through an Infrastructure Utility," "Oxea Shows How Infrastructure Utility Can Deliver Speed and Efficiency" and "Case Study: How IT Utilities Support Rio Tinto's IT Dynamics and Company Moves"). Therefore, it is now time for organizations to strongly move in the direction of "buying industrial IT services" (see Note 4) instead of outsourcing the ones created in-house. Through market research, benchmark or by directly engaging with a limited number of suppliers, understand which are the "typical" or market SLAs for the class of services you are looking for, and buy these levels, adapting to the providers' industrialized class of services.

Even organizations that do not measure their current SLAs can start leveraging on SLAs that are provided by outsourcers, without the unknown of the typical service measurement period that is part of the transition into an outsourcing deal.

Action Item: During the preparation of the deal, the organization must obtain from independent market sources, through RFIs or meeting with potential providers, the most likely service descriptions and SLAs that they offer. Enterprises should then select the "industrialized SLA" that better aligns to their business requirements, in particular ensuring that these service levels meet their minimum business requirements. Gartner's recommended best practices are to do so as part of the sourcing strategy preparation (Stage 2: Analysis of options; see "Gartner on Outsourcing, 2008-2009," "IT Infrastructure Utility Services Reach 5% of Data Center Outsourcing Revenue" and "Gartner Introduces the Infrastructure Utility Maturity Model").

Rule 3: Treat the Transition Into Outsourcing Like Any Other Business-Critical Project

A major complaint among Gartner clients concerns the transition phase of any outsourcing deal. The transition phase starts with the transfer of responsibility (and assets) to the provider and ends — theoretically — with the deal's steady state. Some of the worst situations in outsourcing occur when — 12 to 18 months into the contract — the client is unhappy and the transition phase has not even ended. It's very hard then to judge if the entire deal is unsatisfactory or the end of the transition will make it work.

The major reasons are:

- The target service levels — described more in terms of capabilities than in terms of outcome — are often measured as part of this period of time.
- The final state is, therefore, undefined in terms of SLA, operational processes, integration rules and so on.
- The overall transition period is affecting the service, the users, and the organization's business and IT interfaces; however, it's often left to the provider and not co-managed as a complex program.

If the transition steps fail to deliver on expectations, the organization cannot change the transition program/project because it has already engaged in the long-term outsourcing relationship, of which the transition is a part.

Once you have defined the service target on the basis of the provider industrialized service portfolio, then it is possible to look at the transfer and transition activities as a (complex) project that will enable the organization to move from the current state (internal delivery) into the new state (service delivered by the provider, assets transferred if applicable, and new service management processes in place). This project/program should be treated as any other project, including common management and the possibility to cancel the project and return to the previous state.

Action Item: Don't necessarily accept the provider's standard contract provisions for the transition project. Select two potential finalists, enable enough due diligence time for them to judge the current situation, and plan for an explicit transition project (activities, effort, timelines and deliverables/outcomes). For large and complex deals, ask them to phase it (by geography, business units or teams; not for line of service) in a way that a failure during the early phases could trigger the end of the entire contract. Make the quality of the transition plan one of the key elements of the final decision on the winner.

Bottom Line: Trade Your Unnecessary Service Customization, Not Your Business Flexibility

In a maturing IT service market, clients have the possibility to remove costs from their IT operations — starting from the infrastructure layer — by trading current inefficiencies, absence of economy of scale, and unnecessary customization in their services and operations. This will provide more satisfactory outcomes to organizations, in terms of better, less expensive, more-flexible service, as reported by the case studies already mentioned. This is also going to prove positive for providers in the midterm; an increased level of standardization enables better economies of scale and a much better effect of continuous improvement, which becomes applicable to multiple clients at a time, when delivered within the same industrialized class of service. While this industrialization trend is still in the initial phase, it's the time for organizations to start changing their approaches to outsourcing.

RECOMMENDED READING

"Q&A on IT Services Industrialization"

"Keiper: Adopting an Infrastructure Utility for Flexibility and Efficiency"

"Case Study: Areva Gains IT Flexibility Through an Infrastructure Utility"

"Oxea Shows How Infrastructure Utility Can Deliver Speed and Efficiency"

"Case Study: How IT Utilities Support Rio Tinto's IT Dynamics and Company Moves"

"IT Outsourcing Success: Stop the Most Common Mistakes in Provider Selection and Contracting"

"Don't Outsource Just to Save Money"

"Best-Practice Process for Creating an IT Services Sourcing Strategy"

"Use Five Steps to Make Data Center Outsourcing Decisions"

"How to Build the Sourcing Business Case"

"Gartner on Outsourcing, 2008-2009"

"Gartner on Outsourcing, 2007 to 2008: Utility Delivery Models"

"IT Infrastructure Utility Services Reach 5% of Data Center Outsourcing Revenue"

"Gartner Introduces the Infrastructure Utility Maturity Model"

Note 1

Service Definition

IT services are not defined by any common standard. Data center outsourcing, application maintenance and desktop outsourcing mean nothing in practice; they are all just titles. An IT service transaction — to be defined — must have detailed descriptions of what the service outcomes are expected to be. The main components of this description are: scope of services, SLAs and responsibility matrices. While the contract is just the framework for the legal relationship, some terms and conditions may also have significant impacts on the quality of service. For example, liabilities, force majeure clauses and disclaimers about specific responsibilities (such as provider and client rights on planned maintenance and planned downtime) may limit the actual value of SLAs. What is not detailed in the contract may affect even more client satisfaction. Some examples of that are the actual activities, schedule and outcome of the transfer and transition phases.

Very often, long-term outsourcing relationships start with a partial definition of some of the fundamental elements, usually referring to the transition phase as the period of time when all the unknowns get resolved.

Note 2

Techniques to Demonstrate Cost Savings

A vendor that is asked to prove cost reduction that is not already feasible tends to:

- Pick the service areas where it can more easily provide such cost reduction and discard other areas where the client costs cannot be improved (deal shaping)
- Build appealing entry conditions (for example, asset payments) that the client will pay for during the contract life
- Build appealing cost reduction based on long-term financials
- Reduce the service content or the service levels to make possible the cost reduction that is needed (for example, reducing the staff planned for the service)
- Build appealing price points by defining multiple small-service elements as "not included/optional" so that the organization will then spend more when requesting these necessary services

- Delay any detailed description of service levels and responsibility matrix until after the deal is signed and the first transition phase begins

Note 3

Price-Driven Relationships (Also Known as Financially Stressed Deals)

When a contract starts with a defined price and undefined service levels, the service provided to the client will be tailored to this price. The vendor will then know the maximum admissible direct cost (that is, price less gross margin) and will plan to deliver through that cost. Service-level details will then be fixed according to the service the vendor can deliver for such cost. Organizations that found themselves in such situations — some providers are quite open that this is the reason for the problems, once the organization is there — experience not only a bad service, but even a general inability to fix problems and make changes, if not improvements, to the current status of the deal.

Note 4

Industrialized, One-to-Many Services

Most service industrialization effects are currently visible at the infrastructure level, with the clear example of infrastructure utility services and the emerging cloud computing approach. Nevertheless, other alternative delivery and acquisition models (ADAMs), such as software as a service (SaaS), business process utilities or cloud-based services, are affecting the delivery of IT services in the same way. Additionally, the mainstream establishment of global delivery is forcing all providers into a process of standardization of their service portfolios, including service components, SLAs and pricing. Increasingly, the technical definition of services will move into the provider's responsibility.

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