

## Outsourcing: Evolving Toward Trust

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Since successful businesses in Europe and the United States have historically been self-contained and proud of their independence, surrendering essential business processes to another organization was unheard of until just a few years ago. Motivated first in the 1990s by the need to curb costs, outsourcing today seeks to add value well beyond cost reduction. Complete applications and even underlying business processes are being outsourced, and a new business entity called the Application Service Provider (ASP) is emerging to offer pre-built outsourcing solutions. A recent study by Deloitte and Touche predicts that the revenues for this new segment alone will reach \$48 billion by 2003. In addition, market trends toward business process outsourcing (BPO) and outsourcing in the context of trusted long-term relationships are also emerging, yielding a spectrum of operating models and potential value opportunities.

Outsourcing, or the transfer of IT services or business processes from one company to another, has roots in *service contracting*, but there are important differences between the two. In a pure contracting transaction, one company purchases services from another while retaining ownership and responsibility for the underlying processes; the client tells the provider *what* it wants and *how* it wants the work performed. By contrast, in an outsourcing arrangement, the *provider* assumes most of the ownership responsibility from the client, and determines how to meet the client's service needs. *Business process outsourcing* involves an even broader delegation of responsibility from client to provider. In a BPO relationship, the client authorizes the provider to not only own and operate, but also redesign underlying processes, to reap even greater cost and efficiency benefits. Successful BPO relationships may even apply new technology or apply existing technology in new ways. Accordingly, moving along the continuum from client to provider control of non-core processes can create distinctive value, especially in a trusting, long-term relationship.

Whatever its scope, an outsourcing relationship will eventually take the form of a jointly executed long-term plan that seeks to minimize up-front costs and deliver high-quality services for a relatively certain fee, while also providing flexible access to specialized resources when needed. When provider and client create such a long-term alliance -- based on linking the core competencies of each -- several benefits are likely to accrue, both near and longer term.

In the short term, clients gain:

- Ability to focus resources and attention on core business initiatives
- Reduction in headcount and attrition rates in the outsourced function

- Re-skilling of remaining staff with better and more marketable skills
- Refinement of project management, risk management, and service delivery skills
- Implementation of demand management and service delivery disciplines
- Optimization of systems management and support processes
- Access as needed to specialized resources.

Typical long-term benefits include:

- Predictable results-based expense for the outsourced function over the life of an outsourcing agreement
- Joint and proactive problem-solving and innovation
- Superior management of the business application portfolio
- Enhanced career opportunities for client staff, based on sophisticated management, contracting, and outsourcing integration skills.

Companies seeking these outsourcing benefits generally engage in a systematic process led by the outsourcer and designed to ensure a positive and mutually beneficial experience for both client and provider. Although the scope and content of outsourcing relationships vary widely, the process typically involves the following key steps: (1) aligning expectations between client and provider, (2) clarifying the governance model, (3) setting price, (4) preparing service level agreements, and (5) augmenting services as client needs and technology demands change over time. Let's explore each step more closely.

### ***Step 1. Aligning Client and Provider Expectations***

CSC's first step in an outsourcing engagement is to jointly define the client's business needs, outline the range of potential outsourcing solutions, and design a process for ensuring that both client and provider build a successful, productive relationship based on shared expectations. A recent outsourcing of enterprise resource planning systems to our Application Value Management practice typifies the approach, beginning with a workshop-oriented planning session and followed by detailed value assessment. (See the *Exhibit*).

DISCOVERY WORKSHOP. Preliminary meetings were held among executives from both firms to share initial objectives, ideas, and concepts. After concluding that alignment was feasible, the parties arranged for a Discovery Workshop to further explore the scope, approach, and potential value of an outsourcing arrangement. This workshop quantified the key challenges the client CIO faced in delivering quality services to the business, and developed options for improvement and corresponding order-of-magnitude cost estimates. Once the client representatives agreed that the business issues had been correctly identified and high-level benefits accurately captured, we moved toward the Value Assessment phase of the project.

VALUE ASSESSMENT. The goal of Value Assessment is to reach a determination of the prospects for a mutually rewarding outsourcing engagement. In concept, the client expects substantial savings over current costs at existing or improved quality levels. Value Assessment identifies the specific approach to execution that will deliver targeted benefits while also generating a reasonable return to the provider over the length of the agreement. Here, the interplay among the scope of services to be delivered, the outsourcer's economies of scale, and the length of the contract gives the provider the flexibility to design a value proposition balancing the needs of both parties. In this case, the process continued intensive research into the application areas under review, using document reviews, interviews, and financial modeling based on a broad database of CSC cost parameters and operating experience. At the completion of the Value Assessment, the joint client/CSC team had developed the following key decision materials:

- Specific application modules to be outsourced
- Client software release and version detail
- Number and scope of software implementations
- Application configuration details
- Functional process templates for flow of financial and logistics data
- Detailed system platform and infrastructure requirements
- Alternative host data centers, staffing levels, and required hours of service
- Processes tailored to support the client's international locations

- Scope of maintenance and user support to be provided
- Detailed CSC tasks
- Detailed client tasks
- Expected client benefits
- Cost and term structure of a proposed relationship.

The findings were presented in a work plan for thorough review by the project governing body. Following revisions and a final handshake at this milestone, we formed a project team whose first deliverable was the creation of a complete and rigorous governance model.

### ***Step 2. Clarifying Governance***

After the client decides to outsource a specific application, service, or process, client and provider together design an approach to governing the relationship. This goes beyond the mere performance of contractual obligations. It focuses on proactive and collaborative management of the relationship, the evolution of services provided, communication processes, performance review standards, and overall relationship management. In CSC outsourcing engagements, a well-defined governance model addresses at least these core questions:

- Expectations. How does the client help set expectations? How does the client help perform the services? What does the client supply to the provider?

- Monitoring. What are the processes for performance monitoring? How are targets established? What happens until they are in place? Is there work in progress or a backlog to take into account? How well were services provided before the monitoring began?
  
- Communication and reporting. What is the schedule of client reviews and discussion? What is the escalation process for issue resolution? What provisions are made for special or emergency issue resolution? What are the schedule, content, and format of standard reporting? When and how are exceptions to be reported?
  
- Scope change. How are changes in service scope or content provided for?
  
- Agreement modification. How can the agreement itself be changed to be more responsive to client needs? What threshold operating levels should trigger the change process automatically? What must client and provider do to change the agreement? What are the limitations on change posed, for example, by the economics, term, technology requirements, or software licensing stipulations of the outsourcing relationship?
  
- Termination. Under what conditions can the agreement be terminated? What do client and provider need to do to initiate termination? What fees apply?

Communication is the hub of the governance process. From the client perspective, communication builds confidence in our understanding of their requirements and reinforces our ability to perform to expectations. From a CSC perspective, the more we meet and exceed client expectations, the more likely we are to be entrusted with broader responsibility.

### ***Step 3. Setting Prices***

Though an essential part of the outsourcing process, pricing decisions remain a sensitive subject. Outsourcing arrangements customarily run from millions to even a billion dollars over the course of the multi-year agreement. Further, when the relationship involves purchasing assets such as data centers and staff, a substantial investment is made by the outsourcer based on client accounting, resource quality,

ability to integrate client facilities into the provider's existing data centers, and a host of other considerations. Accordingly, price setting itself is both complex and iterative.

In general, contracts can be written on a fixed-price basis or on more flexible terms. In fixed-price arrangements, the provider takes on the risk of absorbing cost variability in order to provide cost certainty to the client. While setting fixed prices helps reassure clients of predictable final costs, it may have adverse effects if the agreement is not carefully crafted. When set too low, fixed prices diminish the outsourcer's flexibility and motivation to respond to changing business objectives or emerging technologies, because of the potential investment requirements and profit impact beyond what has been incorporated into the contract.

The opportunities for creativity and balance are greater under variable pricing, in which price may be based on straight service usage, on the sophistication of services used, on risk sharing, or on a combination of approaches. Risk-sharing relationships enable the outsourcer to share in benefits generated for the client, thus ensuring aligned objectives and perspectives. However, while allowing variable prices or incentives may motivate appropriate change, it may also create misunderstandings if and when costs exceed expectations, especially if scope and accountability are ill-defined. The communication process established in the governance discussion helps avoid and resolve potential conflicts over price arising from these and other issues.

Increasingly, a combination approach to pricing is taking center stage in outsourcing relationships in an effort to strike the right balance between cost predictability for the client and profit protection for the outsourcer. In these arrangements, for example, transactional services may carry a fixed price, while more strategic services like Web development, hosting, and communications infrastructure may be priced to better reflect value, risk, and technical sophistication.

#### ***Step 4. Preparing Service-Level Agreements***

Effective service level agreements (SLAs) identify the expected results and the measures by which both parties will evaluate performance. As binding agreements with the force of standard contracts, SLAs for outsourcing frequently require sophisticated legal and technical expertise, because of their complexity and variety. Importantly, most outsourcing failures occur because neither side has articulated how to assess the progress

made against a specific goal or target. Even when *targets* are clear, *measures* may not be effective. Finally, the absence of a balanced set of performance penalties and incentives can undermine the delivery of results, especially when expectations are not in alignment. (One expert commentator recently suggested that clients intuitively expect service levels in the top 10 percent, while providers consider the top 25 percent acceptable.) Accordingly, clear performance areas and effective measurement are essential to outsourcing success.

In brief, a well-designed outsourcing SLA begins by describing standard requirements such as start and end dates for the service, the schedule for reviewing performance, and documentation to be used in measuring the service.

The agreement then carefully delineates the scope of services, including:

- Assets, equipment and infrastructure to be serviced
- Types of services to be provided
- Decisions to be made by the provider
- Decisions to be made by the client.

Equally important is a breakdown of fees, with both penalty and incentive provisions clearly outlined:

- Amounts period by period
- Volume of work covered
- Quality of work to be provided
- Provision for over- and under-performance.

Good performance metrics measure results, not just activity, and they are kept to a minimum. We have developed several guidelines for selecting outsourcing metrics, including:

- Aligning metrics with the business goals of the service
- Selecting metrics that enhance the ability to diagnose problems, escalate attention, and remedy performance issues
- Avoiding metrics that distract from the service itself
- Limiting the metrics for each service to one or two.

The following is a sample of the types of measures applied to data processing outsourcing activities:

- Availability, typically two clock times between which the system must be up
- Hours required to fix a system error or interruption
- Response time for a transaction, typically in seconds
- Turnaround time for a batch job, typically in minutes or hours
- Batch window, typically a clock time by which the batch must finish
- Network uptime and availability, including time to back up a failed line

In outsourcing as in other service activities, the tightest service definitions produce the most successful relationships.

### **Step 5. Augmenting Services**

Rapid changes taking place in technology add to the challenge of outsourcing, often requiring an equally swift ability to augment services. One example of service augmentation focuses on client cost management. Parties to an outsourcing agreement quickly come to appreciate that the way to minimize costs is to focus on the future drivers of today's service expense. For example, *preventive maintenance* can forestall problems before they occur and lead to costly downtime. *Proactive user support* anticipates user needs providing training sessions, improved documentation, or new help screens to effectively manage the future demand for key services. Full-service providers typically collect data on user inquiries and, in a long-term relationship, use that information to design effective programs for proactive support and preventive maintenance.

Another example of service augmentation addresses refining the overall balance and content of client projects using portfolio modification and supplementary projects. *Portfolio modification* provides a vehicle for anticipating and responding to rapid change by working with the client to shift the priority of certain projects in the development queue. A savvy outsourcer can assist in preparing the client to meet changing performance, competitive, or regulatory demands by modifying the portfolio in a timely manner. *Supplementary projects* are initiatives requested by the outsourcing client to help it protect and exploit the value of its application portfolio into the future. Typical supplementary projects tend to be larger in scope or deliverable, and rather than extend an existing application, they provide new capabilities, insights, or levels of support. Typical supplementary projects include developing an IT strategic plan, performing a review of enterprise application integration, developing and testing disaster recovery plans, and implementing major release upgrades of operating systems and enterprise resource planning packages. Clients sometimes resist simply giving an outsourcer more business, but our experience shows that a trusted provider can add superior value through improved business operations, leveraging the outsourcer's intimate knowledge of the client's business, its supporting information technology, and the evolving technology environment.

In approaching the augmentation of services, outsourcing providers help their clients make decisions in various ways:

- The client may delegate to its provider the decision to accept and schedule modification requests falling under a certain cost, requesting a periodic report on decisions and sometimes providing an upper limit for total expenditures
- The provider may implement procedures for accepting only modification requests that exceed a certain threshold for return on investment (ROI), which the client can set and revise to control financial impacts
- The provider can work within the governance organization to approve and prioritize work requests as they arise
- The provider can expand its services to the client into business process outsourcing, and potentially reduce cost, increase flexibility, and provide superior service compared to the client's existing path and performance.

The approach chosen will depend on a combination of trust and confidence developed over the course of the relationship and consistent with the culture and operating preferences of the client.

### ***Maintaining Trust***

Successful outsourcers need to be accomplished at creating and nurturing long-term relationships. CSC believes that the outsourcing model performs optimally only when leaders on both sides of the agreement pool their knowledge and work together in governance sessions to develop new strategies, processes, and infrastructures. Good SLAs foster this collaboration by providing an equitable process by which either party can request or recommend changes. As an outsourcer, CSC goes further in bolstering client trust by identifying in its earliest presentations to the client any potential risks and all assumptions on which the agreement is based, for example: staffing risks, anticipated user satisfaction issues, or potentially adverse reactions to recommended training intensity. In addition, we take pains to clearly identify projects included and not included in the scope of the agreement, applications not covered by the base outsourcing agreement, limitations in support hours, and elements of hardware that are not the responsibility of the outsourcer. We strive to manage outsourcing relationships with a consistency and reliability that reinforces confidence and trust. One CSC client recently

described our successful outsourcing relationship as follows: “All I know is that we pay a fair price and when problems arise, they come up in a monthly governance meeting and then go away by the next month.”

### ***Looking Forward***

Outsourcing may well become a matter of survival in the e-business age. Nimble dot-coms, as well as high-performance traditional companies, have demonstrated that a reliance on best-of-breed outsourced services is simply good business. In the words of Scott McNealy, CEO of Sun Microsystems, “...the best thing about outsourcing is that it frees you to concentrate on your business.”

Continued growth in the numbers of outsourcing-related mergers is likely as the economics of scale and the concentration of talent favor larger combinations of powerful technology providers. Many client IT staff members are delighted to work for a company for whom technology is the core business, and CIOs are glad to be free of staff retention and retraining issues that so frequently bedevil their efforts to staff rapidly changing project portfolios.

Overall, we expect the next few years to bring exciting developments in the availability and differentiation of outsourcing services; in the business organization and technical infrastructure that support them; and in the legal terms and agreements designed to protect, empower, reward both sides of the agreement. Over time, business executives will be increasingly open to the outsourcing option, and successful outsourcing relationships will be characterized by flexibility, open communication, and sustained high performance delivered in an atmosphere of trust.

EXHIBIT: KEY STEPS TO REACHING AN OUTSOURCING DECISION

