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Client Satisfaction with Outsourcing

U.S. Outsourcing Program

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Abstract

This report takes an objective look at the outsourcing market. It concentrates on the views and perceptions of current outsourcing clients. The client mix represents eight vertical industries. The contracts studied range from just less than one year to seven years into their life cycle.

The report examines how satisfied clients are with the outsourcing experience. The current level of satisfaction is measured as well as some indication of future intentions relative to outsourcing.

Expectations are compared to the perceived benefits. A review of what has been effective in managing the outsourcing relationship is also conducted. In addition, a "wish list" of what would be done differently in the next contract is discussed.

Conclusions are drawn from the data presented and recommendations are made for three groups: vendors, current clients and prospective clients of the outsourcing vendor.

This report contains 56 pages and 28 exhibits. It was prepared as part of INPUT's Information Systems Outsourcing Program.

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Client Satisfaction with Outsourcing

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Exhibits

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I

Introduction

This report is based on research conducted as part of INPUT's 1993 Information Systems Outsourcing Program. It addresses the U.S. market for outsourcing, directing the focus of the research exclusively at clients, not vendors.

The number of outsourcing contracts continues to grow each year. Many are now well into their life cycle, whether a five-year or a 10-year contract. It is very important to the market to assess how satisfied the typical outsourcing client is with services rendered by vendors.

A Scope and Purpose

This report measures user satisfaction with existing outsourcing arrangements. It looks at client satisfaction overall and separates types of clients to identify any real difference in their experiences with outsourcing contracts.

Once relative client satisfaction is identified, a number of management issues are addressed. Past experience is always a valuable base upon which to build an improving partnership between client and vendor.

B Methodology

Surveys conducted for this study solicited data from experienced clients of outsourcing vendors. Targeted contracts had to be at least one year old, but other than that stipulation, no attempt was made to balance the mix of contract types so as not to skew the results.

1. Research Methodology

A series of telephone interviews measured satisfaction levels, identified management techniques that worked and generally probed client attitudes toward various pricing policies and contractual arrangements. Appendix A, at the end of this report, contains the questionnaire used in the survey.

Exhibit I-1 tabulates the mix of contracts studied in this survey.

EXHIBIT I-1

Types of Contracts Studied

Types	Number in Sample
Platform Operations	13
Applications Operations	12
Desktop Services	10
Network Management	1

A clear differentiation showed between platform and applications operations contracts. In many cases, desktop services contracts were held by either the platform operations or the applications operations vendor. In three cases, the desktop services contract was not held by the same vendor with the systems operations contract.

Only one case of a network management contract was studied, but keep in mind that all of the systems operations arrangements included a network component.

2. Demographics of Respondents

Exhibit I-2 summarizes a cross-section of respondents, identifying positions they hold in their organizations. The mix is somewhat weighted toward CIOs, but that is not a disadvantage in this case because these individuals tend to be most critical of the outsourcing vendor. About 70% of respondents were with the client when the outsourcing decision was first made.

EXHIBIT I-2

Positions of Respondents

Positions	Number
CEO/Chairman	1
Chief Operating Officer	1
Chief Financial Officer	4
VP Operations	9
Chief Information Officer	11

3. Relative Contract Size

Contracts studied included various contract sizes. Because there are many more smaller contracts than larger ones, it is proper that they should be heavily represented in the sample mix. Exhibit I-3 lists these statistics.

EXHIBIT I-3

Contract Size Represented in Sample

Contract Value Range	Number of Contracts
Less than $25 million	18
Between $50 and $120 million	1
Between $120 million and $1 billion	6
More than $1 billion	1

The length of the contract should be significant enough to assure that valid experiences were collected. In the sample, seven contracts were in effect since 1989 or earlier, nine originated in 1990 and 1991, nine were 1992 contracts and three were contracts that started in the first two months of 1993.

In addition, eight vertical industries are represented in the sample, with 10 organizations from the manufacturing sector and five from the banking and finance vertical market.

C

Related INPUT Reports

For a complete view of the outsourcing market and related information services markets, review the following INPUT reports:

Information Systems Outsourcing Market Analysis 1993-1998

Business Operations Outsourcing (1993)

The CFO's Role in Outsourcing (1993)

Outsourcing Awards Analysis (1993)

Client Satisfaction With IT Outsourcing Services - Europe (1993)

IS Outsourcing Competitive Analysis (1993)

Interaction of Downsizing with Outsourcing (1992)

Outsourcing Desktop Services (1992)

Strategic Assessment of IS Outsourcing (1992)

Outsourcing of Network Management (1992)

Methods of Approaching IS Outsourcing (1992)

II

Executive Overview

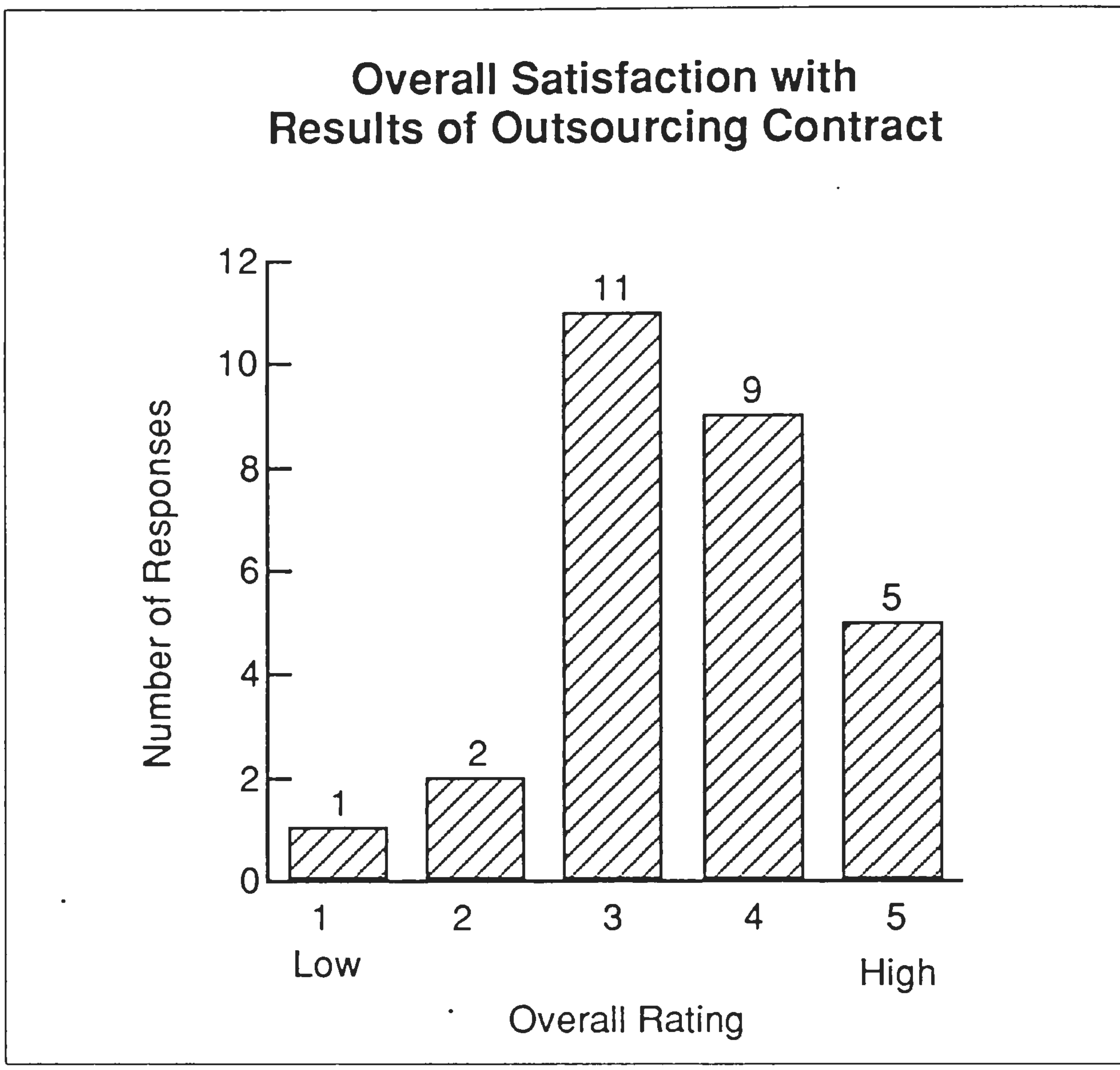
The level of satisfaction among a group of outsourcing contract holders is a good indicator of the market's health. It also provides valuable insight into both the vendor and client communities. For vendors, it tells what they do right, what they must improve and what new services are required by clients. For the current client, the experience of others provides a good parameter to measure the success of its organization's own outsourcing contract. For the prospective client, it is a valuable source of information about what to build into the vendor agreement.

A
Overall Client Satisfaction

The level of client satisfaction with the outsourcing arrangement can contain many factors. The life of the contract and complexity of the vendor's duties contribute to the user's perception of satisfaction.

In Exhibit II-1, responses to the question on overall satisfaction with outsourcing contract results are presented. The scale was from one to five, with five meaning extremely satisfied and one meaning not satisfied at all.

EXHIBIT II-1

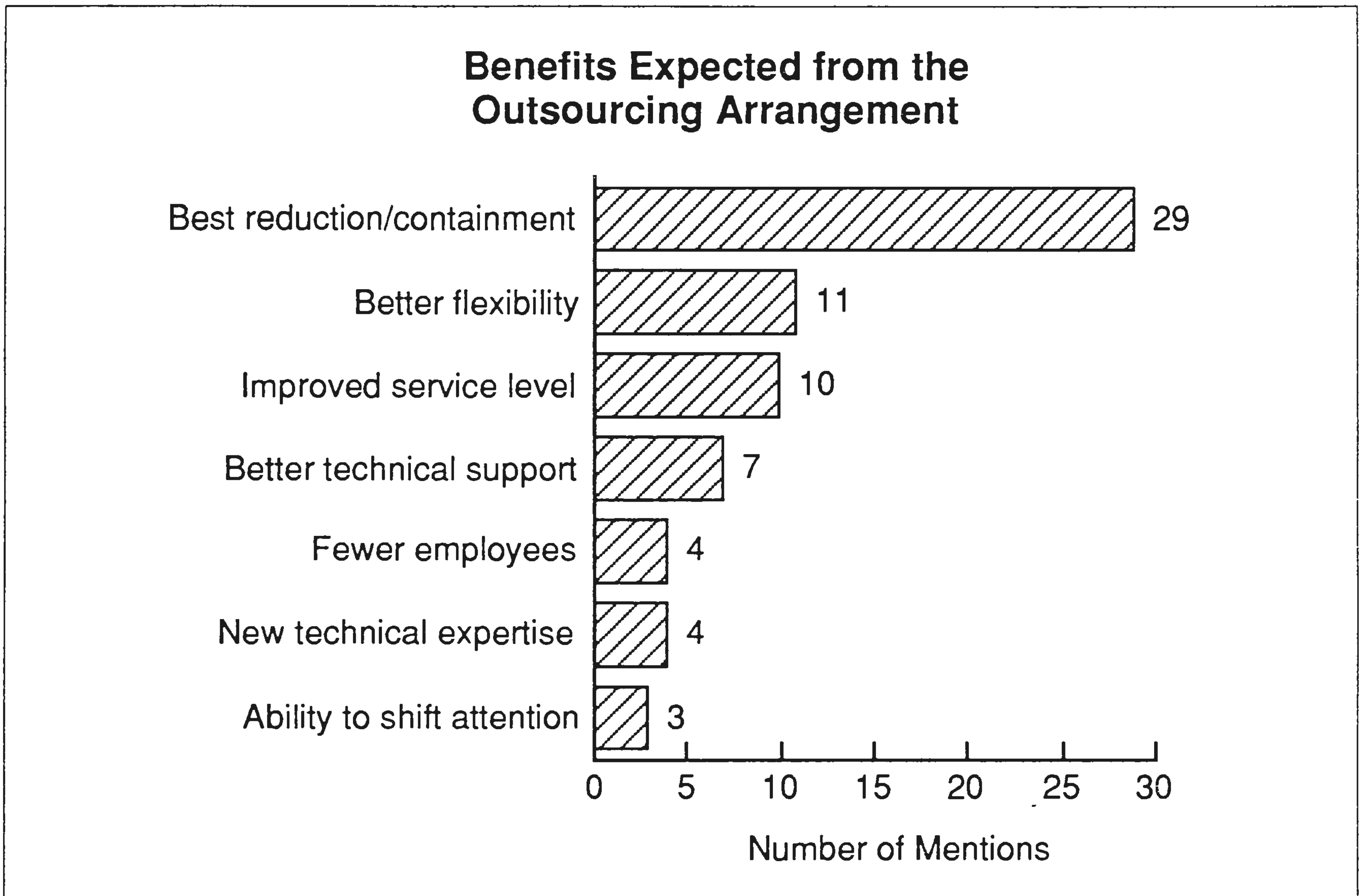


Responses cluster around 3 and 4, indicating a relatively high level of satisfaction with the market in general. Less than 11% of respondents rated the results below a 3. The fact that five respondents indicated extreme satisfaction by rating the achievement level at 5 is also worth noting.

Another question asked early in the discussion dealt with benefits the client organization expected to achieve with the outsourcing agreement. The client also rated how well that benefit had been attained.

Exhibit II-2 lists the frequency associated with each response. The interviewees were not given a preselected set of benefits but were asked to identify them within the context of their own operating environment.

EXHIBIT II-2



The results are predictable. Cost benefits are still most often cited by the client. Many outsourcing contracts are motivated first by the need to reduce operating costs, or at least reduce capital expenditures. The outsourcing arrangement seems to be doing that.

The importance of the flexibility issue has risen since earlier surveys were conducted. This probably reflects the fluid situation in organizations that must constantly upgrade their information technology to adapt to rapidly changing business conditions.

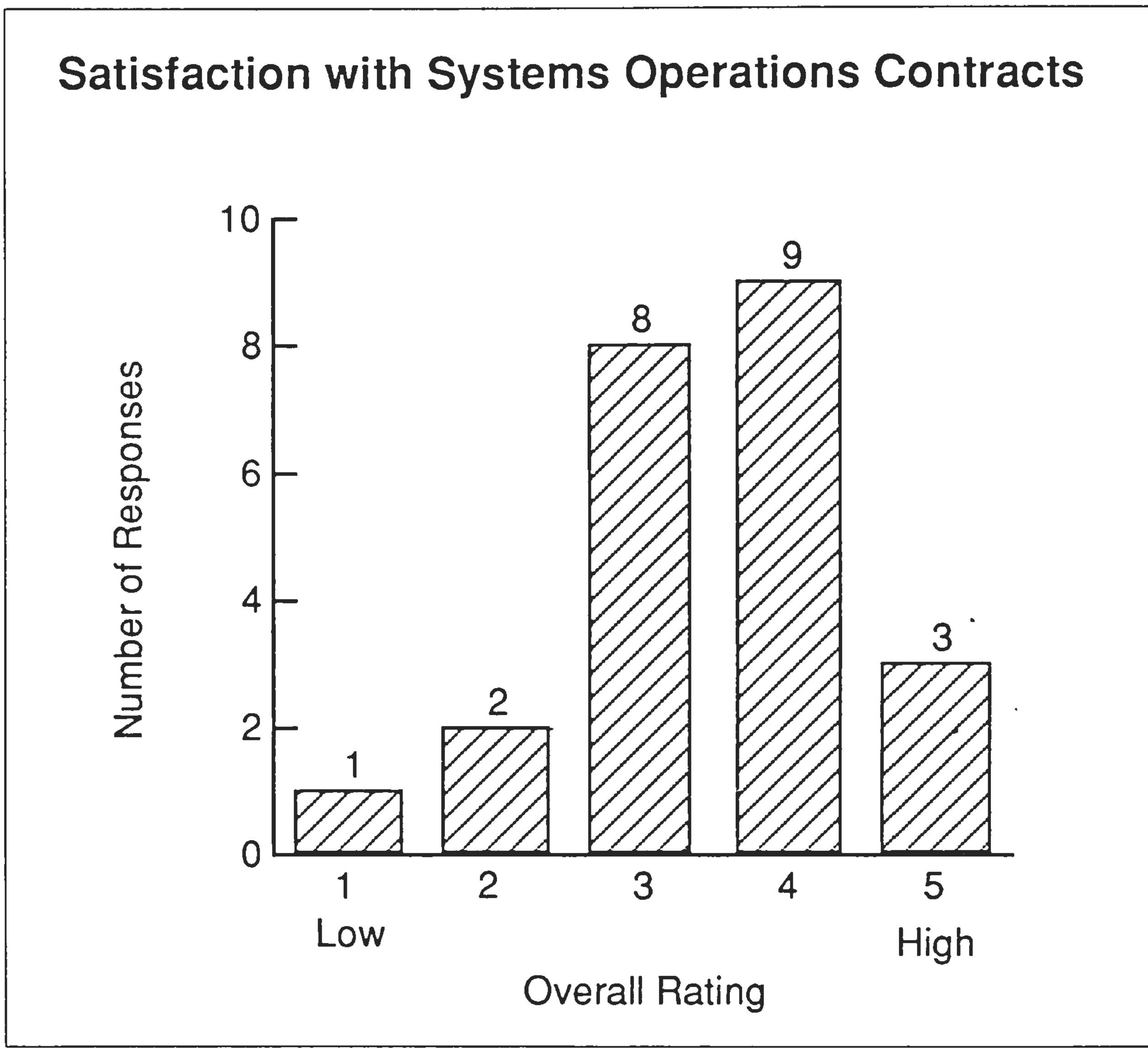
Improved service levels reflect the vendor's good management practices. They bring experience in data center and software management to the new relationship. This generally shows in improved processing capacity and better turnaround time for software development.

The two items regarding better technical support and new technical expertise are related. They depend on vendors' ability to attract and keep high quality staff. Some clients have been disappointed on this score, particularly regarding better technical support.

1. Systems Operations Clients

Exhibit II-3 illustrates the distribution of responses for clients with systems operations arrangements. This includes clients with either an outsourced data center or those outsourcing data center and applications maintenance and development.

EXHIBIT II-3

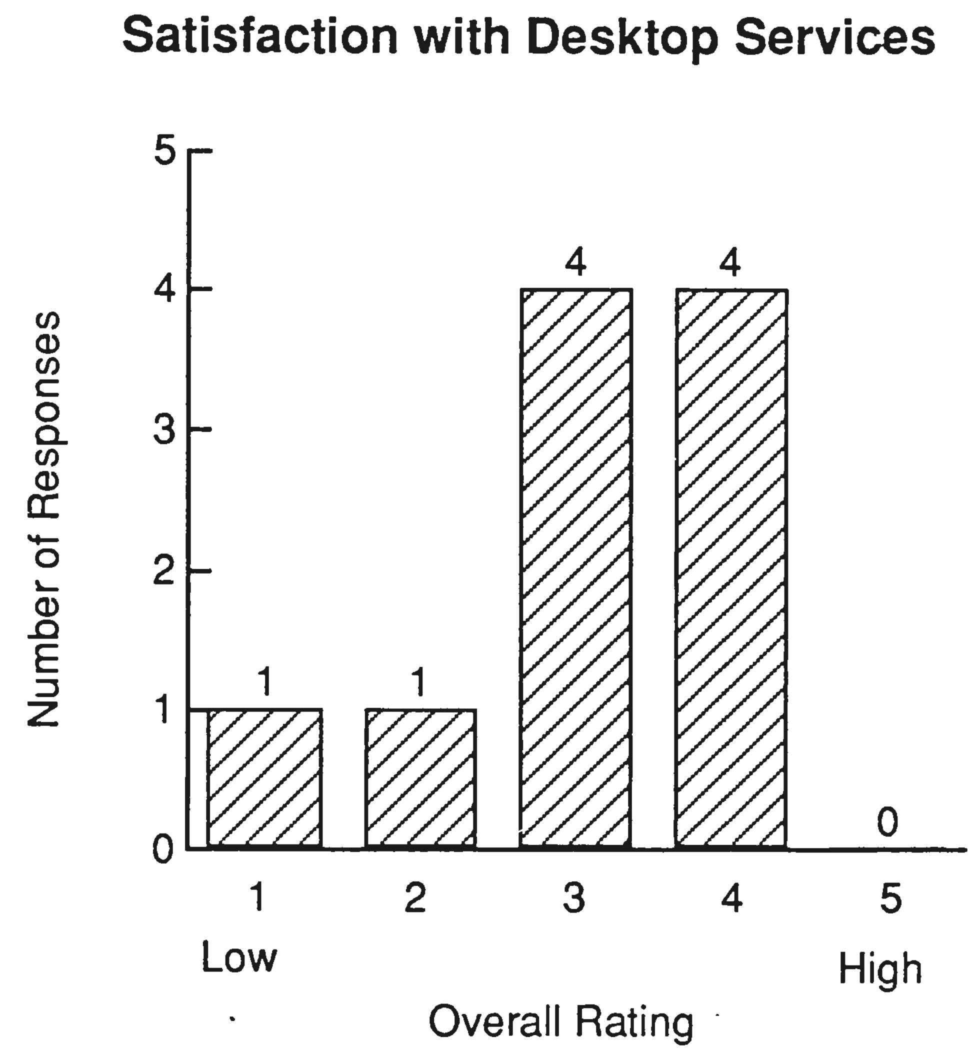


A very large number are clustered around the 3 and 4 levels, indicating a relatively high level of satisfaction. Three respondents gave the vendor a satisfaction rating of 5, which is noteworthy. All three were platform operations clients, indicating that it may be easier to manage a platform operations contract and keep the client happy.

2. Desktop Services Clients

A substantial number of respondents had desktop services contracts, though only two had network management contracts in our sample. The distribution of these responses is included in Exhibit II-4.

EXHIBIT II-4



The average satisfaction rating for these clients is 3.5. Most desktop services clients were also applications operations clients, so were among the more sophisticated users of outsourcing arrangements. Again, responses clustering in the 3 and 4 range indicates a relatively high level of satisfaction.

B

Management Issues

Techniques that work for managing relationships with vendors who provide software design and development, contract programming and facilities management, will work in the outsourcing environment also. A new element is the closer working relationship that must exist between vendor and client.

1. Cost Control

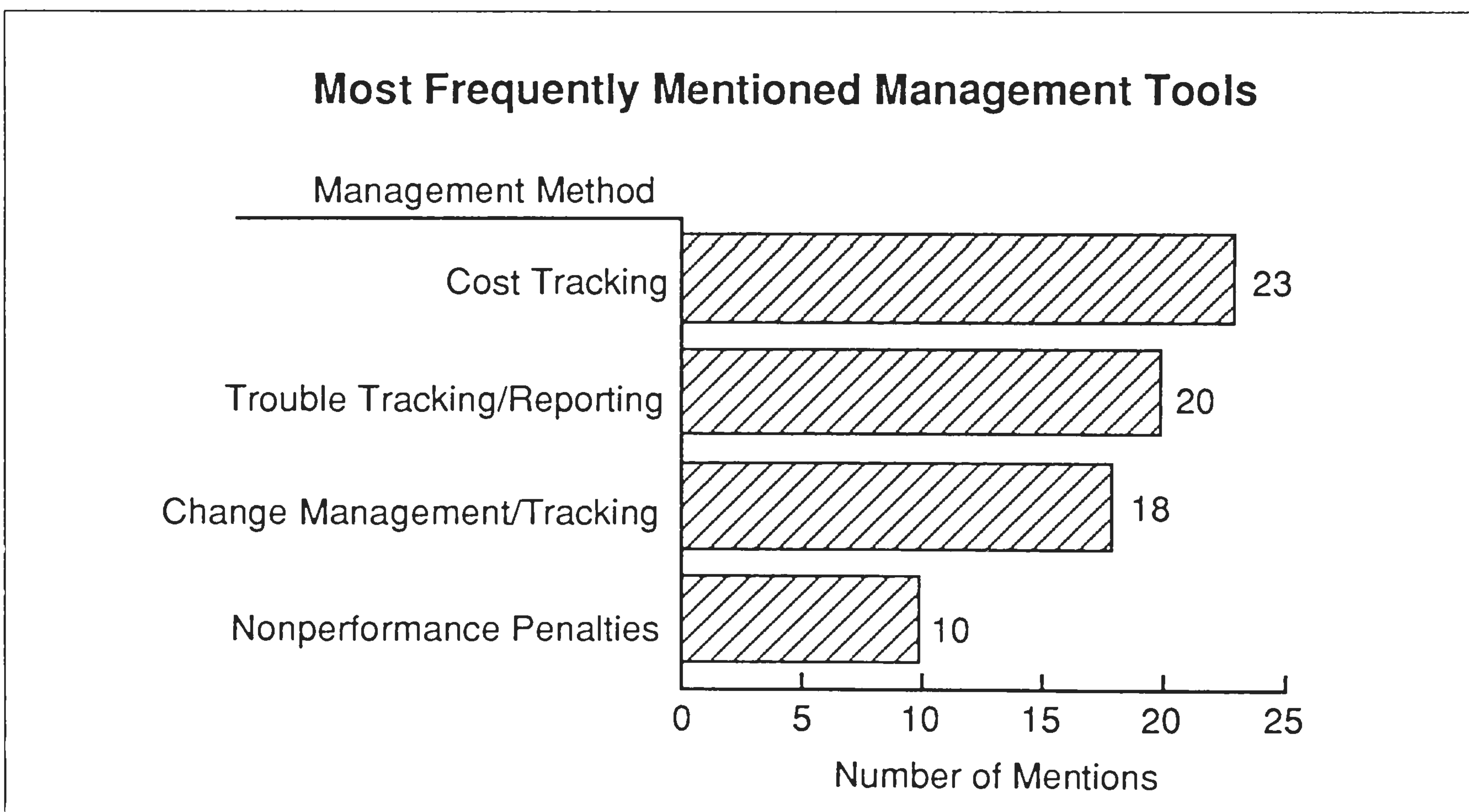
All respondents used some cost-tracking mechanism to monitor contract costs. Several respondents indicated they use much the same audit procedures they used before the outsourcing contract was awarded. The same good accounting practices that apply to management of data processing operations apply in this environment.

None of the respondents indicated they had devised a new, better method of tracking costs. It still seems to involve auditing costs after they occur and taking corrective action for the subsequent period where appropriate. Several users mentioned that the algorithm used to calculate costs was overly complicated when there was a fixed and variable component. This indicates there may be a lack of communication on this issue between vendor and client, a situation that could lead to trouble later in the relationship.

2. Performance Measures

Exhibit II-5 lists the most frequently mentioned management tools cited in the survey. Because cost is an important benefit, it is reasonable that cost tracking be the most important tracking mechanism. Problem and change tracking methods are also considered essential for smooth operating of the contract.

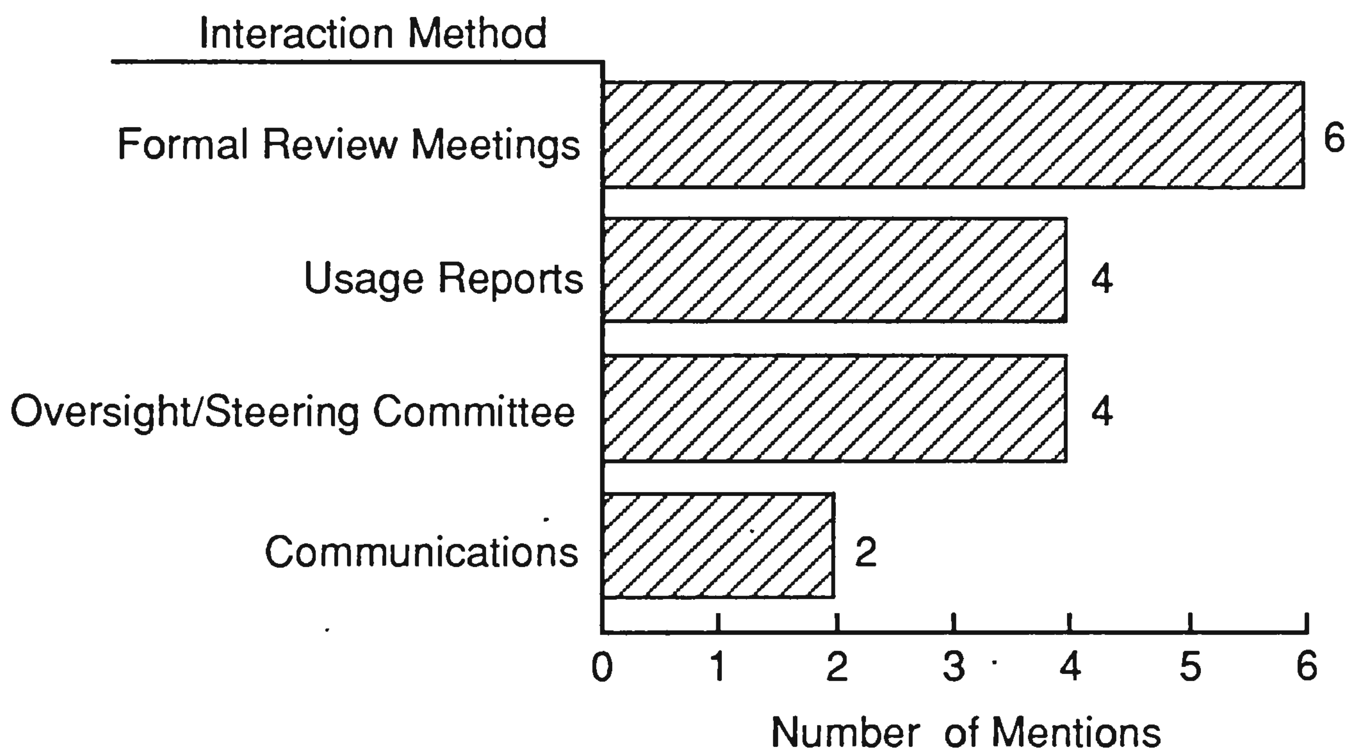
EXHIBIT II-5



Among the other management methods cited, 15 items mentioned measure how the client and vendor interface with each other. Exhibit II-6 summarizes this data. This reinforces earlier INPUT findings that good communications is essential for smooth functioning of the outsourcing contract.

EXHIBIT II-6

Client/Vendor Means of Interacting



The use of oversight committees was cited, particularly in the financial committee. Six other respondents indicated regularly scheduled formal review meetings were held to communicate between vendor and client. Three others cited usage reports as management tools, certainly a form of communications. Two respondents simply stated that all communications between the two parties are considered part of the management process that monitors the vendor's performance.

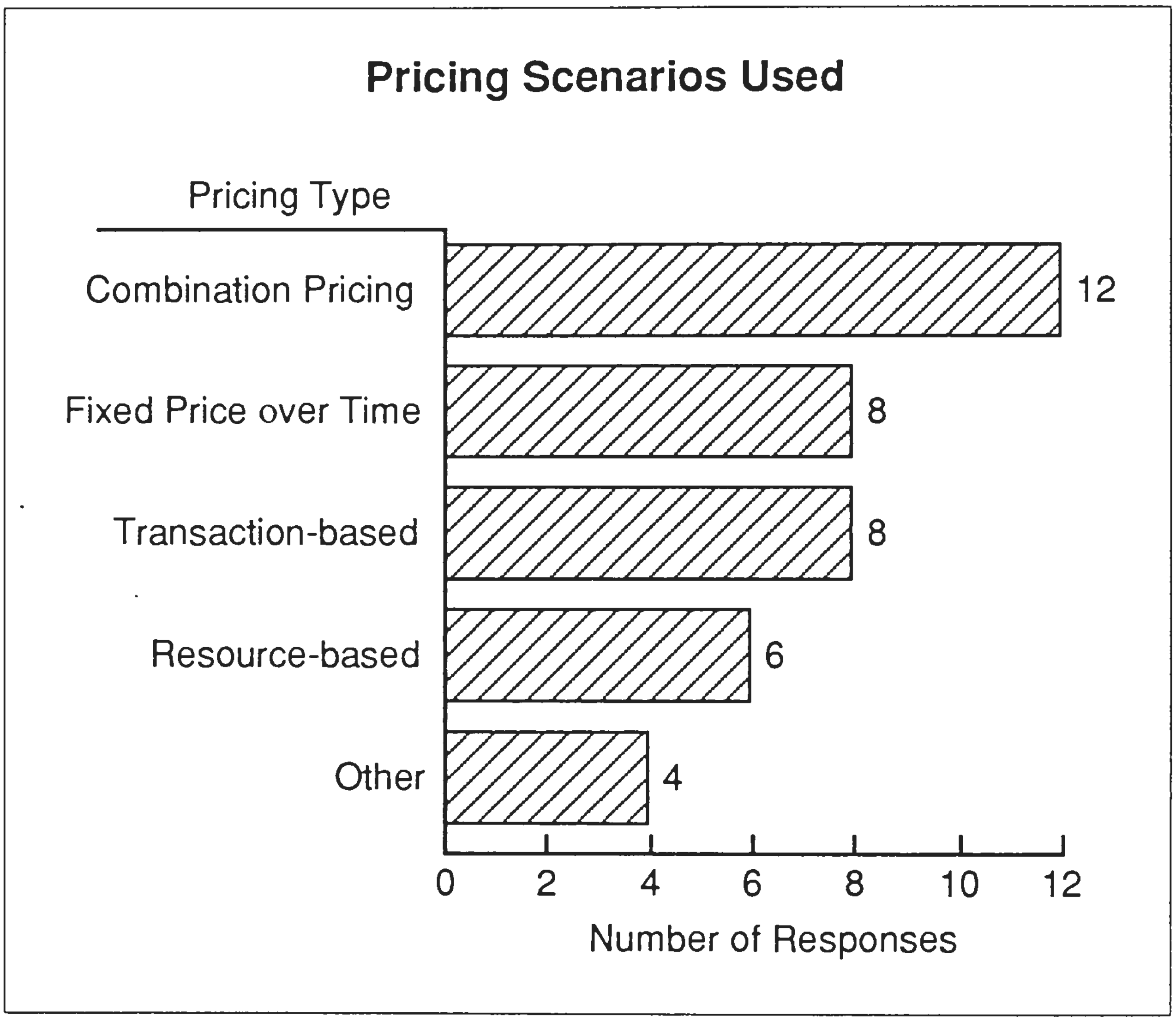
Many clients also indicated at least one resident vendor account manager was on site when the size of the contract warranted it. Of course, when the IS organization staff transferred to the vendor, then several vendor managers were on site to interact constantly with the organization's users.

C
Pricing and Contract Issues

1. Pricing Scenarios

A variety of pricing scenarios were reported. Exhibit II-7 illustrates the mix of pricing methods among the respondents.

EXHIBIT II-7



Because the world is complicated, the combination pricing model was cited in more cases than any other single pricing method. In a typical combination pricing scenario, the client used a certain amount of processing capacity each month, varying by plus or minus 10%, without incurring any additional charges. However, if usage was above that limit, as defined by the number of transactions processed, or by the amount of a specified type of resource consumed, the contract would call for a predefined surcharge assessed on the client for that month.

It is not surprising that the transaction-based pricing scenario and the resource-based scenarios are less commonly used in the outsourcing market. Both scenarios were inherited from the facilities management market. They have the advantage of more closely relating to the way the client conducts its own business, but do not provide a rational basis to define all the client's business, according to many respondents.

The next most common pricing mechanism is the fixed-price-per-time-period scenario. This assesses the same fee to the client, no matter what the usage pattern or the level of transactions for a specified time period. This allows the client to predict IT costs from period to period, thus permitting the organization to plan and budget better.

2. Contract Changes

Clients indicated what they would do differently in their next outsourcing contract, which provides a measure of current satisfaction and a signal of changes in the user requirements relative to contract terms.

Almost half of the users (42%) said they would not do anything differently in their next contract. The responses from those who would change included the following that received multiple mentions:

- Look more closely at the vendor's capabilities before awarding the contract (3 mentions);

- Require more technical skills from the vendor (3 mentions);

- Build in more evaluations than just financial performance measures in the contract (2 mentions);

- Prepare internal people better and sooner for the change (2 mentions).

The first two sets of responses are subtly different. They really say that users were either disappointed with the vendor's technical skills or anticipated needing more technical skills for their operations in the future. There were several instances cited where the client was surprised that vendors did not provide the caliber of people they had promised or the level of service specified.

The third set of responses indicate there has to be technical performance measurements also, not just financial performance measurements. This is from respondents who generally said that service levels and performance were better after the vendor took over operations, rather than before.

D

Conclusions and Recommendations

This study surveyed a variety of clients with outsourcing contracts, some relatively small, some very large. It also included contracts that were barely a year old and some that were six or more years. The scope of the sample allows us to draw certain conclusions about the client's view of the market and make recommendations to vendors, clients and potential clients of the outsourcing vendors.

1. Conclusions

The first conclusion is that most of those surveyed are relatively satisfied with the outsourcing arrangement they entered into. They had some expectations when they started. These have been largely met. In fact, in some cases there were side benefits, such as improved service levels and adapting more easily to new technology, that clients had not foreseen as benefits.

The advantage of lower costs continue to be one of the greatest benefits of the new arrangement. In some cases, this may be because the client has a better way of measuring this than other, less quantifiable, benefits. Nonetheless, the perception is that outsourcing contracts save the organization money, both in terms of operating expenses and certainly in terms of capital investment.

EXHIBIT II-8

Conclusions

- 90% of clients are satisfied with outsourcing
- Cost benefits continue to be very important
- Combination pricing still most popular scenario
- Communications with vendor key to good management
- Only 20% wouldn't recompete contract

Clients report in most cases, a combination of fixed monthly price with a variable component is the most common way to pay for services. This allows regular budgeting of IT costs while permitting both vendor and client additional flexibility if there is a sudden demand for or a reduction of required services.

The fixed price contract is the second most popular form of contract. It has the distinct advantage of providing a predictable IT cost structure over the year, but some clients express reservations that this limits their flexibility and causes them to pay more than they should for some services.

Both parties to the agreements, vendors and clients alike, repeatedly stated that good communication between the two parties is essential. This communication can take the form of formal meetings, day-to-day interaction and written, regular reports. This supports earlier INPUT research on the importance of interactions between vendor and client personnel.

Finally, it should be noted that though 90% of the clients expressed relatively high levels of satisfaction, only 10% indicated they would probably continue with the current vendor without recommendation, while another 10% planned on adding more functions to the contract at renewal time and stay with the same vendor. It is still a very competitive market and most clients will re-evaluate their relationships with the current vendor and recompete the contract. A minority expressed an interest in bringing the activity back in-house.

2. Recommendations

Based on the above conclusions, recommendations to clients and potential clients of outsourcing vendors, as well as to the vendors themselves, are outlined in Exhibit II-9.

EXHIBIT II-9

Client Recommendations

- Measure both cost and performance benefits of contract
- Be prepared for changes in contract within three years
- Communicate with vendor in a variety of ways

Many respondents indicated they could generally measure cost parameters associated with their outsourcing contracts and even measure response time and throughput accurately. These were, after all, traditional measures placed on IS departments in the past. Many were uncomfortable, however, that additional measures of the vendor's performance were not being considered.

As the outsourcing relationships become more all-inclusive and complicated, it will become important to measure the impact on not only the costs, but also on the customer service levels, or the change in competitive posture of the client. Clients must derive ways of measuring these parameters as valid indicators of the value of the outsourcing arrangement.

If one message was clear in the interviews, it was that the outsourcing contract changed in almost all cases from the original arrangement that had been concluded between the vendor and the client. This simply reflects the changing nature of IT technology and the IS function in the organization.

Several clients indicated they were surprised to find the outsourcing arrangement made it easier for them to react to changing conditions than if the IS operations had been retained in-house. This was reported as a "hidden" advantage of the contract.

The need to communicate was also made evident by vendors and clients alike. Both formal communications, such as regularly scheduled meetings, and informal daily contact between vendor and client personnel, are invaluable. The formal communications in particular must include senior management from both parties.

EXHIBIT II-10

Vendor Recommendations

- Be willing to change agreement as client changes
- Expand range of services available
- Suggest to client how to manage contract
- Communicate with client in a variety of ways

The issue of change is one that clients are much concerned with. Vendors must, first of all, demonstrate that they can change with the needs of the client organization, providing new and modified needs as they arise. This will not only require new technology and techniques, but often a review of the conditions under which the two parties operate.

Often, new conditions may mean reducing the vendor's revenue. In this era of downsizing and re-engineering, the new environment is often smaller. The vendor who enters an agreement with that in mind is ready with contingencies when the inevitable happens.

The most common change vendors will respond to is the need for additional services. This is not a problem for the astute vendor, but an opportunity. The client's redesigned operating environment will need more PC and LAN management and may require expanded network management capabilities. A good vendor must be able to provide these services directly or through alliances even before they are needed.

The issue of how to manage the contract effectively is still a big issue with most prospects. Any vendor who can visibly demonstrate a series of management tools will gain one more discriminator in differentiating itself from the rest of the market.

Finally, the need to communicate is an issue to be addressed by both the vendor and the client. As mentioned above, many clients feel this makes the difference between a successful and an adversarial relationship. The vendor providing good communications throughout the contract has a high probability of being in that small group of situations where the client decides to extend the contract without recompetition.

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III

Client Satisfaction

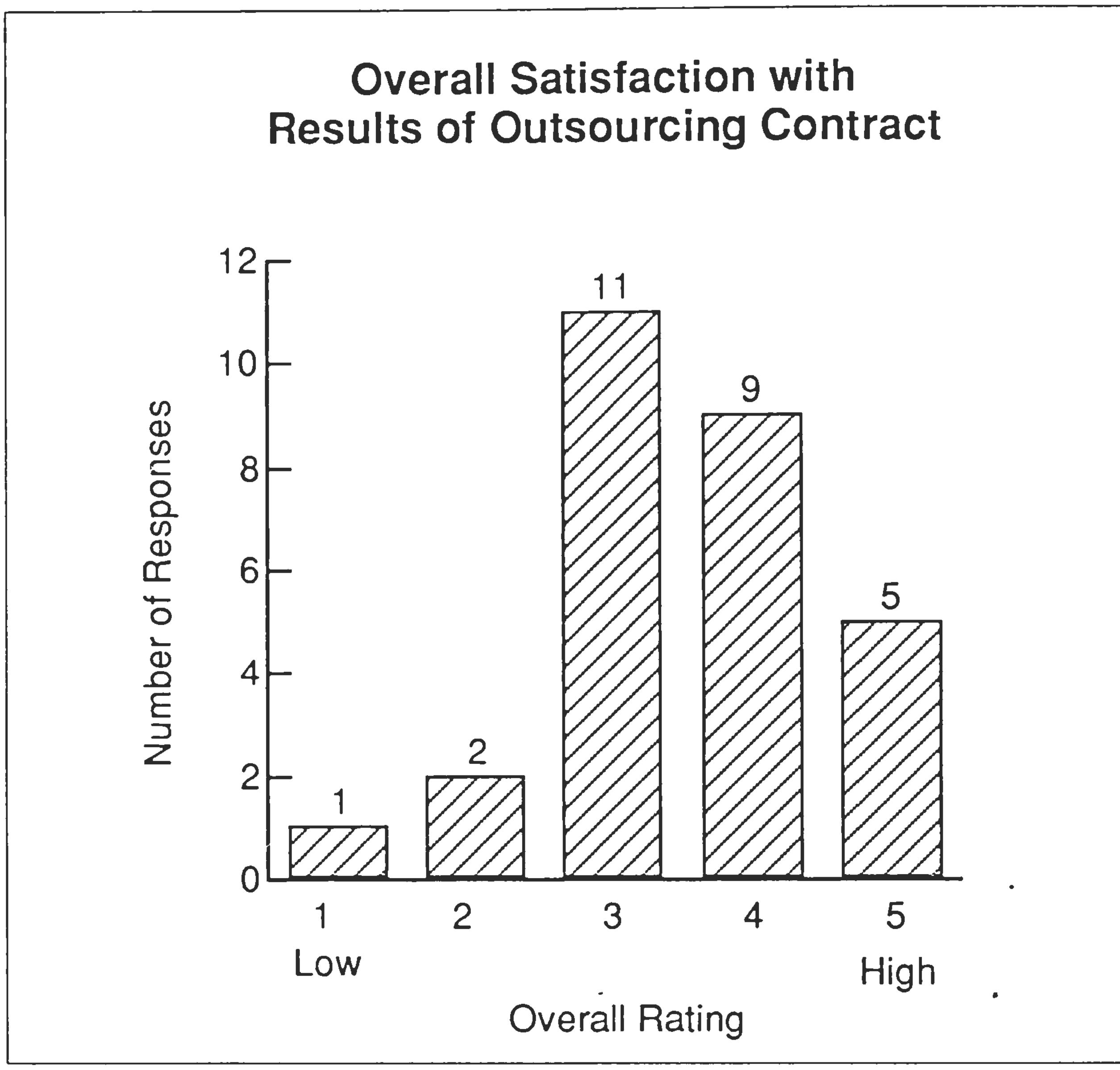
Many outsourcing contracts have now been in place long enough to allow a retrospective look comparing actual experience to the client's expectations. In some cases, individuals who actually negotiated the contract are still in place. In other cases, the outsourcing contract has been inherited by a new management team. Some of these are not certain what the original expectations were but can decide for themselves how well the vendor is currently performing.

A
Overall Satisfaction

The responses of all survey participants were grouped to derive some overall measures of client satisfaction with vendors, no matter what type of outsourcing is provided.

Exhibit III-1 shows how the overall satisfaction with the outsourcing contract results were distributed. The scale was from one to five, with five meaning extremely satisfied and one meaning not satisfied at all. The average of the satisfaction values was 3.6.

EXHIBIT III-1



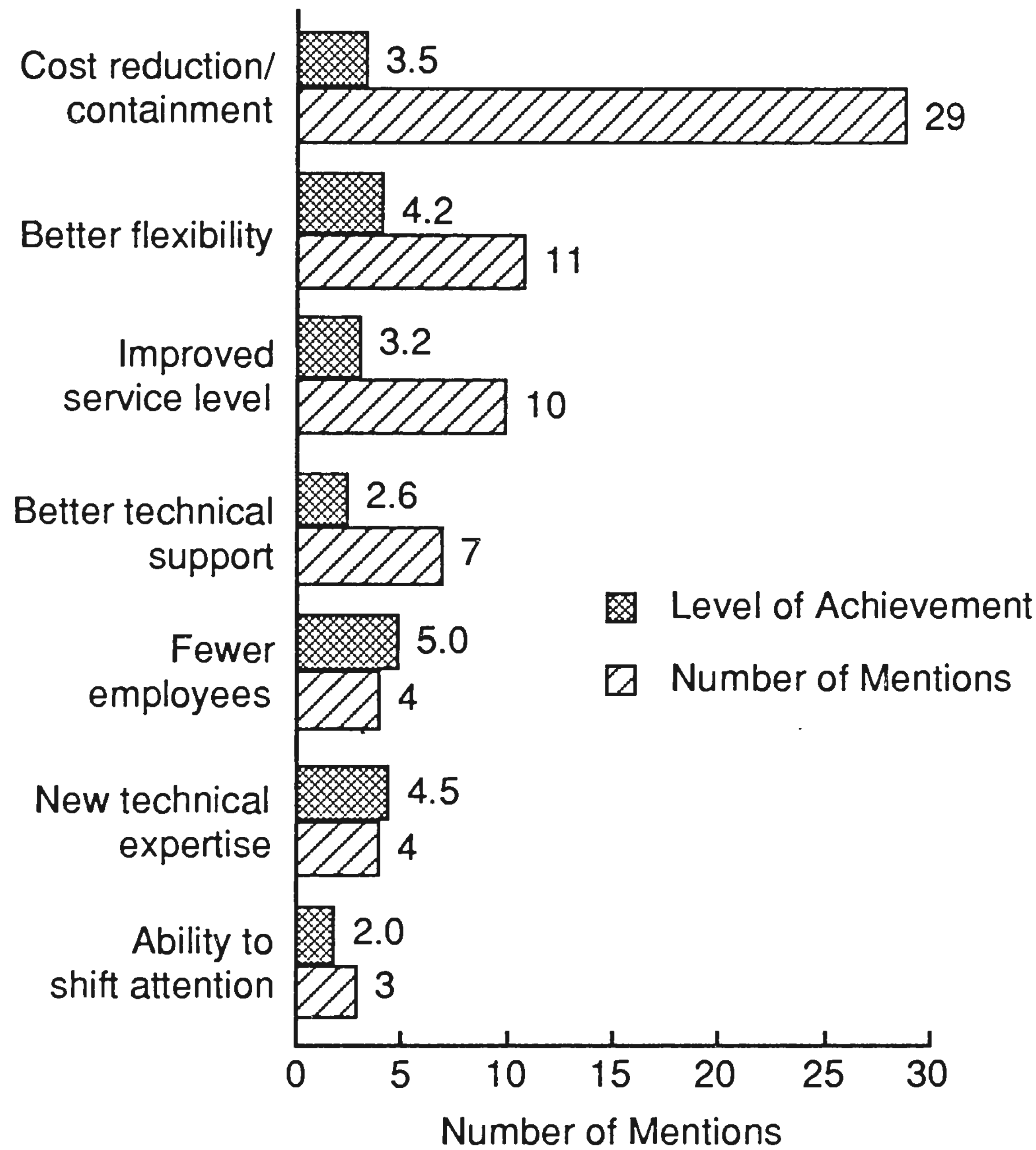
Responses are clustered around 3 and 4, indicating a relatively high level of satisfaction in the market in general. Less than 11% of the respondents rated the results below a 3. The fact that five respondents actually indicated they were extremely satisfied is also worth noting.

Another question asked early in the discussion was whether benefits that the client organization expected with the outsourcing agreement were actually achieved. The client also rated how well that benefit was attained.

Exhibit III-2 lists the frequency of each response and the level of satisfaction that a particular client attained. Interviewees were not given a preselected set of benefits but were asked to identify them within the context of their own operating environment.

EXHIBIT III-2

Benefits Expected from the Outsourcing Arrangement



The results are not unexpected. Cost benefits still are most often cited by the client organization. Many outsourcing contracts are motivated first by the need to reduce operating costs, or at least to reduce capital expenditures. The outsourcing arrangement seems to do that.

The importance of the flexibility issue has risen since earlier surveys were conducted. This probably reflects the fluid situation in organizations that must constantly upgrade their information technology to adapt to rapidly changing business conditions.

Improved service levels reflect good management practices of the vendors. They bring experience in data center and software management to the new relationship. This is generally reflected in improved availability for processing capacity and better turnaround time for software development.

The two items of better technical support and new technical expertise are somewhat related. They depend on the ability of the vendors to attract and keep high quality staff. Some clients have been disappointed on this score, as is discussed later, particularly relative to the better technical support issue. That may reflect on the fact that the vendor often takes on the client's IS employees, then uses fewer of them to accomplish the same tasks.

Exhibit III-2 also shows the relative level of satisfaction, on a level of 1 to 5, with 5 again being the highest. This time the issue of flexibility scores high again, outscored only by the few respondents who expected to see fewer employees and indeed did so.

The relatively high level of satisfaction with the achievement level is apparent. Organizations wanting to reduce staff did so, although those that wanted to achieve cost reduction benefits in general were not as satisfied with the results.

Organizations wanting the vendor to provide new technical expertise were generally happy with the results, and those who sought better flexibility also achieved their objectives.

Benefits receiving the lowest responses should be considered in particular. Organizations that expected the outsourcing vendor to improve service levels and provide better technical support were less satisfied with the results. These responses reflect the trend among many vendors to assimilate the client's staff into their own organization. In many cases, the same people are providing the service who were there before. They may even initially resent being transferred to the vendor staff and have some level of lessened morale. It generally takes a period of time for the vendor to grasp this problem and remedy the situation.

Those who hoped to turn the IS function over to the vendor and shift their attention to other matters were generally disappointed. This last benefit is often cited as a strong qualitative reason for going to an outsourcing vendor, one benefit that cannot be measured very accurately, but carries a lot of value. Client experience suggests that outsourcing may not be as effective in shifting management focus as had been hoped.

B

Satisfaction Relative to Age of the Contract

There may be a correlation between the age of the contract and the overall satisfactions levels. Exhibit III-3 charts that contract data in this sample.

EXHIBIT III-3

Relationship of Age of Contract to Satisfaction

There is a definite pattern emerging here: New contracts are meeting expectations. Those clients who are one or two years into the contract period are the ones who seem to be the least satisfied. Clients with contracts of three years and more appear to achieve more satisfactory levels of expectation again.

In the related INPUT European study of client satisfaction, the same early high satisfaction ratings were experienced, but the satisfaction rating did not rise again in the older contracts.

These numbers probably reflect the following scenario in the life of a typical outsourcing contract:

In the first months, there is some euphoria over early results and some positive reports generated to justify this major change. As the contract moves on in its life cycle, new problems arise and the vendor may not respond as fast as when he tried to make a good first impression. The vendor may have also reduced the staff to improve the margins. This causes delays, drops in service levels and other problems. Consequently, the level of satisfaction drops. These problems are overcome as the contract approaches maturity, operating problems are ironed out, functions become more structured and better managed. The level of satisfaction again goes up as old problems are forgotten.

The vendor who can remove the dip in satisfaction that seems to occur in the early years of the contract can improve its renewal rate. Keep in mind that the numbers in Exhibit III-3 were the mean values. The satisfactions levels for each life span varied somewhat, although there were no 1s and 2s in either the new or the oldest contracts.

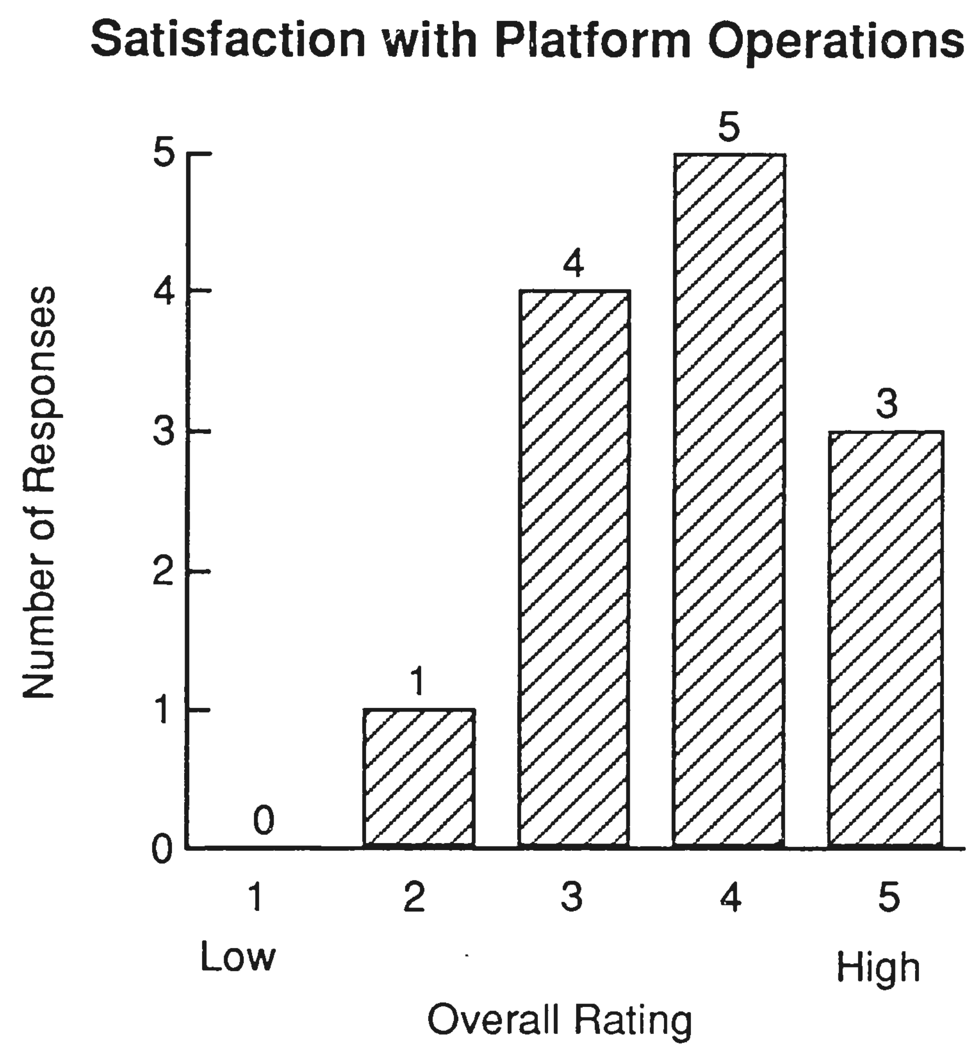
The interesting question to be addressed next is whether satisfaction levels observed overall are the same within each submode of outsourcing. At the risk of reducing the sample size too much, the survey will now be subdivided into those categories.

C

Platform Operations Clients

The distribution pattern of responses from clients who had platform operations contracts, when just data center and its associated network is involved, is presented in Exhibit III-4. The average satisfaction rating for these clients was 3.8.

EXHIBIT III-4



Three respondents in this group gave their vendor the highest satisfaction rating of 5. The top rating was shared by three vendors with each vendor getting one. This was the only type of outsourcing in which the clients registered such a high satisfaction level. In these three cases, contracts had been in effect from two to four years, so there were ample opportunities for problems to develop.

When the benefits achievement responses are separated into the same categories, platform versus applications operations, contrasts are more dramatic. In 70% of the platform operations clients, cost benefits were the first mentioned. Among applications management and desktop services clients, 50% of the clients mentioned cost benefits as the most important.

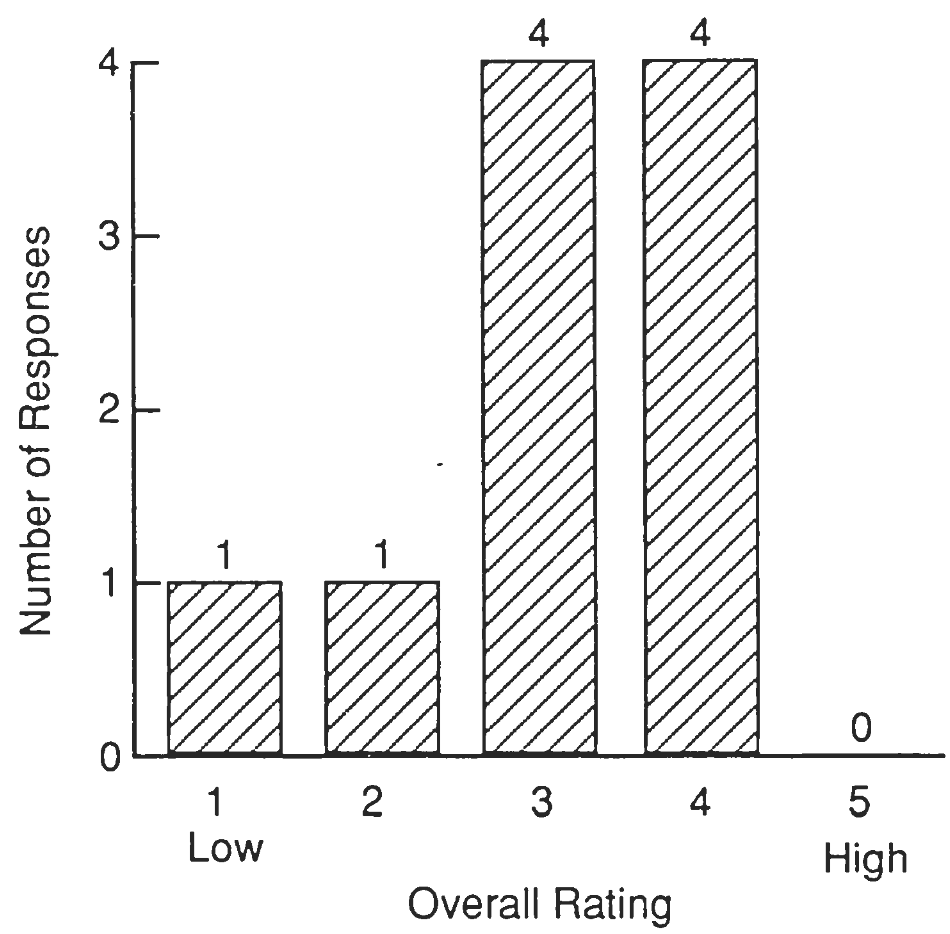
D

Applications Operations Clients

The distribution pattern of responses from clients who had applications operations contracts is presented in Exhibit III-5. In applications operations contracts, the data center, its associated network and the applications software are involved. The average satisfaction rating for these clients was 3.6.

EXHIBIT III-5

Satisfaction with Applications Operations



The slightly lower satisfaction ratings for applications operations contracts (there were no 5s) indicates that such a contract is more difficult to manage. Vendors are very good at running data centers, but when there is software development and maintenance involved, schedules are harder to meet and the level of service is often perceived as somewhat lower. Even experienced vendors can't make the software development process run smoothly all the time.

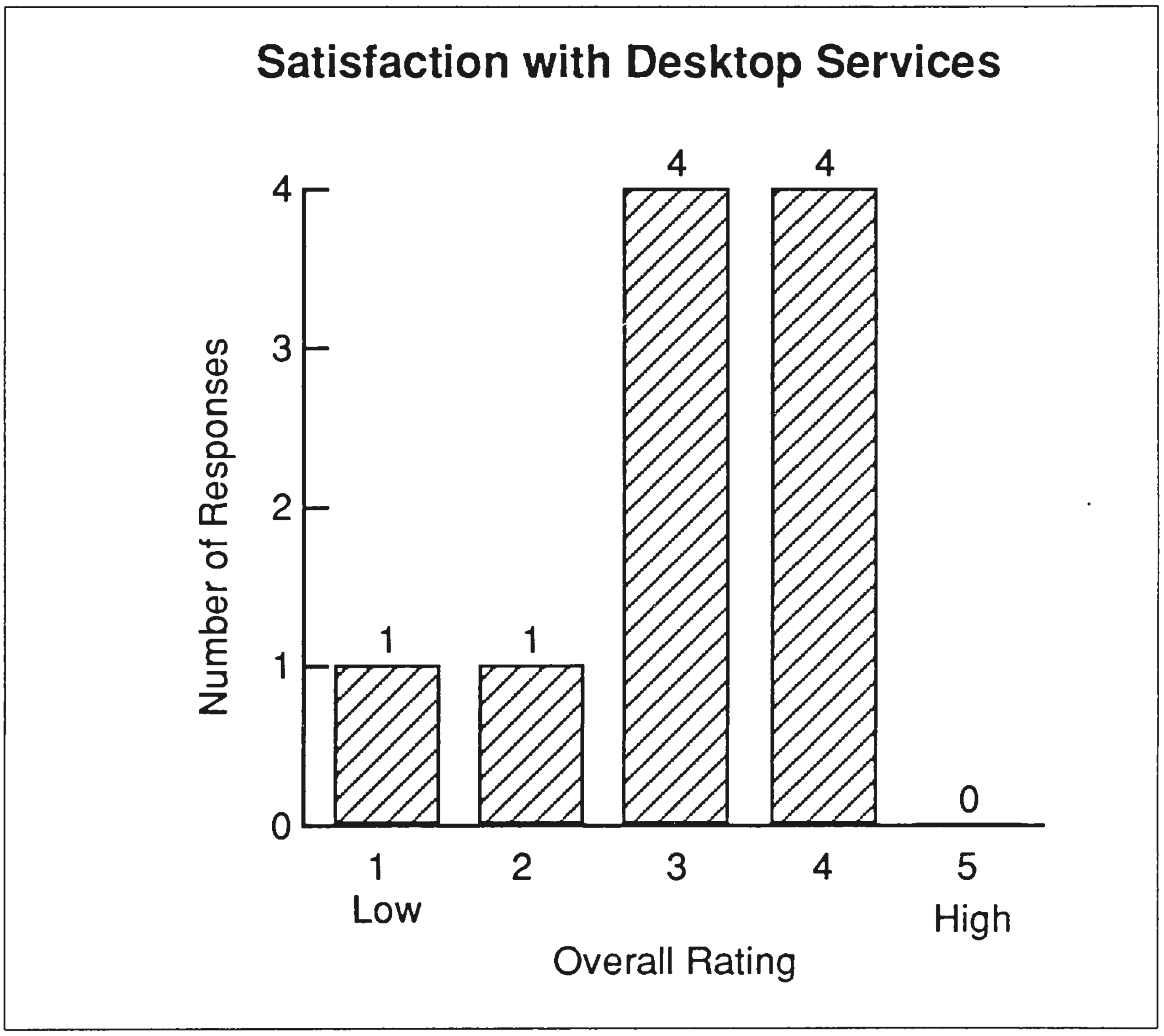
E

Desktop Services Clients

A substantial portion of respondents had desktop services contracts, either with the same vendor who managed their systems operations or with a separate vendor.

The distribution pattern for these responses is illustrated in Exhibit III-6. The average satisfaction rating for these clients was 3.5

EXHIBIT III-6



The fact that the average satisfaction level and distribution of responses is the same for both applications operations and desktop services is not surprising. In most cases, clients who had an applications operations agreement with the vendor also had a desktop services arrangement with the same or another vendor.

All but one of the desktop services clients were also applications operations clients. In two of the cases, different vendors hold the contracts, while in the eight other cases, the same vendor provides both services. Only one of the desktop services clients had a platform operations contract. This finding reinforces early INPUT research that had found clients tending to use the same vendor for additional services.

In discussions with respondents, the desktop services portion of the contract, when it was with the same vendor, was often added as the PC/ workstation inventory increased and managing the environment became more difficult.

The satisfaction rating was usually the same for all aspects of the outsourcing contract, though a few respondents indicated they were more satisfied with one aspect of the arrangement than another.

F

Network Management Clients

The sample of users was selected randomly with no attempt to balance the mix of contracts and possibly skew the results. For that reason there were only two responding clients who had separate or solely network management contracts. The level of satisfaction was rated 4 for one respondent and 5 for the other. With this small sample, it is impossible to do more than report the results.

G

Vertical Industry Experience

Can the measure be related in any way with the vertical industry that the client is in? Exhibit III-7 summarizes some of the data in that form. Note there is not always a large enough sample size in each vertical industry to make the mean value meaningful, so INPUT reports the range of values instead.

EXHIBIT III-7

Satisfaction as Related to Industry

Vertical Industry	Range of Satisfaction	Sample
Manufacturing	2 to 5	10
Banking/Finance	3 to 4	5
Retail	4 to 5	4
Insurance	3.5 to 4	3
Business Services	1 to 3	2

Note: Other vertical industries had only one respondent

It is not valid to say anything about industry acceptance when the sample size is too small. The only conclusion to be drawn from this data is that the Banking and Finance industry is probably more content with its outsourcing arrangements than the Manufacturing sector. Because situations and contract sizes vary greatly in the Manufacturing sector, it is no surprise that the range of satisfaction is so broad.

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IV

Management Methods

When a client turns over management of the IS function or some of its components to a vendor, there is always a sense that some degree of control is lost. Yet this vendor/client relationship is not a new one in the IS environment. Organizations have used vendors to do contract programming, remote processing and systems integration for many years. The same management techniques can be refined to function in the outsourcing environment also.

Clients who participated in this study were asked a series of questions about management tools and their effectiveness.

A
Cost Controls

Cost reduction was ranked as one of the principal achieved benefits of the outsourcing arrangement. The method for monitoring and controlling vendor costs must therefore be an important management tool for client organizations.

In fact, all respondents used some cost-tracking mechanism to monitor contract costs. Most users reported a pricing mechanism that combined a fixed price with a variable component, depending on the amount of resources used in a specified time period. For that reason, the typical control mechanism was an audit trail of transactions checked on a biweekly or a monthly basis to track resources consumed versus charges incurred.

Several respondents indicated they use much the same audit procedures they used before the outsourcing contract was awarded. The same good accounting practices that apply to managing data processing operations also apply to monitoring the vendor/client operating environment, as one might expect.

No respondents indicated they had devised a new, or better method of tracking costs. It still seems to involve auditing costs after they occur and correcting for the subsequent period if that is appropriate. Several users did mention that the algorithm used to calculate costs was overly complicated when there was a fixed and variable component. This indicates there may be a lack of communication on this issue between vendor and client, a situation that could lead to trouble later in the relationship.

Barring some sophisticated ways of tracking costs, many prospects might be tempted to select the lowest overall bid to ensure low cost operations. A related INPUT European survey asked clients that question. The markets are similar enough to report the results here for additional information.

Only about one-third selected the vendor who rendered the lowest bid. Of 37 clients surveyed, 13 selected the lowest bidder. There are many other criteria to be considered other than price, so selecting the lowest-priced bidder is no substitute for developing good ways to measure cost performance.

B

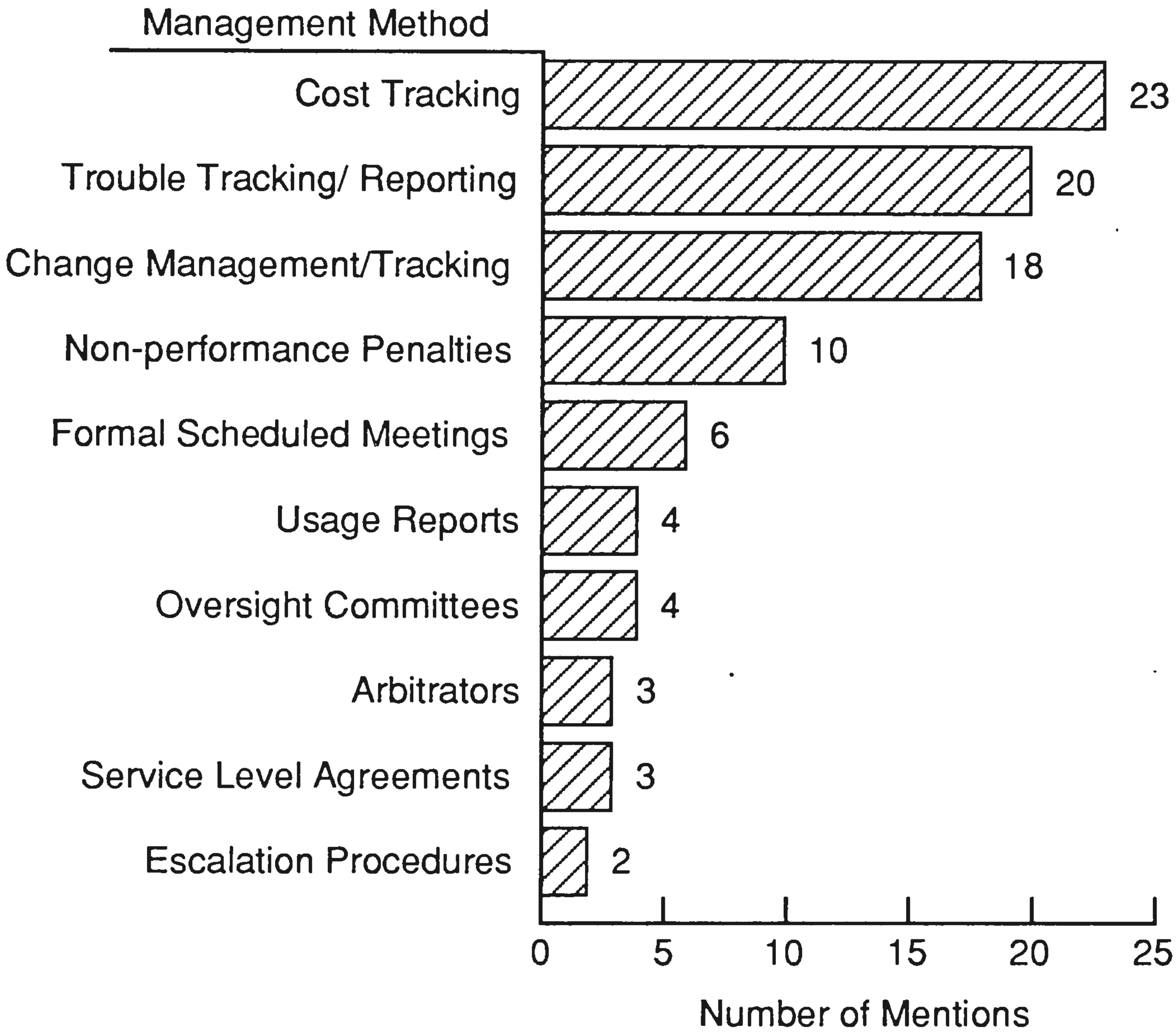
Vendor Performance Measures

Exhibit IV-1 illustrates the frequent use of management tools by client . organizations to manage the outsourcing vendor relationship. As mentioned above, most of respondents (85%) indicated they used some cost tracking methods, about 75% indicated they used some trouble-tracking mechanism, while two-thirds had some mechanism for change management and tracking in place.

Only one third of the respondents indicated they had non-performance clauses in their contracts. Upon further analysis, no correlation was found between the contract's age and the presence of non-performance clauses. There was a negative correlation between the presence of such a clause and the size of the contract. In fact, of the five largest contracts included in the survey, only one had non-performance clauses. Some respondents indicated that these are often unenforceable, or the remedy of invoking them is more damaging than finding an alternative remedy.

EXHIBIT IV-1

Frequency of Mention of Management Tools



Among the less frequently mentioned management tools, many stressed communications between vendor and client. Formal, regularly scheduled meetings—weekly, biweekly or monthly—were cited as a good and necessary management device. These were usually supplemented by periodic meetings between senior management of vendor and client, those not directly involved in day-to-day operations of the contract.

Usage reports are another cited communications vehicle that draws attention to how the service is used and gives early warning of any impending major change.

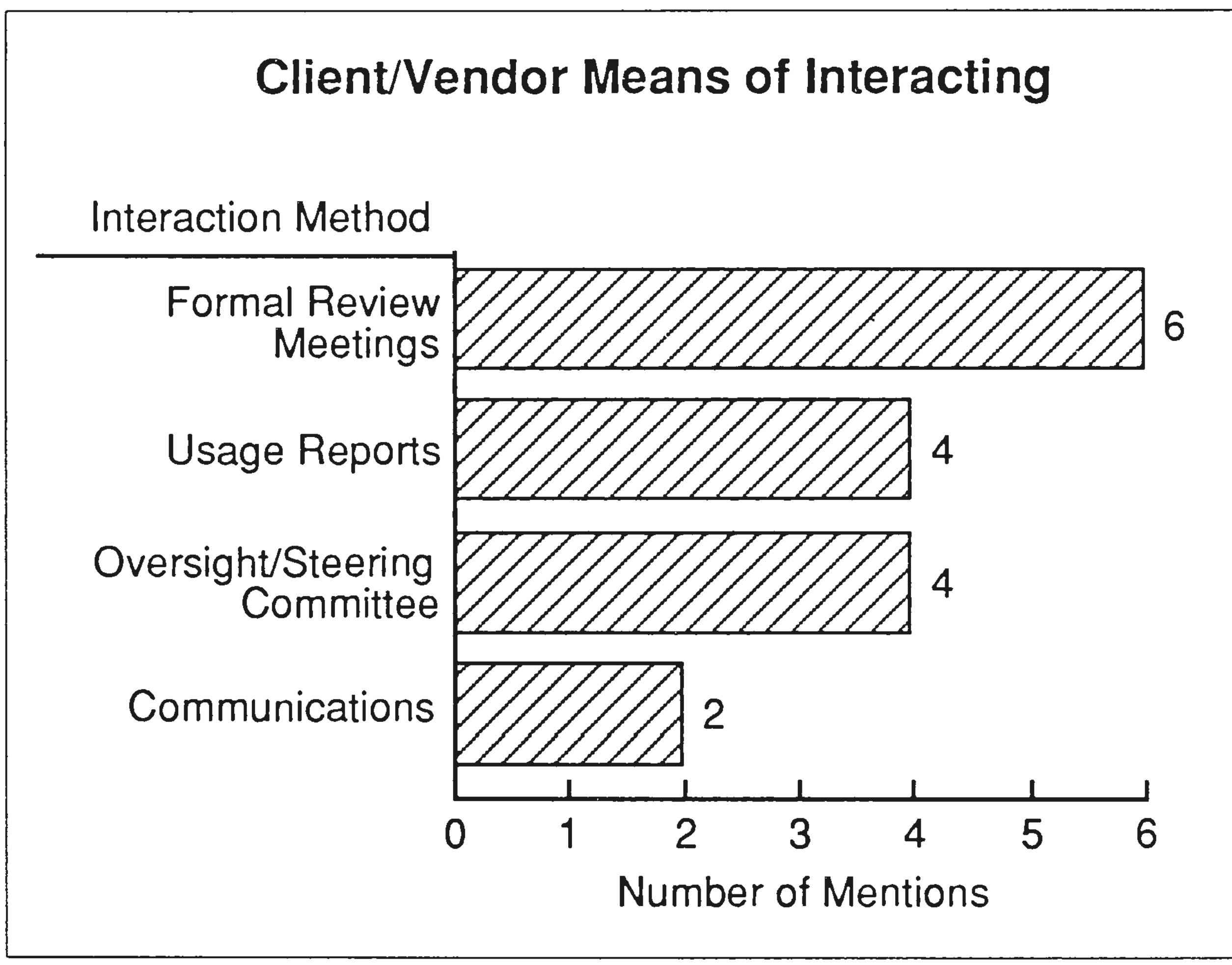
The financial community frequently cited oversight committees as a management tool. Two respondents indicated they had escalation procedures in place for resolution of disagreements between vendor and client. Service level agreements were cited by three organizations as a good means of performance monitoring. Finally, arbitrators were sometimes used as a means of conflict resolution, though this was a less acceptable alternative.

C

Client/Vendor Interfaces

As mentioned in the preceding section, among the other management methods cited, 15 items mentioned measure how the client and vendor interface with each other. Exhibit IV-2 summarizes this data.

EXHIBIT IV-2



The use of oversight committees was cited above, particularly in the financial community. Six respondents indicated that there were regularly scheduled formal review meetings to communicate between the vendor and the client. Four others cited usage reports as management tools, certainly a form of communications. Two respondents simply stated that all communications between the two parties are considered part of the management process they use to monitor the vendor's performance.

This reinforces earlier INPUT findings that good communication is considered essential for smooth functioning of the outsourcing contract.

These examples were used during the discussion of management techniques used by the client. In addition, many of clients indicated there was at least one resident vendor account manager present on site when the size of the contract warranted it. Of course, when the IS organization staff transferred to the vendor, several vendor managers were on site to interact on a constant basis with the user community.

D
Change Management

As shown in Exhibit IV-1, 18 respondents indicated they have some change management mechanism in place to oversee any service level change that is initiated.

Respondents with some change management mechanism are not only those with applications operations contracts, but many of the platform operations contracts also. Only holders of short duration contracts—three years—did not indicate whether they were concerned about change management.

In fact, two types of changes were identified by the respondents:

- In the applications operations area, standard management tools to control software versions and provide testing, as well as acceptance of software changes, were mentioned often.
- In the platform operations environment, changes usually related to processing requirements, initiated by changing business volumes. Most respondents indicated their contracts allowed some level of change without any contract renegotiation.

One issue that arose several times was the inability to adjust the contract as the load requirements changed. When the outsourcing agreement was made with some plan for transitioning away from mainframes, reduced costs for the outsourcing service were anticipated. In most other cases, volume requirements shifted considerably, even though it was not anticipated. In those cases, respondents complained that vendors were reluctant, or at least slow, to adjust the costs downward. The pricing algorithm usually was designed to handle an increase in volume, but a decrease in volume that is likely to be permanent was a bigger problem for the vendor.

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V

Pricing/Contract Issues

The pendulum continues to swing on the outsourcing market contract issue. Several years ago, users and vendors alike stated the contract was a necessary evil, not to be referred to except in dire emergency after it was signed. An earlier INPUT report noted that if the contract had to be referred to, the relationship between the two parties was already in trouble.

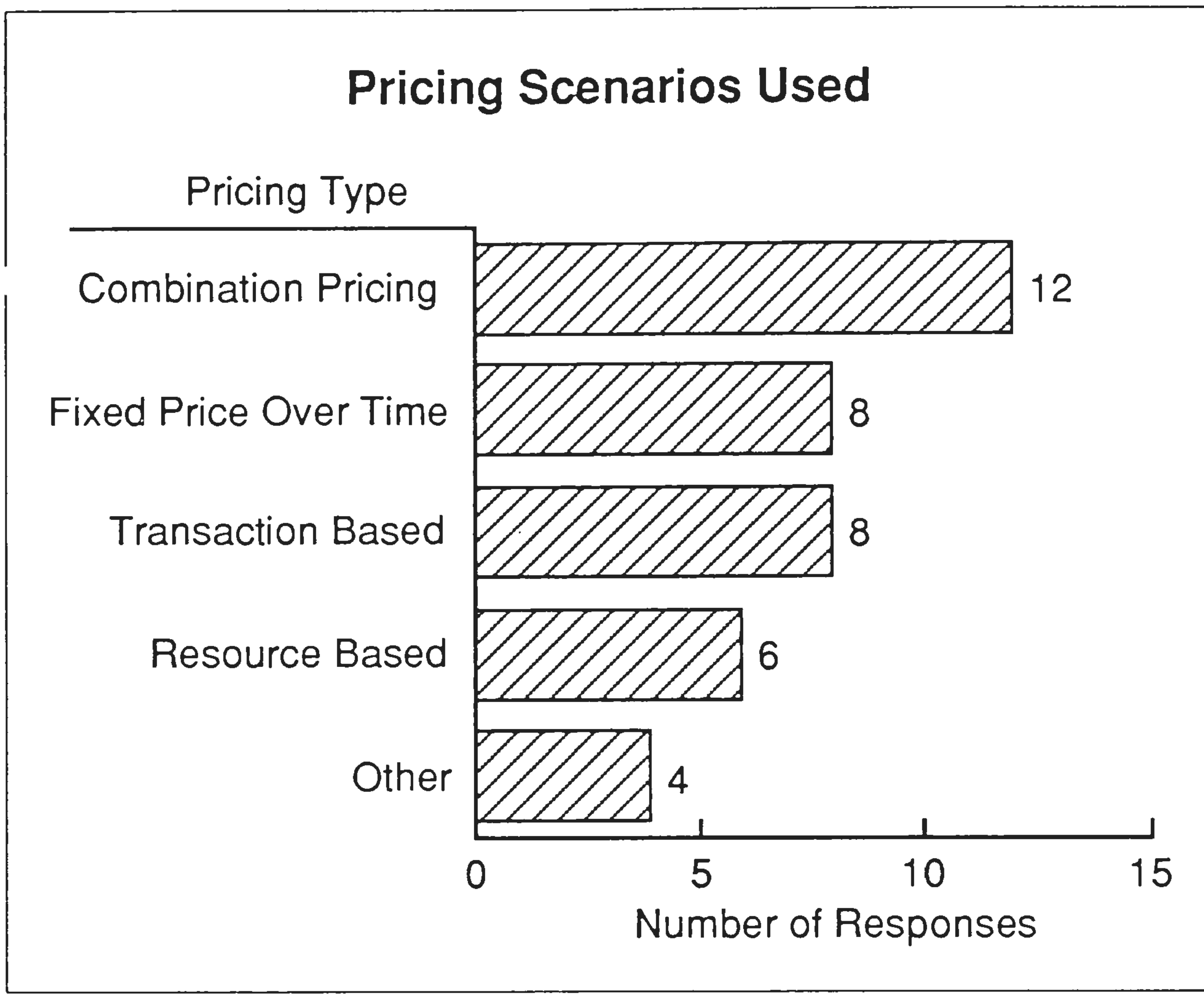
More recently, several industry spokespersons say the contract is extremely important and should not be left to amateurs to develop. The truth is somewhere between these two positions.

The outsourcing environment has become more complicated in the last several years. More IT operations are outsourced; some entire business functions are now turned over to vendors. The total financial commitment has grown, in most cases, for both parties. Both vendors and clients are more sophisticated relative to what to expect and how to manage the relationship. For all these reasons, the contract has indeed become more important.

A
Type of Pricing

Some interesting observations were derived from the data on pricing approaches. Exhibit V-1 illustrates what the mix of pricing methods was among respondents.

EXHIBIT V-1



It is not surprising that transaction-based pricing and resource-based scenarios are less common in the outsourcing market. Transaction-based pricing was one of two scenarios inherited from the facilities management market. It has the advantage of being closely related to the client's own business, but does not provide a rational basis to define all the client's business, according to many respondents.

The resource-based pricing option, the other pricing scenario inherited from the facilities management days, is still used by a quarter of the study's respondents. It has the advantage of tracking consumption of the vendor's processing capacity and charging the client only for resources used. This may be the best mode for a platform operations contract.

When applications maintenance and development or other personal services from vendors are included, then the model does not work well for either party. This pricing model usually also results in an unpredictable IT budget from month to month, a definite disadvantage for many users.

The next most common pricing mechanism mentioned is the fixed-price-per-time-period scenario; this is, as it states, the assessment of the same fee to the client, no matter what the usage pattern or level of transactions for a specified time period. This allows the client to predict IT costs from period to period, thus permitting the organization to plan and budget better.

The time period is usually a year minimum for the pricing plan to be considered a fixed price contract. Fixed price does not mean fixed over the entire period of the contract, but rather over a defined budget period. This allows the computing environment to change rapidly resulting in periodic reevaluation in all fairness to both parties in the relationship.

Becuase the world is complicated, the combination pricing model was used in more cases than any other single pricing method. In this situation, there is a fixed price, predictable component to the monthly IT charges which is modified, depending on the usage pattern, each month.

Thus, in a typical combination pricing scenario, the user uses a certain amount of processing capacity each month, varying by plus or minus 10% without incurring any additional charges. However, if the usage were above that limit, as defined by the number of transactions processed, or by the amount of a specified type of resource consumed, the contract calls for a pre-defined surcharge to be assessed for that month. If usage is below the range, adjustment can be made downward, though this is less common.

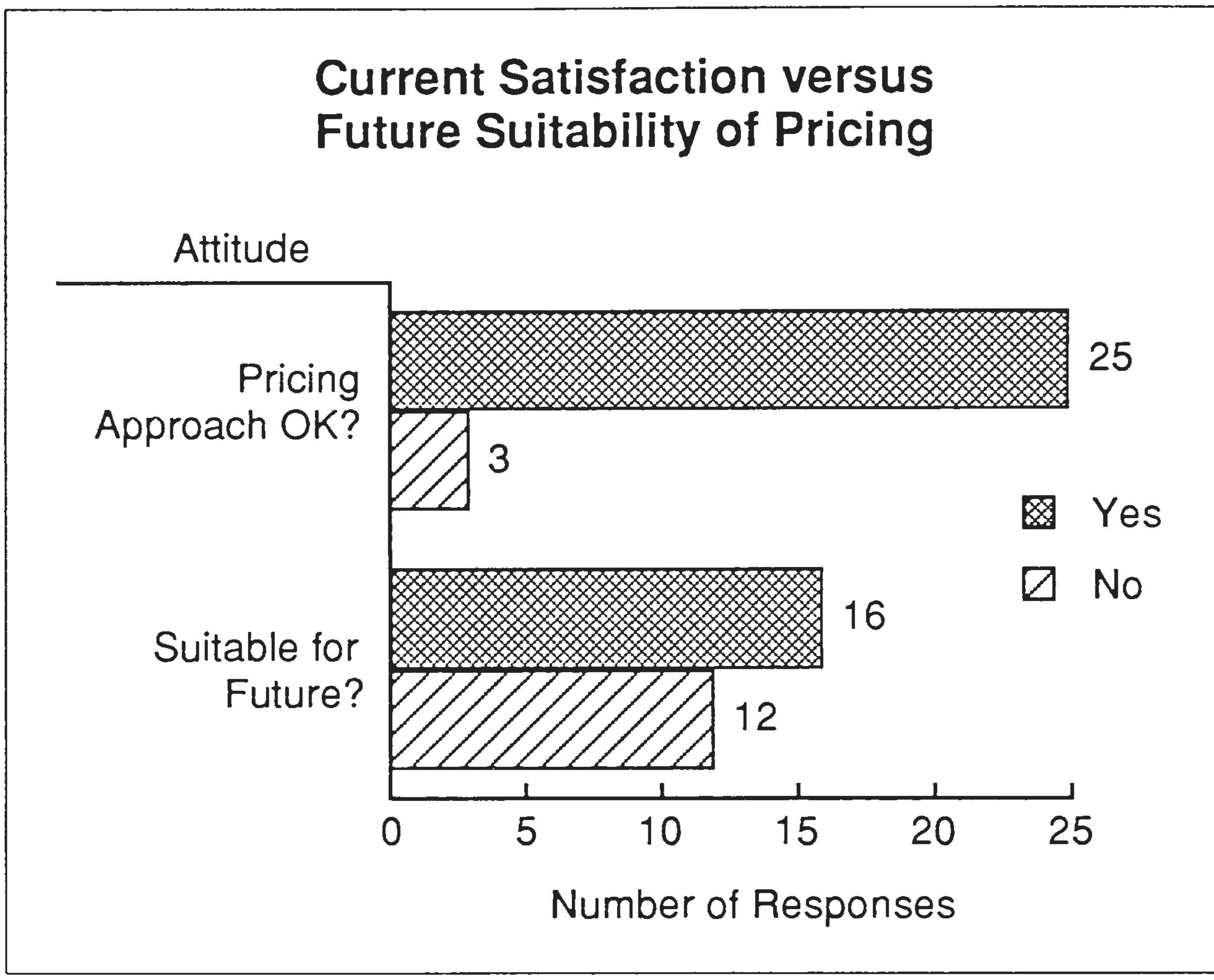
There is only a shade of difference between the last two pricing scenarios mentioned. Both account for a changing IT environment. One simply trades off predictability against more protection for the client. The trend is definitely toward a large fixed price component in all of these pricing agreements.

B

Attitude Toward Pricing

Exhibit V-2 illustrates that the large majority of respondents (89%) were satisfied with the pricing approach being used, but only slightly more than half (57%) indicated the same type of pricing would be appropriate in future outsourcing contracts.

EXHIBIT V-2



This apparent dichotomy between actual and future situations is a signal that clients realize their IT environment is changing rapidly. Solutions for today will not necessarily apply tomorrow. Thus, the pricing mechanism that is adequate in the current contract will not be suitable when desktop services are added to the next one or if the vendor is asked to take over more of the operations within the client organization.

When users were asked what advantages and disadvantages each pricing scenario held, some interesting comments were made. Rather than trying to quantify these in any rigid way, the comments themselves are recorded below to illustrate what the user attitudes were.

1. Fixed Pricing

Advantages:

> "The budget is easy to define in this case."
>
> "We're saving a fortune."
>
> "This makes it affordable to bring the outlying offices on board."
>
> "The costs will be kept low as the organization grows."

Disadvantages:

"Costs are not linked in any way to quality."

"Contract will become expensive beyond 1996."

"Not easy to adjust baseline to stay in bounds."

These comments indicate users like the predictability of the method, believe they are saving substantially over their old costs, but still have limits as to resources they can use without incurring additional costs. Thus even in a so-called "fixed cost" environment, they are really operating on a combination pricing basis.

2. Resource-based Pricing

Advantages:

"It's simple to figure out what we are paying for."

"This gives us more flexibility when we are downsizing."

"It has lowered our internal costs."

Disadvantages:

"We pay even if we don't use the minimum."

"We can't renegotiate as costs come down overall."

Again, these comments indicate that resource-based situations have a lower limit that cannot be crossed, even if processing loads are below that limit. Lower costs as downsizing occurs came from one organization that obviously had no such lower limit. The simplicity of this approach reflects its present costs in the old resource-based style that users were used to seeing when the IS department was running the operation.

3. Transaction-based Pricing

Advantages:

"Costs can be predicted based on the number of policies each month."

Disadvantages:

"We still pay a certain minimum no matter what the number of transactions."

It is evident here also that the transaction-based systems still have a minimum threshold value that must be remitted to the vendor, no matter how few transactions are processed.

4. Combination Pricing

Advantages:

> "We know what our costs will be."
>
> "We pay for the processing costs that we incur only."
>
> "It is easy to interpret the bill."

Disadvantages:

> "We still have a fixed minimum charge to worry about."
>
> "It is an administrative nightmare to administer."

These responses included one client who thought the bill was easy to interpret and one who called the billing an administrative nightmare. In the latter case, there was a bill-back procedure in place for individual departments, so this would explain the comment.

These comments belie the responses earlier in this section. It seems most contracts have some limiting clause so the fixed price per month cannot go below a certain value. Also, transaction- and resource-based contracts seem to have a lower threshold value that cannot be passed. In fact, most contracts included in this study were some combination of fixed and variable, including the "other" category, even when respondents identified them as specifically one type or the other.

C
Contract Changes

Another measure of the current level of satisfaction is to ask clients what they would do differently in their next outsourcing contract. This also serves to signal any changes in user requirements relative to contract terms.

Almost half of the users (42%) said they would not do anything differently in their next contract. Responses from those who would change included the following that received multiple mentions:

- Look more closely at the vendor's capabilities before awarding the contract (3 mentions);
- Require more technical skills from the vendor (3 mentions);
- Build in more evaluations than just financial performance measures in the contract (2 mentions);
- Prepare internal people better and sooner for the change (2 mentions).

The first two sets of responses are only subtly different. They really say that users were either disappointed with the vendor's technical skills or they anticipate needing more technical skills for their operations in the future. In fact, discussions surrounding these responses indicate that both cases existed. There were several instances cited where the client was surprised that vendors did not provide the caliber of people they had promised or the level of service specified. There is always a danger that vendors try to do too much with too little to improve their margins.

The third set of responses indicates that there must be technical performance measurements also, not just financial performance measurements. This is from a group of respondents who said service levels and performance were better after the vendor took over operations, rather than before.

Finally, two respondents indicated they did not prepare their people properly for change. By internal people, they refer not only to the IS people that may be most affected by the transfer of responsibility, but also members of user departments being served. This is one area where an experienced vendor can suggest some activities to remedy this situation.

Other comments included the following:

- Develop a true partnership by getting the vendor to buy in to the deal.
- Build more flexibility into the contract so that changes can be made more easily.
- Make clear in the contract that penalties will be enforced.
- Add vendor support for networks and PCs to the contract.

These last comments, though only mentioned once each, cover a wide range of issues. The partnership issue was raised. The first two responses deal with the relationship between the vendor and the client. The fact that respondents would change it means they believe it still needs improving.

Enforcement of penalties was another issue that received some mention, though lower than expected. Some clients indicated they already had these measures built into their current contracts, however, and would not change that.

The need to add vendor support for PCs and networks simply reflects the evolving nature of the IT activity and should become a more significant issue in the years ahead. This issue of technology refreshment was not raised as frequently as expected. Respondents seemed to be primarily concerned with the current situation and are still not planning for the future.

VI

Future Purchasing Intentions

Still another measure of customer satisfaction is future purchasing intentions. This indicates the general satisfaction level for the user community. It is more significant as a bellwether of what is really happening in the market and how that market may be changing.

A Service Expansion

Exhibit VI-1 illustrates the likelihood of additional functions being outsourced in the next two to three years. The clients responded on a scale of 1 to 5, with 5 representing a high probability that the function would be outsourced. The mean values for responses for each type of outsourcing are presented in this exhibit.

EXHIBIT VI -1

Likelihood of Additional Function Being Outsourced

Function	Mean Value	Number of Respondents
Data Center Management	3.4	5
Software Support and Maintenance	1.7	12
New Software Development	1.8	12
PC and LAN Support	1.9	13
Network Management	2.3	12
Transition Management	1.7	16

1=low, 5=high

The number of respondents measures the predominance of the activity in the current sample. The fact that only five respondents indicated they would consider outsourcing their data center operations in two to three years simply means most of them are doing it already.

The number of responses for other outsourcing functions was relatively level. The mean of the likelihood value indicates what additional outsourcing opportunities are likely to emerge. As Exhibit VI-1 illustrates, most other functions are not highly likely to be outsourced by these clients. The only function more in demand was the network management function. Because other INPUT market data indicates this is a fast-growing market, the results are not surprising.

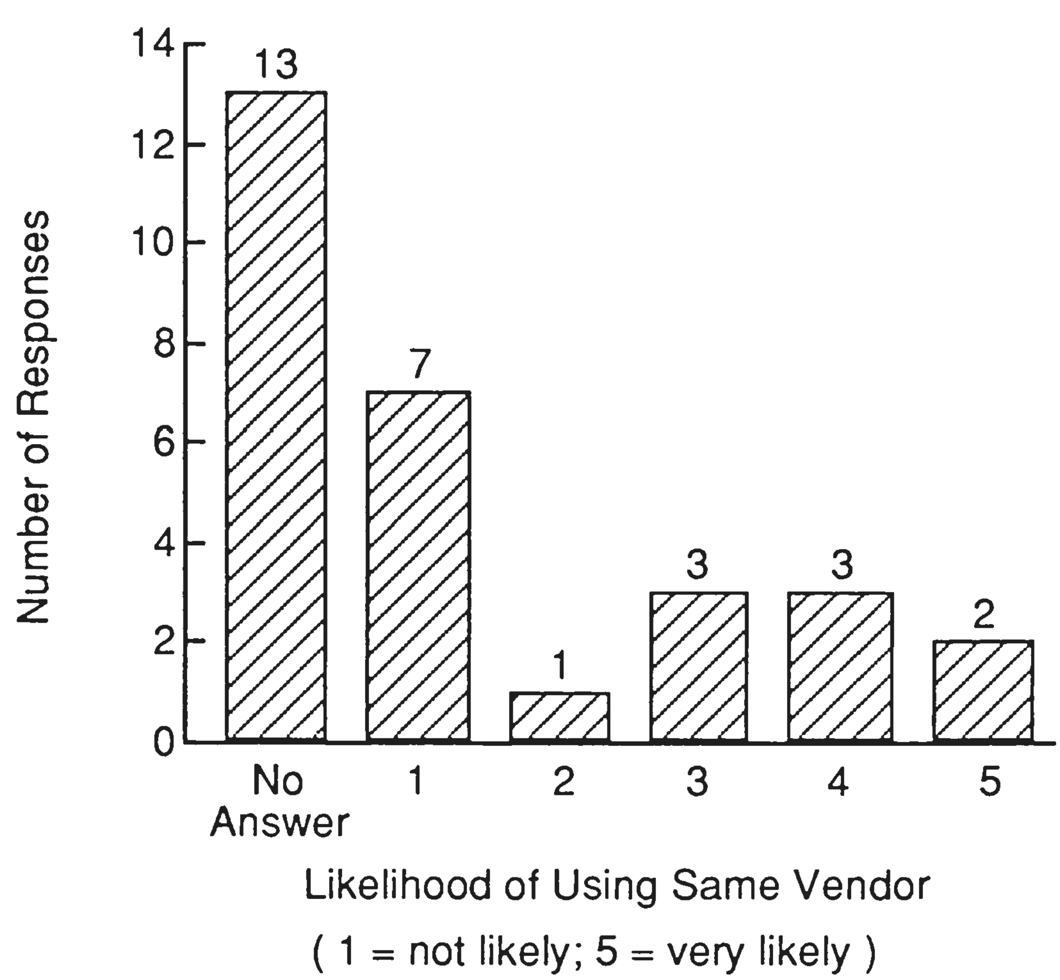
B

Vendor Preference

Respondents indicated whether they would use the same vendor for subsequent outsourcing activities. Exhibit VI-2 illustrates the responses.

EXHIBIT VI-2

Likelihood of Using the Same Outsourcing Vendor



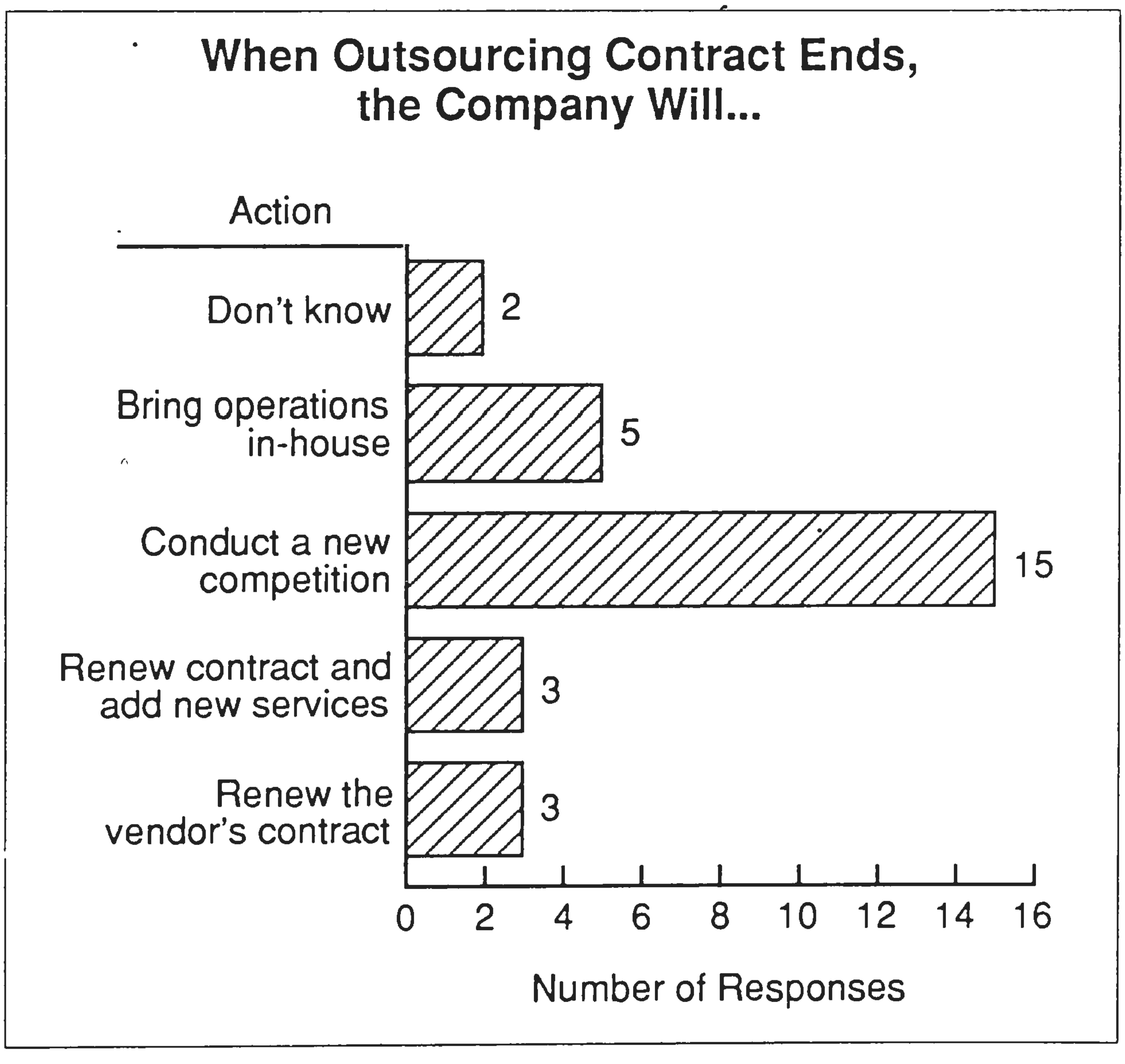
Only about half answered this question. Most who did not indicated the decision would not be made until it was time for renegotiation. Of those that did respond, however, almost half assigned a low likelihood that the same vendor would be considered for outsourcing other functions, too. That was rather surprising, because many of these same respondents indicated earlier they were relatively pleased with the present outsourcing arrangement.

This attitude is in sharp contrast to the situation in the INPUT study of client satisfaction in Europe. In that environment, less than 10% of the clients reported that it was likely they would change vendors at contract renewal. The overall probability of using the same vendor (on a scale of 1 to 5) was 3.9 for Europe. For the U.S. study, the equivalent value was only 2.6.

Upon further query, it was found, despite the part that vendors do a good job in one processing environment, they are still required to compete for the next job with the rest of the outsourcing vendors.

In a related question, Exhibit VI-3 illustrates a variety of options would be exercised when the outsourcing contract came up for renewal.

EXHIBIT VI -3



The majority of clients are satisfied enough with the outsourcing option that they plan to continue. Those who will renew the vendor's contract and those who will conduct a recompetition are obviously planning to continue outsourcing their operations.

Five clients plan to bring their operations in-house, but this must be qualified. Three plan to bring the data center operations back in, one expects to have converted to client/server by then and will manage that internally, while another plans to take back the remaining data center operations but outsource the PC and LAN management.

The largest group plans to recompete the outsourcing contract when it comes up for renewal. That makes sound business sense when the relationship is on a strictly client-vendor basis. If the relationship were a true partnership as some are advocating, there would be less need to recompete.

Some correlation does seem to exist between the type of contract and the stated intention of the client at renewal time. As Exhibit VI-4 shows, all the platform operations clients are satisfied enough with the outsourcing arrangement and plan to either renew with their current vendor, or recompete.

EXHIBIT VI-4

Intention of Client: Based on Type of Outsourcing

Type of Client	
Platform Operations	2 renew 2 renew with more service 8 recompete
Applications Operations	1 renew and add services 3 recompete 2 bring in-house
All Services	1 renew 2 recompete 2 bring in-house

The situation differs where the vendor provides more than the basic data processing center management. When applications are also involved, two clients are dissatisfied enough to plan on bringing the work back in-house. In the third case, where the software management and the desktop services are included, there are also some clients who intend to bring the operations in-house.

The conclusion to be drawn is that adding functions to outsourcing increases the probability that the contract will be more difficult to manage and that some dissatisfaction with the vendor will result. This conclusion emphasizes that vendors still have work to do to improve their software management procedures, an area that has been traditionally been hard to manage in the IS activity.

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A

Questionnaire

Study Title: Satisfaction with Outsourcing

Name: ______________________________

Title: ______________________________

Company: ______________________________

Address: ______________________________

City: ____________________ St.: __________ Zip: __________

Phone: ______________________________

Fax: ______________________________

The following definitions apply to this study:

INPUT defines outsourcing as contracting for the management of part or all of an IS function to an external vendor to two or more years. Outsourcing contracts usually range between 5-10 years in length.

Outsourcing does not include project activity such as the development of a specific systems for a fixed price.

INPUT Satisfaction With Outsourcing User Questionnaire
Company Confidential

1. Does your company outsource any of the following activities? Indicate the vendor used for each one.

Circle One

(a) The operation and management of computer equipment or data centers.

Vendor used: ________________________ Yes/No

(b) The support and maintenance of in-house developed systems.

Vendor used ________________________ Yes/No

(c) The management of new systems development activity.

Vendor used ________________________ Yes/No

(d) The support of the personal computer infrastructure including local area networks?

Vendor used ________________________ Yes/No

(e) The operation and manage of wide area and other telecommunications networks?

Vendor used ________________________ Yes/No

(f) The operation and management of "old" systems while "new" ones are being developed.

Vendor used ________________________ Yes/No

If you have more than one outsourcing contract for the above services, answer the following questions for one contract only. The contractor should be providing services to your company for at least six months.

A separate questionnaire should be used for each outsourcing contract you have.

Indicate here on which outsourcing contract you will be answering the remaining questions:

____

2. (a) When did this outsourcing contract begin?

Enter years ______________________

(b) What is the total length of this outsourcing contract, including option years?

Enter years ______________________

(c) What is the approximate overall value of this outsourcing contract?

Enter amount $ ______________________

(d) How many vendors bid on this outsourcing project?

Enter number ______________________

3. Please rate your company's overall satisfaction with the results of this outsourcing contract so far? Use a 1-5 scale where 5 means extremely satisfied, and 1 means not satisfied at all.

Circle one: 1 2 3 4 5

4. Now for each component service the contractor is providing in this contract, rate your company's level of satisfaction, using the 1-5 satisfaction scale again.

		Circle One				
(a)	The operation and management of computer equipment or data centers.	1	2	3	4	5
(b)	The support and maintenance of in-house developed systems.	1	2	3	4	5
(c)	The management of new systems development activity.	1	2	3	4	5
(d)	The support of the personal computer infrastructure including LANs.	1	2	3	4	5
(e)	The operation and management of wide-area and other telecommunications networks.	1	2	3	4	5
(f)	The operation and management of "old" systems while "new" ones are developed.	1	2	3	4	5

5. In your opinion, what is making or will make your company a satisfied outsourcing customer?

____

____

____

6. What is your company particularly pleased with or dissatisfied with in regards to your contractor's outsourcing service?

Pleased with: ________________________________

____

Dissatisfied with: ________________________________

____

7. Indicate your agreement with each of the following segments, again using a 1-5 scale, where 5 means total agreement, and 1 means no agreement.

	Circle One				
(a) Outsourcing has/will achieve good value our money	1	2	3	4	5
(b) Outsourcing has/will improve the effectiveness of our information systems.	1	2	3	4	5
(c) Outsourcing will/has improved service levels.	1	2	3	4	5

8. What were the three main benefits your organization expected to achieve through IS outsourcing? For each benefit, indicate the level of achievement the contractor has attained so far using a 1-5 scale: where 5 means very high level of achievement, and 1 means no level of achievement.

Enter Benefit	Achievement Level Circle One				
________________	1	2	3	4	5
________________	1	2	3	4	5
________________	1	2	3	4	5

9. Which of the following management methods is our company using to manage and monitor your outsourcing contractor, or in other words what is your company doing to control/manage the contractor?

Method	Check all that apply
Cost tracking	________
Change management/tracking	________
Trouble reporting/tracking	________
Non-performance penalties	________
Arbitrators	________
Other (specify): ____________________	________
Other (specify): ____________________	________
Other (specify): ____________________	________

10. Which of the following pricing scenarios apply to your contract?

Transaction based	________
Fixed Price/time period	________
Resource Based	________
Combination	________

Describe

____

____

11. Is your company satisfied with this pricing approach? Circle one: Yes/No

12. What are the advantages or disadvantages of this pricing approach?

Advantages:

____

____

Disadvantages:

____

____

13. What type of pricing would your company prefer in future outsourcing contracts?

____

____

14. When this current outsourcing contract expires, do you think your company will....?

	Check one
Renew the vendor's contract	_______
Renew the vendor's contract and add more services	_______
Conduct a new competition	_______
Bring operation back in-house	_______
Other (specify) ______________________________	_______

15. Based on your experience, how would you improve on outsourcing relationships with vendors in the future?

____

____

16. For each of the following functions indicate the likelihood of your organization outsourcing additional functions to a vendor in the next 2-3 years using a 1-5 scale. Use the 1-5 scale. This time 5=highly possible, and 1=not possible at all.

		Circle one				
(a)	The operation and management of computer equipment or data centers	1	2	3	4	5
(b)	The support and maintenance of in-house developed systems.	1	2	3	4	5
(c)	The management of new systems development activity.	1	2	3	4	5
(d)	The support of the personal computer infrastructure including LANs.	1	2	3	4	5
(e)	The operation and management of wide-area and other telecommunications networks.	1	2	3	4	5
(f)	The operation and management of "old" systems while "new" ones are developed.	1	2	3	4	5

17. Using the 1-5 scale, indicate the likelihood that your company would consider your present outsourcing contractor to provide any of the above functions you may be considering outsourcing. This time 5=highly likely, and 1=not likely at all.

Circle one: 1 2 3 4 5

Thank you for your participation
You will receive an Executive Summary of this study's highlights