Outsourcing: Contracting and Implementation

Paper 1

INPUT®

San Francisco • New York • Washington, D.C. • London • Paris • Frankfurt • Tokyo

The information systems (IS) outsourcing revolution is spreading. IS expenditures are already over $12 billion and may exceed $40 billion in five years: Some of the world's largest companies are participating. This paper is one of a series that provide a strategic assessment of the IS Revolution:

- Outsourcing: Directions and Opportunities
- Outsourcing: Buyers' Perspectives
- Outsourcing: Contracting and Implementation
- Outsourcing: Vendor Characteristics

This series examines the rationale for IS outsourcing; the different types of IS outsourcing (it does not just apply to computer centers!); and the new opportunities in transition management, desktop services, and business operations outsourcing.

Published by INPUT 1881 Landings Drive, Mountain View, CA 94043-0848 U.S.A.

For additional information, please contact INPUT at tel. (415) 961-3300, fax (415) 961-3966

Outsourcing: Contracting and Implementation

Definitions

EXHIBIT 1

IS Outsourcing Definition

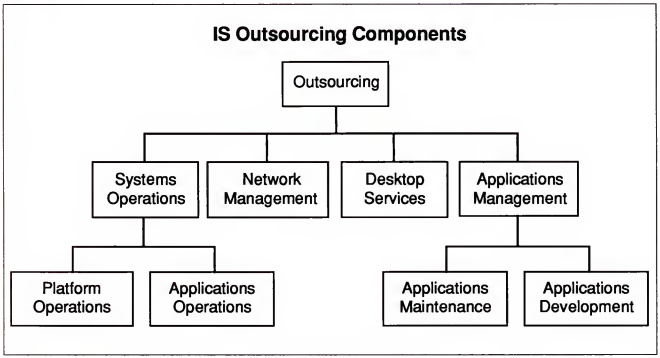
Information systems (IS) outsourcing is the contracting of an IS process or function to an external vendor on a long-term (1+ years) basis.

The various IS outsourcing segments are, as shown in Exhibit 2,

1. Systems Operations - Contracting to a vendor the information systems operations in either of two ways:

- *Platform Systems Operations* - The vendor is responsible for managing the computer systems and their associated networks.

EXHIBIT 2



- *Applications Systems Operations* - The vendor is responsible for developing and/or maintaining a client's applications software as well as operating and managing the computer systems and their associated networks.

2. Network Management - Contracting to a vendor for the operations and management of the computer-related telecommunications network, transmitting data and text, voice, image, and video as required. Voice-only network operations are not part of information systems outsourcing.

3. Desktop Services - Contracting to a vendor for the deployment, maintenance, support, and connectivity of the organization's PC/workstation inventory. The service may also include performing the "help desk" function.

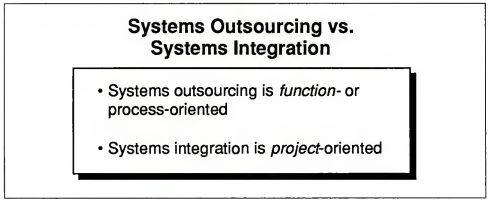
4. Applications Management - The vendor is responsible for the development and maintenance of all the applications systems a client uses to support a business operation.

- *Applications Development* - Contracting for the design, development, maintenance and enhancement of new applications software associated with a business operation.

- *Applications Maintenance* - Contracting only for the maintenance of the existing applications software associated with a business operation.

Information systems outsourcing is distinguished from systems integration in the following way: Systems integration is project-oriented, i.e., there is a definable start and end point to the relationship other than the contract period. Systems operations and other forms of outsourcing are process-oriented, i.e., there is a continuing relationship. (See Exhibit 3.)

EXHIBIT 3

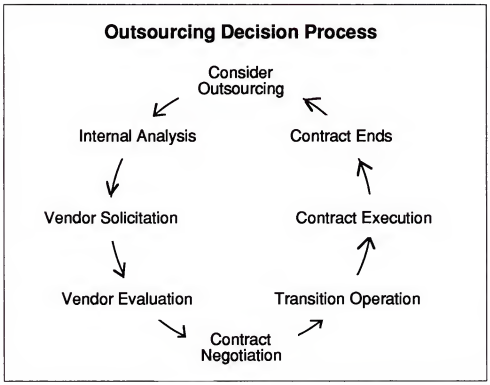


This report addresses the outsourcing decision process and the factors impacting outsourcing decisions and vendor selection; it presents ideas for managing the vendor and discusses organizational impacts. It discusses "insourcing." The last section provides a framework for assessing benefits from outsourcing.

Outsourcing Decision Process

Exhibit 4 depicts the outsourcing life cycle.

EXHIBIT 4



The process starts with consideration of outsourcing, often initiated by a top executive or board member.

- If the internal analysis is done by the IS unit then there is almost never a substantial outsourcing result. In addition, there are consultants whose disguised objective in the "internal analysis" phase is to develop follow-on contracts to improve internal IS operations—"bring them up to external vendor standards." When such consultants are involved, vendors should refuse to bid.

- During this phase, the organization will evaluate what segments of its IS operations should be considered for outsourcing. As shown in Exhibit 5, companies that have outsourced are not just including data center operations, the traditional computer facilities management.

EXHIBIT 5

Outsourced Functions in Existing Contracts

Function	Number of Resp.	
	Yes	No
Data Center Operations	20	1
Network Operations	10	11
Applications Management	10	11
Applications Maintenance	1	20
Desktop Services	7	14

Survey of 21 outsourcing contracts

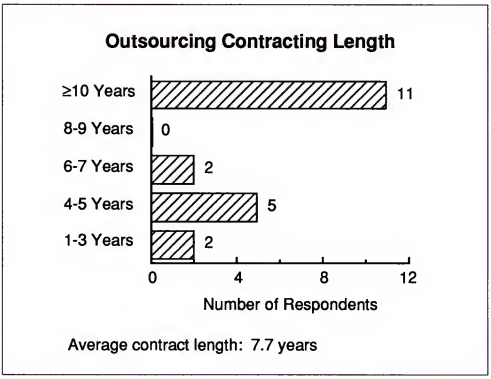
- Vendor solicitation and evaluation usually lead to negotiations with one or more vendors—but INPUT recommends selecting no more than three. Selected vendors must fit in culturally, technically, and business-wise with the client. Initial flexibility in discussions will solidify the nature of the IS components to be outsourced separately or together.

- The vendor/contract negotiation phase is discussed later.

- The transition phase should be kept as short as possible (usually less than three months) because of the people and process issues—this requires intense, early, and effective planning.

- A key consideration in the contract negotiation phase must be the length of contracts to be awarded. As shown in Exhibit 6, there is quite a variation in length of contract; shorter ones tend to be transitional in nature. As discussed elsewhere in this report, the average length of contract is decreasing because of the increased difficulty in predicting contract conditions and the increasing frequency of transition management contracts.

EXHIBIT 6



- Another consideration of course is price: not just the actual amount but the method of calculation and its variation with time. As shown in Exhibit 7, pricing methods vary. Although this chart shows resource-based pricing to dominate in this sample, it is becoming less popular, primarily because both clients and vendors are concerned by the potential major impacts of new technology and IS architectures. Thus result-oriented pricing is becoming more popular.

- At the end of the contract period, clients have the option of bringing the process in-house. As shown in Exhibit 8, most current users don't know what they will do simply because they are 1 or 2 years into a 10-year contract! Those in this sample that plan to bring the function back in-house are all companies that planned to do so using short, transitional contracts. No long-term clients planned to do so.

EXHIBIT 7

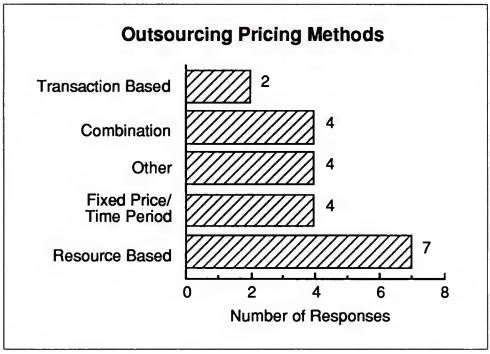
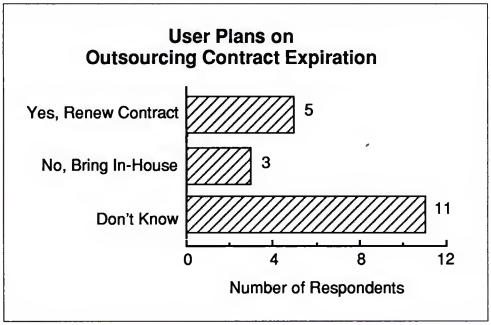


EXHIBIT 8



Outsourcing Decision Factors

A variety of factors is driving a greater number of organizations to consider IS outsourcing. Exhibit 9 provides two perspectives on outsourcing decision factors: that of the organization or business and that of the information systems function.

EXHIBIT 9

Business and IS Outsourcing Considerations

Business Executives	IS Executives
Cost (Business)	Cost (IS)
Merger/Acquisition	Control
Restructuring	Personnel
New Directions	Motivation
Focus/Time	Compatibility
Response Time	Response Time
Quality Sooner	Quality

1. Business Executives' Perspective

Many of the major outsourcing decisions that have been chronicled in the industry press and those identified by INPUT can be tracked directly to a major shift in the direction of business. Mergers, acquisitions, LBOs, and restructuring all lead senior management to ask for quick, responsive, and cost-effective IS organizations. When senior management participates in the outsourcing decision, the process becomes very business driven, as indicated by the factors listed in the left-hand column of Exhibit 9.

- A number of the organizations considering outsourcing are looking for ways to lower investments and costs immediately after an LBO or divestiture.

- One of the companies interviewed turned to a systems operations company to support its merger and acquisitions strategy. The IS executive knew there was no way his IS strategy could be supported internally on a cost-effective basis. The response time required to absorb acquired companies and "spin off" divestitures could only be accomplished with the capabilities and flexibility provided by a systems operations vendor.

- A principal element in the growing use of outsourcing is simply response time. Today's complex systems take significant blocks of development resources that are best outsourced—especially when they also require technical skills not present in adequate quantity within the current IS staff. Operating management increasingly knows what it wants and when it is needed; the decision to outsource is then a result of business needs, not the personal or technical preferences of IS experts.

2. Information Systems Managers' Perspective

When the outsourcing decision falls to IS management, it can become entangled in the internal pride and history of a support organization that is increasingly in the limelight. The result is that most IS management still typically looks at outsourcing negatively, at least initially. IS managers believe

- Outsourcing will lead to a loss of direct control, create new management challenges, and further, represents the growing involvement of operating management in the operation of IS. (Interestingly, the last two are something IS management has sought in prior years.)

- Outsourcing often results in organizational upheaval and consequent personnel issues. IS management continues to prefer to deal with the technical, not the personnel, issues. An IS manager may not realize that once the outsourcing agreement is implemented, the people management challenge of the job may diminish.

- Outsourcing entails long-term commitments at a time when management is asking for increased flexibility and speed of response. It's not apparent to IS managers that the vendor can be more flexible and responsive than the internal IS organization.

The management challenge for IS is to transcend this list and to adopt a set of factors that more directly parallels that of the organization as a whole.

For example, a recent decision by a major manufacturing firm to outsource its data center resulted from a need to build a new center at a time of significant capital demands by the business.

- The data center had to move and be upgraded. The CIO realized that the capital required would be taken from more critical business programs. He introduced the outsourcing concept, then spent a year developing the alternative and selling it to senior management.

- This CIO transcended the issues of control and internal pride and provided the organization with more capability and flexibility while avoiding a major investment. In addition, the community gained because the outsourcing vendor agreed to install a regional data center in the city.

Client-Vendor Relationship

1. Type of Outsourcing Relationship

As discussed previously, there are some important differences in the various categories of outsourcing. These are contrasted in Exhibit 10 on the basis of the types of relationships that are established and the differences in the characteristics of those relationships.

EXHIBIT 10

Outsourcing Relationship Classification

Relationship Type	Outsourcing Category	Relationship Characteristics
Partnership-Based	Applications Management Systems Operations Network Management Desktop Services	Management-oriented Broad scope Open-ended timing Broad expertise Personnel transfer Flexible agreement Service levels
Objective-Based	Transition Management Applications Maintenance (Systems Integration)	Project-oriented Specific scope Specific timing Specific expertise Focused agreement Target dates

The stated objective of today's outsourcing vendor is a partnership with its clients, yet the result of many major outsourcing decisions remains an *objective-based* relationship that is tied to fairly specific but complex goals.

- Systems operations, applications management, network management, and desktop services can be classified as having a true partnership as an underlying goal.
  - Although it is services that are being sourced, it is the management process along with a broad basis of expertise that is most critical to success. The customer becomes dependent on the vendor for day-to-day, minute-to-minute support.

- The relationship scope is broad and nonspecific and deals with a large set of individual services.

- The timing is designed to be open-ended and starts with a long-term commitment.

- There are significant, lasting organizational impacts.

- The business structure must be flexible and allow the client to change its business and the vendor to suggest changes that are of mutual benefit.

- Performance is based on service-level measurements not specific point-in-time accomplishments.

- The cost structure needs to be predictable. Predictability usually means a fixed base level of cost plus predefined incremental costs and penalties for changes in service requirements.

• Applications maintenance, transition management, and systems integration decisions are generally based on a set of specific objectives. While they also tend to be single-source decisions, the breadth of the decision and the various delineating elements are more specific.

- The primary goal tends to be project oriented; timing and scope are tied to specific goals.

- The expertise required by the vendor is specific and often not available within the client's staff.

- The business relationship is focused on the specific goals, and performance measurement is tied to specific dates and costs.

The objective-based relationships can certainly lead to partnership-based relationships.

• An applications maintenance relationship, if successful, will extend over a long time and can expand to cover a complete set of applications and even new development.

- A systems integration relationship can become, or include from the beginning, systems operations requirements.

When the change occurs, it is critical that the client and vendor recognize the differences in characteristics of the changed relationship. The result will probably mean a redefinition of the business relationship.

It is essential that IS management defines the expected outsourcing relationship from the start and understand the key characteristics desired for the relationship. Otherwise, the vendor may define it, or worse, both parties may get it wrong.

2. Systems Operations Experience

Exhibit 11 ranks a number of criteria used by a group of IS organizations that have made outsourcing decisions and are using a systems operations vendor.

EXHIBIT11

Systems Operations
Original Decision Factors

Ranking	Criteria
1	Better/more flexible service
2	Availability of internal operating skills
3	Lower operating expenses
4	Faster application changes
5	Data security/privacy
6	Faster application development
7	Response to personnel changes
8	Reduced capital investment
9	Mission-critical applications
10	Labor relations/unions
12	Executive energy and time
13	Operation on a dedicated system

Vendor Selection

Having made a decision to seriously consider outsourcing, the next step is the vendor selection process.

The components of the outsourcing requirement are the initial set of criteria for vendor assessment. Exhibit 12 provides a sample list of the standard components of most systems outsourcing decisions.

EXHIBIT 12

Components of an Outsourcing Decision

- Tangible components
  - Hardware
  - Software
    - Systems
    - Applications
  - Personnel
  - Telecommunications
  - Facilities
- Process components
  - Security/disaster recovery
  - Planning
  - Change management
  - Control
  - Communications/reporting
  - Organizations/location
- Financial components
  - Specified costs
  - Unspecified costs
  - Capital acquisitions/transfers
  - Lease transfer
  - Price/inflation changes
- Management components
  - Conversion plans
  - Exit/contingency plan
- Cultural components

- Taking the time to create an initial requirements specification for each of these standard components, as well as any unique components, will provide a foundation for understanding and comparison.

- The same requirements specification provides the basis for a true evaluation of whether to continue to insource the portion of IS activity under study.

- The requirements specification will also identify the critical elements and type of vendor relationship required should outsourcing result.

Exhibit 13 ranks the criteria used to evaluate vendors.

EXHIBIT 13

Systems Operations
Vendor Evaluation Criteria

Ranking	Criteria
1	Vendor Systems Operations experience
2	Overall cost
3	Data security and protection
4	If SI contract, SO by prime contractor
5	Vendor provided hardware and software maintenance
6	Application software repair
7	Application software improvements
8	Reduced capital investment
9	Cash flow improvements
10	SO performed in client's facility
11	Labor relations/unions
12	SO performed at vendor location

- Not surprisingly, prior experience in systems operations and overall cost received the highest ranking. The experience criteria include proven management capability.

- The least important criterion was where the systems operations was to be performed. Once you decide to have someone else operate the processing utility, it doesn't really matter where it is located. The key measurement becomes service level, not location.

- The linking of systems integration and systems operations, as indicated by the fourth-ranked evaluation criterion, is further validation of the linking of these services by the customer.

Exhibit 14 depicts similar results concerning the selection of systems integration vendors. Four of the first five criteria map directly to the objective-based relationship that is the basis for systems integration.

EXHIBIT 14

Systems Integration Vendor Selection Criteria

Ranking	Criteria
1	Industry experience
2	Application knowledge
3	Cost/performance
4	SI experience
5	Project management skills
6	Support skills
7	Service orientation
8	On-site visits
9	References
10	Alliances

- Without the combination of industry, application-specific, and project-oriented experience required for success, there is little reason to keep the vendor on the list.

- The second tier of criteria tends to deal with either the ability to counter potential weaknesses through alliances, or verification that the vendor has performed efforts of similar complexity.

Managing the Vendor

1. Information Systems Management Responsibilities

When the decision has been made and the vendor selected, just what role must IS management play? Although some vendors might imply they should "walk away and leave them the keys," those with experience know that does not work because it eliminates a key element necessary to the partnership.

- IS management serves as the buffer, the policeman, and the controller of the relationship.

- IS must do all the things a purchasing agent does to manage the relationship with a principal supplier of components to a manufacturing plant. Just-in-time management applies in systems outsourcing as well.

- Information systems management provides the primary management between the partner managing the outsourced services and the business organization, a relationship that is very similar to that which IS has with current, major internal users such as business units or divisions.

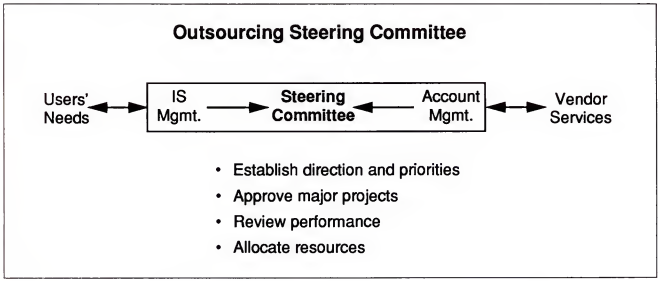
2. Outsourcing Steering Committee

Remember the information systems steering committee, the often-suggested, seldom-effective means to draw senior management into the information systems planning and decision process? Such a structure is proving to be an ideal approach to managing an outsourcing relationship. Exhibit 15 provides a framework for an outsourcing steering committee.

- The benefits accrue to both the client and vendor. The relationship needs a forum for structured interchange and planning that is separate from the day-to-day operational interface.

- The primary interface must be with an account manager from the vendor. That person may be responsible for the day-to-day as well as the overall relationship. By using a steering committee, the account manager and the internal IS manager have an infrastructure that permits them to back away and look at the relationship with a broader perspective. Without the steering committee, the broader perspective is not easily developed.

EXHIBIT 15



- The steering committee provides a structure to draw operating management into the relationship with the outsourcing vendor on a routine or as-needed basis, while keeping operating management separate from the daily interface.

- When there is a need to make a change in the relationship, which is inevitable, the forum exists for client management to present that need.

3. Contracting Issues

Constructing an agreement for a broad set of services can be complicated and time consuming. There are simply too many possibilities and unexpected events to be able to anticipate them all in the agreement.

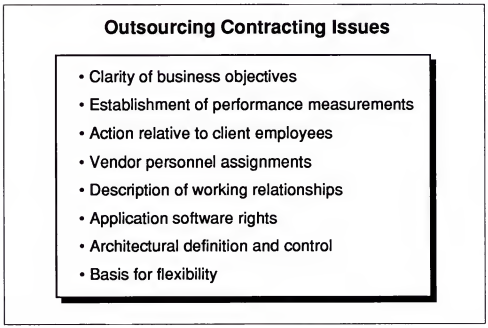
From discussions with IS managers who have negotiated outsourcing agreements, INPUT has concluded that the success of the contractual process is directly tied to the quality of the work that has preceded this phase.

- If the decision is well thought out, and the services to be outsourced defined and understood, the contractual element can become a reasonably straightforward event.

- Research on both systems integration and systems operations contracting efforts has confirmed that the process can be efficient and nondisruptive. While these agreements may be vastly different from those previously negotiated by IS managers, such agreements can be created with reasonable effort and without significant apprehension.

Exhibit 16 lists the key issues that need to be addressed prior to starting the actual negotiating process.

EXHIBIT 16



- If the business objectives are clear and the performance measurements defined, the majority of the monitoring controls will already exist.

- If the action relative to existing client personnel and the key vendor assignments is defined, then personnel surprises will be prevented. The one repeated complaint from clients is that the vendor changes the account manager at the wrong time, just when he/she is doing a good job.

- If the working relationship for operations and planning is described, then both parties will know how issues will be worked out. If there is to be a steering committee (INPUT recommends one), then specify the participants and obligations in the agreement.

- If applications software is involved, either owned by the vendor or developed by the vendor, the agreement must specify ownership and rights beyond the term of the initial agreement. It is the applications software, not the processing capability, that has significant long-term value.

  - If the applications software is vendor owned, does the customer retain the right to keep it if they insource or change vendors in the future?

  - If developed by the vendor for the client, what rights does each party have?

  - If developed by the client, but enhanced and maintained by the vendor, what rights does each party have?

- The smart vendor will agree that the final control on the use of information technology must remain with the client. The definition of the architecture is essential to success today, whether outsourcing is used or not. If you decide to use the outsourcing alternative, you must create and maintain an IT architecture to assure clarity of overall direction to both parties.

- Most importantly, think about and define in simple terms the type of flexibility required to meet the longer term business objectives of the organization.

The contractual process really starts before the vendor selection process when the outsourcing specification is created. Exhibit 17 defines four phases of the contracting process. Viewed in this way, the process is not a single step, and negotiations are just one step in the process versus an activity in and of itself.

EXHIBIT 17

Outsourcing Contracting Process

Phase	Objectives
Investigation	Clarity of business objectives Initial vendor elimination
Relationship Definition	Define it without the lawyers Emphasis on service and flexibility Business versus contractual Include IS responsibilities Define transition responsibilities
Contract Negotiation	Keep it short Provide mutual incentives Clarity about people issues
Contract Monitoring	Ability to adjust plan, not contract Control by a steering committee

- One of the first requests to a vendor receiving serious consideration should be for a sample contract. All vendors have them and, even though you may want to use your own contract, it will provide insight into how each vendor defines its client relationships.

- As noted above, the key to a successful contract is a clear definition of the desired business relationship. If it exists, the contract will reinforce it, not complicate it.

- If the relationship is to resemble a partnership, then there must be mutual incentives. Build incentives into the contract and make them simple to measure.

- In the long run, a key element of the agreement will be how it deals with changes in requirements. Nothing is constant, yet a common goal is a fixed-price, easy-to-understand business relationship. Create a framework to absorb change without disrupting the basic agreement. Doing so will provide a true test of how interested the vendor is in a long-term relationship.

Insourcing

Certainly any organization that makes an outsourcing decision must consider the potential need to insource at a future date.

- An applications outsourcing agreement will mean the deterioration of internal knowledge about a set of applications.

- A systems operations or network relationship means elimination of extensive technical knowledge and systems and personnel capabilities.

Only a transition outsourcing effort has limited long-term exposures. If the outsourcing vendor assumes responsibility to operate the existing environment while a new technology and application set is implemented, then the old skills do not have to be maintained while the new ones are being developed.

1. Vendor Perspective

Vendors indicate that the insourcing issue, while always present, is not a critical factor.

- Vendors offer protection to their clients with commitments to help insource, licenses to software proprietary to the vendor, and help in training new staff.

- All vendors say they have not experienced significant decisions to insource at the end of agreements and that they believe this success record will continue as the outsourcing concept becomes institutionalized.

- Once the IS executive and organization as a whole can concentrate on futures, they are not interested in returning to the distractions of operations and maintenance.

- More common is the expansion, or major modification, of the outsourcing relationship midway through, or at the end of, the initial term of the agreement.

• Systems operations and applications management vendors report very few losses to other vendors at the end of the agreement.

- This is an indication that strong balanced relationships are being developed between vendor and client.

- Perhaps movement among vendors will develop as outsourcing and competition among vendors grows. But if there are five years of reasonable success between a vendor and client, there will have to be significant incentives to change.

2. IS Managers' Perspective

IS managers tend to downplay the issue. Having made and implemented their outsourcing decision, the idea of insourcing was years into the future.

• More than one IS executive has been heard to say, "I do not want to ever run a data center again."

• Others commented that in five years the central data center will be even more of a processing utility. They cannot conceive of strategic reasons to insource.

Decisions to insource major applications management and systems operations agreements on expiration will be driven by one or other of the following:

• A significant and unexpected shift in the cost equation in favor of insourcing

• A decision to shift the underlying information technology

• A monumental failure on the part of the vendor

IS Outsourcing Benefits

If IS is to look at outsourcing in a balanced manner, it needs to recognize the specific benefits that will result. Exhibit 18 summarizes the key potential benefits against the most common outsourcing categories. Although this table is an oversimplification, it provides a framework for IS management to consider outsourcing on a balanced basis.

EXHIBIT 18

Outsourcing Benefits

Outsourcing Category	Benefits						
	Costs		Skills Access	Rapid Response	Application Staff		Management Time
	Oper'n.	Cap'l.			Vendor	Client	
Applications Systems Operations	X	X	X	X	X		X
Platform Systems Operations	X	X	X	X		X	X
Desktop Services	X	X	X	X	X	X	X
Network Management	X		X	X		X	X
Applications Management	X		X	X	X		X
Applications Maintenance	X		X	X	X	X	X

- Cost benefits can be of two types: operational and capital.
  - Vendors have a proven ability to lower operating costs. In many cases the savings reach 20% or more, over many years.

- With systems operations (and potentially, desktop services), the capital costs transfer from the client to the vendor. The ability to transfer capital needs to another company can be of great benefit and can permit the capital so gained to be applied to core business functions. Additionally, many outsourcing systems operations contracts include the purchase of computers and facilities by the vendor, generating cash and capital.

- The ability to access skills not available internally, and thereby respond much more quickly, is a benefit gained from all categories of outsourcing. With access to the larger pool of vendor resources, more rapid response to unplanned needs can be obtained.

- Making the best use of the application skills of the vendor and the internal IS staff is important.

  - In applications management and applications SO, the vendor absorbs the client's applications staff.

  - With applications maintenance, the internal skills needed to achieve development of the new are no longer diverted by the never-ending maintenance of the old.

  - In a transition management situation, IS can focus its internal staff on the strategic goal, moving to the new systems, while the vendor operates the old.

- Furthermore, IS can gain by reducing the day-to-day management efforts in one or more areas (e.g., data center operations) and applying them to more strategically important areas (e.g., planning a future IT architecture).

INPUT recently assisted one company in its IS outsourcing process. It provides a good example of the reasons why companies outsource and also the problems encountered.

The company is a major nationwide services provider which was considering outsourcing the majority of its IS activities. At the time INPUT became involved, proposals had been received from two vendors for provision of these services and a comprehensive plan had been received from the internal IS function for comparative purposes. A "Big 6" accounting company had been retained to assist in providing information to the prospective outsourcing vendors, to assist in analyzing the proposals, and to assist in developing the contract.

INPUT was retained to review the process by which the proposals were obtained, to review proposals and contracts for completeness and consistency with industry practice, and to provide recommendations for improvement.

Motivation for Outsourcing

The company developed an interest in outsourcing for the following reasons:

- It was dissatisfied with the performance of its application development activities. Projects were slow to be completed, were developed at an excessive cost, were more complex and detailed than required, and were not well disciplined. Further, application maintenance backlogs were excessive and were impacting the performance of the corporation. These opinions were widely held throughout the enterprise. It was considered that having these services provided by an outside organization, even at increased cost, would result in more sensitivity to cost and more emphasis on what was needed—not what would be nice to have.

- The mainframe computer system was running at full capacity and an upgrade was contemplated. Entering an outsourcing arrangement would obviate the need for a processor upgrade.

- The company wanted to relocate the IS function: outsourcing would significantly simplify moving and would greatly reduce corresponding risk.

- Outsourcing would convert much of the IS expense from "fixed" to "variable." That is, the company would have the capability to increase or decrease expense based on its need. This capability would motivate the organization to spend resources wisely and use what was needed.

- "It is hoped, and believed, that outsourcing of the MIS function will result in overall cost reduction." Obviously, therefore, cost was not the prime motivator.

INPUT Observations on the IS Outsourcing Rationale

1. Mainframe Operations

There was little concern over outsourcing the mainframe operations and systems programming.

- These activities were not viewed as strategic, were mature, and should be subject to economies of scale.

- The physical location of these service activities was of little consequence and outsourcing would materially simplify relocation.

The head of the IS function did express concern and disagreement with respect to outsourcing responsibility for the distributed applications (System 36 and AS/400). The feeling was that

- These activities are strategic to the enterprise

- The prospective outsourcing vendors had little to offer in this area with respect to applications

- There was no economy of scale and the benefits all accrued to the outsourcing vendor

INPUT countered that these views do not take into account some of the potential benefits of working with an outsourcing vendor:

- The opportunity to apply advanced development technologies currently utilized by most outsourcing vendors
- The potential availability of superior business analysis techniques and methodologies
- Enhanced sensitivity to cost

2. Applications Development

With respect to the application development issue, INPUT saw several problems with the current environment.

- The IS unit was highly centralized and was not as in touch with the business as it should be.
- There was no charge-back system nor a consistent cost/benefit analysis on projects.
- User departments did not appear to take responsibility for systems cost and competed for shares of the development activity.
- Tools, methodologies, and techniques used for development were below industry standards.

Outsourcing to an applications systems operations firm with significant and relevant applications development skills is a means of solving these problems. It should provide immediate benefits and is the easiest solution to implement.

Chronology

Interest in outsourcing evolved from discussions between the finance department and a major vendor involving possible development of a new general ledger package. The need to go outside for this package arose from the belief that the internal IS department was too busy to implement a new system. As a result of the discussions, the vendor submitted an outsourcing proposal.

The company had discussions with three other major outsourcing vendors and requested a proposal from one of them. This proposal was received some two months after the initial proposal from the first vendor.

A "Big 6" accounting company was engaged to assist in determining outsourcing requirements, evaluating proposals, and developing a contract. After analysis of the initial proposals, identical letters were sent to the two vendors requesting modification of their proposals to provide the specific services received. One vendor responded virtually immediately and then submitted an unsolicited additional modification two months later. The second vendor's response was also virtually immediate; after requests for clarification it submitted a further response one month later.

The internal IS department was requested to prepare seven-year cost projections to encompass the same services requested of the outsourcing vendors. This permitted a comparison of the external versus internal solutions. A projection was received several weeks after the vendor submissions, and a revised projection one month later.

INPUT was engaged shortly thereafter to sort out the situation and completed a preliminary analysis in two weeks. The preliminary analysis identified significant discrepancies between the proposals. Additional discussions then took place on specific points with each of the vendors in order to provide more refined data for the final analysis.

Both INPUT and company personnel discussed the key issues with the vendors, obtained clarification on some points, and negotiated changes. The company then entered into final negotiations with the recommended and selected vendor.

INPUT Observations on the Process

The process used was a reasonable one. Initially giving vendors the freedom to identify those areas that they wish to support is helpful to a client in determining the types of services that can be obtained, the approach and level of consistency offered, and the cost.

Holding preliminary discussions with a set of vendors (four in this case) helps the client determine the scope of services it wishes to consider and select those vendors with which it feels comfortable. The client is then in a position to identify to the selected vendors the specifics they need to consider, and it should then be able to make direct comparisons on the bids.

At least two proposals should be solicited, as was the case here. Perhaps three is optimal; more than that makes the process unnecessarily complicated.

Having a reliable in-house estimate of cost for providing comparable service is a requirement in assessing the benefit and risk of vendors' proposed solutions. In this case, considering only two external solutions, provides no guarantee that they are getting the "best" solution, but comparing two external proposals with the in-house solution provides comfort that they are getting a "good" solution.

Using an external consultant also makes sense, since it is unlikely that there is the internal experience and expertise in this area. There is certainly a lot of technical and application expertise in the IS organization, but it's not objective.

However, the consultant must have the knowledge and expertise necessary. In this case the "Big 6" consultant didn't. Consequently, the company was having great difficulty in making its selection. The "RFP" was sufficiently vague that the resulting responses could not be compared in a straightforward manner.

Assuming relatively comparable costs, one of the most important considerations in selecting an outsourcing vendor is choosing a firm in which the company has confidence. "Cultural fit" and "trust" are important. It is a long-term, close relationship with a high degree of interdependence. It involves the transfer of a number of employees from the client to the vendor, and they need to feel comfortable with the relationship for it to be successful for either party. It must be perceived as a "win-win-win" for the vendor, client, and employees. However, this should not be construed as implying that a good, tight contract is not required. A good contract will help ensure that problems and differences will be minimized.

Proposal Analysis

INPUT analyzed the key components of each proposal and the significant differences between them. We then developed a financial analysis that put the three proposed solutions on a comparable footing.

INPUT used the following 13 key proposal elements in this analysis as summarized in Exhibit 19. The same process can be followed in analyzing other proposals.

1. *Coverage*—What is being proposed by each vendor? What function and units will be outsourced? For example, who will handle the user help desk? INPUT used a staff checkoff list as a control: if the vendor didn't deal with a staff unit in its proposal then it was not a covered item.

2. *Personnel*—What is being proposed for all staff covered by the proposal? Where will they be located if kept? Who will be transferred to the vendor, left with the company, or terminated? What will the next staff reduction consist of?

EXHIBIT 19

13 Key Proposal Elements

1. Coverage
2. Personnel
3. Applications Development and Maintenance
4. Computer Hardware
5. Software
6. Network
7. Service Levels
8. Security
9. Account Management
10. Audit
11. Mediation and Arbitration
12. Contract Termination
13. Financial Considerations

Of those transferred, how many will be relocated? Who will pay the relocation costs? (In this case, one vendor required the company to pay, the other vendor included the costs in its bid.)

For staff transferred but kept at the client's site, who provides and pays for facilities, services, and support? What about severance terms (one vendor included severance payments in its bid, the other did not)? What employment guarantees are made?

What additional staff will be provided? (In this case, application development and maintenance needed considerable strengthening.) For staff required in excess of the planned and bid number, what will be the billing rates? (There were considerable variations in this case.)

For transferred staff, what salary and benefit policies will be followed? Would there be parity? What about scheduled increases?

Some of these personnel points may seem trivial, but they are not. Unhappy staff can and will cause problems. Both company and vendor are most vulnerable in the transfer stage.

3. Applications Development and Maintenance—How will this be handled? Which organization units in the vendor will be responsible? What are the staff levels that will be applied? Where will they be? How will they communicate with the client?

What tools, techniques, and management processes will be applied? Who provides and pays for development equipment? (In this case one vendor included it and one did not.) What new software kernels, packages, etc., will be applied?

What will be the rates of development, support, and maintenance at different stages of the contract? What rights to third-party software will the client have? In other words, can it select another company's software package to run on the outsourcing vendor's systems?

4. Computer Hardware—What is the basic platform that will be used? How is this likely to change over the life of the contract? Will the platform be dedicated or shared?

What capacity level is planned? (In this case, both vendors planned for the identical capacity use over the next seven years. They then proposed incremental rates for processing (MIPS) and storage on DASD.)

What are the charges and variations with time of these charges for incremental resources? (It was in this area that INPUT was able to be most helpful to the client—saving it a substantial amount of money over the life of the contract. INPUT found it almost unbelievable, but one vendor was actually proposing that DASD charges should increase annually at the rate of inflation, in spite of the rapidly decreasing cost of DASD storage!)

What are the provisions for "pass through" of technology and price/performance improvement? (These were initially almost non-existent in this case.) How will the client be kept current with respect to technology?

5. Software—Who will retain the software licenses and pay the maintenance costs? (In this case, one vendor included these costs, the other expected the client to pay and to also make the arrangements for transfer.)

Who will negotiate with third-party software suppliers?

What operating environments (operating system, network protocols, database systems, user interfaces) does the vendor use and which will be used in this contract?

Will the client be required to change standards, names, JCL, etc.? Will the user interface change?

6. Network—What communications facilities will be covered? (One vendor in this proposal included voice network management, the other did not.) How will network changes be made? Who is responsible for remote devices, terminals printers, switches, etc.?

What technology will be used? How will remote devices be configured? What about remote LAN management? Who will pay for communications? (In this case one vendor included all communications in its bid, the other agreed to manage data communications but expected the client to provide all hardware and remote software and to pay communications costs directly.)

7. Service Levels—What commitments are made? How are service levels determined and measured? How is quality measured? (INPUT carried out these evaluations in this case.) What are the schedules of system availability? What are the reliability/availability objectives and how is performance measured? What are the schedules for production work, and how can they be changed?

8. Security—How is this handled? What about physical and system security? What about back-up and disaster recovery? (One vendor in this case proposed a "cold site," the other a "hot site." In INPUT's opinion, this should be specified by the client.) How are files and programs backed up and protected?

9. Account Management—What are the proposed methods of account management? Who will communicate with the client/vendor and how will this be handled? What will be the make-up of the steering committee?

How will changes be handled? What notifications are required? What approval processes will be used? How will capacity planning, service level agreements, billing, training, regulatory compliance, security, and day-to-day administration be dealt with?

What will be the reporting on capacity use, reliability response time, etc.?

Many of these details should be defined in an operations manual.

10. Audit—How does the client audit/validate use of resources? What benchmarks will be used? For development activities, how are billing hours reported?

11. Mediation and Arbitration—What are the procedures for resolving disputes? Who will perform these tasks and how will they be chosen?

12. Contract Termination—How can this be done? In what circumstances? What are the termination costs? (In this case one vendor refused to consider termination in the first three years. Starting in the fourth year, the fee was 25% of the remaining fee for the period of the contract. The other vendor proposed a flat fee for years 2 to 4 and specified a declining fee thereafter.)

Who has rights to software developed and in development at the time of termination?

13. Financial Conditions—What are the fees, costs, and schedule of payments. (In this case one vendor used the same fee for each of the seven years proposed for the contract; the other vendor had a substantially higher charge for the first year, then lower charges for the remaining six years.)

What inflation assumptions are built in? What is the basis for adjustment? (One vendor proposed the CPI-U and the other the average of the ECI and the CPI-U. After negotiation both vendors agreed to include a rate of 3% in their bids. The client would then pay all or some portion of the excess inflation in any year.)

To what does the inflation rate apply? (In this case, one vendor applied it to everything including DASD; the other vendor applied it to personnel with expectations of reductions in rates for equipment resources.)

How will variations in client capacity requirements be handled? (One vendor only allowed for upward escalation of capacity requirements; the other vendor allowed for reduction of capacity requirements as well.)

The above gives some idea of the scope of a proper proposal evaluation program. The process in this case would have been greatly improved if the consultant employed by the client had been more knowledgeable and explicit in developing requirements.

Proper specifications, as in everything dealing with computers, go a great way to reducing the effort and cost of bidding and negotiations (on both sides).

Conclusion

Based on the analysis, INPUT recommended that the client make one last pass at one vendor to see if some of the vague aspects of its proposal could be cleared up, and subsequently, that the company proceed with contract negotiations with the other selected vendor as follows:

- Requiring the vendor to either rebid the proposal or resubmit the proposed contract reflecting in writing the changes in clauses regarding inflation, completion of current development, etc., negotiated verbally with INPUT

- Setting up a team to develop the operations manual discussed above

- Insuring that the weaker technical aspects of the proposal were resolved and documented for the life of the contract

The company has since negotiated a final contract with the selected vendor.