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common problems with outsourcing deals and how to avoid them

by John Nicholson

John Nicholson is an attorney in the Technology Group of the firm of Shaw Pittman in Washington, D.C. He focuses on technology outsourcing, application development and system implementation, and other technology issues.

John.Nicholson@ShawPittman.com

Outsourcing is frequently considered a panacea: A vendor promises that because of their experience, knowledge base, proprietary tools and systems, leverage with suppliers, and so on, they can do what you do better and for less money. Unfortunately, it rarely seems to work out as well as it should. Why?

Any function can be a candidate for outsourcing, provided it is not critical to what makes your company competitive in its environment. IT is generally the poster child for outsourcing because it started that way – companies outsourced their data processing to large time-share mainframes. These days, many other aspects of IT are also subject to significant economies of scale, both in terms of operation and purchasing. Also, IT is something of a black box to the rest of the organization; therefore, if the organization doesn't understand how IT works or why it's strategically important, it must be a commodity that someone else could also do. But outsourcing is not limited to IT. HR can be outsourced, as can something like claims administration for an insurance company. Even product development can be outsourced to one of the many engineering design firms that perform that function. There are marketing firms/advertising agencies that are basically outsourced marketing departments for the companies they represent. There are even some companies that use an outside law firm as their outsourced general counsel's office. It all depends on what you do, what you need, and what you're good at.

The purpose of this article is to look at some of the common, fundamental problems in outsourcing relationships, regardless of the industry or function being outsourced, and to suggest ways of structuring the relationship to increase the likelihood that it will be successful.

Problems with Outsourcing

Problem 1: Salespeople and Executives

Salespeople are good at selling. They tell executives what the executives want to hear in order for the executives to want to buy the product that is being sold. Executives like to do big, sexy projects. An outsourcing is a dramatic way to look like you are doing *something*. The executive is bringing in an Expert who is "Best in Class" to provide a service better and cheaper than the executive's company can do for itself. Who could say no?

The first big problem in outsourcing comes from the fact that the vendor's salespeople don't necessarily understand your problems – they just know that given enough time and money, their people are likely to be able to do what your company needs well enough that you won't throw them out. The executive, always under pressure to do more with less, listens to the salesperson's promises, but probably doesn't necessarily understand the intricacies of the functions that the vendor is proposing to take over. What the executive hears is that the salesperson says that the vendor can save the executive's company some large amount of money – savings that the executive can either use for other projects or simply claim credit for. The executive trusts the relationship that has developed with the salesperson, and is frequently razzle-dazzled by the high-powered support that the salesperson can bring in to boost his or her case. Who wouldn't be impressed when the CEO of the vendor calls you up to tell you how important your business would be to them?

Unfortunately, the vagueness and ambiguity of the conversations between the salesperson and the customer executive lead directly to problems 2 and 3. Furthermore, the savings that were "promised" rarely actually appear, and almost never on the scale that was promised.

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Problem 2: Philosophical Differences

The second big problem with outsourcing deals, and the reason why so many of them fail (or are at least unsatisfying), is lack of communication and lack of work up-front to design the relationship. Customers and vendors approach outsourcing with two radically different philosophies, but they rarely discuss those philosophies and the impact that they will have on the relationship.

The customer expects the outsourcer to act exactly like the customer's employees act. So if the customer asks the outsourcer to do some extra work, the customer expects that the outsourcer will just prioritize the work or stay a little late and get it done at no additional cost.

The outsourcer, on the other hand, thinks that it is charging a defined price for a defined scope of work, and if the customer asks the outsourcer to do something more, it's only fair that the outsourcer get to charge for it.

The big problem is, no one really discusses this philosophical difference openly, and it festers as the outsourcer issues change order after change order asking for more money, and the customer thinks that the outsourcer is just gouging the customer because, after all, the customer's old employees wouldn't have asked for more money. Bit by bit, the relationship deteriorates.

An additional aspect to this problem is that while the company's employees would frequently go above and beyond the call of duty to make sure that problems are resolved and customer impact is minimized, the outsourcing vendor doesn't necessarily have the incentive to do that, and so perceived customer service degrades.

For example, one company I worked with recently had a few help desk personnel who would perform a sort of level 1.5 triage. If a problem couldn't easily be resolved via the phone from the help desk, one of these people would go work the problem from the deskside. These people were integral to the customer service perceived by the end users. Part of the outsourcing vendor's proposed savings was to move the help desk off-site and eliminate those deskside visits. The customer management wanted the savings and was willing to accept the loss of that level of assistance. However, from an end-user perspective, customer service was degraded. Without a sufficiently detailed communications plan that informed users that this service would be going away, the end users would perceive this as a failure of the vendor to provide the same level of customer service as they received before the outsourcing.

In such a scenario, the customer begins hearing from its users that the service provided by the vendor isn't as good as the service they received before the outsourcing, while

Different philosophies + poor internal management communication + a poorly defined scope = an unhappy relationship.

the vendor is asking for additional money. The vendor, from its perspective, is providing its services in exactly the way that it told the customer it would, and is only asking for more money to cover the additional scope that the customer is requesting.

Problem 3: Ambiguous Scope

The deterioration in the customer-vendor relationship is facilitated by the third big problem in outsourcing – lack of understanding of the scope. When an outsourcing vendor submits a proposal, it describes in general terms what it is going to do, but only very, very rarely supplies a detailed description of how things will work, who has responsibility for which functions, etc. Developing such a document takes a great deal of time and effort, and requires the cooperation of the people who are either about to be outsourced or who are already overburdened running the operation. These people do not want to spend days (weeks!) in conference rooms defining the scope. They just want the vendor to get on with it. At the same time, the senior executives who have decided that outsourcing is a "Good Thing" want the deal to happen fast, generally because they have already factored the savings from the outsourcing into their next quarter's budget.

So the scope ends up being poorly defined, and each side has a different idea of what they are responsible for doing. The customer assumes that the vendor will do everything that the people who held the positions that were outsourced did – even if that stuff wasn't in the job descriptions for those functions. The vendor, on the other hand, thinks that it has specifically defined the functions that it will perform (never mind that the proposal from the vendor is generally about as specific as Swiss cheese – the vendor *thinks* it's done a thorough job) and that it has priced the services it thinks it's going to provide.

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How to Decrease the Chance of Being Unhappy

Where a function is going to be outsourced, it is the customer's job to make sure that the contract is properly created, in order to increase the likelihood that the relationship will be a happy one.

Competitive Procurement

First, use a legitimate competitive procurement process. You will get a better deal and have negotiating leverage in a competitive procurement that you do not have in a sole source deal. This seems intuitively obvious, but I am astounded at the number of times I hear supposedly rational, educated executives say things like, "We're not going to compete the deal because if we don't make things difficult for the vendor now, they will remember that and go the extra mile for us later on." By that logic, you should pay full price (or more) for a car in the hopes of getting better service down the road.

A second part of this is that you have to legitimately want the best deal to win. If you have already decided which vendor you want, but you are just using the other vendor(s) to drive down your selected vendor's price, all of the vendors will know and it will not work. The less preferred vendors will not put in the effort or resources because they know that they do not have a fair chance of getting the deal.

To establish a good competitive procurement, you will need to understand the scope of what you want to outsource and document your requirements as part of an RFP. The

RFP should clearly describe what you want the vendor to do, detail any assumptions that you want the vendor to make, and provide a clear timeline. The RFP should be structured so that it will be relatively easy for you to compare the proposals from each vendor. The pricing provided by the vendors, in particular, should be broken down to a level that makes "apples to apples" comparisons possible.

At the time you begin your RFP process, you should also look at the service levels that you will want for the outsourced services, and if you aren't already tracking them, you should start. Most vendors want to see at least six months' worth of performance data before they will agree to a service level, and if you start recording at the beginning of the RFP process, you are likely to have enough data to make the vendors comfortable.

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Clearly Document Scope, Service Levels, and Pricing

Second, document the scope, service levels, and pricing up-front. The scope should be sufficiently detailed that it is absolutely clear who is responsible for doing what. While it does not need to reach the level of desk procedures, the scope document should be fairly thorough.

The scope should clearly define what the vendor is responsible for doing and when, and the service levels should be tailored to measure the vendor's performance of those responsibilities. If a service level measures an activity that is performed jointly or that requires some activity by the customer before it can be completed, then the situation is ripe for finger-pointing between the vendor and customer if the service level is not met.

There should be no "assumptions" in the final agreement. "Assumptions" are vendor code for "If this doesn't turn out to be true, the price will change." Any assumption should be discussed in detail, and the impact to the price or services of variations in that assumption should be clearly documented. For example, an assumption that the volume of moves will be 10,000 per year simply says that if it's not 10,000, something will change. The vendor will interpret this as, "I will be paid for a minimum volume of 10,000 moves, regardless of whether or not they happen, and I will get an additional charge for each move over 10,000." The customer position, on the other hand, is more likely to be, "If I require fewer than 10,000 moves, the vendor isn't having to do the work, so I shouldn't be charged for it, and if I do a few more, the vendor should be able to absorb those in the capacity that is already in place." The final agreement should *clearly* specify what happens to the pricing if the required number of moves is different from 10,000. The scope, service levels, and pricing should all be completed *before* the contract is signed, which leads us to . . .

Due Diligence

Third, all vendor due diligence should be completed prior to contract signing. The vendor should not be able to "re-open" the deal after the contract has been signed. The only exception to this might be if you don't have sufficient data regarding service levels. In that case, you and the vendor can agree to interim service levels while the vendor monitors its actual performance over a specified period to set the permanent service levels.

Deal Consultants

The previous three suggestions are all things you can do on your own, but if you use an experienced deal consultant and get them involved before you send out an RFP, these steps will all be much easier. For one thing, the deal consultant will have more

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experience evaluating and comparing the proposals from the vendors. Also, the deal consultant will understand the industry, in terms of what are reasonable positions and what are not, and also understand the pitfalls of structuring these types of deals. Vendors have people who do nothing but negotiate these deals, and if you try to go up against them without an experienced deal consultant with you, you are working under a handicap for two reasons: (1) the vendor negotiator is very experienced and practiced at negotiating deals that maximize the benefit to the vendor while minimizing its risk and liability, while you are at a disadvantage because of your relative inexperience; (2) the vendor has a team of people who can spend almost full time working on the project, while you and your people also have to keep your business running. A deal consultant can be the additional resource that helps balance out the vendor's resource advantage.

Conclusion

The majority of problems with outsourcing deals are caused by poor communication and lack of effort early in the process. As with any relationship, communication and understanding of mutual expectations are key to the ongoing health of the relationship. Customer executives considering an outsourcing need to understand what they are trying to achieve and be willing to put the effort in at the outset to increase the likelihood of getting what they want.

Negotiating outsourcing deals is not easy. You are designing a relationship that will last for five or more years, and you are attempting to build in protections for both sides for all of the things that might change during that time. Documenting the full scope of work and associated service levels takes a substantial effort; you should assume that negotiating the deal will take several months from RFP to contract for small or heavily fast-tracked deals, and even longer for large or unusually complicated deals.

By using an RFP, clearly documenting the scope, SLAs, and pricing, and making sure the deal is closed when it is signed, you can dramatically increase the chances that your outsourcing will work. If you involve an experienced deal consultant in the process, those odds will get even better.