

# Outsourcing – what lies beneath

PA's international IT outsourcing survey 2009





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This report is based on results gathered from the PA Consulting Group IT outsourcing survey, undertaken in late 2008, using responses collated from over one hundred customers, service providers and lawyers of large-scale enterprises across the UK, Sweden, Norway, the Netherlands, Denmark, Germany and the US.

# Management overview



## The risks of cost cutting

The analyst community agree that the global outsourcing market is set to grow by 8.1% in 2009,<sup>1</sup> as organisations look to impose tighter cost control over IT expenditure. However, the PA Consulting Group (PA) IT Outsourcing Survey, undertaken with large-scale US, UK and European enterprises, reveals that short-term cost gains are likely to be achieved at the expense of fast rising corporate risk. In a bid to mitigate this risk, organisations are likely to see unexpected costs rise significantly in forthcoming years.

### **Invest in governance**

One of the fundamental requirements in controlling both cost and risk, as well as in meeting IT outsourcing objectives, is the quality of governance that organisations need to apply in managing their outsourced relationships.

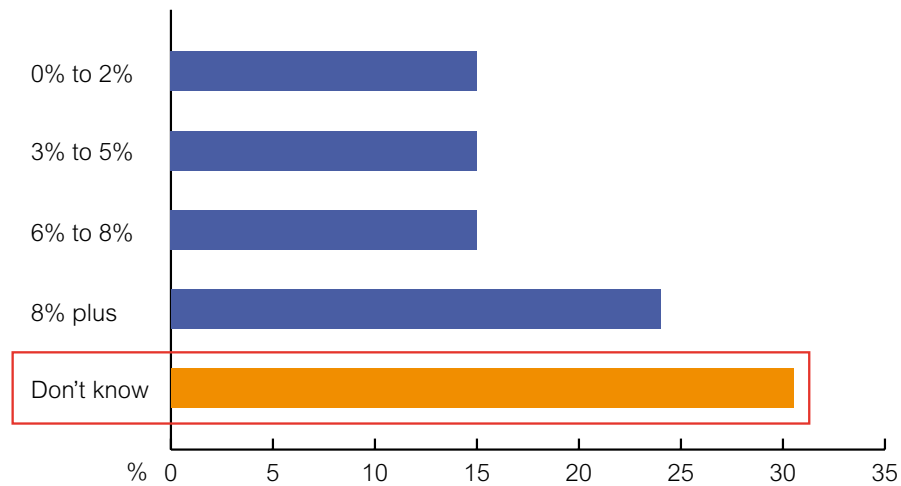
Yet over 30% of companies still have no idea of the cost of the internal governance organisation (see Figure 1). Furthermore, only 16% of those surveyed assessed themselves as having a mature governance model for outsourced services (see Figure 2). The inadequacy of internal governance and associated capability is at the heart of each of the main issues identified by the survey.

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<sup>1</sup>Source: Gartner

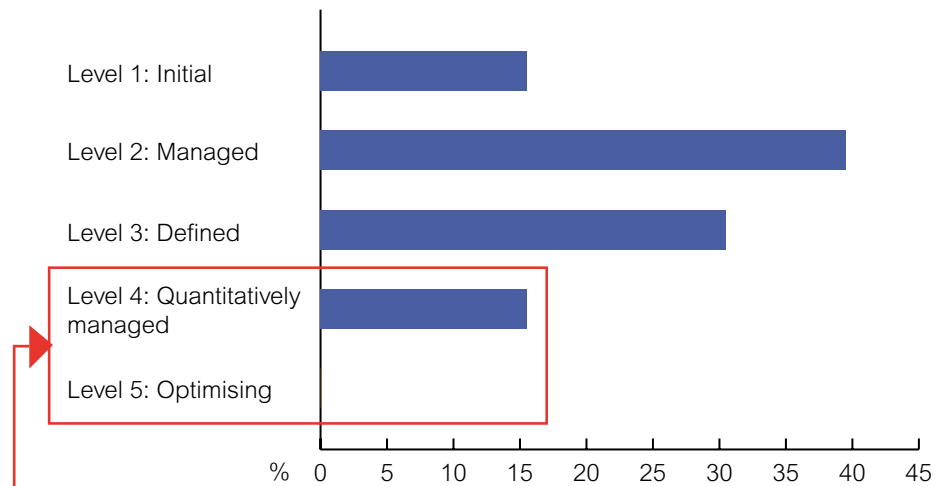
**Figure 1**

**Q.** What is the cost of your retained governance organisation, ie the total cost of managing, as a percentage of the annual contract?



**Figure 2**

**Q.** Please indicate the maturity levels of your management model for outsourced services against the following criteria:



Only 16% of those surveyed assessed themselves as having a mature governance model for their outsourced services.

As identified in previous PA surveys, lack of investment in internal governance, and the appropriate capability to manage outsourcing agreements, have been long-standing issues. Yet as this survey reveals, there has been no significant move to improve the quality, maturity and expertise of the internal governance organisation.

### **Integration**

While organisations have previously survived by papering over the cracks, the trends identified by the survey are likely to make the 'management of integration' the number one outsourcing issue over the next two years.

This lack of governance of outsourcing is intensified by the strong trend away from single-source outsourcing to multi-source contracts, with almost three-quarters of organisations now moving in this direction. If organisations cannot effectively manage a single supplier, there are very real questions to be asked about their ability to define multiple distinct contracts and manage integration between suppliers.

Furthermore, with an overwhelming focus on short-term cost savings, organisations are failing to undertake the change management programmes required to define and manage the transition to and integration of multi-source contracts.

This cost pressure is combining with the lack of internal maturity and expertise to fundamentally

undermine the supplier/customer relationship. High levels of miscommunication through poorly defined requirements in contracts, confused expectations and an inability to manage the relationship using industry-recognised service management disciplines, all serve to damage the relationship.

### **Relationship advice**

The survey reveals that rather than focusing on cost reduction, suppliers are responding to the economic downturn by making marked changes in the area of business relationships, through both sales and operational teams. However, such attempts at building relationships will not be helped by client organisations increasingly using non-performance clauses as a reason for embarking upon contract renegotiation – and using open market, competitive processes to support the multi-source trend.

Focusing purely on the deal and on lower headline numbers may provide short-term political glory for a few, but it is likely to leave some ticking cost time bombs within the organisation if the capability to manage the relationship continues to be ignored.

### **Innovation differentiation**

For the users of outsourced services, the need to achieve cost improvements quickly is creating unfeasibly tight procurement and implementation deadlines. This drive to cut a deal quickly can unwittingly become the overriding consideration, resulting in organisations losing sight of the

opportunity to use innovation to deliver both strategic and tactical improvements. In the current climate innovation should incorporate cost reduction as a key component of the outsource objective.

Unfortunately, neither organisations nor suppliers have a good track record with regard to innovation. Generally, organisations have used vague statements about innovation that leave the supplier with no clear direction, focus and no tangible output measures. Similarly, suppliers cite research centres or centres of innovation excellence, but no clear commitment to improvement. In reality, supplier delivery of innovation has usually been limited to the areas of technology and commercial packaging.

Innovation should be a clear differentiator when selecting suppliers as it is a distinct area where organisations can maximise the value of the IT outsourcing investment and improve the business' bottom line. Maintaining current practice will constrain innovation to a sideshow – and organisations should leverage the current focus on cost saving to clearly define innovation requirements, with appropriate output measures, in the contract.

Outsourcing can meet both short-term goals for reducing costs and longer-term objectives around delivering innovation and mitigating business risk. Unfortunately, in this headlong rush to squeeze down the price of outsource contracts, organisations are in very real danger of adding untenable risk and building in a massive financial headache further down the line.

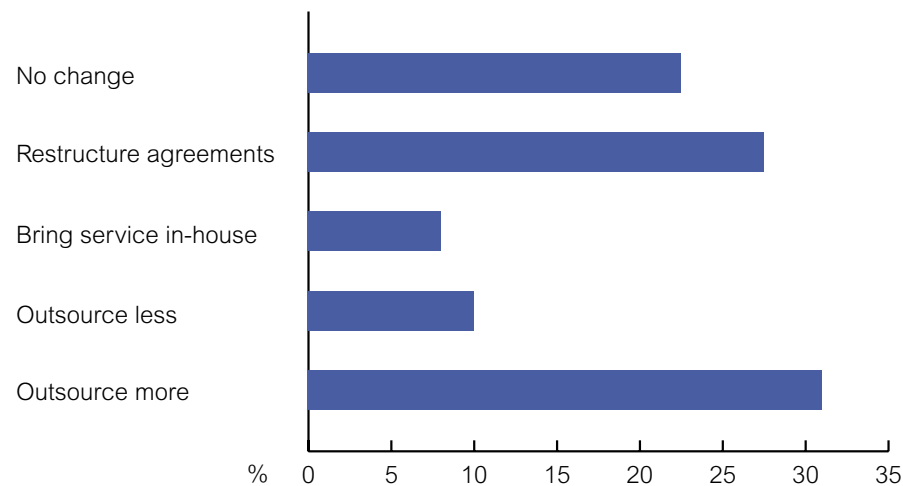


# Introduction

The current economic conditions are driving growing numbers of organisations to rethink and refocus IT outsourcing strategies. According to the latest survey of over 100 customers, service providers and lawyers undertaken by PA during late 2008 across the UK, Europe and the US, nearly 60% plan to either restructure existing agreements (28%) or outsource more (31%) services this year in a bid to attain more value (see Figure 3).

**Figure 3**

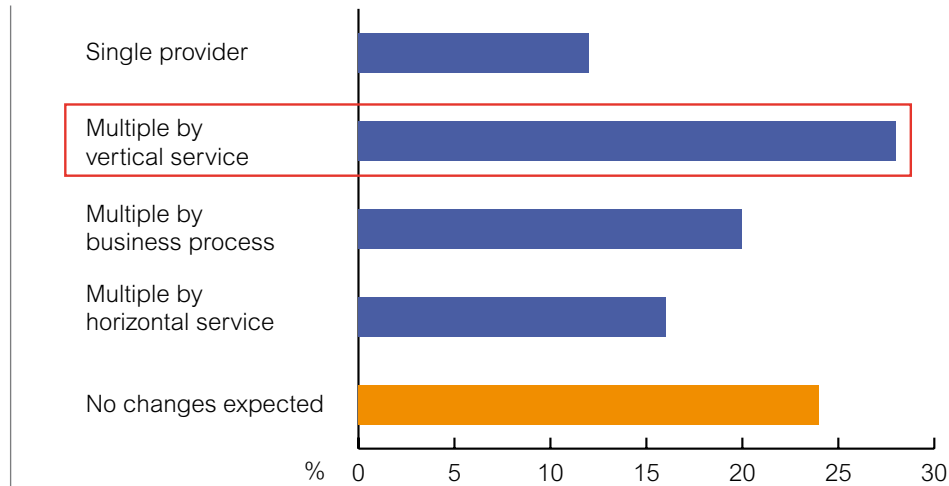
**Q.** How will firms alter their sourcing mix in response to the economic downturn?



This trend poses significant challenges for both customers and services providers, not least in managing the massive upheaval in existing relationships during any period of renegotiation. This challenge is exacerbated by the very strong trend away from single sourcing to multi-sourcing. Almost three-quarters (73%) of organisations are currently in the process of moving to the use of multiple service providers for key outsource requirements, thereby breaking up standard single contracts into multiple separate agreements. This focus raises very real concerns about the long-term value of the contracts currently being agreed.

**Figure 4**

**Q.** Over the next three to five years, how do you expect your organisation to change the way IT outsourcing services are provided?



The CIO community remains under increasing board-level pressure to cut costs. How best to achieve that goal without incurring additional corporate risk? If the outsource deal is to deliver long-term value rather than simply assuage a short-term requirement to cut costs, there is a clear need to implement and adopt appropriate governance, supported by both strong relationship and innovation obligations in the contract.

Certainly the service providers seem to be increasingly focused on relationship building, with many organisations reporting a change in the way service providers are looking to interact – at both a sales and operational level. About a third of respondents observed changes in sales provider tactics, in the current climate. Those reporting changes insist that providers are emphasising relationship building, especially from service providers’ operations, then increasing flexibility and, only finally, reducing prices. This appears to be a defensive strategy by suppliers to protect and retain existing business in the current and medium-term economic climate.

In a headlong rush to cut costs, just how many organisations are looking to exploit this new service provider willingness to build a stronger relationship?

The key issues from the results of the survey will now be explored in greater detail;

- Multi-source appeal – beware the ‘i’ word!
- Building relationships
- Achieving innovation.

# Cost reduction, first and foremost

Not surprisingly, the unusual worldwide economic climate that the survey was conducted within dominated respondents' thinking and attitude. Inevitably, the pressure to reduce costs was paramount, almost to the point of exclusion of wider considerations and implications.

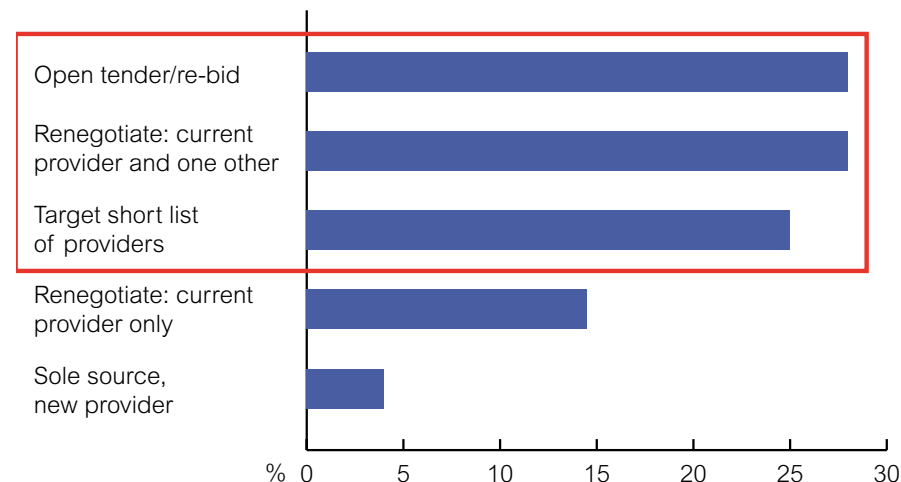
Until now, most organisations have endured performance issues, preferring to avoid upheaval and investment to improve performance, where possible. But with upheaval now endemic along with a lack of willingness to invest more money and resources, organisations believe it is now time to restructure their agreements, with over one-third of respondents citing non-performance as the mechanism to bring suppliers to the table.

35% of client respondents identified non-performance as their major reason for restructuring the existing IT agreement

These organisations also plan to be far more aggressive in the way they restructure, with 75% planning to use a competitive sourcing approach in a bid to drive costs down as far as possible (see Figure 5). Indeed, with the growing trend towards multi-sourcing, a competitive or market-led approach is really the only viable option.

**Figure 5**

**Q.** What process would you follow to restructure your IT outsourcing agreements?



However, organisations need also to understand the implications of this strategy. Most companies are hoping to achieve cost reductions by Q4 2009 or Q1 2010 at the latest. Undertaking a full competitive process can be lengthy and expensive – but that time is simply not available. Extreme time pressure within a competitive process will inevitably lead to poor decision making.

Add into the mix the pressure to split up large, single contracts into separate agreements, and a trend towards undertaking a multi-sourcing approach, organisations are creating an integration management problem that is likely to add significant cost and risk further down the line.



# Multi-source appeal – beware the ‘i’ word!

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Certainly the temptation to move towards multi-sourcing is understandable. The mega, single-source outsourcing deals in many cases failed to deliver against expectations. By breaking up these contracts and allocating key elements to different suppliers, organisations hope to improve competition, maximise supplier skills and expertise and, critically, drive down costs by achieving better contract pricing.

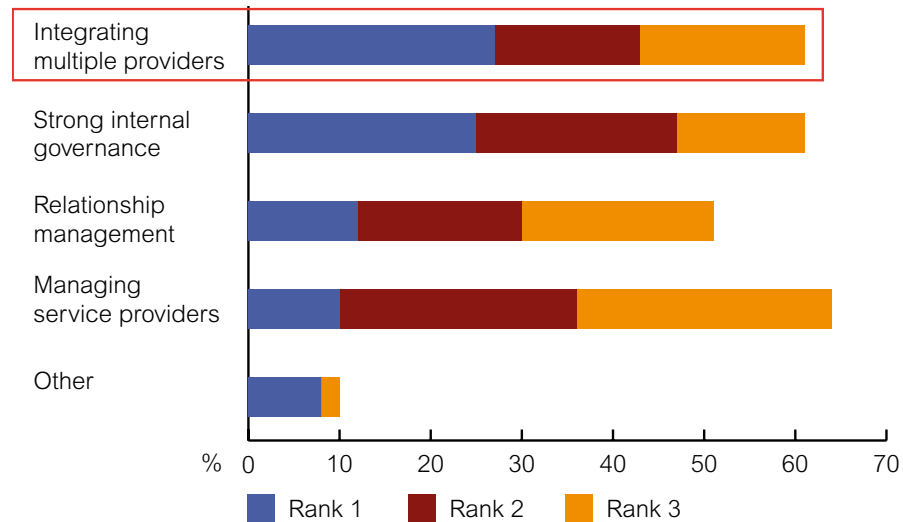
However, the problems with replacing a single outsourcing arrangement with a set of separate agreements for the component parts are twofold. Firstly, in the traditional single-source model, the supplier typically undertakes a significant amount of work to cover the gaps between defined areas. Much of this work is unseen and unpaid, but it is key to ensuring service consistency and continuity. Suppliers are prepared to cover such gaps in order to preserve the business relationship and bank some potential commercial leverage that could be used at a later stage.

Break up the contract into its component parts and no single vendor is going to undertake that massively increased integration role any longer, making the client organisation accountable for holding everything together.

Some organisations are beginning to recognise this problem. According to our survey, the risk of integrating multiple providers ranked as the top concern by over one-quarter of organisations, followed by concerns regarding strong internal governance and relationship management (see Figure 6).

**Figure 6**

**Q.** What would you rank as the top three reasons to focus upon when considering multi-sourcing?

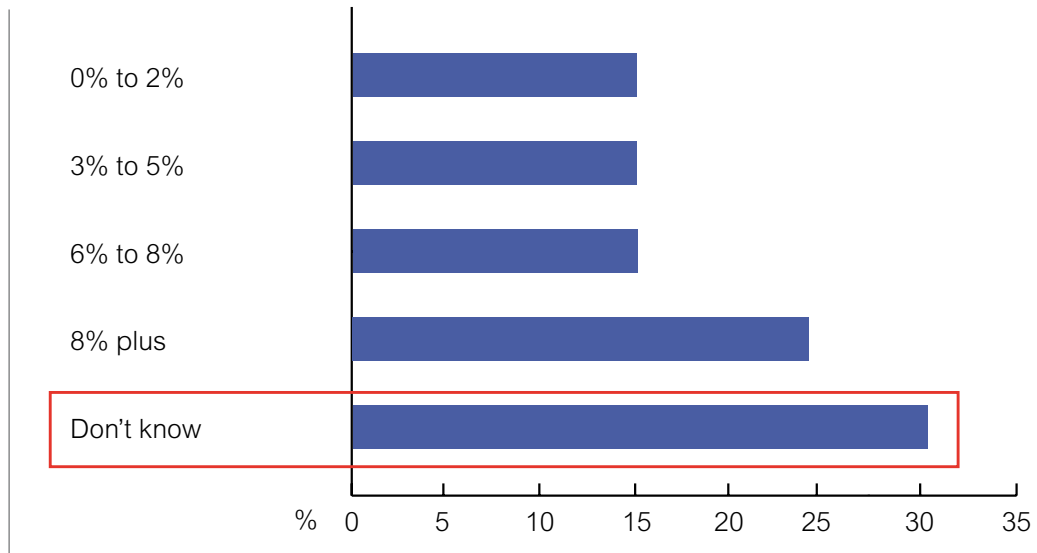


The second key problem with multi-sourcing is that typically, the organisation has neither the capability nor the resources to undertake the integration role. Organisations rarely have the skills, expertise or knowledge to manage these multiple supplier relationships. More critically, few as yet even recognise the problem, failing to accept that a successful transition from single to multi-sourcing requires a significant and sustained programme of change. Few are willing to even contemplate the necessary investment at a time when cost reduction is paramount.

Indeed, given the endemic poor management of single-source outsourcing contracts, it is extraordinary that so many organisations are attempting to embrace multi-sourcing without considering the operational impact. Two years ago, PA's 'Understanding Misunderstanding' sourcing survey revealed that 50% of organisations had no idea of the cost of the retained organisation managing the outsource relationship. Today the survey reveals that upwards of 30% still cannot put a figure on this cost (see Figure 7).

**Figure 7**

**Q.** What is the cost of your retained governance organisation, ie the total cost of managing, as a percentage of the annual contract?

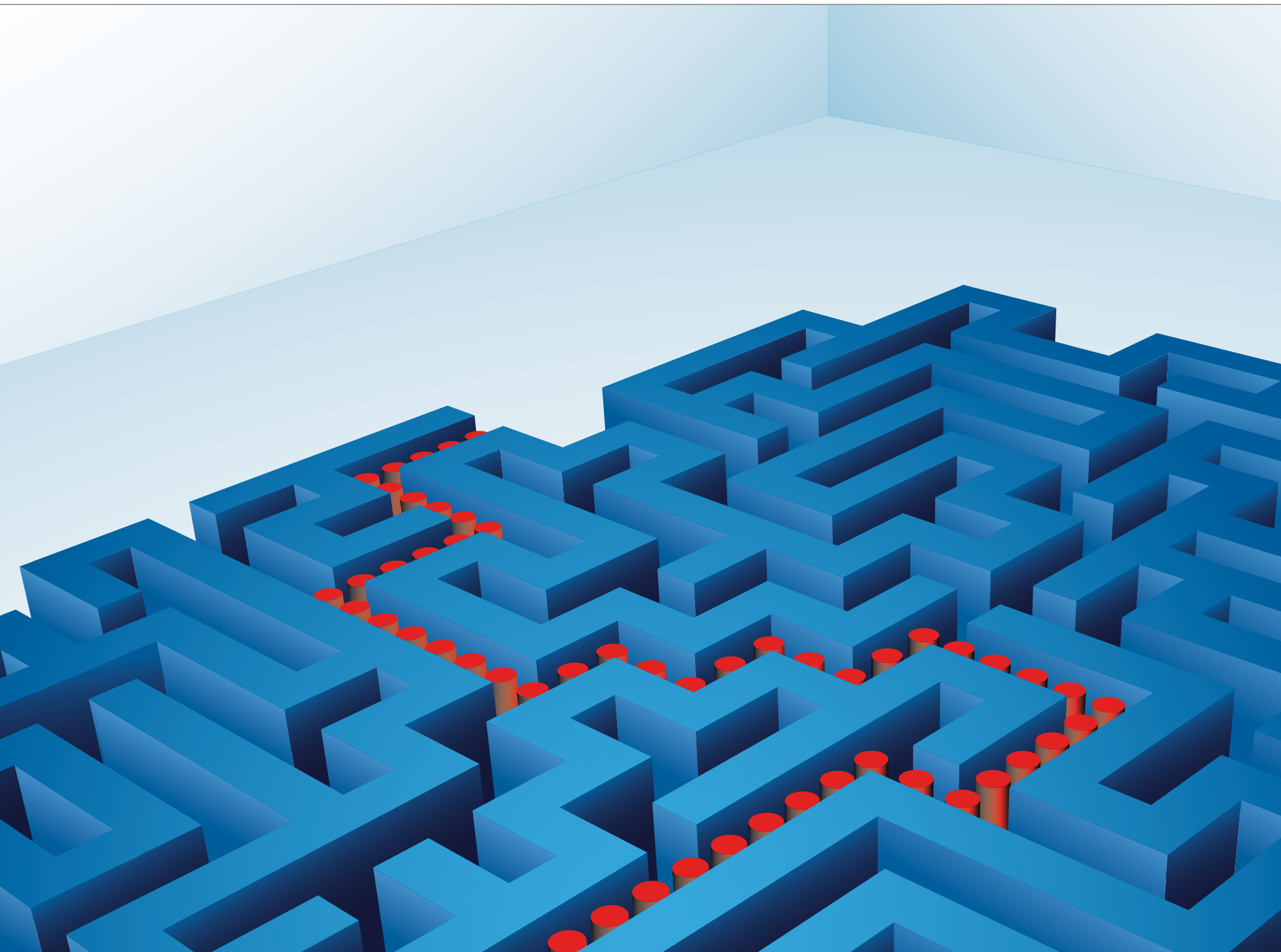


And it is from this base that organisations are planning to move into an environment that requires absolute discipline in the coordination of suppliers, and a new set of competencies for staff engaged in managing the new arrangements.

The business risk associated with a poorly designed, implemented and managed multi-source strategy is significant. Contracts rarely address the critical issue of managing integration across different suppliers, the amount of change control required and the need to define how the bridging role between services will be carried out by suppliers. Suppliers are unlikely to commit to legally binding management processes and will guard against the black hole that is integration – even well-meaning collaboration is not guaranteed.

Therefore, unless organisations plan to appoint a prime to act as service integrator, they will have to be prepared to take on end-to-end accountability internally – and many 'tier one' organisations have already had to invest heavily in large teams of people to fulfil the integration requirement.

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# Building relationships

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The combined trends of multi-sourcing and sustained cost focus are also putting possibly untenable pressure on the supplier relationship. PA's survey revealed that miscommunication on requirements and expectations is still the top cause of failure among customer and service provider relationships. Add in the challenges posed by multiple relationships and diverse supplier expectations and the problems can only get worse.

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Miscommunication on requirements and expectations were identified as the top causes of failure among customer and service provider relationships

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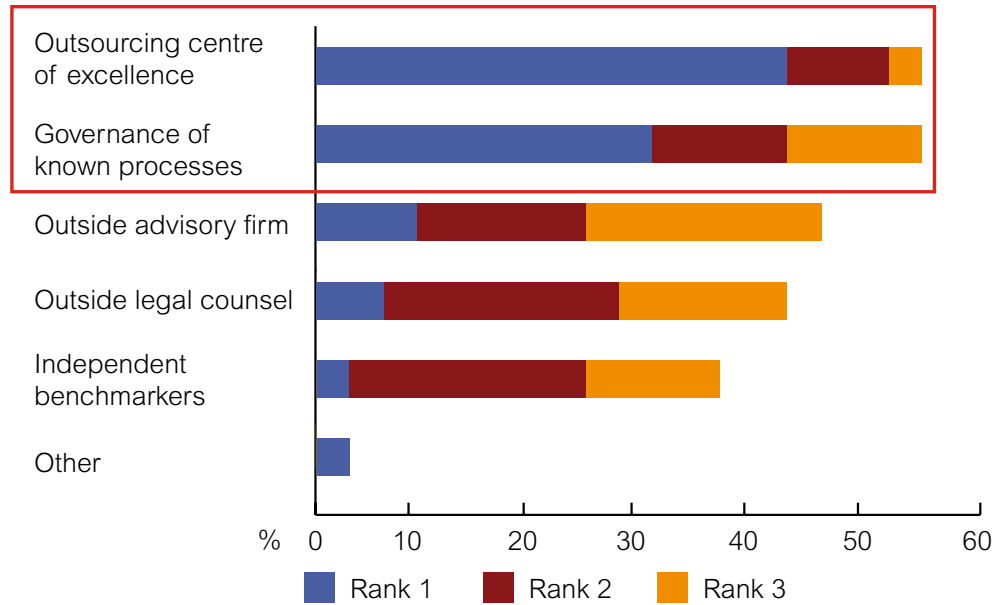
Certainly if the outsource contract is specified badly up front, the organisation is setting unrealistic expectations. Each provider needs to understand what is required within each contract, and where their responsibilities lie across the entire environment. With multiple providers disagreeing, both among themselves and with the customer, the result can only be finger pointing and poor service delivery.

To achieve effective, successful multi-source outsourcing, contracts need to be clearly structured, based on common terminology and with defined interfaces and agreed roles and obligations.

Yet despite this increasing complexity and escalating business risk, organisations still seem to prefer to manage the outsource relationship purely internally, either through an internal outsourcing centre of excellence or governance of known processes. These approaches rank far higher than the selective and targeted use of outsourcing advisers, legal counsel, independent benchmarkers or other resources (see Figure 8).

**Figure 8**

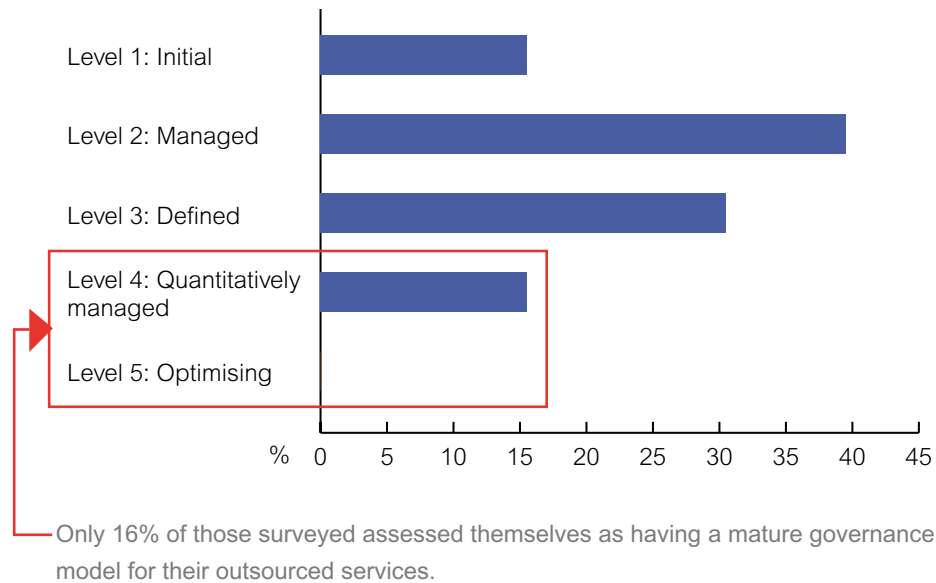
**Q.** How do you govern your outsourcing operations?



Our survey also revealed a clear lack of maturity in the internal organisation – with only 16% of those surveyed assessing themselves as having a mature governance model for outsourced services (see Figure 9). This lack of maturity provides an obvious insight into why miscommunication is such a strong factor in the failure of outsourcing relationships: organisations do not know how best to engage mature, experienced providers in a manner that ensures business needs are understood, based on agreed terminology and consistent service delivery.

**Figure 9**

**Q.** How would you rate the maturity levels of your management model for outsourced services?

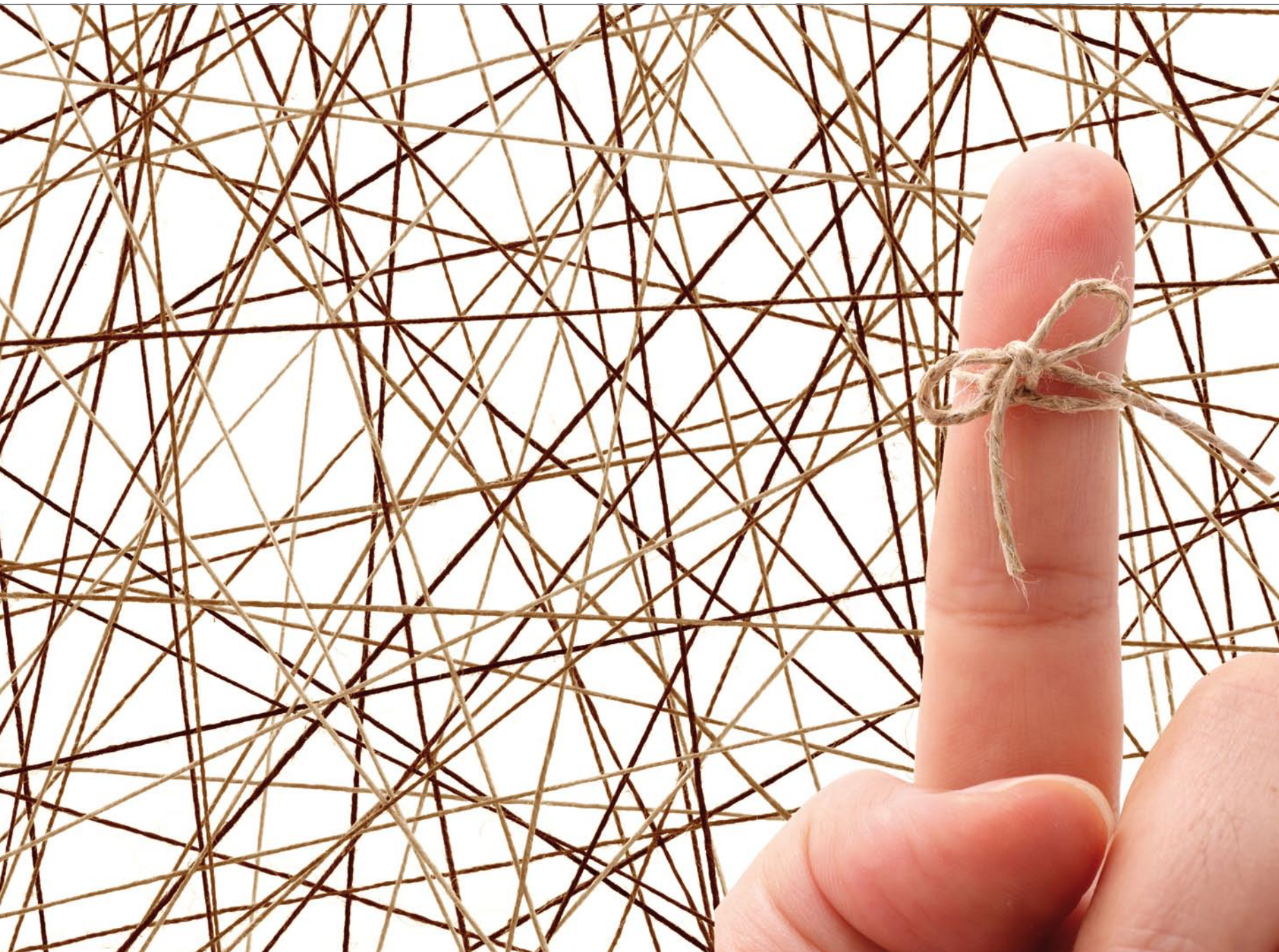


When the current lack of maturity within the retained organisation is coupled with the implications of adopting a multi-sourcing strategy, it raises a major dilemma. The overriding requirement to cut costs is compromised by the need to be making serious efforts to improve the maturity of the retained organisation and establish the required breadth of core capability. But, in the current climate, there are very real questions surrounding organisations' willingness to invest, to achieve this level of maturity.

According to the survey, a growing number of organisations now recognise that vital skills are in short supply and are building outsourcing centres of excellence in a bid to improve their core competence to manage this increasingly complex environment. But too many organisations are attempting to do this in parallel – building up skills internally while also trying to introduce multi-sourcing arrangements that really demand that the internal governance organisation is already in place.

This problem is further underpinned by the lack of understanding of the cost of the retained governance organisation. Not only have a third of organisations still not got to grips with the costs involved but the perception of costs is far from consistent. Organisations are evenly split in their cost perceptions, with similar numbers putting the cost at between 0–2%, 2–4%, 4–6% and 6–8% of the overall contract value.

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# Achieving innovation

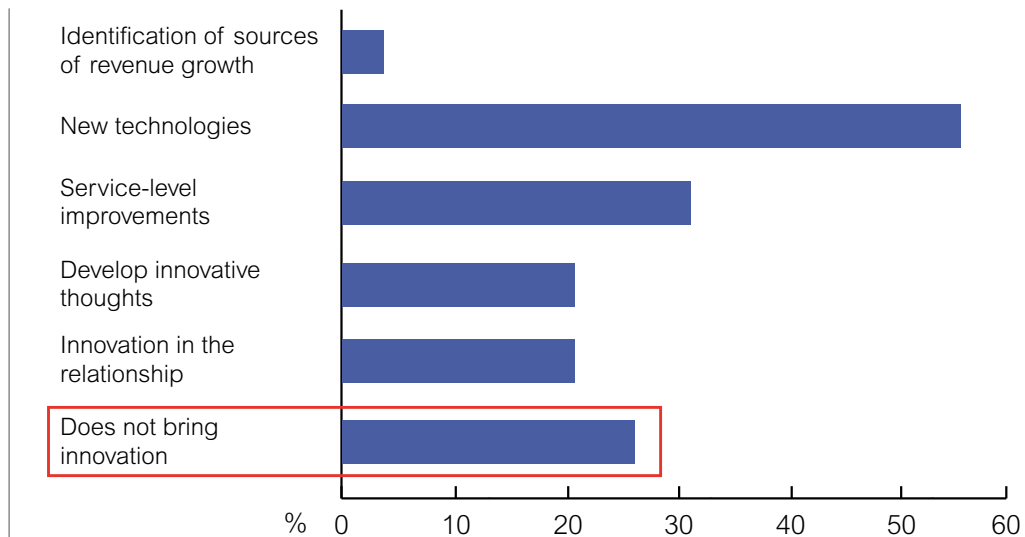
While the majority of providers are making increasingly strong promises around the delivery of innovation within an outsource contract, in the main, these promises are not being realised.

PA's survey found that 75% of companies reported having service providers that have displayed innovation in some form during the sales process. Yet only a third of all IT outsourcing (ITO) relationships deliver some

form of technological innovation, which might be expected with ITO. Few respondents are receiving innovations that target the core business, and over a quarter report receiving no innovation at all (see Figure 10).

**Figure 10**

**Q.** What form of innovation does your ITO relationship deliver?



Certainly the figures reveal that service providers are more likely to display innovation around technology and commercials, and less related to specific industries or processes. Very few are delivering any innovation that helps to drive revenue.

Service providers are increasingly pushing innovation as a differentiator in this market, emphasising research centres or centres of innovation as examples. Unfortunately, these organisations are not explicit in how that innovation will translate into the customer's business situation.

However, the lack of innovation realisation is not entirely the fault of the provider. There is a clear disconnect between customer and supplier objectives that is causing problems. Many organisations are very unclear about what is meant by innovation. The innovation demands are left open-ended, leaving the service provider unsure or unable to respond adequately. It is not surprising therefore that only 3.6% of respondents stated that the service provider always met the contractual commitments to innovation.

If organisations are to achieve the innovation that should be a core component of any outsourcing agreement, there needs to be some serious work undertaken to define what is required and just when that should be delivered. And, unlike the current vacuous statements about innovation that appear in most contracts, organisations should include explicit expectations about both innovation and the timing of delivery to ensure all parties understand expectations.

But achieving this shift requires significant expertise in defining expectations and measuring delivery. Today many firms continue to struggle with quantifying and measuring outputs from their innovation provisions – only 25% of agreements include specific 'output' measures of innovation. The majority of agreements emphasise 'input' measures of innovation such as discussions and workshops, while only a few create 'output' targets or outcomes. This reflects a lack of understanding surrounding the outputs from innovation and therefore an inability to document possible gains and expectations within the contract.

Those organisations that define innovation within the contract are far more likely to realise innovation and are more satisfied with their outsourcing when they experience supplier innovation.

But suppliers also have a role to play. Mature, innovative providers leverage past experience and lessons learnt, and should be willing to document the output measured from requests for innovation in the agreement, rather than the input measures. The drive towards cost reduction also provides significant scope for innovative solutions to be proposed by suppliers.

Despite clear desire for innovation on both sides today, innovation is an also-ran on most contracts due to the current poor practice. Innovation should be a differentiator in terms of supplier selection and is one of the key long-term success factors for any outsourcing agreement.

# Conclusion



The business risk associated with poorly designed, implemented and managed IT outsource contracts – especially under a multi-source strategy – is significant. Contracts rarely address the critical issue of managing integration across different suppliers, the amount of change control required and the need to define how the bridging role between services will be carried out. Suppliers are unlikely to commit to legally binding management processes – and even well-meaning collaboration is not guaranteed.

Therefore, unless organisations plan to appoint a prime to act as service integrator, they will have to be prepared to take on end-to-end accountability internally – and many ‘tier one’ organisations have already had to invest heavily in large teams of people to fulfil this requirement.

As a result, while the objective is to reduce costs, in reality making multi-sourcing work is proving to be an expensive exercise, due to:

1. The intangible cost associated with failing to improve business agility
2. Defining and managing end-to-end service levels that hold all suppliers within the chain to account
3. The direct costs of additional headcount to support and manage this complex operational strategy.

Without embarking on a significant shift in strategy, appointing a service integrator to oversee the process or investing in the required skills today, organisations can expect unexpected costs to soar over the next few years.

Furthermore, organisations are also missing out on the tangible benefits that could and should be achieved as a result of a strong business relationship with inbuilt measurable goals and business objectives. The relationship will prosper if it is managed through industry-recognised, service management disciplines. It will be further enhanced if organisations deploy appropriately skilled teams that are comparable in expertise to that of their supplier counterparts.

Organisations need to take a more simplified but specific approach to their requirements for innovation. The acid test should be to determine the business outcome that is required to be met and the areas of activity that fall within the suppliers' scope. Organisations should provide direction and measurable objectives, leaving suppliers to work out the 'how'. For example, the hunger for cost reduction should provide a simpler business target for the application of innovation with tangible bottom-line benefits; relatively easy to define and target.

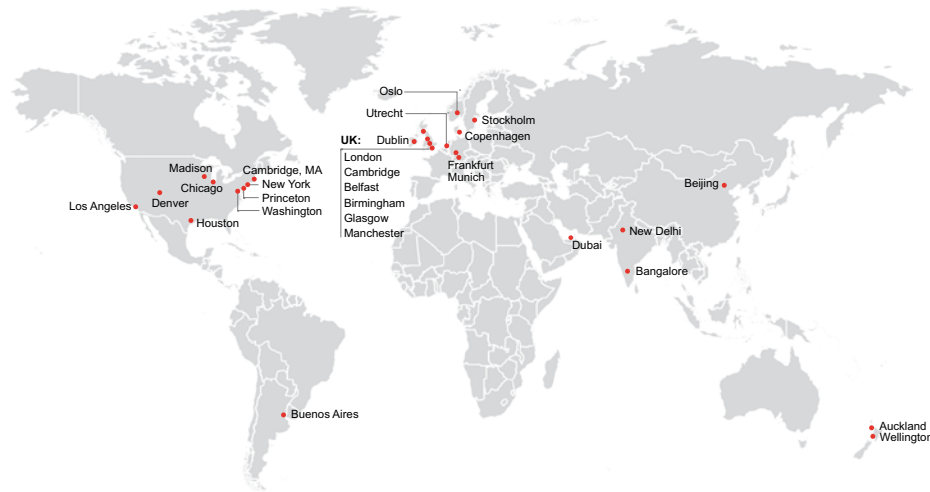
Outsourcing can – and should – deliver both short-term gains and longer-term corporate objectives. But defining service expectations and building relevant contracts is a complex and time-consuming operation that requires expertise. Attempts to renegotiate quickly, putting suppliers under huge cost pressure, can only create problems, and costs, down the line.

There are enough businesses losing money today by not thinking through the consequences of actions – this is not the time to join them by failing to consider the true implications of IT outsourcing.

## Sourcing – there is a better way

For further information on our IT outsourcing survey or to discuss your sourcing needs in more detail, please e-mail [sourcing@paconsulting.com](mailto:sourcing@paconsulting.com) or visit [www.paconsulting.com/sourcing](http://www.paconsulting.com/sourcing)

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