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Murphy's Law in Outsourcing

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Gordon Moore, a founder of Intel, famously foresaw that the number of transistors crowded into a microchip would double every eighteen months. His insight, christened Moore's Law, has driven the computing revolution of the past twenty years. Translated into practice, Moore's Law has meant declining costs, economies of scale and growing complexity. To manage that complexity and achieve desired economies, many enterprises have entrusted IT operations to the likes of IBM, EDS and CSC, among others, in what has become a huge global business.

Those who outsource should remember a much older maxim known as Murphy's Law: What can go wrong, will go wrong (and could go wrong on your watch). Outsourcing IT can offer operational, economic and other advantages, but is no panacea. Much can go awry. The customer may pay too much (or too little). Changes may blow past budgetary constraints. Service may disappoint. An incumbent supplier may grow complacent, or use customer accounts to train a changing cast of inexperienced staff. Contracts may prove confining and inflexible, rather than a framework for mutual, long-term success.

Some of these hazards can be anticipated when (or even before) the contract is written. Much, as always, depends upon execution, and prevention through effective management. What can be done? How do these relationships go wrong, and how can these risks be avoided, or at least reduced?

Remember Why Contracts Work

People think of contracts as armories full of rights and remedies: termination, audit, service levels and the rest. These have their uses, but they are less than the whole story. The point is to avoid trouble in the first place. Contracts necessarily police, prohibit and (at least potentially) punish; but motivation by fear is rarely sufficient to assure outstanding performance at reasonable cost. Excellence and value require talent, teamwork, continuity, strong consensus, process excellence and attentive leadership, among other things. None of these derive from the legal "boilerplate." Rather, good contracts succeed by anticipating contingencies, and allocating risks, rewards and responsibilities in ways that motivate the parties to perform, and to do the right thing when trouble arises. Contracts, like treaties, are honored because performance advances the parties' interests. Good contracts are good deals for both sides and permit both parties to succeed.

Relationships Drive Everything Else

The relationship drives the deal, which drives the contract. Before outsourcing, pause to consider the quality and character of the desired relationship. Is the outsourcer part of the household or just household help? Despite ritual talk of "partnership," some companies treat outsourcers as suppliers of such familiar commodity services as catering, cleaning or copying. For such services, competitors and substitutes abound, price is the decisive criterion, and disengagement is straightforward. Some regard outsourcing as an essentially adversarial relationship in which the customer must obtain and enforce the most favorable terms possible. Others regard outsourcing as a kind of alliance, and treat the outsourcer's team (including transferred staff) as an extension of the company's own organization, serving the same customers.

No single answer applies in all cases. The right choice for any company will depend upon its needs and philosophy, as well as the kind of services (and some IT services have become commodities). The choices have consequences. A supplier of commodity services, whose margins were squeezed by competitive bidding, is more likely to work to the letter of the contract. Conversely, a supplier entrusted with responsibility for a wide range of services and projects, chosen without competitive bidding, may tolerate some "scope creep," but charge more.

Negotiate for Long Run Success

Wise negotiators seek long term success, rather than short term advantage. Too often, people "keep score" during negotiations, tallying compromises and concessions as in a contest. Negotiation is neither a zero-sum game nor an adversary proceeding. In fact, negotiation is an opportunity to begin building business relationships (including the crucial ability to resolve differences) and reach sensible understandings for future contingencies (without destructive gamesmanship). Effective long term contracts often include incentives as well as sanctions, penalizing poor performance but rewarding excellence. They contemplate active governance, including joint executive oversight. Organizations usually perform better when leaders pay attention without "micro-managing."

Make Haste Slowly

Legendary basketball coach John Wooden admonished his players to "be quick, but don't hurry." It was sage advice. Unsuccessful outsourcing relationships are often rushed. Before entrusting operations to a contractor, companies must understand existing operations, their strengths, weaknesses and costs. Historic cost data and budget categories may not provide a true picture of expenditure or future trends. The assessment required to write a request for proposals (RFP) may identify deficiencies that should be fixed before handing off to someone else. Outsourcing, by itself, solves very little.

Don't "turn it over to the experts"

Lawyers and consultants sometimes flatter themselves that they "run the deals." Sometimes this is true. When true, it is usually a mistake. No one but the customer really knows the customer's business. The customer must live with the results and make the relationship work after the advisers go home. The advisors' methods, processes and form books embody experience and expertise, but one size rarely fits all. Methods and forms are not recipes, but can (and usually should) be tailored. Some methods are predisposed to favor particular strategies, which may not suit every situation or company. One may rely on advisers, even to lead negotiations, but should never abdicate ultimate responsibility for the process and outcome.

Competitive Bidding Has Consequences

Many advisors recommend competitive selection, with its familiar rituals: RFPs, proposals, then negotiation with one or more finalists. However, many contracts are negotiated on a sole-source basis, or through limited, less formal competition among a few qualified suppliers. Bidding usually assures favorable terms and the lowest price, but it focuses competition upon price. Bidders must match specific requirements or risk disqualification. The process takes months and costs money, not only for professional fees, also the indirect costs of the customer's own team (who have day jobs), and related distractions. Delays defer savings and other benefits. Nonetheless, formal competition is often the best choice, especially when buying commodity services and stable technologies.

Sophisticated companies recognize the secondary consequences of competitive bidding. Emphasizing price motivates both sides to lean into the wind, occasionally at the expense of prudence. Suppliers are motivated to offer, and buyers to believe, hopeful estimates. Scoring term sheets is useful, but not all criteria are easily quantified, and even such “hard” numbers as prices are mere estimates built upon complex assumptions (some of which are bound to be wrong). For suppliers, bidding costs, sales commissions, the “all or nothing” nature of selection, and competitive adrenaline may lead to improvident concessions. Leverage may tempt customers to press, and even over-reach; but if the customer wins every point, the result may be a contract the supplier cannot successfully perform. When this happens, both sides lose as surely as if the customer signs a supplier’s lopsided “standard form” contract. If negotiations become contentious, adversarial thinking may infect the parties’ dealings after the contract is signed.

Define Scope Precisely

No documents matter more than those that define scope: what the outsourcer will (and will not) do for the base charge. After signing, most controversies concern scope. The more precise the documents, the less the risk of later uncertainty and acrimony. Neither side can estimate costs reliably without a good definition of scope. Contract documents cannot (and should not) spell out each and every task and function. Where gray areas exist, agreed principles can fill gaps – for example, by assigning the outsourcer responsibility for IT-related functions formerly performed by transferred staff, or requiring each side to perform functions inherent in its responsibilities. Exceptions or limitations should be plainly stated, leaving as little as possible for later guesswork or debate.

Manage the Outsourcer

Many companies neglect contract management, assuming that one or two people left behind will suffice. Managing a contractor differs in important ways from managing operations and calls for different skills. Large-scale outsourcing requires a contract management organization with sufficient depth and budget to provide strategic direction, coordinate with business units, oversee performance, manage and forecast costs, administer the contract and generally tend the relationship. “Best-of-breed” arrangements, overseeing many suppliers, call for still greater effort. Automated tools can help, but talent matters more. The abler the team, the better the outcome.

Don’t File Away the Contract

During negotiations, business people look forward to putting the contract in a drawer to get on with business. Doing so is often a mistake, for the contract records what has been agreed. It spells out what should be done to manage the relationship, deal with contingencies, and resolve differences. Literal-minded management to the letter of the contract is rarely healthy, of course, but neither is blissful disregard for contractual rights, obligations and processes. Think of the contract as a desk reference, tool kit, or constitution for the relationship, rather than just a weighty doorstop. Those who ignore the contract risk waiving its protections.

Use the Contract Effectively

Good contracts provide many tools and protections, including, among others:

- Regular oversight to help forestall trouble and assure executive-level access and attention.
- Rights to audit performance, service levels and charges.
- Written change management, so that all changes are documented, and authorized through a disciplined process.
- Withholding of disputed amounts, or of payment for unsatisfactory work, coupled with executive-level review to resolve disputed matters promptly.
- Detailed performance reports with assured access to underlying performance and other data.

These tools can help customers to manage performance effectively, and get their money's worth. Surprisingly, they are not always used, even when they should be.

Savings May Be Elusive

Customers expect to save money. Sometimes they are disappointed. Why?

- Comparisons with historic data may mislead, especially if historic data are incomplete or inaccurate, or the customer underestimates contract management costs.
- If costs continue to decline, yesterday's bargain may exceed tomorrow's market rate. In any event, as internal operations have grown more efficient, the outsourcers' scope for cost reduction has diminished. They too have costs for people, equipment, bandwidth and such, plus overhead and profit.
- Today's distributed, networked operations offer less scope for economies of scale than yesterday's mainframe data center.
- Consumption-based charges may provide little incentive for the outsourcer to consolidate operations and save money. Too few companies take full advantage of the financial and other disciplines outsourcing imposes to reduce costs by managing consumption.

Granular pricing – per device, incident, call and so on – charged back to business units can help to combat the historic tendency to regard IT as "free." Incentives to consolidate devices or reduce consumption may motivate greater efficiency. Periodic benchmarking can help assure that charges are and remain competitive, especially when coupled with rights to take work in-house, or send it elsewhere.

Service Levels – Necessary, but not Sufficient

Customers commonly require outsourcers to measure and report service level performance, and to pay credits ("penalties") when service levels are missed. Service levels do focus attention on services that matter most. They reassure management that the contract has teeth; but in practice, service levels matter less than is often supposed, for several reasons.

- They are rarely missed. Suppliers never sign up for service levels they cannot consistently meet or beat.
- When service levels are missed many customers do not enforce them.
- Service levels measure only a few specifics, not overall performance. Just as good vital signs are not good health, meeting the service levels cannot assure satisfaction or excellence.
- Unsuccessful relationships tend to go wrong for other reasons. Uneven or mediocre overall performance is usually a greater risk than prolonged outages of key systems.

Customers can improve the usefulness of service levels by attaching modest financial consequences to numerous service levels of secondary importance, and negotiating for the right to adjust service levels annually or semi-annually, within agreed parameters that allow the supplier to bound its overall exposure, and respect the technical limitations of infrastructure. Many customers seek escalator clauses, tying increases in service levels to anticipated or actual improvements in performance.

Understand the Outsourcer

Outsourcers should know their customers. The reverse is equally true. Computer services companies are very large, complex organizations, divided functionally into service lines, delivery organizations and such familiar support groups as sales, finance and HR. Winning new business costs a great deal of money, and sales cycles are long. Outsourcers hope to recover sales and transition costs through long-term relationships, and earn their margin through standardization, economies of scale, improved technology and other efficiencies. They also hope that satisfied customers will provide good references, and opportunities to sell additional (preferably higher margin) business. Computer services firms, like the rest of industry, are to some extent sales-driven. They (and Wall Street) watch new bookings and backlogs, as well as profitability. New opportunities and renewals command executive attention, and give customers leverage.

From the customer's standpoint, key team members are the sales executive, who crafts the proposal, and the account executive, who oversees performance. Good account executives know their company's resources and capabilities, advocate for the customer within their own company, deliver good service profitably, and hope to grow the relationship. Smart customers insist on good account executives, involve them in negotiations (partly to temper the sales team's exuberance), keep them in place for a reasonable term, and help them to succeed with users and their own management, for the benefit of the relationship as a whole. In this way, the customer is more likely to get the best that the outsourcer can deliver.

Communicate – Let Nothing Fester

Outsourcing means more or less continual negotiation about changes, projects, clarifications, charges, operational hiccups and much else. None of this should be surprising or cause for particular concern. Actually, it's healthy. Even occasional friction is normal. Real trouble ensues when issues are left to fester, and the parties do not communicate regularly, at all levels – users with technicians, account management with customer IT staff, and at regular intervals, both sides' senior management. Disputes, when they occur, should be addressed promptly, confidentially and candidly. Bad news, unlike good wine, does not improve with age. Applying changing technology to today's demanding economic climate is difficult. Both sides will err. Learn what went wrong, preferably without "keeping score," make reasonable accommodations, and move on.

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