Shaw Pittman

White Paper

"Evolving Outsourcing Through Value Chain Analysis"

Synopsis

Outsourcing is the delegation to a third party of significant business functions. Over the last 15 years, businesses around the world have made outsourcing of information technology functions a standard corporate strategy. Within the past few years, these businesses have also placed increasing emphasis on the outsourcing of indispensable business functions such as human resources, finance and administration, and procurement.

The standard outsourcing paradigm is as follows: "I (the outsourcer) will perform the same services you previously performed, at the same or a higher level of delivery, for the same or a lower price." Significant is the historical nature of this promise. To fulfill this commitment, suppliers need to understand what you were previously doing, at what level of performance and at what cost. While these may seem appropriate inquiries, experience has shown obtaining the necessary facts is time consuming, expensive and subject to potentially divisive negotiations.

An alternative approach that substantially revises the thinking about how outsourcing relationships should be conceived and structured, that is only now emerging, is to apply "Value Chain" analysis to the issue. A business can use this approach in the collection of needed data, the assessment and evaluation of potential sourcing strategies, the implementation of specific large-scale outsourcing transactions, and the ongoing monitoring, management and restructuring of existing outsourcing relationships.

Instead of focusing merely on historical activities, this approach starts by decomposing the relevant business practices along a value chain. It then maps these processes to a uniquely created "span" describing the factors of production used in the business processes across a company's geographies and business units. The resulting matrix serves as input to develop a scope or operating model for the proposed outsourcing relationship, interaction models to depict the potentially high-friction contacts between customer and supplier, a service level regime to ensure appropriate levels of performance, and a pricing model relating pricing metrics to service delivery obligations. The result is a customer-supplier relationship organized around how your business actually operates.

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Options

The concept of outsourcing provides customers a business proposition that is hard to ignore. Put simply, the outsourcing industry offers to take over a customer's operations (or portions of such operations) and to perform at the same or a higher level of delivery for the same or a lower price. This business case is highly compelling not only for senior executives, but also among the managers in charge of operations currently in vogue to be outsourced (i.e., support organizations such as information technology, human resources and accounting, as well as line operations such as insurance claims administration, mortgage processing and retail bank call centers).

But how can it be that a supplier, an outsider who may barely understand the inner workings of a customer's operation, can deliver more for less – especially when compared to the customer's own hardworking workforce that is unencumbered by profit margins? The answer lays within the limited number of options operational managers have to obtain the delicate balance between cost and effectiveness.

Keeping the right balance is not easy under the best of circumstances, but add in the high velocity of change currently experienced by most businesses (e.g., processes, skills, knowledge, technology, geography, business needs) and one can begin to appreciate the real need for continuous improvement at the operational level. So the managers in charge of these operations find themselves constantly searching for what changes are necessary to deliver or support their company's objectives. Said another way, the solutions to keep an operation performing as needed must be continually "sourced" from the viable options. The problem is, there are but a handful of such options:

- **Do Nothing**. Used when the value of change does not warrant its cost. This approach is often overused, leading to the perception that there is a fundamental breakdown within the organization that requires substantial change to fix.
- **Change It (alone)**. Basically, re-tooling the operation by developing new work processes and either training the existing personnel and/or hiring others with the requisite skill sets. For the right type of change, this option offers the least level of disruption on the operation; however, it places the burden squarely on the operation itself to identify the necessary changes and actually carry-through with the effort.
- **Change It (with outside assistance)**. Reengineering by another name, this option is typically used when large-scale change is required and knowledge

of how to perform the change, or what the target environment should look like, is not well established within the customer's organization. The upside is that the leading consultants in this space are knowledgeable of the level of effort required to effect the change and bring a set of best-practices for the target environment. The downside is that these engagements can last 9 to 12 months or longer, are costly, don't come with guaranteed results and are oftentimes highly disruptive to the workforce. While order-of-magnitude change can come from this type of reengineering, there is a risk that, for truly large-scale operations, the advisor may not have sufficient knowledge of the applicable best practices or may lack the ability to impose the needed change across the multitude of internal groups implicated by such change.

- **Outsource It**. In short, a reengineering with a guarantee. The customer determines what functions it would like a qualified supplier to perform and contracts for the provision of those services for a price. As the price or pricing mechanisms are pre-established, the customer can focus on the remainder of its operations and leave the change of the outsourced component to the chosen supplier.

Unfortunately, regardless of the type of change required (e.g., process, service level, geography, skill-set, technology, cost), the available options are, for the most part, limited to those described above. In the kindler and gentler world of yesterday, the pace of change and the pressures it placed on operations to adapt were generally manageable by the incumbent staff. But today, where it is expected that an operation rapidly acquire the capabilities necessary to begin delivering best-in-class, risk-mitigated change on-time and on-budget, an outsourcing agreement, stipulating more for less, is often the most rational decision to be made in the face of uncertainty of future outcomes (i.e., "a bird in the hand" versus "two in the bush"). From all perspectives, outsourcing appears to be here to stay and will more than likely continue to grow by providing a broader spectrum of services and integrating more closely with its customers' operations.

Issues

With commercial-grade outsourcing now in the middle of its second decade of existence, both early adopters and first-timers expect more out of their outsourcing relationships than a supplier that will maintain the status quo for the contractual term at a reduced cost (assuming your crystal ball was good enough to forecast your costs accurately). To appreciate why it has taken this long to come to this seemingly simple conclusion, it is important to understand that, while the theory behind outsourcing is for the customer to specify its desired outputs and to allow the supplier the latitude to produce such outputs as it deems best, it has been with rare exception the theory has been put into practice.

There are lots of explanations for this, but the most compelling is that leading edge adopters learn to survive by adequately mitigating the risks inherent in change. As one of the largest risks in the earliest outsourcings (generally data processing centers and other information technology based infrastructure responsibilities in the late 1980s and early 1990s) was the supplier's ability to perform adequately, it made sense for the work to be meted out in a highly controlled fashion.

Accordingly, rather than the outsourcing agreements simply describing the supplier's solution to achieve the customer's objectives, a detailed description of the relevant portion of the customer's operation was provided as the basis for the schedule of work. These schedules were highly negotiated. Suppliers did not want to take on more responsibility (read "risk") than their customers otherwise did with their own operations, and customers did not want to be charged additional amounts for services that were being performed by their operations, but somehow did not get written up in the schedule of services.

As each new customer of outsourcing was just as interested in mitigating outsourcing risks as its earliest adopters, the words and the mechanisms supporting the process of outsourcing became de rigueur and, by the mid-1990s, was beginning to look like a commodity. For information technology outsourcing ("ITO"), this produced a set of established services for performing the various components of information technology. These ITO components, or "towers" as they are often referred to, appeared to produce the ability to benchmark the services, which ushered in the inevitable commoditization of the services and focus on price as the primary distinguishing feature between the suppliers' offerings. Over time, this led the outsourcing industry to the conclusion that if the towers were commodities, then by selecting the best supplier for each tower (known as "best-of-breed" sourcing) a customer could develop the best possible delivery engine at the lowest cost.

Symptoms

So is tower-oriented, best-of-breed sourcing the end-state? "Yes" for some, but a resounding "no" for those on the leading-edge. These leaders want to advance the practice by: (1) creating value from their outsourcing arrangements rather than just reducing costs; and (2) shifting from relationships characterized by limited responsibility and accountability to more broadly defined and predictable relationships with their outsourcing suppliers.

Two seemingly apple pie and motherhood type objectives that no one would argue with, except for the fact that it would take a comprehensive re-tooling of the outsourcing industry (suppliers, consultants, lawyers, benchmarkers, etc.) to produce such a transaction. Think LPs to CDs, land-yachts to gas misers and back again, radio to television, etc. Without question, the manner in which an outsourcing transaction is produced is well established and does not easily lend itself to achieving the two above-stated objectives.

How can this be? There are many reasons, but some of the key reasons are as follows:

- **Schedule of Work**. As previously discussed, these schedules are developed based on what the customer does today. The underlying idea is that if the customer was doing it before, then the supplier should do it tomorrow. Seems simple, right? But ask yourself: why does the customer want to outsource in the first place? If it is to achieve the same for less, then using history to describe the future seems okay, but what if, as generally occurs in practice, the customer wants more or better than what they have today?

  By basing the schedule of work on what the customer does today, the customer will still have to articulate what it does today (which is not an insignificant task to perform accurately) and since nothing has otherwise changed, the customer and supplier will still feel compelled to negotiate the wording. Further, the customer will also have to describe, in written form, what else it wants (i.e., the "more" or "better" parts) which will lead to more negotiation.

  What is needed is a lingua franca that both customers and suppliers can use to describe the functions to be transferred back and forth. If the lingua franca were developed based on the best practices promulgated by the appropriate standards-based organizations (think "ISO-like"), then the customers could be assured what they do (not how they do it) would be adequately described and the suppliers, who almost universally tout their adoption of best practices, would be free to perform their processes without risk of contractual non-compliance with the schedule of work. Further, since the supplier needs to change the way in which the underlying services are performed so it can deliver on the offer of cost reduction, it seems superfluous to describe the customer's recipe. Imagine the inferior product that would result from ordering a meal at five-star restaurant by describing how you prepared the dish at home.

- **Customer Objectives**. One of the chief complaints heard from outsourcing customers is that their suppliers do not, without additional revenue incentive, voluntarily make meaningful changes to the environment during the term of the agreement. There are two primary reasons for suppliers taking this approach: (1) the practice of defining the schedule of work based on a snapshot of what the customer's operation was previously doing, unless the proposed work specifically includes a well-developed set of change activities; and (2) neither specifying the customer's objectives during the development of the transaction nor developing the basis for future change.

  The solution for the first issue is to base the statement of work on industry standard processes and not on what the customer has historically done. This lingua franca must, of course, include the appropriate mechanisms for sourcing the responsibility of the various aspects of change. As for the second issue, what is needed is a fundamental change in the sourcing process. Currently, most sourcings are designed to ensure the suppliers competing for a customer's business are all bidding on the same work. In fact, in some sourcings, the customers actually go so far as to develop the solutions to their woes and ask the suppliers to merely price its implementation. While this approach may work for certain smaller customers or problems with well-known solutions, it is not designed to leverage the suppliers' access to more subject-specific knowledge and their experiences with a broad spectrum of diverse customers. Imagine the less than spectacular results that would occur if homeowners hired Frank Lloyd Wright to design their homes, but then proceeded to instruct the architect on *how* he was to achieve their space, intended use and esthetic requirements.

  What is needed is a shift to outcome oriented outsourcing. Instead of telling the supplier what the customer does today, develop a lingua franca to quickly and accurately inform the suppliers what they will have responsibility for tomorrow (i.e., the scope of services) along with a structured set of objectives the customer expects the supplier, given the defined scope, to deliver. Instead of judging the suppliers' responses on just their price, which tends to become normalized across suppliers during the course of negotiations, the suppliers' full depth of abilities would be on display for review, selection and ultimately contractual obligation.

- **Towers of Service**. Based on the successful principles of business process re-engineering, the identification of value creation opportunities cannot be understood by looking at an operation at the macro level. Rather, an operation must be disaggregated to its base processes to understand what an organization is doing and how it interacts internally and with others.

Developed initially for supplier pricing purposes, towers, as the term applies across the spectrum of ITO and Business Process Outsourcing ("BPO"), are generally groupings of either various technologies or other things on which processes are performed. While this has worked well for developing pricing constructs, it has institutionalized within the outsourcing community the belief that the towers are somehow walled-off from one another and therefore safe to source without repercussion.

Unfortunately, this thinking has been a primary contributor to service delivery failure and ultimately customer dissatisfaction. The tower-based mindset results in the foundation activity (i.e., the development of the sourcing strategy) focusing rather simplistically on which tower(s) should be outsourced, rather than taking a hard look at the full spectrum of base processes and analyzing the operation in question to determine the right sourcing disposition to achieve the customer's objectives. Similarly, by cleaving an operation into pieces by outsourcing towers, the processes that span the various towers (of which there are many) are broken and require the customer, as general contractor, to provide the glue to integrate the now separated processes into a single coherent function.

However, even more damaging is the value that is destroyed by this fixation on towers (or, "silos" as others would describe it). Businesses have worked hard to tear down their silos and reap their just rewards. Automobile manufacturers have learned how to pull the development of new cars across their organizational structures to cut by over half the seven or more years it otherwise took to traverse the silos of marketing, design, engineering, manufacturing, sales, etc. Financial institutions have learned brand loyalty is hard to achieve when they force their customers into procuring and managing their services separately such as for retail banking, mortgage banking, investment banking, etc. What these and other operations have found is that while they may be organized vertically like their organization charts show, the work processes move horizontally across the operation. The key to value creation is through a process-oriented approach, not a tower-based segmentation.

What is needed is a mechanism such as a value chain from which all of the key sourcing decisions across the various stages (i.e., strategy, transaction and operation) can be made. By using a common denominator across the lifecycle of sourcing stages (a) the re-work inherent in developing different tools and documents depending on what stage or phase of a stage is being addressed can be eliminated; (b) there is a significantly reduced potential for a gap or overlap in the sourcing of the operation to occur; and (c) most importantly, value can be created by ensuring key service delivery processes are, wherever possible, left intact or earmarked for detailed discussions as to how the mixture of delivery actors will jointly produce the desired outcomes.

- **Best-of-Breed Sourcing**. For varying reasons, customers, their advisors and even some suppliers like the concept of best-of-breed sourcing. Customers like it because the notion of assembling the best suppliers is thought to produce the best results. Advisors like it because it produces more transactions on which their services can be utilized. And certain suppliers like it because it gives them more opportunities to get their foot in the customer's door.

Unfortunately, from the customer's perspective, the benefits of the concept are rarely achieved. As everyone eventually learns, a simple assemblage of the best parts does not necessarily make the best result. Imagine the headaches of assembling a car from the perceived best parts from among all of the manufacturers, or building a home from blueprint elements of other houses. What the sum total lacks in each case is the interoperability of the parts and, by default, the customer inherits the problem of making the creation work – generally the complete opposite of what it had in mind when assembling the collection in the first place.

Customers also find they do not have the stamina to produce the desired number of outsourcing transactions. Outsourcing transactions are notoriously exhausting for an operation and most customers give up on their search for supplier perfection long before reaching their goal.

What is needed is a mechanism to help the customer and its suppliers understand the complexity a planned outsourcing transaction will have on the totality of the operation. By looking at the whole operation rather than just the portion to be outsourced, it should be possible to identify the linkages or interactions required to properly manage the whole.

- **Governance**. As outsourcing has grown in popularity, so too have the issues customers and suppliers have in trying to develop symbiotic relationships. To date, the cure for such ails has been to increase the level of governance – more executives, more committees, more meetings, more reports, faster escalation procedures, streamlined dispute resolution processes, etc. Unfortunately, the types of problems producing the most friction between customer and supplier are not appropriately solved using the corporate governance technique of developing guiding principles.

  Consider the example of a supplier with responsibility to develop, for an ITO customer, an annual infrastructure architecture plan. While the customer might be highly interested in the format and level of detail to be contained in the supplier's architectural document and the supplier might be highly interested in what information the customer is going to make available from which a revised architecture can be developed, current approaches for addressing this issue often do not deal with this level of detail. Rather, the supplier may simply be directed to produce a draft procedure for the interaction as much as 12 months after the outsourcing agreement becomes effective. Without meaningful customer guidance about what to include in the procedure, the resulting draft is often rejected by the client as totally useless.

  What is needed is a mechanism to allow both customer and supplier to understand the interactions of high importance, as such interactions can either create or destroy value. Accordingly, the sourcing process should be modified to identify and document, with substantially more specificity than historically done, the intended interactions and how the parties will address each such interaction. A supplier's willingness to develop such interactions and the supplier's standard process for identifying, documenting and implementing the interactions should, from the customer's perspective, be a key supplier selection criteria.

Solution

Shaw Pittman has recently developed a second generation methodology for approaching large-scale, complex outsourcing transactions. In 2002 , we "beta" tested the methodology on a major transaction in Canada and are currently applying it to several transactions, including work we are performing for one of the largest multi-national credit repositories, a global investment bank and a top-tier North American telecommunications provider.

To briefly summarize this new methodology, we initiated its development by forming a team, comprised of senior consultants with substantial backgrounds in change management, process engineering and strategy and senior lawyers with significant transactional experience, to address the deep-seated issues that have plagued the outsourcing industry from its earliest days. The resultant methodology, through consistent application of a value chain construct, provides a rigorous yet flexible structure that can be applied to the management of the entire sourcing lifecycle: Strategy; Transaction; and Operation. It can be applied equally to outsourcings and their renewals/renegotiations, as well as consolidations, acquisitions and divestitures.

The key attributes of our patent pending value chain methodology are as follows:

- The core of the methodology is the construction of an operating model for the entirety of the operation, that is the "retained" as well as the "sourced" components, so all service delivery actors (both internal and external) can be identified and allocated to specific functions. In contrast, the traditional scoping model focuses solely on the components to be sourced and does not provide good organizational context within which broad-based sourcing strategies or transactional decisions can be assessed.

- The operating model is expressed in terms of the full spectrum of processes specific to the organization's operations (i.e., a value chain). Our IT value chain contains over 70 processes (e.g., change management, security architecture, standards development, communications operations). For each process, the model identifies the elements on which such processes are enacted (e.g., PCs, telephones, routers, circuits, servers, applications, third-party contracts).

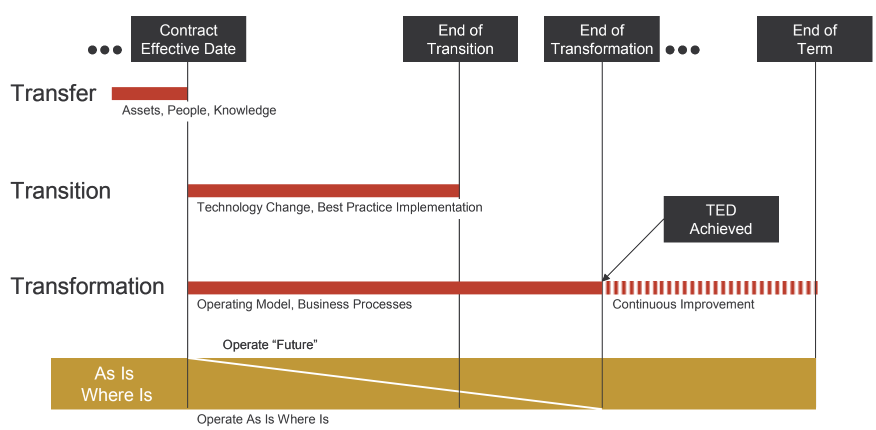
- The processes are defined, wherever possible, using terminology provided by standards-based organizations (e.g., ITIL, PMI, SEI, ITGI). Feedback from outsourcing suppliers, as well as actual experience, indicates this approach can dramatically shorten the time taken to negotiate the scope of services.

- Applying the operating model to a specific outsourcing transaction, its scope is defined in terms of the processes and elements, rather than by traditional service towers. This approach provides a complete mapping of how the sourced functions will fit into the customer's organization so the areas of interaction between supplier(s) and customer can be readily discerned. Once discerned, the level of complexity and risk can be evaluated and, if necessary, either the scope can be adjusted or interaction models can be designed prior to the contract being finalized. This helps ensure the supplier(s) is accountable for end-to-end responsibility for outsourced processes and thus reduces post-signing implementation risk.

- The approach is designed to facilitate the capture of data such as personnel, equipment, applications, third party contracts, etc. using the same organizational structure in which the scope is defined. This is an improvement over the traditional model because it aligns the data with the customer's view of its existing organization, making its collection easier, and providing the precise data needed by the supplier to design informed service and price proposals.

- By organizing the scope of a transaction along process lines, the methodology makes it easier to identify where service level requirements are needed and/or determine if adequate service level coverage has been developed. Moreover, it provides a mechanism to link pricing of the services to the scope of the services, thereby resolving some of the more heated customer/supplier discussions.

- By employing a construct we refer to as the "Three T's" (T^3): Transfer, Transition and Transformation, the methodology provides customers with a tool to specifically express their desired outsourcing objectives at an appropriate level of detail to help ensure supplier proposals are responsive to their needs without unduly restricting the suppliers' creativity in producing optimized solutions (process, people, organization, technology, geography, measurement, etc.). As indicated in the chart below, T^3 provides, depending on the stage of sourcing in question, the rationale for the outsourcing and its objectives.



- Lastly, the methodology addresses the substantial shortcomings associated with reliance on governance alone as the cure for a poor relationship. Simply put, governance models are insufficient to resolve the operational issues that tend to give rise to a bad relationship. Accordingly, our methodology identifies the areas of high friction as a result of sourcing decisions and utilizes detailed interaction models to precisely design and enhance the desired manner of exchange.

For customers interested in using outsourcing as a strategic tool to generate value and shift away from relationships characterized by limited responsibility and accountability, Shaw Pittman – leaders in sourcing advisory innovation – provides the premier solution.

For more information on Shaw Pittman and the professionals that comprise its Global Sourcing Practice, contact us at:

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