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The Swingtide CIO Monograph Series

Outsourcing Health Checks and IT Sourcing Wellness



SWINGTIDE

Introduction: Common Symptoms of the Ailing Deal

“Happy families are all alike; every unhappy family is unhappy in its own way.”

Tolstoy’s observation about family life at the beginning of *Anna Karenina* can also be applied to information technology outsourcing deals. Every unhappy outsourcing deal *is* unhappy in its own way. However, the paths these deals take to arrive at their own special form of unhappiness are well worn.

The list below is a collection of common complaints or issues that haunt outsourcing deals. On any given engagement it’s not unusual for a number of these complaints to accumulate. Recognizing them, and addressing them early, will keep or make any deal successful.

- Expected/forecasted cost savings not realized
- Service provider can’t make money on the deal
- Service provider not performing based on service levels
- Service provider not performing based on customer experience, or expectations not reflected in service levels
- Client objectives change
- Client priorities change
- Exit barriers (*e.g.*, punitive termination-for-convenience fees) eliminate options for the client and allow the service provider to underperform
- Contract terms allow imbalances in financial benefits to parties
- Hidden or opaque costs lead to distrust
- Client starting to think about end-of-term options, with renewal not the obvious choice.

Readers will recognize many or all of these issues from their own experience. Active governance should address most of them. So why does it so often fail to do so — and what’s the best way to organize an approach to resolving all the problems that are occurring in

parallel?

Outsourcing is a long and winding road. Where it leads depends on how one heeds these warning signs.

The Ailing Deal and the Need for a Health Check

The process of entering into an outsourcing deal, even if done under the time pressures of an executive mandate, is often accomplished with reasonable rigor and careful analysis. The working team convened within the client organization usually involves representatives from the appropriate disciplines (law, sourcing, finance, IT, business unit IT, *etc.*). The client almost always engages outside counsel with a high level of expertise in constructing appropriately detailed agreements. Additionally, these days a client will also often engage an advisor firm to help with the financial, sourcing, transition project and governance aspects of deal creation. These deals don't occur every day. Experience is needed because of the complexity and financial size to avoid costly pitfalls and years of dissatisfaction.

Once the deal goes live, however, the working teams are disbanded. The outside counsel and the advisor go on to the next thing. The client, despite the attention paid to setting up an adequate governance organization, often finds the deal varying from expectations in a way that quickly begins to wear away at the good will and optimism that were present when they entered the deal. Many clients lose the analytical spirit that prevailed when the deal was put in place and find that it has been replaced by an atmosphere of blame, contentiousness and defeat. This emotional dimension, coupled with the loss of a dedicated working team, often results in client governance organizations being overwhelmed or preoccupied with the tactical problems of the moment — thus preventing a higher-level perspective.

It is precisely because the friction of day-to-day performance issues can wear away the analytical rigor of the deal process that the best way to turn things around is to recreate the

atmosphere that existed when the deal was begun. Clients can do this by reviewing and documenting the state of the relationship and the way it varies from expectations with a prescriptive, analytical approach similar to that used initially. Both parties can then regain a secure position and move forward in a spirit of enlightened self-interest and sensible improvement. A fact-based approach, driven by data, can get everyone past the emotions and rebalance the relationship. It makes current dissatisfaction a constructive force — a means to improve the deal, processes, scope, service, and pricing, and to help clarify options for change.

Artifacts

One benefit a health check process has (compared to the initial deal creation process) is that, instead of being based on service provider representations, industry information about “best practices,” and the assumptions contained in the client’s cost models, it is based largely on the artifacts of the client’s actual experience with the service provider. These artifacts consist of:

- A commercial contract, as amended
- Documented historical performance (*e.g.*, SLAs)
- Actual governance-related experience with the service provider
- The final business case updated with actual performance.

These artifacts become the bases for the health check, which follows a step-by-step process described in the following sections.

Health Check: Phase Zero – Getting Started

The process described in this monograph involves the creation of five specific deliverables that are detailed in process steps below. The following work needs to be done in preparation for creating those deliverables.

- Form a team of people from the client and service provider who are both involved in the deal and outside the deal to get facts and a fresh, objective perspective
- Review the artifacts
- Interview people for context
 - ◊ Deal “framers” (if available)
 - ◊ Relationship Managers
 - ◊ Executives
 - ◊ “Run the Business” staff whose roles involve day-to-day interaction with service provider.

Health Check: Phase One – Review of Objectives

Every measure of success occurs within the context of client objectives. The original objectives, valid or invalid, are subject to change over time. If the average longevity of a CIO is less than three years, and a client’s deal is two to three years old, it’s almost a certainty that a new CIO has entered the organization after the deal was made and that he or she has an opinion about making revisions in the deal — more commonly around cost than around improved governance.

See the two charts below. The first lists common objectives that clients seek when they elect to pursue outsourcing. The second shows the objectives that are most strongly correlated with outsourcing.

Common Client Objectives for Outsourcing	
<ul style="list-style-type: none">• Cost transparency• Reduced costs• Demand management• Market pricing• Enhanced processes• Access to expertise when needed• An effective change agent	<ul style="list-style-type: none">• Predictable upgrades without individual project justification• Tools, measurements, reports• New functionality faster – innovation and currency• Eliminate headache of running IT

Common Objectives That Carry a Strong Outsourcing Correlation
<ul style="list-style-type: none">• Ability to focus on core business• Defined and committed service levels• Scale and scalability• Increased discipline from third party not mixed up in politics

In Phase One, the client should identify the originally anticipated benefits of the outsourcing and how they have changed since deal inception.

Regarding this phase, clients should be asking themselves the following questions:

- What was the original purpose of the deal?
- Were the objectives established and documented?
- Were these objectives *valid*?
- Have the objectives changed? If so, are the new objectives valid?
- Have the sponsor or other key leaders changed?
- Have new leaders ratified the original objectives or have they proposed their own revised set?

ACTION ITEM: Document original and current objectives.

Note that in the final step of the health check process we will be reviewing long- and short-term options. If among the client's revised objectives there are many that do not strongly correlate with the benefits to be expected from outsourcing, then the client should examine options involving insourcing or repatriation.

Health Check: Phase Two – Review Service Provider Performance

Reviewing service provider performance is the most common of the necessary steps that clients take in looking at the success of their outsourcing relationships. Often, however, the effort focuses on service levels and does not go far enough into other relevant aspects of the relationship. At the highest level the client needs to look at:

- SLAs
- Completeness of SOW delivery
- History of contract changes and effects on RUs and price
- Success in timely and constructive resolution of disputes.

Key Categories of Outsourcing Supplier Performance	
<ul style="list-style-type: none"> • SLA history <ul style="list-style-type: none"> * Supplier meeting SLAs * Flexible in changing allocations * Calculation errors * Supplier actively refocusing resources for better performance • Performance against SOW obligations • Meeting transformation/transition milestones <ul style="list-style-type: none"> * Are projects dragging, causing delays in receipt of savings? * Asset issues – new infrastructure procurement, decommissioning * Facilities issues – timely build-out • Continuity/turnover of key staff (and transition project managers) <ul style="list-style-type: none"> * Important cause of transition delays 	<ul style="list-style-type: none"> • Pricing Administration <ul style="list-style-type: none"> * Billing errors * Disputes * Behavior under “extraordinary events” circumstances (outside of negotiated ARCs/RRCs ranges) • Governance <ul style="list-style-type: none"> * Meeting reporting requirements * Crisp Issues resolution • Cross-functional efficiency <ul style="list-style-type: none"> * All-tower help desk responsiveness * Management of third-party suppliers * Monitoring of environment • Improvements/stewardship

To paint a clear picture of how the outsourcing vendor is performing, ask these questions:

- How is the outsourcing vendor performing?
- Is there a history of contract changes?
- Has performance been timely?
- Is transformation complete? Has “steady state” been achieved?
- Are the expected metrics and dashboards being provided?
- Are internal customers satisfied?
- Have some functions been brought back in-house because of performance issues?

The chart on the previous page offers a more comprehensive (but still only representative) sample checklist for service provider performance issues to review and document.

ACTION ITEM: Document service provider performance findings and the financial and technical state of the transformation/transition plan.

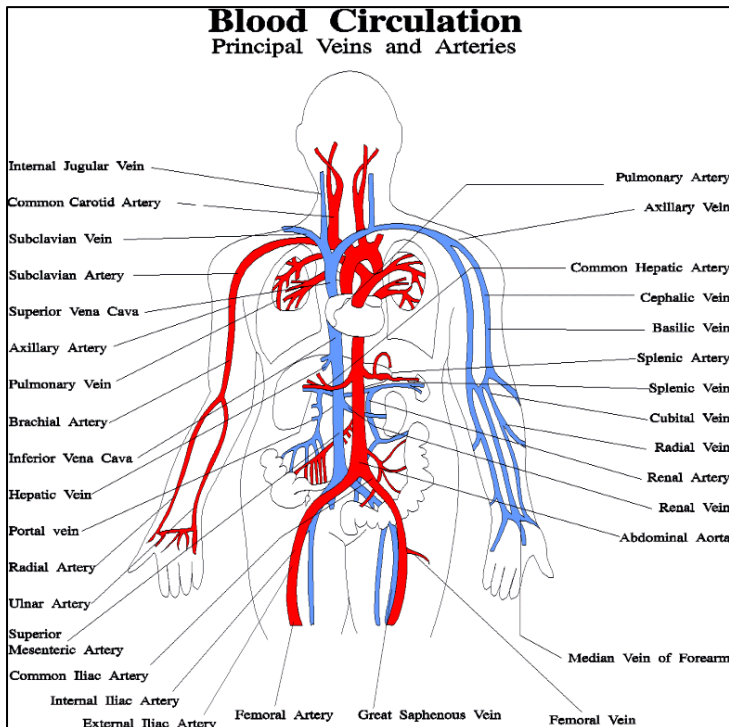
Note: In the final step of the process, when options are being investigated, one of the key branchings of the decision tree is based on the client’s appraisal of the service provider’s history of performance, ability to perform, demonstrated competence, *etc.*

Health Check: Phase Three - Contract Review and Contract Knowledge

After the revised client objectives, the artifact that provides the best starting place for review of the client relationship is the written contract. Outsourcing agreements are enormously complex. The discipline that should drive the review is whether the contract sufficiently reflects and supports revised client objectives and whether it is well-understood by those who need to be familiar with its terms.

Parties' compliance with key exhibits should be the basis for the review (at least SOW, SLAs, and charges). A detailed review of the historical issues lists will show other areas that most need modification to improve compliance and understanding.

We often find that one of biggest problems with outsourcing contracts is simply how poorly they are understood by the client stakeholders. Very rarely is there any formal effort to



The “Heart” of the Matter

As complex as the human circulatory system, outsourcing agreements are long and involved.

Following the effects of a change in one provision can take one on a journey into the far capillaries.

Parties' compliance with key exhibits (including statements of work, service level agreements, and charges) should be the basis for the contract review.

Detailed review of the historical issues lists will show other areas that most need modification to improve compliance and understanding — and to keep things flowing smoothly.

train staff on the terms of the agreement and to maintain the currency of that knowledge. If the right people don't understand what's in the agreement, then:

- Behavior that conflicts with the negotiated scope can thrive and reverse planned savings or improvements
- Disharmony will arise from teams who interpret behavior out of the context of the negotiated agreement
- Avoidable misunderstandings clog the escalation channels that should be reserved for handling substantive problems.

Regarding this step in the process, the questions the client should be asking are:

- Is the contract explicit enough? Reviewing the history of disputes may show where the contract is ambiguous or not prescriptive enough.
- Are the obligations documented well enough for support in the event of disputes?
- Is the contract "as written" understood and implemented?

ACTION ITEM: Document the places where the contract does not support revised objectives (map through all exhibits) and establish a curriculum to train the affected staff on the agreement.

Note: In the final step of the process, when options are being investigated, one of the most common required short-term activities is for the client to develop and deliver a curriculum to improve contract knowledge among the key client stakeholders.

Health Check: Phase Four - Governance

Industry information always stresses the amount of ‘value leakage’ that arises from inadequate governance of outsourcing agreements, yet few organizations know how to implement and sustain effective governance processes. Fewer still understand how critical the client’s role is in the process. The old relationship model that prevailed for simple IT contracts was that the client’s only obligation was to pay. A client’s obligations under an outsourcing agreement can be significant. Understanding governance includes not only attempting to measure how well the client is managing the performance of the service provider, but also how well the client is performing its (usually extensive) obligations under the agreement.

With respect to this step in the process, the questions the client should be asking are:

- Is the original design of the governance organization effective?
- Have there been changes that complicate the governance context (e.g., the introduction of new third parties)?
- How active and effective are escalation processes and the engagement of the sponsor?
- Have the prescribed governance practices been followed (e.g., meetings)?

**The Contractual Obligations Matrix:
A tool to concretely identify who needs to do what and when**

Contract Exhibit ID	Section ID	Description of Client Obligation	Owner in Client Organization
Contract	4.5	The Supplier Transformation Manager shall meet at least once a week with Client’s transformation manager to report on Supplier’s progress in performing the Transformation Projects and meeting the requirements of the Transformation Plan.	Client IT C Head
Contract	10.5	At least annually and as more fully described in Exhibit B (Service Level Methodology), Client and Supplier shall review the Service Levels and shall make adjustments to them as appropriate to reflect improved performance capabilities associated with advances in the technology and methods used to perform the Services.	Client Relations Manager
Exhibit A, SOV	4.2	Review and approve the implementation of any Supplier-proposed solutions to meet new or changed Client requirements.	Client IT C Head
Exhibit A, SOV	5.1	Define policy regarding Hosting Services shutdowns and restarts.	Client IT C Head
Exhibit D1, Transformation Plan	4.5	Client and Supplier Transformation teams will jointly review the status report and take actions necessary to jointly execute the Transformation Plan.	Client IT C Head
Exhibit E, Governance	2.3	Client and Supplier shall appoint a functional management committee, which shall meet at least once every month, to provide guidance and review of functional groupings of Services being performed under the Agreement.	Client IT C Head

**The Governance Scorecard:
A tool to measure supplier management**

Metric Description	INFRASTRUCTURE SERVICE PROVIDER			
Governance Meetings Held Versus Meetings Prescribed	Meetings Held in period		Meetings Prescribed	
	5		9	
SLAs Metric I: Calculations Validated and Understood: (Initial Appraisal)	Cumulative Validated SLAs		Total SLAs (including those currently without point allocations)	
	40		50	
SLAs Metric II: Ongoing Errors	SLA calculations w/errors detected		Total SLAs	
	10		50	
Billing Verification	Calculation errors detected in prior period		Calculation errors detected in current period	
	7		5	
Issues Log	Time Issues remain open after originally scheduled date for resolution			
	On-time	30Days	60 Days	90 Days+
	5	3	2	1
	Number that have completed training		Total Number that should be trained	
Completion of Contract Training	15		45	

ACTION ITEMS:

- Create a contractual obligations matrix to identify both parties' obligations in supporting the relationship, and to measure compliance
- Create a governance scorecard that helps measure how well the client is managing the service provider and fulfilling its obligations under the agreement. (See example of the metrics that reflect how well the client is managing the service provider on the previous page.)

Note: In the final step of the process, when options are being investigated, one of the most common required short-term activities is for enforcement or redesign of governance processes.

Health Check: Phase Five—The Business Case

In order to ensure the contract’s financial targets are reached, a process needs to be established to periodically measure actual performance against the original assumptions and objectives.

The process should show where the assumptions were incorrect so that appropriate changes can be made to realign them.

The expected savings of the outsourcing contract should be calculated against what the IT environment would have looked like if the status quo had been allowed to continue (see Rationalized Baseline chart below).

The expected or committed savings are based on the difference between the normalized baseline and the savings model, which reflects the chosen direction and executed

The Rationalized Baseline Calculation: A key constituent of a “rational” benefits realization process.

- ❑ This is the standard calculation of normalized and rationalized baselines.
- ❑ This represents adjusted IT run rate based upon your *original* Status Quo State

BASELINE	<u>Total IS and related actual expense and capital</u>
MINUS NONRECURRING COSTS	<u>One-time, non-recurring costs (write-offs, license settlements, discontinued operations)</u>
PLUS RECURRING COSTS	<u>Recurring costs or savings implemented but not completely reflected in base year (e.g., full-year impact of in-year initiatives)</u>
NORMALIZED BASELINE	
MINUS SAVINGS OPPORTUNITIES	<u>Savings opportunities identified in the current state but not executed (excess license elimination, server consolidation, etc.)</u>
PLUS UNINCURRED EXPENSES	<u>Additional expenses identified but not yet incurred in current state (e.g., COLA adjustments in current contracts)</u>
PLUS ADD’L FUNCTIONALITY	<u>Additional functionality purchased (e.g., disaster recovery)</u>
RATIONALIZED BASELINE	

Note that the Rationalized Baseline has a speculative component to it : It addresses the additional question: “What would we probably do on our own, if we decided we were not going to pursue outsourcing?” Its purpose in the initial evaluation is to put more pressure on the case for outsourcing.

outsourcing contract.

Comprehensive models reflect total client expenses impacted by the decisions, *e.g.*,

- Financial effects of change in software and asset ownership
- Additional staff to manage outsourcer
- Vendor charges
- Additional travel to monitor service provider.

In order to determine that the committed savings are realized (the difference between the normalized baseline and the savings model), the client should track and compare actual spend against the savings model:

- If the actual spend matches the savings model, the benefits have been realized.
- Variances arise mainly from changes in the following four things:
 - ◊ Scope: *e.g.*, Adding a service or a new BU or geographical region to the contract;
 - ◊ Volume: *e.g.*, Email storage growth is larger than modeled, leading to higher costs;
 - ◊ Rates: *e.g.*, The assumed tax rate in the business case is lower than what is actually being collected;
 - ◊ Timing: *e.g.*, Some transitional projects are delayed into the next fiscal year.

ACTION ITEMS: Complete a comprehensive benefits realization process that identifies variances to drive activities to manage costs.

Note: In the final step of the process, when options are being investigated, one of the key steps is to identify the actions that need to be pursued to realize benefits based on the existence of variances identified in the benefits realization exercise.

Health Check:

Pulling It All Together and Options Analysis

After completion of the above processes, the client will have the following deliverables:

1. Refreshed/revalidated objectives
2. A picture of service provider performance relative to client objectives
3. A list of contract issues to address and a curriculum for contract education
4. A governance scorecard to show how well the client is managing the service provider and performing client obligations
5. A completed financial model to monitor how well the deal is doing relative to client objectives and forecasts.

The above process outputs are goods in themselves since they clarify, for all relevant dimensions, the state of the success of the deal. Based on one's review of these outputs, courses of action become more self-evident. If minor or major changes are needed, the outsourcing health check process described above creates revised baselines and a road map for the desired relationship with the current or new service provider to help put structure and definition around ongoing decisions and actions.

A final step, however, is needed to formally synthesize the above content in order to identify immediate, near-term and longer-term options and actions via decision trees and checkpoints appropriate to one's organization.

Common short-term improvements identified by a health check:

- Modify the contract to reflect new objectives
- Update SLA definitions, calculations or reports to reflect what is important
- Perform joint training of parties on contract administration
- Create a client governance scorecard
- Update business case to show actual performance
- Increase communication of processes
- Create new cross-functional roles/processes
- Update escalation processes
- Initiate client/provider team-building activities.

Common longer-term improvements identified by a health check:

- Benchmark services/renegotiate prices and SLAs
- Bring select functions in-house
- Terminate in whole or in part
- Develop wind-down and transition plans
- Re-structure to pursue multi-sourced strategy around best-of-breed service providers
- Collaborate with incumbent on revised technology and process roadmaps
- Renegotiate with contract extensions in exchange for additional rate reduction commitments and process improvements.

Conclusion

The process outputs of the outsourcing health check, in addition to providing clients a static analysis of their relationship, also provide them with a dynamic basis for a more functional working relationship, because:

- They are always recalibrated to the client's rationalized objectives
- They recognize the client's ongoing role in the success of the relationship.

Swingtide states that it is a recommended practice to build the health check process into outsourcing contracts during the negotiation process. This sets the expectation that the client and the provider will be revisiting the performance of the deal at defined intervals, it provides the structure for the evaluation of the deal, and it provides the form of the options review that will be conducted in synthesizing the process outcomes.

It will have already occurred to the reader that much of the analysis and review steps described in relation to checking the health of an outsourcing relationship are also required to run a healthy IT organization, whether it uses internal or external service delivery.

To run an IT department as a business, clients should be applying the same systematic oversight to internal functions and projects as are recommended here to be applied to agreements with third parties. Moreover, there must also be the same overarching, consistent and actively maintained vision of the business benefits expected to accrue from any activity and how those benefits fit into a broader organizational context.

Swingtide believes that all IT departments should aspire to a balanced, open, business-focused, non-adversarial approach to service and service level definition, vendor selection, and contracting. Doing so will enable faster, cheaper, more successful, lower-risk transactions and more strategic and functional service provider relationships. Learning to construct and govern such relationships is the mark of an IT department that understands the vital role it plays within its organization.

If you are interested in discussing the concepts in this white paper or obtaining assistance in performing a health check for your deal, contact:

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About the Swingtide Outsourcing Health Check Process

The Swingtide Outsourcing Health Check Process is a time-limited but comprehensive analysis of existing outsourcing relationships against stated goals, industry standards, and initial expectations. It can be performed at any stage of an existing outsourcing relationship and offers a common-sense path to remediation of problem issues.

About Swingtide

Swingtide, Inc. is a technology and management consulting firm dedicated to client results and service excellence. Each Swingtide practice area is staffed with senior business and IT professionals with the experience required to solve complex business problems in rapidly changing environments.

Founded in 2001 with backing from Pequot Ventures and private investors, Swingtide helps its consulting clients reduce costs, efficiently outsource and effectively complete mergers, acquisitions and divestitures, successfully adopt new technologies in the area of web services, and realize the benefits of other new technologies in information-intensive industries including insurance and financial services.