



knowledge powering results

November 2006

## In Outsourcing, It Often Doesn't Win to be the Lowest Price

By Dave Tienstra  
Project Director, TPI

### CONTENTS

3. Confidence in the Cost of the Current State: Defining the Financial Base Case
4. Ability to Deliver: Focusing on Quality
5. Apples-to-Oranges: Normalizing the Solution within the Fruit Family
6. Financial Risk Mitigation: Strategizing the Long-Term Win
7. Conclusion



All organizations acknowledge the need to be more competitive in their markets. That's a fact of life in capitalistic economies — increase operational effectiveness while at the same time lower costs. There are varying techniques available to corporate executives for this relentless challenge, and strategic outsourcing is often considered.

Evaluating outsourcing alternatives can be difficult, especially when looking at the results of the sourcing evaluation against corporate priorities. For example,

how do you defend any decision other than selecting the lowest cost sourcing alternative when the organization must lower costs?

Experience shows that corporate executives frequently select a service provider that has not offered the lowest price. They conclude that the lowest cost alternative is not always the best one; here are some considerations before selecting the lowest cost alternative.



## CONFIDENCE IN THE COST OF THE CURRENT STATE: DEFINING THE FINANCIAL BASE CASE

First, clearly understand whether the lowest cost alternative would actually provide a real savings opportunity to the organization. Substantiating this requires a clear understanding of the current-state costs, which provide the foundation for comparing the alternative solutions offered by candidate service providers. The current costs include all costs required to deliver the scope of service. Ensure that all costs are considered — labor, capital, technology costs, occupancy, overheads, and so forth. Adjustments may be needed to reflect the level of past investments in labor and capital. These might include raising the funding within the Base Case if recent experience

has shown a lack of investment within the scope of operations. Likewise, consider smoothing one-off investments that are exceptionally large at any given point in time. The model should also accommodate the reasonable productivity improvements that are likely from the incumbent organization, for nothing is static. The result should be an indicative run-rate financial model that reflects the total cost of delivering the scope of services internally. When comparing sourcing alternatives, a well-established Base Case can build confidence in the savings projections forecast within the business case. Everything is relative, after all.



## ABILITY TO DELIVER: FOCUSING ON QUALITY

On the surface, the lowest cost alternative is a financial analysis, strictly focused on cost. This approach, however, does not take into consideration the service provider's ability to deliver the scope of service. A promise that cannot be fulfilled is an empty promise. Today, organizations are spending more time reviewing the service providers' solutions, providing each service provider with feedback, and coaching providers on the client environment and the challenges currently faced. Understanding, in as much detail as possible, exactly how the scope of services will be delivered is important. It helps to reveal the level of conviction that the competing service providers hold over their delivery models and solutions — important factors when evaluating the

wherewithal to deliver on promised pricing. Where will support organizations be located? How many in-scope employees will transition? What investments are planned? What level of service is required? How are problems tracked and resolved, and so forth?

It is critical to provide the service providers as much information about the current state as possible; however, organizations that have outsourced successfully are approaching sourcing alternatives by clearly defining “what” is required rather than “how” it is delivered. Allowing the service provider this freedom drives innovation and creativity — critical elements to achieving a lower cost, highly effective solution.



## APPLES-TO-ORANGES: NORMALIZING THE SOLUTION WITHIN THE FRUIT FAMILY

A lower cost solution can certainly be provided, particularly if it offers an alternative that is less than the required scope of service. Rarely does a service provider's initial solution map exactly to the requirements of the scope of services. If an alternative does not map to the scope exactly, look for ways to augment the service provider's solution to ensure full coverage of the original scope. Financial adjustments may be needed to reflect updates to the support model and to ensure the service coverage anticipated within the Base Case.

It is important to avoid forcing all competing service providers towards the same delivery solution. This will stymie the creativity of the technical and financial proposition. It is equally important to maintain a consistent basis of reference — we can't reasonably compare widely varying alternatives.

In comparing scope, it is critical to review, within each alternative, both the level of quality and the level of service to be provided. How does the quality of the alternative scope compare to that being delivered today? Does the level of service satisfy the requirements of the business? Has an alternative been over-engineered, driving excessive cost for a level of service that cannot be justified from a business perspective? Or, is the anticipated level of service for an alternative scenario less than what is being received today? A lower cost solution may be provided, but ineffective, if the level of service does not meet the requirements of the current business model.



## FINANCIAL RISK MITIGATION: STRATEGIZING THE LONG-TERM WIN

The lowest cost alternative may look promising, but it may not be a sustainable solution over the long run. The business, technical and financial landscape varies year over year. It is not enough to have a win-win on day one. The real objective is a win-win over the term of the transaction. The win-win must be sustainable.

Ensuring a sustainable relationship over the long term is a difficult proposition. Although multi-year transactions are completed, it is very difficult in today's world to craft a relationship that is perpetually sustainable. As business models change, the resulting changes in scope and requirements can quickly lead to an outdated contract. Process improvements and advances in information technology bringing greater productivity and price performance can add additional stress to that once considered a win-win contract if the client believes that the benefits are disproportionately allocated. As the time horizons for sourcing decisions become shorter, it is anticipated that more sustainable relationships can be forged. Is the lowest cost alternative driving only for an immediate "win-win," or does it provide for an enduring, sustainable relationship between the client and the service provider?

Further, change is inevitable. It is vital to model various scenarios of change, and understand the degree to which the candidate service providers are committed to working through the spectrum of uncertainty that the future may offer. What appears to be a lowest-

cost alternative today may not look as attractive in the light of some common change events in the future.

There are a number of other financial considerations in evaluating alternative scenarios:

- Evaluate the staffing plan to ensure that it provides for the required level of service. Do a service provider's leveraged capabilities make it difficult to determine the actual labor model?
- Understand the capital investments that a service provider is planning to make over the term of the contract. See if these investments are at the same cadence as investments previously experienced.
- Ensure that all third-party contracts are accommodated within the service provider's financial solution — perhaps either recovered from its direct rates or as a pass-through charge that is carried by the client.

Ensure that commitments for continuous investments are clearly defined. For instance, how has the organization maintained the environment to date? While the lowest cost scenario may be contemplated, if — at the end of the agreement — the infrastructure has not been maintained, it may not be the best alternative for the organization.



## CONCLUSION

In today's highly active outsourcing market — with shorter contract durations, increased competition, dramatic moves offshore, and multi-sourcing strategies at play — corporations are selecting service providers at least partially based on confidence in their ability to achieve a desired business case. The lowest cost alternative may not yield the degree of confidence required to be selected. Business is still largely based on relationships — especially through outsourcing — and confidence comes through a sincere appreciation for the objectives of the parties, and a belief in the conviction to achieve those objectives.

After carefully considering the service provider's ability to deliver the scope of services and the quality

of service being proposed — and after completing a diligent analysis, selection of the lowest cost alternative may be what is best for the organization. The track record of large-scale outsourcing contracts tells a different story — being the lowest price may connote unacceptable risks by virtue of lack of understanding, overly-risky implementation approaches, or an intractability regarding future change events. It is through considerations like those described above that an organization can truly achieve lower costs while at the same time realizing their loftier goals of operational effectiveness and improving their competitive position in the marketplace. It often doesn't win to be the lowest priced alternative.

