CIO

Bennett Gaines, CIO of Cinergy Corp., found that the small, well-defined relationship with dbaDIRECT was so useful that he expanded the arrangement to the entire enterprise.

SIMPLE & Successful Outsourcing

CIOs who outsource discrete processes that have well-defined business rules are almost always happy with the outcome

BY STEPHANIE OVERBY

PHOTO BY STEPHEN WEBSTER

Reader ROI

- Why transactional relationships are the most successful type of outsourcing
- How to determine which processes can be outsourced
- What to watch out for in outsourcing relationships

A CISR-*CIO* STUDY

Part 1 of a three-part series about outsourcing strategies and success models, defined in original research by MIT's Center for Information Systems Research and *CIO*.

You've heard the tales of outsourcing gloom and doom and read about the staggering percentages of outsourcing failure. Now consider these three CIOs' experiences:

- **Five years ago,** a business unit at energy giant Cinergy Corp. outsourced database administration services, with no plan to extend the contract to any other part of the business. But when Cinergy centralized IT two years later, CIO Bennett Gaines called on dbaDIRECT to provide database administration services enterprisewide. Since then, dbaDIRECT has proved instrumental in a major technology shift—from data marts to an enterprise data warehouse.
- **Four years ago,** Summit Information Systems, a software developer for credit unions, outsourced disaster recovery services for its data center, located in central Florida. In 2004, as Florida faced the worst hurricane season in its history, "[the outsourcing vendor] was willing to do whatever it took to keep our systems up and running," says Steve Steinbach, Summit's vice president of data center operations.
- **Three years ago,** JM Family Enterprises outsourced all mainframe hardware, software and operations because mainframe usage at the $8.2 billion automotive holding company had leveled off. The outsourcing vendor immediately optimized operations so that critical month-end financial reports landed on the desks of JM Family executives first thing in the morning rather than late in the afternoon, as was the norm. "It was the same hardware. The same data. But they were able to gain efficiencies because they knew how to run a mainframe better than we were ever able to," says Senior VP and CIO Ken Yerves.

What's this? IT executives who are satisfied with their outsourcing arrangements—even praising their vendors? This might seem strange, as mass indictments of outsourcing have led to misperceptions. In fact, some slices of outsourcing are almost always successful.

Cinergy, Summit and JM Family achieved success by outsourcing well-defined processes that had clear business rules. Jeanne W. Ross, principal research scientist at MIT's Center for Information Systems Research (CISR), calls such outsourcing arrangements "transaction relationships." These are the most straightforward of outsourcing deals. The work is relatively easily defined, and the CIO wants to farm it out for clear reasons: to gain access to specific technology expertise, to deal with variable demand for certain IT services, or to free up internal staff for higher-value work. And in these relationships, vendor and customer needs are usually aligned; what the two parties want coincides more often than not.

THE MIT CISR REPORT

Sustainable Value from Outsourcing

BY JEANNE W. ROSS AND CYNTHIA M. BEATH

IT executives entering into IT and business process outsourcing arrangements seek a variety of benefits, including cost reductions, variable capacity and reduced management time spent on IT. But outsourcing succeeds only if both the vendor and the client achieve expected benefits. Often client and vendor interests are not aligned. How can clients and vendors settle into a "sweet spot" where their interests coincide? New research from the Massachusetts Institute of Technology's Center for Information Systems Research (CISR) and *CIO* examined 90 outsourcing deals in 84 companies to help executives recognize opportunities for long-term benefits from outsourcing relationships.

We found that the outsourcing sweet spot depends on the nature of the client-vendor relationship. We distinguish among three types of outsourcing relationships: 1. a transaction relationship, in which an outsourcer executes a well-defined, repeatable process for a client; 2. a co-sourcing alliance, in which client and vendor share management responsibility for a project's success; and 3. a strategic partnership, in which an outsourcer takes on responsibilities for a bundle of its client's operational services.

This article focuses on transaction relationships, describing the kinds of services outsourced, the metrics that enable executives to assess the success of the outsourcing arrangement, and the risks to both client and vendor. In Parts 2 and 3 of this series, we will address co-sourcing alliances and strategic partnerships.

HOW TO MAKE TRANSACTION RELATIONSHIPS WORK

Transaction relationships are appropriate for activities guided by clear business rules that are common across many organizations. These activities include commodity services—necessary but nondistinctive services—such as accounts payable processing, expense reporting, desktop provisioning, backup and disaster recovery, and mainframe processing, as well as more specialized, repeatable processes such as credit checks, online gift registry services or unique technology services.

Our study found statistically significantly greater satisfaction with transaction relationships than with either of the other types of relationship and 90 percent success rates for both clients and vendors. We attribute that satisfaction to a large overlap between what clients want from their vendors and what vendors are able to deliver.

Clients have three key objectives in their transaction relationships: access to best practices, variable capacity and the ability to redirect management attention to core competencies. Vendors address those needs by developing best practices, solid, scalable technical platforms and other valuable assets that allow them to improve service and lower costs. For example, eFunds has built a large database of debit information

In a recent study by CISR and *CIO* magazine of 90 outsourcing deals at 84 companies, CIOs showed much greater satisfaction with transaction relationships than with any other type of outsourcing. this page, for a summary of the research findings and the three types of outsourcing arrangements identified.) Nine out of 10 IT executives in the study reported success with their transaction outsourcing. And CIOs who develop satisfactory transaction relationships can reap more rewards than simply saving money or freeing up staff."Companies excelling at transaction relationships achieve agility because managers focus on processes that distinguish the company, rather than the silly things they must get right but don't want to bother with,"Ross says.

That's not to say all these stories have happy endings. After all, there is the 10 percent that doesn't work out. And even successful transaction relationships can create significant problems if you're not careful, such as application silos and poorly structured enterprise architectures. But CIOs who engage in well-defined and well-managed transaction relationships with outsourcers will, in all probability, gain the sustainable value they're seeking.

that is the key to its credit-checking process. This distinctive asset—which clients either cannot or would not replicate—helps to protect the vendor's margins.

Successful transaction relationships have low management overhead. Customization, protracted contract negotiations or client interference with how the vendor performs the process will increase costs and undermine benefits for both parties. But a hands-off transaction relationship can deliver hassle-free, high-quality services to clients and reasonable margins to vendors.

UNDERSTANDING THE THREE TYPES OF OUTSOURCING

The three types of outsourcing relationships are so different that learning gained in one type of relationship does not transfer to another. We believe companies can become competent in all three types of relationships. But it is important to match specific outsourcing needs with the appropriate type of relationship.

Clients managing transaction relationships as strategic partnerships incur expensive and unnecessary overhead. Co-sourcing that isn't treated like a team environment is sure to suboptimize outcomes. And clients and vendors in strategic partnerships who refuse to regularly renegotiate and adapt to the changing needs of their partner will become embroiled in bitter contract battles.

IT executives need to understand the risks of each relationship. Risks increase as the boundaries between client and vendor responsibilities blur and the scope of responsibilities expands. Even transaction relationships bear significant risks. We found that companies emphasizing transaction relationships had statistically significantly less mature enterprise architectures. Low architecture maturity means that a company has unnecessary variability in technical platforms, redundant systems and limited access to shared data. Companies with mature architectures can utilize outsourced transactions on a plug-and-play basis, but companies with low architecture maturity might simply reinforce application silos. In the short term, this could help a company clean up isolated processes, but over time it inhibits the organization's ability to respond to changing market conditions.

CIOs should encourage a gradual approach to transaction outsourcing as their architecture matures and they develop standardized, low-maintenance electronic interfaces. In all outsourcing, both client and vendor should target the sweet spot to maximize benefits to both parties.

Jeanne Ross is principal research scientist at the Massachusetts Institute of Technology's Center for Information Systems Research. Cynthia Beath is a professor emerita in the Department of Management Science and Information Systems at the University of Texas at Austin.

How to Decide What Goes

Choosing which work to outsource and which vendor to send it to are the first decisions any CIO makes in a transaction relationship. But these first steps can be the most critical. The key to success with this kind of outsourcing, says Ross, is making sure that what you send to the vendor is something"extractable"—that is, easily definable, removable or considered noncore. Tasks such as desktop provisioning, business continuity and mainframe processes tend to fall into this category.

In some cases, the categorization of a slice of IT work as extractable is straightforward. Guy de Poerck, CIO of the International Finance Corp. (IFC), an arm of the World Bank, has been outsourcing help desk services to Affiliated Computer Services (ACS) for six years and hasn't had to give it a second thought."With help desk, the transaction is pretty simple,"says de Poerck. "I know it's successful because I hear so little about it. I've never been confronted with a problem."

But what is easily definable, removable or considered noncore can vary by company. JM Family has a well-defined annual process for categorizing its technology. The process helps it to prioritize IT spending and decide what should be done in-house versus what might be a candidate for outsourcing. Every August, CIO Yerves divides all technology into four categories: emerging, mainstream, contained and retirement. Emerging and mainstream technologies are where the IT department focuses its budget, training and staff. Contained technologies are systems—often legacy systems—that are not growing in usage but that must be kept up and running and are therefore candidates for outsourcing (although internal improvements in efficiency might suffice as well). And retirement systems are, well, on their way out.

Going through this process in August 2002, Yerves and his leadership team categorized mainframe operations in the contained cate-

PHOTO BY JEFFERY SALTER

gory for the first time. One of the company's three business units had plans to wean itself from the mainframe. The others continued to employ the services but with no increase in usage. In addition, managing mainframe operations was a fixed cost in the IT budget, even though the company's usage was variable.

So Yerves began to examine potential outsourcing vendors in early 2003, narrowing the field to two contenders by April. He put together a valuation matrix that explored what the vendors could offer in variable capacity and cost. Variability was important because of the peaks and valleys in the business's mainframe processing needs. Ultimately Yerves went with IBM.

But settling on the right outsourcer wasn't the trickiest part for JM Family. As evidenced in the CISR-*CIO* study, protracted contract negotiations can ruin a transaction outsourcing arrangement. "The concept of a transaction relationship is, in some respects, an oxymoron. Ideally, there is only barely a relationship—much like we'd have at the grocery store with the sales clerk. I find what I want, the clerk rings it up, I pay," Ross says. "If client and vendor engage in protracted negotiations about unique features or special pricing arrangements, they no longer have a simple transaction."

And Yerves had heard horror stories from peers and analysts about disputes over outsourcing contracts. So he sought to circumvent contractual conflicts by streamlining the process. Yerves gathered leaders and lawyers from both the vendor and JM Family and sequestered them in a local hotel. "We gave them 72 hours and said if we can't get to an agreement by then, we don't have a deal," he says. And it worked. Before the clock ran out, JM Family and IBM had inked a deal. "We were able to mitigate that early risk" of long or contentious negotiations, he says.

In fact, a mark of good transaction relationships is that contract negotiations are straightforward. The services to be outsourced are extractable, and companies and vendors have similar goals for the arrangement: Make it fast, easy and cheap. "It's a lot easier to get to success with transactional-type outsourcing [than with other types] if the customers have well-defined requirements," says Mary Lacity, professor of information systems at the University of Missouri. "If the customers know exactly what they want, they can tell the vendor, and the vendor can price [the contract] correctly. The expectations [for the outsourcing arrangement] can then be well defined in the contract."

Learn to Let Go

When it comes to transaction relationships, management is best when it manages least. Client interference with how the vendor performs the process will increase costs and undermine benefits for both parties, according to the CISR-*CIO* study. But letting go of the day-to-day management can be difficult for CIOs.

Summit's Steinbach is ultimately responsible for the Florida data center that supports 125 of the company's 300 customers. It houses 1.2 million bank accounts and processes a million transactions a day. If the data center goes down, Steinbach goes down. In 2001, Steinbach decided it would be easier and cheaper to outsource disaster recovery services. But that left him dependent on an outside organization to keep things running come hell or high water (or high winds). He was confident in his selection of Hewlett-Packard to do the work. But still, "my biggest concern was a lack of control," he says. "If you're doing it yourself, it seems like you have more control over it, and you feel much more comfortable about it."

So when the transfer to HP took place during the summer of 2002 (a quiet hurricane season in the Atlantic), Steinbach eased his mind through testing. He purchased two extra days of testing beyond the six days included in the deal, and after each test he attended the postmortem, during which HP figured out how to further streamline the backup and disaster recovery processes. It was a learning experience for client and vendor alike. With each test, HP performed better. And after each test, Steinbach loosened his reins a bit more. "I felt it was important to take that extra time the first year to make sure we knew what we were doing," he says. "I became more familiar with how their facilities were laid out and with their staff. And they became more familiar with us and our business."

But 2004—dubbed "hurricane summer" down south—was a test of a different sort. Steinbach declared three emergencies at the data center that year, but by that time he was comfortable with standing back and letting HP handle it. The vendor provided monitoring and remained on standby throughout Hurricane Frances, a Category 4 storm that made landfall close to Summit's data center. HP even agreed to leave its backup systems on for the remaining months of hurricane season in case more storms hit, without charging Summit more. That solution "saved both parties a lot of time and effort and turned out to be a great plan," Steinbach says.

Steinbach funneled his energy into streamlining processes on the Summit end, such as learning that he needed to declare an emergency to HP sooner in the process rather than waiting and hoping a storm might take a different path. Today, he says, he spends very little time on the relationship with HP. And the more he's stepped back, the more they've stepped up. When the hurricanes started up again early this summer, the vendor was calling *him* rather than the other way around. "They're totally in tune with us and what we need now," Steinbach says.

But while transaction relationships tend to be hands-off from a day-to-day management perspective, it can be valuable to revisit these relationships to see what can be improved. And because client and vendor needs and expectations are often in alignment, outsourcers are often amenable to making the arrangement more effective because what they learn may help them serve their entire client base better. Steinbach, for example, has made changes to his contract with HP four times, adding equipment to their backup site or addressing methods of improvement. "They've been very flexible with us," he says. "And we weren't expecting that."

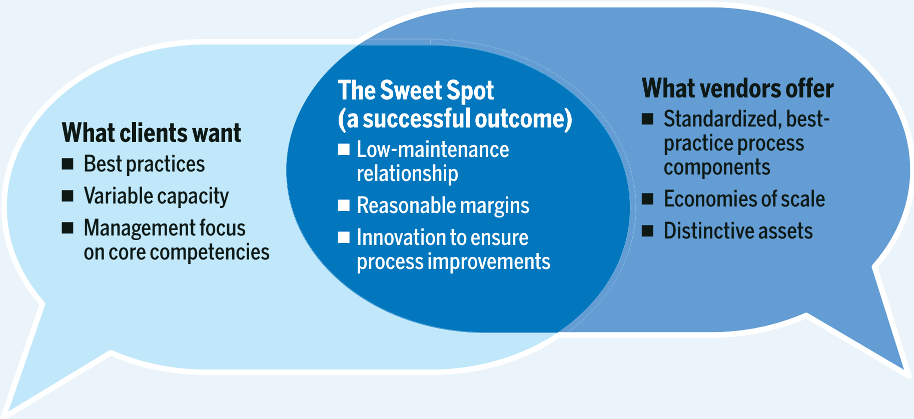
The suggestions for improvements can sometimes come from the vendors themselves. Of course, the outsourcer has its own motives, such as cost efficiencies, for making such advances, but given the nature of transaction relationships, these can work out well for the customer too. For example, under its original contract with International Finance Corp., ACS had been providing onsite help desk service during work hours in IFC's Washington, D.C., office. At night, a single ACS employee took a pager home to handle off-hours problems. It worked out OK, and there were no major complaints. "But frankly," says de Poerck, "the service was dependent on the ability and commitment of that one person."

Nine months ago, ACS approached de Poerck with a proposal: ACS could now offer 24/7 help desk support to IFC for the same price. The reason? ACS was now able to transfer off-hours calls to its Bangalore office. De Poerck had significant experience with offshoring application development and maintenance to another outsourcer in Chennai, and was game.

Find the Sweet Spot

90% of transaction relationships succeed because CIOs' goals and vendors' capabilities match up well

Transaction Outsourcing: Objectives



Transaction Outsourcing: Parameters, Benefits and Risks

WHAT IS OUTSOURCED?	KEY METRICS	CLIENT RISKS	VENDOR RISKS	CLIENT/VENDOR SUCCESS
Clearly defined, repeatable processes	Quality and/or cost per transaction	Desired service might not be available	Competition can erode margins	90% for each side (as judged by outsourcing clients)

SOURCE: Survey and interviews conducted by Jeanne Ross and Cynthia Beath

After a pilot, he signed up.

De Poerck says that the impetus for the change was the looming end of the multiyear ACS contract, which the World Bank requires IFC to put up again for bid at the end of a contract period. If ACS could offer IFC extended help desk service for the same price, perhaps it could outbid all comers. Regardless, "now that we have that team in Bangalore, there's a level of performance and processes that weren't in place before," de Poerck says. "We're getting a lot better service."

Clean House Before Outsourcing

If the success rates and benefits of transaction relationships have you wondering why you don't just outsource everything that you can characterize as extractable, beware. There is a potential trip-up. Emphasizing transaction relationships can make a company less innovative with its IT architecture. In the short term, transaction outsourcing can help a company clean up isolated processes, but in the long term these deals may actually reinforce application silos in a company, according to the CISR-*CIO* research.

This potential problem makes the need for enterprise architecture planning even more important for companies engaging in transaction relationships, Ross says. "We think of a transaction as a smallish piece of IT that the vendor ought to be able to provide value on," she says. "But that can be dangerous. Until companies have cleaned up internal processes, outsourcing transactions is going to reinforce silos. And that can make your internal architecture messier and messier." Over time, a weak enterprise architecture could inhibit a company's ability to respond to changing market conditions.

Cinergy could have fallen into that trap. Before CIO Gaines's arrival in 2002, the company had commenced a transaction relationship with dbaDIRECT to do database administration for its commercial energy business unit only. At the time, Cinergy IT was decentralized, with each of the company's four business units operating autonomously. The dbaDIRECT deal "worked reasonably well and served its purpose," Gaines says. "But there was not a lot of visibility into it. It was filling a rather specific need in that business unit, and it wasn't scalable."

When Gaines took the reins, he was charged with centralizing IT for the $4.7 billion company. One of his first acts was a review of Cinergy's entire IT service delivery model. He also looked ahead to future needs. "We had an opportunity to get into some new emerging technologies, but that would require incorporating an enterprisewide data warehouse," he says. Gaines knew he did not have enough internal expertise to tackle that job.

Gaines began to look at outsourcers. He liked that dbaDIRECT had experience with his company. "The database work they would be handling was complex, and they were already managing a highly reliable database for us," he says. So he hired the vendor for database administration enterprisewide. dbaDIRECT started with the company's Oracle databases. And as Gaines continued to centralize IT, the outsourcer took responsibility for most of Cinergy's databases.

By reexamining the outsourcing relationship with dbaDIRECT and expanding it as part of a larger enterprise architecture strategy, Gaines avoided the silos that transaction outsourcing sometimes produces. The vendor has also proved valuable working directly with Cinergy's other outsourcers, with whom Cinergy cosources much development and maintenance of applications that in turn rely on database functioning and availability.

But most impressive to Gaines has been how quickly dbaDIRECT, with its well-honed database experience and best practices, has been able to move Cinergy from its old data mart model to an enterprise data warehouse. Far from stagnating Cinergy's architecture, transaction outsourcing has improved it. "I would never have been able to bring that [enterprise data warehouse] into this company as quickly if we tried to do it ourselves," says Gaines. dbaDIRECT "had that core competence because it's their business. It wasn't rocket science. But the need was so urgent for us—we had customers in the business who were building new applications dependent on having a data warehouse—that finding a partner like them was important."

CIOs should not be lulled into believing that success with transaction relationships means they're ready for riskier adventures in outsourcing. According to Ross, knowledge from transaction outsourcing does not necessarily transfer to other, more complex types of outsourcing. "You'll never find the level of success you have with transaction relationships in other types of outsourcing because nothing else is as extractable," she says.

Smart CIOs who have found success in transaction relationships know this, and consequently, they approach all outsourcing—even further transaction relationships—with due caution. "With transaction relationships, you tend to find a lot of happy people. They're outsourcing smaller pieces of IT," says Ross. "But the bigger it gets, the riskier it gets." CIO

"With help desk, the transaction is pretty simple. I know it's successful because I hear so little about it." –**Guy de Poerck,** CIO, International Finance Corp.

Senior Editor Stephanie Overby (*soverby@cio.com*) covers outsourcing.