

# Contents

<i>List of Figures</i>	vii
<i>List of Tables</i>	ix
<i>List of Contributors</i>	xi
<i>Professional Credits</i>	xv
<i>Acknowledgments</i>	xvii
<b>Part I Introduction</b>	<b>1</b>
Chapter 1 Outsourcing Practice: The Search for Flexibility and Control <i>Leslie Willcocks and Mary Lacity</i>	3
<b>Part II Studies of Outsourcing's Rise to Prominence</b>	<b>35</b>
Chapter 2 Realizing Outsourcing Expectations: Incredible Promises, Credible Outcomes <i>Mary Lacity, Rudy Hirschheim and Leslie Willcocks</i>	37
Chapter 3 Contracting and Relationships in IT Outsourcing <i>Guy Fitzgerald and Leslie Willcocks</i>	59
Chapter 4 Cooperative Partnerships and IT Outsourcing: From Contractual Obligation to Strategic Alliance? <i>Leslie Willcocks and Chong Choi</i>	79
Chapter 5 Offshore Outsourcing: A Country Too Far? <i>Kuldeep Kumar and Leslie Willcocks</i>	97
Chapter 6 IT Outsourcing in Public Sector Contexts: Researching Risk and Strategy <i>Leslie Willcocks, Mary Lacity and Thomas Kern</i>	123
Chapter 7 IT Sourcing: Examining the Privatization Option in Public Administration <i>Mary Lacity and Leslie Willcocks</i>	159
Chapter 8 Analyzing IT Outsourcing Decisions: Size, Interdependency and Risk <i>Wendy Currie and Leslie Willcocks</i>	187
Chapter 9 Information Technology Insourcing: Myths and Realities <i>Rudy Hirschheim and Mary Lacity</i>	213

Chapter 10	Contracts, Control and “Presentation” in IT Outsourcing <i>Thomas Kern and Leslie Willcocks</i>	232
<b>Part III</b>	<b>Studies 2000–2008: From IT to Business Process and Offshore Outsourcing</b>	<b>265</b>
Chapter 11	IT Outsourcing Configuration: Defining and Designing Outsourcing Arrangements <i>Sara Cullen, Peter Seddon and Leslie Willcocks</i>	267
Chapter 12	IT Outsourcing Success: A Framework for Assessing Intentions and Outcomes <i>Sara Cullen, Peter Seddon and Leslie Willcocks</i>	303
Chapter 13	Business Process Outsourcing: The Promise of the Enterprise Partnership Model <i>David Feeny, Leslie Willcocks and Mary Lacity</i>	339
Chapter 14	Outcomes from Offshore Outsourcing: Evidence from a Client’s Perspective <i>Joseph Rottman and Mary Lacity</i>	389
Chapter 15	Offshore Outsourcing, Strategy and the Role of Social Capital <i>Joseph Rottman and Mary Lacity</i>	445
Chapter 16	Creating Global Shared Services: Sourcing Lessons from Reuters <i>Mary Lacity and Jim Fox</i>	467
<i>Index</i>		488

# Part I

## Introduction



## 1

# Outsourcing Practice: The Search for Flexibility and Control

*Leslie Willcocks and Mary Lacity*

## Introduction

This book has an earlier companion volume in *Information Systems and Outsourcing: Studies in Theory and Practice* (Palgrave, 2009). There we gathered together our major papers and subsequent reflections on two themes: the theoretical perspectives utilized for studying outsourcing; and the learning that has emerged from our research, cast in the form of lessons for practice. In the present book we take the journey further, looking to give insight into the evolution of our research, and of outsourcing practices themselves, as they have developed from 1988 through to the present day. Here we build from a primary concern with Information Technology (IT) through to the burgeoning market for business process services (BPO), and the moves to offshore, nearshore and hybrid models typical of the late 2000s.

Details of the research base we draw upon can be found in each chapter of the book. But combined, our work as at 2009 formed a 630 (and growing) case research base held by researchers at the London School of Economics Outsourcing Unit, and the Universities of Melbourne and Missouri, St Louis information systems departments. Including survey work, the research base by 2009 represented data from 1,600 plus organizations. It covered all major economic and government sectors, including financial services, energy and utilities, defence/aerospace, retail, telecoms and IT, oil, transportation, central state and local government, health care, industrial products and chemicals, and has been drawn from medium, large and multinational organizations based in Europe, USA and Asia Pacific. Most importantly, as will emerge in this book, we have been able to track many of our cases over the life of their outsourcing contracts, and indeed into their second and third generation, thus providing us with unique insights into clients' and suppliers' *a priori* expectations juxtaposed against actual outcomes (see in particular Chapters 2 and 12 of the present volume).

#### 4 The Practice of Outsourcing

In this chapter we will assess the evolution of our research and our findings, as well as the major changes in the outsourcing market and how clients have shaped and used the ever expanding service base. Our focus is from 1989 through to the present day, with some comment on present and future trends, especially in the light of the global economic downturn beginning from 2007, and deepening into 2008/9.

### **Outsourcing's rise to prominence: 1990s IT trends, practices, and lessons**

Ever since Kodak's landmark decision to outsource the bulk of their IT functions to three suppliers in 1989, IT outsourcing has been a widely-publicized practice. Most of us are familiar over the years with a number of other high-profile IT outsourcing mega-deals besides Kodak. Companies and public sector organizations that have, since the 1990s, outsourced significant portions of their IT functions by transferring their IT assets, leases, licenses, and staff to outsourcing vendors include (often with name changes along the way): British Aerospace, British Petroleum, Chase Manhattan Bank, UK Inland Revenue and Department of Social Security, Continental Airlines, Barclays, DuPont, First City, General Dynamics, Commonwealth Bank, McDonnell Douglas, and Xerox. When such mega-deals were first signed, the trade press tended to report *expected* outcomes, including reduced IT costs, better service, access to new technology, and an ability to refocus in-house staff on higher-value work. But, even in the 1990s there was substantial debate about the long-term consequences of such deals.

Proponents pointed out that: *"IT outsourcing is a harbinger of the transformation of traditional IT departments and provides a glimpse at the emerging organizational structures of the information economy"* (McFarlan and Nolan, 1995, p. 11). Opponents argued that companies that signed long-term contracts lost control of their IT assets and capabilities. Critics admonished: *"Outsourcing, the Scam May Be on You"* (Gantz, 1994), *"Outsourcing, a Game for Losers"* (Strassmann, 1995), and *"Selling One's Birth Right"* (Dorn, 1989). Despite that debate that is ongoing to this day (the contemporary version includes questions of consolidating supplier numbers down to as few as possible) the growth of the IT outsourcing market during the 1990s was undeniable. For example, IDC estimated the global outsourcing market for 1995 at \$76 billion. By 2002 the global market revenues from IT outsourcing were probably \$US120 billion (Lacity and Willcocks, 2001).

An interesting fact lost in the focus on mega-deals was that the dominant trend was quite otherwise, even in the 1990s. By 2000, worldwide, there were only about 140 such deals. Our research shows consistently that, in the lead markets of USA and UK, over 75% of organizations outsource 15–50% of their IT budgets, typically with multiple suppliers (Lacity and Willcocks, 2001; Willcocks and Lacity, 2006). A mega-deal, especially with a single supplier, always has been a distinctly minority pursuit. As we will

see later in the book, one explanation relates to organizations seeking to lower the high risk profile inherent with large-scale outsourcing to third party suppliers (see especially Chapters 6 and 8). One should also not forget that by 2000 many organizations (USA 10%, UK 23%, other countries much higher) had no significant IT outsourcing contracts (Kern and Willcocks, 2001). Chapters 8 and 9 of this book will detail why in-house provision has often been seen as the economically, operationally and strategically effective option for at least part of any organization's IT portfolio.

As companies accumulated experience with IT outsourcing through the 1990s, we took the opportunity to assess the practices that differentiated success from failure. A major synthesis of our thinking and research appeared in Lacity and Willcocks (1998). This looked at 61 sourcing arrangements over the 1991–98 period (expanded to 116 in Lacity and Willcocks, 2001). There we recorded seven major findings and developed our thinking on three contracting models being utilized by outsourcing practitioners. To position the evolution of outsourcing practice and of our own research, these are worth revisiting, albeit briefly. First, the major findings:

**Finding 1: Selective outsourcing decisions achieved expected cost savings with a higher relative frequency than total outsourcing or total insourcing decisions.**

We defined the three main sourcing options in play as:

**Total Outsourcing:** The decision to transfer the equivalent of more than 80% of the IT budget for IT assets, leases, staff, and management responsibility to an external IT provider.

**Total Insourcing:** The decision to retain the management and provision of more than 80% of the IT budget internally after evaluating the IT services market.<sup>1</sup>

**Selective Outsourcing:** The decision to source selected IT functions from external provider(s) while still providing between 20% and 80% of the IT budget internally. This strategy may include single or multiple vendors.

Selective outsourcing decisions achieved expected cost savings more frequently (85%) than all-or-nothing approaches (29%). Few vendors or internal IT departments possessed the expertise to perform all IT activities most efficiently. With selective outsourcing, organizations could select the most capable and efficient source – a practice some participants referred to as “best-of-breed” sourcing. Sometimes, the ability to focus in-house resources

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<sup>1</sup>Included in our definition of insourcing is the buying-in of vendor resources to meet a temporary resource need, such as the need for programmers in the latter stages of a new development project or the use of management consultants to facilitate a strategic planning process. In these cases, the customer retains responsibility for the delivery of IT services – vendor resources are brought in to supplement internally-managed teams.

## 6 The Practice of Outsourcing

to higher-value work also justified selective outsourcing. In most total outsourcing cases, participants encountered one or more of the following problems realizing expected cost savings:

- excess fees for services beyond the contract or excess fees for services participants assumed were in the contract;
- “hidden costs” from both client (such as IT spend hidden in decentralized budgets) and suppliers (such as costs to transfer software licenses);
- Inflexible contracts that are poorly adapted to changes in technology, market prices, business processes, and business direction.

Exclusive sourcing by an internal IT department was generally successful (67%). However, in some of our cases, internal IT “monopolies” promoted complacency and erected organizational obstacles against continuous improvement.

**Finding 2: Senior executives and IT managers who made decisions together achieved expected cost savings with a higher relative frequency than when either stakeholder group acted alone.**

It appears that successful sourcing decisions require a mix of political power and technical skills. Political power helped to enforce the larger business perspective – such as the need for organization-wide cost cuts – as well as the “muscle” to implement such business initiatives. Technical expertise on IT services, service levels, measures of performance, rates of technical obsolescence, rates of service growth, price/performance improvements, and a host of other technical topics were needed to develop requests-for-proposals, evaluate vendor bids, and negotiate and manage sound contracts. The need for joint sponsorship is most apparent when outsourcing and insourcing decisions are analyzed separately because we found that senior business executives realizing their expected cost savings only 40% of the time when they *outsourced* IT. Meanwhile, IT managers realized their expected cost savings only 56% of the time when they *insourced* IT.

**Finding 3: Organizations that invited both internal and external bids achieved expected cost savings with a higher relative frequency (89%) than organizations that merely compared external bids with current IT costs (71%), or that had an informal bid process (50%).**

We believe this was because formal external vendor bids were often based on efficient managerial practices that could be replicated by internal IT managers. The question was: If IT managers could reduce costs, why didn’t they? Some of this was due to internal political barriers. The issue is pursued in detail in Chapter 9 of this book.

**Finding 4: Short-term contracts (up to four years, 83%: 4–7 years, 70%) achieved expected cost savings with a higher relative frequency than long-term contracts over seven years, 40%).**

Short-term contracts involved less uncertainty, motivated vendor performance, allowed participants to recover from mistakes quicker, and helped to ensure that participants were getting a fair market price. Another reason for the financial success of short-term contracts was that participants only outsourced for the duration in which requirements were more stable, thus participants could adequately analyze the cost implications of their decisions. Also, some participants noted that short-term contracts motivated vendor performance because vendors realized customers could opt to switch vendors when the contract expired.

**Finding 5: Detailed fee-for-service contracts achieved expected cost savings with a higher relative frequency than other types of fee-for-service contracts.**

Many different types of contracts are used to govern IT outsourcing relationships. We deal with this issue in detail in Chapters 3 and 10. However, it is useful at this point to outline the main contracting forms we encountered in the 1990s. In general, these IT sourcing contracts can be categorized as follows:

1. **Fee-for-Service Contract:** A customer pays a fee to a supplier in exchange for the management and delivery of specified IT products or services. This can take many forms, including:
  - a) **Standard Contract:** The customer signs the vendor's standard, off-the-shelf contract.
  - b) **Detailed Contract:** The contract includes special contractual clauses for service scope, service levels, measures of performance, and penalties for non-performance.
  - c) **Loose Contract:** The contract does not provide comprehensive performance measures or contingencies.
  - d) **Mixed Contract:** For the first few years of the contract, requirements are fully specified, connoting a "detailed" contract. However, subsequent requirements are only loosely defined, connoting a "loose" contract.
2. **Strategic Alliance/Partnership:** Collaborative inter-organizational relationships involving significant resources of two or more organizations to create, add to, or maximize their joint value. In the contract, the partners agree to furnish a part of the capital and labor for a business enterprise, and each shares in profits and losses.

**3. Buy-in Contract:** A customer buys in vendor resources to supplement in-house capabilities, but the vendor resources are managed by in-house business and IT management.

Detailed, fee-for-service contracts achieved expected cost savings in 91% of cases compared with 50% for standard, 40% for mixed, and 0% for loose contracts. These organizations understood their own IT functions very well, and could therefore define their precise requirements in a contract. They also spent significant time negotiating the details of contracts, often with the help of outside experts. In contrast to the success of the detailed contract, all the loose contracts in our sample were disasters, not only in terms of not achieving expected cost savings, but in terms of service. In our sample there was only one strategic alliance, namely that of Phillips with the Dutch software company, that emerged over time as successful. Strategic alliances are discussed in more detail below and in Chapter 4.

**Finding 6: More recent contracts had higher success rates than older contracts.**

We offer two explanations – learning curve effects and increased sourcing options. First, customers were accumulating experience with IT outsourcing and were thus getting better at negotiating deals. In fact, some of our participants adopted incremental outsourcing precisely to develop an in-house knowledge base learnt from the outsourcing experience. Second, more recent contracts may have achieved expected cost savings more frequently because the outsourcing market was changing in the customer's favor. Once dominated by a few big players, such as EDS, Andersen, CSC, and IBM, the IT outsourcing market in the 1990s fragmented into many niche services. As competition in the global outsourcing market has increased generally throughout the 1991–2008 period, companies and public sector agencies have had more power to bargain for shorter contracts, more select services, and better financial packages. At the same time, of course the complexity and size of IT outsourcing has expanded considerably into the 2000s, so findings on contract success will always be time and context bound.

**Finding 7: Size of IT function did not usefully differentiate financially successful decisions from financially unsuccessful decisions. Managerial practices were emerging to be more important than economies of scale associated with size when seeking IT cost reductions.**

We were interested in the size of IT function because of the theoretical argument that external service providers have lower average costs than internal IT functions due to mass production and labor specialization

efficiencies. We would expect that organizations with small IT functions would gain significant savings by accessing a vendor's economies of scale through outsourcing. We would also expect that organizations with large IT functions would have equivalent economies of scale as a vendor, and therefore could achieve cost savings on their own through insourcing. This prompts the question: Do companies with small IT functions successfully outsource, while companies with large IT functions successfully insource?

In this study, the findings were apparently contrary to expectations based on the theoretical arguments. Large IT insourcing cases did not achieve expected cost savings with greater frequency than small IT insourcing cases. In general, all the size indicators suggested, as the theory of economies of scale predicts, that small IT cases were able to reduce costs through outsourcing. However, small IT outsourcing cases did not achieve expected cost savings with greater frequency than large IT outsourcing cases. When all indicators of size are considered, size does not usefully differentiate an organization's ability to achieve expected cost savings. We suggest the following interpretation of this finding: *In practice, the ability to reduce IT costs may depend more on IT managerial practices than inherent economies of scale associated with size.* This issue is pursued in much more detail in Chapter 9 (see also Lacity and Hirschheim, 1995).

### **Management lessons from the 1990s: “fee-for-service” or “strategic alliance”?**

In the 1990s IT outsourcing was, as it still is, a widely publicized and much debated practice. In particular, practitioners and academics have argued about the validity of long-term, “total” outsourcing. The debate is clarified by our classification of three types of IT outsourcing contracts: fee-for-service contracts, strategic alliances/partnerships, and buy-in contracts. By highlighting the critical elements of various contracting models, we can perhaps reconcile some of the apparent discrepancies on the best ways to outsource IT.

**Fee-for-Service Contracts.** We found that such relationships required *detailed contracts* that fully specify requirements, service levels, performance metrics, penalties for non-performance, and price; and *short-term contracts* that last only for the duration for which requirements are known. Such contracts were best suited for IT activities where companies could clearly define their needs in an air-tight contract. Fee-for-service contracts were not suited for IT activities in which the technology was ill-defined, immature, or unstable. In these cases, the customer's inability to define baseline requirements together with subsequent unreasonable expectations that additional/undocumented services would be provided without additional costs, caused relationships to deteriorate.

An important insight from our work of this period is that several of our case companies signed fee-for-service contracts, but mis-labeled them as

strategic alliances or strategic partnerships (see also Chapters 3 and 4). The rhetoric of a “partnership” prompted the signing of loosely-defined, fee-for-service contracts (perhaps more aptly labeled “flimsy” contracts). Vendors’ bids were based on the ill-defined baseline services the customers originally specified. Customers believed vendors would provide additional services free or at reduced prices under the spirit and trust of the “partnership”. In reality, additions or changes to the fee-for-service contract triggered additional vendor costs that were recovered through excess fees. Such excess fees contributed to the customer’s inability to realize expected cost savings.

**Strategic Alliances/Partnerships.** In the context of IT, the idea that outsourcing vendors should be treated as “strategic partners” may be attributed to Eastman Kodak. A Kodak manager overseeing the contracts told an audience of practitioners, “*We think of our alliances as partnerships because of their cooperative and long term qualities*” (Lacity and Hirschheim, 1993ab). Kodak’s original contracts were only a dozen or so pages long. The importance of Kodak’s IT outsourcing model cannot be over-stated – statistical analysis shows that the early 1990s IT outsourcing trend can be attributed to imitative behavior of Kodak’s decision (Loh and Venkatraman, 1992; Applegate and Montealegre, 1991).

Kanter (1994) found eight essential factors for successful alliances:

1. *Individual Excellence*: both partners are strong and have something of value to contribute
2. *Importance*: the relationship plays a key role in both partners’ long-term strategic plans
3. *Interdependence*: neither can accomplish alone what both can do together
4. *Investment*: partners invest in each other
5. *Information*: communication is reasonably open
6. *Integration*: partners develop organizational linkages so they work together smoothly
7. *Institutionalization*: the relationship extends beyond the deal-makers and cannot be broken on a whim
8. *Integrity*: the partners behave in honorable ways toward each other

Given these criteria, only one of our 1990s cases could really be described as a joint venture, namely Phillips’ relationship with a Dutch software company. Phillips provided 1,000 IT employees and owned over 30% of the venture. The Dutch software company provided sales and marketing capabilities. The partners developed and supported application software for external customers, as well as delivering service back to Phillips. Outside of the cases we studied, including the ones described in Chapter 4, there were, in the 1990s, a number of reported IT strategic alliances that may meet most of Kanter’s criteria. In principle, these strategic alliances combine strengths to add value by selling jointly-developed IT products and services

to the external marketplace. Because each party shared in the revenue generated from external sales, the deals were not based on fee-for-services, but rather on shared risks and rewards, often accompanied by joint investment. Some examples of strategic alliances announced in the 1990s trade press included:

- The Xerox-EDS contract – provided for future shared revenues from the development and sale of a global electronic document distribution service. At the time of the contract signing, the President of EDS and CEO of Xerox announced:

“We realized that each of our companies brought to the table specific best-in-class capabilities that enabled a level of performance that neither could achieve independently. This is a case of two technology companies enabling one another to achieve a shared vision for adding value for their customers.” (reported on October 10, 1996 on WWW at <http://www.xerox.com/PR/NR950321-EDS.html>)

- Andersen Consulting and Dow Chemical formed a strategic alliance in which the partners planned to sell any systems developed for Dow to external customers (Moran, 1996).
- Swiss Bank signed a 25-year outsourcing deal with Perot Systems worth \$6.25 billion. The partners planned to sell client/server solutions to the banking industry (Schmerken and Goldman, 1996).
- In Australia, when Lend Lease outsourced all its information systems to ISSC, it took a 35% holding in ISSC Australia (Lacity and Willcocks, 2001).
- Telstra (Australia’s telecommunications company) outsourced its IT to ISSC, which in turn outsourced its network operations and management to Telstra. Additionally, Telstra took a 26% stake in ISSC (Kern and Willcocks, 2001).

Such deals had high expectations for success, but the partners had to truly add value by offering IT products and services demanded by customers in the market. Looking back at these deals from 2006 we concluded that several of these really did not deliver on their promise, and most have had the formal joint venture component in the deal terminated (Willcocks and Lacity, 2006) One widely-publicized deal that failed this litmus test in the 1990s was Delta Airlines and AT&T(NCR) forming TransQuest to provide IT solutions to the airline/travel industry. Their goal was to generate \$1 million a year for the 50-50 partnership. Under the \$2.8 billion, ten-year agreement, Delta transferred 1,100 employees and 3,000 applications to TransQuest while NCR contributed 30 employees, software, and cash. In 1996, however, the joint venture was terminated and Delta brought everything back in-house. An article of the time speculated that NCR’s inexperience with large-scale professional service deals was a major contributing factor

to the early termination (Hoffmann, 1996). The issue of why such deals succeed or fail is dealt with in much more detail in Lacity and Willcocks (2001). We provide more extensive treatment of the debate and outcomes in Chapter 13 where Xchanging used the model in the 2000s for setting up and running business process outsourcing arrangements.

**Buy-in Contracts.** One contract model that emerged from our study was the buying-in of vendor resources to supplement in-house abilities. We labelled this an insourcing option because the customers managed the IT activity and vendor resources internally. This strategy was most successful for the development of applications dependent on new technologies. In these cases, companies wished to access the vendor's technical expertise but could neither negotiate a detailed contract (because they didn't fully understand requirements), nor could they afford to miss a learning opportunity. In such cases the best use of the market was found to be to buy in external resources to work under internal management control.

The three general contract models identified above provide a good starting point for understanding customer/supplier relationships. These definitions also reconcile some of the apparent debates in the literature. For example, McFarlan and Nolan (1995) studied over a dozen total outsourcing contracts. Their findings were contrary to our own on a number of points, including their assessment of the viability of long-term IT outsourcing and a call for flexible contracts. The differences in their findings and ours may be attributed to the types of deals we each studied. McFarlan and Nolan primarily studied strategic alliances; we studied fee-for-service contracts.

By 2000, we could conclude that sourcing information technology capability remained a problematic area. The increasing number of vendors and services available in the marketplace were providing more opportunities, but were also complicating decision-making, contracting, and management issues. Our case studies, and the work represented in Part I of this book, contributed to the mounting experience base, particularly in the area of fee-for-service contracts, and especially for contracts directed at cost reduction. We were finding that detailed, short-term contracts worked well for the firms we studied if participants clearly defined their requirements. This ensured they were paying market prices, motivated vendor performance (perhaps with a threat to switch suppliers when the contract expired), allowed organizations to gradually learn how to competently outsource, and, in some cases, allowed organizations to recover from their mistakes more quickly. Our ongoing research was finding a number of emerging practices that in principle would achieve success through other means. These practices included flexible pricing, competitive bidding beyond the baseline contract, beginning long-term relationships with a short-term contract, and performance-based contracts.

In practice into the 2000s, the first three of these options have been regularly adopted by clients. The fourth has been altogether more difficult to

operationalize. In the fee-for-service contracts we studied, performance measures focused on ensuring the vendor's technical performance, such as on-line availability and response time. However, we found some contracts relying more on the vendor's business performance. However, even by end of 2008, performance-based contracting was still a relatively untried concept, accounting for only a small percentage of ITO, and even BPO, revenues.

In the 1990s, then, we found practitioners wanting to source their IT portfolios to minimize costs, maximize service, and leverage resources to deliver real value, today and in the future. The practices we identified helped organizations significantly, particularly when reduced IT costs were the primary objective. These practices were selective outsourcing, joint IT/senior executive sponsorship, comparing external bids with newly-prepared internal bids, short-term contracts, and detailed fee-for-service contracts. Our research also provided insights into why practices such as strategic alliances and variations of fee-for-service contracts were emerging. Emerging practices stemmed from organizational learning about the benefits and pitfalls of past IT outsourcing experiences. Our post-2000 research represented in Part III of this book uncovered additional practices that helped sourcing expectations to be met in an ever changing outsourcing environment.

During the 1990s then, in the course of our research, we had identified some individual better practices for sourcing IT. No one company, however, had combined all such practices into a blueprint that others could use. Equally, if not more important, none had constructed an analytical framework explaining why such practices worked. What would such a blueprint and such a framework look like? To show how a company's decision-making process could evolve from conventional approaches to the one we were beginning to advocate, in the mid-1990s we offered the story of Energen, a fictitious petroleum company based in Houston, Texas, that represented a composite of many of the organizational practices identified in our studies to that date. The Energen case is found in Appendix A and illustrates how a client company may answer nine key outsourcing questions:

1. Is this IT system or activity truly differentiating?
2. Are we certain that our IT requirements won't change?
3. Even if an information system activity is a commodity, can it be disaggregated from other IT and business activities?
4. Could the internal IT department provide this IS activity more efficiently than an outside provider could?
5. Do we have the knowledge to outsource an unfamiliar or emerging technology?
6. What pitfalls should we be on the lookout for when hammering out the details of a contract?
7. How can we design a contract that minimizes our risks and maximizes our control and flexibility?

8. What in-house staff do we need to negotiate strong IT contracts?
9. What in-house staff do we need to make sure that we get the most out of our IT contracts and keep control of our IT destiny in the face of changing technologies?

### **From IT to business process and offshore outsourcing: 2000 and beyond**

Our findings and stipulations have tended to hold up well to comparison against outsourcing experiences and outcomes during the first decade of the new century. During 2000–05, IT sourcing strategies, practices and the staffing configuration of client organizations were shifting as clients and suppliers moved up the outsourcing learning curve. This has been a necessary development in the face of growing use of the IT and (since 1998) BPO services market – more organizations increasing their individual ITO and back office (BPO) budget spend, and doing so on a multiple supplier basis. Indeed by around 2005 it was widely portrayed that “multisourcing”, as it came to be called (Cohen and Young, 2005), was the main game in town when it came to ITO and business process outsourcing. Unfortunately, practitioners’ application of this concept often sometimes left out the key notion inherent of selective sourcing, not just of external supply, but also of internal supply where warranted. There was also the vital question: what number of suppliers is optimal? Clearly the transaction costs of dealing with multiple suppliers could build to formidable levels, and the complexities of contracts and managing relationships could become daunting.

If the global IT outsourcing market was approaching \$US250 billion by 2008, then the new decade also saw the rapid growth of two related phenomena, namely business process outsourcing and offshoring. We have estimated that the market for mainstream BPO expenditure was likely to grow worldwide by 10% to 20% a year from \$140 billion in 2005 to potentially \$350 billion by 2010 (Lacity and Willcocks, 2009). Meanwhile offshore outsourcing revenues have been rapidly rising averaging more than 20% per annum compound growth since 1998 to reach well over \$US30 billion by 2010. The question about offshoring inherent in the title of our Chapter 5: “A Country Too Far?” has been answered by the obvious advantages in terms of cost, quality and speed often experienced using offshore providers, initially often for Y2K work leading up to the new decade. Subsequently the boom in IT and BP service provision in India, and, on our count, over 120 other locations worldwide has also made offshoring in both outsourcing and captive forms attractive. At the same time the caveat in that chapter has continued to haunt events and findings through 2000–09: like any outsourcing, offshore outsourcing needs very careful management, but it also throws up distinctive issues and challenges that can be very problematic.

In Part III of this book we provide six chapters that reflect such developments in the ITO, and the newer BPO and offshoring, spaces. On IT, Chapter 11 introduces and elaborates our concept of configuration, defined as: *a high-level description of the set of choices the organization makes in crafting its IT outsourcing portfolio*. The concept is derived from research into 49 ITO arrangements studied over time. We identify seven attributes – Scope Grouping, Supplier Grouping, Financial Scale, Duration, Pricing, Resource Ownership, and Commercial Relationship – as key descriptors of an organization's ITO configuration. The contribution of the chapter is its articulation of the concept of configuration as a taxonomy of ITO structural characteristics, the key attributes, and demonstration that configuration is an important concept for understanding, comparing, and managing ITO arrangements.

In Chapter 12 we revisit the issue of IT outsourcing intentions, outcomes and degrees of success, updating our perspective with new data. Based on results from three ITO surveys conducted during 1994–2000, a review of the literature, and data from 49 in-depth ITO cases, it is argued that although some organizations may, at times, seek outcomes from outsourcing similar to other organizations, fundamentally what each firm seeks from outsourcing is different. Accordingly, it is argued, studies that recognize the idiosyncratic and changing nature of outcomes sought are likely to offer greater insight into what comprises successful outsourcing. Developing this idea, the chapter proposes an ITO outcomes framework consisting of a comprehensive list of 25 goals that organizations, frequently pursue when outsourcing IT. In practice, we found organizations typically pursuing between three and seven such goals, in various combinations and with different emphases, but invariably with cost saving as one of them. Despite over 20 years of research the independent variable – IT outsourcing success – is surprisingly under-researched. Our key argument is that ITO success should be assessed by, first, asking organizations to nominate the outcomes that were/are most important to them at various times in the life of the contract, then second, gauging the extent to which each organization has achieved its nominated outcomes during the period when those outcomes were being pursued.

We provide an overview of developments in business process outsourcing in Chapter 13, which also then investigates in considerable depth the promise of the joint venture model, discussed above in the context of ITO, but this time in the post-2000 context of delivering BPO services. The particular company is a pure play BPO start-up called Xchanging which gained its first contract in 2001 and has since been particularly successful in getting additional clients, but also delivering service.

Two chapters follow that provide overviews and case studies of offshoring outsourcing practices. In Chapter 14, the offshore outsourcing journey of a US-based biotechnology multinational is detailed and lessons drawn from its experiences. Meanwhile in Chapter 15 the research investigates how

practitioners can invest the *right amount* of social capital to ensure that they get overall value from offshore outsourcing. In looking at a US Fortune 100 manufacturer of industrial equipment with over 75,000 employees spread across 20 countries, the chapter reports that, at a minimum, clients must invest in social capital by laying the foundation for trust (called the relational dimension of social capital), creating shared language, codes, and systems of meaning among parties (called the cognitive dimension of social capital), and designing social linkages among people (called the structural dimension of social capital). However, the research points to one important caveat: if clients invest too much in social capital, they will erode cost savings.

Our final chapter returns to our theme of operating a truly selective sourcing regime. The study in question looks at shared services as an in-house sourcing option, in this case as adopted at Reuters. Creating shared services requires a coordinated integration of four change programs: business process redesign, organizational redesign, technology enablement, and sourcing redesign. If managed properly, shared services reduce costs, improve services, and can even generate revenues. However, surveys show that many executives fail to achieve the promised results. In this last chapter, we present the lessons Reuters learned during a five year journey to create global shared services within their finance organization. Lessons address the right transformation approach, how to identify processes for shared services by analyzing the costs, attributes and readiness of process activities, and getting business unit clients and internal staff to cooperate and embrace the shared services initiative. It is a good way to conclude the documentation of a 20-year research program that has focused on outsourcing practice as part of larger concern for developing sourcing strategy aligned with business objectives.

## **Trends 2009 to 2014**

To give more context to the chapters and studies that this book contains, it is useful to suggest the larger trends we are seeing, and that our research reflects. Based on recent work we pinpoint the following 12 emerging trends.

**Trend 1: Spending will continue to rise in all global sourcing markets, but BPO will overtake ITO.** The global IT outsourcing (ITO) market has increased each year since we have been tracking it. Back in 1989, global ITO was only a \$9 to \$12 billion market (Krass, 1990; Lacity and Hirschheim, 1993ab). In 2007, the global ITO market was estimated to be between a \$200 to \$250 billion market (Blackmore *et al.*, 2005; Willcocks and Lacity, 2006). The BPO market in 2008 was less than the ITO market, but growing at a faster rate. We estimate that the market for mainstream BPO expenditure is likely to grow worldwide by 10% to 20% a year from \$140 billion in 2005 to potentially \$350 billion by 2010. BPO expenditure will be in areas such as the human resource function, procurement, back office administration, call

centers, legal, finance and accounting, customer facing operations and asset management.

BPO is outpacing ITO because many executives recognize that they undermanage their back offices, and do not wish to invest in back office innovations. Suppliers are rapidly building capabilities to reap the benefits from improving inefficient processes and functions. IT provides major underpinning for, and payoff from, reformed business processes. Thus, many of the BPO deals will swallow much of the back office IT systems. This is also evidenced by the shift in strategy of traditional IT suppliers like IBM, HP, and EDS to provide more business process services. Suppliers will increasingly replace clients' disparate back office IT systems with web-enabled, self-serve portals.

There have been some high profile back-sourcing (returning services in-house) cases in recent years, for example Sears (1997), The Bank of Scotland (2002), JP Morgan Chase (2004) and Sainsbury (2005). Although media-worthy, these cases have never represented a dominant trend towards back-sourcing. Based on our case studies and surveys, *the most popular course of action at the end of a contract will continue to be contract renewal with the incumbent supplier*. We also estimate that a quarter will be re-tendered and awarded to new suppliers, and only a tenth back-sourced.

**Trend 2: The ITO and BPO outsourcing markets will continue to grow through multi-sourcing.** Although ITO and BPO spend is increasing, the average size of individual contracts and the duration of contracts is decreasing. For example, the Everest Group found that among the ITO contracts signed in 1998, 24% of contracts were worth more than \$400 million and 33% of contracts were worth between \$50 and \$100 million. In 2005, only 11% of contracts were worth more than \$400 million and 57% of contracts were worth between \$50 and \$100 million. Concerning contract duration, the Everest Group found that 37% of contracts signed in 1998 were more than nine years in duration compared to 18% in 2005 (Tisnovsky, 2006).

How can we reconcile smaller, shorter deals with an overall increase in the ITO/BPO markets? All these figures suggest that client organizations are actively pursuing more multi-sourcing. Multi-sourcing has always been the dominant practice and the overall growth is driven by client organizations signing *more* contracts with *more* suppliers. While multi-sourcing helps clients access best-of-breed suppliers and mitigates the risks of reliance on a single supplier, it also means increased transaction costs as clients manage more suppliers. Multi-sourcing also means that suppliers incur more transaction costs – suppliers must bid more frequently because contracts are shorter, suppliers face more competition because smaller-sized deals means that more suppliers qualify to bid, and suppliers need to attract more customers in order to meet growth targets.

**Trend 3: Global clients will stop viewing India primarily as a destination to lower costs, but rather as a destination for excellence.** Within our case studies, we saw considerable evidence that US clients initially

engaged Indian suppliers to provide technical services such as programming and platform upgrades. But as these relationships matured, US clients assigned more challenging work to Indian suppliers. For example, a US retailer first engaged their Indian supplier to help with Y2K compliance. As the relationship matured, the retailer assigned development and support tasks for critical business applications to the supplier. From this retailer and other satisfied clients we heard, “*We went to India for lower costs, but we stayed for quality*” (Lacity and Rottman, 2008). Supplier executives we interviewed from three of the large Indian suppliers all mentioned their desire to assume higher-value tasks for their clients, like research and development.

**Trend 4: China’s investment in ITO/BPO services signals promise, but Western clients will still be wary.** Within China’s ITO and BPO markets, China invested \$142.3 billion in information and communication technologies (ICT) in 2006 (Lacity and Rottman, 2008). China hopes that its huge investment in ICT will pay off in terms of its ability to compete globally in the offshore services market. China’s long-term ITO/BPO future is expected to be strong. For example, The Everest Group estimated that the Chinese offshore services market was only \$2 billion in 2006, but it predicts that China’s market will grow 38% annually to reach \$7 billion by 2010 (Bahl *et al.*, 2007).

So far, the main ITO/BPO suppliers in China are either large US-based suppliers like Accenture, Cap Gemini, Dell, EDS, HP and IBM, or large Indian-based suppliers like Genpact, Infosys, Satyam, and TCS. Like Indian suppliers, many Chinese suppliers do not want to compete solely on low-level technical skills. Chinese suppliers are trying to show they can fill the needs for product development, systems design and consulting services.

Despite the optimism, many Western client organizations are wary of China’s ITO and BPO services. Language barriers, cultural barriers, and fears over losing intellectual property remain significant obstacles for the companies we talked to in North America and Western Europe. The Chinese government and Chinese business sectors are well aware of these barriers and are actively seeking ways to address them. For example, the Chinese government is investing \$5 billion in English-language training to target the ITO/BPO markets (Lacity and Rottman, 2008).

**Trend 5: Developing countries beyond India and China will become important players in the global business and IT services market.** In addition to India and China, suppliers from all six continents will develop centers of excellence. Many US clients already use Central American suppliers for Spanish-speaking business processes like help desks, patient scheduling, and data entry. Synchronous time zones are another favorable factor for US firms looking to source in Central or South America.

In Western Europe, organizations will increasingly source IT and businesses services to providers located in Eastern Europe. For example, the Visegrad-Four Countries (Czech Republic, Hungary, Poland and Slovakia) offer Western European firms closer proximity, less time zone differences, and lower transaction costs than Asian alternatives.

Even in Africa, many countries are actively seeking to become players in the global ITO and BPO markets. North Africa already exports IT services to Europe. One interesting study examined five Moroccan IT suppliers that provide services to clients in France (Bruno *et al.*, 2004). The common language, similar time zone, and cultural capability make Morocco an attractive destination for French organizations. South Africa is also exporting IT and BP services, primarily to UK-based clients. South Africa appeals primarily to UK-based clients because of the similar time zone, cultural similarities, English-speaking capabilities and good infrastructure. Even some sub-Saharan countries are building their future economies on IT.

**Trend 6: Large companies will give application service provision (ASP) a second look.** When we first published our book on ASP called *Netsourcing* in 2002, we noted that many large companies were not interested in ASP because they already had ASP product offerings and expertise in-house, they wanted customized services, and they wanted to source to stable providers, not risky start-up ventures (Kern *et al.*, 2002). Many thought that ASP died with the dot.com bust. But there are several reasons to believe that large organizations will reconsider ASP for targeted activities. First, large organizations will want net-native applications (proprietary applications designed and delivered specifically for Internet delivery) that are only available through ASP delivery (e.g., Salesforce.com). Second, large organizations may finally be ready to abandon their expensive proprietary suites, for cheaper ASP alternatives. Third, ASP providers got the message: clients want customized services, even if the products are standardized. The need for customized services actually increases the service providers' viability because they can generate profits by charging for value-added services.

**Trend 7: Outsourcing will help insourcing.** As organizations become smarter at outsourcing, they also become smarter at insourcing. In-house operations are facing real competition in nearly every area and can no longer assume they will retain their monopoly status with the organization. As a result, in-house operations are adopting the techniques of the market. However, insourcing will be impeded by a supply shortage of talent within developed countries, particularly for IT skills. The USA is not alone in this. Nearly every research report suggests that other developed countries will suffer a shortage of domestic IT workers within the next five to ten years. In the United Kingdom, for example, some research found that the UK will experience a shortage of 714,000 IT workers by 2010 (Aggarwal and Pandey, 2004). The shortages in developed countries will be caused by the gap between a strong demand for domestic IT workers and a dwindling

supply of domestic IT workers due to the lingering effects of declining enrolments today and future effects of “baby boomers” retiring from IT.

**Trend 8: Nearshoring will become more prevalent.** We define “nearshoring” as outsourcing work to a supplier located in an adjacent country. Compared to offshore outsourcing, the benefits of nearshoring include less travel costs, less time zone differences, and closer cultural compatibility. Canada, for example, is a significant nearshore destination for US clients. Some analysts argue that US clients can have lower total costs with nearshoring to Canada than with offshoring to India.

The Czech Republic, Poland, and Hungary are significant nearshore destinations for Western Europe. According to a report by Deutsche Bank Research (Meyer, 2006), imports of IT-based services from Central and Eastern Europe to Western Europe rose an average of 13% per year between 1992 and 2004. This growth rate is nearly comparable to the import of IT services from India, which averaged 14% per year over the same time period. Clients in Western Europe are attracted to Central and Eastern European suppliers for many of the same reasons that the USA is attracted to Canadian suppliers: common language, cultural understanding, minimal time zone differences, and low labor costs. However, Central and Eastern Europe may be more attractive for BPO than ITO because these countries provide excellent general education, but have not graduated IT students at near the pace of India. For that reason, IDC predicts that Western Europe’s growth in BPO will increase annually by 14.6% compared to 7.2% for ITO.

**Trend 9: Knowledge process outsourcing will increase.** Knowledge process outsourcing (KPO) is the outsourcing of business, market, and/or industry research. KPO requires a significant amount of domain knowledge and analytical skills. KPO suppliers design surveys, collect new data, mine existing data, statistically analyze data, and write reports. Although the KPO market was, in 2008, quite small, industry analysts expected a huge growth in this sector over the next five years. Evalueserve (2007) estimated that the KPO market in 2007 was \$3.05 billion and will grow annually by 39%. They expected the KPO market to be \$16 billion by 2010 or 2011, employing approximately 350,000 professionals globally.

The increase in KPO is directly related to our previous observation that offshore suppliers are moving up the value chain. As client/supplier relationships mature, the suppliers have gained an enormous amount of knowledge about the client’s business domain as well as the expertise to find, analyze, and report on domain knowledge. US, Canadian, and UK clients value this deep knowledge and will pay Indian suppliers \$20 to \$100 per hour for KPO services, compared to onshore rates of \$80 to \$500 per hour. Offshore suppliers are struggling to find enough workers with advanced degrees to fill the demand. But once hired, we anticipate that supplier employee turnover in this space will be lower because professionals finally

have the client-facing and intellectually challenging work they did not find in programming.

**Trend 10: More companies will sell their captive centers or create virtual captive centers.** While it is widely recognized that Western companies are setting up sites offshore, we also note an emerging trend that might be called “The GE Effect”. General Electric may not have been the first US footprint in India, but certainly Jack Welch’s enthusiasm for India made it acceptable for other CEOs to locate back offices in India. GE established GECIS (GE Capital International Services) as a captive center in India in 1997. In the winter of 2004, GE sold off 60% of GECIS to two equity companies, Oak Hill Capital Partners and General Atlantic Partners. A year later, the name was changed to Genpact, which is now one of the top ten BPO/ITO suppliers in India. Some have called GE’s approach “the virtual captive center” because GE still maintains primary equity holding (Aggarwal, 2007). With a virtual captive center, the company owns the physical operations, but the staff is employed by a third party supplier. Presumably the virtual captive center offers the best of both worlds – the client investor still maintains strategic control but the supplier is better equipped to attract, develop, and retain local talent.

Among our US clients, we have several examples of organizations selling their captive centers. Beyond the anecdotes, the Black Book of Outsourcing 2007 survey of 18,272 buyers found that selling captive centers may indeed be a significant trend. Among the survey respondents were 487 companies with captive centers in India and the Philippines. The survey found that 29% of these companies were actively seeking to sell out or already had an exist strategy in place. Respondents from large organizations were more likely to investigate a sell out than mid-sized businesses. The main reasons for selling captive centers were:

1. Captive center was built to protect data and intellectual property which is no longer viewed as a threat if provided by a third-party supplier
2. Senior executives are no longer committed to captive centers
3. It is no longer necessary to keep decision-making authority in-house
4. Third parties are now able to handle complex processes

There is a difference between the ITO and BPO captive centers: companies are much more likely to erect a captive center for BPO than ITO. We reason that the differences are attributed to higher maturity of Indian IT services compared to BPO, as well as the client view that BPO services are more critical to operations.

**Trend 11: Outsourcing failures and disappointments will continue.** Outsourcing will continue to be a high-risk practice with significant hidden costs in organizations where learning is sometimes painfully slow, in deals where suppliers do not make reasonable margins, and when client

organizations do not strategize, configure, contract for, monitor and manage their deals effectively. There will also be those suppliers who over-promise and under-deliver.

Extrapolating from past evidence, we estimate some 70% of selective sourcing deals will be considered relatively successful. Typically clients will be spending anything between 15–58% of their operating budgets on outsourcing. In contrast, we estimate that only 50% of large-scale deals involving complex processes that represent more than 80% of the operating budgets will be successful. Ironically, the client organizations with the messiest back offices will benefit the most from total outsourcing – if they can successfully manage the outsourcing life cycle. In contrast, companies that successfully clean up their back offices prior to outsourcing leave few opportunities for suppliers to add value.

**Trend 12: The global economic downturn will have mixed but deep impacts on these trends.** By 2008 we were seeing many of the client behaviors exhibited in previous economic downturns. These included: delaying making decisions to commit to new contracts; negotiating down rates in current contracts, looking for dramatic cost savings in new contracts; looking to reduce the number of suppliers used; looking to cut down on the use of outsourcing contractors; looking to offshoring destinations for either cheaper captive or outsourced service; looking to cut the amount of work carried out in existing deals; clients looking for better and longer term financing and asset transfer deals as part of their outsourcing arrangements. All this means suppliers will need to be sharper than ever in cost control, standardization, financial planning for themselves and clients, and also on innovation that plays into client's short- and long-term challenges.

Of course, where the downturn deepens, an increasing number of deals will get cancelled where clients cease to exist, or where mergers and acquisitions change requirements, or bring other rival extant suppliers into play. At the same time outsourcing is as likely to grow in a recession as it is in time of economic upturn, even though the terms of trade will be different, and the objectives pursued by the client may well have quite different emphases – that may well change quite quickly across the course of the deal.

It is likely that the 2007/8 global economic downturn will deepen and turn into recession and only pick up around late 2010. If so, it becomes even more important not to jettison the learning from the evidence on what works and what does not accumulated over the 20 year history of global outsourcing. Economic conditions and technologies change but sound management principles tend to be much longer lasting. For them, as William Faulkner once observed about the southern states of the USA: “The past is not dead. It is not even past”.

## Conclusion

In effect, our research has documented the 20 year rise to globalism of IT and business services outsourcing. The key quest for clients has been how to leverage the ever expanding services market for significant business advantage. The common denominator in the findings: we have uncovered no quick fix. Much depends on experiential learning and sheer hard work. Back office executives must conquer a significant learning curve and build key in-house capabilities in order to successfully exploit outsourcing opportunities. They need to accept that outsourcing is not about giving up management, but managing in a different way.

Suppliers have also faced learning curves in their attempts to differentiate their services, find new markets, and deal with new competition from potentially anywhere in the world. We find that a large player needs a mix of 12 key capabilities if it is to deliver on its full promise of cost-effective service delivery, strong relationships and back-office transformation. The 2007/8 economic downturn makes these capabilities, and suppliers' abilities to leverage them ever more critical.

The sheer dynamism of modern business and public sectors makes our lessons more important to learn and apply, and our trends more important to watch and take suitable action on. Moreover, as outsourcing spend increases, the alignment of business and sourcing strategy becomes a key issue, as does CEO and business executive involvement in outsourcing objectives, relationships and implementation. This requires a further advance in client thinking and action. One way of looking at our work historically is to say we have documented how organizations have been learning, experientially and often painfully, how to *manage* back-office outsourcing. But the increased size, importance, complexity of the phenomena, and the risks they engender, suggest that in the next phase we will be researching how organizations seek to provide *leadership* in outsourcing. Leadership is about shaping the context and mobilizing resources to deal with the adaptive challenges organizations face. In our glimpse into the future, it is pretty clear that changing business needs, the globalizing and technologizing of the supply of business services, and the much greater use of outsourcing, will provide challenges that will require this shift from management to leadership – if governance, control, flexibility and superior business outcomes are to be outsourcing's consequences.

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## Appendix A: "Energen": the future shape of IT sourcing?

**About the case:** We created this fictitious organization based on the actual experiences of several client firms we studied. The purpose of the case is to illustrate how client organizations may competently answer nine key questions on ITO:

1. Is this IT system or activity truly differentiating?
2. Are we certain that our IT requirements won't change?
3. Even if an information system activity is a commodity, can it be disaggregated from other IT and business activities?
4. Could the internal IT department provide this IS activity more efficiently than an outside provider could?
5. Do we have the knowledge to outsource an unfamiliar or emerging technology?
6. What pitfalls should we be on the lookout for when hammering out the details of a contract?
7. How can we design a contract that minimizes our risks and maximizes our control and flexibility?
8. What in-house staff do we need to negotiate strong IT contracts?
9. What in-house staff do we need to make sure that we get the most out of our IT contracts and keep control of our IT destiny in the face of changing technologies?

Energen's senior managers ran up against the limitations of an all-or-nothing, strategic-versus-commodity approach to IT, came to see that maximizing flexibility and control should drive their sourcing decisions, and then pursued a course that they were able to change along the way. A version of this case originally appeared in *Harvard Business Review* in 1995, as a way of indicating the direction client organizations would take were they to adopt the many better practices we had already uncovered in our research. The case forms a useful attempt to predict where outsourcing practice could, and should, lead to in the following decade. As such we will use it as a baseline later in this Appendix for assessing what actually happened from 2000–08 as documented by our research in Part III of this book.

### **Energen: decisions, decisions...**

In 1992, the CEO of Energen began to question the company's huge investment in information systems. Over the previous three years, almost every

division of Energen had reduced costs by 10% as a result of a major restructuring effort. The glaring exception was IT, whose costs had risen by 20%.

To Richard Andrews, the CEO, most of IT seemed like a commodity service. He began to wonder whether the company really needed to own and operate its huge data centers in Houston, Dallas, and New York; its private telecommunications network; and its 2,000 personal computers. When a company he contacted offered to buy Energen's IT assets for \$75 million and claimed that it could provide the same service as Energen's IT department for 9.0% less, Andrews was tempted.

Not surprisingly, Donald Peregrine, the vice president of information systems, tried to change Andrews's mind. He argued that IT was not just an expense: other departments had been able to cut costs or increase their business because of IT. Andrews conceded that Peregrine had a point and agreed not to make a hasty decision. He assigned John Martin, Energen's CFO and Peregrine's boss, to head a task force to explore the company's outsourcing options.

The task force, which included Peregrine and the vice presidents of the major functional areas, decided to start by dividing Energen's IT operations into two categories: commodity systems and "strategic" systems. Minimizing costs would be the paramount consideration in deciding whether to outsource the commodities. The commodities that an outside supplier could probably provide as well as and more cheaply than Energen could were the private telecommunications network, the three data centers, support for personal computers, central accounting systems such as payroll, and electronic data interchange.

For the strategic systems, maintaining high levels of service would be the priority. Certain activities were too critical to Energen's business to entrust to an outsider: analyzing seismic data, monitoring quality control in the refineries, and scheduling and tracking oil from the wells, ships, and pipelines. The task force decided to keep those systems in-house for the foreseeable future.

But as the task force members discussed how to proceed, the shortcomings of tackling IT in this fashion became apparent. For instance, they recognized that there were a variety of unknowns – in terms of both technology and issues facing Energen's business – that somehow had to be factored into their decisions.

For example, it was already clear that client-server technology was replacing mainframes and would change the way Energen deployed personal computers. The last thing Energen wanted was to be stuck with outdated technology. So the task force decided that the company should seek only a two-year outsourcing contract for its personal computers.

Another uncertainty was the payroll department. Energen was just beginning to consider whether to outsource the entire department, and Martin, the CFO, thought the company needed to make that decision before it could think about outsourcing the IT system that supported the function.

He had not forgotten what had happened several years earlier. Energen had signed a five-year contract with a supplier that would take over a significant piece of the IT system for the company's warehouses even though there was talk about closing some warehouses. Two years into the contract, Energen's management did decide to close the warehouses and had to pay the supplier a large fee to terminate the contract. Not wanting to repeat the same mistake, the task force postponed the decision about outsourcing the payroll department's IT system until the department's future was clear.

The task force also recognized that although an IT system might be a commodity, it could still be too critical to hand over to an outsider. One example was the telecommunications network that connected Energen's gas stations to headquarters. When Energen's managers had first considered outsourcing the network, seven years earlier, they hadn't felt confident that any of the existing suppliers would be able to keep the system up and running. But the problems that had prompted the company to consider outsourcing at that time had not gone away. The infrastructure was costly to manage, and Energen had had trouble retaining topnotch people: Several employees had left for more promising careers at communications companies. In the end, the task force agreed that Energen should see if there were now more qualified suppliers out there.

The telecommunications discussion sparked a realization: An IT system could be critical but not differentiating. Perhaps the word "strategic" was misleading language in this context. That is, a system could be crucially important without differentiating Energen from its competitors. In this light, the task force saw that of the three systems originally labelled "strategic", only one – the system for analyzing seismic data – truly was. Although many oil companies that engaged in exploration and production had such systems, the task force thought that Energen's enabled the company to excel in analyzing reserves.

The task force then realized something else: just because an IT activity was business-critical or even "strategic" did not mean that all its elements had to be kept in-house. Take the system for scheduling and tracking oil. It was clearly critical and had to be kept in-house, but did the same apply to a major upgrade of the system's software? This question was especially pertinent because Energen wanted to update the software and was going to hire an outside developer for the project. Martin argued that although state-of-the-art software was critical, the software itself would not give Energen a competitive edge, because the company's rivals maintained similar systems. He convinced everyone that Energen would have a better chance of getting the best possible software if the developer was allowed to sell it to other companies.

### **How to choose suppliers?**

Having decided what to outsource, the task force then turned to the job of choosing suppliers. The first step was designing a process. The group concluded that seeking relatively short contracts was a good idea. It also

decided that Energen should solicit separate bids for each service. Adopting this approach would ensure that the company could tap suppliers' particular strengths and would prevent any one supplier from ending up with too much power. Peregrine, the vice president of information systems, knew of several organizations that had come to regret their decision to outsource large portions of their IT operations to only one or two suppliers. In one instance, a supplier had charged extra for dozens of services that the company had assumed were covered in the base price and had dragged its feet in introducing new technology.

The members also agreed that they could not automatically assume that a supplier would outperform their own IT department and decided that the department should be allowed to compete when such doubts arose. Peregrine said the data centers were a case in point. The centers had long been forced to satisfy individual users' idiosyncratic needs, resulting in inefficient practices. If his department had the authority to institute best practices, it might be able to operate the centers more cheaply than a supplier, which had to earn a profit. Further, he said, until the department found out how inexpensively the centers could be run, it wouldn't be able to negotiate a good contract with an outside provider.

After the task force agreed on the basic approach to outsourcing, teams consisting mostly of IT managers were formed to request proposals for bids for each contract. With their deep technical knowledge, the managers had the clearest understanding of the company's IT needs. But, fearing that it would be difficult for them to weigh internal and external bids objectively, the task force decided to make the final decisions itself.

The company then started negotiating bids. It found a supplier willing to sign a two-year contract for the personal computers; the deal promised to cut Energen's PC-related costs by 10%. And when Energen negotiated the contract to develop the scheduling and tracking software, it gave the supplier the copyright in exchange for a discount.

The IT department's bid for the data centers was based on a plan for consolidating the three centers into one, thus cutting costs by 30%. That bid was lower than both external bids. One outside bidder then proposed a joint venture with Energen's IT department. Peregrine rejected it. He feared that the combined challenges of consolidating the centers and getting the joint venture on its feet would be overwhelming and that service to Energen would suffer. The department's bid prevailed.

When the task force turned to the telecommunications network, it discovered that there were now qualified providers. Energen awarded a four-year contract for its network to a respected manufacturer of midsize computers that had acquired expertise running its own world-class private telecommunications network. The task force transferred all the employees that had supported Energen's network to the supplier except for two experts, whom it retained to manage the contract.

Because Energen knew what it took to run the network, it was able to hammer out a detailed contract aimed at ensuring that the supplier met Energen's demanding performance requirements. The supplier would have to pay \$50,000 the first time network availability fell below 99%, and the penalties would escalate with each subsequent lapse. In addition, if Energen decided not to renew the contract, the supplier would have to cooperate in making the switch to a new supplier. For example, it would have to furnish copies of all programs, data, and technical documentation and also provide installation assistance.

### **Continuous learning**

The process of outsourcing the personal computers and consolidating the data centers went smoothly. But other transitions were rockier. One lesson Energen learned was that technical people accustomed to running an internal IT operation could not necessarily make the leap to managing an outsourcing contract.

For example, the two Energen experts retained to manage the telecommunications contract had difficulty understanding that their job had changed. Instead of actually operating and maintaining the network, they were now responsible for interpreting users' needs and communicating them to the supplier. When a technical problem arose, the two experts still wanted to solve it themselves rather than just report it to the supplier's account manager, who argued that technical matters were his domain. Peregrine intervened and recruited one of his data-center managers, who had overseen Energen's hardware leases. The two experts were retained as consultants.

Separately, the company clashed with the telecommunications supplier over the interpretation of the service levels outlined in the contract. For example, Energen had assumed that the 99% availability requirement meant that all nodes on the network had to be up and running 99% of the time. The supplier, however, interpreted it to mean that the host node had to function 99% of the time. When links to 20 of its service stations went down, Energen demanded a cash penalty, which the supplier refused to pay.

Six months into the contract, Energen discovered that it could pressure the supplier by offering a carrot. Energen had expanded into the Midwest by buying a regional oil company's service stations in five states. The supplier, which wanted to get the contract for the stations' network, agreed to renegotiate the service requirements. Energen awarded the new contract to another supplier but told the first supplier that if its performance improved substantially, it might win the contract for the new subsidiary in two years, when that contract came up for renewal.

Finally, with the emergence of client-server technology as a cheaper, more flexible alternative to large mainframe operations, Energen eventually decided to outsource the data center. The company was no longer fully uti-

lizing its mainframes, but it didn't want to invest the time and energy to find outside customers for its excess capacity. Another reason to outsource the data center was to free up the company's applications experts to develop programs for the client-server networks. It was unreasonable to expect the programmers both to continue supporting the mainframes and to develop client-server applications.

Did the company regret not outsourcing the center originally? No. As Peregrine had argued at the time, his department had found the most efficient way to run the center, and the company's knowledge of the operation enabled it to negotiate a strong contract later.

### **Commentary on Energen**

In confronting whether and how to outsource their IT operations, Energen's senior managers acknowledged what they knew and what they didn't or couldn't know about their business, the course of technology, and the capabilities of outside providers, and of the company's own IT department. Then, with the goal of maximizing flexibility and control, the managers sought bids from many suppliers, let the IT department compete for parts of the business, negotiated short-term contracts, postponed some outsourcing decisions, and retained managerial control of business-critical operations. Finally, they realized that deciding to outsource an IT activity was not the end of the manager's work. The case points to ten valuable questions practitioners need to ask, in order to formulate and deliver IT sourcing strategy:

**1. Is this IT system or activity truly differentiating?** We found that most IT systems or activities that managers consider differentiating actually are not. In the 1990s research we found very few systems differentiating companies from their competitors. There is a difference between IT that is a "critical differentiator", i.e., gives your business competitive advantage in the marketplace, and one that is a "critical commodity", i.e. underpins your business strategy, and is a minimum entry requirement to operate in the sector, but gives no competitive advantage. By way of illustration Lacity and Willcocks (2001) cited British Airways airline reservation system in the 1990s as a critical differentiator, but its aircraft maintenance systems as a critical commodity. The former should be retained in-house, the latter is in principle outsourceable. Many managers try to make a system differentiating by investing in fancy equipment and customized software. All too often, however, they find that even after they spend lots of money, their systems still do not differentiate the company from its rivals, especially given the pace at which rivals can develop similar systems of their own.

**2. Are we certain that our IT requirements won't change?** The rise of new technology, of course, will change a company's IT needs. By the late 1990s organizations were experiencing two generations of technology every five years. How can you contract for the implications of such change?

In addition, whenever a company plans to move into a new market or faces potential changes in its existing market, or is involved in a merger or acquisition, its IT requirements may change.

**3. Even if a system is a commodity, can it be broken off?** Many senior executives think of IT as something that can be plugged and unplugged, like an appliance. But most systems are integrated parts of the businesses they support and cannot be so easily separated. For example, decisions concerning the payroll data center cannot be made independently from those concerning the payroll function. Many IT systems require data from or feed data to other systems and therefore cannot be successfully isolated and handed over to an outside provider. As obvious as it may sound, many managers do not seem to consider that when they make outsourcing decisions.

**4. Could the internal IT department provide this system more efficiently than an outside provider could?** As argued above, one challengeable assumption is that inherent economies of scale, highly skilled people, and superior practices allow external suppliers to provide IT commodities more efficiently than an internal IT department ever could. We found, however, that many IT departments have equally sophisticated technology and adequate economies of scale but aren't allowed to adopt the best practices that would help them match or beat a supplier's bid. By inviting their IT departments to bid for the contracts, companies accomplish two things. First, they motivate their employees to find ways to provide good service at a lower cost. Second, such companies gain a much deeper understanding of the costs of a given service and the best way to provide it.

**5. Do we have the knowledge to outsource an unfamiliar or emerging technology?** A company cannot control what it does not understand. Many managers think that because no one in the company has enough technical expertise to assess new technologies, they should hand the job over to an outsider. After all, why devote internal resources to acquiring "esoteric" knowledge? Most of the companies in our studies that outsourced emerging technologies experienced disastrous results because they lacked the expertise to negotiate sound contracts and evaluate suppliers' performances. One alternative is to hire a supplier to team up with a company's IT staff on the project. Such an arrangement enables the company to learn enough about the new technology that it can negotiate a contract from a position of strength if it does decide to outsource.

**6. What pitfalls should we be on the lookout for when hammering out the details of a contract?** One of the biggest mistakes companies make is signing suppliers' standard contracts. Although large client organizations

rarely make this mistake, smaller client organizations sign supplier written agreements to reduce transaction costs or because they trust the supplier. Such contracts usually contain details that not even a company's legal staff can understand or unravel, especially if the company is outsourcing a technology with which it is not familiar. Among those details might be a lot of hidden costs. We also have seen numerous instances in which hidden clauses severely limited companies' options. In addition, many suppliers will try to maximize profits by charging exorbitant fees for services that customers assume are included in the contract, such as personal-computer support, rewiring for office moves, or even simple consultations about which equipment to purchase. But even companies that spell out every imaginable detail in a contract have often been frustrated by the unimaginable.

**7. How can we design a contract that minimizes our risks and maximizes our control and flexibility?** One way to hedge against uncertainty and change is by creating what we call a measurable partnership, in which the company and the supplier have complementary or shared goals. If a supplier is being hired to develop a new application, for example, the contract might stipulate that the company and the supplier will share any profits that come from selling the application. Another way to maintain control over outsourcing arrangements is to withhold a piece of the business from a supplier and use that potential contract as a carrot, as Energen did with the telecommunications contract for its subsidiary. Or a company can split an IT operation between two suppliers, thus establishing a threat of competition. A company should also try, whenever possible, to sign short-term (3–5 year) contracts. Short-term contracts are desirable because they ensure that the prices stipulated will not be out of step with market prices, technology will change less, staff turnover would be less, and they sharpen supplier concerns about contract renewal.

**8. What in-house staff do we need to negotiate strong IT contracts?** A negotiating team should be headed by the top IT executive and include a variety of specialists. Many of the worst contracts we saw were broad agreements negotiated by just the CEO with the help of corporate lawyers who were equally unschooled in technical details. However, although the CEO might not be involved in actual negotiations, he or she must provide the team with a mandate and thus authority with both internal groups and the supplier.

The specialists on the negotiating team should include at a minimum in-house technical experts with a deep understanding of the company's IT requirements; operational people who will have to deliver the contract; an IT outsourcing expert who can translate those internal requirements into the supplier's requirements; and a commercially-minded contract lawyer specializing in IT who can detect hidden costs and clauses in contracts. In

our research, we found that many companies fail to include one or more of those specialists – usually the IT lawyer or the outsourcing expert – on their negotiating teams.

**9. What in-house staff do we need to make sure that we get the most out of our IT contracts and keep control of our IT destiny in the face of changing technologies?** Few of the companies we studied staffed their teams sufficiently; some had only one or two persons. In addition, many companies underestimated the importance of contract management. Some mistakenly believed that overseeing the contract required little more than assigning someone to review the supplier's monthly bill. And many assigned a technical expert without considering whether that person could manage the complex relationships involved. In subsequent work Feeny and Willcocks (1998) codified in more detail the basis of core in-house IT capability. The research suggested that the future IT function had four tasks – eliciting and delivering on business requirements; ensuring technical capability; managing external supply; and governance, coordination and leadership. The key in-house capabilities are:

**IS/IT Governance** – “integrating IT effort with business purpose and activity”.

**Business Systems Thinking** – “ensuring that IT/e-business technologies capabilities are envisioned in every business process”.

**Relationship Building** – “getting the business constructively engaged in IT issues”.

**Designing Technical Architecture** – “creating the coherent blueprint for a technical platform which responds to present and future business needs”.

**Making Technology Work** – “rapidly trouble-shoot problems which are being disowned by others across the technical supply chain”.

**Informed Buying** – analysis of the external market for IT/e-business services; selection of a sourcing strategy to meet business needs and technology issues; leadership of the tendering, contracting, and service management processes.

**Contract Facilitation** – “ensuring the success of existing contracts for IT services”.

**Contract Monitoring** – “holding suppliers to account against both existing service contracts and the developing performance standards of the services market”.

**Vendor Development** – “identifying the potential added value of IT/e-business service suppliers”.

Part of this is an organization needing a team of technical experts to help them stay on top of changing technology, changing business needs, and the changing capabilities of available IT providers (both internal providers

and suppliers competing in the marketplace). This team can play a significant role in uncovering business opportunities by helping a company understand new ways to use IT. Very few companies have such a group. But without such teams, companies often pay more than they should because suppliers are constantly trying to sell services or technologies that are not included in the basic contract.

One of the team's missions is to look for gaps between the IT the company has and what it needs. With that goal in mind, the team should constantly benchmark the company's IT resources and providers, and should help the company decide whether to change course when an IT contract comes up for renewal. Another of the team's primary responsibilities is to assess emerging technologies. New technologies such as client-servers, object-oriented systems, and multimedia may sound very tempting, but will the company really be able to take advantage of them? The answer is no or not yet in a surprising number of instances. Of course, companies can hire consultants to carry out some of this work, but consultants may have their own agendas. For this reason, we think the team should consist of a core of in-house people who can assess suppliers' capabilities and determine which new technologies can best be applied to the company's businesses.

# Index

- Accenture 467  
 agency problems 268, 296  
 Ahmed, N. 99–100  
 Aladwani, A. 406  
 analysis theory of IT outsourcing 305,  
 309, 311, 314  
 Andersen Consulting 11, 195, 199,  
 345–8  
 Andrews, David 342–56, 364, 368,  
 380–1  
 Andriole, S. 468  
 Ang, S. 124, 405  
 Annan, Kofi 428  
 Anthony, R.N. 235  
 application service provision (ASP) 19  
 Apte, U. 105–6  
 arms-length relationships 290  
 AT&T 11–12, 292  
 Attenborough, John 342, 346, 349,  
 351, 356–7  
  
 back office functions 17, 21–3, 351,  
 386–7, 465, 486  
 backsourcing 17, 213  
 BAE Systems 340, 343–4, 353, 356–76,  
 380–6, 469, 474–5  
 Bah, Evan 161  
 Bailey, Alan 357  
 Bangalore 476, 482–3, 486  
 Bank of America 341  
 Bank of England 191–2, 204–7, 210  
 Bass plc 106–9  
 Bauernfeind, David 357  
 Beath, C.M. 303–4, 310  
 behavioral change model 349  
 Benbasat, I. 126  
 benchmarking 180  
 Benjamin, John 365, 380  
 Bester, Andrew 374, 378  
 “best-of-breed” sourcing 5, 280–1, 487  
 best-shoring 98  
 “blended” approaches to  
 outsourcing 486–7  
 Boland, R.J. 235  
 Bowen, Steve 363–6  
  
 BP Exploration 89–91, 190, 280, 345  
 Bramley, John 342–6, 354, 356, 380  
 Bravard, J.-L. 44  
 British Home Stores (BHS) 86–9, 93–4  
 British Telecom (BT) 200  
 Browne, John 89  
 budget restructuring 42  
 Burnett, R. 238  
 business process outsourcing  
 (BPO) 14–21, 339–87  
 business process redesign 468–74,  
 478–9, 482  
 buy-in contracts 8, 12  
  
 call centers 387, 482  
 Canada 20  
 capability maturity model 426, 457  
 career paths 455–6, 473–4  
 Carmel, E. 426  
 Carroll, J. 406  
 centralization 468  
 Chadwick, Andrew 348–9, 351, 366–7  
 Chandler, Barbara 363  
 change control procedures 239–40,  
 247, 259–60  
 Child, J. 233, 235  
 Child Support Agency 125  
 China 18  
 Choi, C. 83, 103  
 Clemons, E. 105, 118  
 Clinton, Bill 160  
 coaching 472  
 Codd, E.F. 109–10, 115–17  
 Commonwealth Bank 292  
 Competing for Quality review 159  
 competitive bidding 144  
 component-driven architecture 348  
 compulsory competitive tendering  
 (CCT) 62  
 computer-aided software  
 engineering 109, 112  
 configuration, *see* information  
 technology outsourcing  
 configuration  
 Continental Airlines 292

- Continental Bank 209  
contingency theory 296  
contracts 65–70  
    and the client-vendor  
        relationship 232–4  
    degrees of definition in 73–5  
    enforcement of 236, 247–50  
    need for formality in 83–4  
    neo-classical 76, 101–2, 118  
    role of 241–7  
    types of 7, 66–7, 73, 101–2  
control, concept of 235–6, 254–60  
cooperative relationships 82–5, 290  
Corbett, M. 331  
Corbitt, B. 268  
core business activities 190–1  
core capabilities and core  
    competencies 43, 192, 343, 377  
co-sourcing 124  
cost-based contracts 285  
cost control 41, 46, 248–9  
cost savings 5–9, 12–13, 40–1, 97, 100,  
    105, 178–81, 184, 226–30, 422, 425,  
    446, 465, 467–8, 484–6  
cost/service trade-off 229–30  
Craig, A. 182  
Craig Smith, A. 128  
creative contracting 276  
CRESTCo Ltd 191–2, 204–7, 210  
Cross, J. 190  
Cullen, S. 267, 315  
cultural differences 84–5, 420  
Cung, Glory 114  
Currie, W. 148, 178, 285  
Czech Republic 19–20
- data categories 404  
Date, Chris 109–10, 115–17  
Davenport, T. 126  
Dawley, D.L. 100  
DEC (company) 467  
Deloitte (company) 268  
Delta Airlines 11, 292  
Denzin, N. 392  
Department of Defence, UK 151  
Department of Defense, US 161–2  
Department of Social Security 125  
Dibbern, J. 274–5, 287, 290, 292,  
    303–4, 334  
Dickson, Chris 377  
dispute resolution 239
- Doherty, John 368–71  
Domberger, S. 309  
Dow Chemical 11  
duplication of success 51  
DuPont (company) 280
- Eagle Star Insurance 192  
Earl, M. 124, 285  
Earls, A. 268  
economies of scale 8–9, 41, 103, 150  
efficiency, proving of 49–50  
Eisenhardt, K.M. 235  
Enron 292  
enterprise partnership model 340–87  
equity issues 82  
equity relationships 290–2  
Ericsson (company) 276  
Everest Group 17–18  
“evergreen” contracts 287  
exaggerated claims for  
    outsourcing 51–2  
expectations about outsourcing 37–55  
    for business 42–5  
    financial 40  
    political 48–53  
    realization of 55  
    technical 45–8  
external service providers 8–9
- Fasone, Phil 113–14  
Faulkner, William 22  
fee-for-service outsourcing 7–13, 349,  
    376, 384, 387, 486  
Feeny, D. 101, 103, 117, 129–30, 146,  
    153, 182  
First City Bank 292  
Fischer, S. 235  
Fisher, Darren 357  
Fitzgerald, G. 86, 93, 100, 103, 129–30  
fixed-price contracts 285  
“flimsy” contracts 10  
Forehand, Joe 341  
Fowler, A. 310
- Gallivan, M.J. 276, 280  
Gartner Group 341  
General Atlantic Partners 351  
General Electric 21, 467  
generalisability of research  
    findings 331–3, 393  
George, Peter 380

- Ghoshal, S. 427  
 Giles, Adrian 361  
 Gopal, A. 407  
 Gore, Al 161  
 Granovetter, M.S. 459  
 Gregor, S. 305, 309, 311  
 Grover, V. 304, 306, 309–14, 331, 405  
 Guba, E. 128  
 Gudea, S. 400–1, 414
- Hackney, R. 292  
 Halvey, J.K. 234  
 Hancox, M. 292  
 Harvey Jones, Sir John 199  
 Henderson, J. 71, 85–6, 94, 103, 118  
 Hewlett Packard 98  
 Hilmer, F.G. 190  
 Hirschheim, R. 76, 93, 103, 167–8,  
 179, 315, 334  
 Hoenig, Christopher 169  
 Hofstede, G. 235  
 Holiday Inns 106–18  
 Houghton, Richard 356–7, 364,  
 368, 375  
 Huber, R.L. 190  
 Hugh-Smith, Sir Andrew 347  
 Hui, P.P. 303–4, 310  
 Hungary 19–20
- IBM 98, 161, 468, 486–7  
 ICI plc 190–1, 199–204, 210  
 IMP Group 104  
 India 17–21, 98, 111, 390  
 information sharing 379  
 information technology outsourcing  
   configuration 267–97  
   attributes of 276–92  
   model of 270–4  
   research on 274–5  
   testing of 292–6  
 Inkpen, A. 462  
 Inland Revenue 125, 144, 147,  
 183  
 insourcing 9, 12, 19, 57, 60, 115–16,  
 182, 189, 192–3, 213–31  
   archetypes of 220–6  
   different perceptions of success  
     and failure for 226–31  
   total 5  
 Insurance Underwriters  
   Association 340, 344, 353
- intellectual property 83, 105, 148–9,  
 446–7, 461, 464–5  
 internal bids for contracts 181,  
 230  
 internal IT departments 178, 194  
   advantages of 57  
 Internal Revenue Service, US (IRS)  
 162–9, 177–84
- Jeffs, B. 310  
 joint ventures 10–11, 98, 189–94,  
 292  
 Jones, W. 124, 281, 283, 285, 290  
 Jurison, J. 124
- Kanter, R. 10  
 Kennedy, Michael 107, 113  
 Kern, T. 147, 150, 270, 330  
 King, W.R. 304  
 Klein, H. 394, 422–4  
 Klepper, R. 104, 124, 281, 283, 285,  
 290  
 Knolmayer, G. 287  
 knowledge process outsourcing  
   (KPO) 20  
 knowledge transfer 419, 425–7, 456–8,  
 461–2, 465, 483  
 Kodak 4, 10, 37, 85  
 Kumar, K. 105
- labour shortages 19  
 leadership in outsourcing 23  
 learning curve effects 8, 14, 23, 211,  
 407  
 Lee, A. 126  
 Lee, J. 407  
 Lee, J.-N. 274–5, 285, 304  
 Lichtenstein, Y. 407  
 Lincoln, Y. 128, 392  
 Linowes, David 160–1  
 Lloyds of London 340, 344, 353,  
 383, 469  
 local government 125  
 Logistic Information Systems Agency  
   (LISA) 126–54  
 London Stock Exchange (LSE) 191,  
 195–9, 204–10, 347–9  
 longitudinal studies 127  
 long-term contracts 285–7  
 “loose” contracts 7–8, 73, 75  
 Lorange, P. 82

- McAulay, M. 310  
 McCarthy, Tony 355, 376, 383  
 McFarlan, W. 4, 12, 100  
 McNeese, Fred 177  
 Macneil, I.R. 234  
 Main, Chris 366–7  
 Malhotra, Y. 304  
 managerial practices 8–9, 383  
 Margetts, Mike 373  
 Markus, L. 126  
 Mason, R. 392  
 Melby, B.M. 234  
 mergers and acquisitions 43–4  
 Millar, V. 290  
 Mingers, J. 392–3  
 Mintzberg, H. 159, 178  
 monitoring of service levels and  
   products 250, 255  
 Moore, Bryony 351, 358–60  
 Morgan, R. 44  
 Morocco 19  
 Morris, John 362  
 motivation theory 83  
 mourning-forming-storming-  
   norming-performing cycle 349,  
   356  
 multi-media industries 84  
 multiple-supplier outsourcing 14, 17,  
   189–91, 210–11, 280, 404–5,  
   409–11, 461, 464–5  
 Myers, M. 394, 422–4
- Nahapiet, J. 427  
 National Health Service (NHS) 125  
 nearshoring 20  
 Newton, Daniel 107–14  
 Ngwenyama, O. 125  
 Nolan, R. 4, 12, 100  
 NV Philips (company) 91–3
- offshore outsourcing 14, 16, 20,  
   97–119, 267, 387, 389–428, 445–51,  
   455–6, 461, 465  
   decision factors for 99–101  
   definition of 389  
   research on 435–8  
   success rates for 390–1, 406  
 Oh, W. 276, 280  
 Oliver, C. 81–2, 93  
 open book arrangements 248–9, 379  
 organizational culture 84–5  
 organizational redesign 468–80  
 Orlikowski, W. 235  
 Osei-Bryson, K. 125  
 Oshri, I. 427, 448–9  
 Ouchi, W.G. 235  
 outsourcing  
   decision-making on 181–2, 210  
   definition of 60  
   determinants of 213  
   evaluated from a client  
     perspective 204  
   failures in 21–2, 39, 54, 129, 267–8,  
     390–1, 446  
   guidelines for success in 53–7  
   measurement of success for 303–34  
   problems with 64–5  
   scope and scale of 62–4, 97, 123,  
     193, 389–90  
   types of 188–9
- Palmquist, M. 321  
 participants' evaluations of project  
   outcomes 401–4  
 partnership arrangements 7, 10,  
   68–73, 76–7, 80, 86, 103–4, 118,  
   147, 182, 190, 198, 292, 331,  
   349–51, 354, 376–9  
   business-based 71–3  
   *see also* strategic partnerships  
 penalty payments 249–50  
 performance-based contracting 13,  
   124  
 performance measures 250–1  
 Perot Systems 11, 292  
 Pettigrew, A. 127  
 Phillips (company) 10  
 Poland 19–20  
 "politics" within companies 6,  
   39–40  
 Pollard, Alan 136–40, 147  
 Poppo, L. 406  
 Porter, M. 85  
 The Post Office 191–2  
 post-contract management and  
   control 235–40, 247–56, 260  
 power relations 94, 459–60  
 Prettejohn, Nick 375–7, 383  
 pricing frameworks 283–5  
 privatization 159–62, 178, 184  
   arguments for 160–1  
 Procter & Gamble 341, 475, 486

- profit-making by vendors 69–70,  
233–4, 255
- public-sector outsourcing 125,  
148–53, 159, 178
- Quinn, J.B. 190
- Racal Network Services 201–2
- Rajkumar, T.M. 100
- Ravichandran, R. 99–100
- reciprocity 81–2
- redundancy 484–5
- Reid, Kim 354–5, 360–1, 365, 379–80
- relationship-building 81–3, 255,  
260, 330–1
- relationship management 104
- research methodologies 59–61,  
127–8, 162–3, 187–8, 195, 214–19,  
392–5
- residual rights theory 287
- resource allocation 50
- resource-based view of strategy 377
- resource buy-in and resource  
buy-out 56
- retained capabilities 145–6, 153,  
179, 182–4
- Reuters 467–87
- Rich-Jones, David 368
- Richardson, Margaret 168
- Richmond, W. 407–8
- Ring, P.S. 82–3
- risk analysis framework 152–3
- risk assessment 477–8
- risk mitigation 123–30, 140–54, 192
- risk-sharing 75, 80, 94
- Robinson, Jim 376
- “rollover” contracts 286–7
- Roos, J. 82
- Rouse, A. 268, 334
- Row, M. 105, 118
- Royal Bank of Scotland 192, 207–10
- Ruggier, Paul 352, 361–2
- Saarinen, T. 101
- Sahay, S. 126
- Sambamurthy, V. 268
- satisfaction surveys 252
- Saunders, C. 309–10
- Scheepers, R. 331
- Scott, W.R. 82
- secrecy, problems caused by 455
- Seddon, P.B. 331
- Seidmann, A. 407–8
- selective outsourcing 5–6, 38–9, 56,  
124–5, 188, 194, 213, 268
- senior management, role of 48–53, 56,  
181, 227–9, 460, 484–6
- service level agreements (SLAs) 250–1
- shared services 16, 467–87  
definition of 467
- short-term contracts 7, 9, 12, 42, 56–7,  
65, 68, 285–7
- Six Sigma techniques 361–2
- Slovakia 19
- Smith, Dick 107, 113–14
- Sobol, M. 105–6
- social capital 15–16, 445–7, 454,  
458–66  
definition of 445
- social relationships 418–19, 425–7,  
445, 458–61
- sourcing redesign 469, 478–9,  
482–3
- South Africa 19
- spin-off companies 124
- start-up companies 44–5
- strategic alliances 7–13, 79–81, 85–6,  
93–4, 103, 189–94  
definition of 80  
and transaction costs 80–1
- strategic outsourcing 465
- strategic partnerships 56, 85–7,  
93–4, 342
- strategic planning, definition of 235
- Straub, D. 405
- succession planning 462–3
- Sun Microsystems 48
- supplier engagement models 406,  
412
- supplier relationships 280, 330–1
- Swiss Bank 11, 292
- switching costs 150–1, 290
- Symons, C. 93
- tacit knowledge 426, 449, 454
- technical services, standard of 45–6
- technical talent, access to 46–7
- technological innovation 47–8
- technology enablement 468–71,  
474–5
- technology maturity 101, 182
- Telstra 11, 292

- Tho, I. 125  
“tight” contracts 73–6  
Tjia, P. 426  
Toh, S.-K. 124  
Tollander, Greg 107, 113  
total outsourcing 5–6, 9, 12, 38–9, 43,  
79, 85, 93–4, 124–9, 189–94,  
210–11, 268, 283  
Toyota 377  
training 457–8, 463–4, 483  
transaction cost theory (TCT) 76,  
80–1, 101–2, 105, 287, 405–6  
transaction risk 105, 118  
The Travelers Corp. 102  
The Treasury 149  
troublesome business functions,  
elimination of 52–3  
trust in commercial relationships 292,  
378, 420, 446, 454, 456  
Turner, J.H. 83
- uncertainty, dealing with 74–5  
unit-priced contracts 285  
United States 159–61, 179, 184,  
*see also* Internal Revenue  
Service; Westchester County  
Unum Insurance 99
- value-added outsourcing 124, 290  
Van de Ven, A.H. 82–3  
vendor selection 143–4  
Vespsalainen, A. 101  
virtual captive centers 21
- Walsham, G. 126  
Welch, Jack 21  
Wessex Regional Health  
Authority 125  
Westchester County 161–3, 169–84,  
213  
Whipp, R. 127  
White, David 365  
Williamson, O.E. 76, 101–2, 118, 150,  
280–1  
“winner’s curse” in outsourcing 70,  
330
- Xchanging (company) 339–87, 475  
Xerox (company) 11
- Yin, R. 392
- Zeneca 191, 201–4  
Zenger, T. 406  
Zmud, R. 126

