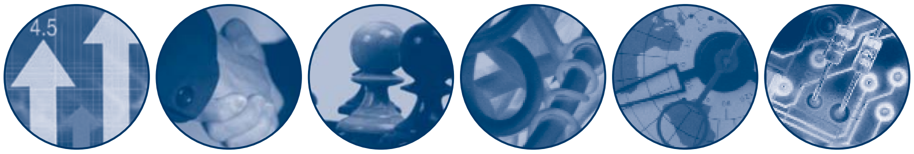

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Update

The AMCs of Modeling Your Outsourcing Contracts:

Mitigating the Risk of the One-Size-Fits-All Contract

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Many people have the view that an organization can let go of commodity functions but must not let suppliers get their hands on strategic areas. Others call that nonsense and use third parties wherever they think they should. The arguments over this point generally result from inappropriate generalizations made on either side.

Outsourcing is just not that simple to categorize as a binary (yes/no) issue. There are many forms of outsourcing as well as many ways to employ it strategically as a management tool and as a way to shape the resultant contract.

To help you understand some of the complexity, I developed the AMC (Advantage, Maturity, and Competence) Model more than two decades ago. This model provides a useful, high-level "helicopter" view of a framework your organization can use to consider its competence relative to its peers, the maturity of the market providing the services, and the degree to which activities are core/noncore in order to determine which outsourcing form is the best to use (see Figure 1).

In this *Executive Update*, each form of outsourcing will be discussed, followed by an examination of the dimensions.

OUTSOURCING FORMS

There are four different forms of outsourcing that can be applied — commodified, controlled, transitional, and distinctive — as well as a retain option, which we will discuss at the end of this section.

Commodified

Commodity outsourcing is characterized by having specifications and market prices that are well known and understood by buyer and seller organizations (e.g., PCs, data center operations). In addition, commodity outsourcing uses industry standard key performance indicators (KPIs) for service components. To make a commodified contract work, you cannot want anything outside the mainstream and must have very certain scope requirements. All this allows you to use industry standard/template contracts (from the buyer's perspective) — a very basic tool for very basic needs.

Controlled

Controlled outsourcing is used when there are specific market risks, such as few providers, coupled with high switching costs and long switching periods. In this case, you are unlikely to invoke any termination rights you might have because (1) there are few alternative sources of supply, and (2) there is a long setup time. Alternative solutions that you can

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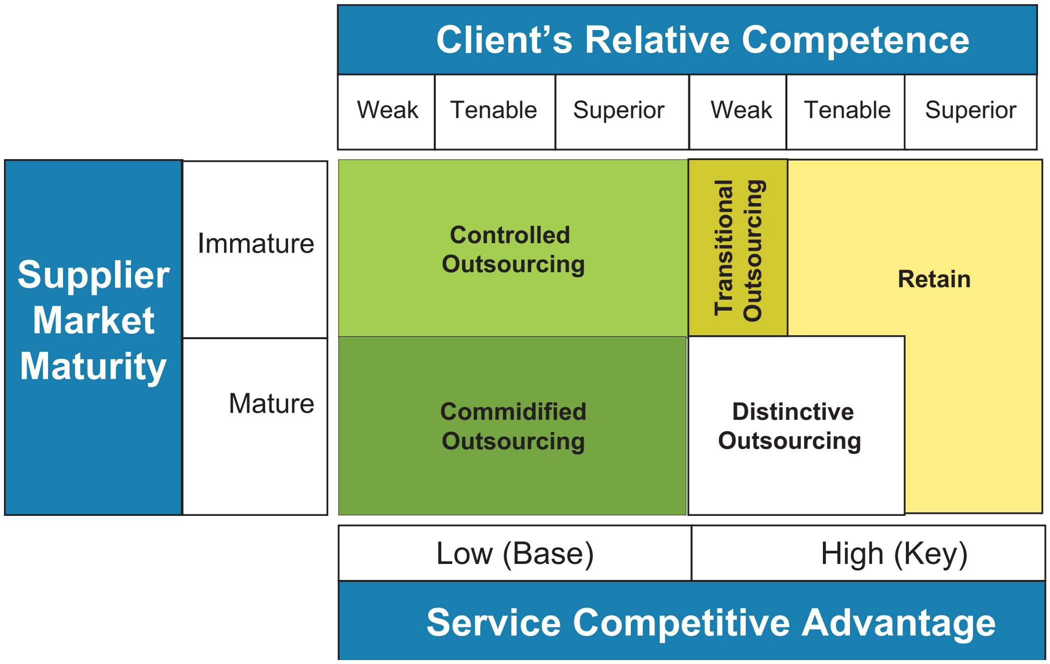

Figure 1 — The AMC Model.

employ must be included in your contract; for example:

- Benchmarking provisions that help keep costs and service levels near the current market (since you cannot easily switch providers).
- Relationship management techniques that build a strong affiliation between the parties, such as a governance charter [1] and a relationship values charter [2]. Your dependence means you cannot afford to have a dysfunctional relationship and cannot afford to allow either party to manage the contract ineffectively.
- Proactive joint issue management that involves a system whereby both parties can raise and resolve issues before any have a chance of becoming a disputer; invoking third-party dispute resolution clauses is expensive and often does not yield win-win outcomes.

Transitional

Transitional outsourcing is designed to help you obtain something you do not currently have. A common arrangement of this type of outsourcing is one where you want to gain internal expertise not currently present in your organization. You use the market to gain such knowledge so you can then backsource the work if you want to. Knowledge transfer techniques are key elements in this case (i.e., secondments, training, and keeping ownership of any intellectual property development).

Alternatively, you may want to put in technologies you do not have without having to outlay a huge capital investment. In this manner, you can "piggyback" on existing platforms of providers until the price point of the technology is such that you can economically afford to set up your own operations. In this case, disengagement provisions are key, whereby the provider has a contractual obligation to help you set up your new shop, sell the technology you are using at fair market value (or book value, if you have agreed to that), and provide post-termination support at agreed rates.

Distinctive

In the distinctive form of outsourcing, your needs are either fairly new or unique in the market or you want to restrict your competitor's access to proprietary know-how, technologies, or applications that the provider will inevitably acquire expertise in (thus keeping competitive advantage). In the case of the latter, the contract most certainly will have you owning all the ownership rights in developed intellectual property, will have identified key personnel that would individually sign confidentiality agreements (in addition to the provider's obligations), and might have the right of termination should the provider win a contract to provide similar work to that of the buyer. (Note: you generally cannot stop the provider because most countries have a fair trade act that prevents you from restricting your suppliers' trade without compensation.)

In the case of the former, your unique requirements necessitate carefully constructed contracts not catered by standard contract templates.

One example of this is using multiple competing providers to deliver end-to-end IT solutions where providers are not accustomed to collaborating with each other and would not naturally do so. While becoming more common, it is still an immature capability of most markets and the providers that comprise those markets. Accordingly, organizations have to create solutions where there is no template. These solutions include:

- **Joint management committees** — made up of representatives from all the providers and the client organization (chaired by the client, of course)
- **Colocation** — where key personnel from all the providers are colocated at the client's site to form closer working and personal relationships
- **A cross-provider management agreement signed by all providers and the client** — clearly stating how all the providers are expected to work together, collaborate, and innovate (and what happens if one does not)
- **KPI portfolios** — individual provider KPIs within their scope, as well as end-to-end KPIs for which each provider refunds a portion of the fees commensurate with their contribution if failure occurs or shares in a reward for success
- **Provider satisfaction surveys** — not just of the client's satisfaction with the providers but also each provider's satisfaction with the others
- **An inhouse integration unit** — ensuring seamless workflows and acting as the "lubricant" in responsibility handovers between providers

The Retain Option

This particular model's primary purpose is to help you decide what form(s) of outsourcing arrangement you might require, rather than to help you decide whether or not to outsource; for that, your business case will need to decide whether adequate value for money can be achieved with manageable risks. That said, there is a clear retain option displayed in Figure 1, for when you have at least tenable competence in strategic areas in immature markets or superior competence in mature markets.

However, some organizations use this superiority to offer value to other organizations through commercializing the inhouse activity. We have seen this, for example, with Philips Electronics forming Origin to sell its development and operational IT capability on the IT services market.

DIMENSIONS THAT APPLY TO OUTSOURCING FORMS

Look at Activities Not Critical for Competitive Advantage

Outsourcing any part of an organization fundamentally implies an in-depth understanding of the core competencies and technologies on which the organization intends to build its future competitive advantage. This dimension looks at the importance of the service in terms of its contribution to the organization's sustainable competitive advantage.

If an activity is not creating competitive advantage, is the organization overly investing in it? There may be better investments an organization can make with its human/asset capital for greater effect. In fact, retaining marginal commodity activities may result in competitive disadvantage if competitors are better at leveraging scarce resources. Being the best at nonadvantage activities is easy to be proud of, but shouldn't the organization really be best at something else?

If the organization is superior at a noncore IT activity, it may have unlocked shareholder value that can be realized through the sale or commercialization of the function, and then could use an outsourcing contract with the new entity to provide ongoing service. The market maturity will then drive the type of outsourcing model needed — whether it is controlled or commodified.

Of course, another alternative if you are more competent in an IT activity than the market, in terms of cost and capability, is to keep the activity inhouse for the meantime and look to outsourcing later when the market has caught up on price/performance.

Look at Maturity of the Market

The next dimension looks at the maturity of the suppliers and the market in the locations relevant to your organization.

In a mature market, there are many very experienced providers, switching costs are low, and switching time frames are short (so that termination clauses can economically be invoked). If the market is mature, a commodified outsourcing arrangement can be the starting point.

If the market is immature (few suppliers or immature capabilities), a greater degree of control is required in ensuring ongoing benefits, accelerating the market's capabilities, and developing alternative competitive supply; hence, a more controlled style of outsourcing is required. Control can be obtained through numerous means — for example, multisourcing, whereby one provider can step into the work of another if need be; a panel, whereby each provider must regularly compete for work; or a phased approach, where you outsource one part and package further parts for competitive bidding at a later stage as capabilities mature or the market becomes more competitive.

Look at Your Organization's Relative Competence

The third dimension looks at your organization's relative competence in the area compared to the market and your competitors in terms of effectiveness, cost, and value.

Are there activities that can deliver competitive advantage but your organization does not possess the competence? Transitional sourcing can bring that competence to the organization, typically buying in external competencies to work under inhouse management control and facilitate transfer of learning in order to build the competence further. However, you will need to design the arrangement to transfer the requisite knowledge while keeping options open for backsourcing as your relative competence grows.

Does the organization have at least a tenable position in competitive advantage activities where the market is not mature? The organization will want to retain these services inhouse and not let its competitors have access via suppliers.

If you are considering outsourcing mission-critical areas where you are at least equal in competence to an immature market or superior in a mature market, you really need to ask yourself why. Just because something can be outsourced does not mean it should be (even if you believe the 20% cost savings myth so often bantered about).

CONCLUSION

A particular deal may require that all forms of outsourcing are employed in different capacities. For example, a single global PC supply contract may be commodified in the US because the logistics chain is reliable and efficient, but could require controlled contracts elsewhere due to the lack of mature logistics/distribution chains (i.e., in Eastern block and African locations). Or perhaps the PC supplier does not have its own distribution chains but rather relies on resellers whose services and capabilities differ substantially between them. In such cases, a master agreement can be reached with the supplier on price, but each location is likely to need another agreement with the reseller on delivery dates, recall, and warranty fix turnaround times.

In another example, an operations contract may have the legacy mainframe operations under a commodified contract, while putting a new platform in place goes under a transitional arrangement, which will be your proprietary system under a distinctive contract.

Further still, a help desk arrangement for standard level one support (which can use a commodified arrangement) may be offshored (which requires a controlled contract) while also actively seeking to diagnose caller issues and reduce dependence on the help desk (needing a transitional arrangement).

It is important to acknowledge the different outsourcing models and choose the right mix of models to deliver on the situation of the organization, the context of the market, and the goals that the organization is seeking to accomplish through outsourcing.

Of course, no type of deal can deliver results if it is poorly constructed and managed. Hopefully, the AMC Model has shown you different ways of thinking about constructing a deal that will work for you.

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