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Whitepaper

In association with the London School of Economics Infomation Systems Group

The Outsourcing Enterprise
The CEO guide to selecting effective suppliers

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Releasing your potential

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Eight key supplier lessons from The Outsourcing Enterprise

Eight key lessons regarding supplier capabilities have emerged from our fifteen years of research into over 1200 organisations:

1. The supplier selection and negotiation phase is when the client enjoys most bargaining power. If this power is not used wisely at this point, there can be very negative repercussions. The CEO's authority and influence is a key resource in this process.

2. Customers need to assess suppliers' capabilities and competencies rather than their resources. Twelve key capabilities can be leveraged into delivery, relationship and transformation competencies that are of overriding importance to clients.

3. Choosing the right supplier model, or configuration of suppliers, is the essential first step. This is part of a sourcing strategy and the CEO should be closely involved.

4. Customers should assess a supplier's capabilities and competencies for each new business context: not every business context requires suppliers to excel in all twelve capabilities and all three competencies. In assessing suppliers there are three different sets of criteria: mandatory, qualitative and price.

5. It is vital for CEOs to avoid the 'winner's curse' – deals which excessively favour the client at the expense of the supplier, as these do not work to the client's advantage in the long run. The key for the CEO is getting the best value in return for a fair price.

6. Tendering is generally the most common and effective strategy to select suppliers. Joint decisions involving the CEO, business executives and IT are the most effective. Direct negotiation without tendering and competition is only for highly experienced clients.

7. The more interaction and transparency between client and potential supplier at bid and negotiation stage the better. A range of techniques have been developed to facilitate this on both sides.

8. Fundamentally, the client CEO has two key roles to play. The first is ensuring the right supplier is selected at the right price. The second is shaping the context and contract as well as staffing retained management such that the supplier will perform to the best of its capabilities.

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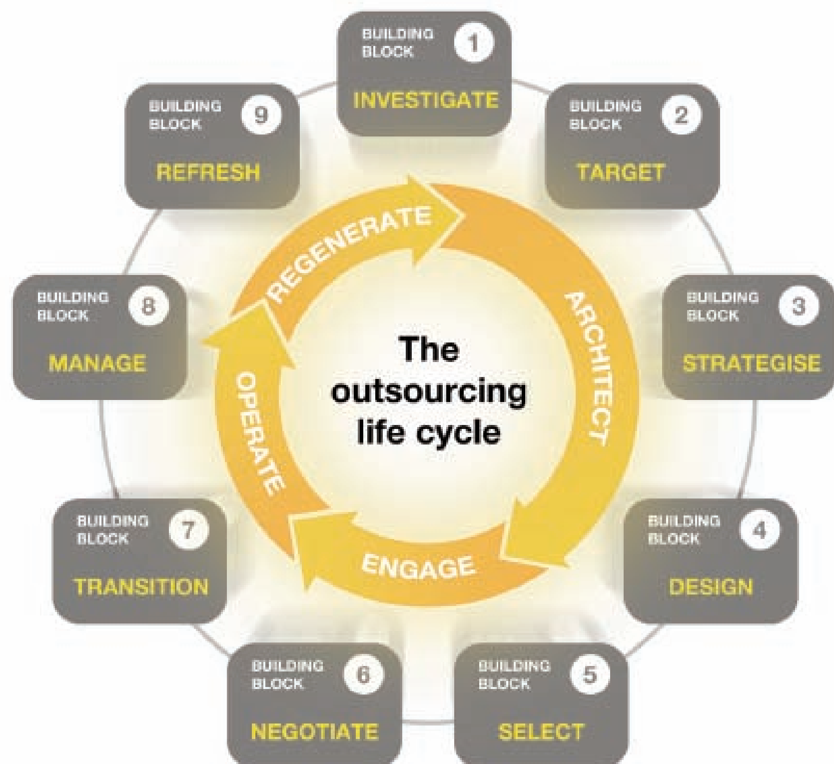
Introduction – capitalise on bargaining power

The evidence we have accumulated shows clearly: organisations that have the CEO and a multidisciplinary team involved in sourcing strategy and supplier configuration make more effective decisions.1 The CEO ensures the identification of clear business needs and objectives, and the availability of in-house IT sourcing capabilities and resources. As we demonstrated in the first Outsourcing Enterprise report, the CEO brings brains and influence, but also responsibility to key risk areas, because getting sourcing strategy and selection of supplier(s) wrong can hit share price, disable business strategy, as well as be very costly operationally. CEOs are responsible for shaping the four pillars of strategy, process, relationships and people. Our first report focused on the CEO role and strategic advantage, the second on the power of relationships. Here we focus on the supplier selection process and acquiring the right supplier competencies and people. Our research consistently shows that where these supplier capabilities are absent, CEOs leave themselves exposed to significant problems – however good the strategic thinking was, and however strong the contract drawn up.

Figure 1:
The outsourcing life cycle



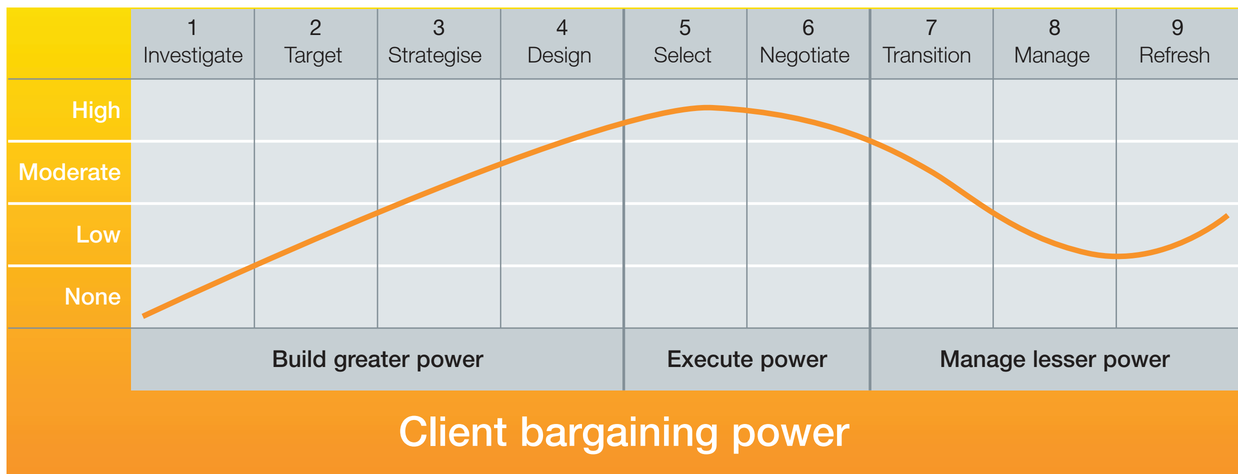
CEOs must be involved in selecting and managing the supplier because, while some organisations see outsourcing as an opportunity to pass on risk, in practice such risk displacement is largely illusory. In reality, an organisation is left very exposed when it chooses the wrong supplier. Moreover, the organisation itself can inhibit or facilitate supplier performance enormously. The CEO is responsible for making sure superior supplier performance is possible. One key part of the answer lies in helping to shape the supplier selection process.

As shown in our first two reports, outsourcing is most successful when managed as a life cycle not a one-off transaction (see Figure 1).

The outsourcing life cycle consists of nine building blocks in four phases. The first four blocks comprise the architect phase, which lays the foundation for the deal. The fifth and sixth blocks make up the engage phase, when the client selects the supplier and negotiates the deal. The seventh and eighth blocks make up the operate phase, when the deal is operationalised and managed. Regenerate, the final phase, is when the client assesses options and the cycle can resume.

The client's bargaining power fluctuates throughout this life cycle, as shown in Figure 2.

Figure 2:
Bargaining power and the life cycle



This report focuses on the engage phase - the select and negotiate phases, when the client's power is at its height. Clients can emerge from this phase with unrealistic expectations of what their responsibilities are, what the service provider will actually do for the price and how the deal will work out in practice. Organisationally and strategically, the CEO is the ultimate pivot of bargaining power and must be involved in forming and utilising this power. As a management process, the constant aim during the outsourcing life cycle is to build and manage relative bargaining power. Clients entering the engage phase of the life cycle without having first amassed the best possible bargaining power prior to negotiation, will find it almost impossible thereafter to improve their position.

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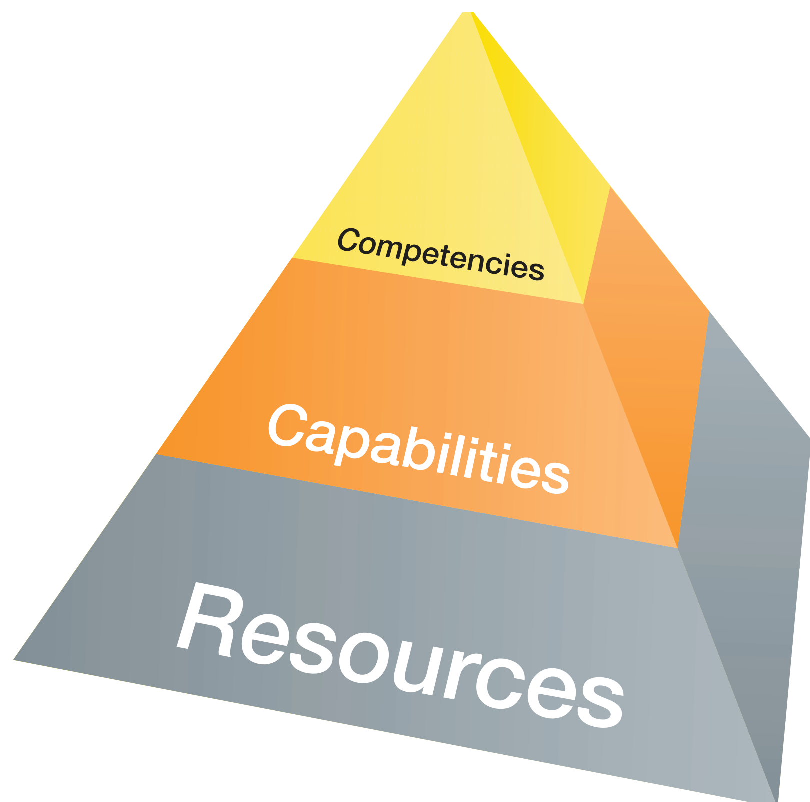
How to choose a supplier

Concentrate on capabilities and competences not resources

When evaluating suppliers, clients tend to focus on suppliers' resources because these are highly visible on site tours, balance sheets and resumes. But they should be more interested in suppliers' ability to turn these resources – its physical and human assets such as physical facilities, technologies, tools and workforce – into capabilities that, in turn, can be combined to create high-level customer-facing competencies. Figure 3 illustrates the relationship between these three types of asset.

Figure 3:
The relationship between supplier resources, capabilities and competencies



Our research has identified twelve key supplier capabilities that clients should look for. 2

1. Leadership

Leadership is the capability to identify and deliver overall success throughout the deal. A capable leader should not only have strong relationships with the client-side leaders, but must also have strong relationships with top management of the supplier's own organisation.

2. Business management

This is the ability to deliver in line with the service agreements and the supplier's and the client's business plans. The 'winner's curse' below discusses the possible outcome of the lack of business management.

3. Domain expertise

Domain expertise is the capability to retain and apply professional knowledge. The key here is not just a supplier's technical know-how. It also involves the much harder to acquire ability to understand the business and experience in a client's specific kind of sectoral back-office environment, for example procurement, IT, or human resources in a manufacturing environment.

4. Behaviour managment

The ability to motivate and inspire people to deliver high-level service is a key capability in suppliers. Those with patchy human resource records and that manage transferees indifferently will not deliver the qualitative service improvements expected.

5. Sourcing

This is the ability to access resources as needed. Clients should investigate supplier assertions on economies of scale, superior infrastructure and superior procurement practices. It is also vital to verify the availability of specialised professional skills and the dynamic areas of quality and costs of staff in offshore locations.

6. Process improvement

Process improvement is the capability to incorporate changes to the service process to meet dramatic improvement targets. Supplier track records can provide vital information on re-engineering for clients, and also the supplier's skills and change capability.

7. Technology exploitation

This is the capacity to swiftly and effectively deploy new technology, not just make promises. In our findings, a major reason that clients outsource business processes is to harness supplier IT capability and investment: investments that clients were unable or unwilling to make.

8. Programme management

Programme management goes beyond project-level capabilities to the capability to deliver a series of inter-related projects. Strong supplier capability in programme management can influence a client's decision to expand use of the supplier.

9. Customer development

How customer-focused is the supplier? This relates to the suppliers ability to enable their clients to become customers who are able to make informed choices about service levels, functionality and costs.

10. Planning and contracting

This is the capability to deliver 'win/win' results for customer and supplier. Does the supplier communicate its vision of the potential reward for both parties and a coherent process for achieving it? Do they contract in ways that facilitate or contradict this process?

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11. Organisational design

This is the ability to design and implement successful organisational arrangements. In practice suppliers vary greatly on their flexibility in this area. Some emphasise a 'thin' front end client team, interfacing with consolidated service units. This could constrain the ability to customise service and deliver to a specific client business plan. Others allocate most of their resources to 'enterprise partnerships' created for each major deal. Our research found quite major deals sometimes taking two years to optimise clientsupplier organisation fit. In offshore deals, we found clients frequently experimenting.

12. Governance

Clients must consider the degree of flexibility they require from the supplier. Lastly, is the capability to track and measure performance. The overriding responsibility for governance arrangements lies with the client, but every supplier will have some type of joint service review committee that defines, tracks and evaluates performance over time.

It should be noted that properly skilled, experienced and motivated people are fundamental components of each of these capabilities. The wise CEO contracts for the right mix of capabilities and, where possible, the personnel from the supplier organisation who guarantee them.

As can be seen in Figure 4, these twelve capabilities, in turn, can be leveraged into three important competencies: delivery competency, transformation competency and relationship competency.

Figure 4:
Twelve supplier capabilities

Delivery competency

The delivery competency is based on the supplier's ability and willingness to respond to a customer's day-to-day operational needs. Primarily, it involves the supplier's leadership, business management, domain expertise, behaviour management, sourcing, programme management and governance capabilities.

Transformation competency

The transformation competency is based on the supplier's ability to deliver radically improved services in terms of cost and quality. This competency mainly involves the supplier's leadership, behaviour management, sourcing, process improvement, technology exploitation, programme management and customer development capabilities.

Relationship competency

The relationship competency is based on the supplier's capacity and will to align itself with the customer's values, goals and needs. The primary capabilities within this competency are: leadership, customer development, planning and contracting, organisational design, governance and programme management. Among these, the planning and contracting capability presents the greatest challenges because it is very difficult to align customer and supplier incentives.

Most outsourcing relationships are still based on fee-for-service contracts, in which a customer pays the supplier a fee for delivery of a service. With a fee-for-service contract, the customer is motivated to squeeze the supplier for more resources and services without wanting to pay more. The supplier is motivated to squeeze as much profit margin as possible through contract add-ons and delivering only to service levels agreed. The customer has to ensure that the plans and contracts motivate the supplier to meet sourcing expectations. By far, the relationship competency is the hardest competency to find in a supplier.

CEOs should focus on the supplier's delivery competency when they primarily want the supplier to maintain or slightly improve existing services, such as maintaining legacy systems, operating data centres, or servicing a fleet of desktop devices. The CEO should be involved in focusing on the supplier's transformation competency when seeking radical improvements in costs and services and also on the relationship competency when seeking a substantial and long term commitment from the supplier. Consistently we find that suppliers cannot focus and utilise such competencies unless enabled by the client. The role of the CEO is to shape the context to ensure the supplier is properly empowered.

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Get the supplier configuration right

There are a number of ways to choose suppliers. The first involves deciding which configuration of suppliers best fits the client's purposes. The CEO must be aware of the options and be involved in the choosing between them. Pragmatically, CEOs and their fellow executives should be wise enough to recognise their own limitations in choosing supplier capabilities and configurations. The market for experienced professional outsourcing advisers is now quite mature and can be drawn upon for analytical work, information, facilitation and management. The process of selecting suppliers has also been translated into a template by several consulting companies and many CEOs will find such standardised practices useful. There are four configuration options: sole supplier, prime contractor, best-of-breed and panel.

Sole supplier

In a sole supplier configuration a single supplier provides the entire portfolio or deal. The benefits include sole accountability and seamless service, but this model can compromise service quality, as no one supplier is outstanding in all areas.

Prime contractor

A prime contractor arrangement consists of a network, with several suppliers under the control of the head contractor. It is a well recognised form of supply chain contracting. The head supplier is accountable and contractually liable for the entirety of the contract, but uses any number of subcontractors to deliver all or part of it. Typically, the subcontractors have expertise or operate in regions that the head contractor does not, or they are deployed by the client to support its local customers. Alliance networks where two or more suppliers offer services as a package is a long-term trend in outsourcing. Suppliers in this arrangement require contract provisions that limit what can be subcontracted and to which firms. They also require provisions which mandate the means by which the subcontractors will be monitored and controlled.

Best-of-breed

In a best-of-breed network, also known as multi-vendor, multi-sourcing or selective sourcing, the organisation has a number of suppliers and thus is in effect the head contractor itself. It represents a low risk outsourcing option that has been adopted by 75 per cent of UK and 82 per cent of US organisations.3 The benefits and problems associated with this option relate to competition: although competitive tension leads to continuous improvement and cost effective benchmarking, it is often difficult to manage suppliers working in keen competition with one another.

Panel

In a panel arrangement there is a list of preferred suppliers working in continuous competition. Interactions are many and brief and work is not guaranteed: each supplier competes on a regular basis for various contracts or work orders over a defined period. This approach is often used in applications development, hardware purchasing, and consulting, as the work tends to be periodic and the requirements vary with each initiative.

The benefits, risks and issues associated with each configuration are analysed in Table 1.

Table 1: Supplier configuration options

Option	Benefits	Risks	Management issues
Sole supplier	• Sole accountability • Potential to pass on economies • Streamlined contracting costs and processes • End-to-end key performance metrics	• Monopolistic supplier behaviours • Compromise quality where the supplier is not best of breed (in services, industries or geographic locations)	• Extensive contract flexibility rights due to the dependence on supplier • Independent expertise to avoid solution channelling and ensure value for money (quotes are market values)
Prime contractor	• Single point of accountability • Allows best-of-breed subcontracting • Streamlined, but a bit more complex, contracting costs and processes • End-to-end KPIs	• Prime must be expert at subcontracting (selection, management, disengagement) • Client may desire different subcontractors • Client often required to resolve issues between the prime and subcontractor/s • Primes and subcontractors often encroach 'territories'	• Contract ensuring various rights over the subcontracting (access, selection, veto, etc) • Compliance auditing ensuring the prime passes obligations to the subcontractors • Oversight ensuring all parties are operating as an efficient and united front
Best-of-breed	• Greater control • Flexibility to chop and change • Promotes competition and prevents complacency	• Attracting the market for small 'slices' of work • Keeping suppliers interested, giving management focus and allocating staff • Interdependent services and contracts • Integration complexity • Tracing accountability	• Designing interdependent contracts between independent suppliers • Multi-party interface and handover management • End-to-end process management is more difficult • Multiple life cycle management
Panel	• Buy services and assets when required • Promotes ongoing competition • Prevents complacency	• Attracting the market when panel is a pre-qualification and does not guarantee work • Adding new panel members or wanting to use suppliers not on the panel	• Panel bidding process for work • Ongoing ranking of panel members based on performance • Managing and evaluating the total program

Another way to choose suppliers is to look at the supplier market in which the client wants to operate. The CEO has three main choices: domestic versus offshore, local versus global and niche versus broad.

Domestic versus offshore

Offshoring has been mainly a 'best-of-breed' approach, although some organisations set up a prime contractor to manage offshore suppliers. Typical services for which the overseas labour market has shown superior cost advantages include applications coding, call centre operations, data entry and transaction processing. As a result, the offshore market has tended to be very niche-orientated. This is changing as the bigger offshoring suppliers become more global in intent and build their capabilities for most forms of business process services. In so doing, of course, they compete against existing global suppliers. Owing to offshore price pressure, all of these have also stretched, in reverse direction, towards developing offshore facilities. The interesting development here is 'bestshoring' – mixing offshore, nearshore and onshore in the same deal. Thus in its deal with a large multinational bank, an Indian provider has resources in Mumbai, Budapest, Netherlands, Luxembourg and Sao Paulo. This locates capabilities where they are best employed, at the best price to the customer.

Local versus global

Global providers are a common choice if an organisation opts for the sole supplier configuration, because of their international reach and broad service offerings. Such large suppliers have access to more resources and are better able to assemble and deploy SWAT teams as needed.

Niche versus broad

The respective advantages of these two types of supplier are described in Table 2. In their limited service offerings niche suppliers represent a 'best-of-breed' option and are either contracted directly with the client, or indirectly through a prime contractor.

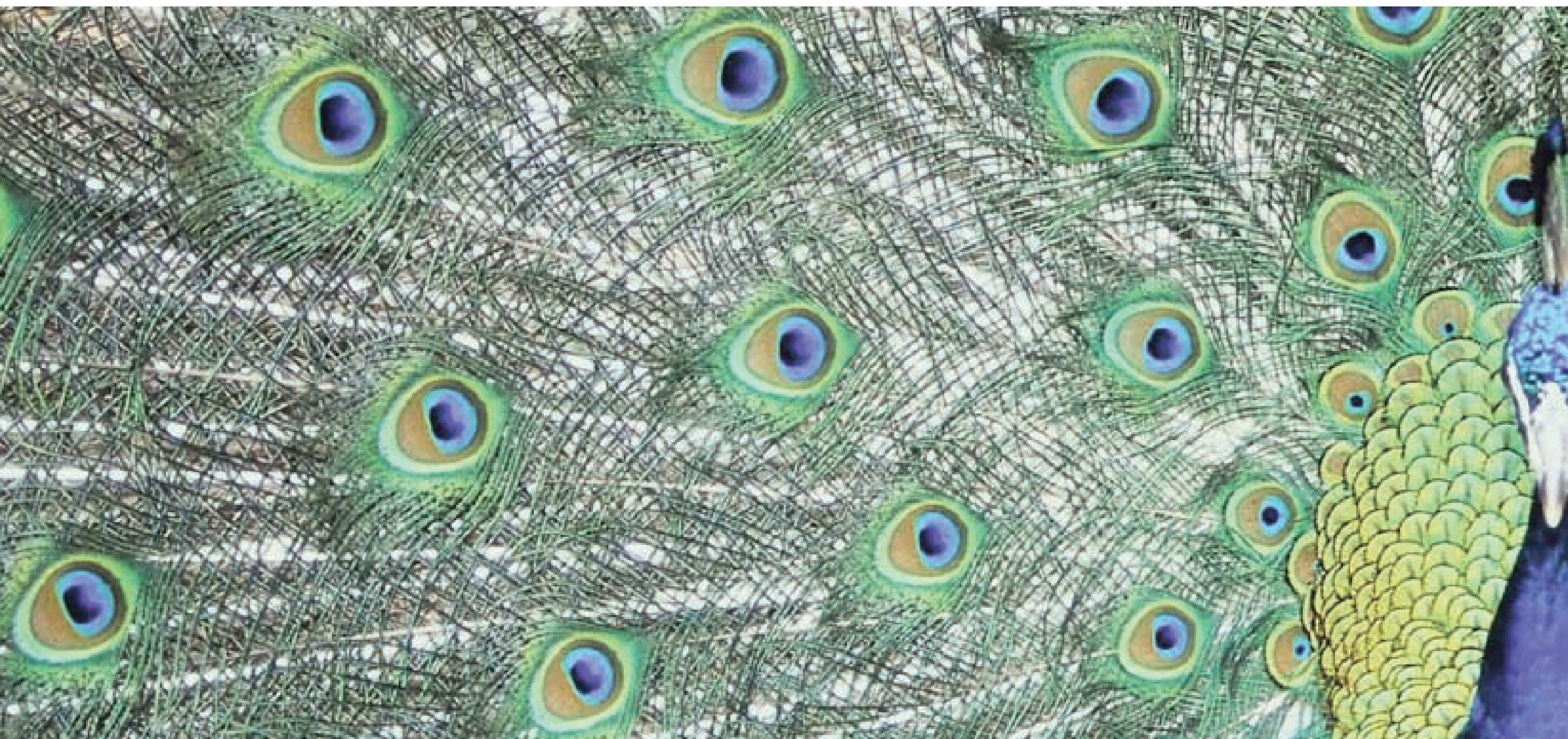

Table 2:
Niche versus broad

Table 2: Niche versus broad		
Supplier capability	**Niche supplier**	**Broad supplier**
Leadership	Supplier leaders will be well known and there will be easy access to CEO and straightforward deployment of resources	Harder to contact top management
Planning and contracting	Suppliers have more vested interest in the relationship because they cannot absorb or afford failures	The client should push hard for creative contracts, as suppliers have greater ability to absorb risk than niche players
Organisational design	Less formal design is required and the deal is more based on personal relationships	Formal organisational design is more important
Process improvement	Niche suppliers may rely less on processes (like Six Sigma, CMM) but make up for this with domain expertise	Broad suppliers may rigidly use CMM
Domain expertise	There will be better domain knowledge because of specialisation, but specific elements of business knowledge will still need to be transferred to the supplier	Clients need to pay special attention to knowledge transfer. Large suppliers can gain domain knowledge through the transfer of relevant employees

Supplier modelling: a case study

This case study illustrates how a CEO can compare current domestic suppliers with an offshore supplier, by assessing relative capabilities and competencies. The customer was a large US retailer with an eight-year relationship with a domestic supplier for legacy system maintenance and enhancement. The existing contract was quite large, with the supplier assigning nearly 500 IT workers to the account. The question was whether to award a large re-platforming project to the existing supplier or an Indian supplier. The existing supplier was seen as capable but costly. It charged US$100 per hour for programming, while the Indian supplier charged US$30 per hour. The Indian supplier had already performed well on some pilot projects, but the retailer had underestimated the extra burden of managing remote teams and the volume of re-work required because the supplier did not understand the business. These issues eroded much of the cost savings. Rather than letting the hourly rates dominate the decision, we show how the twelve-point capabilities model can help bring about an informed decision.

In this scenario, the retailer was primarily interested in the following supplier capabilities:

- leadership – who will be responsible?
- business management – can the supplier earn a margin on this bid?
- programme management – can the supplier organise, manage, test and transfer the large number of program rewrites?
- sourcing – will we get the supplier's best programmers and project managers?
- behaviour management – will supplier employees be motivated, productive and easy to work with?
- organisational design – where will supplier employees be located and how will we interface with the supplier organisation?
- technology exploitation – does the supplier have automated tools to develop and test the new platform?
- planning and contracting – what is the fixed price?
- governance – how will the supplier track, report and fix performance?

Because the re-platforming project was mostly technical and involved clear requirements, the supplier would not have to interact with end users, so customer development and domain expertise capabilities were not pertinent. Furthermore, the retailer was not seeking new processes, so the process design capability was also irrelevant.

The analysis in Table 3 shows that the domestic supplier had superior capabilities to deliver the project compared to the offshore supplier. However the Indian supplier had the advantage on contract price. The retailer decided to use the offshore supplier bid to pressure the domestic supplier to reduce its price by 10 to 50 per cent.

Table 3: The relative capabilities of the two suppliers

Supplier capability	Domestic supplier	Offshore supplier
1. Leadership	**Strong** The supplier had named a well-respected manager with a good support team	**Good** The supplier had named a well-respected manager but is less clear on who will serve in the supporting team
2. Business management	**Strong** Given the high cost bid, the supplier should have been able to deliver the project and still earn a profit	**Strong** Although the bid was low, the supplier cost base was low and should have been able to deliver and still earn a profit
3. Domain expertise	N/A	N/A
4. Behaviour management	**Strong** Supplier employees would ask the customer if they needed clarification. Many of supplier staff will have worked with the client before	**Weak** Supplier employees were eager to please but did not share bad news promptly. The supplier staff were mostly new to the client
5. Sourcing	**Weak** It was likely that the supplier would assign low level programmers	**Weak** It was likely that the supplier would primarily use new hires from Indian universities
6. Process improvement	N/A	N/A
7. Technology exploitation	**Strong** The supplier had performed this work in the past and had automated tools	**Strong** The supplier had performed this work in the past and had automated tools
8. Programme management	**Strong** The supplier had demonstrated this capability in the past	**Weak** The supplier relied heavily on an on-site engagement manager who was expected to fulfil too many roles
9. Customer development	N/A	N/A
10. Planning and contracting	**Weak** The supplier was very expensive	**Strong** The supplier's bid was 60 per cent lower than the domestic supplier
11. Organisational design	**Strong** Supplier staff were primarily on-site	**Weak** The supplier staff would be offshore, with an on-site engagement manager as the contact
12. Governance	**Strong** The supplier already had reporting processes in place and reported twice a week	**Weak** Although the supplier was CMM5, internal supplier reports were not shared, and in the past the client had had to request daily reporting

'We were paying about US$100 for commodity type coding (with domestic suppliers),' commented the director of contract management. 'The domestic suppliers saw the writing on the wall. We put out a bid to the approved list of domestic contractors and the current director of the project management office made it very clear that we were not going to pay those kinds of prices anymore. Our domestic prices dropped from about US$100 per hour to US$80 and some of the rates even dropped into the US$50 range for some services.'

However, by forcing the domestic supplier to reduce their costs the retailer weakened the domestic supplier's business management capability, i.e. its ability to earn a profit while delivering the service. Significantly, our research has found that domestic suppliers are increasingly using offshore captive centres to compete with Indian suppliers on costs, while leveraging their domestic presence to keep customer service levels high.

Apply appropriate selection criteria

Not every business context requires suppliers to excel in all twelve capabilities and all three competencies. Every supplier does not have to be a partner possessing a strong relationship competency. Some suppliers may be better at delivering commodity services, such as desktop services, for which the typical vendor management practices apply. Customers who want suppliers to maintain legacy systems will focus on the capabilities that enable the delivery competency. CEOs should be involved in seeking a supplier with a strong relationship competency if they are looking for a long term partner to serve as the primary source of IT services. Likewise the CEO must take responsibility when looking for a supplier to transform the IT function. The focus must be on the seven 'transformation' capabilities (see Figure 4).

Clients need to assess supplier capabilities and competencies in each new business context. A supplier's ability and willingness to deliver the twelve capabilities is not fixed across the supplier organisation, nor is it fixed in time. Because supplier organisations can be very large (some suppliers employ more than 100,000 people worldwide) and complex, a single supplier can present many different faces.

Suppliers' willingness to deliver the twelve capabilities also depends on their perception of the desirability of the customer. Customers assume – falsely – that all suppliers are vying to have their business. A supplier's willingness to 'go the extra mile' for a particular customer depends on:

- the prestige of the customer
- the degree to which the client CEO is personally involved
- the size of the contract
- the potential for additional supplier revenues and good profit margins with this client and with other clients because of this deal
- the opportunity to enter into new markets
- the opportunity for knowledge transfer to supplier
- the perceived risks
- the supplier headquarters' sales targets or other financial considerations, such as like meeting quarterly sales quotas.

The CEO must be involved in creating a strategy for influencing and creating incentives for the supplier to go that 'extra mile'. As one executive observed, 'I see myself in competition with all its other clients for the supplier's prime attention and resources'.

When the selection process has begun, there are three main types of criteria that should be used to evaluate suppliers: mandatory, qualitative and price.

Mandatory criteria – the first gate through which the bidders must pass

Mandatory criteria are 'drop dead' criteria – the first cut that eliminates non-compliant responses and disqualifies providers who cannot meet even the most basic expectations. Typically, mandatory criteria are of such importance that if these criteria are not met it does not matter what else is in the bid or how low the offered price.

Qualitative criteria – the 'value' part ot the 'value for money' equation

Qualitative criteria are the criteria applied to the non-financial attributes and solutions the provider is offering. These criteria, and their importance relative to one another, determines what kind of information clients request from bidders and it makes most sense to develop the information requirements after deciding what criteria will drive the selection process. The task of evaluation is simplified and providers do not waste time on low-priority items.

Price criteria – the 'money' part of the 'value for money' equation

Many deals falter on price criteria, so it is important to discuss how that can be avoided. The CEO needs to influence pricing because getting it wrong can disable the whole outsourcing arrangement and have adverse effects on business performance.

Bid effectively – avoid the ‘winner’s curse’

> “It’s unwise to pay too much, but it’s unwise to pay too little. When you pay too much you lose a little money, that is all. When you pay too little, you sometimes lose everything, because the thing you bought was incapable of doing the thing you bought it to do...”

John Ruskin, 1819-1900

Successful outsourcing is not about getting the lowest price at all costs. It is about getting the lowest price for a sustainable solution under a fair contract from a superior service provider. As we’ve shown in this series, outsourcing is not an isolated economic transaction that automatically implements itself after the parties sign an agreement. It is an ongoing commercial relationship with long-term economic and strategic consequences that depend on the choices the parties make and how they subsequently conduct themselves. If a client chooses unwisely, these consequences can be serious.

There can be severe repercussions when the provider is saddled with a contract from which it stands to make no money – what we term the ‘winner’s curse’ (see Figure 5). The consequences can be devastating, not only for the service provider but also the client. A 2002 study of 85 contracts found the winner’s curse came into play in nearly 20 per cent of the cases and that in over 75 per cent of those cases it was also visited on the client.[4]

Figure 5:
Winner’s curse – and other options

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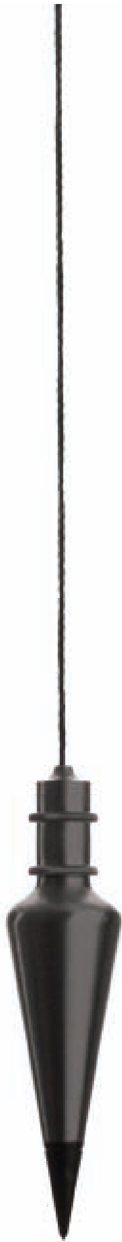
		Client: Negative impact	Client: Positive impact
Supplier	Winner’s curse	Client has cost/service issues / Supplier does not make margins	Client cost/service satisfaction / Supplier makes margins
Supplier	No curse	Client experiences cost/service issues / Supplier makes margins	Client cost/service satisfaction / Supplier makes margins



Clients should be on their guard. A provider may deliberately offer a very low price to get the organisation's brand into its portfolio. Alternatively, it may be so desperate for business that it undercuts other bids in the hope that, once the contract is secured, it can recoup profits by selling additional services to the client. In other words, the provider is prepared to take a hit in one area in order to make it up in others. Under worst-case scenarios providers may even bank on securing a profit through restricted interpretations of the contract and exploiting contract loopholes and ambiguities.

Clients therefore should not automatically select the least expensive option. Nor should they leap to the opposite extreme and opt for the service provider that is qualitatively ranked highest. Instead, they should weigh price against quality to get the best value for money. Indeed, choosing service providers on a 'best value for money' basis has become the norm in outsourcing. Organisations have learnt that the lowest bid price does not mean the lowest cost overall. In fact, the opposite is often the case. The costs involved in additional oversight, out-of-scope charges, constant renegotiation, dispute resolution, re-working and backsourcing, can make the price originally agreed no more than a distant memory.

These considerations also apply to modern offshoring deals which, from 2000 onwards, are often pointed to as the 'magic bullet' on price. It is true, of course, that the cost of labour in offshoring deals is dramatically lower, but that has been changing, as Indian suppliers in particular experience high labour turnover and wage hikes. Clients must look at the price-cost equation carefully in every instance.

Transaction/coordination costs can be higher than anticipated in offshoring deals; infrastructure and communication costs need to be fastidiously calculated, but may be dynamic and decreasing over the contract period. The long-term strategy of the supplier must be analysed. Is the supplier pricing low just to get new clients and meet aggressive revenue expansion plans? Does the supplier assume that making an initial loss on a deal can be made up by securing more of a client's business, even if that business hasn't been clearly defined? The 'winner's curse' must be avoided in offshoring as in all other outsourcing.

Most organisations use tendering to select service providers. Such an approach has the advantage of putting pressure on service providers to deliver best value for money against their industry peers. It is also the best way to discover a variety of capabilities and potential solutions, thus allowing a well-informed selection decision to take place. The alternative is direct negotiation with appropriately placed organisations. However, direct negotiation is only likely to be successful if:

4 one service provider is so outstanding that there is no benefit in evaluating alternative service providers

- the client is an informed buyer and knows the market prices and industry norms regarding service definitions, technology and key performance indicators
- the organisation knows exactly what it wants and can quickly draw up an effective contract, service level agreement and price schedule
- speed is more important than cost or exploring alternative solutions comparing service providers. But organisations must be careful not to throw away advantages in speed by poor preparation
- the client is an experienced outsourcing manager and can expertly manage the provider and the arrangement
- the client has significantly more bargaining power than the service provider.

In contrast, non-competitive processes such as direct negotiation may seem easier to carry out and faster to put in place. Yet, while several CEOs have been lured by these advantages, very few get great results. For most organisations tendering is the most suitable strategy. Moreover, many organisations, particularly in the public sector, require competitive tendering.

In the bidding process, paper transactions – issuing documentation and expecting an informed and comprehensive response – are unrealistic. Bidders require interaction to be effective. The more an organisation can help potential providers understand its organisation, strategies and ways of operating, the better the responses will be. There are also a number of interactive techniques by which clients can increase their knowledge of potential suppliers, the most common being presentations by bidders, interviews with key supplier personnel, site visits to the supplier and its other customers, and joint workshops to pilot working together. It is vital for the CEO to use his influence and play a high-profile role during this process.

The winner's curse: a case study

A well-known global equipment manufacturer had a successful outsourcing business in Europe and wanted to enter the Asia-Pacific market. The equipment manufacturer cut a deal with an industrial manufacturer that wanted to outsource its IT function. The service provider created a new wholly-owned subsidiary for the region. The deal was the first of what were planned to be many.

In order to get the first critical deal with the client, the supplier's sales team bid a price that was below cost. The supplier did not realise that, however, since it was dealing with its first client and had no idea what the actual cost would be. The supplier team basically bid the price they thought necessary to win the contract without having a firm grasp of what price was needed to make a reasonable profit. The client knew the service provider could not be making money on the deal but took comfort in the strength of its well-known global brand.

After eighteen months the service provider still had not won any further clients. A review of the subsidiary by its parent organisation showed that it was making unacceptable losses and there was little possibility of a rapid turnaround. That meant that the subsidiary had to start making money from its one client. The service provider assigned a new account manager – a lawyer. His mission was to re-interpret the contract and reclaim any possible money he could. This was possible because the contract had no date limitations regarding when work could be billed and reimbursements claimed.

Nine months of intense dispute followed. Invoices were raised for work deemed out of scope, a number of additional charges and reimbursements were claimed which went right back to the start of the contract. Work that the client had been obtaining was stopped if the account manager interpreted the work as out-of-scope. Eventually the two parties reached a settlement through a third-party intermediary. The wholly-owned subsidiary was wound-up, and the client had to find a new service provider.

However, further difficulties followed with the new service provider. The client had developed a deep distrust of service providers, and the new service provider had to invest a lot of time and effort in relationship management and repair in order to regain enough trust to be able to function effectively.

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Logica's top twelve predictions for the supplier market, 2006 – 2011

Global suppliers will evolve to stay competitive.	Under increasing competitive pressure large global suppliers will have to reposition themselves, restructure their cost base, diversify their services and expand their customer base.
ITO suppliers will increasingly diversify into BPO.	Mainstream BPO expenditure is likely to grow worldwide by 10 per cent a year. ITO suppliers will expand their services into the new dominant market play.
Major global and Indian suppliers will increasingly emulate one another.	Global suppliers will replicate the low cost structures of Indian competitors, thereby eroding Indian suppliers' relative advantages, and in return the major Indian suppliers will replicate the high-value, high-touch service of their global competitors.
Large global suppliers will increase the number of low-cost captive centres to stay price competitive.	As the Indian market becomes saturated, global players will quickly erect captive centres in other low cost countries like China, Philippines, Eastern Europe as well as Central and South America.
Indian suppliers will mature and diversify.	Indian suppliers are well placed to invest their significantly higher profit margins to develop higher-valued services, attract top international talent and expand their operations.
'Nearshore' suppliers will increase sales.	As customers seek a better balance between maximising service with domestic suppliers or minimising costs with offshore suppliers, nearshoring will become more attractive. Nearshore centres in Eastern Europe will service Western European clients, and North African centres will service those in Southern Europe.

Alliance supply networks such as prime contracting and best-of-breed will become the norm.	This will push providers into 'collaboration' structures for particular clients. Those providers who demonstrate they can work well with other providers will gain a competitive advantage over those that cannot.
Large global suppliers will use acquisition to expand customer base.	Global suppliers will increasingly target middle-market customers by acquiring smaller suppliers with significant traction.
As multi-sourcing dominates, suppliers will have more customers with lower value deals.	Customers are wary of large, single-supplier deals and will increasingly shift to multi-sourcing when large contracts expire.
Suppliers will increasingly use 'netsourcing' to lower delivery costs.	Location isn't the only factor in lowering costs. The key to success will be for suppliers to differentiate themselves by offering customer-focused services while at the same time commoditising their delivery platforms.
Competitive tendering will be on the rise.	Clients with second and onward generation deals will be more likely to put deals to competitive tender. Direct negotiation or limited 'invitation only' competition is common for first generation deals, but not thereafter.
When selecting providers, clients will look beyond technical expertise.	When selecting providers, clients will look beyond technical expertise. Clients will look into suppliers' business models, workforce management techniques, and market segment strategies, not least because of increasing regulatory pressure to do so. And 'triple bottom-line' clients will also seek social and environmental alignment with the client's objectives.

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The research bases

The first research base consists of 112 sourcing case histories (mainly in the area of IT) studied longitudinally from 1990 to 2001. These are described in Lacity, M. and Willcocks, L. (2001) Global IT Outsourcing: In Search Of Business Advantage (Wiley). The second is a study of relationships through seven case histories. This appears in Kern, T. and Willcocks, L. (2001) The Relationship Advantage (OUP, Oxford). The third is a 2001-2005 longitudinal study of business process outsourcing practices, with a particular focus on four cases in aerospace and insurance. See Willcocks, L. and Lacity M. (2006) Global Sourcing of Business and IT Services (Palgrave, London).

We also draw upon a fourth research stream consisting of ten cases of application service provision, published in Kern, T., Lacity, M. and Willcocks, L. (2002) Netsourcing (Prentice Hall, New York). Additionally, there are two published studies of offshoring arrangements we draw upon. These are by Kumar, K., and Willcocks, L. ((1997) Offshore Outsourcing: A Country Too Far? in ECIS Conference Proceedings, Lisbon. In addition, Rotman, J., and Lacity, M. (2004) Twenty Practices For Offshore Sourcing, MISQE, 117-130.

A further research stream analysed vendor capabilities and is represented in Feeny, D., Lacity, M. and Willcocks, L. (2005) Taking the Measure of Outsourcing Providers. Sloan Management Review 46, 3. We also draw upon five outsourcing surveys carried out in USA, Europe, and Australasia in 1993, 1997 2000, 2001 and 2002 covering multiple sectors and over 900 organisations.

A final research stream, by Sara Cullen, assessed 100 ITO/BPO initiatives of a variety of business functions during the decade from 1994 to 2003 to determine what worked and what did not work, what drove the various degrees of success and failure, and the emerging lessons. The research is represented in Cullen, S. and Willcocks, L. (2004) Intelligent IT Outsourcing (Butterworth) and Cullen, S., Seddon, P. and Willcocks, L. (2005). Managing Outsourcing: The Lifecycle Imperative MISQE, 4, 1.

Combined, this work forms a 450 case research base held by the researchers at Warwick, Melbourne and Missouri, St, Louis Universities. The research base covers 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 is drawn from medium, large and multinational organisations based in Europe, USA and Asia Pacific.

Notes

1 See Lacity, M. Willcocks, L. and Cullen, S. (2007) Global IT Outsourcing: Search For "1st Century Advantage (Wiley, Chichester) Also the 2001 edition of this book

2 More detail can be found in Willcocks, L. and Lacity, M. (2006) Global Sourcing of Business and IT Services (Palgrave, London) The original article is Feeny, D., Lacity, M. and Willcocks, L. (2005) Taking A Measure Of Outsourcing Providers, Sloan Management Review, April.

3 See Willcocks and Lacity (2006) op. cit.

4 See Kern, T. and Willcocks, l. and Van Heck, E. (2002) The Winners Curse In IT Outsourcing: Strategies For Avoiding Relational Trauma. California Management Review, 44, 2, 47-69.

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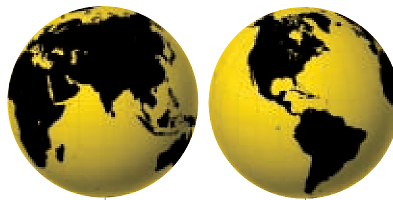

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