Hidden Costs of IT Outsourcing: A Case Study from a Business, Vendor and Employee Perspective

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Executive Summary

Many companies today are outsourcing Information Technology (IT) to reduce the overall operating costs. What many companies do not realize is that hidden costs associated with outsourcing often reduce their expected savings. These hidden costs can be tangible and intangible costs that impact not only the business, but also the outsourcer and the employees involved.

ABC Chemical Company outsourced its IT support to IT Outsourcer (ITO) to reduce the overall cost of IT within the company. The contract mistakes made by both companies along with hidden costs associated with outsourcing have a financial impact on both companies. Employees are also being impacted as the outsourcer attempts to perform the required tasks with less staff causing additional stress and health concerns for employees.

While hidden costs cannot be entirely avoided, more due diligence and planning could have helped reduce some of the errors and problems encountered by ABC and ITO. Both the business and the outsourcing vendor must work in a partnership to improve the overall business-vendor relationship. ITO Employee morale issues need to be addressed immediately or employee turnover will continue to have a real impact on the ability to meet service level agreements.
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Information Technology (IT) Outsourcing

Overview

What is outsourcing? Simply put, it is “the procuring of services or products, from an outside supplier or manufacturer in order to cut costs”\(^1\). So why are companies outsourcing IT? In a study performed by the Outsourcing Institute, Chief Information Officers (CIOs) were asked what were the top reasons for outsourcing their IT functions.

\[\text{Figure 1: Reduce and control operating costs is the leading reason for outsourcing IT functions followed closely by improve company focus}^2.\]

Many business functions today are seen as commodities that can be handed to other companies that specialize in that particular function. Similar to what Kodak Corporation started in 1989, ABC Manufacturing, one of the two companies profiled in this case study, also began refocusing its efforts on the core business, manufacturing, and outsourcing the non-core business functions\(^3\). ABC had outsourced most of its human resources, payroll, logistics and other non-core business services over the last 10 years. Outsourced and contractor labor was a common business practice employed by ABC. IT was the next business function to be outsourced in 2003.
Outsourcing Foundation: Vendor Selection, Contract and Service Level Agreements

Outsourcing is a very complex business arrangement between two companies. IT is constantly changing due to software and hardware technology advances. This makes creating good outsourcing arrangements difficult because future business needs and technology are essentially unknown. The companies must work in a partnership for the business relationship to be successful. There is a direct correlation between the quality of the partnership and the overall success of the outsourcing arrangement therefore the right vendor must be selected for the organization.

Vendor Selection
Cost is often the most important criteria in vendor selection. However, vendor selection is the most important criteria for outsourcing success as indicated by figure three.

![Figure 2](image)

*Price is the most important criterion when selecting an outsourcing vendor.*
Choosing the right vendor is deemed the most critical part of a successful outsourcing followed closely by a properly structured contract and relationship management.

The view that price is the most important criterion in selecting a vendor, yet vendor selection is the most important component of a successful outsourcing, is perhaps why so many outsourcing arrangements are considered failures. Companies need to delve into the competencies of their vendor candidates such as their commitment to quality, contract terms, scope of resources, and their ability to add value to the organization\(^2\). Looking beyond price is difficult for many companies that choose to outsource purely on the short-term financial benefit it will provide the company, without considering the long-term impact of these decisions.

An important component of any outsourcing arrangement is the contract and detailed service level agreements. The contract lays the foundation for managing performance and details how the business and the vendor will conduct business\(^5\). The contract should be of reasonable size, but not overwhelming and complicated. It should clearly define the expected service levels and allow for service level review and modification each year. It should also include service
credits or adjustments for failing to meet the service levels agreed upon by both parties\textsuperscript{6}. The contract should clearly define what conditions constitute a breach of the contract allowing the execution of an exit clause. Outsourcing contracts can be for individual projects or several years depending upon the scope of service being offered. On average most outsourcing contracts last seven years and are often renegotiated within three years\textsuperscript{6}.

**Service Level Agreements (SLAs)**
The service level agreements allow the business to measure the outsourcer’s performance. A service level generally includes measures of the quality, speed, availability, capacity, reliability, customer satisfaction, timeliness, conformity, efficiency or effectiveness of services\textsuperscript{7}. The following is a list of questions to consider when creating service level agreements.

**Ten Key Questions for Developing Effective Service Level Agreements**\textsuperscript{7}
1. Which service levels will you measure?
2. What will you measure, exactly, for each service level?
3. What process will you use to measure achieved performance?
4. What is the measurement period?
5. What reports will be provided?
6. How well will the supplier agree to perform?
7. Will the minimum and target service levels change over time?
8. Will the SLA include service level credits?
9. Will the supplier have the right to service level bonuses?
10. When does failure to meet service levels allow termination for cause?
Service level agreements provide the company with the assurances that the services meet their specific expectations. The service levels also allow the company to compare pricing between multiple vendors more easily. The company and the vendor should try to make the service levels reasonable and not become overburdening with details that make them too difficult and time consuming to be useful.

Service levels should be established before the outsourcing work begins. Companies that do not establish the expectations from the vendor prior to the work commencing will find the vendor more inflexible than if they had been agreed to prior to obtaining the contract. In this case, the outsourcer no longer has an incentive to agree to more challenging service levels\(^7\). Service levels should be reasonable. Asking for service levels that exceed your requirements may cost the company more money and potentially strain the relationship between the business and the vendor\(^7\).

**Partnership**

Partnership is a quality difficult to quantify but significant in the overall success of an outsourcing arrangement. Extensive research by Dr. Kim and Dr. Lee provides the best insight into this subject as it relates to IT outsourcing. Partnership quality was determined on the following criteria: trust, business understanding, benefit and risk sharing, conflict, and commitment\(^8\). They break the partnership determinants into three sections listed in the table below below\(^8\). While no vendor or business will say they are not a good “partner”, many may not
realize that they are hindering the overall effectiveness of the outsourcing relationship by not being aware of the needs of the other party. These needs could simply be better communication between the partners and understanding the business needs of each partner. One partner cannot be focused solely on its own needs in an IT outsourcing arrangement.

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**Hidden Costs: Business, Outsourcing Vendor and Employee**

**Introduction**

While there are can be many potential advantages to outsourcing IT, the reality is that these benefits cannot always be attained. Nearly half of 2003’s outsourcing projects will be considered failures by senior managers⁶. Additionally, a Diamond Cluster International survey revealed that 70% of companies have terminated an outsourcing relationship with a vendor citing lack of due diligence and planning upfront⁹. These are definitely not statistics favorable for the concept of outsourcing business services.

**Lessons Learned: Reasons for Outsourcing Terminations and Failures⁹**

- Outsourcing isn't always cheaper/cost savings not realized.
- Scope and objectives must be clearly defined at the outset.
- Service-level agreements must be defined upfront
- The relationship must be treated as a partnership
Most research and industry articles focus heavily on hidden costs businesses incur when they outsource. Outsourcing vendors and even the employees involved are often the victims of hidden costs as well. Vendor hidden costs can often attributable to employee cost factors like benefits and wages. Also, a poorly negotiated outsourcing contract can become a financial burden to an outsourcer for several years. Some outsourcers intentionally under-bid contracts to win new customers in efforts to gain additional business from that customer. This is a financial risk that does not always pay off for the vendor if the business elects not to outsource additional work or projects to the vendor. Outsourcing can also negatively impact employee health, job security and happiness.

**ABC and ITO Outsourcing Arrangement**

ITO is an international conglomerate of companies in many diverse industries. Several years back they entered the IT services and outsourcing space by acquiring a medium-sized nation-wide company. Since that time, they have put forth a lot of resources and effort into growing the company to compete with the large IT players like IBM and EDS. The company’s efforts have finally started to pay off as they are increasing market share and receiving industry attention from IT industry trade groups like Gartner.

ABC is a diverse manufacturing company that produces chemicals, pharmaceuticals, oil & gas, health & nutrition products and other product segment groups. The desktop PCs are standardized as well as most of the applications that run on the PCs. The server environment runs Microsoft Windows Servers
and Novell Netware servers. The decision to outsource seemed like an easy one. All of these are staples of a standard IT infrastructure environment. In February 2003, ABC announced it had outsourced its IT support to ITO effective March 2003. The outsourcing agreement was negotiated for a term of five years and covers the United States, Canada, Puerto Rico and limited support for Mexico. Cost savings was the leading reason cited for the outsourcing by senior ABC management.

**ABC Outsourced the following IT functions to ITO:**

- Help Desk Call Handling
- Desktop Support (Hardware and Software)
- Server Support (Hardware and Software)
- Printer and Peripheral Maintenance and Repair
- E-mail Support
- IT Procurement
- 24/7 Server and Application Monitoring for Critical Systems

**Business Hidden Costs**

*Managing the Outsourcing Vendor*

Many companies assume that once they outsource their IT functions, the need for internal resources “goes away”; however, just managing the IT contractor can cost a company an average of $300,000 a year⁹. Ensuring SLAs are met and simple relationship management are very time-consuming and costly endeavors. If these are neglected then the entire outsourcing arrangement could be put in jeopardy. If the vendor is not meeting SLAs, then the appropriate credits may not
be granted and the company ends up paying for a higher service level than it is actually receiving. The relationship must be managed to ensure the IT outsourcer and staff understand the IT strategy for the company and that all parties are working toward a common goal.

The managers for ABC and ITO are all considered the Project Management Office (PMO). The ABC PMO team includes an overall outsourcing relationship manager, four regional infrastructure managers, a systems security manager, an operations/change management manager, a process and procedures manager; plus the many employees who report to these ABC managers. The entire PMO team (ABC and ITO) regularly meets to review SLAs, process and procedure changes, resolve contract differences and discuss issues that need to be addressed jointly. The required management overhead to fully manage the outsourcing arrangement adds additional costs that may not have been accounted for in the overall savings expected from outsourcing.

*Losing Touch with the Customer*

According to Uday Karmarkar, a business technology and strategy researcher at the University of California Los Angeles, outsourcing often leads to a loss of service competitiveness. Uday is not against outsourcing, but states that companies must stay customer focused to maintain a competitive advantage. All businesses compete for customers and the business that can best execute a strong customer-oriented strategy will garner the best long-term success. The businesses that cannot remain competitive and maintain customers will
eventually struggle and fail. Companies that choose to outsource must pay special attention to customer needs or risk stagnating and losing out to more nimble competitors.

As business trends change like the recent shift from traditional office workers, to mobile workers and home-office employees; the IT strategy must be able to change to support these needs. A company bound by the constraints of an IT outsourcing contract may not be capable of quickly reacting to this or other changing business needs. The IT strategy must be flexible and agile; the IT outsourcing contract should also reflect that need.

Not considered in the decision by ABC to outsource IT are all of the proprietary applications and systems used throughout the company that are vital to daily operations. One of my job responsibilities at ABC prior to outsourcing was the support of the many laboratory systems that analyze sample data from the manufacturing runs. Most of the knowledge I had gained was through hands-on experience with the vendors that implemented the systems and hands-on troubleshooting of the systems. One of the systems is so specialized that a consultant from Texas had to be flown in to do the implementation because the lab vendor did not have staff in the state capable of installing or supporting the system. Today, ABC does not have anybody on staff capable of quickly responding to these outages due to the outsourcing. The people who understood and supported these systems were either laid off by ABC at the time of the IT outsourcing or are not permitted to because the work is outside the scope of the
support contract. ABC has many proprietary systems like this one, but elected to not include the support in the ITO contract because it added too much additional cost. The loss of support concern was so great that the labs had to purchase a costly 24/7 support contract with the lab system vendor to provide the support they needed. This is just one example of how the company has lost touch with the requirements of its own business needs. The objective of reducing corporate IT support costs by outsourcing was achieved, but other departments are now absorbing additional costs to support their proprietary IT-based systems.

**Contract Details**

The most important aspect of any outsourcing relationship is the contract. When ABC outsourced IT support to ITO, they had a skilled team of contract writers and negotiators. The contract was signed during a period of slow IT spending and was a buyers market. ABC had many suitors for it's outsourcing contract and was able to leverage the slowdown in IT spending and large outsourcing deals to its advantage. The contract was negotiated with very low margins due to the competitive nature of the market at the time. It also contains many broad statements that allow ABC to consider almost all desktop and server related work to be covered as daily support operations, at the standard monthly contract rate.

To reduce the overall contract price, ABC elected to remove all support for Storage Area Networks (SAN) and SAN related backup maintenance. At the time, SAN technology was only deployed in the corporate headquarters’ data center. ABC has a 24/7 operations group that performs all of the backups in the
datacenter and monitors mainframe operations. A year and a half into the contract, other larger ABC locations have implemented SANs and SAN backup technologies with even more planned in the coming years. It was fully intended for ITO to be responsible for all backups and restores in the environment, but the contract explicitly states that ITO is not responsible for supporting SAN technology and SAN backups. The shift in the implemented storage technology at these sites now requires ABC to re-assume ownership of this task at these sites.

Another recent contract issue arose when ABC sold off one of its smaller divisions. ABC offered to provide IT support for the former business unit for a transition period of 18 months, and gave the new company the option to renew for an additional 18 months to avoid business disruption. The ITO agreement however, states that ITO is only responsible for providing support to divested sites for 12 months. ABC is now obligated to pay for IT support for the two divested sites for 6 months and potentially up to 18 more months if the option is renewed. I suspect that if ABC wishes for ITO to continue to provide support for these sites for the additional 6 months and possibly up to an additional 18 months thereafter, it will be at a higher rate than is currently charged in the ABC/ITO outsourcing contract.

Large-Scale Out of Scope Projects

ABC's internal worldwide network was running out of internet protocol (IP) addresses. To address this concern they adopted a new internal networking
address range and allocation procedure. This requires that all servers, workstations, network printers, routers, switches and any other device that has an IP address on the network be changed to a new IP address in the network address range. This network change over in North America was to be jointly handled by ABC and ITO. An initial pilot project was conducted at one of the smaller ABC sites. While the conversion was a success, ABC used the billing from this smaller site to evaluate the cost of conversion across all sites in the United States, Canada and Puerto Rico. The estimated cost for ITO’s assistance to convert all of the sites to the new IP address ranges exceeded $500,000. The project has since been placed on indefinite hold even though it is in the company’s worldwide IT strategy for the future.

**Vendor: Hidden Costs**

The largest expense an outsourcer incurs is the cost associated with employees. While employee salaries have not grown at the rates seen prior to the recent economic slow-down, employee benefit costs have skyrocketed. Additionally, estimating costs for a multi-year outsourcing agreement is difficult. If estimated support requirements to employee ratios are off, the impact could be many hundreds of thousands of dollars per year.

**SLA Overload**

To satisfy the customized contract obligations at ABC, ITO must meet 65 SLAs each month. This is in contrast to most ITO customers that have about 15. Each SLA has a non-attainment penalty resulting in potentially tens of thousands of
dollars in service credits each month. ITO managers spend about a week each month reviewing SLA data figures from the previous month, correcting clerical errors and analyzing SLA misses. While the data is stored electronically, it must be pulled from many different sources like the Help Desk ticketing software, the server monitoring systems, end-user survey results and then reconciled into one SLA summary report. This process is time consuming and an inefficient use of resources but is required to avoid substantial SLA penalties. Service levels that exceed reasonable requirements may cost the company more money and potentially strain the relationship between the business and the vendor\textsuperscript{11}. The excessive SLAs imposed upon ITO by ABC have frequently been a source of contention between the two companies. Efforts by ITO to streamline the SLAs to be more manageable have failed.

Many of the ITO/ABC contract SLAs are redundant and overlap heavily with other SLAs. An example of this is the monthly server availability SLAs. There is an individual critical server SLA that states that every server deemed critical by ABC in the environment must maintain 99.5\% availability individually. There is also a critical server average availability SLA that says all critical servers must maintain a 99.9\% availability average. These two SLAs overlap each other but both still qualify for SLA credits if both or either misses attainment. The same is true for non-critical servers within the ABC environment. Another example is with the help desk’s phone response SLAs. There is an SLA for how long it takes a help desk analyst to answer an incoming call. Directly correlated to this SLA is the call abandon rate, how many callers hang-up before a help desk analyst answers the
phone. Both SLAs are essentially measures of phone response times, but both have to be tracked, reported and both qualify for SLA credits if missed.

Support Logistics

ABC has over 50 business locations in the United States, Canada and Puerto Rico supported by ITO. ITO has had a difficult time supporting many of the smaller ABC sites that are located in sparsely populated areas. These sites often are too small for ITO to have a dedicated onsite employee, so they must rely on third party/local vendors. ITO must still maintain the same response and repair SLAs for these sites. On many occasions when the third party vendor was contacted, the technicians from these local companies were assisting other customers and could not respond within the time requirements of ITO’s SLA with ABC. In the past two years, three separate occurrences of a server outage during the night resulted in no third party technicians responding to the late pages or calls for assistance. These technicians are often not on call, nor do they have a significant interest in meeting another customer’s SLA.

Yet another roadblock to support is the fact that many of the ABC sites are manufacturing oriented. Given the chemical, pharmaceutical or other products being manufactured at these sites, security background checks are required in advance for all employees performing work at these sites. This security requirement further reduces ITO’s ability to quickly respond with substitute support staff if the approved primary support technicians are unavailable. After
many issues early on with this requirement and not having eligible staff available, ITO requested that all sites have at least three people eligible for site entry.

*Rising Benefit Costs*

Employee benefits, specifically health care coverage, have risen sharply over the last few years. According to the Kaiser Family Foundation (KFF), 2003 average health benefits for single coverage $3,383 ($2,857 employer contribution) and $9,068 ($6,656 employer contribution) for family coverage. Health insurance premiums have been on the rise since 1996, but 2001, 2002 and 2003 all saw double-digit increases of 10.9%, 12.9% and 13.9% respectively. These cost increases are more than most employers had anticipated.

Many factors could be driving these health care premium increases. According to KFF, most often cited reasons are rising prescription and hospital service costs. Citing research, he estimates that workplace stress costs $300 billion each year in health care. Additionally, workers who report being stressed incur 46% higher health care costs than non-stressed employees. I personally see this as a vicious cycle where employers are demanding more productivity from employees to reduce costs, yet these demands are fueling higher employee costs on benefits negating some of the productivity increase related financial gains at the expense of employee health.
Employee Turnover

All companies experience employee turnover. Employees who have survived downsizing and ever increasing job requirements are more likely to look for other jobs as the economy improves. According to a recent USA Today article, typically only 10% of employers experience a high percentage of employee turnover; but as high as 50% of all employers may find themselves seeing significantly higher turnover as the economy improves\(^4\). Employees' reasons for leaving may vary, but employee turnover is very real problem for employers.

According to Sharon Jordan-Edwards, an employee retention expert, the cost of replacing an IT professional is about two times that employee's annual salary\(^5\). This includes costs associated with advertising, lost productivity and new hire training. When it comes to an outsourcing agreement where SLAs must be met, that task becomes even more difficult. In my current employment with ITO, we are staffed at bare essentials to provide the minimum of required coverage to ABC. When a team member takes vacation for a week, we struggle under the workload to achieve our SLAs. The many weeks or months it would take to fill a vacancy has a real material impact on ITO's ability to meet its obligations. Turnover to-date has been relatively low due to the poor job environment, but the instances where employees have left, ITO has had difficulty finding suitable replacements.

The soft costs of employee turnover really impact outsourcers. Customers like ABC have many software and hardware systems critical to their operations. The
outsourcer has agreed to support these systems. The five member server support team I work on consists of four former ABC IT employees. The fifth member worked and trained onsite with a former ABC employee for over six months before he started fully understanding the customer’s systems, processes and procedures. After the last round of ITO employee cuts, each of the four regions was left with one person and an overall floater to assist as needed; each region previously had two people. The knowledge and understanding of the ABC operations at different sites has taken many years for me to learn; even with similar technical abilities a new hire could never easily replace this proprietary knowledge.

**Employee Hidden Costs**

**Job Insecurity**

When I started working for ABC in 1996, I thought I had a long-term and secure job in IT. The petro-chemical industry was considered one of the best industries to be employed in the region. These jobs typically had excellent benefits, great pay and they offered a lot of employee training and employee career advancement.

I was encouraged by my manager that I would quickly move up within the company and could easily have a job similar to his, IT Manager, within a few years. I was motivated by these comments and started working on my Master of Science degree in Information Systems to insure my future advancement within the company.
However, as raw material prices skyrocketed and global competition increased, many petro-chemical companies started looking for ways to reduce costs. It was a sudden realization for me that job security is a very relative term. My employee reviews were always excellent and I regularly received praise from the user community and even ABC directors. Yet my “secure” job was in very real jeopardy when ABC announced its intent to outsource IT in North America in February 2003. In March 2003, my job was outsourced. Of approximately 130 ABC IT employees affected, ITO only kept about half of them, the rest received severance. I was fortunate enough to still have a job with ITO after the outsourcing. At the time the economy was recession, IT spending was down sharply and unemployment was high. For the first year, I tried to make the best of the transition and see what new opportunities were available to me.

Now almost two years into the outsourcing agreement, I realize that career advancement opportunities are very limited. The management and employee turnover rates are very high relative to other companies. Job security seems non-existent and employee morale is very low across the entire company, regardless of customer account.

*Health and Stress*

Working in IT is often considered stressful; dealing with new technology and project deadlines are a few examples. However, there is a distinction between good stress and bad stress in the workplace. The article “Sick of Work,” lists the
following as an example of good stress and bad stress. Good stress is meeting a
deadline and being challenged in your job. A constant feeling not being in
control, tension with co-workers and managers, and inadequate staffing, causes
bad stress\textsuperscript{13}. Medical research cited shows that “bad stress” raises the risk of
obesity, heart attack, higher cholesterol, and a weakened immune system\textsuperscript{13}.

When ABC outsourced IT support to ABC, it was considered a major down-
sizing, just over half of ABC’s IT staff were laid off, and ITO further reduced the
staff one year later by about 20\% to reduce costs and improve. The risk of dying
from a heart attack after a downsizing doubles, and the risk increases to five
times normal after four years\textsuperscript{13}. One of my co-worker’s, who is in his mid-thirties
and in good health, suffered a heart attack in 2004. While his family had known
issues with heart disease and his father had died from a heart attack in his mid-
fifties, I could not help but wonder how much of the on-the-job stress contributed
to the early age heart attack.

In the article “Sick of Work”, John Schwartz believes that employee downsizing,
an unforgiving economy and ever increasing productivity demands have
employees “paying” with their health\textsuperscript{13}. Another side-effect of high stress work
environments is increased anxiety and depression, both conditions I know very
well. More employees are turning to antidepressants and anti-anxiety drugs to
help them cope with the added stress and pressures of work\textsuperscript{13}. In early 2004
when ITO reduced the remaining ABC support staff by about 20\% to reduce costs
and improve profitability, the workload and stress became too much for me to
handle alone. I sought medical help for dealing with my depression and anxiety. I was prescribed an anti-depressant/anti-anxiety drug for six months until I could better adjust and handle the stress of my job. Having always been very detail and customer oriented, I was not adjusting well to the assembly line approach of getting the job done. I was forced to do the bare minimum of support just to get a help desk ticket closed and keep customer interaction to a bare minimum as that consumed valuable time which I needed just to try and stay current with the excessive workload. Today, I can better handle the stress, but I am actively looking for a new job.

**Poor Management**

While I have had a several different managers and supervisors over the past several years, I am frequently appalled at the poor quality of the managers that ITO has on the ABC account. In two years, the ABC account is now on its fourth Director. One of the initial Director’s was described by ABC as out of touch and unavailable, while another was seen as “acidic” and unapproachable. The next started out as a “kitten” and eventually turned into a “lion” according to one ABC IT manager referring to her initial willingness to be flexible and her eventual hardcore line in the sand stance.

The networking services group to which I belong started out with a very pro-employee manager that listened to our concerns and took action. He was not the most organized manager but the staff enjoyed working with him. Less than a year after his hire, he was fired and replaced with another manager. The
replacement manager is condescending, seems to have his own agenda and completely lacks forward thinking and planning. The entire staff dislikes his micro-management of little issues, while he completely looses focus on large-scale upcoming projects. We repeatedly are thrown into crisis mode and “need this now” scenarios because of his oversights. This mode of operation is draining and has killed staff morale. Whereas our initial manager understood the nature of our job and the demands, our new manager is completely out of touch with the stress and pressure under which we operate. According to the book Love ‘Em or Lose ‘Em, “employees will leave if they don’t like their boss even when they are well paid, receive recognition and have a chance to learn and grow” and this is one of the top reasons for talent loss.\textsuperscript{16} My former ABC IT Manager realizes this and has told me even though it would “cripplé” his organization if I were to leave, he would give me the recommendation I deserve to find a new job.

\textbf{Suggestions for Improvement}

While it is impossible to get rid of hidden costs, many steps can be taken to reduce them. If a company chooses to outsource, they need to make sure they stay focused on the customer. Having a good relationship with the outsourcing vendor and a balanced contract agreement can go a long way toward reducing hidden costs. Outsourcer’s must realize that they rely heavily on their employees to be profitable.

One of the worst things that can happen to a company is for it to get so focused on reducing costs that it loses sight of supporting the needs of its customers.
Being out in the trenches in the manufacturing sites is a totally different environment than the corporate office culture where these decisions are made. The manufacturing sites have special needs and I see that everyday. The IT department before outsourcing used to be involved with the business units and helping them improve their systems. Today, very few sites have any local IT staff. ITO’s role is only to provide support, not make technology recommendations or system improvements. ABC needs to re-assume an active role in interfacing with the customers and identifying their needs. The business groups understand operations and manufacturing; they are not experts on information technology and need regular assistance and input from IT experts.

Outsourcing arrangements are supposed to be partnerships. If either party has a strong advantage over the other the relationship will be contentious. Everyday I see where the imbalance of the outsourcing contract in ABC’s favor causes tension. ITO signed a five-year contract for support services that in support responsibilities is often vague and over-reaching, yet is extremely tough and detailed on service level agreements and obligations. ITO also believed they would receive additional billable work or outsourcing opportunities from ABC that have not materialized in the last two years. With server support responsibilities requiring significantly more time than originally anticipated alone, it has a material impact on the bottom line. With almost 300 Microsoft Windows based servers in the environment, a new critical security patch alone taxes our resources for scheduling and deployment, much less maintaining day-to-day operations. The constant barrage of security patches did not exist until recently. Yet ITO is
contractually obligated to perform all server administration tasks based upon the contract details. Until the relationship between ABC and ITO can become more balanced, there will always be tension and no real partnership.

Every customer is different and many want different levels of support or different options. ITO, having learned from previous contract mistakes, has shifted to a pre-packaged approach to outsourcing. It now limits customization on outsourcing agreements, a practice it regularly did in the past to win new customers. Pre-packaging helps, but does not eliminate completely hidden costs. ITO no longer will add new customers running on Novell Netware due to the company's lack of knowledgeable support staff for this platform. Contracts will no longer allow for the broad all encompassing terms like those in the ABC agreement.

As benefit costs continue to escalate, they eat away at contract margins for outsourcers. While ITO has started offering non-traditional options in health care coverage to reduce costs, maybe the problem lies more with business demands for productivity. A work environment where employees like myself, need medication to overcome anxiety, depression and stress is unhealthy and needs to be corrected. As IT employee morale decreases, so does worker productivity. IT employee morale is at an all-time low and 72% of IT organizations, according to Meta Group, indicate that morale is a problem. Of the companies cited, only 2% were willing to hire more workers, considered to be one of the biggest morale boosters. They are not concerned with retention issues right now because
employees have very few options. Once the job market picks up however, many companies will face a serious employee retention problem. As previously stated, costs to replace an IT worker could run upwards of two times the employee’s salary. IT employers need to start working immediately on fixing morale and staffing issues or they will be some of the hardest hit by a mass exodus of employees. In the case of ITO, they should not place an undue hardship on the employees to produce due to a bad contract arrangement that was negotiated with ABC. I have been actively job-hunting for many months now and I have had discussions with other employees who have been doing the same.

Hidden costs are inevitable. Some are more difficult to measure like lost productivity, loss of proprietary knowledge and experience, and an overall loss of business innovation and competitiveness with regard to IT. Others are more tangible like employee turnover, higher benefit costs and missed SLA credits. Whatever the source of hidden costs, they impact both companies that outsource IT and the outsourcers as well. The best defense against these hidden costs is proper planning, a good relationship with the outsourcing vendor and focusing on employee morale issues to maintain employee productivity.

**Thoughts on the Future**

ABC set out to reduce the overall cost of IT. ITO gained a very large customer with potential to gain additional work. What in theory was supposed to be win-win scenario for both companies might end up being a rude awakening for ABC in the near future. Already just over two years into the five-year contract, ITO
realizes that the promise of more billable work from ABC has not materialized. With the current support agreement offering poor profit margins, I feel that when contract re-negotiation comes up that ABC will be in sticker shock at the cost of continued IT outsourcing. ABC has essentially created an IT-dependency upon ITO that will be very difficult to recover should they elect not to renew the outsourcing agreement. If ABC decides to pursue other outsourcers to support its IT needs, they will have no working knowledge of applications and systems used throughout the company. ITO had the advantage of hiring former ABC IT support staff; a replacement vendor will not have a similar option.

ABC will have to accept that the next outsourcing contract with ITO or any vendor will cost considerably more than what it is paying now. ITO having made many contract mistakes with ABC will be much better prepared the next time around. I believe items like “broad coverage” of all server functions will be replaced with more specific responsibilities. This will likely include more billable services like security patches rollouts, new server installations and operating system changes which have taken considerably more manpower than originally anticipated. Nonetheless, the contract will be dramatically different if renegotiated.

It is through the efforts of the employees that ITO has been able to support the ABC account with a minimal staffing level. I have talked with many other ITO employees who are also looking for new jobs. If drastic steps are not taken, the toll on employee morale may be too difficult for ITO to fix. As the economy slowly, but steadily improves, the likelihood of extremely high employee turnover
rates will increase. It is unfortunate because many of the employees like myself have supported ABC for many years now, but feel we must look elsewhere to escape the stress, health impact and work demands of ITO.
Works Cited


What Are Hidden Costs?

- Any cost (tangible or intangible) that was not anticipated or not expected to be as great as the final cost.
- IT is often outsourced as a means to reduce costs, but often the cost savings returned are not as great as initially anticipated due to hidden costs.
- Hidden costs are not exclusive to businesses that outsource, but can be incurred by the vendors and also the employees whose jobs are outsourced.

ABC Chemical Company

- Chemicals, Plastics, Agricultural Products and Nutrition, Performance Products and Oil & Gas
- Sites in approximately 26 US States, 4 Canadian Provinces and Puerto Rico (54 Locations) supported by ITO.

ITO (IT Outsourcer)

- Multi-national Provider of IT Outsourcing Services
- Has been gaining market share on the major outsourcing vendors IBM and EDS.

Employee

- Started working at ABC in 1986
- Job outsourced to ITO in 2003

Business Hidden Costs

- Managing the outsourcing vendor
  - Costs an average of $300,000 per year*
- Losing Touch with the Customer
- Contract Details
  - Out of scope work
  - SAN/Backup Technology
- Large-Scale Out of Scope Projects

Vendor Hidden Costs

- SLA Overload
  - 65 Measurable SLAs each month
- Support Logistics
  - Over 50 sites supported by ITO
- Rising Benefit Costs
  - Health insurance premiums have been on the rise since 1996, but 2001, 2002 and 2003 all saw double-digit increases of 10.9%, 12.9% and 13.9% respectively
- Employee Turnover
Employee Hidden Costs

- Job Insecurity
- Health and Stress
- Poor Management

Suggestions for Improvement

- ABC
  - Reverse Customer Focus
  - Recognize the Contract Imbalance
- ITO
  - Standardizing Outsourcing Contracts Will Help
- Not all Hidden Costs can be avoided, but better planning and execution can mitigate many of them.

Thoughts on the Future

- If issues related to contract imbalance, partnership, excessive SLAs are not resolved the relationship between ABC and ITO will continue to be strained.
- ABC should prepare for "sicker shock" when contract renewal comes around again due to a lack of additional work offered and higher than expected customer demands (due to poorly written contract).
- If ITO does not begin addressing employee issues soon, they will be faced with a mass exodus of staff on the ABC account once the IT job market picks up again.

Works Cited