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CONTRACT RENEWAL DECISIONS IN IT OUTSOURCING: "SHOULD I STAY OR SHOULD I GO"

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ABSTRACT

Increasingly, outsourcing companies decline to renew their contracts automatically at the end of their duration. They send out requests for proposal instead, and may select a new provider for their IT services. The costs of selection and knowledge transfer processes are substantial, however. Service delivery continuity is also under pressure when a transfer to a new provider is made. We analyze the contract renewal decision for application management at a service provider. The findings are useful for outsourcing companies facing contract renewal decisions. We find that in the current, increasingly mature outsourcing market, qualitative factors are considered most important in deciding contract renewal versus switching supplier, for outsourcing companies are now well capable of negotiating a market-conform price.

Keywords: case study, contract, contract renewal, coordination costs, IT outsourcing, service provider, transaction cost theory.

INTRODUCTION

According to IDC, worldwide IT spending has seen an annual compounded growth rate of more than 5% since 1995, to almost USD 1.5 trillion in 2009 [15]. In this growing market, outsourcing companies increasingly decide not to renew their contracts automatically at the end of their duration [25]. The first generation of outsourcing contracts were almost all renewed. But a few years ago, renewal percentages dropped below 85% and they are now much less than 75%. Whitten et al. [25] even claim that in the American market they have sunk below 50%. Also, many outsourcing companies renegotiate their contracts before their period has run out [20, 22]. Contract renewal decisions for IT outsourcing have become a dynamic game.

If a contract is not renewed, backsourcing becomes an option [12, 24]. A possible backsourcing scenario also can be restricted to specific services: carve out. The other services either can be renewed or contracted with a new provider. However, the labor arbitrage that is the consequence of a rise in salaries in low-wage countries has rendered backsourcing less attractive for most multinational companies. Few outsourcing companies are capable of setting up service provisioning in low-wage countries themselves, however, as they usually lack the international experience and scale needed [7]. Therefore, contracts that are not renewed are mostly replaced by contracts with a new provider [17].

The interesting research question is: Why do outsourcing companies decide not to renew their contracts? Non-renewal may occur even when the current provider's performance is satisfactory. Which factors are the most important in these decisions?

TRANSACTION COSTS IN IT OUTSOURCING

Transaction costs theory distinguishes between production costs and coordination costs [1, 9, 26]. In IT outsourcing relations, production costs consist of the provider's monthly invoices. Coordination costs are those costs incurred for contract acquisition and management; they are made by both the outsourcing company and their service provider.

Outsourcing companies must, when a contract is running out, compare their current provider's production costs with those of other potential suppliers. They also have to include coordination costs in their comparisons: contract management for both current and future providers, as well as the costs of the selection process and transfer costs when a new provider is chosen. These post-contract-phase coordination costs are substantial [8] and should not be underestimated. A selection process takes six to nine months and requires both a project team and a steering group, whose members must be senior-level professionals who dedicate a large portion of their time to the process and are thus less available for other work [10]. In terms of management attention, the information technology has to compete with business projects. This requires stakeholder management to avoid the circumstance where there is not sufficient management attention for information technology. The provider's sales costs, made during the selection process, may not be a directly recognizable component of the coordination costs, but as these must somehow be recovered, they are part of the provider's cost price, and thus, indirectly increase the whole of the costs as well.

Transferring service delivery know-how takes two weeks to three months, depending on the complexity of the services involved – whether simple desktop services or the management of highly complex applications. During this period, 'double' staff is required, and the outsourcing company must set up project organization, including all providers involved, to coordinate the knowledge transfer (under the new provider's responsibility). After this phase, a stabilization period usually follows, during which the former provider is available to support their successors [23].

Outsourcing companies must estimate whether the extra coordination costs incurred can be recovered from the decrease in production costs expected from the switch of supplier. Another question is whether renegotiation costs for the current contract will be lower than the sum of a new provider's production and coordination costs. The continuity of the service provisioning is impacted by transferring service delivery to a new supplier, as sometimes the employees of the current provider lack motivation to transfer the knowledge to the new provider. In addition, immature providers might not fully cooperate. Typically, there is also a dip in the quality of the service provisioning at the beginning of the new service start-up, mostly related to the ambiguity of responsibilities between the current provider, the new provider, and the outsourcing company. Moreover, there is also the risk of selecting an immature new service provider, resulting in poor service provisioning overall, which possibly is followed quickly by a contract termination. These risks must be factored into the decision-making process, even though these risks are decreasing overall as the market matures.

Nowadays, outsourcing companies should not have difficulties agreeing on a market-conform price with their current supplier, and coordination costs should not differ much between one supplier and the next. This means that renegotiation with one's current provider is attractive, since one does not incur extra coordination costs, and there are no switching supplier risks involved. Of course, there are providers who are willing to contract for prices below market conformity in order to attract new clients. While this may seem attractive, the question becomes how they will later recover profits during the contract's duration, and what these lower prices mean for the flexibility of their service delivery. Taken together, these considerations mean that, while price remains an important issue in contract renewal decisions, issues of service delivery quality have become the determining factor as the market grows increasingly mature.

FACTORS OTHER THAN PRICE

If price has become less important, which then are the factors that decide the issue of contract renewal or transfer? For one, the outsourcing company's requirements may have changed during the contract period, and the current provider may not be able to meet the new terms of service. This is the case when, apart from the service provisioning as defined in the contract and its service level agreements, the client seeks to pursue innovation as well [21]. This factor might also be considered as an additional requirement; however, this is more an attitude than a specific service. The outsourcing company also may wish to expand into geographical areas where their current provider has no presence. It may even be a matter of having developed a new IT strategy or new technological developments; these may cause the outsourcing company to demand higher service levels and/or additional requirements for certification of the service provisioning. Another situation arises when mergers and acquisitions on the part of the outsourcing company change the context of the outsourcing relationship. Synergy may be achieved from combining several contracts into one, and the current provider may not be the one to get it. This is referred to as portfolio management [2, 19]. The incumbent service providers are not able to influence and/or anticipate these changing requirements.

The factors detailed below are under the influence of the incumbent service provider(s). The strategy of a provider may have changed over the original contract period; if the provider has divested part of their operations, for example, this will have an impact on their service levels. One current trend reveals providers are splitting up their consulting, application development and application management and infrastructure services. These divestments impact the provider’s capabilities and profile. Still another argument may be made concerning the provider’s reputation [3]. This may have been damaged during the contract period by the loss of certification or an involvement in bankruptcies or even fraud. While this doesn’t necessarily impact the quality of the services delivered to the outsourcing company that needs a new contract, it may still have an impact on decision making.

Finally, staff changes may affect the decision to renew or transfer one’s outsourcing contract. Outsourcing relations involve a kind of psychological contract between the client’s and the provider’s staff [14]. Service delivery continuity especially demands that the service manager and service delivery manager positions are stably manned, and this holds for that of account manager as well (even though it is slightly less important here, since the account manager is further removed from actual operations). If these people move to other jobs, the client may feel less inclined to continue the outsourcing engagement.

CONTRACT RENEWAL DECISION FRAMEWORK

In order to make informed contractual renewal decisions, a contract renew decision framework is required. This contract renew decision framework is structured around both price and none price factors.

The price factor includes three sub-factors. First of all, there are the monthly costs for the service provisioning to be considered. Secondly there are the coordination costs for both the outsource company and the service provider. The coordination costs of the service provider might also be an integral part of the monthly costs for the service provisioning. The alternative with the lowest price of the combined price factors is the most favored option.

The none price sub-factors include organizational changes and adjustments of the service portfolio, the reputation of the incumbent service provider(s) and changes in the customer-facing staff of the incumbent service provider(s). In addition, other factors play a role, such as future requirements, innovation, revised geographical scope, certification and organizational changes at the outsourcing company (mergers & acquisitions).

Actually, the none price factors are at least of equal importance as the price factors. The outsourcing company should evaluate the current service provisioning based on the current contractual conditions. The outsourcing company has to estimate improvement potential of a sole source contract negotiation with the current service provider(s). The estimated renewed contractual agreement with the current service provider(s) should be compared to the estimated contractual agreement with (new) service provider(s) in a competitive contracting process. Envisioning these different scenarios requires a lot of market knowledge. Involving the procurement specialists is recommended. In addition to the procurement specialists of the purchasing department, the internal legal advisors, controllers and tax advisors should be involved as well.

The contract renewal decision framework is detailed in Figure 1.

Basically, there are two options: start contract renewal with the current service provider or start competitive bid, which might result in new supplier. This contract renewal decision is driven by the expected benefit of a competitive bid over a sole source selection.

METHODOLOGY

The research methodology used for this article was of a qualitative character and involved a single case study. The aim was to better understand the implications of contract renewal. This included assessing the presented framework. This approach is called’ analytical generalization’ [18]. This research involves theory-testing and focuses therefore on validation through corroboration of converging findings in line with some replication logic [16, p. 231]. The factors of the contract renewal decision framework are explored in the investigated case study, an international company.

For this case study, the author and was personally involved as an external consultant in the contract renewal process. This can be qualified as action research [4]. The findings presented here are predominantly based on information drawn from the corporate documents of the companies involved - requests for proposal, meeting minutes, contracts, and service level agreements. Information available in the public domain, such as annual reports and newspaper clippings, was also included in this research. This process of cross-validating the documentary data with the author’s observations allowed for ‘within method’ data triangulation and increased interpretive validity [13].

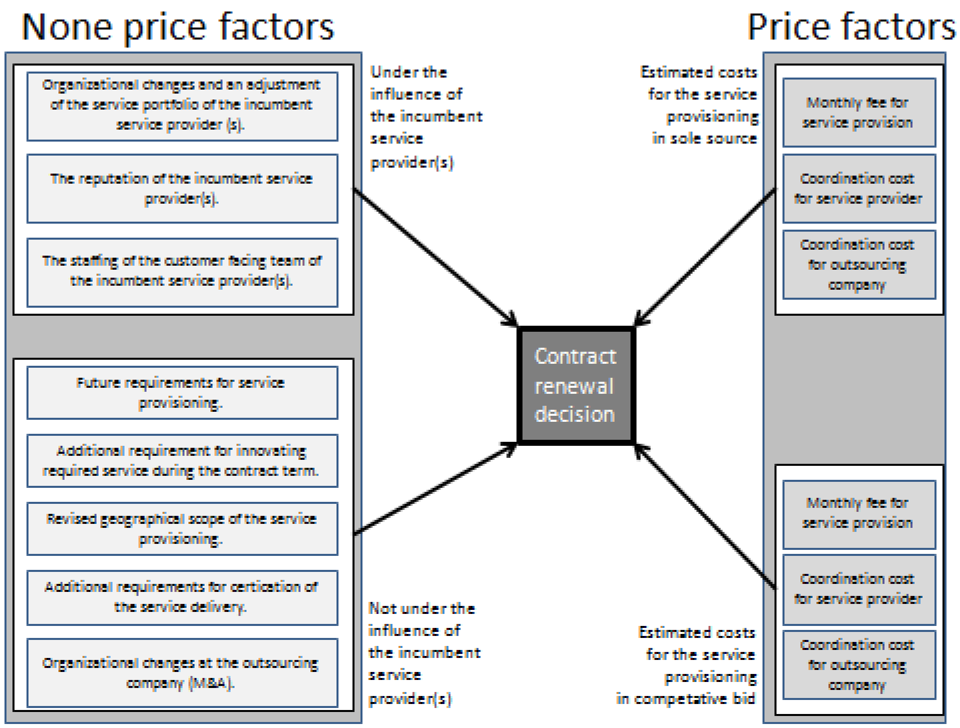

Figure 1: Contract renewal decision framework

CASE DESCRIPTION

The investigated company is a leading international service provider. The service provider has a long track record in contracting IT services.

For many years, the service provider has contracted their application management services for Business Support Services with three service providers. All three service providers are respected multinational companies. The share of wallet is unbalanced: 87.5% - 10% - 2.5% (indicative purpose only). The application management services for Business Support Services are only a small part of the outsourced IT services of the service provider. The three service providers also provide service in other domains to the service provider. The application management services for Business Support Services are, however, substantial. The annual contract value exceeds 30 million USD, which equals 20 million Euro (indicative purpose only). The envisioned contract term is five years.

In the current service provisioning, a small number of internal staff is involved, less than ten IT professionals. In the envisioned end-state, this internal staff is transferred to the service provider of choice. Acquired Rights Directives are applicable to the involved internal staff.

All three involved incumbent service providers partly provide the service out of their delivery centers in low-cost countries. This includes nearshore and offshore delivery centers. The service provider is looking for additional cost savings by increasing the nearshore and offshore service delivery significantly. The envisioned cost savings are about 50% for nearshore versus in-country service provisioning, and again about 50% for offshore versus nearshore. The envisioned cost savings exclude the required additional coordination effort for the service provider. The location strategy is, however, an important factor in the costs of the service provisioning.

The service provider is most satisfied with the largest service provider. The service provider is less satisfied with the service provisioning of the other two incumbent service providers. As part of the overall IT strategy and IT sourcing strategy, the service provider is looking to reduce the number of involved service providers and to transform the current time*material engagements into contract-based output obligations.

FINDINGS

The findings are structured by the price factors and the none price factors of the contract renewal decision framework. The analysis provides insights in the decision process of the service provider. The analysis also serves to provide pointers for other organizations who are about to make a contract renewal decision.

Monthly fee for service provisioning

Recurring costs are an important factor in contract renewal decisions. The service provider was looking for additional savings by increasing the service provision from both nearshore and offshore delivery centers. Also, transferring service provisioning from the nearshore delivery center and offshore delivery center was considered to be a feasible option to decrease the Total Costs of Ownership for the in-scope services. Additionally, the service provider was not satisfied with the current offered hourly rates by all the three incumbent service providers. These rates were negotiated in separate Master Framework Agreements with all three incumbent service providers.

The key question for the service provider was whether a competitive bid would be beneficial for their company. The current contract included benchmarking clauses. Also, by increasing the share of wallet for the largest incumbent service provider, economies of scale were expected. Furthermore, renewing this engagement would be a substantial win for the largest incumbent service provider. They would qualify this opportunity as a "must win," which was not known by the telecommunication company at the time of the decision making. In addition, it was the understanding at the service provider that the largest incumbent service provider would not provide the services at a lower price in a competitive bid, which was also the worry for launching a competitive bid. One or more invited potential service providers could submit a price at or below their costs level. This would jeopardize the service provisioning, as the largest incumbent service provider expected that the service provider would try to earn back their costs. This was definitely not the situation the service provider was looking to create.

Coordination cost for service provider

The envisioned transition costs of a contract renewal with the largest incumbent service provider are substantial. First of all, transition costs are envisioned for transferring the nearshore part of the service provisioning to the offshore delivery center. This effort is a smaller effort than the effort to transfer the responsibility for the service provisioning from the incumbent service provider to a new service provider, as the incumbent service provider is able to leverage their global service delivery processes. A new service provider has to implement the client specifics from scratch. Secondly the transfer of internal staff of the service provider requires effort. This effort is not substantially different from any contract renewal decision. Finally, the work provided by the other incumbent service providers has to be transferred to the largest incumbent service provider. A contract renewal decision toward the largest incumbent service provider, already responsible for about 87.5% of the in-scope service provisioning, definitely is beneficial for the service provider.

The coordination costs for alternative service providers are, therefore, envisioned to be higher than the coordination costs for the largest incumbent service provider. This factor is clearly in favor of a contract renewal decision.

Coordination cost for outsourcing company

The coordination costs for the outsourcing company are envisioned not to be different for any contracting option. However, in this case study, the coordination costs will decrease for all contracting options, as the largest incumbent service provider decided to transfer the design activities to the service provider of choice. These were formerly in-house activities. To ensure a proper implementation of the end-to-end responsibility for the service provisioning, these activities would be transferred to the service provider and become part of the monthly fee for the service provisioning. This transfer of activities would also result in the transfer of the in-house staff, and potentially lead to redundancies. The costs of the social plan have to be considered as one-time coordination costs for the outsourcing company. Again, these coordination costs are not different for any contracting option.

This factor is in favor of neither a contract renewal nor a competitive bid option.

Changes at the service provider

All current incumbent service providers have substantial delivery centers across the global. It is fair to say that these three incumbent service providers are capable of providing any service possibly required by the service provider.

This factor is of no significant impact for either a contract renewal or for a competitive bid option.

Reputation

The reputation of all three incumbent service providers is irreproachable. They are all Tier 1 service providers. A competitive bid would not result in bringing in service providers with a reputation that exceeds the reputation of the three incumbent service providers. At best, the reputation of the three incumbent service providers will be matched.

Reputation is in favor of neither a contract renewal nor a competitive bid option.

Customer facing staff

For many years, the client-facing representatives of all three incumbent service providers have been stable teams. Starting a competitive bid could jeopardize this stability. Therefore, this factor is in favor of a contract renewal.

Future requirements

For the service provider, this was an important factor. In the current contracts with incumbent service providers, no obligations are detailed related to future requirements. The outsourcing company was looking for more cost control, improved quality and increased cost predictability. In addition, service levels and penalties were on the wish list. The contract structure was also different from today. For application development, the service provider had a preference for contracting based on function points. For application management, the service provider was looking for a fixed prices.

The largest incumbent service provider had a track record in facilitating these future requirements. However, so did other service providers, including the two remaining incumbent service providers.

This factor was the most difficult factor to determine as to whether a competitive bid would be beneficial for the service provider. The general belief of the outsourcing company was that a contract renewal would be so important for the largest incumbent service provider that a competitive bid was not required to facilitate the future requirements in conjunction with the most favorable price, as detailed previously under the "monthly fee for service provision" factor.

Innovation

Innovation was on top of the list for some stakeholders at the service provider. This was linked to the preparation of an improvements plan as a requirement for the new service provider. Innovation was, however, indisputably in the sweet spot of the largest incumbent service provider. Additionally, for all service providers involved, innovation resulted in an expansion of the scope of the services. Therefore, innovation is neither in favor of a contract renewal nor in favor of the competitive bid option.

Geographical scope

The geographical scope has not changed since the initial service provisioning. The services are provided to a single European country only. This country is also the country that hosts the outsourcing company's headquarters. The three incumbent service providers have substantial operations in this country. In terms of both revenue and number of staff, this is a top 10 country for the largest incumbent service provider. However, most of the services are expected to be provided out of low-cost countries. The largest incumbent service provider also has substantial delivery centers in the appropriate low-cost countries.

Therefore, the geographical scope is not in favor of either a contract renewal or a competitive bid option.

Certification

The security requirements involved had increased significantly over time. This was partly due to changes in regulations. This impacted the required certifications. The incumbent service providers were capable of meeting the increased security and certification requirements. The service provider did not expect that any other service provider would be able meet to these requirements more efficiently or effectively.

Therefore, this factor does not impact the contract renewal or competitive bid decision.

Changes at the outsourcing company

The outsourcing company was in the process of divesting parts of their business, and revenues and profit margins were both under pressure. Cost saving initiatives were highly sought after. However, the cost saving initiatives were linked to the monthly fee for the service provisioning and the coordination costs. The divestments had not impacted the profile of the service provider. There were no changes at the outsourcing company that were in favor of either a contract renewal or a competitive bid option.

DECISION OF OUTSOURCING COMPANY

Based an in-depth analysis, the service provider decided to explore the sole source option. The service provider decided to investigate a contract renewal with largest incumbent service provider. The services provided by the other two incumbent service providers were to transfer to the largest incumbent service provider. One important argument for this decision was the minimal transition risk and transition costs attached to this option compared to a sole-source negotiation with one of the other two incumbent service providers. In the analysis of the outsourcing company, no factors supported a competitive bid. The impact by factor is detailed in Table 1, supporting the decision of the telecommunication company for a contract renewal with the incumbent service provider.

The service provider has already executed this decision. In a swift and efficient contracting process, the service provider and the incumbent agreed on a five-year contract. This contract was signed in Q1 2011. For now, both the outsourcing company and the service provider are comfortable with the contract renewal.

If the service provider had chosen a competitive bid process, in addition to the transition impact, the timelines of the contracting process and the associated costs for the service provider would have been more substantial. However, this approach would not have been a guarantee for improved contractual terms with either the chosen incumbent service provider or any service provider in a competitive bidding process.

Table 1: Summary of Findings

<table>
<tr><th>Factor</th><th>Short description of factor</th><th>In favor of contract renewal - sole source</th><th>In favor of competitave bid</th></tr>
<tr><td rowspan="6">Price factors</td><td rowspan="3">Monthly fee for service provisioning</td><td>- The incumbent service providers have service delivery centers in offshore locations and provide already services out of these offshore location to the telecommunication company</td><td rowspan="3">- cost savings are important, however competition might result in a price at or below cost level jeopardizing the service provisioning</td></tr>
<tr><td>- Current contracts of incumbent service providers includes benchmark clause</td></tr>
<tr><td>- Sole source service provider of choice has qualified this opportunity as must win - not known by the telecommication company at the time of decision making</td></tr>
<tr><td rowspan="2">Coordination costs for service provider</td><td>- Client specifics are know by the incumbent service providers.</td><td rowspan="2"></td></tr>
<tr><td>- High transition cost for migrating the services to another service provider (87.5% of the service provisioning is with sole source service provider of choice)</td></tr>
<tr><td>Coordination costs for outsourcing company</td><td colspan="2">- (negative contribution, increase of coordination costs due to requirement of end-to-end service provisioning) Making staff telecommunication provider redundant due to scope increase: end-to-end service provisioning, this increased the coordination costs for the outsourcing company equally in sole source as well as in a competative bid.</td></tr>
<tr><td rowspan="8">None price factors</td><td>Changes @ service provider</td><td colspan="2">- All incumbent service providers have delivery centers in developing countries, however the maturity of de delivery centers of the sole source service provider of choice is at least equal to the maturity of the other service providers.</td></tr>
<tr><td>Reputation</td><td colspan="2">- The reputation of all current incumbent service providers is solid and has not changed over the life time of the current</td></tr>
<tr><td>Customer facing staff</td><td colspan="2">- For many years the client facing representatives of all three incumbent service providers are stable teams. Starting a competitive bid could jeopardize this stability.</td></tr>
<tr><td>Future requirements</td><td>- The sole source service provider of choice has a track record in facilitating future requirements.</td><td>- In the current contracts with the incumbent service providers obligations related to future requirements are not detailed in the contracts.</td></tr>
<tr><td>Innovation</td><td colspan="2">- The sole source service provider of choice has a strong track record in the implementation of innovation.</td></tr>
<tr><td>Geograficial scope</td><td colspan="2">- All current service providers have substaintial service delivery centers in the HQ country of the outsourcing company as well as in developing countries.</td></tr>
<tr><td>Certification</td><td colspan="2">- Increase of security requirements @ the outsourcing company, however this increase is not perceived as diacritical of the sourcing strategy, as most service providers are able to meet the additional security requirements</td></tr>
<tr><td>Changes @ outsourcing company</td><td colspan="2">- No changes at the outsourcing company, including divestments and acquisitions, that impact the sourcing strategy of the outsourcing company.</td></tr>
</table>

CONCLUSION

Outsourcing companies must make timely and well-considered decisions on the way in which they wish to outsource their IT services. Contract renewal is one of those options; finding a new provider is the other. Apart from cost considerations based on the transaction costs theory, outsourcing companies must also consider the risks of switching to a new service provider, and the question arises as to how well their current supplier can meet their service delivery demands in a new contract period.

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