

Data Center Outsourcing



From what's being outsourced to how much it costs and what makes it successful, our survey sheds light on current IT outsourcing practices.

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Data Center Outsourcing

BY DIAN SCHAFFHAUSER

THE CONCEPT OF OUTSOURCING, while far from passé, is becoming dated. That's not to say that organizations are no longer feeding IT or business process work to third parties. They are — in ever greater numbers. But many companies now have several years of outsourcing experience and have honed their skills in setting strategy, selecting vendors, implementing governance policies, managing relationships, negotiating contracts, and defining the business value of their efforts. It's no longer just outsourcing. They refer to what they do as "servicing," "multi-sourcing," or simply "sourcing." They're able to isolate processes, functions, or activities as well as resources and determine with laser-beam focus which functions should be retained in-house, which can be managed offshore, which should be assigned to a single vendor (some functions may be handled domestically while others are handled offshore), and which should be divvied up among service providers working together. Such is the new face of sourcing.

Gone are the days when a single vendor — typically, IBM or EDS — signed a decade-long, multi-million dollar outsourcing contract, inherited 5,000 staff, took over the hardware and software, and turned around and resold the IT services back to the client organization. Such engagements still take place, of course, but they're rare enough to make the headlines. Just as often, it's the dismantling of these initiatives (IBM and JPMorgan Chase, for example, or Sears and CSC) that we read about instead.

Nowadays, the GMs and ABN Amros of the world are signing up multiple vendors, expecting they'll build an IT organization that competes and strives —

on a daily basis — to deliver best-of-breed service to its users. The contract terms are smaller and the contract periods are shorter.

The largest corporations aren't alone in taking this approach, which is why this year's survey, co-developed by Enterprise Systems and Sourcingmag.com, isn't as broad as the last survey on the topic. The service provider handling your application maintenance work is no longer necessarily the same vendor running your IT infrastructure.

To derive more useful, applicable insights about the outsourcing endeavors among our readers, we invited people specifically involved in data center out-

sourcing to tell us about their efforts. In the course of drilling down on responses to questions about the functions being outsourced, costs and time considerations, greatest concerns, and other matters, we learned many things.

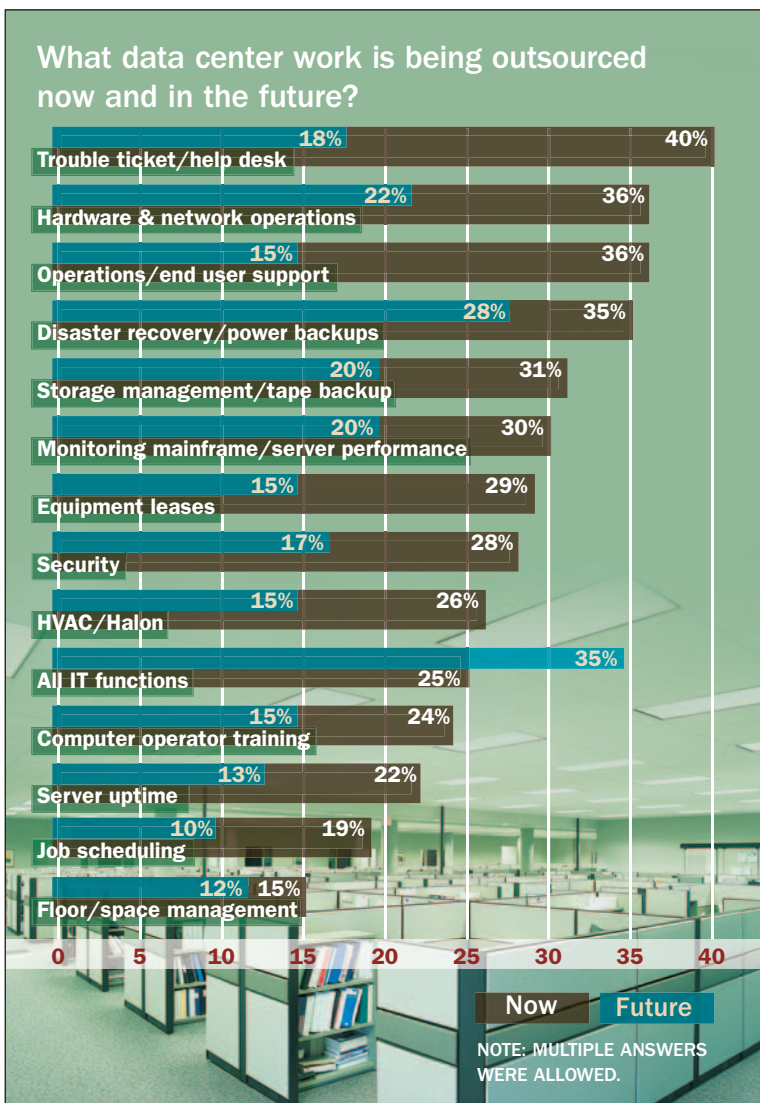
For example, "cost savings" is no longer the primary driver for outsourcing. It's just as likely that companies are outsourcing to access IT resources they don't have internally. (This may be because they've whacked their IT budgets down so close to the bone that there's little meat left when new projects require IT attention.)

Furthermore, we discovered that IT is not a dying profession in the U.S. and that all the work is not heading overseas. Yes, India does attract a good amount of IT work; but that has little to do with data center operations. Most outsourcing remains on domestic soil. Likewise,

METHODOLOGY

We invited visitors and e-mail newsletter subscribers on Sourcingmag.com, Enterprise Systems, Application Development Trends, Federal Computing Week, and iSixSigma.com to take the 35-question survey, which was available online. Respondents from 463 companies or organizations did so.

FIGURE 1: OUTSOURCED WORK



SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

more data center work is typically being handled in-house than out-of-house.

Organizations are getting smarter about pricing outsourcing contracts, too. More report paying actual costs in line with what they expected.

Finally, we learned that data privacy and security concerns rank high among companies doing outsourcing in the data center. The fact that many notable security breaches reported in the last two years have involved simple thefts of notebooks or CDs containing customer data left in insecure places says this isn't

just something for service providers to figure out; nor is it relevant only to companies doing outsourcing.

Use the following data from your fellow IT and business managers and line staff to formulate your thinking about the sourcing your company is undertaking. Are you signing contracts that are too long — at the behest of the vendor? Are you handing over more than you should? Are you involved in the total lifecycle of the outsourcing initiative? If your team is more accustomed to doing the work than managing it, do you have a plan in place

for bringing their skill sets up to speed or filling in the staffing gaps? Finally, are you constantly evaluating your approach to the data center work your organization needs? There is no longer any single right answer to that question.

WHAT'S BEING OUTSOURCED

The most common data center functions currently being outsourced is trouble ticket/help desk operations, as reported by four out of 10 respondents. As Figure 1 shows, the next three most commonly outsourced functions are hardware and network operations, end-user support, and disaster recovery and power backups.

A quarter of respondents said they're presently outsourcing all IT functions. However, that's a trend that's showing some pick-up; a third of respondents expect to see all IT functions being outsourced in the next 12 months.

The next most likely candidate for outsourcing in the near future is in the area of disaster recovery and backup; 28% of respondents report that their organizations have taken it under consideration.

That said, overall, more work is still being handled in-house than by a service provider — the ratio is 55% to 45%.

HOW MUCH, HOW LONG

It's common to read about "mega-deal" contracts that extend for a decade in the future. That's actually less common than it might appear. The average contract length reported by our respondents for the mostly commonly outsourced functions tends to be between four and six years. As Figure 2 shows, contracts encompassing the outsourcing of all IT functions were, on average, five years long, as were trouble ticket- and help desk-related contracts.

Only 17% of the highest-value contracts had a duration longer than five years.

Running a data center — whether you do it with internal resources or through service providers — is an expensive propo-

Developing a contract with a pricing structure you can count on often seems more like an art than a science.

sition. It comes as no surprise that the contracts of highest value were those that covered the outsourcing of all IT functions. The median price tag on those contracts is about \$4 million. Another similarly pricey proposition for outsourcing in the data center — though less typical — are equipment leases, which register a median of \$4.3 million.

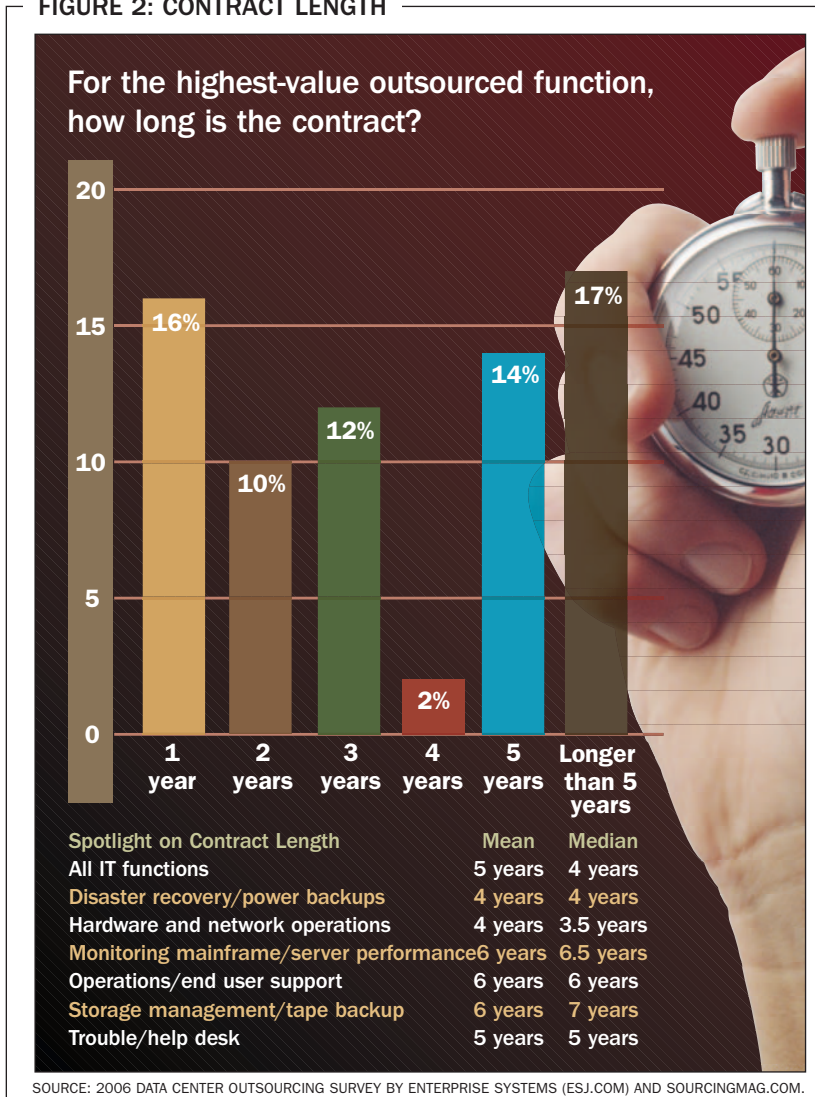
Aside from contracts encompassing all IT operations or equipment leases, the two most frequently cited outsourced functions with the highest price tag are 1) hardware and network operations, and 2) operations and end-user support. On average, each costs about one million dollars per year.

Developing a contract with a pricing

structure you can count on often seems more like an art than a science. However, the largest percentage (45%) of respondents said their actual costs are about the same as those stipulated in their contract. When organizations were wrong, they were more often in the position of spending more — not less — than the contract price. As Figure 4 shows, three out of 10 respondents said the actual costs are higher than the contract costs. Half that number said they were lower.

The largest group of people said their contracts are structured with fixed pricing (45%). The next most common pricing

FIGURE 2: CONTRACT LENGTH



SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

Pricing Schemes in Outsourcing

Activity-based pricing: Clients agree to pay a flat fee for the service provider's fixed and variable costs — including hardware and software, labor, infrastructure, administration, and maintenance. Activity-based costing is often used when establishing an offshore development center (ODC) or putting together a build-operate-transfer model.

Cost-plus pricing: Also known as “open-book” pricing. In this model, the client pays the service provider for the actual cost of the service plus a markup or profit margin. Popular with offshore development center (ODC) or build-operate-transfer models. Frequently used as an interim contractual measure. Appropriate for efficiency deals.

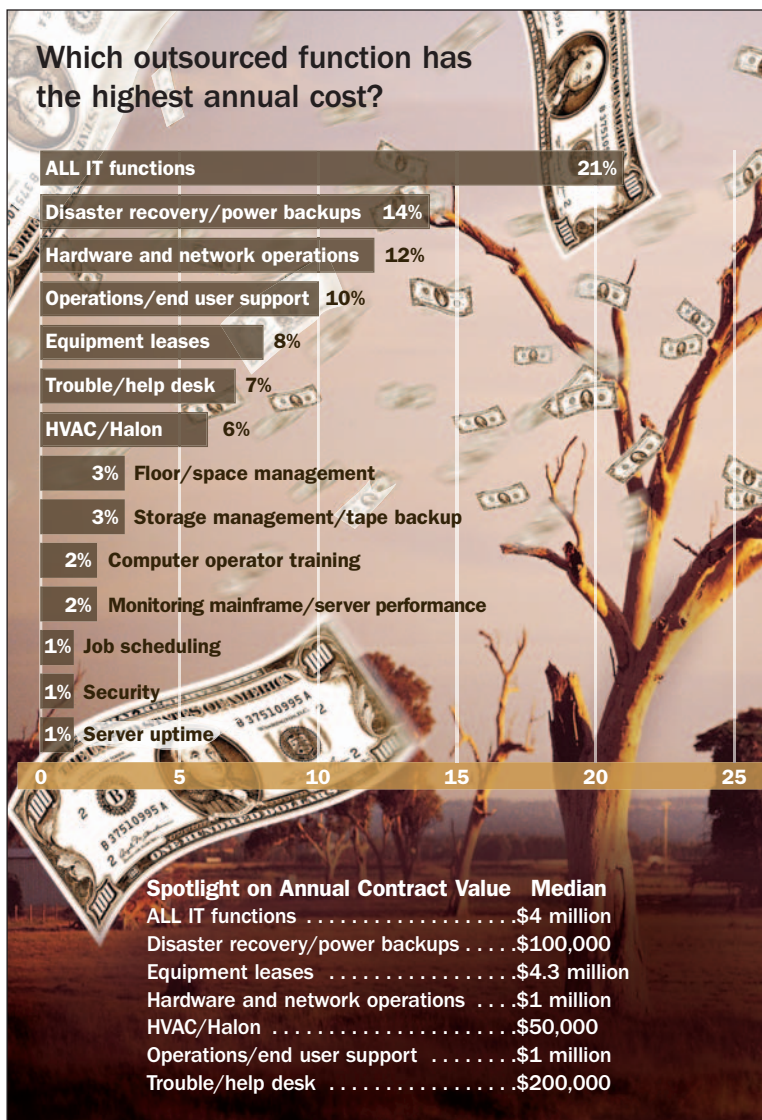
Fixed price: A model of pricing in which a project is undertaken by the service provider for a pre-agreed-upon price. One advantage is that it's easy for the client to budget for the project. Two disadvantages are that the service provider may overestimate costs beforehand for possible unforeseen conditions or cut corners during the project to compensate for expenses that are higher than anticipated. The service provider will charge a premium for a fixed price relative to the risks involved. Also, if the service requirements drop, there's no reduction in price for the client. Appropriate for efficiency deals.

Gain-sharing: The service provider has some form of incentive for constantly improving the business process. When the client benefits (through reduced expenses, greater revenues, or improved efficiencies), so does the service provider.

Time and materials pricing: A pricing model in which the client pays set rates and related expenses for each worker provided by the service provider. Paying this way, while allowing more flexibility, may lead to a less disciplined approach to the project.

Transactional pricing: Also known as “unit pricing.” The client pays the service provider a flat fee per unit of work (order taken, application processed, sales call made).

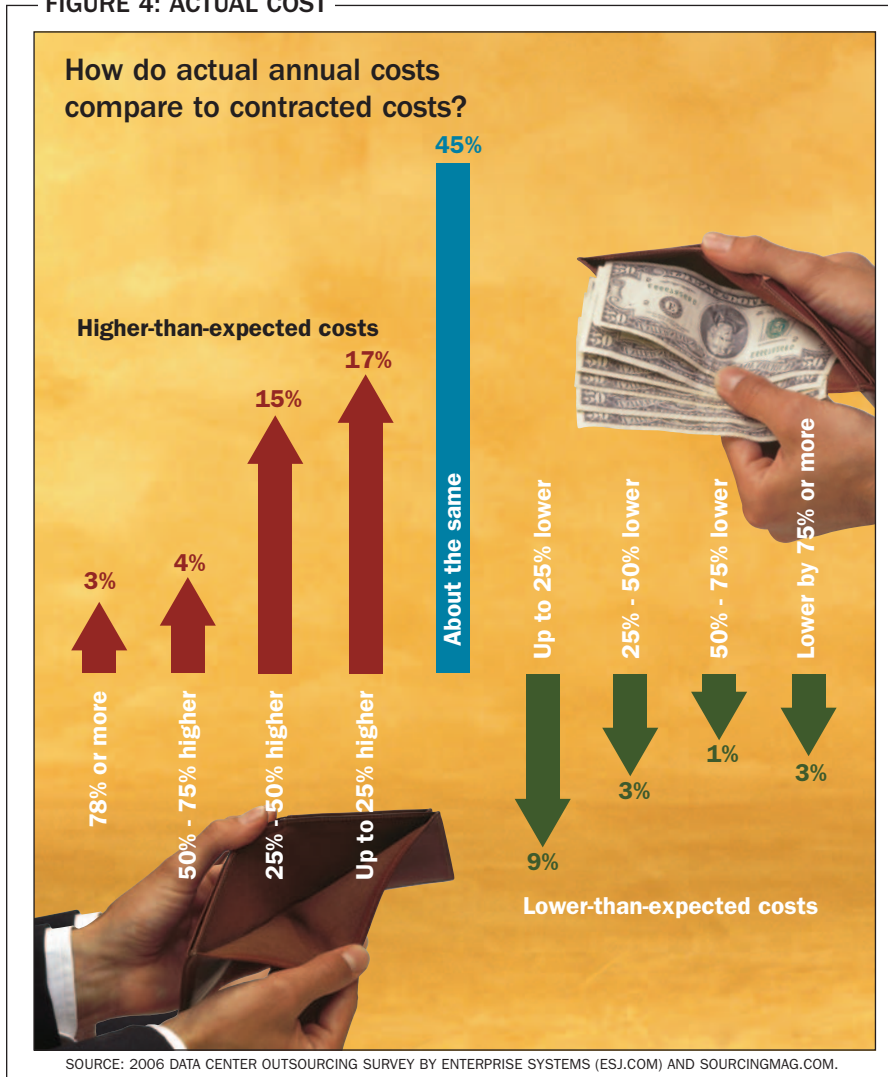
FIGURE 3: CONTRACT VALUE



SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

Developing a contract with a pricing structure you can count on often seems more like an art than a science.

FIGURE 4: ACTUAL COST



ing structures were activity-based and time and materials (both specified by 19% of respondents). Cost-plus pricing came in at 11% and gain-sharing and transactional pricing were being used by a mere 2%.

WHY OUTSOURCING AND WHERE

The primary reason companies outsource their data center functions is what you'd expect: 44% cited "to reduce or control costs," as shown in Figure 5. The motivation for outsourcing doesn't end there. A solid third of respondents also

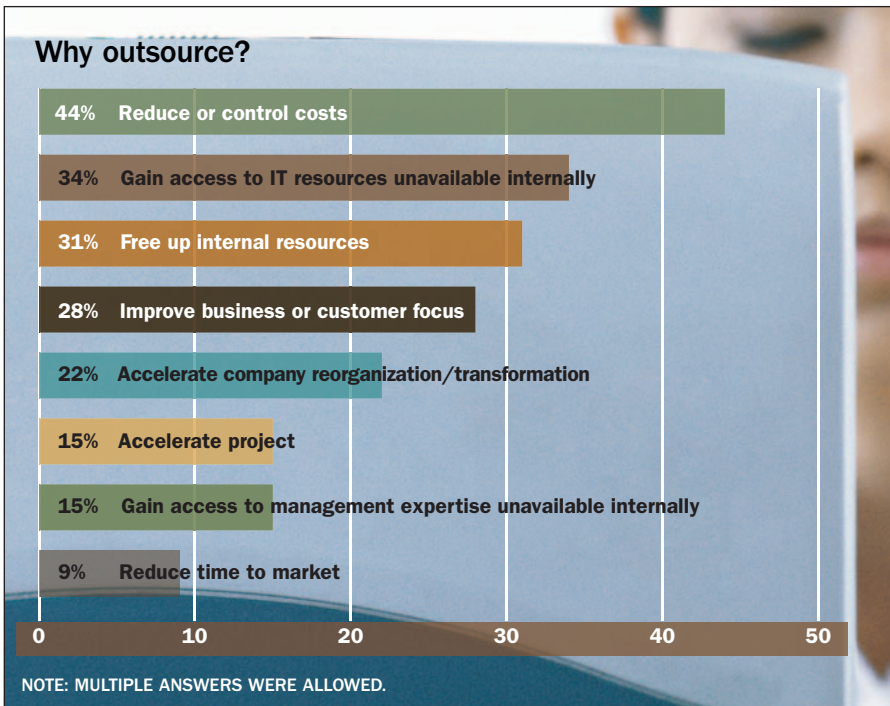
The primary reason companies outsource: to reduce or control costs.

said they do it to gain access to IT resources — people, processes, and equipment — that aren't available internally. Three out of 10 also said their organizations outsource to free internal resources or improve business or customer focus.

If you read most popular press on the subject, you might conclude that out-

sourcing equates to offshoring. That isn't true of our survey respondents. For them, most outsourcing involves hiring a domestic company to handle functions domestically. Eight of 10 respondents told us their primary service provider is a company with its headquarters located domestically.

FIGURE 5: WHY OUTSOURCE



SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

Of course, just because a company has its headquarters in one country doesn't mean the work is being done in that same country. So we asked a follow-up question about where the work was actually being performed. In 73% of the cases, it was being performed in the U.S. Only 12% said it was being done in India. The remainder — 14% — said their work was being handled in another country, though no single country dominated.

However, for one former director of service delivery for IT management at a global port company, going global makes too much sense to ignore. He said:

My previous employer would always do things on a small scale by



geographic region. I was part of the team that came to the realization that there was power in numbers. We were underutilizing the power that we had. I was pushing with my peers overseas to stop getting into domestic agreements and look wider scale — to get more into global agreements because it would be more financially advantageous to the entire organization.

The decision was made easier by having HP, a global operation itself, as one of its primary vendors. "You carry much more weight when you approach them as a global entity."

Eight of 10 respondents say their primary service provider is headquartered domestically.

MULTIPLE PROVIDERS

The days of working with a single service provider to cover all IT needs are diminishing. According to our results, only a third of organizations are working with one vendor in their data center work. On average, our respondents used three vendors.

In general, companies are satisfied or highly satisfied with the service providers they're working with. Only 14% report being dissatisfied or highly dissatisfied.

The shorter the contract length, the higher the satisfaction: When comparing satisfaction with service providers the organization works with, 62.5% of those with one-year contracts were satisfied or highly satisfied. Satisfaction

CHART 6: LOCATION

**Satisfaction
dropped to 43.8%
for those with
contracts longer
than five years.**



SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

dropped to 43.8% for those with contracts longer than five years.

Satisfaction was also higher for those working with fewer providers. For those working with just one provider, 76% reported being satisfied or highly satisfied, while the figure fell to 53% for those with three providers.

For future outsourcing work, firms expect to invite bids from an average of six vendors, but only expect to receive responses from five of them.

A preponderance of companies report being neutral, satisfied, or highly satis-

fied with the number of vendors available to provide the data center work they need performed.

Which primary service providers were most frequently cited? The ones you'd expect: IBM was referenced most often, followed closely by CSC, then EDS and HP, and Sungard brought up the rear of the top five pack. None of the major India vendors — TCS, Infosys, or Wipro — registered much in data center work; however, we would expect them to make a bigger showing for application-oriented work.

SELECTION SUCCESS FACTORS

When selecting a service provider, it's useful to draw upon the experience of those with successful projects. Six in 10 respondents said the most important factor was identifying a partner with a commitment to quality. That aspect was closely followed by price. About half of respondents cite scrutiny of a vendor's proven competencies as important. Only 37% specified technology fit as most vital factor to success. Flexible contract terms, geographic location, and cultural fit were near the bottom of the rankings.

Table 1:

Factors in Identifying Service Provider Fit

Commitment to quality . . . .	.60%
Price . . . . .	.57%
Proven competencies . . . . .	.53%
Technology fit . . . . .	.37%
Flexible contract terms . . . .	.26%
Geographic location . . . . .	.23%
Cultural fit . . . . .	.21%
Scope of resources . . . . .	.18%
References and/or reputation . .	.12%

Note: Multiple responses allowed.

SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

One manager of IS for a large global publishing company, which signed a seven-year deal several years ago with IBM Global Services to take over data center operations, said it was obvious that IBM was committed to quality. “The management that came in brought in a series of processes and procedures, and they worked with us to make sure the quality was there,” recalls the manager, who de-



clined to be named. “It was fairly simple for them to do that — they hired all the people who were here. Then they brought in a few people who took over the management role. They’ve had a few people leave and move and shuffle around. . . . But the people they brought in were nothing but quality.” When faced with a new person from IBM who had what he calls “the old internal IS attitude: It’ll get done when it gets done,” the company replaced that individual with others who were more “customer service oriented.”

The former port company manager suggested putting price — albeit impor-

tant — before other matters can be a mistake. “It comes down to relationship building. You want to pay a fair price,” he said. “If you squeeze a vendor too hard, ultimately you’re squeezing yourself. They’re going to cut corners. They’re not going to be as free with their information. The trust factor is going to start to take a hit. If they feel they’re being squeezed into a corner, you are not going to be given the attention that your engagement really does deserve.”

Although it was graded less important overall by survey respondents in identifying service provider fit, the manager said references and reputation ranked high for him. To do vendor checks, he calls on his network. “I’m a part of several associations — the Help Desk Institute, itSMF [IT Service Management Forum]. I go to a lot of trade shows [and] focus groups. I get together with my network quarterly. It’s an active approach. . . . If I look to do something in my organization, there’s a pretty good chance that somebody in my network has done it already. I want to know the pros and cons.

success with your outsourcing? Nothing really overwhelms the discussion, but according to respondents, the top consideration was communication — both between the client and service provider management and between the client and service provider personnel.

The publishing company’s IS manager said his operations group meets weekly with IBM’s operations group to “review the process and procedures.” He calls communication “key to everything.”

One area of communication that could have used improvement, according to the manager, was what his group was told about the contract his company signed with the service provider.

I’m sitting in an applications position where I have 50 or 60 people maintaining these three or four systems. I have a certain level of expectation of what I was going to get out of the data centers. Over the years, you develop relationships. People bend the rules a little once in a while for you.

About half of respondents cite scrutiny of a vendor’s proven competencies as important.

What am I getting myself into?”

During the evaluation process, he advised spending a considerable amount of time evaluating the likelihood that the vendor is going to “be around.” “Financial stability of the vendor is very important,” he noted. “Who their channel partners are, who they are doing business with from a technology perspective, who are some of their short-term success stories in addition to their longer term success stories.”

OUTSOURCING SUCCESS FACTORS: COMMUNICATION IS KEY

Once you’ve chosen a vendor, what are the most important factors in achieving

The contract goes into force. We were never told what was included in the contract. We were going on our own merry way, expecting the service we were getting before. Suddenly, we were running into these little roadblocks. “Well, sorry, that’s not in the contract” or “It’s not in the contract.” . . .

That’s one of the more important things. You don’t have to tell people what the financial parts of the contract are, but you sure as hell should tell them, “Here’s what expected of the vendor and here’s what’s expected of us.”

Table 2:
Factors in Successful Outsourcing Initiatives

Communication between client and service provider management . . . . .	.44%
Communication between client and service provider personnel . . . . .	.42%
On-going management/governance . . . . .	.41%
Selecting the right vendor . . . . .	.41%
Having a properly structured contract/outsourcing agreement . . . . .	.38%
Having a properly structured service level agreement . . . . .	.33%
Understanding the business goals internally . . . . .	.30%
Strategic vision . . . . .	.25%
Having previous outsourcing experience . . . . .	.18%

Note: Multiple responses allowed.

SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

The former port director cited a different aspect of communication: what employees are told as plans for outsourcing unfold.

When an IT person hears outsourcing, they think, ‘This is not a good thing. There is huge potential for job loss.’ If you’re not communicating frequently and effectively as to what this means — I’m not saying be fictitious; sometimes it’s going to be very difficult information that needs to be communicated — [it’s] better to communicate it often and effectively than not to communicate at all.

Paying attention to ongoing management and governance and selecting the right vendor rode closely on the area of communication as the most important aspects of successful outsourcing. These areas were specified by 41% of respondents.

The former port company director pointed out that “governance is not a one-time effort.” Doing it well requires having in place metrics and KPIs — key performance indicators. Otherwise, he said, “How can you tell whether you were adhering or not if you’re not measuring?” He advises making sure “that roles are clearly defined and understood...” That will determine who gets what types of metrics and how frequently. “If you’re on the front line in the network group, clear-

ly you want frequent information on your metrics, in comparison to being CIO,” he said. “Depending on who you ask and what role they play, you’re going to get a different answer. And you should!”

Having a properly structured contract or service level agreements were specified by 38% and 33% of respondents respectively.

The former port director believes in calling on the experts as early as possible when setting up contracts or agreements. That includes both the procurement group and the legal department. How does he prevent procurement peo-

ple from taking too much of a bottom-line perspective? “What you want to do is match your expertise — what you’re trying to accomplish — providing tech services to assist with your organization to become more profitable — with their expertise on contract negotiation, on things to look for in a contract that may raise a flag. The more time you spend with them upfront — [explaining] what you’re trying to accomplish — the more effective they’re going to be.”

There’s much to worry about when it comes to outsourcing initiatives. Data confidentiality was the top concern, referenced by 34% of respondents. Security risk and exposure was number two, and tied with the experience level of service provider employees, at 33%. Rising expenses and employee turnover at the service provider were cited by about a quarter of respondents.

The publishing company manager cited data confidentiality as his number one concern. Why? “The more this [work] goes overseas, the more chance you have for data to be compromised. Other countries don’t have the same rules, regulations, laws, [and] protections set up.”

Table 3:
Major Areas of Concern with Outsourcing

Data confidentiality . . . . .	.34%
Experience level of service provider employees . . . . .	.33%
Security risk/exposure . . . . .	.33%
Rising expenses . . . . .	.27%
Employee turnover at service provider . . . . .	.24%
Impact of outsourcing on internal staff . . . . .	.21%
Lack of management oversight by our organization . . . . .	.19%
Inadequate or improper service-level-agreement metrics . . . . .	.18%
Culture clash . . . . .	.17%
Conformance to regulations/company policies . . . . .	.16%
Working attitude of service provider employees . . . . .	.14%
Lack of management oversight by service provider . . . . .	.11%
Domain knowledge of service provider employees . . . . .	.9%
Executive visibility7%
Language7%
Time zone difference6%

Note: Multiple responses allowed.

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CONTRACT CANCELLATION ISN'T THE NORM

Respondents contradicted a common refrain from analysts, who often state that half of all outsourcing contracts are canceled or renegotiated before their termination date. Only 28% of organizations said they've canceled or renegotiated an outsourcing contract.

Among respondents who knew the reason for term changes or termination, the most common reason cited (by 38% of respondents) was that the service provider failed to meet the contract terms. A third said service quality was poor, 28% said there was a change in business strategy that mandated the change in outsourcing, and 21% told us outsourcing became more expensive than expected. A mere 10% said their organization found better terms with a different service provider.

PERSONNEL MATTERS

Most companies don't displace anyone in an outsourcing engagement, according to 61% of respondents. Another 10% said only contractors were displaced, 21% said both contractors and employees were shifted, and 9% said only employees were displaced. (The total exceeds 100% due to rounding.)

What did that displacement look like? It varied. About a quarter were laid off permanently. A third were either hired by the service provider or were offered positions elsewhere in the client



company. In 42% of the situations where people were moved, the client company employed a combination of layoffs and transfers.

How many were affected? On average about 928 people, though the median was a much smaller 121, indicating how a few large projects overshadowed others (the largest number of companies displaced fewer than 50 people).

The IBM contract with the publishing company involved the transfer of between 50 and 60 people. That, said the manager, exposed a weakness in the plan. "We cut way too deep... The tech people [IBM] brought in knew the product, knew SAP. They didn't understand our application of SAP; they didn't understand our business process. We have since been very fortunate. We have been able to hire back several people and put them into positions we call business systems analyst."

Only 28% of organizations said they've canceled or renegotiated an outsourcing contract.

PARTICIPATION IN OUTSOURCING

Three-quarters of respondents work for U.S.-based companies. The average revenue of these organizations is \$3.8 billion — a notch above mid-market size (which we peg at \$3 billion per year in revenue) but not by much.

That said, the largest industry represented in the survey is government (21%), followed by computer and IT services (18%), finance/banking/accounting (11%), non-computer manufacturing (9%), defense/military (8%), and transportation/utilities (8%).

As shown in Table 4, 12% of respondents hold C-level or senior executive positions. A fourth have technical or line-of-business staff job titles. One fifth are directors, VPs, or managers of a business function (such as accounting or marketing), and a tenth have similar titles on the IT side. Another 14% are project managers with IT responsibilities and 9% are project managers with business responsibilities.

Nearly two-thirds of respondents consider themselves part of the IT functional group. The business or executive functional groups represent another 17%.

Personnel involvement in the entire outsourcing lifecycle varies widely. Just under a third have absolutely no involvement at all. Of the remainder, slightly more than half participate in evaluating responses from service providers and slightly fewer than half

Table 4:
Job Titles

CEO/CFO/COO/CIO/CTO/President/Owner	.12%
Technical or line of business staff	.25%
Director/VP/Manager of business function	.21%
Director/VP/Manager of an IT function	.11%
Project Manager with IT responsibility	.14%
Project Manager with business responsibility	.9%
Consultant	.7%
Other	.2%

SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

Table 5:
Involvement in Data Center Outsourcing Work

Develop strategy to outsource . . . . .	.45%
Develop outsourcing budget . . . . .	.31%
Authorize the decision to outsource . . . . .	.21%
Develop RFI or RFP . . . . .	.41%
Select potential service providers . . . . .	.48%
Choose geographic location to outsource to . . . . .	.17%
Evaluate responses from service providers . . . . .	.51%
Meet with service providers finalists . . . . .	.41%
Perform due diligence on service provider finalists . . . . .	.32%
Choose winning service provider(s) . . . . .	.31%
Develop outsourcing contract . . . . .	.31%
Provide legal guidance . . . . .	.9%
Sign contract(s) . . . . .	.17%
Benchmark internal service levels . . . . .	.32%
Develop service levels . . . . .	.32%
Act as IT liaison to service provider . . . . .	.41%
Act as project management liaison to service provider . . . . .	.31%
Act as business liaison to service provider . . . . .	.28%
Perform project management or governance . . . . .	.29%
Renegotiate the outsourcing contract . . . . .	.16%
No involvement . . . . .	.29%

Note: Multiple responses allowed.

SOURCE: 2006 DATA CENTER OUTSOURCING SURVEY BY ENTERPRISE SYSTEMS (ESJ.COM) AND SOURCINGMAG.COM.

help develop the strategy to outsource and select potential service providers.

CONCLUSION

The globalization of services will continue, reaching beyond the IT core that has defined outsourcing for the past decade. More companies have outsourced human resources management processes, finance and accounting, and, of late, legal services, product development, R&D, and training. The shock and awe experienced by IT rank and file —

as well as management — in witnessing the shifting Tectonic plates of employment will soon be felt by people in all divisions of the corporation.

Those in IT have had plenty of time to regain their sense of balance. That means they have the chance to play a role as leaders in future outsourcing endeavors within their companies. They know how to work with vendors. They know how to define what the job consists of — apart from how it needs to be done. They know that even if a function can be sent

down the wire to be performed somewhere else in the country or the world, that doesn't mean it should be or will be.

James E. Powell contributed to this article.

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